

KIM Sung Chull

CHAPTER FOUR

INTER-KOREAN ECONOMIC RELATIONS

Samuel S. Kim and Matthew S. Winters

For more than four decades, there were no inter-Korean economic relations of any kind. Then on November 21, 1988, 40 kilograms of North Korean clams arrived in Pusan, the first realization of economic exchange between the two Koreas. The terms had been announced by South Korean President Roh Tae Woo in his "Special Declaration in the Interest of National Self-Esteem, Unification and Prosperity" and in the ROK's "Basic Guide for Cooperation and Exchange between South and North Korea." In January 1989, South Korea imported paintings, pottery, woodworking, and industrial art from the North, beginning a trade that totaled \$18.7 million for that year. The following year saw the Doosung Industrial Company (Seoul) sign a direct barter contract with the DPRK, and in 1991 Samsung and Hyundai followed suit. Since those meager beginnings, inter-Korean trade has continued to grow and diversify, so that 2002 saw \$343 million worth of commercial trade and an additional \$298 million of non-transactional trade (i.e., border-crossing goods related to humanitarian and development projects). In 2002 the ROK became the DPRK's second largest trading partner after China.

What is rather striking about this growth in trade 40 forty years of strict noninteraction is its persistence and expansion in the presence of the so-called DMZ, which remains one of the most heavily fortified and sensitive conflict zones in the post-Cold War world, where more than 1.8 million military personnel, including 37,000 Americans, confront each other, armed to the teeth with the latest weapons systems. As shown in table 4.1, the 1994 nuclear crisis had no dampening effect as inter-Korean trade continued to grow in 1995 before receding slightly in 1996. While trade numbers fell in 1998 because of the Asian Financial Crisis, even the Taepodong missile crisis in August of that year could not derail the recovery. And despite the North's nuclear revelations in October 2002, the year 2003 was the most substantial trading year yet between the two Koreas. The month-by-month comparison of trade before and after October 2002 (table 4.2) reveals that trading has been substantially higher in each corresponding month except two.

This resilience of inter-Korean trade in the face of continuing military standoff is the key puzzle of both theoretical and real-world significance addressed in this chapter. Beginning with a review of international relations theoretical literature on the pacific benefits of trade and the role of economic interdependence in preventing or mitigating armed conflict, we argue that inter-Korean economic interaction defies

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Table 4.1 South Korean–North Korean trade (1989–2002) (Unit: US\$1,000)

Year	Import from North Korea	% change	Export to North Korea	% change	Total trade	% change
1989	18,655		69		18,724	
1990	12,278	-34.2	1,188	1,621.7	13,466	-28.1
1991	105,719	761.0	5,547	366.9	111,266	726.3
1992	162,863	54.1	10,563	90.4	173,426	55.9
1993	178,167	9.4	8,425	-20.2	186,592	7.6
1994	176,298	-1.0	18,249	116.6	194,547	4.3
1995	222,855	26.4	64,436	253.1	287,291	47.7
1996	182,400	-18.2	69,639	8.1	252,039	-12.3
1997	193,069	5.8	115,270	65.5	308,339	22.3
1998	92,264	-52.2	129,679	12.5	221,943	-28.0
1999	121,604	31.8	211,832	63.4	333,437	50.2
2000	152,373	25.3	272,775	28.8	425,148	27.5
2001	176,170	15.6	226,787	-16.9	402,957	-5.2
2002	271,575	54.2	370,155	63.2	641,730	59.3

Note: These figures include both transactional and non-transactional (i.e., noncommercial) trade.

Source: KOTRA at <http://www.kotra.go.kr>.

Table 4.2 Inter-Korean trade for the year preceding and following the October 2002 nuclear revelation by the DPRK (Unit: US\$ million)

	2001-02	2002-03
October	38.621	97.944
November	32.954	126.655
December	40.276	74.060
January	27.400	47.397
February	28.737	41.351
March	31.881	39.431
April	41.971	37.985
May	56.280	42.415
June	28.668	59.655
July	26.402	71.962
August	39.478	65.618
September	62.255	98.901

Source: Ministry of Unification, Republic of Korea at: <http://www.unikorea.go.kr>.

standard commercial liberal explanations because of the *sui generis* character of the relationship between the ROK and the DPRK—at once a little more and a little less than two separate but fully sovereign states. Rather, a more synthetic and eclectic theory of inter-Korean economic relations is needed, one that can be specified by looking at developments in inter-Korean relations through the lenses of conflict management and functional cooperation, with nods also to traditional liberal and realist theories. We conclude with an assessment of the future prospects of inter-Korean economic cooperation and a cautionary note on the relevance of investment versus trade and the functional significance of inter-Korean social and cultural exchanges.

Competing Theoretical Perspectives and Explanations

The starting point for understanding inter-state economic relations has long been the classical liberal view that expanded trade is a remedy for war. "Commerce cures destructive prejudices," Montesquieu wrote. "It polishes and softens barbarous mores. The natural effect of commerce is to lead to peace."¹ Most often cited is Immanuel Kant's proposition that "the *spirit of commerce* sooner or later takes hold of every people, and it cannot exist side by side with war."² Economic interdependence, democracy, and international organizations constitute Kant's three-cornered construct of the structure of "perpetual peace." Frequent reference is also made to Norman Angell's sadly ironic prediction in 1912's *The Great Illusion* that war was conceivable under high economic interdependence only as an act of collective irrationality, a theory quickly tested by the outbreak of World War I.³ Most recently, Bruce Russett and John Oneal and others have folded the economic interdependence argument into the theory of the democratic peace to suggest the appropriateness of Kant's formulation of perpetual peace in contemporary world politics.⁴

These liberal theories rely on an assumption that states are deterred from conflict by fear of losing the welfare gains that come with expanded trade and economic interdependence. The premise is that higher levels of trade will make conflict increasingly costly.⁵ While the liberal analysis is usually intended for the systemic level, it can be applied at the dyadic level on the Korean peninsula. As the DPRK becomes increasingly reliant on trade with the ROK, it becomes increasingly costly for the North Korean government to undertake any actions that would damage this trade (and the aid coming from the South that is subsumed under "trade"). A whopping 77.2 percent of the DPRK's export trade in 2002 consisted of interaction with just three countries: Japan (23.3 percent), China (26.9 percent), and the ROK (27.0 percent). Likewise over half of its imports come from China, the ROK, and India. Badly in need of trading partners, the benefits to military action would need to be perceived as substantial in order for North Korea to undertake an endeavor that might interrupt these flows.

The liberal argument gives insight into why North Korea would not act so as to hinder or dissuade the growing level of trade with South Korea. However, given that trade with North Korea made up but the most meager amount of the ROK's \$314 billion of international trade in 2002 and that, in terms of quantifiable economic benefits, the ROK gains little from this trade, the liberal argument does

not provide sufficient explanation as to why South Korea continues to engage in trade with the North. Nor does it explain the origins of the trading relationship after 40 years of prohibition of economic interaction.

To begin answering these questions, it is important to remember that with trade comes *influence*. In his classic work *National Power and Foreign Trade*, Albert Hirschman demonstrates the "influence effect" of trade—as one country becomes dependent on trade with another country, the latter state has increasing influence in the policy design of the former state. Of course, with increased gains from trade comes increased vulnerability to this effect, and a state can avoid these vulnerabilities only if it has alternate markets at its disposal.⁶ The DPRK therefore finds itself in a position that, because it needs the economic benefits of South Korean trade and aid, it must bend in some ways to Southern suggestions for policy changes and economic reforms. The ROK recognizes this as well and understands the leverage that comes with trade. However, as explained later, South Korea is not using this leverage in a manifestly *realpolitik* way but rather in a more constructive, engaging manner.

Contemporary realist theories of international political economy draw some of their conclusions from Hirschman's understanding of trade but end up in a seemingly more reductionist position. For realists, states as security maximizers have a fear of inequality that can result from trading gains; realist theorists propose, that is, that relative gains matter.⁷ From the southern side of the DMZ, however, the absolute gains in the North are simply not large enough to matter in the way that realists propose, as amply shown in table 4.3. By a similar logic, the DPRK cannot believe that it is improving the South Korean position through inter-Korean trade, given that it represents such a tiny fraction of total South Korean trade. Because the ROK holds such a superior economic and geopolitical position to the DPRK, Seoul has no reason to be worried that trade with the North will result in a military or economic advantage for Pyongyang. The realist economic analysis does not apply to the dyadic relations on the Korean peninsula, and relative-gains concerns can be disregarded in favor of absolute economic gains for the DPRK, something that is regarded as desirable in both Pyongyang, for reasons of regime survival, and Seoul, for reasons of peninsular stability. By the absence of the dynamic it proposes, the realist framework of relative gains, like its liberal counterpart, provides some intuition as to why trade continues on the Korean peninsula, but neither of the two mainstream international relations theories demonstrates why the ROK is involved in such trade in the first place or why it is willing to ignore Northern military-first policy posturing. Whether rejected or accepted, each describes a logic as to why there is an environment in which trade can persist but does not provide a logic as to why it actually does.

The problem with both the liberal and the realist relative-gains views of international trade in looking at Korea is that they reflect upon the impact of trade without considering the larger questions of its origins and the possibility of its non-*realpolitik* strategic use. Not surprisingly, theories that incorporate economic relations into a broader perspective provide more leverage in explaining why inter-Korean trade emerged 15 years ago and why it continues in the face of mutual security concerns. The dyadic trade being witnessed between North and South Korea can be reconceptualized by looking at it through the lenses of functionalism and conflict management.

Despite variations in usage, classical functionalism as formulated by its leading exponent, David Mitrany, is in essence a prescription for a welfare-oriented approach

Table 4.3 Comparison of major economic indexes of North and South Korea (2002)

Sector/category	Unit	North Korea (A)	South Korea (B)	A : B
Population	1 million	22.4	47.6	1 : 2
Nominal GNI	\$ billion	17	477	1 : 28
Per capita GNI	\$	762	10,013	1 : 13
Rate of economic growth (2002)	%	1.2	6.3	1 : 5
Total foreign trade volume	\$ million	2,270	314,600	1 : 139
Exports		735	162,470	1 : 221
Imports		1,535	152,130	1 : 99
Trade balance	\$ million	-800	10,340	
Trade as % of GNI	%	13	67	1 : 5
Scale of assessments for UN budget	%	0.009	1.728	1 : 192
Industrial structure	%			
Service		31.8	54.1	1 : 1.7
Mining and manufacturing		26.0	30.3	1 : 1.2
Construction		7.0	8.2	1 : 1.2
Agriculture, forestry, and fishing		30.4	4.4	1 : 0.14
Electricity, gas, and water		4.8	2.9	1 : 0.6
Coal production	1 million tons	23.1	3.8	1 : 0.2
Power generation capacity	1 million kw	7.6	50.9	1 : 7
Power generation	100 million kwh	202	2,852	1 : 14
Petroleum import	10,000 tons	58	11,724	1 : 202
Grains production	10,000 tons	394.8	620.0	1 : 1.6
Rice production	10,000 tons	168.0	551.5	1 : 3.3
Fishery products production	10,000 tons	74.6	266.5	1 : 3.6
Iron ore production	10,000 tons	420.8	22.7	1 : 0.05
Nonferrous metals production	10,000 tons	9.2	114.0	1 : 12
Cars production	10,000	0.57	294.6	1 : 517
Steel production	10,000 tons	106.2	4,385.2	1 : 41
Cement production	10,000 tons	516.0	5,201.2	1 : 10
Fertilizer production	10,000 tons	54.6	350.0	1 : 6.4
Synthetic fiber production	10,000 tons	2.7	234.0	1 : 87
Total length of railroad	Km	5,224	3,125	1 : 0.6
Total length of road	Km	23,963	91,396	1 : 3.8
Capacity of harbor loading/unloading	10,000 tons	3,550	46,960	1 : 13
Shipping possession	10,000 tons	85.0	659.3	1 : 7.8

Sources: ROK Ministry of Unification and UN Docs. A/Res/55/5B (December 23, 2000) and ST/ADM/SER.B/568 (December 26, 2000).

to world order. Functionalism looks at that domain of international life that is assumed to be intrinsically more cooperative than conflictual: the domain of global "low politics." Concerned with finding openings within civil societies as well as between states and civil societies for a different sort of world order—one capable of sustaining peace over time—this approach envisions an inexorable move of the state

system from a model of territorial conflict to one of transnational (non-territorial) cooperative networks of socio-functional interdependence. In essence, functionalism sees the territorial state system as incapable of resolving borderless social and economic problems and seeks to build functional institutions upon social interests rather than upon state interests. "Peace will not be secured," Mitrany argued,

if we organize the world by what divides it. But in the measure in which such peace-building activities develop and succeed, one might hope that the mere prevention of conflict, crucial as that may be, would in time fall to a subordinate place in the scheme of international things, while we would turn to what are the real tasks of our common society—the conquest of poverty and of disease and of ignorance.⁸

In Mitrany's vision, the nation-state would be subverted indirectly and made irrelevant through intricate networks of trans-territorial social and economic interdependence. While committed to world peace as the ultimate end, functionalism attacks social and economic causes of war through an incremental "peace by pieces" approach. The logic of functionalism is that the promotion of welfare leads to the prevention of warfare by eliminating the long-term underlying causes of war.

While Mitrany and his followers spoke of functionalism as being built at the international level, the ideas certainly have applicability at the dyadic level. Viewed in a functionalist manner, inter-Korean economic relations can better be seen as part of a conscious plan—clearly on the part of the ROK and conceivably on the part of the DPRK—to develop ties between the North and the South, to promote contacts and interaction, and to bridge the social and cultural gap that has grown between two halves of a divided people over five decades of hostile separation. Inter-Korean economic relations are in many ways not at all about economics but about reconciliation and the reduction of political and military tensions. As Hirschman describes, broader influence comes from trading relations. The influence inherent in inter-Korean economic relations, while in some ways threatening to the weaker North Korea, also contributes to confidence-building measures that are a part of dealing with the larger security issue.⁹ The functionalist solution seems particularly appropriate to Korea because of Mitrany's belief that the growth of functional linkages would lead to a change in popular attitude regarding the "us versus them" dynamic, such that people would be willing to look beyond the boundaries of the state.¹⁰ On the Korean peninsula, looking beyond the boundaries of the two extant states in a contained sense means looking toward the reunification of the peninsula and of the Korean nation.

Coherent with a broad functionalist scheme is a conflict management approach.¹¹ Conflict management allows for dyadic interactions at multiple levels. Therefore, whereas the liberal and realist frameworks seem to suggest a direct causality between economics and security, keeping an eye on conflict management lets economic relations continue in the face of contrasting developments in the traditional security realm. The ROK, if operating under a conflict management perspective, can make a conscious decision to continue economic interaction in the face of the DPRK's surprise announcements about its nuclear program and in the face of naval incursions into ROK waters. These seemingly very negative occurrences are in part mitigated by more positive occurrences elsewhere in inter-Korean relations, such as

on the economic front. Conflict management dissects an all-or-nothing security environment and creates varied pathways of engagement and response.

An odd pattern emerges from looking at these theoretical considerations. In the communist state that should be driven by ideology, economics would seem to be playing the driving role in inter-Korean economic relations, while in the capitalist state that should be driven by economics, a functionalist ideology and a pragmatic conflict management approach hold sway. The traditional liberal mechanism by which trade prevents conflict because of a rational cost-benefit assessment does well to explain why the DPRK cannot risk provoking Seoul to the point where it might cut off burgeoning economic relations, implying that there are limits to the patterns of its current hostility and that Pyongyang may just be testing the boundaries of cooperation. On the other side of the coin, inter-Korean trade arises as an exceptional case in realist theory in which the states are not dissuaded from engaging each other because of relative-gains concerns. Functionalist and conflict management ideas explain why the ROK is willing to continue to pursue inter-Korean relations in the face of various military provocations by the DPRK.

In a more strictly economic vein, Nicholas Eberstadt argued in 1994 that South Korea can choose to pursue a strategy of "rapprochement through trade" because the North Korean economic system objectively needs inputs that the South can provide, because the DPRK recognizes its deep economic difficulties, because the ROK has a growing need for a low-wage labor force, and because of the success of *Nordpolitik* in the early 1990s in using economics to broker rapprochement with communist states. He also noted, however, that the possibility of trade and investment relationships that are mutually beneficial from a strictly economic standpoint is constrained.¹² But in the past ten years, trade has more than tripled; clearly the constraints imposed by economic benefit concerns are being ignored or surmounted. The functionalist explanation fills in the missing pieces, although ultimately it is unclear how far market interaction between North and South Korea might go or where it might hit a roadblock. The fact that inter-Korean economic relations have been largely state-driven and state-moderated, for instance, implies that an entirely different dynamic might result under a more *laissez faire* environment. As discussed later vis-à-vis inter-Korean investment, issues in the security realm could have a larger impact if not for the current close control and cross-issue coordination by the central government in the North or in the South. Even with these caveats, however, the development of inter-Korean relations since the end of the Cold War has been remarkable, and the role of inter-Korean economic relations—and in the face of military provocations by the DPRK—is quite notable. As the evidence shows here, trade between North and South Korea serves a function in furthering relations and crafting peace.

Inter-Korean Trade

The first trade between the ROK and the DPRK, as noted earlier, was purely symbolic: it was accomplished because it could be and because it was impressive that it could be. South Korean President Chun Doo Hwan had raised the idea of trade in August 1984, leading to talks that collapsed two years later. Only with the cross-border shipment of artistic products in 1989 was inter-Korean trade truly

inaugurated. But as trade developed over the 1990s, it began to have some economic meaning in addition to its continued symbolic importance. Gold, zinc, and iron were the first major trade products, imports from the North. After the mid-1990s, agricultural, forest, and textile products came to top the list. In 2002, animal products—mainly seafood—were the largest North Korean export on a value basis. As figures 4.1 and 4.2 show, inter-Korean trade was very strong during the years just before the

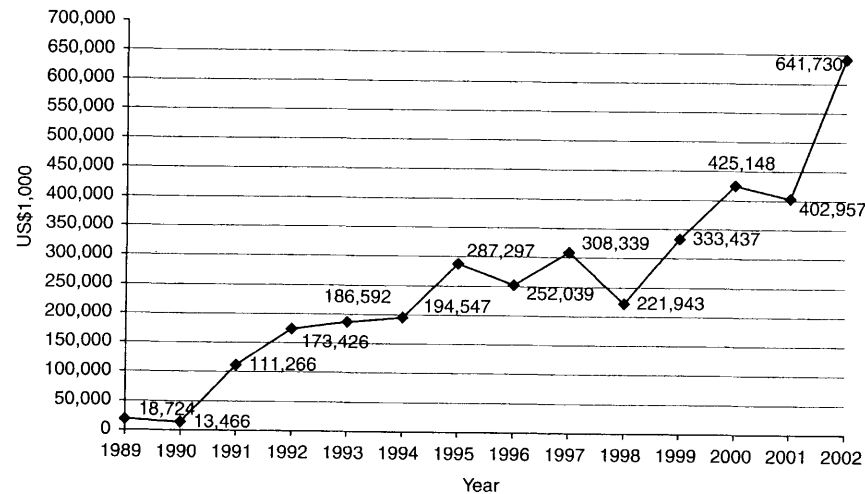


Figure 4.1 South Korean–North Korean trade (1989–2002).

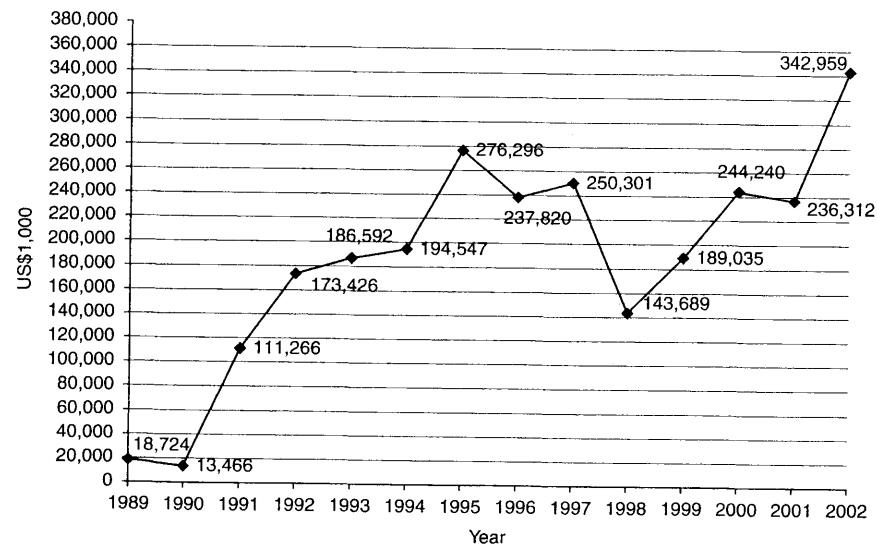


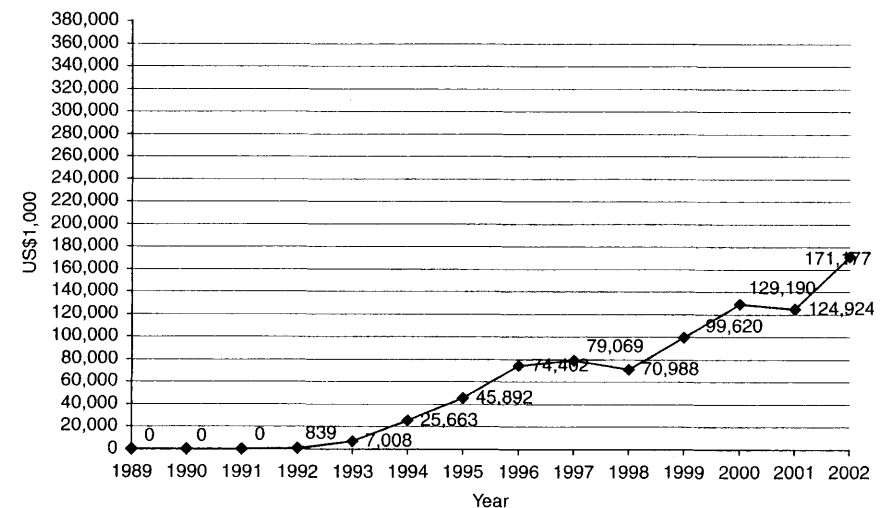
Figure 4.2 South Korean–North Korean transactional trade (1989–2002)

Asian Financial Crisis of late 1997. Trade fell substantially because of the crisis but then saw a terrific rebound in 2000 that was associated with the inter-Korean summit of June of that year. The Joint Declaration produced by that summit was conspicuously silent on security and military issues, in effect anointing economic relations as the practical pathway for the development of inter-Korean relations.

The most important development has been the quick growth of processing-on-commission (POC) trade, which involves South Korean companies sending raw materials north and then reimporting finished or semifinished products. This allows South Korean companies to take advantage of cheaper labor in the North, since rising wages in the ROK have made production less profitable there. As indicated in figure 4.3, POC trade began modestly in 1992 and rocketed to one-half of all transactional trade in 2002.

POC trade is comparable to Mexican *maquiladoras*—border factories that export directly to the United States. *Maquiladoras* are responsible for nearly one million jobs in Mexico and account for \$40 billion in exports, one-half of Mexico's total, indicating the possibilities that might lie in store for North Korea in the future.¹³ For South Korean companies, POC trade offers the greatest economic benefit. Besides the benefit of cheaper labor than in the ROK or even China, the ROK government classifies trade with the DPRK as *intra-Korean* trade, and therefore duties and rules that would apply under World Trade Organization statutes can be avoided.¹⁴ POC trade also implies technology and information transfer. Many of the POC plants that have been established use South Korean machinery and supervisors. By 2003, South Korean companies were making shoes, beds, television sets, and men's suits in the North.¹⁵

POC trade alone is a remarkable development in inter-Korean relations given that it requires more and deeper communication than would mere exchanges of finished products across a border. It allows, referring to the framework above, more functional linkages between the two countries. The willingness of the North Korean



government to allow South Korean supervisors and South Korean factory organization within its territory indicates a slackening of its fears of cultural pollution and of attacks on its political system. Indeed, in April 2001 the DPRK passed the Processing Trade Law, representing its deep interest in POC, and in 2003 the new DPRK prime minister, Pak Pong Ju, led a group of North Koreans on a tour of semiconductor plants in the South.¹⁶ North Korea has found itself in a position such that it must engage in the contradictory pursuit of economic revitalization through the ROK as a mechanism for legitimating Kim Jong Il's regime and insuring its continued existence.¹⁷ A note of skepticism might be sounded, however, given the unpredictability of Pyongyang. In November 2000, for instance, the DPRK denied Hansung Shipping vessels entry to the port of Nampo, even though that was the shipping line that carried 90 percent of all North-South POC trade at the time.¹⁸

In addition to classifying all trade with North Korea as intra-Korean trade, the ROK also includes in its trade statistics a category of "non-transactional trade." This is actually an accounting of aid sent to the DPRK, including goods related to the now-moribund KEDO nuclear reactor projects, the Mt. Kumgang tourist project, and humanitarian aid. The fact that the ROK statistically ties together commercial trade and aid is indicative of its perspective on inter-Korean trade: like aid, it is a component of a functional project of expanding interactions and relations with the DPRK in pursuit of a more peaceful and harmonious coexistence or reunified existence. Non-transactional trade began in 1995 and has increased to such a degree that it is almost as great as transactional trade. Figure 4.4 shows the massive growth in non-transactional trade since 1996. In comparison with the commercial trade

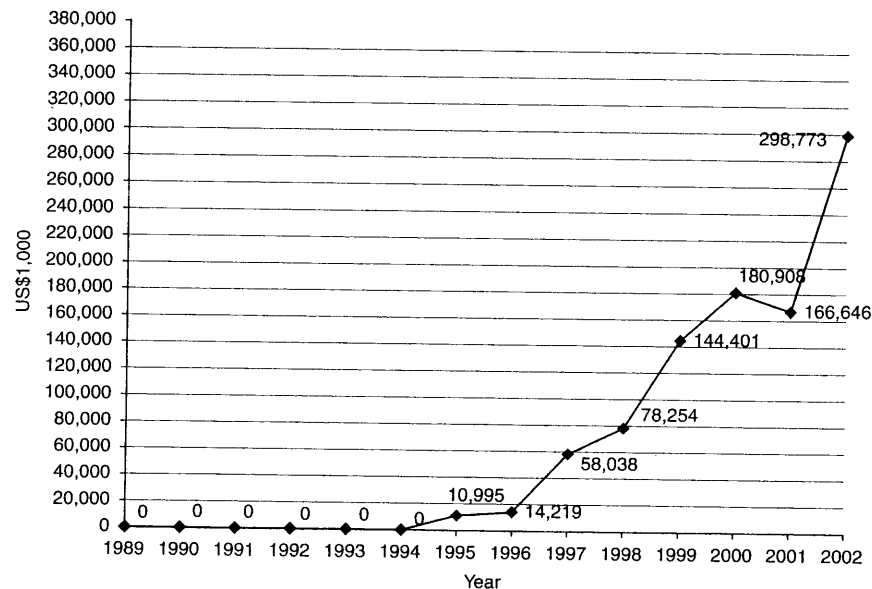


Figure 4.4 South Korean-North Korean non-transactional trade (1989-2002).

depicted in figure 4.2, non-transactional trade has seen greater and steadier growth, although growth in both categories has been concurrent, pointing toward the existence of a broader project of interlocking relations and flows.

To a certain extent, even the transactional trade is a form of aid. Because of a lack of hard currency, the DPRK cannot import South Korean goods to the extent that it might like, and so the ROK maintains a trade deficit with the DPRK in terms of transactional trade, although if non-transactional trade is included, trade since 1998 has technically yielded a surplus for the ROK. Clearly, given the proportion of the ROK's total trade that consists of inter-Korean trade, this trade deficit is not fiscally significant. With the DPRK's 2002 adjustment of its exchange rate from 2.1 DPRK won to the dollar to about 900 won per dollar, the balance of payments is likely to be more reflective of actual value and world market currency rates.¹⁹ Nonetheless, the fact that South Korea is importing more than it exports implies a bolstering of the North's foreign exchange reserves, and South Korea has become the largest provider of hard currency to the DPRK, which it uses to purchase indispensable imports from other countries. In November 2003, the Inter-Korean Economic Promotion Committee agreed to begin conducting more efficient settlement clearance transactions on a trial basis in 2004 (see #38 in table 4.4).²⁰

As Marcus Noland notes in regard to the Sunshine Policy of former ROK President Kim Dae Jung, the ROK's willingness to push trade forward and to provide aid under the guise of trade is part of an understanding that the South lacks the economic, social, and political capacity to handle a collapse of the North, making peaceful coexistence a preferable state. In addition, while the ROK's traditional reunification policy put an almost exclusive emphasis on high-level government-to-government talks, the Sunshine Policy sought to encourage nonofficial contacts. As Noland observes, the Sunshine Policy aimed to create "a set of interdependencies that in the long run would discourage the North from external aggression and perhaps even promote the internal transformation of the regime."²¹ The threefold increase in trade over the term of Kim Dae Jung's presidency—from \$221 million in 1998 to \$641 million in 2002—is indicative of the success of the Sunshine Policy in this regard.

Within a functionalist framework, it is not increased trade alone that makes the difference. Nor is it just the increase of aid with trade that is notable. Key to both the functionalist scheme and the Kantian vision, and implicit in the use of trade as a tool of conflict management, is the idea that trade brings with it cultural, social, and ideological flows and changes. At a purely technical and pragmatic level, the growth in trade and the recognition of possible trade benefits has led to a degree of economic reform in the DPRK. A September 1998 constitutional revision mentions "private property," "material incentives," and "cost, price and profit" in a document that otherwise reads like an orthodox manifestation of the DPRK's *juche* philosophy.²² Further, Pyongyang has been sending partisans abroad—430 in 2001—to study economics and business administration, and in 2003, three fact-finding missions went to Vietnam to study its economic reforms.²³ As figure 4.5 indicates, with visits from the North to the South beginning in 1999, the number of DPRK citizens who have been to the ROK has grown to a level that while still small is nonetheless quite remarkable. In July 2002, the North Korean regime announced major changes in its economic policy, including price changes, which in large part

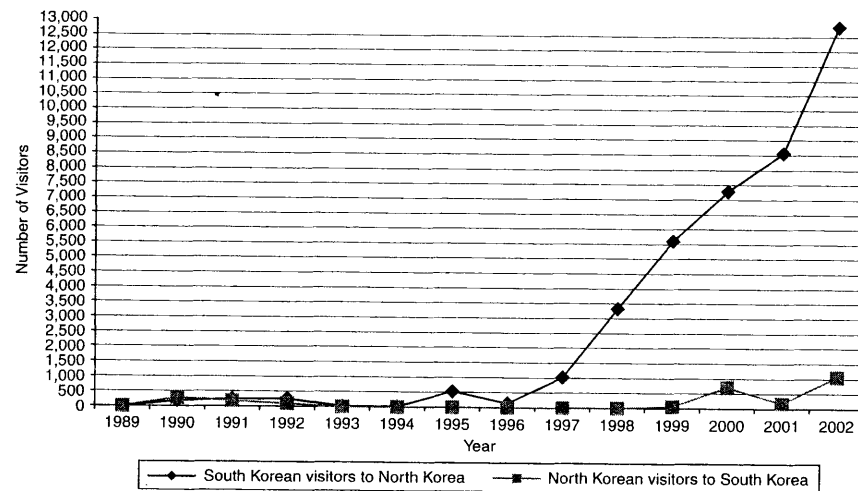


Figure 4.5 Inter-Korean visits.

were a response to the fact that food was being distributed through markets rather than through the state-run public distribution system.²⁴ These changes are significantly linked to inter-Korean economic relations.

For Kim Dae Jung, this trade-off in which the ROK supplied economic goods in exchange for—or at least expectation of—noneconomic goods from the DPRK is part of “comprehensive reciprocity.” In a speech in the United States, Kim contextualized economic exchanges as part of a “larger framework within which there are certain things that we can give to North Korea and certain things that we must take from North Korea.”²⁵ If economic reforms can be taken as evidence of this reciprocity, then they are indeed evidence of the success of the functionalist approach inherent in Kim’s Sunshine Policy. However, as Charles Armstrong points out, it will take continued South Korean engagement and effort to insure that the DPRK consolidates these reforms; the functionalist project cannot be stopped short except at the risk of North Korea reverting to traditional mechanisms of survival and isolation.²⁶

The extent of the ongoing project is captured in a phrase found in the declaration produced from the June 2000 Summit meeting. The fourth Article stipulates that the South and the North have agreed to “consolidate mutual trust by promoting balanced development of the national economy through economic cooperation and by stimulating cooperation and exchanges in civic, cultural, sports, public health, environmental and all other fields.” In previous inter-Korean agreements, such as the 1972 Joint Communiqué and the 1991 Basic Agreement, economic exchanges and cooperation were regarded as goals per se, while the 2000 Joint Declaration treats them as a means to promote balanced development of the national economy. The use of the term “national economy” assumes an eventual integration of North and South Korean economies.²⁷

Since the 2000 Summit meeting, over two dozen agreements have been signed between the two Koreas, as listed in table 4.4. These agreements can be grouped into

three post-summit phases. From the date of the summit through the end of 2000, there was a flurry of cross-border activity with numerous delegations traveling in both directions, culminating in the four agreements of December 16, 2000, on the resolution of commercial disputes, the prevention of double taxation, transactions clearing settlement, and the protection of investments. An 18-month hiatus ensued, coinciding with the first year and a half of the George W. Bush presidency in the United States. In this second phase inter-Korean dialogue stalled and inter-Korean trade dropped, as seen in figure 4.1. The third phase began in August 2002 with a flurry of agreements, many having to do with cross-border road and rail connections.

Table 4.4 Chronology of Inter-Korean agreements, 1972–2003 (as of November 2003)^a

#	Date ^b	Place	Agreement
1	07/04/72		South–North Joint Communiqué of July 4, 1972
2	12/13/91		Agreement on Reconciliation, Non-aggression, and Exchanges and Cooperation Between South and North Korea (The Basic Agreement)
3	01/20/92		Joint Declaration of the Denuclearization of the Korean Peninsula
4	02/19/92		Agreement on the Composition and Operation of Subcommittees from South–North High-Level Negotiations
5	03/19/92		Agreement on the Establishment and Operation of a South–North Joint Nuclear Control Commission
6	05/07/92		Agreement Regarding the Establishment and Operation of a South–North Joint Military Commission
7	05/07/92		Agreement Concerning the Establishment and Operation of South–North Liaison Offices
8	05/07/92		Agreement on the Establishment and Operation of a South–North Joint Commission for Exchanges and Cooperation
9	09/17/92		Agreement on the Composition and Operation of a South–North Joint Reconciliation Commission
10	09/17/92		Protocol on the Implementation and Observance of chapter 3, South–North Exchanges and Cooperation, of the Agreement on Reconciliation, Nonaggression and Exchanges and Cooperation
11	09/17/92		Protocol on the Implementation and Observance of chapter 2, Nonaggression, of the Agreement on Reconciliation, Nonaggression and Exchanges and Cooperation

Table 4.4 Continued

#	Date ^b	Place	Agreement
12	09/17/92		Protocol on the Implementation and Observance of chapter 1, Reconciliation, of the Agreement of Reconciliation, Nonaggression and Exchanges and Cooperation
13	06/28/94		Agreement for the Holding of a Summit meeting between South and North Korea
14	07/02/94		Agreement of the Procedure for Holding a Summit Meeting between South and North Korea
15	04/08/00	Pyongyang	South-North Agreement (on Summit Meeting)
16	05/18/00	Panmunjom	Agreement on Working Procedures for Implementing the April 8 South-North Agreement on Inter-Korean Summit
17	06/15/00	Pyongyang	South-North Joint Declaration
18	06/30/00	Mt. Kumgang	Agreement to Exchange Visits by Separated Families, Establish and Operate a Reunion Center and Repatriate Unconverted Long-Term Prisoners
19	12/16/00	Pyongyang	Agreement on Procedures for Resolution of Commercial Disputes between the South and the North
20	12/16/00	Pyongyang	Agreement on Prevention of Double Taxation of Income between the South and the North
21	12/16/00	Pyongyang	Agreement on Clearing Settlement between the South and the North
22	12/16/00	Pyongyang	Agreement on Investment Protection between the South and the North
23	08/28/02	Mt. Kumgang	Agreement on North Korea's Participation in Pusan Asian Games (Asiad)
24	08/30/02	Seoul	Agreement at the Second Meeting of the Inter-Korean Economic Cooperation Promotion Committee
25	09/08/02	Mt. Kumgang	Agreement at the Fourth Inter-Korean Red Cross Meeting
26	09/17/02	Mt. Kumgang	Agreement on Provision of Materials for Inter-Korean Linkage
27	09/17/02	Mt. Kumgang	Agreement Reached at the First Round of Working-Level Talks on Inter-Korean Railways and Highways
28	11/09/02	Pyongyang	Agreement at the Third Inter-Korean Economic Cooperation Promotion Committee
29	01/22/03	Mt. Kumgang	Agreement Made at the Third South-North Korean Red Cross Working-Level Contact

Table 4.4 Continued

#	Date ^b	Place	Agreement
30	01/25/03	Pyongyang	Agreement Made at the Second Meeting of Working-Level Consultations on the Connection of South-North Railways and Roads
31	01/27/03	Panmunjom	An Interim Military Guarantee Agreement for the Use of Temporary Roads between South-North Control Zones in the Eastern and Western Coastal Districts
32	05/23/03	Pyongyang	Agreement reached at the end of the Fifth Meeting of Inter-Korean Economic Cooperation Promotion Committee
33	06/09/03	Kaesong	Agreement on Connection of Inter-Korean Rails and Roads
34	07/04/03	Munsan	Third Meeting Agreement on Connection of Inter-Korean Rails and Roads
35	07/31/03	Kaesong	Agreement of Second Meeting of Inter-Korean Consultation on Economic Cooperation System
36	08/28/03	Seoul	Agreement reached at the end of the Sixth Meeting of the South-North Economic Cooperation Promotion Committee
37	10/28/03	Kaesong	Agreement of Seventh Working-Level Contact on Connection of Inter-Korean Railways and Roads
38	11/08/03	Pyongyang	Agreement of Seventh Meeting of Inter-Korean Economic Cooperation Promotion Committee
39	11/21/03	Mt. Kumgang	Agreement from the Second Inter-Korean Red Cross Talks

^a Agreements between the DPRK and KEDO (of which the ROK is a member) as well as numerous "joint press statements" are excluded.

^b Date signed or entered into force.

Source: The ROK Ministry of Unification at <http://www.unikorea.go.kr>.

The fact that this third phase continued through the DPRK's nuclear revelations of October 2002 speaks to the strength of the functional relations between the two Koreas. Consistent with a conflict management approach, Seoul opted to continue its dialogues and the issuance of formal agreements with the North despite the revived security challenge of nuclear proliferation.

The agreements on roads and railways are indicative of one of the problems of expanding trade with the DPRK: the lack of infrastructure. Because of the underdevelopment of transportation infrastructure in the North and the lack of connections across the DMZ, President Kim Dae Jung proclaimed in March 2000, in a speech dubbed the Berlin Declaration, "To realize meaningful economic collaboration, the

social infrastructure, including highways, harbors, railroads and electric and communications facilities, must be expanded. . . . The Government of the Republic of Korea is ready to respond positively to any North Korean request in this regard."²⁸ These projects are considered more fully in the next section.

Inter-Korean trade has served an economic purpose for North Korea and a broader functional purpose for South Korea. Ultimately, however, inter-Korean trade is constrained by several structural factors. Both production facilities and infrastructure in the DPRK are dilapidated and in need of serious updating. Pyongyang's lack of hard currency reserves mean that it cannot import as much as it otherwise might from the ROK, and because of the state's control of the economy and the general poverty in the country, there are no free domestic markets for South Korean products. To increase the efficiency of trade and the willingness of South Korean companies to engage in trade with the DPRK, Pyongyang will need to continue revising its laws, institutionalizing its commercial practices, and demonstrating rule of law. For Seoul to continue using trade in a functional way, it will need to see progress of this sort in the North. Marcus Noland calculated that the normalization of trade between the two Korean states—as if they were just two contiguous states in the international system—would imply that 35 percent of the DPRK's total trade volume would be with the ROK; this leaves room for current trade to almost double and implies an increase of significantly more if the DPRK economy improves.²⁹

Inter-Korean Investment

The prospects for inter-Korean investment, however, are less clear. While the DPRK certainly needs investment to the same degree that it needs trade—if not to a greater degree—ROK firms, especially the chaebols, are less willing to pursue investment given uncertainties surrounding the rate of return, liquidity, and ultimate safety of any investment in the North. Establishing the economic institutions for trade that provide the necessary perception of certainty has been difficult enough; establishing institutions that will make investors feel secure in North Korea is even more problematic. South Korean investors have been content thus far to observe the North as a potential investment partner and not actually to invest in it.³⁰ Nonetheless, there is evidence of tentative investment by South Korean companies, and the Kaesong Industrial Complex represents the DPRK's latest and best push to catalyze Southern investment. Given the DPRK's status as self-styled socialist hermit kingdom in the global economic system, ROK investment remains North Korea's best hope for capturing flows of productive investment.

Inter-Korean investment has not only lacked the two-way flows of inter-Korean trade but has also lacked the progressive time frame of that trade. Only after Kim Dae Jung inaugurated the Sunshine Policy was the possibility of investment in North Korea effectively opened. Kim removed the upper limit on the amount of investment possible for South Korean companies, allowed for investment in all fields unless strictly prohibited (as opposed to maintaining a list of the only acceptable sectors for investment), and simplified the approval process. Yet a survey two-and-a-half years later found that ROK companies were alarmed by the lack of institutional framework, the possibility of double taxation, and the impossibility of investment guarantees.³¹

These concerns have been addressed both at the domestic level within the DPRK and at the dyadic level. Congruent with the launch of the Sunshine Policy in the South, the DPRK promulgated its 1998 Constitution and then three subsequent laws focused on external economic cooperation: the Foreign Equity Law, the Contractual Joint Venture Law, and the Foreign Enterprises Law.³² At the inter-Korean level, four agreements were signed in December 2000 on commercial disputes, double taxation, transactions clearing settlement, and investment protection (see table 4.4). It took another three years, however, for negotiators to agree to implement these agreements, leading many to question the worth of the Inter-Korean Economic Cooperation Promotion Committee, which should have been exactly the institutional mechanism needed to spur investment.³³ (In the interim, though, the DPRK did pass domestically the Foreign Trade Act of February 2001 and the Enforcement Decree of the Foreign Investment Protection Act of December 2001.) The Committee finally issued a declaration in August 2003: "The South and the North will take follow-up steps to the 'four agreements,' which institutionally guarantee inter-Korean economic cooperation."³⁴ One auspicious component of the June and July 2003 talks leading to the August declaration was that the South Korean negotiating team "commuted" each day through the DMZ on land in June, while the North Korean team made the journey southward through the DMZ in July.

The slow pace of these developments is not at all remarkable. Laws about taxation of foreign investment, control over foreign exchange, the role of foreign banks, leasing of land, and customs are in many ways discordant with the *juche* philosophy that undergirds the DPRK. As Harry Eckstein pointed out as part of his theory of congruence, the dissonance created by incongruent organizations of state and society runs the risk of destabilizing an entire system.³⁵ The North Korean regime is certainly aware of this threat, and this explains some of the foot-dragging that has occurred. The investment that is indeed allowed is not completely divorced from *juche* principles. For instance, a Hyundai-financed greenhouse in North Korea belongs not to Hyundai but to the DPRK, which also claims 40 percent of the produce grown there for state use.³⁶ According to a Korean Development Institute survey, of 672 companies that started doing business in the DPRK in 2000 or 2001, only 171 were still involved in North Korea in November 2001, and only one-third of the 115 firms who responded said that they were making a profit in their Northern ventures.³⁷ While some companies are willing to overlook these low returns either in deference to the grander goals of peaceful coexistence and reunification or because of a belief that they can capture market share at an early stage, others are not so willing.

South Korean companies have also cited the lack of transportation infrastructure as a factor militating against investment. Negotiators undertook this issue in 2003, signing in January an agreement for "military assurances" that would allow for work to begin on roads and railways crossing the DMZ.³⁸ The unpaved tracks that are to be turned into roads have seen some use, as noted earlier, as conduits for negotiating teams, and this carries serious symbolic import: Kim Dae Jung referred to the reconnection of the lines, severed just before the Korean War in 1950, as *de facto* reunification. Road and rail reconnection is both a component of the developing trade and investment linkages and also a functional connection between the ROK and the DPRK in its own right. The fact that the two Korean states can cooperate to build

transportation infrastructure across the most heavily militarized border in the world is a powerful statement at several levels and one rightly judged as a contribution to a broad program of functionalist engagement.

As an indicator of the seriousness of the rail and road projects, 12 out of 17 inter-Korean agreements signed between August 2002 and November 2003 dealt with the procedural and operational details of the work on the Sinuiju–Seoul (Kyonggui) and Donghae rail lines and highways. The completion of de-mining work in December 2002 was described by the North as “a shining fruition of the June 15 North–South Joint Declaration, a landmark of national reunification, and product of the desire of all the Koreans.”³⁹

The investment in rail—the creation of the “Iron Silk Road”—is one that could stand to reap great gains for both North and South Korea and also Russia. Reconnecting railroads through the Korean peninsula would reduce the time it takes a South Korean shipment to get to Europe by half—from 30 days by sea to 15 days by rail—and the cost by a quarter.⁴⁰ Russia sees reconnected railways as its route to the South Korean consumer market and also holds out hope for the DPRK’s repayment of \$3.6 billion in Soviet era debt. Shipping costs on the peninsula would drop significantly, increasing the profitability of and capacity for POC trade. However, despite all these motivating factors there is little progress on the rail project in the northern half of the peninsula because of a simple lack of investment.⁴¹ There is a developing chicken-and-egg conundrum, whereby the DPRK needs better infrastructure in order to get investment but needs investment in order to improve its infrastructure. The recent decision by a multinational consortium to route a 3,035-mile natural gas pipeline around the DPRK, despite South Korea’s eagerness for the pipeline to go through North Korea, feeding thermal plants along the way, suggests that international investors are generally casting a wary eye toward the DPRK.⁴² Inter-Korean investment is likely to be the most significant investment in the DPRK in the near future.

In this light, the Kaesong Industrial Complex (KIC)—the largest inter-Korean economic project in development—becomes all the more important. Forty miles north of Seoul, the KIC is designed to lure South Korean businesses to use cheap North Korean labor, with the expectation of the kind of effects that China’s SEZ reaped from its proximity to Hong Kong—the stimulation of a hinterland.⁴³ With 22,000 Korean companies having set up factories in China, it would appear that there is an ample investment base waiting to move into the KIC. Hyundai announced the project in February 2001 as part of the Mt. Kumgang tourism agreement, and so far over 1,300 small- and medium-sized companies have applied to set up factories.⁴⁴ According to Hyundai Asan, Hyundai’s North Korean arm, production at the KIC should be around \$2 billion in its first year and reach \$14.5 billion in its ninth year.⁴⁵ Exportation from Kaesong to the EU and even Japan is likely, although the “Made in North Korea” label probably will prohibit entry to U.S. markets.⁴⁶ The KIC certainly appears better positioned to reap gains than the remote and infrastructure-less Rajin-Sonbong Free Economic Zone, which, despite having been in existence for over a decade, boasts of only a hotel and casino as its main investments.⁴⁷ And the future of the Sinuiju Special Administrative Region is highly uncertain since the arrest in China of Yang Bin, the Chinese tycoon selected by Kim Jong Il to run the zone. This leaves the KIC as the most attractive region for investment in North Korea.

However, enthusiasm for the possibilities of the KIC must be tempered. Companies that wish to locate in Kaesong will need to supply their own infrastructure, which could be quite expensive in the face of North Korea’s dysfunctional road system and decrepit electricity grid. The fact that exports from Kaesong are likely to prove unsuitable for the United States—and perhaps Japanese—markets will also dissuade many investors. If the KIC were to become a major producer, the international community might then begin to protest the tax-free trade between the two Korean states, creating problems within the WTO. The challenges to Kaesong’s success are evidenced in the lack of a marquis investor beyond Hyundai. The industrial park has not attracted interest from the chaebols—although Hyundai at one point claimed Samsung would invest in Kaesong, meeting with Samsung’s denial⁴⁸—but rather from small- and medium-sized enterprises. Whether because of the questionable interest in the project or because of fear of negative attention from Washington, the primary actors in Kaesong have tried to keep a low profile, for instance by not publicizing the June 2003 groundbreaking ceremony.⁴⁹ The most important factor in determining the ultimate success or failure of the KIC will be the DPRK’s ability to convince South Korean companies of the safety of their investment and the sanctity of rule of law in North Korea: Pyongyang must actually implement the business laws that it has been passing.⁵⁰

Of particular interest for Kaesong and elsewhere will be the possibility of developing inter-Korean collaboration on information technology (IT) projects. The DPRK has shown significant interest in increasing the amount of IT production within its borders, presumably in part because of the technology sharing that would accompany such production. While South Korean companies have shown interest in bringing IT production to the North, it is unclear whether the North has the human capital to make these projects worthwhile. In addition, there are some significant path-dependent differences between the computer systems used in the DPRK and those used in the ROK, including even keyboard layouts.

The importance of investment growth or lack thereof in terms of the broader issue of creating a secure environment on the Korean peninsula has recently been substantiated in work by Erik Gartzke, Quan Li, and Charles Boehmer. Beginning from basic liberal contentions about interdependence and the economic opportunity costs of military conflict, the authors discover that capital interdependence sometimes matters more than trade in reducing the resort of states to violence.⁵¹ Using a set of statistical models, the authors demonstrate that in different models either trade or, surprisingly, regime type loses significance in the face of monetary and capital variables.⁵² Using coefficient estimates from one model, the work shows that starting from a baseline of two contiguous countries—one democratic and one undemocratic—with low trade dependency, low economic growth, and average capital flows, the probability of militarized dispute can be reduced to only 27 percent if exposure to capital flows and capital openness increase by one standard deviation on their statistical scale, or to only 12 percent if trade dependence also increases by one standard deviation and a joint currency area is formed.⁵³ These results indicate the potential benefits of increased inter-Korean investment and suggest the possibility of a joint currency zone as a mechanism for both further integrating the two Korean economies and furthering the causes of security, peace, and reunification. At the very

least, they demand that the low degree of inter-Korean investment be regarded as a limitation on the functional effects of inter-Korean economic relations.

Inter-Korean Social and Cultural Exchanges

The economically least successful investment in North Korea has been the most successful in terms of publicity: the Mt. Kumgang resort area. Under the sponsorship of Hyundai, Mt. Kumgang tours began in November 1998. Hyundai paid a \$400 million business fee for the privilege and has lost additional millions of dollars ever since.⁵⁴ This led to the need for financial restructuring with significant contributions from the ROK government to keep the tourism project going, something that proved mildly difficult in the face of embarrassing revelations about a \$450 million payment—some say “bribe”—from Seoul to Pyongyang channeled through Hyundai prior to the June 2000 Summit. Nonetheless, calls to keep the Mt. Kumgang tourist visits alive have been strong. For instance, on the five-year anniversary of the project, the *Korea Herald* editorialized that the visits to Mt. Kumgang had “served as a catalyst for other forms of inter-Korean exchanges and certainly narrowed the distance between the peoples of the divided nation, geographically and emotionally.”⁵⁵ Figure 4.5 indicates the tremendous growth in the number of ROK citizens visiting the DPRK since the opening of Mt. Kumgang. Out of the Mt. Kumgang project have grown an overland route to the mountain, tours of Pyongyang, tours of the town of Kosong near Mt. Kumgang, and conversations about opening Mt. Paekdu.⁵⁶ On the other hand, the hotel at Mt. Kumgang is staffed mostly by ethnic Koreans who live in China, demonstrating Pyongyang’s willingness to forsake microeconomic gains in favor of preventing what it views as cultural pollution.⁵⁷

In some ways, the sterile atmosphere that the DPRK maintains—government agents closely monitor tourists, preventing conversations with locals and even certain photographs—defeats the functionalist mission inherent in the tourism project.⁵⁸ While the hope is that the tourism and its investment component would spread cultural contacts and help form inter-Korean social relations, the DPRK agitates and protects against this.

Likewise the other spectacular media event, the reunions of separated families, has found its lasting impact limited by the strictures and slowness surrounding it. Through the end of 2003, eight rounds of family reunions had occurred, and in November 2003 North and South Korea agreed to build, using North Korean labor and South Korean capital, a permanent facility for the hosting of the reunions near Mt. Kumgang that could also be used as a hotel.⁵⁹ Nonetheless, the meetings are brief, occur only once, and do not include allowances for future contact, and at the current rate, most of the 122,000 aged South Koreans who have applied to participate will die before given the opportunity, as some 20,000 already have.⁶⁰ Like the Mt. Kumgang tourist visits, these reunions, while symbolically important and emotionally moving, are strictly containerized so as to limit the functional outgrowths it is hoped they will produce.

Given Pyongyang’s penchant for restricting the benefits that might come from these cultural and social exchanges, economic activity and exchange becomes more

important, albeit more difficult. While the North can control and restrict tourists and family reunions, it is more limited in its capacity to do so with investors and factory managers, since there are direct economic consequences if they are too restricted. Therefore inter-Korean economic relations provide a type of leverage that cannot be found in more glamorous interactions between North and South. As long as social interaction remains circumscribed, it is economic interaction that can be expected to do the heavy lifting in inter-Korean relations.

Conclusions

The development of inter-Korean economic relations has been a cautious and speculative one, marked by occasional bumps, either endogenous (e.g., DPRK foot-dragging) or exogenous (e.g., the Asian Financial Crisis). However, the fact that there is cross-border trade, South Korean investment and tourism in the North, and the reopening of transportation connections across the DMZ is nothing short of incredible. And the impressiveness of this is increased by the fact that it has been sustained through the development of a new nuclear crisis and several naval provocations by the DPRK.

Drawing from several theoretical traditions in international relations, we propose a set of causes for this seemingly nonchalant continuation of inter-Korean economic relations. The liberal school of thought relies on the notion of economic opportunity costs to explain why trading interdependence will decrease the chances of military dispute, while liberalism’s sometimes polar companion realism proclaims that states will fail to trade or that trade will inspire military conflict because of concerns about relative gains, as one state becomes more powerful because of its trading habits. As the aforementioned evidence shows, North Korea certainly has much to lose from an interruption of trade with the country that has become its second largest trading partner, while South Korea has little to fear in terms of relative gains by North Korea because the DPRK would need to make tremendous absolute gains in economic ability before it would begin to seriously intimidate the South again. While these observations provide a logic as to why an environment exists where trade might persist, they do not explain why trade began or continues to increase in the face of an often uncertain security situation.

A functionalist explanation stresses the use of multiple pathways to create a peaceful, highly interconnected environment. South Korea, beginning particularly with Kim Dae Jung’s Sunshine Policy, has attempted to expand the depth and number of types of links between itself and the DPRK precisely in the name of developing a safer, less perilous environment on the Korean peninsula. For the reasons noted earlier, inter-Korean economic relations—and inter-Korean trade in particular—have been the most successful route for pursuing functional linkages. The post-Cold War environment has aided this endeavor, and inter-Korean trade numbers have maintained a steady upward trend over the past decade. Inter-Korean economic relations, therefore, can be said to have provided a set of successful functional linkages on the Korean peninsula.

However, this conclusion must be tempered with a caution endemic to any discussion involving North Korea. As the limited degree of investment demonstrates,

much is still holding back inter-Korean economic relations, and there is still significant uncertainty on the peninsula, which is detrimental to profitable investment. For inter-Korean economic relations to continue to progress, there must be a willing acceptance on the part of the North to be a full participant and to work toward making economic ties mutually beneficial. Most importantly, Pyongyang will have to demonstrate the prevalence of rule of law and its willingness to undertake continued economic reforms. In addition, economic relations must eventually expand and intensify social and cultural relations, since these are the more effective functional linkages in the pursuit of which the ROK is willing to undertake economic relations. The functionalist analysis implies a full system of connections, and inter-Korean economic relations can only carry the majority of the weight for so long.

Notes

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17. See Charles Armstrong's comments in chapter 3 of this volume.
18. Dong, "After the Summit," 90–91.
19. Brooke, "Quietly."
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 54. Tait, "Playing," 306.
 55. *Korea Herald*, November 19, 2003.
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 57. Faiola, "A Crack."
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CHAPTER FIVE

CHINA AND INTER-KOREAN RELATIONS: BEIJING AS BALANCER*

Andrew Scobell

Since 1949 the People's Republic of China (PRC) has played an important function as balancer on the Korean peninsula. Particularly since the late 1980s, Beijing has served a key constructive role in reducing tensions and facilitating reconciliation between Seoul and Pyongyang. There are, however, limitations to China's role in Korean conflict management linked to its policy preferences vis-à-vis the Korean peninsula and desired political outcomes on the peninsula. While Beijing's enlightened self-interest has fueled its constructive involvement on the peninsula, self-interest and extreme aversion to rapid major change also constrain the extent of its contribution. Indeed, Chinese diplomacy tends to eschew bold transformational initiatives in preference for efforts that are far more conservative and aimed at maintaining the status quo. This tendency by Beijing toward excessive caution is even more in evidence as a leadership transition from the so-called third generation headed by Jiang Zemin to the fourth generation headed by Hu Jintao is underway. And China's national interests vis-à-vis inter-Korean relations dictate a preference for what might be dubbed peninsular conflict management without swift resolution.

China plays a key role as balancer and stabilizer on the peninsula but always operates on the sidelines and never at center stage. Beijing has a unique status in inter-Korean relations as the only capital since the 1980s to have consistently enjoyed cordial relations with both Seoul and Pyongyang. Moreover, China is geographically proximate, with strong cultural affinities and an unresolved divided nation issue of its own. China also conducts significant trade with both North and South Korea. Bonds of socialist ideology and a history of military alliance link China with the North. But China has developed burgeoning ties with the South, driven increasingly by its own economic and strategic interests.

While China is arguably the key balancer on the Korean peninsula, its constructive role in inter-Korean conflict management has significant limitations. This chapter reviews the history of Beijing's relations with Pyongyang and Seoul and then surveys China's contribution to conflict management on the peninsula in the areas of diplomacy, economics, security, and unification. In each area China's contribution is limited because its policy preferences on the peninsula are restrained by its conservative risk-averse logic and guided by China's own national interests. Furthermore, Beijing's immediate term policy is constrained by its long-term designs for the peninsula.