

THE MATTER OF THE KAESONG INDUSTRIAL COMPLEX IN THE KOREA-U.S. FREE TRADE AGREEMENT NEGOTIATIONS

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I. Introduction

An issue under discussion in the negotiation of the Korea-U.S. Free Trade Agreement (FTA) is whether items produced in the Kaesong Industrial Complex (henceforth, just “Kaesong”) in North Korea will be subject to preferential treatment under the FTA. The South Korean position is that such items should be eligible for FTA preferences. The U.S. position is that, because Kaesong is located in North Korea, which is not under the effective sovereignty of South Korea and, furthermore, is designated as a “rogue state,” such items should not be thusly eligible. Both sides have, thus far, been quite insistent upon the position they have taken. Some analysts (see especially Schott et al. [2006] and Noland [2006a]) believe that this issue has the potential to be a deal breaker, one that could derail the negotiation or U.S. congressional ratification of an agreement such that the FTA never comes to fruition.

Kaesong is one of three such zones that have been announced in North Korea but is the only of the three to show much signs of life and, also, the only zone whose products South Korea seeks to have included in the FTA.¹ The genesis of Kaesong lies in the Sunshine Policy of former South Korean president Kim Dae-jung, which was meant to improve relations between the two Koreas. The Kaesong complex thus was formally announced in late 2002.² Kaesong is located just north of the border with South Korea and takes its name from a nearby and ancient city that is the burial place of many Korean kings. The complex is directly on the route an army invading the North from the South, or vice versa, would likely take, and straddling the likely invasion routes with a cooperative endeavor between the two Koreas was a deliberate symbolic act. In practice, Kaesong has been developed jointly by the South Korean government and by the Hyundai Asan firm, and it has formally been in operation since late 2004. The role of the government has largely been to subsidize investments there.

Development of the complex has been hampered by the financial difficulties of the Hyundai firm and South Korean government participation has occurred in some measure to compensate for the inability of Hyundai to finance the undertaking. At the current time, the scale of operations is modest but, by 2007, the South Korean government anticipates that some 300 South Korean companies will have operations

1. The other two zones are at Sinuiju on the Chinese border and at Rajin-Songbon in the northeast. Rajin-Songbon has drawn something like \$88 million in investment, but this is a small sum. The area is unfavorably situated and seems unlikely to be developed further. Sinuiju’s development was undertaken by Yang Bin, a Chinese-Dutch tycoon who seems to have in mind to develop a casino-resort complex there, with Chinese money and oriented toward the Chinese market. At last report, Yang was under arrest in China on charges of corruption, and Sinuiju was not being developed.

2. At the same time, the Mt. Kumgang area of North Korea was designated as a special tourist zone and the special administrative region was designated at Sinuiju.

in Kaesong employing as many as 150,000 workers. Noland (2006a) indicates that Kaesong could, if developed as intensively as planned, earn as much as \$1.7 billion per annum for the North Korean government, an amount that, if realized, almost surely would dwarf the revenues to this government from its current illicit activities. However, there has been expressed skepticism in the business press as to whether Kaesong will be developed as fast as the South Korean government has indicated it will be.

That products from Kaesong should be subject to preferential treatment under an FTA in which South Korea participates is not an idea unique to the Korea-U.S. FTA (Schott et al. 2006). Indeed, under an FTA under negotiation between South Korea and the Association of Southeast Asia Nations (ASEAN), products made in Kaesong would be subject to preferential arrangements.

In its essence, the U.S. position is based on political considerations, albeit ones with economic overtones. In a word, the United States believes that to allow FTA preferences for items produced in Kaesong would convey economic benefit to North Korea, which is seen by the United States as a rogue nation that has been attempting to develop nuclear weapons and long-range missiles that (again from a U.S. perspective, at least) would be destabilizing to the world order. Moreover, the United States maintains that the North Korean government has engaged in criminal activity such as the counterfeiting of U.S. currency, drug trafficking, trafficking in prohibited products (for example, animal parts from endangered species), and money laundering.³ In U.S. eyes, nothing then should be undertaken that would convey economic benefit to this state, because economic benefits might then translate into capacity to do further mischief of the sort that North Korea is already engaged in. Thus, the United States has not only signaled that it cannot accept that products from Kaesong be subject to FTA preferences; the U.S. government has, for the most part, shown no enthusiasm whatsoever toward the zone or South Korea's plans for it.

3. On these activities, see Noland (2006a) and Asher (2005). Noland notes that North Korea has long engaged in such activities but that they were stepped up during the mid-1990s when the North Korean state began experiencing severe economic difficulties, including cessation of aid that previously had been received from then-socialist countries, and food shortages that led to famine conditions. It is not known how much revenue North Korea derives from these activities, but a U.S. government estimate in 2001 was that these revenues are about \$560 million a year; Noland stresses that this number is subject to considerable uncertainty, and he implies that the number is likely on the high side. Moreover, there is some evidence that, since the late 1990s, illicit trafficking by North Korea has become "privatized" such that the revenues from at least some of this trafficking do not accrue to the government there. One thing that is clear is, if Kaesong were to be successful, it would seem highly likely that revenues from Kaesong to the North Korea government then would greatly surpass those from illicit activities. This in turn suggests that some sort of bargain whereby North Korea would cease its illicit activities in exchange for some sort of U.S. acceptance of Kaesong might be possible. See conclusion of this article.

The U.S. stance in this matter is consistent with U.S. policy applied to other nations whose governments are seen as pariahs or rogue states. Typical U.S. policy toward such states has included application of economic sanctions, which come down mostly to bans on trade between these states and the United States. The United States currently maintains economic sanctions against North Korea as well as a number of other nations, including Burma (Myanmar), Syria, Cuba, and Iran. A point that has been made is that these sanctions have accumulated a poor record of achieving what presumably is their goal, notably alteration of the behavior of the nation in question or regime change in the nation, or both (Hufbauer, Schott, and Elliott 1990). A number of analysts, including Hufbauer, Schott, and Elliott (1990) argue that U.S. sanctions have enabled dictatorial regimes actually to intensify their hold on the nations noted above, because the regimes have been able to point to the sanctions, rather than their own failings, as the source of poor economic performance by these nations.

In addition, U.S. analysts note that inclusion of products produced in Kaesong under FTA preferences would raise concerns regarding treatment of labor. Noland (2006a) notes that these concerns are of two types, substantive and procedural. Substantive concerns center on the fact that North Korea does not adhere to core labor standards as per the International Labor Organization (ILO). Such concerns have been addressed in other FTAs negotiated by the United States but also have, in some cases, led to difficulties obtaining passage of the required enabling legislation from the U.S. Congress.⁴ Procedural concerns center on the fact that, even if the FTA were to include language so as to bring Kaesong into conformity with ILO standards, neither the United States nor South Korea would be in a position to enforce such standards. On the labor issue, South Koreans have retorted that the United States trades with Vietnam and China and that wages in Kaesong would not be lower than those paid in the export sectors in Vietnam or parts of China and, moreover, labor conditions are generally as favorable in Kaesong as in these nations. The U.S. counterretort has that, even though the United States might trade with these nations, the U.S. government is not considering entering into FTAs with Vietnam or China, and one reason for U.S. reluctance to consider such agreements is concern over labor-related issues.

South Korea's position regarding Kaesong is that, if a high degree of economic success were to be achieved in this zone, this success would have the potential to induce the North Korean state to alter its behavior so as to comport better with international standards than currently is the case. A high degree of economic success, the South Korean government believes, is more likely to be achieved if output of the Kaesong special economic zone (SEZ) were to be granted preferences under the Korea-U.S.

4. This was especially so with respect to the U.S. FTA with Central America (CAFTA), the enabling legislation for which only marginally passed in both the U.S. House of Representatives and the U.S. Senate.

FTA than if not. Moreover, South Koreans argue that if the South Korean position were to be proved correct, that is, if a success at Kaesong were to lead to a changed behavior of North Korea, this outcome would concord with U.S. policy aims with respect to North Korea. After all, above all else, the U.S. goal with respect to the North Korean state is for it to cease its rogue activities.

The main objective of this paper thus is to probe whether there is any basis for believing that the South Korean position might in fact be correct, notably that an economic success in Kaesong could trigger a constructive transformation in North Korea. The reader should note the use of the word “probe”; the author is not presumptuous enough to claim to be able to answer the implicit question: Is the U.S. or the South Korean position the correct one? Rather, all that is meant here is to explore the issue of whether the South Korean position has any merit.

The main reason, in fact, to believe that the South Korean position indeed is of merit is simply this: The success of SEZs in China, a country that neighbors both South and North Korea, during the past two decades or so did eventually lead to (or at least significantly contribute to) a major change in the international behavior of that country.⁵ Four SEZs were designated in a number of locations in China during 1980 under circumstances to be described later in this paper, and a fifth SEZ was created in 1988. In addition, 14 coastal cities were in 1984 designated as “economic and technical development zones” (ETDZs), essentially becoming additional SEZs albeit that, while most privileges granted to exporters in the SEZs were also granted to exporters in the ETDZs, the latter did not benefit from all privileges granted to the former. By most (but not all) criteria the SEZs and the ETDZs were quite successful, indeed so much so that, in announcing a number of important reforms in China in 1992, then-premier Deng Xiaoping cited the prosperity being created in and around these zones as the major reason for the reforms. Following implementation of these reforms, there was a notable surge of economic growth that began during the early to mid-1990s and has continued into the first decade of the 2000s. Moreover, much of the growth in China continues to take place in and around the zones.

Moreover, during the 30 or so years between the end of the Cultural Revolution in China and the accession of China to membership in the World Trade Organization (WTO), the international behavior of this country has clearly changed markedly. From the late 1950s through the early 1970s, a goal of China was to export Maoist-Marxist revolution to developing nations around the world and, during these years, China might fairly have been branded as a rogue nation, as is North Korea today. Similar to North

5. Moreover, a number of authors have suggested that the Chinese experience is what induced North Korea's leadership, up to and including the head of state, Kim Jong-il, to allow the zones to be established.

Korea today, the Chinese military then exercised a pervasive influence over the policy and conduct of the country. But, since sometime in the 1970s, the goal of China to export revolution ceased to be operational, the scope of influence of the military on national policy has been reduced, and in most regards China has become a “good world citizen.”

One can, however, argue about causality: Did China’s abandoning its goal of exporting revolution come about as an effect of the SEZs and the ensuing economic growth? Or was it the other way around: By abandoning rogue-nation behavior did China make itself, in some sense, ready for the SEZs and the economic growth and rising prosperity that followed? This last question is in fact quite difficult to answer, but it is a rather crucial question if China is to be seen as a model for how and why North Korea might come out of rogue-nation status and whether Kaesong is likely to play a definitive role in such a change of status. The timing of events as depicted above in fact would indicate that China ceased being, in any true sense, a rogue nation prior to the establishment of the SEZs. However, it is arguable that well into the 1980s and even into the 1990s, there remained important factions within the Chinese leadership that were backed by the military and that would have continued to “export revolution” but whose voices diminished as economic growth took hold in China. Thus, in the pages that follow, the question of the extent that the SEZs contributed to China’s moving away from export of revolution is explored, but, alas, at the end of the day, a definitive answer proves elusive.

An even more basic question is as follows: Is it likely that Kaesong has the potential to do economically for North Korea what the SEZs did for China, that is, to foster reforms that lead to high economic growth and rising prosperity? On this question, in fact, the available evidence with regard to the success of export processing zones in fostering economic development in countries other than China is somewhat discouraging (see, for example, Madani [1998]); indeed, China seems in many ways to be a singular case. However, the case can be made that a successful experience with export processing facilities (*maquiladora*) also occurred in Mexico during the 1970s and 1980s.⁶ This experience helped propel Mexico toward adopting important economic reforms and also paved the way for Mexico’s seeking to enter into an FTA with the United States, what now is the North American Free Trade Agreement (NAFTA) (Hufbauer and Schott 1992). Export processing zones in Vietnam have also proved quite successful, and this success might lead to further economic reform there, although in this case probably only time will tell. Thus, while the case of China is in some ways

6. The Mexican *maquiladora* were, as indicated, export processing facilities and not export processing zones. However, these facilities received preferences typical of those received by enterprises operating in export processing zones.

