

INTER-KOREAN ECONOMIC RELATIONSHIP AND ITS PROSPECTS: POLICY IMPLICATIONS

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Evaluating the trends of inter-Korean economic cooperation since 1989, North Korea had succeeded in earning its desperately needed foreign currency relying on exporting their primary products to South Korea and processing on commission trade while South Korea had 'qualitative' advantages in terms of political, social and military dimensions, e.g., relaxation from worrying about an outbreak of war and some progress in the South-North relationship. To expand and deepen inter-Korean economic relations in the future, the South needs to seek ideas for becoming a 'partner' of North Korea's economic reform and opening by having North Korea change its economic policy toward South Korea. For the purpose, South Korea needs to rearrange roles and functions of government and private business by separating channels for inter-Korean economic cooperation, i.e., government-level cooperation projects and those for profit-pursuing by private firms. Government-level cooperation projects should be designed to assist North Korea's economic reform and opening or to reduce political and military tensions in the peninsula while civilian firms pursue economic benefits. The government-level plan for economic cooperation should

be focused on inducing North Korea to reform its economic system and on assisting projects by private business in an indirect way. In addition, inter-Korean economic cooperation at the level of private sector should be thoroughly in pursuit of profits and carried out by the business-like manner in conformity with international economic order and practice. South and North Korean participants in economic cooperation projects should take responsibilities together for the success or failure of their businesses, and it is necessary to make it a norm for their decision-making.

Introduction

The North-South Korean relationship seemed on the verge of dramatic progress last year as the Korean peninsula and the world witnessed a series of inter-Korean contacts—the landmark South-North Summit Meeting, the June 15 Joint Declaration, reunions of family members separated by the Korean War and continued South-North talks. This seemingly ever-mounting zeal for closer relations became lukewarm this year. After a period of procrastination, the inter-Korean ministerial talks resumed in Seoul from September 15 to 18, 2001 in an attempt to reach a new breakthrough in South-North relations. During this 5th round of minister-level talks, the two sides agreed to continue with the exchange visits of separated family members and ministerial talks. They also agreed on nine economic cooperation projects, which cast a new light on the future South-North economic exchanges. Nevertheless, at the sixth round of minister-level talks held in Mt. Kungang area between November 9-14, 2001, the inter-Korean relationship returned to a stalemate.

Economic cooperation had been perceived as a concrete goal for the

South Korean government's engagement policy toward North Korea. In this sense, any change in the inter-Korean economic relationship would be predictive of the future direction in the relationship between the two Koreas. The government and private businesses have primarily motivated the South-North economic relations. The policies of the U.S., China and other major neighboring countries toward North Korea also affected their relations. When one examines the changes in South-North economic relations, it seems that the scale and scope of economic cooperation has been mainly determined by economic factors, including the economic situations of two Koreas.

The volume of South-North trade steadily increased in the 1990s - even when North Korea's nuclear development program caused military tensions on the Korean peninsula. The channels of economic cooperation diversified into investment in North Korea, processing-on-commission trade and Mt. Kumgang tourism program. This extension, however, has been obstructed by economic difficulties in North Korea and the Asian financial crisis, as well as prolonged economic stagnation in South Korea. High transaction costs produced by the special South-North relationship, uncertainty and risk factors are other obstacles to a continuous expansion of South-North economic cooperation.

Disregarding the KEDO light-water reactor project, Mt. Kumgang tourism project and humanitarian aid, the scale of South-North trade for commercial purposes has hovered around US\$250 million over the last 3-4 years. Investment in North Korea has failed to make any outstanding progress. In November of 2000, South and North Korea agreed to prepare institutional devices (such as investment guarantees, a double taxation avoidance agreement, and procedures for dispute settlement and the clearance of accounts) to create a stable business environment. However, this legal framework has not yet come into effect because follow-up measures were not taken. To expand and strengthen South-North economic relations in the future, the institutional devices agreed upon by the two sides should go into effect as

soon as possible. Additionally, other obstacles - high transaction costs, uncertainty and other risk premiums - should also be eliminated. In the long run, the construction of a peace system on the Korean peninsula is vital for inter-Korean economic promotion. This paper is designed to analyze the current South-North economic relationship, to review related environmental factors, to provide prospects for the future and seek some policy implications for the desirable development of bilateral relations.

Current South-North Korean Economic Relations

At the end of the Cold War in late 1980s, the communist nations of Eastern European bloc reshaped their political systems. Amid this new development, South-North Korean economic exchanges and cooperation attempted to open a new chapter in a history of the inter-Korean relationship. This effort was maintained and expanded constantly, even when the peninsula fell into political or military conflict. In the final analysis, economics has become one of the most important determining factors in the inter-Korean relationship.

Inter-Korean trade

South-North Korean economic relations still largely depend on trade. Despite fluctuating political-military relations, the volume of trade and the number of participating companies have been both on a steady rise. In 2000, 652 companies were engaged in inter-Korean trade, and 647 items were exported or imported. South Korea became the second largest destination for exports as well as the third largest trading partner of North Korea. Key items imported by South Korea from North Korea are agricultural, forest and fishery products (47.2% of the total imports in 2000) while items exported to North Korea are

Inter-Korean Trade Volume: 1989-2001¹

Units: Millions of US Dollars

Year	Imports	Processing-on-commission	Exports	Processing-on-commission	Total Trade
1989	118.655	-	0.069	-	18.724
1990	12.278	-	1.188	-	13.466
1991	105.719	-	5.547	-	111.266
1992	162.863	0.683	10.563	0.200	173.426
1993	178.167	2.985	8.425	4.023	186.592
1994	176.298	14.321	18.249	11.343	194.547
1995	222.855	21.174	64.436	24.718	287.291
1996	182.400	36.238	69.639	38.164	252.039
1997	193.069	42.894	115.270	36.175	308.339
1998	92.264	41.371	129.679	29.617	221.943
1999	121.604	53.736	211.832	45.883	333.437
2000	152.373	71.966	272.755	57.224	425.148
2001 (Jan.-Sep.)	109.970	45.937	181.137	40.771	291.107

Source: Ministry of Unification

primary materials, intermediate products for processing-on-commission trade and other items.

Inter-Korean trade volume in 2000 was US\$425.15 million, marking the highest on record. But after excluding non-business trade related to Mt. Kumgang tourism project, light-water reactor project and humanitarian aid, the volume of business trade amounted to US\$244.24 million, similar to that of 1997.² As for the balance of trade, South Korea has continued to run a deficit with the North (deficits accumulated by the end of 2000 were about US\$1.2 billion). The survey also found that

1 The figure for 1995 excluded aid (150,000 tons valued at US\$237,713,000) to North Korea.

2 Business trade includes commercial trade and trade-on-commission.

only a few companies have been participating in South-North trade for a long period of time.

Processing-on-commission trade began in 1992, and since then, it has grown sharply, accounting for 27.1% of the total inter-Korean trade volume and 52.9% of the inter-Korean commercial trade volume in 2000. The rapid increase in processing-on-commission trade is attributed to its attractiveness to both sides. That is, North Korea can block an inflow of information from South Korea effectively because the production process is under the control. In addition, North Korea can easily earn foreign currency by utilizing idle facilities and labor. Meanwhile, South Korean companies have the advantage of using less expensive North Korean labor without risking large-scale investment. In processing-on-commission trade, textiles and related products make up the bulk of trade, taking up 64.1% of exports and 74.3% of imports in 2000.

Recently, processing-on-commission trade has diversified into higher value added electronic products. Since the introduction of processing-on-commission trade, the number of companies participating in this business grew steadily, totaling 151 in 2000, but most of them have not yet earned profits. Only a few companies with accumulated experience earned from long-term projects have managed to just break even or post a small profit from such trade. As for companies assembling electronic goods in North Korea, most of these businesses do not yet earn profits, though a few have been able to achieve the profitability by boosting productivity through efficient processing management and technical guidance.

South Korea's investment and humanitarian aid

Direct investment by South Korean companies to North Korea is still very low. By June 2001, 41 companies obtained an approval to be

economic cooperation project proprietors, but only 18 projects were permitted. Of these, only 10 projects are currently underway. Excluding the four projects related to the light-water reactor construction project, three projects (conducted by Baeksan Ind., Dooray Village, and Aja Communication) out of 18 approved were suspended, and one (led by Hyundai Electronics, KT, and Onse Telecom) was completed. Currently, only eight projects are in operation, including Daewoo's Nampo plant (operation in suspension), Hyundai's Mt. Kumgang tourism project, Taechang's Mt. Kumgang spring water project (import in suspension), and projects led by Green Cross Corporation, International Corn Foundation, Korea Land, Peace Motors, and Samsung Electronics. The profitability of these projects is uncertain. Mihung Food and Taehung Fisheries/LG discontinued their projects after making initial investments.

After the South-North summit meeting in June of 2000, South and North Korea agreed to reconnect the inter-Korean Seoul-Shinuiju Railway that runs from Munsan in the South to Kaesong in the North. The reconstruction of the Northern section of cross-border railway is currently suspended, following South Korea's rejection on North Korea's request for electric power, and no further progress has been made owing to technical problems and stalled South-North relations. During inter-Korean ministerial talks held in Seoul between September 15-18, 2001, representatives from the two nations discussed the early restoration of cross-border Seoul-Shinuiju Railway and ways to link the infrastructures of North and South Korea. To materialize these projects considerable time, lengthy discussions will be needed.

Meanwhile, humanitarian aid provided by the government of South Korea and the private sector has relieved, to some extent, the prolonged food shortage that has been plaguing North Korea since the mid 1990s. This effort plays a key axis in the process of improvement in the South-North relationship. The South's governmental support to North Korea began in 1995 with 150,000 tons of rice produced in South

Korea (at prices higher than international market rates). The aid given to North Korea by the government reached US\$449.67 million by the end of June 2001, while private organizations provided aid worth US\$134.87 million. The total value of aid sent to North Korea is estimated at about US\$600 million.

Evaluation of South-North Economic Relations

Inter-Korean economic cooperation, largely dependent on trade businesses, has been conducted since 1989 by two channels: trade and investment by the private sector for economic benefits and aid by the government for political and humanitarian reasons. Trade by private companies has continued to expand regardless of political and military tensions. Economic exchanges by the private sector, coupled with aid provided by the government, have kept the South-North relationship from worsening. For instance, a naval battle that occurred in West Sea in the midst of tourism to Mt. Kumgang, was soon settled without any prolonged conflicts between Seoul and Pyongyang. This is a good example of how expanded South-North economic cooperation relieves political and military tension between the two states.

The expanded inter-Korean economic cooperation also contributed to enhancing international confidence in South Korea's economy by reducing its country risk related to unstable inter-Korean relations. For the North, the inflow of foreign currency from inter-Korean trade and tourism to Mt. Kumgang contributed to maintaining and partially rehabilitating its economy. However, the unique South-North Korean relationship is an obstacle to further development of economic relations. The relationship produces high trade costs since most transactions between two sides are made indirectly via third countries, and the relationship is uncertain. Restricted communication and visits make it impossible for companies to perform effective business activi-

ties. The 'Law on South-North Korean Exchanges and Cooperation' was passed to promote and encourage inter-Korean exchanges and cooperation. The Law, however, needs to be amended or supplemented to live up to changes in the South-North relationship. The verbose commission article and the application article, in particular, need to be substituted by concrete and detailed legal contents. It is urgent that the law be amended to remove any possibility of conflict with existing legislation and to make the statute identify inter-Korean economic relationship as domestic commerce.

The North Korean government has more serious problems. It has revised or legislated laws and regulations to induce foreign capital since it began to implement the development plan for the Najin-Sonbong area. However, it still maintains strict administrative control and does not allow economic linkage between the free trade area and domestic economy. Moreover, ambiguous laws and regulations pertinent to South-North Korean economic cooperation need to be clarified. All these obstacles must be removed as soon as possible to advance inter-Korean economic exchange and cooperation. To make matters worse, the economic system of North Korea does not guarantee free business activities. For this reason, it is doubtful whether North Korea will actually apply the formal legal system guaranteeing investment that was agreed upon by the two Koreas.

There is yet another limitation to the development of economic integration. The politically constrained South-North Korean relationship makes it hard to separate the role of the government from that of the private sector. Due to this ambiguity, it is difficult for South Korean businesses to follow the principle of profitable South-North economic cooperation. This is an obstacle to expanding and deepening inter-Korean economic cooperation based on economic feasibility. To expand profit-motivated inter-Korean trade, including trade for processing-on-commission, and to develop comparative advantages of the two economies, first priorities should be to increase the amount of

investment by South Korean companies in North Korea and to create a profitable business model for South Korean firms.

Nonetheless, few incentives exist to expand investment due to excessive transaction costs and restrictions imposed on inter-Korean economic exchanges by North Korea's unique system. For instance, Mt. Kumgang tourism project, which was the South's first full-fledged large-scale investment to North Korea, faces an uncertain future. The profitability of the project is not discussed in the contract, signed by both parties. North Korea seems to view the tourism project only as a way to earn foreign currency. In addition, opening a land route to North Korea, which is regarded as critical to the profitability of the project, seems in doubt.

South-North economic cooperation has depended on trade, and no other large-scale direct investment, except for Mt. Kumgang tourism project, has been made. Since the scale of its investment is quite limited, South Korea has paid a negligible opportunity cost in economic terms compared to the size of its economy. However, its influence on North Korea's economy through foreign currency flows and humanitarian aid has been positive. To some extent, the South's economic support for the North has also had positive ripple effects on the inter-Korean relationship in political, military and social dimensions. Despite its positiveness, a negative effect of an ambiguous role of the private sector and of the government in economic cooperation must also be noted. That is, pushing economic cooperation projects without regard to their economic feasibility in the transitional period made it hard for the South Korean business to create a profit model, which has far-reaching implications for the North's policy toward the South.

Changes in North Korean Economic Policies

In a New Year's editorial appeared in the official North Korean

newspaper in the year 2001, the leadership disclosed its resolution for the year as, "There is no more important task than solidifying national economic power." The editorial made clear that the government would put every effort into developing the economy to mark the age of its new leader, Kim Jong-Il. North Korea also stressed the need to promote 'national economic power' as a prerequisite to building a strong nation. In the meantime, Kim Jong-Il praised the outcome of China's economic reforms during his visit to China from January 15 to 20, 2001. The compliment was an indirect expression of the North Korean leader's will to expedite change in economic policies even though it would differ from that of China. Recently, North Korea has suggested a somewhat new ideological orientation that emphasizes 'new thinking and efficiency of working' to overcome limitations imposed by its system.

With regard to the North's economic system, the revision of its constitution in September 1998 can be seen as a beginning of the Kim Jong-Il regime. It extended the area where collective ownership is allowed - as a form of loose public one - to non-agricultural sectors and stipulates the residents' freedom of residence and travel. The new constitution, in terms of economic relations with foreign countries, demonstrates North Korea's conversion, such as slightly liberalized rules for international trade and the legalization of 100% foreign-invested companies in special economic zones.

North Korea is believed to be aware of the problems facing the Najin-Sonbong special economic zone such as unrealistic policies governing the free trade zone and a poor investment environment. Recently, the North has tried to readjust the role of Najin-Sonbong as a manufacturing, international trade and financial center different from originally planned to be as a simple transshipment center and base for tourism. In other words, North Korea is now focusing on businesses that can produce tangible results in a relatively short period of time.

North Korea's diplomatic push to solicit economic assistance from

the international community has been successful to some extent, but it has increased the North's economic dependence toward the outside world for food and energy. Recently, North Korea is seen recovering from the terrible economic situation in the mid 90s, and its leaders are deemed to be free from the systemic crisis that originated from economic difficulties. Nevertheless, radical policy changes are not tolerated as political power is centered on Kim Jong-Il, and he believes that any revolutionary reform policy disconnected from the past could threaten his regime. This belief might hinder North Korea's adoption of Chinese-style market-oriented reforms, and will be a major obstacle to economic reform. Kim Jong-Il's policy, as distinguished from that of his father, has been apparent since 1998. Since economic recovery is a necessary condition for Kim Jong-Il to be accepted as a legitimate successor to Kim Il-Sung by the North Korean people, Kim's regime is expected to adopt some progressive measures to reshape its ailing economy.

It is possible that in the near future North Korea will try to expand its export markets and to induce advanced foreign technology and capital by improving relations with China and the European Union members. It is also expected to construct an export-oriented processing zone in Shinuiju or other areas in the western part of the country, where some market mechanisms will be allowed. Since the new economic zones for export will largely depend on the Chinese market, Shinuiju is the most likely location. As the inter-Korean relationship progresses, the Nampo and Kaesong industrial complexes will be included.

Even though it is believed that North Korea's economic situation has improved to some extent, food shortages coupled with energy ones will be the most serious obstacles to the development of its economy. North Korea might try to solve the problem of food shortages partly through South-North economic cooperation by extending economic cooperation with the South in some selected sectors. Considering the

possible ripple effects on the political system, Pyongyang will utilize government-level economic relations with Seoul to secure food and energy while economic cooperation with the South's private businesses will be focused on expanding processing-on-commission trade and on attracting cash in exchange for business rights.

Especially, the restoration of cross-border Seoul-Shinuiju Railway, the expansion of tourism to Mt. Kumgang, and the construction of Kaesong industrial complex, while minimizing the possible effects on the North Korea's political system, will be implemented in such a way to secure assistance from South Korea as much as possible. But the realization of such projects will require much more time and patience from the South than initially expected.

North Korea's Relations with Neighboring Countries

The U.S. administration will hold talks with North Korea, but Pyongyang should meet some strict prerequisites for visible improvement of its relations with the US Republican administration. The administration will lift economic sanctions against North Korea and provide economic support for the country only if there are substantive political and economic outcomes. To counteract a reciprocal approach advocated by the U.S. government, North Korea might attempt to sway U.S. public opinion on an engagement policy toward the North by emphasizing Kim Jong-Il's new policies as well as improving diplomatic relations with the EU, holding talks with South Korea.

North Korea and the U.S. are at loggerheads with each other over several outstanding issues, but their relationship will improve gradually as talks resume. If North Korea succeeds in improving its relationship with the EU and in expanding economic cooperation with other western countries, the U.S. will possibly loosen its economic sanctions against North Korea, removing North Korea from the list of nations

that support terrorism and continuing to provide humanitarian aid to Pyongyang.

The most important variable affecting the establishment of a new order in Northeast Asia might be the Chinese-U.S. relations. The concept of control and balance will dominate relations between the two countries, and they will both compete to expand their influence in the region. With China's entry to the WTO, South Korea's share of Western markets might well drop. South Korean firms will attempt to enter the Chinese market to offset any loss of competitiveness in Western markets. South Korea-China relations have two dimensions: competitive and complementary. To maximize the complementary effects, it is vital to combine the factors of production of the two Koreas. China's entry into the WTO could expedite North Korea's reform and opening.

On the other hand, it will take a long time for North Korea and Japan to form a full-fledged friendly relationship, which will be difficult for Pyongyang to rehabilitate its fragile economy using reparations from Japan. Nevertheless, when the North is included in plans to build an infrastructure network for Northeast Asia, e.g., the connection of a trans-continent railway (TSR, TCR), Japan will be able to participate to a limited degree. As North Korea maintains a balanced approach to Russia and China for strategic reason, relations between North Korea and the two giant neighboring countries will improve to a certain extent in the future. But it will be impossible for North Korea to secure a sufficient amount of economic benefits or aid to restore its economy through manipulating a diplomatic relationship with Japan. China will maintain a normal economic relationship after its entry into WTO, and Russia has a limitation in economic capability to expand its political influence on the Korean peninsula by supporting North Korea's economy.

North Korea is expected to create a favorable climate for economic support and stabilization of its political system by improving the relations with China and Russia. At the same time, it will try to induce the

U.S. to convert its agnostic attitude toward North Korea to a friendly one in consciousness of China and Russia. This strategic design was confirmed by Kim Jong-Il's visit to Moscow in August and by Jiang Zhemín's visit to Pyongyang in September of 2001, respectively. Considering delayed North Korea-Japan negotiations in normalizing relationship in addition to negative public opinion in Japan toward North Korea, North Korea has to rely on China and Russia for the realization of its diplomatic strategy. Though North Korea-China and North Korea-Russia relations improve, such relations will contribute limitedly to the revival and development of North Korea's economy in the light of economic and political conditions in China and Russia.

Prospect for South-North Korean Economic Exchanges

To open a new chapter of inter-Korean economic relations in the future, there are some prerequisites: change in North Korea's economic policies, which has been visualized recently to some extent, the North's recovery from economic difficulties, the North's improved relations with neighbor countries, and conducive role of South Korea as an investor. The structural adjustment is an urgent task for countries in Northeast Asia as China enters WTO, and the circumstances require the development of inter-Korean economic relationship as a precondition for the expansion of regional economic cooperation. Actually, potential investment from the South is the only alternative for Pyongyang to raise the needed financial resources to keep up with changes in economic order in Northeast Asia. Nonetheless, the direction for developing South-North economic relations will be determined practically by the conditions of the two sides and the speed of change in the surrounding environment.

Inter-Korean economic cooperation, led by the engagement policy by the South aimed to dissolve the structural legacies of Cold War and

to have the peaceful mood laid root on the Korean peninsula, is presumed to have a goal of forming the South-North economic community. The concept of inter-Korean economic community is designed to pursue joint prosperity through combining factors of production held by both sides while incoherent systems co-exist in two Koreas. This goal is backed up by the June 15th Joint Declaration, longing for balanced development of the national economy. Inter-Korean economic exchange is a cooperative framework and at the same time, a means for maximizing welfare of all Koreans and for constructing the base for reunification by linking South-North industrial structure. Economic linkage between two Koreas can be strengthened by establishing institutional framework for collaborated projects in comprehensive scope—energy, manufacturing, agriculture and fisheries, communication, transportation infrastructure, tourism and international cooperation—and by guaranteeing stability of exchanges and cooperation.

Recently, North Korea is getting through the worst food shortage in its history and longs for relatively practical economic policies. But it looks impossible to normalize the economy by itself. North Korea will have difficulty in inducing foreign capital and in absorbing technology only through improving diplomatic relations with others. Due to fundamental problems resulting from its economic structure such as low operating ratio of industrial sector, the opening policy limited only to some areas, and lack of human capital and needed technology as well as financial resources, it would be difficult, if not impossible, for Pyongyang to exploring the international market without support from outside.

In this respect, it is desirable that the North and South should combine their factors of production to mitigate economic crisis in the North and to maintain the momentum of economic growth in the South. But potential for South-North trade and investment is limited due to insufficient institutional framework. South-North economic relations will have a new momentum for expanding and deepening if the legal and

institutional devices already agreed by both sides go into force.

Reviewing the North's current economic conditions and policies, the South's economic conditions, special features of inter-Korean relationship, and limited economic relations of Pyongyang with neighbor countries, it seems that the only alternative for normalizing the North Korean economy is to strengthen economic ties with Seoul. It is presumed that inter-Korean economic relations will be developed through the following stages: expanding direct and indirect inter-Korean trade including processing-on-commission trade and the implementation of joint projects in accordance with the South-North agreement, expanding investment in North Korea by the South's private business, and combining factors of production in two Koreas. In the process, institutional devices and legal framework will be persistently complemented.

The South and the North might have different criteria for selecting the priority and scale of projects to achieve the 'balanced' development of national economy. But this disparity can be bridged through cooperative feasibility study of relevant project. Considering the North's current economic situation and its meaning as a beginning work for developing inter-Korean economic relations, government-level economic cooperation will take the form of unilateral assistance from the South in an early stage. As inter-Korean relationship progresses, economic aid in kind with focus on selective projects in the area of agriculture and social overhead capital might shift to investment guaranteeing economic efficiencies and persistency.

Looking at the agricultural sector, in the beginning stage, food and raw materials for farming will be provided to relieve the North from serious food shortage, and joint ventures for selected agricultural raw material and farm appliances are likely to be followed. As the cooperation scheme proceeds smoothly, it will be extended to the facilities producing farm appliances and transporting vehicles, research on farming technology, and the facilities for freezing, cold storage, and processing. Collaborated projects in farming could begin with trial cultivation by a

contract or on commission, and target areas and varieties of crop could be expanded. Farm appliances could be provided in kind for contract cultivation and return in harvested crop. To do these, institutional devices need to be implemented for inspection of products, providing technical guidance and handling claims. The inter-Korean land transportation link should be developed for supplying fresh agricultural products in time.

To vitalize North Korea's sagging economy, the South's assistance and investment in social overhead capital are inevitable, and the range of target sectors is broad. Assistance and investment toward North Korean social overhead capital can be provided in a step by step manner for such projects as the reconnection of inter-Korean railway and road transportation system, improvement in the efficiency of power supply system, construction of trans-continental railways connecting the Korean peninsula with Europe via Russia and China, construction of industrial complexes for South Korean companies (Kaesong industrial complex, etc.), and the improvement of transportation capacity in North Korean ports and airports.

The scope and scale of processing-on-commission trade, above all, are expected to grow sharply in the near future as economic exchanges between two Koreas are expanded. Considering the direction of North Korea's policies, the scope of processing-on-commission trade is likely to be extended to the areas such as processing of electric and electronic products as well as agricultural and marine products. If the South supplies production facilities and major parts by land, related institutional framework can be implemented, and trade for processing-on-commission will become the central passage of inter-Korean economic cooperation.

Concluding remarks

Enforced South-North Korean economic relations in the process of the formation of new economic order in Northeast Asia will improve international competitiveness in their economy through complementary combination of factors of production of two Koreas. In the midst of the coexistence of globalism and regionalism in the world economic structure, China's entry to WTO makes it inevitable to reshape an economic cooperation structure in Northeast Asia. To sustain a momentum for growing South Korea's economy and to put North Korea's economy on normal growth path, it is imperative to combine their complementary factors of production and to utilize economies of scale on the peninsula. The inter-Korean economic cooperation, since its start in 1989, has played an important role as a safeguard against political and military conflicts between Pyongyang and Seoul, and has also served as a route for flowing information on North Korea into South Korea, providing the South's people an opportunity to understand the reality of the North. Deepened understanding helped South Korean residents recover sense of national homogeneity and accept differences between two Koreas as they are. Understanding the reality in North Korea, despite the rightfulness of inter-Korean economic cooperation, led public opinion to reckon the profits and losses they might have in the process of inter-Korean economic cooperation.

Up to now, the South-North Korean economic cooperation has been generally pushed in a way to promote their relationship through unilateral imports of North Korean goods and the implementation of supportive projects, rather than serving as a channel for complementary and functional economic cooperation by combining their factors of production. As South Korean economy is under restructuring, from now on, cooperative projects should be selected according to the profitability criteria in relation to a long-term inter-Korean economic development plan in order to sustain the momentum of inter-Korean eco-

conomic cooperation in the future. Such economic aid scheme for the North aimed at humanitarian purposes and political interests for inter-Korean relationship by the government should be implemented separately from investment activities by private companies.

Evaluating the trends in inter-Korean economic cooperation since 1989, North Korea has succeeded in earning its desperately needed foreign currency, relying on exporting their primary products and processing-on-commission trade to South Korea, while South Korea had 'qualitative' advantages in terms of political, social and military dimensions, e.g., relaxation from worrying about an outbreak of war and some progress in the South-North relationship. From the view of current climate and political systems, the scale of inter-Korean trade and direct investment activities will be definitely limited to a certain extent.

To expand and deepen inter-Korean economic relations in the future, the South needs to seek ideas for becoming a 'partner' of North Korea's economic reform and opening by having North Korea change its economic policy toward South Korea. In the past, the North intended to keep limited economic relations for its practical interests without affecting its political and economic system. Since economic relations depending on unilateral supports do not assure the advantages to both sides, it is hard for the South to win public support and to maintain such relations. Creating a profitable business model, backed by North Korea's economic reform, opening and cooperation based on the concept of mutual benefit, is the most important prerequisite for a stable development of inter-Korean economic relations.

The 'balanced development of national economy' through inter-Korean cooperation is intended to resolve the economic dilemma in the North with the South's assistance in short-term and to form the South-North economic community in the long run. Nevertheless, both sides might have incoherent views on the criteria for selecting projects for the balanced development of national economy. Thus, to implement

the project smoothly, a blueprint should be prepared for each stage of economic cooperation in the consideration of North Korea's acceptability, support of the South's public opinion, economic feasibility of the project, possibility of raising needed financial resources, and the role of the Korean peninsula's economy in the new economic order in North-east Asia. For the blueprints to be materialized, of course, agreement and cooperation must be obtained from North Korea.

For the purpose, South Korea needs to rearrange roles and functions of government and private business by separating channels for inter-Korean economic cooperation, i.e., government-level cooperation projects and those for profit-pursuing by private firms.³ Government-level cooperation projects should be designed to assist North Korea's economic reform and opening or to reduce political and military tensions on the peninsula, while civilian firms pursue economic benefits. The government-level plan for economic cooperation should be focused on inducing North Korea to reform its economic system and on assisting projects by private business in an indirect way.

To implement the idea, an environment should be created for North Korea to reduce its political and economic costs, due to reform and opening, and to maximize advantages from changes. For instance, South Korea might support the development of North Korea's reform and opening program, which is able to minimize negative economic effects. In the process of preparing such a program, it can cooperate with neighboring countries and international organizations. South Korea also needs to prepare the criteria for judging North Korea's

3 We can consider the South Korean government's direct assistance for private business involved in inter-Korean economic exchange. But the gap in the quality and quantity of information held by businessmen and government agencies may cause principal and agent problems which may make impossible for the effective use of the government assistance for inter-Korean exchange. To prevent this, an effective evaluation system is necessary but under the special circumstances relating to North and South Korea, it seems very difficult to secure objective evaluation systems and methods.

reform and opening, which are indispensable to win support from public opinion. If North Korea's changes meet the criteria, the South should assist the North for reform and opening by raising financial resources and by developing ideas for the reform policies.

South and the North Korea need to have their agreement in investment guarantee, double taxation prevention, dispute settlement and clearance of accounts, going into effective as early as possible in order to create an institutional environment to cut down tangible and intangible transaction costs related to economic exchanges among them. It is urgent to design a policy for North Korea to help North Korean leaders change their belief that reform and opening can shake the North Korean political system.

Another important task is to prepare ideas for cooperating with neighboring countries. Inter-Korean economic cooperation at the level of private sector should be thoroughly in pursuit of profits and carried out by the business-like manner in conformity with international economic order and practice. South and North participants in economic cooperative projects should take the responsibilities together for the success or failure of their businesses, which will be necessary to make it a norm for their decision-making.