

Foreign Firms Investment in Inter-Korean Economic Cooperation

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I. Introduction

The issue of foreign firms' participation in inter-Korean economic cooperation was reviewed in this study, along with discussions on the internationalization of the Kaesong Industrial Complex in 2005–2016. While these failed to produce practical results at the time, if the denuclearization and sanctions against North Korea realize meaningful progress, then it is highly likely that foreign firms' participation in inter-Korean economic cooperation will become an issue.

This paper examines various channels and issues for foreign firms to invest in inter-Korean economic cooperation with the assumption that inter-Korean economic cooperation can be resumed after sanctions against North Korea have been lifted, and the same treatment is applied to foreign firms.

II. Economic Incentives and Institutional Environment for Foreign Firms to Invest in Inter-Korean Economic Cooperation

1. Economic Incentives

Foreign firms asked the South Korean government to allow them to set up a business in the Kaesong Industrial Complex, because investment in the Kaesong Industrial Complex provided high profits. The South and North Korean governments worked closely together to construct the Kaesong Industrial Complex and establish an institutional basis for obtaining stable profits. Therefore, if foreign firms' participation in inter-Korean economic cooperation is considered in the future, the biggest incentive will be the high profits of foreign firms.

During the period of active inter-Korean economic cooperation, from 2005 to 2008, foreign firms showed interest in the Kaesong Industrial

Complex because of ① reduction in production costs, especially labor costs; ② early advancement into North Korea's domestic market; and ③ preferential treatment of financial services by investment banks. In 2008, PRETTL, a foreign auto parts and home appliance manufacturing firm, received permission to build a factory in the Kaesong Industrial Complex and purchased the site, but failed to actually build a factory within the Kaesong Industrial Complex. In addition, according to media reports, from 2013 to 2016, Bosch (electric power equipment), Audi (automobile), Continental (tire), Daimler (auto parts), Schenker (logistics), Deutsche Bank (finance), KTR Systems (auto parts), among others, visited the Kaesong Industrial Complex.

In addition, the participation of foreign firms in inter-Korean economic cooperation is expected to make a positive contribution to the stability of inter-Korean economic cooperation. If only South Korean firms participate in the Kaesong Industrial Complex, the conflict between the two Koreas will affect the operation of the Kaesong Industrial Complex. However, if firms of various nationalities participate in the Kaesong Industrial Complex, an escalation in political conflict between the two Koreas could possibly not lead to direct shutdown of the Kaesong Industrial Complex. Therefore, the participation of foreign firms in the Kaesong Industrial Complex will promote the stable operation of the Kaesong Industrial Complex. An increase in economic exchanges will lead to the establishment of peace on the Korean Peninsula.

2 Institutional Environment

When foreign firms invest in inter-Korean economic cooperation projects, they are guaranteed to benefit from various preferential investment policies provided by the South Korean government.

First, the production infrastructure of the Kaesong Industrial Complex is made available. As soon as a firm moves into the complex, they are able to use the high-quality factory site, water and sewage, and electric power services that are ready for production. The infrastructure of the Kaesong Industrial Complex surpasses anywhere else in North Korea. Therefore, when foreign firms invest in the Kaesong Industrial Complex, they can take advantage of North Korea's low labor costs and land rental costs, as well as South Korea's skilled industrial complex operation services.

Second, a stable supply of North Korean labor becomes available, and the North and South Korean governments have agreed on a monthly wage of about \$150. The wage increase rate is also stable every year. The union does not engage in strike or sabotage.

Third, foreign firms can receive support from the Inter-Korean Cooperation Fund. When a firm invests in the Kaesong Industrial Complex, the South-North Cooperation Fund supports a certain portion of this investment. In addition, if inter-Korean relations deteriorate and the investment in the Kaesong Industrial Complex incurs losses, these will be compensated through insur-

ance guaranteed by the Inter-Korean Cooperation Fund. When the Kaesong Industrial Complex was shut down in 2016, most of the firms that invested in the Kaesong Industrial Complex received damages.

Fourth, goods produced at the Kaesong Industrial Complex do not have to pay tariffs when brought into South Korea, in accordance with the tariff-free principle agreed between the two Koreas. If products produced in the Kaesong Industrial Complex are exported abroad, the South Korean government and foreign governments can benefit from the Outward Processing Zone (OPZ) agreed upon in the FTA, and most tariff rates are zero or close to zero.

Of course, there were downsides as well.

First, foreign firms looking to invest in inter-Korean economic cooperation projects answered that they had difficulties in acquiring information.

Second, there was the problem that the Park Geun-hye administration's efforts to attract foreign firms' investment into the Kaesong Industrial Complex violated the previous government's 5.24 Measures. If a foreign firm invests in the Kaesong Industrial Complex, this would violate the 5.24 Measures, as they prohibit further investment in North Korea until North Korea apologizes for the inter-Korean military conflict.

Third, foreign firms prefer to invest directly in the Kaesong Industrial Complex, rather than es-

ablishing a branch in South Korea first and then investing through the branch.

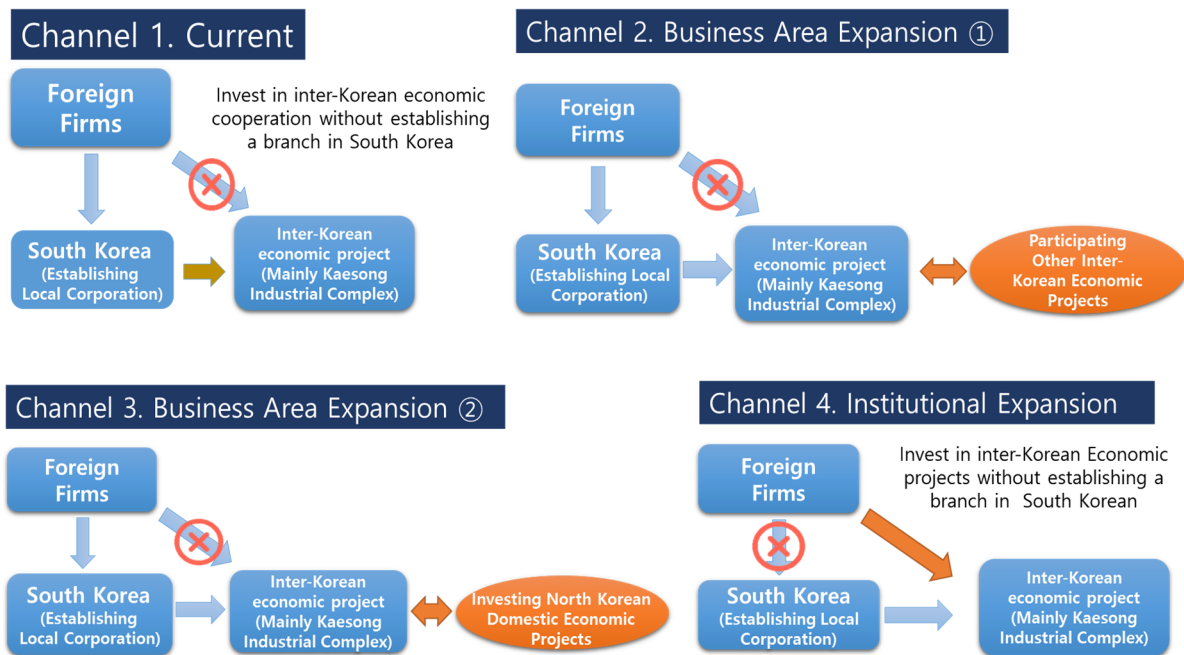
Fourth, the Wassenaar Arrangement allowed only simple processing industries to advance, and regulated the entry of secondary and tertiary industries into the Kaesong Industrial Complex.

Fifth, the poor communication infrastructure in the Kaesong Industrial Complex also hindered the investment of foreign firms.

III. Channels and Issues for Foreign Firms to Participate in Inter-Korean Economic Cooperation

As foreign firms become more active in inter-Korean economic cooperation, various investment channels will be created. The South Korean government prefers to make investments in North Korea via South Korea, and provides various institutional incentives to encourage this. Therefore, the current channel for foreign firms to invest in inter-Korean economic cooperation projects is to establish a branch in South Korea and then invest in the Kaesong Industrial Complex. However, foreign firms prefer to invest directly in North Korea without going through South Korea, and to invest in areas other than the Kaesong Industrial Complex. Also, in both cases, foreign firms want guarantees of the preferential investment benefits that the South Korean government provided to the Kaesong Industrial Complex. Considering this point, a total of four investment channels can be created.

Figure 1. Various Channels for Foreign Firms to Participate in Inter-Korean Economic Cooperation Projects: Current and Expansion



The first channel is for foreign firms to establish branches in South Korea and invest in the Kaesong Industrial Complex. Foreign firms cannot directly invest in the Kaesong Industrial Complex or other economic cooperation projects, as the South Korean government does not allow this by law. If a foreign firm invests in the Kaesong Industrial Complex via South Korea, the investment is made by a South Korean branch and can be regarded as a South Korean firm's investment in North Korea. Therefore, foreign firms can also receive financial support from the South Korean government for firms investing in the Kaesong Industrial Complex. However, if a foreign firm directly invests in the Kaesong Industrial Complex without going through South Korea, it will no longer be a South Korean firm and will not be able to receive the preferential

benefits guaranteed by the South Korean government. In this case, if a dispute arises in North Korea, the firm must directly negotiate with the North Korean government to resolve it.

In the second channel, foreign firms establish a branch in South Korea to invest in the Kaesong Industrial Complex, and invest the products produced in the Gaeseong Industrial Complex in other economic cooperation projects. Currently, there is no inter-Korean economic cooperation project other than the Kaesong Industrial Complex, so this investment channel is not feasible. However, if there are more inter-Korean economic cooperation projects in the near future, permission for the second channel will be considered. Products produced by the inter-Korean economic cooperation project cannot be sold in

North Korea, so their impact on the North Korean economy is limited.

The third channel is for foreign firms to invest in North Korea's domestic industry, after establishing a branch in South Korea and investing in the Kaesong Industrial Complex. This method will have a direct impact on the North Korean economy through investment in the domestic industry, so it will be possible to pursue it after the North Korean economy has grown to some extent. North Korea is very cautious about the entry of foreign firms into the North Korean domestic industry.

The fourth channel is to allow foreign firms to directly invest in inter-Korean economic cooperation projects without establishing a branch in South Korea. As the inter-Korean economic cooperation relationship grows, if North Korea provides institutional guarantees for foreign investment, there is no need to have foreign firms establish branches in South Korea and invest in the Kaesong Industrial Complex.

IV. Conclusion

As the environment surrounding inter-Korean economic cooperation is rapidly changing, a new way of inter-Korean economic cooperation is needed to maintain stable inter-Korean relations. Inter-Korean economic cooperation was active from 2005 to 2010, but there was almost no inter-Korean economic cooperation for 12 years (2010-2022). The economic environment has changed a lot in the past 12 years. As the strategic conflict between China and the United

States intensifies, the emergence of economic blocs is also becoming more pronounced. As protectionism is on the rise, the diversification of overseas production bases is also being promoted.

However, it will be difficult for the two Koreas to achieve integration if they fall into this trend of expanding economic blocs and protectionism. In order to respond to these environmental changes, the method of inter-Korean economic cooperation must also change from limited cooperation between the two Koreas to cooperation with the international community. Only with the international community can we receive the international community's support for inter-Korean economic cooperation. Foreign firms' investment in inter-Korean economic cooperation projects will become a new way for inter-Korean cooperation.

There are two principles in inter-Korean economic cooperation projects: the special relationship and the general relationship. A special relationship means providing economic benefits to each other to promote unification. Because of the economic preferential treatment, the two Koreas will cooperate more and the reunification of the two Koreas will be achieved faster. The general relationship indicates that no economic preference should be given to the two Koreas in inter-Korean economic cooperation, and all firms participating in the project will receive the same treatment regardless of nationality. If general relations are emphasized in inter-Korean economic cooperation projects, foreign firms will be able to participate in inter-Korean economic cooperation projects without any major

obstacles. As foreign firms participate, support for the establishment of peace on the Korean Peninsula and economic integration between the two Koreas will grow.

Inter-Korean economic cooperation projects must accommodate both the special relationship pursued by the two Koreas for unification and the general relationship, in which North Korea is seen as a member of the international community. However, institutionally reconciling the two is not easy. If the priorities of the two relationships are to be determined, the special relationship should be promoted first, and the general relationship should be promoted later.

The South Korean government should prioritize the special relationship between the two Koreas. This special relationship will serve to promote rapid economic integration between the two Koreas. North and South Korea cannot achieve unification without respecting their special relationship. However, when inter-Korean economic cooperation grows beyond a certain level, the overall relationship begins to be emphasized. This is because it is impossible to gain the international community's support for the unification of the two Koreas without emphasizing general relations.

Therefore, foreign firms' investment in inter-Korean economic cooperation must initially recognize the special relationship between the two Koreas. Recognizing the special relationship is for a foreign firm to establish a branch in South Korea and invest in inter-Korean economic co-

operation. The reason foreign firms should respect the special relationship between the two Koreas is because it helps to establish peace on the Korean Peninsula. Since North and South Korea were one country and were divided, conflict cannot be reduced without reunification of North and South Korea. In order to establish peace on the Korean Peninsula, foreign firms must also respect the special relationship pursued by the two Koreas. If inter-Korean economic cooperation grows beyond a certain level in the future, foreign firms directly investing in North Korea will be treated the same as those investing in North Korea through South Korea.

Foreign firms' investment in inter-Korean economic cooperation will provide a new opportunity for foreign firms to earn stable profits, while also playing a role in further solidifying the establishment of peace on the Korean Peninsula. Now, inter-Korean relations have fallen into difficulties due to sanctions against North Korea and the coronavirus pandemic, making it difficult to resume inter-Korean economic cooperation or to expect foreign firms to invest in inter-Korean economic cooperation. However, if inter-Korean economic cooperation is resumed, foreign firms' investment in inter-Korean economic cooperation will be prioritized. **KIEP**