Zone of Engagement: Can North Korea’s Kaesong Complex Be Internationalized?  

By Troy Stangarone

The Kaesong Industrial Complex was shuttered in April this year when North Korea pulled out its workers as inter-Korean tensions escalated, but its role as a zone of engagement between North and South Korea catapulted into the headlines recently when Pyongyang invited Seoul to talks on reopening the complex.

Initial efforts to hold talks failed over a dispute on who would represent each country at the first meeting, but Kaesong continues to play an important role in North-South relations. Troy Stangarone takes a look at the industrial zone and the South Korean government’s ambitions for it.

The Kaesong Industrial Complex, 10 kilometers north of the demilitarized zone separating North and South Korea, was born out of an initiative by the Hyundai Group just over a decade ago, in the early days of South Korea’s “Sunshine policy.” In the intervening years, the complex grew, despite flareups in relations between North and South Korea, and became the primary symbol of inter-Korean co-operation. As part of her policy of “trustpolitik,” the administration of new South Korean President Park Geun-hye hopes to build on the resilience of the Kaesong project and internationalize the zone by attracting non-South Korean companies. However, her first major crisis with North Korea under Kim Jong Un has placed the long-term viability of the project in doubt, making the need to restore confidence in it a priority for internationalization.

For the moment, the complex sits dormant. On April 9, North Korea withdrew the 53,000 North Koreans who worked there, and reports indicate that they may have already been reassigned to new jobs in North Hwanghae Province and are undergoing retraining to eliminate any capitalist contamination that may have occurred while working in Kaesong.1 On May 3, South Korea followed suit as the last seven managers who remained behind to negotiate final wage and tax issues departed the complex.

While North and South Korea have been unable to agree on talks focused on restarting the complex as of this writing, the expectation is that in time the two sides will find a way to reopen Kaesong. However, internationalizing it will require addressing other challenges as well.

THE KAESONG INDUSTRIAL COMPLEX

THE CHALLENGES AHEAD

While a dispute in 2009 over joint war games by the United States and South Korea led to a brief closure of the border, political disputes prior to the current crisis had largely been separated from the economic operations at Kaesong. However, the current crisis is different, with North Korea demonstrating that it is willing to use Kaesong as a tool in its broader political disputes with South Korea in a sustained manner.

While companies might find the occasional border closure a nuisance, North Korea’s withdrawal of its workers for political reasons significantly alters the calculus of potential investors in Kaesong, highlighting the political risk to any investor considering setting up shop in North Korea.

Even prior to the recent suspension of operations, operating in the Kaesong Industrial Complex presented unique challenges to the firms there. Not surprisingly, border crossings were more restrictive than in most areas of the world. Each morning, long lines of trucks queued on the border with North Korea waiting for entry. Communications were restrictive as well. With no cell phone service or Internet, South Korean companies communicated with their plants in Kaesong via landlines.

While the companies in Kaesong have often given high marks to the education and skill of North Korean workers, expansion was often slowed by the inability of North Korea to enlarge the workforce. Additionally, companies face restrictions on their ability to hire workers and set wages independently. In recent years, compensation regularly increased at North Korea’s insistence by a maximum allowed 5 percent, regardless of increases in productivity at the plants.

Most significantly, companies face restrictions on what they can sell their goods. Most goods produced in Kaesong are sold in South Korea, with a mere $37 million of the $323 million produced in 2010 sold to third-party countries.2 Sanctions, along with prohibitively high tariffs and reputational risk, limit the range of markets abroad where goods from Kaesong can be sold. In the case of the US, goods from Kaesong are prohibited even if they are merely component parts of other goods.

While South Korea has worked to have goods from Kaesong included in its free-trade agreements (FTAs), only countries such as India and Singapore, along with the European Free Trade Association and the Association of Southeast Asian Nations (ASEAN), have included provisions that would provide access to their markets. FTAs concluded by the US and the EU do, however, include processes that would allow both sides to add access for Kaesong at a later date.

CAN KAESONG BE INTERNATIONALIZED?

If operating in Kaesong entails additional challenges, is it even possible to attract foreign investors? Some firms have already considered setting up operations there.

One of the initial companies in Kaesong was Taesung Hata,3 a joint South Korean-Japanese venture to produce cosmetics containers. In 2007, Kimberly-Clarke,4 a US maker of healthcare and sanitary goods, considered setting up shop in Kaesong, and German and Chinese companies have at one point considered investing in the industrial zone as well.5 So international interest has been expressed.

But the advantages that attract South Korean firms to Kaesong — proximity, a common language and low wages — are not necessarily incentives that would override the political risk for foreign firms. In the current crisis, North Korea has suggested that, as with the Mount Kumgang Tourist Region, it might seize the factories and enter into partnership with firms from other countries. The prospects of expropriation or extended clo-
sure make low-cost labor in North Korea less appealing when cheap labor and stronger rule of law can be found in less volatile countries.

Initially, South Korea will need to demonstrate a return to normal operations in the Kaesong Industrial Complex before foreign firms will express interest. Most South Korean firms with factories there will likely return once operations resume as they have already invested in the complex and, as small- and medium-sized enterprises, they may not be in a position to liquidate their assets and move production to another location.

The challenge will be to encourage further investment in Kaesong. The first step will likely entail encouraging additional South Korean producers to set up shop there. If South Korean businesses are unwilling to invest in Kaesong, it is unlikely that foreign investors will in their absence. This may require new financial incentives to make investing in Kaesong worthwhile.

Next, South Korea should encourage foreign firms that have experience dealing with the vagaries of North Korea to invest in Kaesong. As mentioned previously, there currently is no cell phone coverage in the Kaesong complex. South Korea could propose that the Egyptian-based Orascom Telecom establish a cellular network in Kaesong for firms in the complex to communicate with their offices in Seoul similar to the one in Rason, where one of China’s industrial zones in North Korea is located. Securing the first early commitments will be key to encouraging other foreign firms to commit. The Egyptian conglomerate has already set up cellular networks in other parts of North Korea, making it a potentially acceptable partner for the North Koreans and a company used to dealing in a high-risk environment. In any initial internationalization phase at Kaesong, it will be companies such as Orascom that will be the first to set up shop.

Additionally, South Korea should focus on trying to diversify North Korea’s economic partners by looking for companies from non-traditional countries for investment. While a good deal of emphasis has been placed on securing market access for goods from Kaesong in developed markets such as the US and the EU, companies from emerging nations that do not share the historical or ideological conflicts with North Korea may be seen as less threatening partners by North Korea.

Beyond encouraging investment from emerging economies or firms used to dealing in high-risk countries, South Korea will also likely have to consider the creation of tax incentives for foreign firms to make investing in Kaesong attractive and to help mitigate the risks. Any incentives, though, should be designed to taper off over time to help encourage the movement of the complex to an economic zone that can survive on market terms rather than through subsidization.

North Korea’s current dismissal of the idea of internationalizing Kaesong should be taken with a grain of salt, as can much of Pyongyang’s rhetoric.
DOES CHINA HAVE A ROLE TO PLAY?
While reaching out to non-traditional partners will be important in the process of internationalizing Kaesong, China can also play a key role in stabilizing the situation. In the ongoing FTA negotiations between South Korea and China there have been discussions of including the respective zones of each country in the agreement. Beyond helping to facilitate trade between Kaesong and the Chinese zones, South Korea should seek a commitment from China to encourage investment in Kaesong. At the same time, South Korea should ensure that South Korean companies have the ability to invest in China’s zones along the northern border.

If a successful cross-pollination of the zones were to occur, it would necessitate the development of additional port and transportation links in North Korea — all of which will be necessary if North Korea is to move towards real economic reform and integration into the global economy, and meet South Korean aspirations for deeper economic integration with North Korea. Additionally, while a Chinese presence in Kaesong wouldn’t make it impossible for North Korea to pull its workers out of the zone during a future crisis, it would certainly raise the potential political costs of doing so.

THE NEED FOR A WILLING PARTNER
While there are steps that could be taken to help internationalize Kaesong, they will require a willing partner in North Korea. If, as the website DailyNK reports, Kim Jong Il directed Kim Jong Un to close the complex as soon as feasible out of concern for ideological contamination and that he never intended the complex to be more than a symbol of inter-Korean co-operation, then North Korea’s actions will likely impede efforts by South Korea to expand and internationalize Kaesong.

However, if North Korea is a serious partner in developing Kaesong, the complex over time will need to move in a more market-oriented direction to attract foreign firms, and specifically Western firms. Issues such as wages, hiring, the establishment of Internet service, a firmer rule of law and the direct payment of workers will need to be addressed in greater detail.

South Korea, though, will need to show patience with the internationalization process. As long as North Korea engages in nuclear and missile tests, attracting large international firms, especially those from the US and Europe, will be challenging due to the risk of sanctions and the uncertainty that continued tests present.

As the case of Taesong Hata and the interest expressed by other Western firms in North Korea demonstrate, internationalization is potentially feasible and not restricted to Kaesong’s current operating structure. Additionally, North Korea in the past has sought foreign investment. Its current dismissal of the idea of internationalizing Kaesong should thus be taken with a grain of salt, as can much of Pyongyang’s rhetoric. The challenge is to create an environment conducive to investment in the zone. As in any business venture, companies will have to take on a degree of risk, but South Korea can take steps to help mitigate that risk.

Because of the damage done to Kaesong’s reputation by North Korea’s recent decision to withdraw its workers, South Korea will need to restore Kaesong’s image to attract foreign investors, and that will take much time and effort. While the future prospect of unification may be a spur to South Korean firms to invest in Kaesong, it has less appeal to international firms looking for profitable investment opportunities.

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