Coming In From The Cold?
An Update on North Korea’s External Economic Relations

Françoise Nicolas

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The Democratic People’s Republic of Korea (DPRK) remains one of the most mysterious and secretive economies in the world. The dearth of statistics and the lack of reliability of available data account for the difficulty in making a precise assessment of the DPRK’s economic situation and of the potential changes of strategy. One way to go about overcoming this difficulty is to examine the country’s external economic relations through so-called “mirror statistics”. These are provided by the country’s economic partners and are expected to be both more reliable and complete.

Analyzing North Korea’s external economic relations is all the more interesting in light of a previous case in which opening up an economy to the rest of the world proved to be one way of reforming a once secluded and isolated communist economy, namely China. In the late 1970s, export orientation and openness to foreign investors were part and parcel of China’s reform strategy, even if these latter measures were mere complements rather than initial drivers of the reform. *De facto* decollectivization in the countryside was actually the first step in the reform and helped pull a large share of the population out of poverty and fuel the development of the private sector. Be that as it may, the openness strategy was no doubt instrumental in China’s economic success.

*Prima facie*, in contrast to most other economies, North Korea has not been taking part in the globalization process and is not integrated in any way with global production networks. This does not mean, however, that North Korea is not engaged in any foreign economic relations. It is in reality less isolated than often thought, but its external economic relations are of a very distinct nature compared to other economies. Not unexpectedly, the DPRK has long maintained close economic relations with its ideological partners, such as the Soviet Union and its different satellites. Since the collapse of the Soviet bloc, North Korean authorities have been forced to increasingly place the emphasis on the development of trade, as explained by Kim Jong-Il himself in 1995. Where does the country stand today? Who are its main economic partners? What is the rationale underlying North Korea’s external economic relations? These are the questions addressed in this paper.

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For the reasons highlighted above, a thorough examination of the DPRK’s current external economic relations is particularly worthwhile and should help shed light on the country’s economic strategy. The objective of the paper is to examine how North Korea is now connected to the rest of the world. To that end it aims to provide an updated assessment of the external economic relations of the DPRK for the purpose of assessing whether the country is heading toward normalization and is on the verge of following in China’s footsteps. The remainder of the paper is organized in two parts. The first part provides an analysis of North Korea’s external trade relations, both in terms of geographic and sectoral coverage with a view to determining whether trade may contribute to potential reform of the economy. The second part addresses the foreign direct investment (FDI) issue. In this respect a comparison between the DPRK’s and China’s approaches to FDI inflows is provided. The concluding section offers a brief analysis of future prospects for the North Korean economy.
Overview of North Korea’s Trade Relations

Background: North Korea’s ambiguous approach to openness

North Korea’s strategy is based on the “Juche” ideology, which from an economic standpoint is more or less equivalent to a strategy of self-reliance. As explained by Ford (2008), “Kim Il Sung believed economic independence was a key to national independence.” As a result, external trade was kept to a minimum and was confined to imports of raw materials not available domestically and to purchases of advanced technology.

However, the successive seven-year plans from the early 1970s to the mid-1980s tried to achieve greater self-reliance, not only as a result of ideological considerations but also because outside capital and resources were becoming increasingly difficult to obtain following North Korea’s default on loan repayments in 1976.

From the mid-1960s economic growth in North Korea slowed down consistently, reaching a record low in the late 1990s. The collapse of the Soviet bloc in 1989 also contributed to North Korea’s economic difficulties since the country lost one of its last remaining benefactors. Disruption in trade ties with former communist allies in the late 1980s led to the food crisis in North Korea in the 1990s. Two developments undoubtedly contributed to the collapse of the North Korean economy as a whole: First the former Soviet Union ceased providing aid in 1987; secondly, and more importantly, both the former Soviet Union in 1990 and China in 1993 demanded that North Korea pay standard international prices for goods, and that it pay in hard currency rather than through barter trade, as previously had been the case.

In response to these difficulties, North Korean authorities started to focus on international trade enhancement in 1995. As explained by Lim (2002) “There is no doubt that it is the dire straits that North Korea has found itself in which have forced its government to resort to commerce, not any real change of mind in the inviolability of the country’s austere socialist system.”

As explained by Kim Jong Il himself, “expanding foreign trade by accommodating to changes in the new global environment, and
earning foreign reserves are important means to effectively resolve the problems in the economy and to improve living conditions in North Korea. In both foreign and domestic economies, various methods must be utilized to promote foreign economic projects, and increase production of main export goods, and exerting all efforts to earn foreign reserves.”

North Korea thus concentrated on improving relations with the West. While efforts to improve relations with the United States ended up in failure, North Korea was more successful with European countries. Diplomatic relations were established with Italy and the United Kingdom in 2000, followed by the Netherlands, Belgium, Spain, Germany, Luxemburg, Greece, a number of other European countries and the European Union itself. By the end of 2009, France and Slovenia are the only two EU member countries not to have established diplomatic relations with the DPRK. North Korea has also established diplomatic relations with a number of other countries such as Australia, New Zealand, and Brazil. In parallel, the progress of the so-called Sunshine Policy in South Korea led to a dramatic improvement in inter-Korean relations.

In line with this move towards openness, in July 2002, North Korea’s government announced “economic improvement measures”, such as creating incentives for factories to operate on a more profitable basis by allowing salaries to increase and prices to rise. The state rationing system also was abolished (except for food), foreign-exchange rates were adjusted, free currency exchange was allowed to strengthen popular consumption, and the economy was partially monetized. The adjustments were all aimed at developing a market economy. New management techniques were also introduced with the goal of creating incentives and accountability. In June 2003, restrictions were also relaxed on farmers’ market activities. Product markets were established, improvements were made to agricultural organizing principles, and agricultural products were allowed to be brought to market using self-managed distribution systems. This followed the formal recognition of commercial transactions between individuals and the 1998 revision to the constitution that allowed individuals to keep profits earned through legitimate economic activities. As a result, free markets and shopping centers that use currency, not ration coupons, started spreading.

Over the past few years, however, there has been an apparent setback in reforms. Efforts at reform initiated in the late 1990s and early 2000s appeared to go into reverse around 2005, in

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2 Interestingly enough, the use of the term “reform” is avoided.
3 Although small farmers’ markets have long existed in North Korea, the Government did not legalize such markets until June 2003.
part as a result of the onset of the nuclear crisis. In the past few years, the authorities have sought to restore dependence on the state distribution system. On August 26, 2007, Kim Jong-il announced that “markets have become antisocialist, Western-style markets.” This has led to a steady stream of government edicts restricting market activity across the country: limiting markets to three days a month and restricting market hours to 2-6 p.m.; banning select items and setting price controls on certain goods; and barring women under the age of 40 (later increased to 49) from markets. The recent currency reform introduced in November 2009 can also be interpreted as another attempt by the Government to regain control and curb the expansion of the private market economy. There are, however, dissenting views on this latter point, as Chinese officials familiar with the North Korean situation argue that the reform should be interpreted as a sign of the active pursuit of a “North Korean-style market economy”.

In May 2009, in an attempt to strengthen national unity, the DPRK government launched the "150 Day Battle" to achieve enhanced production targets. The fundamental aims are the construction of houses, the normalization of farming and railroads and enhancing the activities of local factories and mines.” The instruction was conveyed to the entire Worker’s Party membership in a secret letter from the Central Committee of the Party in March. This first move has been followed by a second 100-day campaign currently under way. As explained by Snyder (2009), the objective of this all-out push is to mark the country’s arrival as a “strong and powerful nation” in 2012, which marks the 100th anniversary of Kim Il Sung’s birth, Kim Jong Il’s 70th birthday, and the 30th birthday of Kim Jong Il’s third son and reported successor, Kim Jong-Eun. This campaign is indicative of the authorities’ willingness to maintain a tight grip on the country’s economic trajectory. However, a non negligible component of the strategy is an effort to attract investment from overseas. North Korea appears to be hovering again between openness and tightly-controlled dirigisme, and the credibility of the openness-based movement is highly questionable.

**Overall patterns and trends since 1990**

**Trade dynamics**

Based on an analysis of North Korea’s external trade (excluding inter-Korean trade\(^5\)), Figure 1 shows that North Korean trade declined very

\(^4\) This looks like a reorchestration of the 100-day battle launched in 1978 and of the 200-day battle launched ten years later in 1988. The five-month campaign was set to culminate in early October, about the time of the anniversary of the founding of the ruling Workers’ Party.

\(^5\) Inter-Korean trade is usually not considered as international trade and is thus excluded from South Korea’s data (KOTRA). The paper is primarily based on KOTRA.
sharply, from close to US$ 4.2 billion in 1990 to a record low US$ 1.4 billion in 1998 at the end of the famine period. Trade started to pick up in 2000 and has kept rising ever since, with acceleration over the last year. As of 2008, however, total trade had not yet recovered its 1990 level.

The inclusion of inter-Korean trade does not make a major difference in the overall trend of trade flows, as can be seen in Figure 2. The sharp rebound observed as of 2000 holds true in whatever data is used. The inclusion of inter-Korean trade merely impacts the level of total trade.

Figure 1. DPRK International Trade, 1990-2008
(excluding inter-Korean trade)

Source: KOTRA data. However, inter-Korean trade has been added so as to give a more complete picture of North Korea’s trading relations. The data covers some 70 countries (compared to more than 100 for the UN Comtrade database).
North Korea’s international trade, including inter-Korean trade, has expanded since 1998 at a 12 percent compound annual growth rate, increasing from about US$ 1.7 billion to US$ 5.6 billion in 2008. This level is equivalent to about 40 percent of the country’s estimated GDP and is a clear indication that the country is becoming increasingly dependent on the rest of the world.

Overall, a striking feature of North Korea’s trade balance since the early 1990s is the persistence of a trade deficit. While the trade deficit consistently hovered around US$ 700 million in the 1990s, it started to deepen in 1999. It crossed the US$ 1 billion line in 2005 to further deteriorate in the following years, reaching a record high US$ 1.5 billion in 2008 (which is equivalent to 10 percent of the country’s GDP). It is worth stressing that the size of the overall deficit is not affected by the inclusion of inter-Korean trade, suggesting that the latter is almost balanced.

To be sure, official trade data only reflect part of North Korea’s trade so that the size of the deficit may be overestimated. Illicit trade
in arms, drugs, and counterfeited notes are further complements to licit trade.\textsuperscript{6} By definition, it is difficult to have a clear assessment of the magnitude of such trade flows, but the non-financed trade deficit gives an approximation of such trade.

**Sectoral and geographical concentration**

Over the past few years, North Korea’s exports have been dominated by mineral products (accounting for 26 percent of total exports in 2006 and 38 percent in 2007), ahead of non-ferrous metals (17 percent) and textiles and clothing (12 percent). Coal exports rank particularly high with a dramatic increase of more than 200 percent in 2007 compared to 2006. The fact that primary commodities such as minerals account for a large share of the total exports demonstrates the still underdeveloped structure of North Korea’s export industry. This is in sharp contrast to observations made a decade ago and expressed for instance by Lim (2002), according to whom “[t]he recent rise in electrical/electronic and chemical exports, shifting away from the traditionally strong textile and steel products, can be viewed as encouraging, demonstrating North Korea’s efforts to make a gradual move towards high-value-added goods.” These changes have not been confirmed.

On the import side, North Korea’s trade is also heavily concentrated, with mineral products as the largest import items (close to 25 percent of total imports)\textsuperscript{7}, ahead of machinery and mechanical appliances (12 percent).

Beyond the persistence of a trade deficit and the strong sectoral concentration, another conspicuous feature of North Korea’s external trade is the dominant role played by both China and South Korea. In 2008, the two countries are entrusted with more than 80 percent of North Korea’s total trade. When excluding inter-Korean trade, China on its own accounts for 67 percent of North Korea’s total international trade.

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\textsuperscript{6} Regular anecdotal evidence confirms the reality of such illicit trading activities. Such was the case in August 2009 with the seizure by the United Arab Emirates of a ship carrying North Korean rocket-propelled grenades and other conventional weapons, reportedly for delivery to Iran in violation of UN sanctions imposed on North Korea’s export of weapons. Similarly, in December 2009 rocket-propelled grenades, missiles and other weapons were found aboard an aircraft transiting from Pyongyang through Bangkok to an unknown destination. Sales of short- and medium-range missile systems remain among North Korea’s largest export earners, and are part of an arms trade that is thought to generate $1.5 billion annually for Pyongyang. Illicit trading activities, however, may be widely overstated, as argued by Haggard and Noland (2008). Due to the uncertainty around these figures, little can be said about this issue.

\textsuperscript{7} Mineral products have been dominating the import structure since 2003, when they were on a par with machinery and mechanical equipment.
A focus on North Korea’s trade with China and South Korea

Since 2003, China and South Korea have been North Korea’s two major trading partners (Figure 3). The typical pattern of its trade with these two countries used to be exports of minerals, metallurgical products, and some manufactured goods (including armaments, textiles and marine products), in exchange for imports of crude oil, coking coal, and capital goods (including machinery and equipment). However, each of these two countries is connected differently with North Korea.

Figure 3. DPRK’s Major Trading Partners, 2000-2008

Source: KOTRA
Figure 4. DPRK's Imports, by major source countries, 2000-2008

Source: KOTRA

Figure 5. DPRK's Exports, by major destinations, 2000-2008

Source: KOTRA
A first difference pertains to the bilateral trade balance: North Korea records a systematic trade surplus with South Korea and a deficit with China. This contrasted state of play reveals different patterns of trade.

Today, China has emerged as North Korea's number one source of imports. Imports from China are dominated by minerals and fuels (crude oil as well as non-crude oil), ahead of machinery and mechanical appliances and electrical machinery. North Korea is thus heavily dependent on China for the survival of its industry.

Exports to China are also dominated by primary products, namely minerals and fuel a well as ores, while apparel and clothing now only rank third. A substantial share of Sino-Korean trade takes the form of border trade in the Dandong area. This is an important feature since it is likely to be contributing to the expansion of market mechanisms in North Korea. In fact, a number of analysts now agree that, although China would also like North Korea to drop its nuclear program, a larger priority is to prevent the régime from falling and sending millions of refugees to China. As a result, China has apparently chosen to exert pressure on North Korea through economic engagement rather than denuclearization.

Within this context, the second major difference between China and South Korea is the share of the aid component in their trade relations with North Korea.

Until 1988 the two Koreas conducted no trade with one another. Inter-Korean trade began in 1989 and rose steadily from US$ 20 million in 1989 to US$ 308 million in 1995, US$ 650 million in 2002, and US$ 1 820 million in 2008. The major driver behind the rise in inter-Korean trade is the implementation of the so-called Sunshine Policy launched by late President Kim Dae-jung in 1998. The policy emphasizes peaceful cooperation, seeking short-term reconciliation as a prelude to eventual Korean reunification. It has resulted in greater political contact between the two nations, exemplified by the inter-Korean summit meetings in Pyongyang in June 2000, which broke ground with several high-profile business ventures and brief meetings of separated family members.

In the economic sphere South Korea continues to supply the North with humanitarian aid, and the two governments also engaged in cooperation projects such as the Kaesong Industrial Complex (KIC) and the Mount Kumgang Tourist Region. These two projects have involved private companies but also substantial government

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8 See Jeong and Bang (2010) for more details on this point.
9 China joined other members of the United Nations Security Council in imposing sanctions against exports of “dual use” technology that might be used in North Korea's nuclear weapons program.
10 Although inter-Korean trade dropped in 1998 as a result of the East Asian financial crisis, it was quick to recover.
subsidies. These subsidies are of particular interest in the KIC case, since export-processing zones typically involve concessions and support on the part of the recipient country rather than from investors.

As a result of this political rapprochement, inter-Korean trade started to rise in 2004 (see Figures 3 to 5), with North Korea’s exports to the South rising at a more rapid pace than imports from the South. The bulk of North Korea’s exports to the South consist of food/aquatic/forestry products, textiles, steel/metal products, and electronics (Maniyin and Nikitin 2009). The major items purchased by the North consist of aid goods, such as agricultural products, chemical fertilizers, textiles, and machinery and transport equipment for railroad linkup.

An important feature of inter-Korean trade is that both countries are primarily trading on a non-commercial basis, with South Korea’s involvement having a growing aid component. This is in contrast to China’s interaction with North Korea, which appears to be increasingly taking place on market-oriented terms. As explained by Haggard and Noland (2008), “this finding has important implications for the purported logic of engagement, which claims that increased economic openness will socialize North Korea toward greater commercial interaction with the world economy. High dependence on aid could in fact have the opposite effect, reducing pressure for economic reform.”

**Beyond the usual suspects**

**Shifting partnerships: the rise and fall of Russia and Japan**

According to KOTRA, North Korea is trading with at least 68 other countries, in addition to South Korea and China. An interesting feature of North Korea’s trade pertains to its rapidly changing partnerships in response to fluctuations in political and diplomatic relations.

Not unexpectedly, North Korea’s trade with Socialist countries was substantial during the Soviet era\(^{11}\), but when the Soviet bloc was dismantled in the early 1990s, North Korea’s foreign trade with these countries plunged. The collapse was due both to the disorder following the dismantlement of the socialist block and to the resulting changes in trading conditions, with barter trade giving way to “normal trade” that had to be paid in hard currencies. In 1991, the Soviet Union demanded that trade with North Korea be denominated in hard currency at world prices.

\(^{11}\) Although the country never joined the Council of Mutual Economic Assistance (Comecon).
Starting in the early 2000s, however, relations between Russia and the DPRK have been improving again and bilateral trade has somewhat recovered. North Korea’s imports of refined oil from Russia rose sharply from US$ 20 million in 2002 to US$ 96 million in 2003 and US$ 173 million in 2005. Russia’s exports eventually dropped again in the wake of North Korea’s nuclear test in 2006 and the resulting sanctions approved by Moscow. As a result, while Russia used to be one of North Korea’s major trading partners until the early 1990s, today, it merely ranks number 5, far behind China and South Korea, but also behind Thailand and India.

Russia ranks number 4 as a source of imports but only number 6 as an export market. The DPRK imports minerals from Russia (in particular coal and non-crude oil) as well as aircraft. In exchange it exports electrical machinery and equipment, nuclear reactors, computers and machinery and mechanical equipment.

Japan is another formerly major trading partner. Although Japan and North Korea have never established official diplomatic relations, the two nations maintained significant economic ties for well over a decade. From the end of the Cold War, Japan was second only to China among North Korea’s top trading partners (see Figure 3). The reason why Japan used to be North Korea’s major non-communist trading partner is due to its geographical proximity and the presence of pro-Pyongyang ethnic Koreans in Japan (known as the Chosen Soren - Chongryun in Korean) who handled a significant share of the Japan-North Korea trade (Park 2004). In 2002, Japan’s imports from the DPRK amounted to US$ 234 million, almost on a par with those of China and South Korea, while its exports to the DPRK totalled US$ 135 million (behind China, South Korea and even Thailand). Interestingly enough, the DPRK has enjoyed a systematic trade surplus with Japan since 1987 (Mimura 2005), with the exception of 2001.

After North Korea’s provocative missile and nuclear device tests in 2006, political relations soured between the two countries. The tensions were further exacerbated by disagreements over the issue of Japanese citizens kidnapped by North Korean agents in the 1970s and 1980s. As a result, Japan imposed strict unilateral sanctions, causing bilateral trade to plummet. Japan banned imports and most North Korean nationals from entering Japan, prohibited all North Korean ships from entering Japanese ports, and outlawed the export of “luxury goods” to North Korea, including caviar, jewellery, liquor, and any food known to be favored by North Korean leader Kim Jong-il. Tokyo has also ceased sending any humanitarian aid to North Korea, and has refused to provide economic or energy assistance until their concerns with Pyongyang are resolved (Mimura 2005). By 2008, total trade between Japan and the DPRK had fallen to US$ 8 million from close to US$ 500 million in 2001 (See Figure 3).
Newly emerging partners (Thailand, India, Brazil)

While it maintains continued cooperation with its traditional allies, North Korea is striving to expand the scope of exchanges and cooperation with Asian, European and African countries (Oh Seong-Yul 2005). Next to China and South Korea, a number of other trading partners have emerged recently. As can be seen in Figures 3 to 5, India and Thailand have been playing increasingly important, although different, roles.

The major explanation behind the rise of Thailand lies in its contribution as a source of food imports. Thailand’s exports are heavily dominated by cereals, namely rice, which accounted for close to 40 percent of its total exports to North Korea. Rubber and rubber products come next, ahead of aluminum and tin products. The importance of Thailand may be overestimated, however, because part of its exports of food products is actually resulting from South Korean food aid.

The importance of Thailand as an export market has been decreasing over time. North Korea still primarily exports nuclear reactors, machinery, mechanical appliances and computers, but in decreasing amounts, while its exports of paper and paperboard products have risen.

India has also emerged as an increasingly important trading partner for North Korea. It primarily exports organic chemicals, and imports plastic goods as well as iron and steel products. According to some sources, India was among North Korea’s top three trading partners in 2008. This extraordinary increase is difficult to explain. Either there was a short-term spike in North Korea-India trading activity, or these numbers are fishy. According to Nanto and Chanlett-Avery (2009, p. 33), the latter hypothesis is the most plausible: “Indian imports from North Korea as reported seem in error. Items such as electrical machinery and parts, in particular, were in fact probably imported from South Korea. Likewise, Indian exports of petroleum products and organic chemicals reported as going to North Korea likely went to South Korea.”

Among other apparently important partners, Brazil is reported to export tobacco and tobacco substitutes and to import plastic products, organic chemicals and precision instruments. The rise of Brazil as a trading partner is recent, however, and it remains to be seen whether this relationship will be long-lasting.

Lastly, other partners have shown a strong interest in expanding their trade relations with North Korea. This is the case of Singapore for instance, which is already, one of Pyongyang’s main Asian trading partners: the two countries have recently signed an investment guarantee agreement which will accord investors in both countries i) non-discriminatory treatment, ii) compensation if their investments are confiscated or nationalized, and iii) free transfer of capital and returns from investment. Moreover a memorandum of understanding was also signed between the Singapore Business
Federation and the North Korea Chamber of Commerce to promote regular exchange of business information and investment proposals, to explore business opportunities and collaboration and to strengthen bilateral economic and trade relations.

**Figure 6. DPRK’s Main Trading Partners (excl. China and RoK), 2007**

![Graph showing trading partners](image)

*Source: KOTRA*

**Figure 7. DPRK’s Major Trading Partners, 2006**

![Graph showing major trading partners](image)

*Source: KOTRA*
The marginal role of the EU

As recalled earlier, North Korea embarked in the 1990s on a charm offensive vis-à-vis European countries so as to diversify its trading partners. For the time being, however, their importance as trading partners has remained limited.

Several member states of the EU have a long history of trade with the DPRK (Frank, 2002). The major export items of the EU to the DPRK are agricultural machinery, cars, steel, electronics and electric supplies, measuring instruments, medical supplies and rough diamonds. The major import items of the EU from the DPRK are clothes, electronic and electric products, jewellery, machinery, plastic products and salt.

However, EU countries as a group still play a very marginal role today. Among the EU 27 member-countries, Germany clearly sticks out. It is well ahead of all other EU countries as a source of imports for North Korea, while it is on a par with the UK as a destination for exports. Overall, Germany ranks ahead of the others, in particular France, Spain and the United Kingdom. For North Korea, Germany is more a source of imports than an export market. Germany primarily exports vehicles, machinery, food, textile accessories, electrical goods, plastics and chemical products, while it imports minerals, raw materials for the chemical and pharmaceutical industries and textiles. One possible explanation for the larger role of Germany relative to its European neighbors has to do with the collapse of the Soviet bloc and with the tight
relationships that used to prevail between the DPRK and the German Democratic Republic. In addition, Germany has a well-known competitive advantage in capital goods, which are in high demand in the DPRK. In this respect, Germany may have benefited to some extent from Japan’s retreat as a supplier of capital goods.

The further development of trade relations between the EU and North Korea may not be an easy task. Although some European firms are seeking to take advantage of North Korea’s low labor costs by having goods produced there and shipped to the European market, the “made in North Korea” label may not prove to be a good selling argument, as suggested by the recent episode of imported jeans from North Korea by a Swedish company (the so-called Noko jeans). Although the Swedish importers insisted that the working conditions at their Pyongyang-area factory were good, the Swedish department store that had initially agreed to sell the North Korea-made NoKo Jeans line, eventually decided to pull the collection from its shelves because it did not want to associate itself with North Korea.

A final point is in order at this stage. The official data may to some extent overestimate the magnitude of North Korea’s exports to China but underestimate its exports to the rest of the world. Part of the former may be redirected from China to the rest of the world, and in particular European countries. Anecdotal evidence seems to confirm this presumption. It is worth stressing that such indirect trade is less likely to encounter the difficulties highlighted earlier.
Figure 9. DPRK-EU Trade, 2007

Source: KOTRA

Figure 10. DPRK - Americas Trade, 2007

Source: KOTRA
Foreign Direct Investment: Is North Korea Following in China’s Footsteps?

In contrast to what is often believed, today North Korea is officially very much open to foreign investment and a legal framework exists for foreign companies to do business in the North. While maintaining its ideological commitment to the autarkic, defiantly self-reliant "juche" philosophy, North Korea has issued extensive laws and regulations that are designed to foster foreign investment, including the Foreign Investment Law, the Free Economic and Trade Zone Law, the Foreign Enterprises Law, the Equity Joint Venture Law and the Contractual Joint Venture Law.

The development of North Korea’s policy to induce foreign investment can be divided into three stages. The first is until the enactment of the 'Joint Venture Act' in September 1984, the first legislation to attract foreign capital. The second stage is from the Joint Venture Act’s enactment until December 1991, when the Rajin-Sonbong Free Trade Zone was set-up (see below) and the Foreigner Investment Act was established. The third stage refers to the period after the establishment of the Rajin-Sonbong Free Trade Zone and includes the enlargement of the open-up policy that established additional Special Economic Zones (Kaesong Industrial Complex, Mount Kumgang Tourist Park).

12 The law was abruptly withdrawn in 1985, reinforcing perceptions of an unstable atmosphere for business.
Box 1. North Korean Laws regarding foreign investment

The Foreign Investment Law (FIL): The FIL, promulgated in 1992, permits foreign investment in "various sectors such as industry, agriculture, construction, transport, telecommunications science and technology, tourism, commerce and financial services," and provides special encouragement and preferential treatment (including tax exemptions and preferential loans) for investment in "sectors that require high and modern technology, sectors that produce internationally competitive goods, the sectors of natural resource development and infrastructure construction, and the sectors of scientific research and technology development." Projects that hinder the development of the national economy and threaten national security or the environment, or that are technically obsolete, are prohibited.

Under the FIL, foreign investment may take the form of an equity joint venture (habyongsa), a contractual joint venture (hapjasa), or a wholly foreign-owned subsidiary. Wholly foreign-owned subsidiaries (Wegugin kiop) are permitted only in Free Economic and Trade Zones.

The Free Economic and Trade Zone Law (FETZL): The FTZs are intended to be duty free areas for the importation of capital goods and materials for the production of exports. The other foreign investment laws of North Korea apply in FTZs, including those relating to the establishment of equity and contractual joint ventures and wholly foreign-owned subsidiaries. In many cases preferential treatment is afforded to foreign-invested enterprises with respect to tax rates, rent and financing. Each FTZ is administered by an FTZ Authority under the supervision of the External Economic Authority.

The Equity Joint Venture Law (EJVL): Equity joint ventures (EJVs) are the preferred vehicle of the North Korean government for high-tech and infrastructure projects. EJVs are established by means of a joint venture contract between foreign and North Korean parties, which must be submitted to the external economic body of the Administration Council of the DPRK or to the Zone authorities for approval. EJVs are juridical persons under North Korean law, taking the form of limited liability companies with each party's liability limited to the amount of its subscription.

The Contractual Joint Venture Law (CJVL): Contractual joint ventures (CJVs) are the vehicle preferred by the North Korean government for basic manufacturing, tourism and service sectors. As defined by law, a CJV "consists of business activities in which investors from the DPRK and from a foreign country invest jointly, with production and management being assumed by the host partner, and the portion of the investment made by the foreign partner is redeemed or the portion of the profit to which the foreign partner is entitled is allotted in accordance with the provisions of the joint venture contract."
The Foreign Enterprises Law (FEL): The FEL provides the basic framework for the creation of wholly foreign-owned entities (foreign subsidiaries). Foreign subsidiaries are permitted only in Free Economic and Trade Zones (FTZs), and are permitted for projects involving high tech production of internationally competitive goods in the following sectors:

- electronics, automation, machine tool and power industries;
- food-processing, garment and everyday consumer goods;
- building materials, pharmaceuticals and chemicals;
- construction, transportation and service sectors;
- other sectors deemed necessary.

Source: Coudert Brothers

Foreign Direct Investment Flows

Pre-1991, under the Joint Venture Act (the law regarding joint-ventures) openness to FDI was restricted to investment in the DPRK by Chongryon in Japan (i.e. patriotic projects), while economic cooperation with capitalist countries was prohibited. From 1986 until 1991, a total of 32 cases of investment in the DPRK by Chongryon-related companies, worth US$ 31.32 million, were declared to the Ministry of Finance. In terms of the value of investment, most was concentrated in 1988/9, with the textile sector accounting for the greatest proportion (Lee 2001).

North Korea has been encouraging international foreign direct investment to the country since 1992, due mainly to the collapse of its previous alliance with the Soviet Union and the Government trade/barter arrangements that were in place prior to then. However, the institutional uncertainty and the difficulties associated with doing business in North Korea have limited FDI inflows.
Today the top foreign investors operating in North Korea originate from either South Korea or China. Foreign companies in North Korea include some 50 South Korean companies, among which Hyundai, Daewoo, Taechang, LG, Haeju, and G-Hanshin. As for Chinese investors, they tend to come primarily from northern Chinese provinces, like Jilin and Liaoning, but also from Zhejiang (Seliger 2006). Prominent among them is the Zhejiang Public Trade Company, which opened the Zhejiang commodities market on three floors of central Pyongyang’s First Department Store.

Chinese investors are particularly active in the natural resource sector. By way of illustration, on November 30, 2008, Interfax China Metals reported that privately-owned Sino Mining International Investment had acquired a 51% interest in the Hyesan copper-gold-silver mine in North Korea for US$ 33.8 million (€22.9 million) from North Korea Hyesan Company.¹³

¹³ Hyesan began production in the 1960s and produced about 80 percent of North Korea’s mined copper, but it has closed several times due to flooding. The North Korean government recently decided to rehabilitate the mine and bring it back into production. Hyesan is expected to process 2,000 mt/day of ore over an estimated 40-year mine life, from reserves containing an estimated 1.5 million mt of copper, 1.9 million oz of gold, and 511 million oz of silver.
Other foreign investors include DHL, ING Barings Bank, Japan’s Hohwa, Saga, and New Future Ltd. Companies, or Taiwan’s JIAGE Ltd.

Egypt has recently emerged as a major direct investor in North Korea. Egyptian Orascom has publicized significant investment plans for North Korea since 2007. In mid-July 2007, Orascom Construction Industries purchased a 50 percent stake in the North’s Sangwon Cement Factory near Pyongyang (now owned by the French company Lafarge). This venture involved the injection of US$ 115 million, which is being used to modernize the facility and increase production capacity from 2.5 million tons to 3 million tons per year. In December 2008, Orascom Telecom Holding, by far the leading mobile phone provider in northern Africa and the Arab world, was granted the first-ever commercial license to provide WCDMA 3G technology-based cellular service to North Korea, and put forth plans to invest US$ 400 million to create a nationwide infrastructure named Koryolink over the next four years.14 Orascom will set up a service beginning in the capital Pyongyang then reaching out to cities elsewhere.15 Immediately after the mobile service was initiated, Orascom Telecom entered a joint venture with North Korea’s foreign trade bank to open up Ora Bank as the country’s second foreign-invested banking facility.

The latter two investments came very much as a surprise. The arrival of a mobile-phone service into North Korea comes several years after North Korea banned the use of mobile phones tied to Chinese networks, citing them as a security risk. As for Ora Bank, it is unlikely to be able to do much more than handle the accounts of foreigners’ interests in North Korea and North Korean trading companies. The only other foreign-invested banking facility, Daedong Credit Bank, a joint venture with British investors and managers, is in business to expedite the flow of funds on behalf of foreign investors, not North Koreans.

Orascom Telecom is also in charge of completing the building of the Ryugong Hotel. Dozens of Egyptian engineers and some 2,000 local workers indeed started refurbishing the top floors of the hotel in April 2008, and according to Orascom’s chief operating officer Khaled Bichara, the construction is “progressing well” (Nkeconwatch, October 2009).

European companies are not fully absent. European-North Korean business ventures include the PyongSu pharmaceutical joint venture, which produces generics like aspirin for the North Korean domestic market, a Polish-North Korean shipping joint venture and a

14 The Egyptian company was given 75% ownership of a subsidiary in which North Korea’s state postal system owns the remaining 25%.
15 As of August, 2009, nearly 50,000 new subscribers had purchased phones and opened accounts through the joint venture between Orascom and the state-owned Korea Post and Telecommunications.
partnership in IT services between the Korea Computer Centre (KCC) and a German partner company. The most successful joint ventures, however, are tobacco and beer. The British American Tobacco (BAT) plant close to Pyongyang is reportedly operating profitably and the North Korean Taedonggang Brewery shipped stock and barrels from Trowbridge in the UK to North Korea to open up a brewery in Pyongyang (Berkofsky 2009). Another major foreign investor in North Korea is the French cement producer Lafarge, which, through its recent acquisition of Egyptian Orascom cement in early 2008, now owns the Sangwon Cement plant near Pyongyang. In this latter case it is worth stressing that the French company is a major investor by chance rather than by design.

In 2007, North Korea also saw a major Russian investment. In the city of Pyeongseong, the Russian auto plant KamAZ opened its first assembly line, specializing in the production of medium-size trucks named “Taebaek-san-96”. Although less than 50 trucks were assembled in 2007, this cooperation became an important milestone in the development of bilateral relations.

Overall, however, FDI inflows are far too limited to have a substantial impact on the host-country.

Special Economic Zones

Early attempts: the failures of Rajin-Sonbong and Sinuiju

After the demise of the Soviet bloc, there was no other choice left for North Korea but to accept investment from capitalist countries. Against this background, the Rajin-Sonbong Free Economic and Trade Zone was established in December 1991. The zone is located along the Tumen River in the northeastern part of the country and near the border with China and Russia. The objective was to develop the area as a “preferential trade, transit, export processing, financial and service region” (Clause 2, Free Economic and Trade Zone Law). North Korea had made the development of the Rajin-Sonbong Free Trade Zone the focal point of its economic opening. This attempt to attract foreign direct investment was perceived at the time as indicative of North Korea’s inclination to reform its system (Cho and Hong 1998).

Some 746 square kilometers were set aside for “foreign capitalists” but there have been very few takers apart from pro-Pyongyang ethnic Koreans from Japan, who have invested because of patriotic duty rather than any expectations of quick returns (Lintner 2001). As explained by Nam (2001), as of 1998, foreign companies from China, Hong Kong and Japan signed US$ 800 million worth of contracts with North Korea, however, only 10 percent (approximately $88 million) of the promised investment was actually made. The non-existence of a consumer market, poor infrastructure in transportation
and communications, and consequently, high logistical costs, are usually highlighted as the major reasons for the Rajin-Sonbong project’s failure to attract foreign investors.

Sinuiju is another early, yet failed attempt to create a functioning special economic zone. In September 2002, the North Korean authorities passed the Basic Law of the Sinuiju Special Administrative Region, which created a “one country, two systems” concept similar to the system of Hong Kong. The region, located in the North-Western part of the country, next to the Chinese border, was supposed to be completely outside North Korea’s normal governing structures (Park 2003). The project received a fatal blow right from the beginning as the Special Administrator, a Sino-Dutch national, was arrested and sent to prison by Chinese authorities on charges of tax evasion and other commercial crimes.

The failure of Sinuiju is in sharp contrast to the dynamism of the Dandong area, which is very close-by. This may explain the renewed attempt at developing a special economic zone in this part of the country. Indeed, Sinuiju appears to be given renewed attention as reflected in the recent project to create a free trade base on Ryucho Island near Sinuiju and to develop a new special economic district.

The Kaesong Industrial Complex: dashed hopes so far

The original project:
As a result of the historic first inter-Korean summit in 2000, the DPRK opened the Kaesong Industrial Complex (KIC) in June 2004 under a contract with Hyundai Asan Corporation and South Korean state-owned Korea Land Corporation. The initiative, led by the Hyundai Group beginning in 1998, coincided with South Korea’s above-mentioned Sunshine Policy, which attempted to improve relations between the RoK and the DPRK.

The complex is located between the city of Kaesong and the western end of the border between the two Koreas, less than one
hour car ride from Seoul. This location is in contrast to the two aforementioned special economic zones, which could not as easily benefit from close proximity with a capitalist country’s firms. In this respect, the KIC is apparently more similar to China’s initial SEZs developed in the Shenzhen area so as to take advantage of the proximity with Hong Kong. The official objective of the KIC project is to attract South Korean companies, particularly small and medium sized enterprises seeking to take advantage of the cheap North Korean labor force, in order to provide an opening for North Korea to liberalize and reform its economy, and to ease tensions between the two Koreas.

South Korean firms operating in the Complex enjoy a preferential treatment. The KIC is a duty-free zone with attractive corporate tax provisions: the rate is 10 to 14 percent with an exemption for the first five years after generating profits, and a 50 percent reduction for the ensuing three years. In addition, a specific KIC Labor Law was drafted and adopted to govern the rights of workers employed by enterprises in the KIC.

The project was planned to evolve in three phases. The first phase (2002-2007) was planned to encompass 800 acres with as many as 300 South Korean firms operating in the complex. In the second phase (2007–2009), the complex was to be opened to non-South Korean investors. At the end of phase 3 (in 2012), the plan is expected to call for as much as 4,800 acres in the industrial zone with as many as 1,500 firms employing 350,000 North Korean workers and producing US$ 16 billion worth of products per year.

The project has been subject to various modifications and delays and the completion of the first phase is now set for the end of 2010. Today, only South Korean firms are operating within the Complex. As of November 2009, 116 South Korean firms operate there with more than 40,800 North Korean workers, producing mostly labor-intensive goods such as watches, shoes, clothes, toys, electronic goods, kitchenware, plastic containers, electrical cords and car parts, among other items.

From the RoK’s perspective, the KIC is part of the country’s engagement policy vis-à-vis the North. The project is expected to induce the DPRK toward embracing economic reforms and opening up to the world, the way Shenzhen did in China two decades ago, and open the path toward reunification.

From the DPRK’s perspective, the KIC is a source of hard currency. The North Korean government derives hard currency from several sources in the KIC project, including leasing fees and its taxes and fees deducted from the wages of North Korean workers. The wages are first paid in hard currency to a North Korean government agency that takes a certain percentage before paying the North Korean workers in Won. The government collects about US$ 20 per month (in social insurance taxes plus its cut of wages) for each of the 10,000 workers now at Kaesong. Its monthly take from wages, therefore, would amount to approximately US$ 200,000 per month or
US$ 2.4 million over a year. One estimate is that Pyongyang has earned a total of about US$ 20 million from the Kaesong Industrial Complex.16

The recent difficulties:
The fate of the KIC has come into question in the first half of 2009. Recent tensions have indicated that the KIC is primarily seen by North Korean authorities as way of extracting cash. They do not seem to have an interest in using the Complex as an experiment and as a way of helping the development of the market economy.

Following the recent UN Security Council Resolution, which pursued tough new sanctions against Pyongyang for testing a long-range missile and detonating a second atomic bomb, North Korea has moved aggressively against the KIC. After a two-month period of rising tensions, on June 11, 2009 the North Korean Central News Agency (KCNA) announced the nullification of all contracts on rent, salaries and taxes adopted for industrial park in Kaesong. Pyongyang wanted the minimum monthly wage to be raised four-fold (from US$ 75 to US$ 300) and demanded an immediate lump-sum land lease payment of US$ 500 million (Petrov 2009). These demands clearly revealed North Korean authorities’ intentions to extract as much as they could from the KIC.

At the time of writing, signs point to a change of course, with a renewed enhancement of inter-Korean cooperation in the KIC. In mid-December 2009, South Korean officials agreed with their North Korean counterparts to conduct a survey of factory parks overseas and to explore ways to enhance the operation of their joint industrial complex in Kaesong.17 According to official sources, “the survey is aimed at taking an intensive look at factors that help improve the competitiveness of the factory complexes being run successfully overseas.”

In contrast to the expectations generated by the project, the KIC has not delivered accordingly. Different measures to enhance the efficiency and attractiveness of the industrial complex are examined below.

Enhancing the KIC’s attractiveness:
Currently, the majority of goods exported from the KIC flow through the South Korean port of Incheon. They are then distributed elsewhere after arriving at the Chinese port of Dalian. This route is expensive and slow. Shipping by sea costs US$ 1,900 per container

16 CRS Report RL33435, The Proposed South Korea-U.S. Free Trade Agreement (KORUS FTA), by William H. Cooper and Mark E. Manyin (quoted in Nanto and Chanlett-Avery (2009)).
17 A team of 10 officials from each side were to meet in Qingdao, an industrial port town in southern China, after which they are to travel to Suzhou, a hub for China’s silk industry, Shenzhen, a southern financial center, and finally Yenpong, a Vietnamese complex near Hanoi.
and takes as many as 10 days, while if the railway infrastructure was built up between Kaesong and Sinuiju (see map), both the cost and the time could be significantly reduced.

A still extremely modest share (17 percent) of Kaesong goods are exported not only to China, but to Europe, the Middle East and Russia. In the mid- to long-term, Kaesong needs to be connected with Rajin-Sunbong so that goods can be distributed throughout Russia and Europe via the Trans-Siberian Railway. In order to make this happen, companies within the KIC are seeking to attract foreign joint ventures and investments while at the same time lobbying North Korean authorities in an effort to convince them of the need for such land transportation infrastructure.

These companies are also pushing for improvements in the highway spanning the 160 km between the KIC and Pyongyang and the injection of KIC goods into the Pyongyang markets, where they could compete with Chinese imports. One part of this effort is promoting the attachment of ‘Made in DPRK’ labels to goods produced in these factories.

A further positive development for the KIC is the possibility for KIC products to benefit from the preferential treatment granted to South Korean products in the context of FTAs concluded by South Korea. KIC goods are neither part of the Korea–US FTA nor of the Korea-EU FTA, but they are included in the Korea-EFTA FTA¹⁸, and are also likely to be included in the forthcoming Korea-India CEPA.

Mount Kumgang
The Mount Kumgang Tourist Park, on the eastern seacoast, came out of a 1989 agreement between Hyundai founder Chung Ju-yung and Kim Il-sung’s government to create a tourist resort for South Koreans north of the DMZ. Since 1998, South Korean Hyundai had been running tour boats for South Koreans to Mount Kumgang in North Korea. The establishment of the Mount Kumgang tourist zone formalized the activities of the previous four years and Hyundai was allowed to open a land route to Mount Kumgang (Park 2003).

Kumgang is reported to bring the DPRK US$ 72 million in rent, and tourists from the South spent some 10 million there annually. Kumgang recorded its one-millionth visitor in the summer of 2005. The resort has been closed since July 2008, after a tragic shooting incident, but looks likely to reopen. In contrast to the KIC, the Mount Kumgang Tourist Park is not an industrial special economic zone. As such it cannot be expected to contribute much to the country’s economic transformation. Again, from the DPRK’s perspective, the major attraction of this special zone is that it is a source of hard currency.

¹⁸ The Korea-European Free Trade Association (Korea-EFTA) includes Switzerland, Norway, Iceland and Lichtenstein.
A comparison with China's strategy

As part of its strategy to open up its economy, China pushed for establishment of special economic zones (SEZs), departing from its past approach of developing the country on its own. SEZs are referred to as government-designated areas that are open to investment by foreign countries. These areas were designed not only to draw foreign investment but also to introduce advanced technology (Nam 2001).

Prima facie, North Korea’s recent attempts to open economic free trade zones mirrors China’s attempts to create autonomous regions dedicated to the influx of foreign trade and investment. In reality, however, the objectives are quite different. A major difference is the willingness on the part of North Korea’s authorities to maintain the SEZs separate from the rest of the economy. The KIC, which is the most successful zone to date, is clearly perceived and conceived as an enclave with as little contact as possible with the rest of the country. The choice of Kaesong rather than Nampo, as initially proposed by South Korea, is an indication that North Korean authorities want to maintain their control over the complex and to keep its potential influence away from the capital city in particular. Moreover, the official openness to foreign investment is not associated with a resolute move towards reform in the rest of the economy. As recalled earlier, the initial reform moves have been followed by a setback.

As for the Mount Kumgang Tourist Park, it cannot be expected to play much of a role in the opening up of the North Korean economy. It is again clearly a major source of hard cash but nothing more.

In the case of North Korea, in contrast to China, SEZs appear to be substitutes for openness, rather than actual instruments of openness.

A number of recent moves may, however, signal forthcoming changes. Such is the case of the Ryucho Island Free Trade base, alluded to earlier. Through this project, North Korean authorities apparently plan to renew efforts at building a special economic district in Sinuiju, the largest gateway city on the Sino-Korean border. It remains to be seen, however, whether this renewed attempt will be more successful than the previous one.

In addition, as explained at the very beginning of this paper, a new component of North Korea’s strategy for achieving its economic and infrastructure goals in the run-up to 2012 is its effort to attract investment from overseas. The Director of North Korea’s newly established Foreign Investment Board unveiled a new plan for attracting equity, contractual, and 100 percent foreign-owned joint venture investments. On paper, the rules incorporate provisions for repatriation of profit, generous tax incentives, and a labor rate of € 30
per month. It is worth stressing that this rate undercuts the compensation of US$ 57.50 (approximately € 40) per month currently offered at the South Korean-invested KIC. Even more generous was the offer of special concessions in North Korea’s natural resources sector for companies willing to build 100,000 units of new housing in Pyongyang that have already been promised in the run-up to 2012 (Snyder 2009). This move is a welcome one since such efforts to open the economy through foreign investment are exactly the course that should be encouraged and advocated for. However, the credibility of the move remains an open question.
Conclusion

This brief analysis of the current external economic relations of the DPRK leads to a number of conclusions. First, the North Korean economy maintains very limited exposure to the outside world and, as a result, to external influence. In terms of volume North Korea’s trade is minuscule, even in relation with the size of its economy. This is also the case for foreign direct investment inflows.

Secondly, although North Korea is less isolated than often thought, its trade and investment flows are very heavily polarized both geographically and sectorally, limiting de facto their potential impact. In contrast to what was the case during the Soviet era, North Korea’s main economic partners are not ideological partners but neighboring economies, namely China and South Korea. They are major partners in trade as well as in FDI. Russia still plays a non negligible role but is in no way comparable to what was the case before the demise of the Soviet bloc.

Thirdly, North Korea’s external economic relations are very much dictated by political considerations. Politics accounts both for the choice of partners and for the nature of the economic relations.

Fourthly, and more importantly, the very distinct nature of the DPRK’s connection with the rest of the world, and primarily with its two major economic partners, sets it apart from other transition economies and in particular from China, but also from Vietnam. In the case of North Korea, economic openness, although announced time and again as an official objective, cannot be seen as an instrument for enhancing competitiveness or as part of a development strategy. The recent, renewed signs of reform in the direction of increased openness should thus be interpreted with utmost caution.

Fifthly, the structure of the country’s external trade is indicative of an economy in survival mode. The substantial aid component in the inter-Korean trade and FDI relationship undoubtedly further substantiates such a claim. Surprisingly, relations between North Korea and China are more often based on a market-economy logic, although this only holds true for trade flows and not FDI flows. The probability of change through trade appears still very limited.

Lastly, the role the European Union may play in the region remains very much an open question but the margin of maneuver is limited. Given the state of play described earlier, it would be extremely naïve to believe that a European engagement strategy vis-à-vis the DPRK could contribute to economic change. In addition the
country’s lack of attractiveness for potential investors is a further obstacle. However, the persistent uncertainty and the lack of visibility over the political and economic evolution of the DPRK should not deter European interest in the region and, far to the contrary, should provide a strong incentive to closely monitor the economic moves made in Pyongyang.
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