THE POLITICAL ECONOMY OF CHINESE INVESTMENT IN NORTH KOREA

A Preliminary Assessment

Jae Cheol Kim

Abstract

This article explores the burgeoning of Chinese investment in North Korea. By drawing on various materials including press reports and official data from both China and South Korea, the paper suggests that this rapid growth serves China's general policy goals toward North Korea, propping up the Pyongyang regime by leading it to embrace sustainable economic reforms. At the same time, Chinese investment has increasingly taken on commercial attributes.

Keywords: China, North Korea, investment, North Korean regime, Sino-North Korean relations

Chinese investment in North Korea is increasing rapidly. In 2004, according to an official Chinese source, the amount of Chinese investment reached $14.13 million, more than a tenfold increase from $1.12 million in 2003.[1] The 2004 investment in the North, according to other Chinese sources, accounted for 48.6% of the total amount China had invested in North Korea to that point.[2] In addition, according to data from the South Korean government,

Jae Cheol Kim is Professor of International Studies at the Catholic University of Korea in Seoul. He wishes to thank an anonymous reviewer for comments on an earlier draft of this paper. This research was supported by the Catholic University of Korea Research Fund, 2006. Email: <jckim@catholic.ac.kr>.

1. People's Republic of China (PRC), Ministry of Commerce, "2004 niandu Zhongguo Duiwai Zhijie Touzi Tongji Gongbao" (Statistical bulletin on China's outward direct investment, 2004), <http://fec.mofcom.gov.cn/table/20040909.pdf>, accessed October 24, 2005.

2. According to these data, the amount for 2004 was $8.99 million, and the total amount was $18.5 million. See *Almanac of China's Foreign Economic Relations and Trade* and *China Commerce Yearbook*, various years.

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this investment accounted for about 85% of total foreign investment in North Korea that year.[3] The figure for Chinese investment in North Korea was expected to soar to $85 million to $90 million in 2005.[4]

Chinese investment in North Korea is not only growing but also experiencing a transformation. The sectors in which Chinese companies invest are expanding from restaurants and entertainment to resource development and infrastructure projects. For example, over the past couple of years China has actively participated in developing mines and building roads and railways. The pool of investors has changed from individual merchants mainly composed of Korean-Chinese to entrepreneurs from all over China.[5] Chinese companies and entrepreneurs have become major players in numerous trade and investment fairs held in North Korea or in China, generally accounting for 80% to 90% of the total number of participants.[6]

This paper explores the burgeoning of Chinese investment in North Korea. The rapid increase in this investment, of course, is not merely the result of China's decision. North Korea too has attempted to attract Chinese investment by introducing economic changes. Given this, the increase in Chinese investment suggests that the North is experiencing economic transformation. This article will examine the investment from the Chinese perspective.

This study provides an opportunity to understand China's policy toward North Korea. Bilateral ties deteriorated considerably when China established diplomatic relations with South Korea in 1992. Although the relationship with Pyongyang began to recover from the late 1990s with the resumption of exchanges of high-level visits, the ties remained constrained until very recently. After North Korea admitted to the U.S. in October 2002 that it had restarted its nuclear program, triggering a crisis on the Korean Peninsula, some Chinese observers began to argue that North Korea was a strategic liability.[7] In view of this, the growth of Chinese investment in North Korea needs to be explained. Why does China invest in North Korea? What does this reveal about China's North Korea policy? Does increasing Chinese investment suggest that Beijing is reaching out to North Korea economically? If so, is this process helping China to regain influence over North Korea?

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3. According to this data, Chinese Investment in North Korea for 2004 was about $50 million. See ROK, Ministry of Unification, *Weekly Report on North Korea*, no. 761 (05.10.7–10.13), p. 20.

4. Andrei Lankov, "China Raises Its Stakes in North Korea," *Asia Times Online*, December 17, 2005.

5. <http://www.huaxia.com/20040615/00211689.html>, accessed August 17, 2005.

6. For instance, out of 76 foreign companies that participated in the 8th Pyongyang International Trade Expo, May 2005, 67 were Chinese. <http://www.xttzw.com/dprk/shownews.asp?newsid=16246>, accessed September 27, 2005.

7. See Shi Yinhong, "Chaoxian He Weiji yu Zhongguode Zhigao Zhanlue Liyi" (North Korea nuclear crisis and China's supreme strategic interests), *Zhongguo Pinglun* (China Commentary), no. 62 (February 1, 2003), pp. 14–18.

Tracking Chinese investment in North Korea is not easy because foreign direct investment (FDI), like everything else surrounding North Korea, is shrouded in secrecy. The country keeps a low profile, seldom revealing data on the FDI it attracts.[8] Although China publishes data about its outward investments, it is not clear whether Beijing's official data provide the whole picture of its investment in the North. China has kept the economic assistance it gives to North Korea secret. In addition, the North does not hesitate to cancel joint economic projects when they draw too much publicity. Therefore, we should expect that Chinese data would understate the amount invested in North Korea. In order to sketch the whole picture, in whatever preliminary way, it is necessary for us to aggregate various materials including press reports and official data from both China and South Korea.

This paper suggests that China's burgeoning investment in North Korea serves Beijing's general policy goals. Despite growing discontent over North Korean actions, China has attempted to avoid collapse of the ruling regime, which would have devastating consequences for Beijing as well.[9] In addition, believing that the viability of North Korea in the long run depends on stable economic development, the Chinese government has pushed Pyongyang to follow the path of economic reform. China's investment is an effort to coax North Korea to embrace sustainable economic reforms by providing seed money and technology. At the same time, however, this investment has increasingly taken on commercial attributes as China pursues its own economic interests.

This article begins by examining several important characteristics of Chinese investment in North Korea. It then explores China's motives for investing in some detail. It reviews this investment from a broader perspective by drawing on existing research on Chinese outward investment. Lastly, the paper examines the impact of Chinese investment on Sino-North Korean relations. It concludes with a discussion of the prospects for future Chinese investment.

Characteristics of Chinese Investment in North Korea

Sector Distribution

As noted, the sectors in which China invested have heretofore focused on service. Restaurants and entertainment operations that drew investment by Chinese

8. In a rare exception, a North Korean official revealed in an explanatory meeting for potential Chinese investors in February 2005 that 120 Chinese companies had already invested in North Korea. Lim Keum Sook, "On Chinese Companies' Investment in North Korea," *Tongil Jeongchaek Yeongu* (Journal of Unification Policy Studies) 14:1 (2005), p. 247.

9. See David Shambaugh, "China and the Korean Peninsula: Playing for the Long Term," *Washington Quarterly* 26:2 (Spring 2003), pp. 43–56; Andrew Scobell, *China and North Korea: From Comrades-in-Arms to Allies at Arm's Length* (Carlisle, Penn.: Strategic Studies Institute, U.S. Army War College, 2004); and "China and North Korea: Comrades Forever?" *Asia Report*, no. 112 (February 2006), International Crisis Group.

merchants and private companies have enjoyed a substantial slice of the North Korean market.[10] Sales and distribution have also become popular sectors for Chinese investment. The changes occurring in North Korea have strengthened Chinese interest in this sector. While its consumption levels have increased, North Korea has not been able to provide enough products on its own. In an attempt to exploit this increasing demand, Chinese companies have opened new markets and department stores in North Korea. In June 2004, for instance, the Shenyang Municipal Association for Trade Promotion opened Daesong Market in Pyongyang, the first wholly foreign-owned company in a non-science sector.[11] By early 2005, three big department stores were being run either by the Chinese alone or jointly.[12] The best publicized case was the First Department Store in Pyongyang, which is a prominent landmark. In a much publicized deal in 2004, a Chinese company signed a contract with a North Korean authority to run the store for 10 years.[13]

The sectors in which China invests have begun to expand further to include manufacturing and processing. Nanjing Panda Electronics Group established a joint venture with a North Korean company to produce computers. A subsidiary of Shenyang Five Metals (Wujin) Group established a joint venture that produces engine oil for automobiles.[14] More recently, China has shown an interest in joint resources development projects. The best known case is the project to develop the Musan iron mines. It is not easy to draw an exact picture of Chinese investment in the mines because many press reports suggest different stories. According to a Korean report, a Chinese company from Jilin Province planned to invest about $500 million in the mines.[15] *Ta Kung Pao*, a Hong Kong newspaper, reported that three companies from Jilin—Tonghua Iron & Steel Group (Tonggang), Yanbian Tianchi Company, and Sinosteel Corporation (Zhonggang)—contracted rights to exploit the Musan iron mines for 50 years. According to the report, the Chinese companies were going to invest 7 billion yuan (about $865 million) and planned to produce 10 million tons of iron ore each year.[16]

10. <http://news.xinhuanet.com/fortune/2004-08/14/content_1788302.htm>, accessed September 23, 2005.

11. <http://www.huaxia.com/20040615/00211689.html>, accessed August 17, 2005.

12. *Yazhou Zhoukan* (Asia Week), May 29, 2005, p. 14.

13. <http:/business.sohu.com/20040824/n221707505.shtml>, accessed August 17, 2005; and <http://www.jl.cinfo.net/content/cn/finance_tpxw/b_111408.htm?te...>, accessed September 22, 2005.

14. <http://news.xinhuanet.com/fortune/2004-08/14/content_1788302.htm>, accessed September 22, 2005.

15. “Trade Traffic Tells of N. Korea’s Dependency on China,” *Chosun Ilbo* (Chosun Daily), July 13, 2005.

16. *Ta Kung Pao*, November 2, 2005, cited in *Joongang Daily*, November 3, 2005, p. 3.

In addition to tapping natural resources, China has begun to invest in developing infrastructure that could facilitate two-way trade and further investment. Because of enduring economic difficulties, infrastructure in North Korea is dilapidated. As a result, China usually faces a problem when it tries to import the natural resources it produces in North Korea, that is, the lack of facilities through which it can carry them back. To solve this problem, China has begun to invest in improving transport links. In the case of the Musan mines, 2 billion yuan (about $240 million) out of the 7 billion China committed to invest was allocated to building roads and railways from Musan to Tonghua in China.[17] The municipal government of Dandong, a city which accounts for 70% of the two-way trade, helped set up a joint venture in 2005 invested in by two Chinese companies (Dangdong China Railways International Express and China Railways Dandong Station) and the North Korea Railways Ministry.[18] In order to facilitate transportation between China and North Korea, the joint venture will buy 50 to 100 freight cars by drawing in investment from other companies, including some in Hong Kong.

Division of Labor between Center and Regions

With regard to investment in North Korea, there exists a division of labor between the center and the regions of China. The central government sets the general direction and pace of investment. Over the past few years, the State Council has taken the initiative to encourage investment in resource development and infrastructure projects by sending its opinions and directions to the regions. In 2005, for instance, the General Office of the State Council issued an "opinion" that asked northeast provinces to expand their overseas investment, especially in transportation and joint development of energy and natural resources. Officials also raised the necessity of promoting investment in building roads and ports connecting China with North Korea.[19] The Chinese center has adopted several measures to encourage investment in the North, discussed below.

It is the regions that implement the investment policies set by the center. Largely because of geographical proximity and historical links, Chinese investment in North Korea has been initiated by governments or companies from the three provinces of China's Northeast. Out of economic self-interest, Jilin Province has been very active in pursuing economic cooperation with North Korea, notably in exploiting natural resources there. According to Wang Min, the provincial governor, Jilin invested in the Musan mines in order to lay the groundwork for developing Tonghua Iron & Steel Group.[20]

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17. Ibid., p. 3.
18. *Yazhou Zhoukan*, October 30, 2005, pp. 8–9.
19. <http:www.jsgs.gov.cn/Page/StatuteDetail.aspx?StatuteID=5645>, accessed September 15, 2005.
20. *Ta Kung Pao*, p. 3.

Another important reason for such investment is to gain access to the sea. Inland Jilin has to send freight long distances to the port of Dalian in Liaoning Province facing the Korean Peninsula. Sizable investment levels might help Jilin secure access to seaports in North Korea.[21] In 2004, Wang Yunkun, the party secretary of Jilin, revealed his intention to strengthen economic cooperation with North Korea with this purpose in mind.[22] The goal was realized in 2005 when two companies from the border city of Hunchun—Hunchun Donglin Trading Company and Hunchun Border Economic Cooperation Region Bond Company—reached an agreement with the municipal government of Rason in North Korea to establish a joint firm, the Rason International Logistics Joint Company.[23] Rason International secured the exclusive rights to run the No. 3 and No. 4 piers of Rajin port for 50 years. In order to secure the rights, China committed to investing 30 million euros ($36 million) to build an industrial park, tourism facilities, and a road from the trade district of Rason city to Rajin Port. North Korea in turn committed to providing China with 5 to 10 square kilometers of land to build the industrial park.[24]

Liaoning, another border province, has increasingly participated in economic cooperation with North Korea. In 2004 an air route between Shenyang, the provincial capital, and Pyongyang was opened, contributing to the acceleration of two-way economic cooperation. Over time Dandong, a gateway city in Liaoning that connects China to North Korea, has emerged as a beachhead for Chinese investment. Not only have many Chinese companies opened offices in Dangdong but also North Korean trading companies run by the government and the party have established theirs in Dandong.

Although provinces located close to North Korea have been in the forefront of Chinese investment there, provinces and companies from southeastern coastal regions of Fujian and Guangdong—which have spearheaded Chinese outward investment—rarely participated in economic cooperation with North Korea. Over time, however, more provinces have begun to show interest in this effort. Many companies from coastal regions have established representatives in Dandong, suggesting that economic powerhouses such as Zhejiang and Jiangsu Provinces could join in as well.[25] At the 8th Pyongyang International Trade Expo in May 2005, Chinese companies from more than 10 provinces participated, including Zhejiang, Jiangsu, and even the Xinjiang region in the far west of the country.[26] The change was inevitable because the economy of

21. The province has attempted to "buy" port access for a long time. See Scott Snyder, "North Korea's Decline and China's Strategic Dilemmas," United States Institute of Peace, October 1997, <http://www.usip.org/pubs/specialreports/early/snyder/China-NK-pt3...>.

22. *Chosun Ilbo*, April 23, 2004.

23. *Jilin Ribao* (Jilin Daily), October 12, 2005.

24. *Heilongjiang Ribao* (Heilongjiang Daily), September 16, 2005.

25. <http://www.huaxia.com/20040615/00211689.html>, accessed August 17, 2005.

26. <http://www.chyl.com.cn/template/aa/z-news/chyl-28.dwt>, accessed August 18, 2005.

China's northeastern provinces lagged behind that of the coastal provinces. Provinces such as Jilin and Liaoning could not produce enough of the light industrial products Pyongyang needed, so they turned elsewhere including China's coastal provinces, which found a tempting market in North Korea.

Led by Small- to Medium-Sized Enterprises

Although big state-owned companies account for the majority of Chinese outward investments,[27] they rarely invest in North Korea, leaving this to small- to medium-sized companies.[28] In the past, most Chinese investors were Korean-Chinese merchants from two areas in China: Liaoning Province and the Yanbian Korean Autonomous Prefecture. Similarities in language and culture made it relatively easy for these merchants to enter the North Korean market. Recently, however, entrepreneurs seeking business opportunities have begun to supplant the small merchants. For instance, a host of merchants from Wenzhou in the eastern province of Zhejiang have begun to make investments. Most are doing business in the Northeast region and are trying to take advantage of their personal links with their home city, which has emerged as a center for light industry products. Despite their participation, as Chinese press reports suggest, the average size of Chinese investment in North Korea is small and the level of technology is low.[29]

There are several reasons for the constraint. First, the Chinese government encourages small- and medium-sized enterprises, not big companies, to make the initial move. These pilot investments by relatively small firms are a way for China to test the market amid the obscurity of North Korea's economic future and the instability of its current economy. Second, merchants and companies that run small companies have been more eager about investing than entrepreneurs who run big companies because the former are more positive about the future of the market and more open to risk-taking than the latter. This difference was vividly revealed at the 8th Pyongyang International Trade Expo. At the fair, big companies on the one hand and small- to medium-sized companies on the other hand varied in their evaluation of the future of the North Korean market. Small- and medium-sized companies expressed high expectations. For instance, a businessman who ran a small company in Zhejiang saw many opportunities for making money as the standard of living in North Korea improved. In contrast, big companies did not show an interest in investing in North Korea. Even

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27. According to data published by the Chinese Department of Commerce, 30 top companies accounted for 80.4% of the total amount of outward investment in 2004. See "Statistical Bulletin on China's Outward Direct Investment, 2004."

28. <http:/business.sohu.com/20040824/n221707505.shtml>, accessed August 17, 2005.

29. <http://news.xinhuanet.com/fortune/2004-08/14/content_1788302.htm>, accessed September 23, 2005.

TCL, which makes the home appliances that North Korea needs, hesitated to evaluate positively the future of the market.[30]

Chinese Motivations for Investing in North Korea

Over the past few years, China has become one of the fastest-growing sources of FDI globally. Its growing foreign exchange reserves, which have been drastically boosted by exports, foreign investment, and even speculative capital, have laid the basis for the rapid growth of outward investment.[31] By the end of 2004, according to a deputy commerce minister, China had invested $37 billion abroad in nearly 8,300 ventures in more than 160 countries.[32]

Existing scholarly literature suggests that the Beijing government has played an important role with regard to outward investment. It has laid the foundation for rapid development of Chinese investment through a "go abroad" (*zouchuqu*) strategy from 2003 that encourages firms to invest overseas. In making decisions about outward investment, Beijing often pays attention to political and strategic as well as commercial considerations.[33] It is true that the importance of economic factors has increased over time. Chinese companies aim to secure new markets, natural resources, and advanced technology. Despite the increasing importance of economic considerations, however, politics still plays an important role in Chinese outward investment. The government attempts to "buy" allegiance by investing heavily in strategically and politically important countries.[34]

The motives that lie behind China's overseas investment in general can also be discerned for its investment in North Korea, which can be seen as an element of broader political activities by the Beijing government. China's efforts are designed not only to bolster the stability and prosperity of North Korea by nudging Pyongyang to embrace reform and opening but also to increase Beijing's influence over its neighbor. Still, the investment efforts no longer constitute unconditional assistance. On the contrary, China is seeking to boost its market share and to obtain natural resources in North Korea.

30. <http://www.xttzw.com/dprk/shownews.asp?newsid=16246>, accessed September 27, 2005.

31. Kevin G. Cai, "Outward Foreign Direct Investment: A Novel Dimension of China's Integration into the Regional and Global Economy," *China Quarterly* (December 1999), p. 863. China's foreign exchange reserves have tripled since 2002.

32. Cary Huang, "Accent Put on Firms' Investment outside Mainland," *South China Morning Post*, March 8, 2005.

33. Cai, "Outward Foreign Direct Investment," p. 859.

34. See, for instance, Mark Y. Wang, "The Motivations Behind China's Government-initiated Industrial Investment Overseas," *Pacific Affairs* 75:2 (Summer 2002), pp. 187–206.

Encouragement by the Chinese Government

In recent years, the Chinese government has encouraged outward investment, discarding a former policy that restricted it. In order to facilitate these investments, Beijing has taken a series of steps, including relaxing its grip on capital outflows. In 2003, officials allowed Chinese companies to use their foreign exchange reserves to buy foreign assets, simplifying the approval procedures for investing in other countries.[35] In addition, Beijing has acted to provide the information needed for outward investment. In July 2004, the ministries of Commerce and Foreign Affairs jointly issued a guideline that encouraged Chinese companies to invest abroad for the first time.[36] Lastly, officials have formulated a series of preferential policies to encourage outward investment. These include tax incentives, subsidies, preferential bank loans, and better access to the domestic market for goods produced by firms overseas that China invests in.[37]

The Chinese government has played a critical role in encouraging Chinese firms to invest in North Korea. China does not want to see turbulence on the Korean Peninsula, which could not only lead to the economic and political collapse of a socialist regime on China's border but could also threaten regional stability. China thus has tried to sustain the Pyongyang regime by providing economic assistance and help.[38] Believing that reform and opening would not only revive the North Korean economy but also reduce the need for regular aid to prop up the regime, Chinese leaders have repeatedly urged their counterparts to embrace market-driven reforms such as those that have made China the world's fastest growing economy. Every time he visits China, North Korean leader Kim Jong Il is taken on tours to see the results of China's economic reforms.

The issue of economic reform, however, has also strained bilateral relations by creating mutual resentment and distrust. North Korea has been reluctant to follow China's path of reform and opening because it worried that the policy may create political problems. In an apparent response to China's recommendation in the late 1990s for reform, for instance, Kim asked Beijing to respect "Korean-style socialism."[39] Nor is China's support for reform unconditional. When North Korea decided to set up a special economic zone in Sinuiju, a city near the border, apparently without prior consultation with Beijing, China aborted the project by arresting Yang Bin, whom North Korea had designated head of the zone, in October 2002.[40]

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35. *Beijing Review*, August 12, 2004, p. 38.

36. <http://www.mofcom.gov.cn/column/print.shtml/b/bf/200408/20040...>, accessed August 29, 2005.

37. Cai, "Outward Foreign Direct Investment," p. 873.

38. China is North Korea's biggest trading partner and provides much of its fuel and food, accounting for most of North Korea's oil imports after the U.S. stopped shipping heavy oil fuel in 2002. See *Chosun Ilbo*, July 15, 2004.

39. Agence France-Presse (AFP), July 16, 1999.

40. "China Arrests Head of North Korea Project," *Washington Post*, November 28, 2002.

By the end of that year, North Korea had triggered a crisis on the Korean Peninsula by admitting to the U.S. that it had restarted its nuclear program. Fearing that the U.S. might attack North Korea militarily, China took the initiative the following year to solve the crisis. Chinese officials rejected sanctions as a means to pressure Pyongyang to abandon its nuclear program, fearing that this tactic could lead to regime collapse there. Instead, China turned to economic means, offering assistance if North Korea would join the six-party talks.[41]

Believing that North Korea had a better chance for survival through embracing reforms instead of playing the nuclear card, the Chinese leadership continued to press for economic reforms. With Pyongyang adopting an economic adjustment policy in July 2002, the Chinese saw the prospect for substantial reform as higher than ever before and began providing the North Koreans with technology and seed money. Of course, China had an additional aim: increasing its influence over North Korea, which in turn could help strengthen Beijing's relations with Washington.

Chinese leaders have promised investment and trade as well as economic aid. In October 2003, Wu Bangguo, chairman of China's National People's Congress, promised his North Korean counterpart that he would encourage economic cooperation between Chinese companies and North Korea.[42] The following year Beijing accelerated its efforts to boost investment by Chinese companies in the North. Just before Kim Jong Il's visit in April 2004, the Chinese government publicized recent economic changes in the North, suggesting that investing in North Korea was a great business opportunity. The official *People's Daily* ran an article pointing out that North Korea had embarked on economic changes and achieved rudimentary results.[43] During Kim's visit, Chinese Premier Wen Jiabao said that the Chinese government would encourage more of its companies to invest and establish their businesses in North Korea.[44] For Chinese firms, the prime minister's statement amounted to a government directive, with some entrepreneurs understanding that Wen's statement was a signal for Chinese companies to invest.[45]

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41. When Wu Bangguo made an official visit to North Korea at the end of October 2003 in order to encourage the North to participate in the second round of six-party talks, he indicated that China would give North Korea $1.5 billion in capital. Guo Feixiong, "China's Role and Objectives in the North Korean Nuclear Crisis," *China Strategy* 3 (July 20, 2004.)

42. *Renmin Ribao* (People's Daily), October 30, 2003, p. 1.

43. *People's Daily*, April 16, 2004, p. 3.

44. Ibid., April 22, 2004, p. 1.

45. Zeng Changbiao, for instance, embarked on negotiations with the North Korean authorities after Wen made the remarks, believing that Wen's remarks finally broke the political obstacle to investing in North Korea. "Wenzhou Shangren Jinjun Chaoxian" (Wenzhou's merchants march into North Korea), *Fenghuang Zhoukan* (Phoenix Weekly), no. 23, 2004, <http://www.phoenix.com.cn/home/phoenixweekly/153/1564page.html>, accessed August 17, 2005.

After Wen made his remarks, Chinese investment in North Korea began to surge. Organizations were formed to smooth such investment, including the Shenyang Municipal Association of Entrepreneurs (Shenyangshi Qiyejia Xiehui), Dandong Municipal Economic Consultation Center for the Korean Peninsula (Dandongshi Chaoxianbandao Jingji Zixun Zhongxin), and Beijing Sino-Korea Economic & Cultural Exchange Company (Beijing Chaohua Youlian). They organized explanatory meetings on investment, drawing numerous applicants.

Government support was crucial to Chinese investors, many of whom were hesitant in part because North Korea lacked a sound investment environment and risk to entrepreneurs therefore increased. Beijing attempted to boost investors' confidence by signing an "Investment Encouragement and Protection Agreement" with Pyongyang in March 2005 when Premier Park Bongju visited Beijing. The framework for economic and technological cooperation was made clearer through the signing of an "Agreement on Economic and Technological Cooperation" that October. Chinese officials have given preferential treatment to firms that invest in North Korea, including financial incentives and guarantees. China's state-run banks have not only provided companies with investment capital[46] but also have underwritten Chinese investment for joint ventures.[47] Beijing granted preferential treatment to products processed in the North, allowing them better access to the Chinese market. Products that were processed in the Rajin area with Chinese materials and then imported to China, for instance, were labeled domestic trade and were thus exempted from customs inspection.[48]

In sum, the Chinese government has guided investment in North Korea. Chinese Premier Wen has alluded to his government's active role, publicly mentioning the need for official guidance along with the principle of "enterprise participation and market operation."[49] That the Chinese government has had to play a guiding role in turn suggests that Chinese investment is politically motivated.

Opening Up and Occupying the Market

Exploring new markets is clearly the predominant motivation for Chinese outward investment. The main reason why Chinese companies seek new overseas markets is that the domestic market has been saturated. Since the late 1990s, production capacity has expanded dramatically, exceeding domestic demand.

46. Tonghua Steel, for instance, borrowed 30% of needed capital for investing in the Musan mines from China Development Bank. Michael Rank, "Minerals, Railways Draw China to North Korea," *Asia Times Online*, November 18, 2005.

47. "China and North Korea: Comrades Forever?" p. 26.

48. *Heilongjiang Ribao*, September 16, 2005.

49. "Top Leaders of China, DPRK Hold Talks in Beijing," *People's Daily Online*, January 19, 2006.

As a result, China's market for some products such as home appliances and light industrial products has matured. Surveys show that currently many industrial products have been manufactured below production capacity. For instance, a recent government report estimated that "three-quarters of all categories of manufactured goods" suffered from overcapacity.[50]

Opening up new markets is a major reason why China has begun to invest in North Korea. Chinese companies are anxious to establish an economic presence there. Zeng Changbiao, chief executive officer (CEO) of the Zhongxu Group, the company that signed a contract to run the First Department Store, has said that his main motive for investing was to take over the North Korean market. He said that he wanted to be dominant in the North Korean retail business by securing and expanding market share.[51] Chinese entrepreneurs also appear to want to develop a strong industrial base there.

Several factors have attracted Chinese entrepreneurs into the North. Improved economic conditions in North Korea have favored investors, and under economic adjustment in 2002, production there has increased to some extent. Domestic demand and consumption have also grown as workers' wages rose and the mandatory distribution system was abolished. Chinese entrepreneurs see that the purchasing power of North Koreans is greater than before. In fact, North Korea's increasingly affluent middle class has been able to afford more products and services. They have begun to buy jackets that cost a month's salary or television sets worth more than two years' wages.[52] Chinese entrepreneurs who invest in North Korea are optimistic about its economic future; they expect that demand for Chinese products will rise once Pyongyang embarks on substantial reform policies.

Second, it costs a lot less to do business in North Korea than in China. Labor costs in the former are far lower, running only 70–80 yuan (about US$10) per month.[53] Building a factory is very cheap, up to one million yuan (about $120,000).[54] Chinese entrepreneurs see that what North Korea needs is largely light industrial products. Because brand consciousness there is weak,[55] these investors believe that many Chinese companies, even small- and medium-sized

50. "Speculators Turn Away from China, Making Revaluation Less Pressing," *New York Times*, January 5, 2006.

51. <http://www.1798.cn/class/print.asp?newsid=945>, accessed September 22, 2005.

52. "Through a Glass, Darkly," *Economist*, March 11, 2004.

53. <http://www.jl.cinfo.net/content/cn/finance_tpxw/b_111408.htm?te...>, accessed September 22, 2005.

54. "Chaoxian Jingji Zhengce Fenxi he Zhongguo Qiye Mianlin de Jihui" (The analysis of North Korean economic policy and opportunities for Chinese enterprise), <http://www.dajingmao.com/sub/view.asp?id=1505>, accessed August 17, 2005.

55. "Yalujiang Duian xiang Zhongguo Qiye Zhaoshou" (The opposite bank of Yalu River invites China's companies), *Minying Jingji Bao* (Private Economy News), April 11, 2005.

ones, can compete in the North Korean market.[56] The scope for making profits is bigger in North Korea than in China because manufacturers can charge more for similar products in the North. For example, the price of a cigarette lighter is three to five yuan ($0.36 to $0.60) in Pyongyang but only 0.5 yuan ($0.06) in Wenzhou, China.[57]

Third, China and North Korea have mutually complementary economies. While there are surpluses of production capacity in China, North Korea needs products, especially those produced by light industry. In other words, China can provide what North Korea needs. Chinese entrepreneurs believe that they can adjust to the North Korean economy more easily because they personally have experienced transition from a planned to a market economy. Because North Korea's economic situation is similar to that of China two decades ago, the entrepreneurs are of the opinion that they can not only better understand the policy changes that are happening[58] but also better predict future changes.[59]

Lastly, in view of the "traditional friendship" that exists between the two countries, Chinese entrepreneurs believe that they enjoy many preferential policies that companies from other countries do not. Although North Korea is eagerly looking for investment from overseas, the Chinese see that the North will not open its doors toward every country.[60] The deputy CEO of Beijing Sino-Korea Economic & Cultural Exchange Company, a Beijing company that helps Chinese companies invest in the North, has been quoted as saying that whether a company is able to invest in North Korea depended not on the company's will but on whether the North would accept it or not. Foreign investors, he added, needed to meet the criterion of "political reliability."[61] In practice, concerns about political contamination limit North Korea's economic cooperation with South Korea, whose government has eagerly pushed economic integration with the North. North Korea's opening therefore means an opening toward China, and this in turn gives Chinese companies very rare advantages.[62] Chinese entrepreneurs enjoy many preferential concessionary terms for their investments, better than those offered to other countries. For example, in the case of the department store discussed above, the Zhongxu Group's Zeng received the lowest tax rate—5% income and 5% import—in the North

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56. <http://www.chyl.com.cn/template/aa/z-news/chyl-9.dwt>, accessed August 17, 2005.
57. <http://www.1798.cn/class/print.asp?newsid=945>, accessed September 22, 2005.
58. <http://www.chyl.com.cn/template/aa/z-news/chyl-9.dwt>, accessed August 17, 2005.
59. <http:/business.sohu.com/20040824/n221707505.shtml>, accessed August 17, 2005.
60. Jin Zhe et al. (eds.), *Chaoxian Touzi* (Investment in North Korea) (Dalian: Dalian Publication Co., 2005), p. 129.
61. "Wenzhou's Merchants March into North Korea."
62. <http://news.xinhuanet.com/fortune/2004-08/14/content_1788302.htm>, accessed September 23, 2005.

Korean tax system.[63] Some see the preferential policies offered to the Chinese as better than those offered by Hong Kong.[64]

The advantages described above mean the Chinese are optimistic about competing in the North Korean market. Some Chinese entrepreneurs see this as a better target market than China, where competition is severe and dominant companies exist in many sectors. However, they do not expect that they can make profits in the North Korean market right away;[65] rather, they plan to be ready for when the North opens to the world, by moving into the market early.[66] In addition to laying the groundwork, these entrepreneurs are trying to incubate the market by investing in a wide range of sectors such as transportation, electricity, and communications. They are approaching the goal from a long-term perspective.

Securing Natural Resources

With its rapid economic development, China has replaced the U.S. as the world's top consumer. According to a report by the environmental advocate Earth Policy Institute, China has surpassed the U.S. in consumption of major basic food, energy, and industrial commodities, except for oil. In 2003, for instance, China's steel consumption was more than twice that of the U.S.: 258 million tonnes to 104 million tonnes.[67] Domestic supplies can hardly satisfy China's resource consumption. By 2020, according to another report, China will be self-sufficient in only six of the 45 most important minerals.[68] To feed its consumption and support its economic growth, China has to import resources. Outward investment is used to acquire a stable supply of vital resources such as oil, aluminum, and iron ore that China's rapid industrialization requires.

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63. "Wenzhou's Merchants March into North Korea." The rate is lower than both the 25% stipulated in North Korea's "tax law for foreign-invested companies and foreigners" promulgated in 1993 and the 14% that South Korean companies enjoy in Kaesong Industrial Complex in the southern part of North Korea. See <http://www.nea-forum.com/informatsia/informatsiadever.asp?Article . . . >, accessed January 26, 2006; and "An Industrial Park in North Korea Nears a Growth Spurt," *New York Times*, February 28, 2006.

64. <http://www.1798.cn/class/print.asp?newsid=945>, accessed September 22, 2005.

65. Data on the profitability of Chinese investment are hard to come by. But the fact that Chinese companies still hesitate to invest and that Chinese leaders have to encourage them to invest in North Korea suggest that it is not very profitable. According to a Chinese expert on North Korea, in his visit to North Korea in October 2005 Hu Jintao attempted to send a signal to Chinese companies to continue to invest in North Korea. Interview in Beijing, November 4, 2005.

66. <http://www.jl.cinfo.net/content/cn/finance_tpxw/b_111408.htm?te...>, accessed September 22, 2005.

67. "Expert: China Overtakes U.S. as Top Consumer," *China Daily*, February 17, 2005; "Consumption Is Ahead of the U.S.," *South China Morning Post*, February 18, 2005.

68. Mark O'Neill, "Long March to Globalization," ibid., February 7, 2005.

Securing natural resources is an important motive behind Chinese investment in North Korea. As far as raw materials and natural resources are concerned, the two countries are in complementary positions.[69] China's Northeast regions, whose economy was heavily dependent on exploiting natural resources, experienced increasing difficulties as the resources were depleted. Factories stopped functioning and unemployment increased sharply, triggering widespread social unrest from the late 1990s. To secure access to resources in an effort to rejuvenate the regional economy, China has shown an increasing interest in participating in resource development projects in North Korea. Importing iron ore from Musan, for instance, was attractive to Jilin Province because of the low transport costs between the two.[70]

North Korea also needs Chinese investment in developing its natural resources. Pyongyang is attempting to lessen its economic difficulties, which have lasted more than a decade, by importing food and light industry products with the revenues it earns by exporting its resources. But its capacity for resource development is severely limited by economic weakness. As a result, North Korea expects China to help it extract natural resources, with the Chinese making in-kind investments and obtaining the natural resources it produces, in return. The North Korean government in turn guarantees redemption by introducing a barter system in which it pays back foreign investment by providing investors with natural resources. The North Korean government has declared that foreign investment, including profits and interest, would be redeemed prior to anything else. In case Pyongyang did not have enough currency, it would redeem the investment with the natural resources it produced. Even foreign investment in non-natural resource sectors would be redeemed with natural resources in what was called a unified settlement of account.[71]

China is interested in this type of cooperation for several reasons. It is eager to transfer the excess production capacity that exists in various sectors to overseas[72] and welcomes this form of investment. Moreover, the type of economic cooperation in which both investment and redemption happen in kind is

69. <http://www.chyl.com.cn/template/aa/z-news/chyl-9.dwt>, accessed August 17, 2005.

70. Jilin Province hopes that importing iron ore from North Korea will contribute to increasing Tonghua Iron & Steel's competitiveness, which plans to increase its steel production from a projected 5.5 million tons in 2007 to 10 million tons in 2010. Rank, "Minerals, Railways Draw China to North Korea."

71. *Yazhou Zhoukan*, October 30, 2005, pp. 8–9. North Korea has shown an interest in this kind of cooperation by offering a similar method of cooperation to South Korea. At the 11th round of economic cooperation talks, on October 28, 2005, the North asked the South to provide it with clothes, shoes, and soap in return for exploring natural resources in the North. *Chosun Ilbo*, October 29, 2005.

72. "2003 nian: Zhongguo Duiwai Touzi Kaizha?" (The year of 2003: Has a gate of China's outward investment opened?), *Nanfang Zhoumo* (Southern Weekend), January 19, 2003.

safe and convenient because the investment brings little risk and is easy to quantify. Thus, as noted earlier, China often makes investment in kind in joint resource development projects. It provides North Korea with facilities and equipment such as machines, electricity, and technology, and receives compensation in the form of natural resources. Chinese investment in this sector, in other words, is mixed with trade.

Resuscitation of an Alliance Relationship?

Chinese investment in North Korea demonstrates the deepening economic relations between the two countries, marking an expansion beyond mere trade. China, which has been Pyongyang's largest trading partner, has become the biggest supplier of capital and technology to the North. Burgeoning investment suggests that China's relations with the North are increasing in economic clout in addition to having political and strategic dimensions.

What, then, are the implications of increasing Chinese investment? Does the growth help China regain influence over North Korea? Does it, as some observers suggest,[73] herald the making of an economic alliance? Increasing investment helps bolster China's influence over North Korea. China's stronger role is marked by the presence of a host of companies and entrepreneurs. In addition, by providing new production facilities and techniques, China is contributing not only to the economic recovery but also to the economic transformation of North Korea. By helping the North Korean economy, Chinese investment has made the China factor more important than previously; however, it is too soon to conclude that this signals the resuscitation of a bilateral alliance. While it *is* important for the North Korean economy, Chinese investment remains minuscule, especially when contrasted with the close political relationship that exists.

Chinese investment projects in North Korea are not only small in number but also weak in scale. There are no detailed data available on their average size, but they likely are no exception to the fact that China's outward investment is generally characterized by its small scale and low level of technology.[74] In practice, one Chinese press report suggests, most Chinese capital has gone into low technology content and labor intensive projects such as resource development, primary processing and manufacture, and service sectors.[75] Large companies through which the Chinese government usually implements its strategic intentions rarely invest in North Korea. Although many Wenzhou

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73. See, for instance, Sung-Wook Nam, "'An Economic Alliance'? Accelerating Dominance of North Korea by Chinese Capital," *Shindonga* (New Donga Monthly), no. 12 (2005), pp. 232–43.

74. See Cai, "Outward Foreign Direct Investment," p. 866; and Wong and Chan, "China's Outward Direct Investment," p. 291.

75. <http://news.xinhuanet.com/fortune/2004-08/14/content_1788302.htm>, accessed September 23, 2005.

merchants have begun to enter the North Korean market,[76] it remains to be seen whether this will lead to enhanced Chinese investment, especially by large firms.

Moreover, there exist differences between what North Korea expects from China and where China actually invests. Although North Korea wants capital in such sectors as home appliances, construction materials, electronic communications products, and machine building,[77] Chinese investment is heavily concentrated in the sectors where China's needs lie, such as resource extraction, or where its companies can make a profit, such as service sectors. The official Chinese guideline for outbound investment, noted above, recommended investment only in such manufacturing sectors as textiles, clothing, and food products, leaving aside other sectors for which North Korea wants investment.[78] This suggests that China is paying increasing attention to whether its companies can make profits by investing in North Korea,[79] while the North tries to solve its economic difficulties by drawing in Chinese investment. This is different from our usual image of an alliance.

This situation also leads us to ask whether Chinese entrepreneurs have really begun to embrace North Korea, as their Western counterparts did previously in China. There are several obstacles that make Chinese companies and entrepreneurs hesitate to invest in North Korea. Firstly, many potential investors are concerned about the country's weak infrastructure.[80] The North suffers from a lack of power, energy, and transportation. In a news conference in November 2005, shortly after President Hu Jintao concluded a state visit to North Korea in which he promised more economic cooperation, Wang Jiarui, the head of the Chinese Communist Party's International Department, pointed out that the North Korean industrial sector was sluggish because of "power and transportation woes."[81]

The Chinese are also concerned about the lack of a sound investment environment. Since 1984 Pyongyang has promulgated a series of laws and regulations related to foreign investment. It also signed with the Chinese government an "Investment Encouragement and Protection Agreement" in March 2005,

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76. Most of the Wenzhou merchants who began to invest in North Korea are doing business in Liaoning Province. See <http://www.1798.cn/class/print.asp?newsid=945>, accessed September 22, 2005.

77. "Yalujiang Duian xiang Zhongguo Qiye Zhaoshou."

78. <http://www.mofcom.gov.cn/column/print.shtml/b/bf/200408/20040...>, accessed August 29, 2005.

79. That Chinese investment is most active in resource development, in turn, suggests that the Chinese are interested in whether they can get redemption for their investment.

80. <http:/business.sohu.com/20040824/n221707505.shtml>, accessed August 17, 2005.

81. "North Korean Leader Pledges to Move Forward with Nuclear Talks," *New York Times*, October 30, 2005.

providing a basic framework to protect Chinese investment. Still, the North lacks basic frameworks needed for drawing in foreign investment. Policies, laws, and regulations about tax, for instance, are not in place. There is no well-established market mechanism for running the economy. The government is still heavily involved in economic management; therefore, potential investors need to have personal networks to open doors, a point that worries potential Chinese investors.

Third, North Korea lacks a sound political environment for enticing foreign investment. The country's economic policies, especially those related to reform, shift continuously, raising questions about the official commitment to reform. Political factors such as uncertainty over Pyongyang's nuclear program discourage Chinese companies from moving fast. Until the fourth round of the six-party talks in September 2005, which resulted in a joint agreement, China had maintained a cautious attitude on investment lest Beijing give the false impression that it supported Pyongyang despite the North's refusal to dissolve its nuclear program.

The lack of necessary preconditions for smooth investment could create problems for the Chinese when they try to carry out investment plans. Questions have been raised about whether some of the investment plans mentioned above have been fully put into practice. For instance, it is not clear whether the well publicized Pyongyang First Department Store contract was put into effective practice. Under the contract, we may recall, China was to run the store for 10 years. An article in a journal published by the National Development and Reform Commission, a ministry-level organization of the Chinese government, suggested that little had changed at the department store by the middle of 2005.[82] South Korean officials also say that the store is still run by North Korea. Similarly, the Chinese press has reported that the Musan iron mines development project was canceled by officials in North Korea, embarrassed by publicity over the deal because it highlighted the degree of foreign investment, a subject that Pyongyang would prefer to handle quietly.[83]

The instability of North Korea, in sum, prevents Chinese entrepreneurs from fully embracing the country. Chinese investment there is still in its infancy. This in turn raises questions about whether Chinese investment, in the end, could contribute to increasing Beijing's influence over North Korea. As one study suggests, despite the economic support China provides it has not been able to enhance its leverage over its neighbor.[84] The current situation does not appear to be different. Let alone buying North Korea's trust, China appears to

82. *Zhongguo Jingmao Daokan* (China Economic and Trade Herald), no. 4 (2005), pp. 50–51.

83. See, for instance, <http://business.sohu.com/20051208/n240909258.shtml>.

84. Scott Snyder, "North Korea's Challenge of Regime Survival: Internal Problems and Implications for the Future," *Pacific Affairs* 73:4 (Winter 2000/2001), p. 391.

be unsuccessful in leading North Korea to undertake Chinese-style reform. While valuing China's economic support, Pyongyang has not given any indication that suggests it plans to follow China's path.

Conclusion

China's investment efforts suggest that it has begun to engage North Korea economically. By investing, the Chinese leadership has attempted to push the North to embrace economic reforms, which in turn could improve the North Korean economy and reduce the country's potential for political instability. In order to lead the North to embark on reform policies, Beijing has tried to provide it with seed money and technology by encouraging Chinese companies to invest. This suggests that despite expectations and allegations from the West that China might abandon its long-time ally, China is committed to supporting North Korea.

The Chinese investment, however, has increasingly been influenced by commercial considerations. Officials in Beijing have stressed that economic exchanges with the North must be mutually beneficial. Chinese companies, which have become responsible for the majority of the investment, have paid increasing attention to market share and natural resources. That China has increasingly tried to gain economic advantage in the North suggests that Sino-North Korean relations are being transformed from being ideology-motivated to interest-motivated.

Despite a stiff increase over the past couple of years, it is hard to say that Chinese investment is either full-fledged or irreversible. Because the instability of North Korea prevents Chinese entrepreneurs from fully embracing the country, Chinese investment must be seen as a pilot project, with Chinese companies and entrepreneurs testing the water. Looking to the future, Chinese investment in North Korea is likely to increase. Despite problems, the Chinese leadership will probably continue to encourage further investment in an effort to exploit developmental opportunities while simultaneously curtailing the flow of direct aid to the North. In addition, China's dynamic economic growth will propel its overseas investment. As China's capital account is gradually liberalized, cash-rich Chinese companies will look for markets and resources abroad to fuel their development. The potential appreciation of the yuan will further force firms to relocate factories producing low-end products to countries where the labor cost is lower. Seen from this perspective, North Korea is a good candidate for future Chinese investment—if there is no major turbulence in bilateral relations.