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**Master's Thesis**

**RETHINKING ECONOMIC  
STATECRAFT?**

**LESSONS DRAWN FROM CHINESE AND SOUTH  
KOREAN ENGAGEMENT OF THE DPRK**

**August 2016**

**Graduate School of Seoul National University**

**International Commerce Major, GSIS**

**Bouros Miruna**

# **RETHINKING ECONOMIC STATECRAFT?**

**LESSONS DRAWN FROM CHINESE AND SOUTH  
KOREAN ENGAGEMENT OF THE DPRK**

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Submitting a master's thesis of International Commerce Major

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**Abstract**  
**Rethinking Economic Statecraft?**

Lessons drawn from Chinese and South Korean engagement of the  
DPRK

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The present study looks at the use of economic engagement as a tool of foreign policy. The capacity of economic statecraft to achieve concessions beyond trade or a transformation of the targeted state's behavior has garnered more interest in recent years, in part due to the growing cost of military intervention. As such, additional studies in the field of both sanctions as of economic engagement are necessary to inform policy choices, both through a theoretic approach, as by looking at past practices, their successes and limitations.

In the present case, the main part of the analysis seeks to test the existing theory on two specific cases of engagement, that of South Korea's *Sunshine Policy*, as well as China's own engagement policy towards North Korea after the onset of the first nuclear crisis of the 1990s. It will be shown that in order for engagement to be pursued instead of sanctions, a specific set of conditions must be achieved, and also that unconditional engagement is a long-term approach which is particularly difficult to maintain over time in the absence of reciprocity or any signal of change.

The success of South Korea's *Sunshine Policy* is debated by scholars. While the projects and co-operation initiated under the leadership of Kim Dae-jung have since then ended through lack of sustained political and popular support, with Kaesong Industrial Complex being the last and latest project to be closed just earlier this year, the relative welfare of the North Korean people as well as their awareness of life beyond North Korea's borders has improved over the past years. It may be that in the longer term this might contribute towards the weakening of state control and a change of government policy, but presently little indications to these respects can be observed.

Meanwhile, China's economic engagement with North Korea exhibits great potential for translating economic influence into political one, yet there are few official signs given that Beijing would seek to exert such leverage over its neighbor, at least at present. While this is no guarantee, a certain degree of restraint can be identified in the current Chinese approach to North Korea. Compared to South Korea's engagement, the Chinese approach seems more sustainable over time due to the nature of the Chinese decision-making mechanisms, which ensure longer-term visions are more easily adhered to and maintained.

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**Keywords: economic statecraft, engagement, North Korea, China, South Korea**

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## **I. INTRODUCTION**

The present paper addresses the use of Economic Engagement as tool of foreign policy, a topic which remains to this day under-studied in IR circles although its use may have important implications for the management and eventual resolution of intra-state conflicts. Taking root at the convergence point between the policy areas of trade and international security, economic engagement can be regarded as the opposite of economic sanctions (or restrictions), yet both approaches may be used in response to a situation of conflict or a breach of international law. The choice of one strategy over the other rests on several domestic determinants. According to previous studies most usually the default reaction of states is to employ sanctions in the first instance, both in order to signal their decisiveness of action as well as to seek to impose a change in the behaviour of the opponent at the lowest cost to the home country. However, other cases exist where states do choose to engage. By engaging with an adversary, the state who initiates the exchange will seek to minimize conflict and induce changes of behaviour in its counterpart by encouraging the expansion of ties between the two sides, according to the liberal view that enhanced interdependence and cooperation minimizes strategic risk and can encourage the onset of peace. While the field of economic engagement has not yet produced many authoritative studies and the present work is too limited in scope to provide an exhaustive analysis of its mechanisms, the following chapters will seek to reflect the essence of the theory and apply it to new cases, thereby contributing in a small way to the growing literature on the topic.

The first part of this study will briefly outline the existing literature on economic engagement and draw up a series of four hypotheses relating to the choice of engagement

over sanctions as well as to the success of engagement once it has been attempted. These four hypotheses will be then tested on two real case examples of engagement in a later part of the analysis. The second part of the study contains the application of the engagement theory on a real-life setting, by looking at two specific cases of engagement attempted by South Korea and China with North Korea since the onset of the first nuclear weapons crisis in the 1990s. First, a bird's view of the North Korean economy and trade relations will be provided to set the overall scene, after which the two case studies of South Korea's *Sunshine policy* initiated by President Kim Dae-Jung and China's own longstanding engagement with North Korea will be outlined and critically assessed.

### **Research Question and Methodology**

The main research question guiding the present study is:

**In what context will economic engagement be employed as a tool of foreign policy, and what may be some limitations to its effectiveness?**

Based on an initial literature review a set of four hypotheses will be presented and later discussed on the basis of two case studies, that of South Korea's *Sunshine Policy* as well as China's economic engagement towards North Korea. The case studies will use trade statistics and data obtained from sources external to North Korea, more specifically from the Bank of Korea, the Ministry of Commerce of China, the South Korean Ministry of Unification, as well as UN COMTRADE, to overcome the absence of official trade data published by North Korea itself.

The two case studies will begin with an overview of the (international) policy setting at the time of their introduction and will then touch in turn upon the decision to

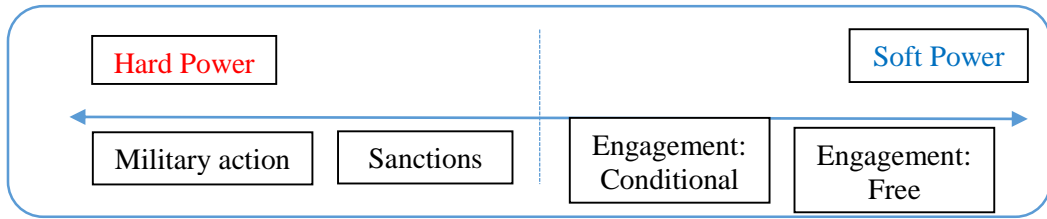
engage rather than sanction, as well as the effectiveness of engagement in terms of clear projects and desirable policy results. This will allow an initial critical assessment of their effectiveness against the clear goal of conflict de-escalation and, ultimately, behavioural transformation represented in the case of North Korea by denuclearization and reintegration in the international community. While clearly the ultimate end goal has not yet been achieved by any means, small intermediate concessions based on economic influence may be observed along the way. By looking at these two specific cases of engagement, it may become easier to understand in which circumstances engagement has better chances of success regarding North Korea, knowledge which may prove useful to policy makers in the future.

## **II. A THEORY OF ECONOMIC ENGAGEMENT**

### **1. The basics of Economic Statecraft**

When faced with the need to curb the actions of a revisionist state, governments may pursue different strategies based on their available policy flexibility combined with careful case-by-case considerations. The vested literature on foreign policy instruments distinguishes an array of such options, listed horizontally on an axis ranging from coercive, or ‘hard’, power expressed through the recourse to military action, to ‘soft’ power, which entails modifying another state’s behaviour or preferences through influencing or co-opting. Closer to the centre of the axis, then, lie the so-called ‘carrots and sticks’, the policies of economic engagement and sanctions, two methods of statecraft which are much more prevalent in 21<sup>st</sup> century inter-state relations than the two extremes.





**Fig. 1.** Illustration of the foreign policy toolbox axis.

Both sanctions and economic engagement draw a link between politics and economics, seeking to translate the effects of trade into political power and influence of one state over another. In the case of sanctions, power is assumed by reducing or all-together ending trade with a partner, usually in response to provocation or misbehaviour of the latter on the international stage. (Blanchard et al., 2005) Economic engagement, also referred to as economic ‘inducements’, on the other hand, seeks to build up a state’s leverage over an adversary through enhancing trade to the point where the foreign policy orientation of the target state is also influenced and may be gradually reshaped into a more benevolent one. (Mastanduno, 2001) Engagement may either be conditional or unconditional (free). In the case of conditional engagement clear concessions are required from the target state in exchange for economic benefits. Unconditional engagement, then, comes closer to classic liberal tenets of inter-state cooperation for mutual gains and commercial peace theory and deals with a longer policy perspective, accepting that reciprocity and eventual behavioural changes might require patience and constancy on the side of the home state for a longer period of time. (Kahler and Kastner, 2006)

Overall, a main issue with sanctions and engagement lies in the discrepancies observed so far between theory and practice, combined with the lack of a definite framework through which to analyse their effects. Ultimately, the literature addressing

‘carrots and/or sticks’ is not yet mature enough to provide an authoritative view on their efficiency. (Baldwin, 1971; Mastanduno, 2001) The present paper aims to contribute a relevant case study to the literature on economic engagement, by testing some of its main tenets on two specific cases of engagement: North Korea’s engagement by its neighbours and main trading partners, China and South Korea. To begin with, the following paragraphs will outline the history of this particular theory, as well as its most representative hypotheses.

Drawing on the early realist trends which were beginning to shape the field of IR-theory after the end of WWII, Albert Hirschmann was the first to introduce the concept of a linkage between trade and national power, in his seminal work *National Power and the Structure of Foreign Trade* published in 1945. Hirschmann’s main argument can be condensed into the concept of a long-term, transformative strategy employed through the means of trade: a powerful state may be able to influence both the economic preferences as well as the foreign policy of a weaker state through a carefully crafted strategy based on an enhanced, asymmetric economic interdependence. (Kahler and Kastner, 2006; Mastanduno, 2001; Hirschmann, 1945)

To this day, however, examples may be found both of cases which validate this theory, as well as cases which disprove it, while no definitive study of the topic has yet been produced. Moreover, the response to the original publication of Hirschmann’s theory remained somewhat muted on the backdrop of an international system defined by the ‘high-politics’ of the Cold War period. Later on, and particularly in the context of international conflict, this ‘positive’ strategy had to contend increasingly with its ‘negative’ counterpart, the restrictive approach represented by the use of sanctions. Beginning with

the 1990s, sanctions have quickly risen to the fore as the preferred tool of remedial statecraft of the international community<sup>1</sup>, prompting a rapid growth in the number of studies and resources dedicated to understanding the mechanisms of restriction, while little thought was set aside for engagement. To this day, few comprehensive theoretic studies of economic engagement may be found. The reasons for this are manifold, as will be explained next.

## **2. The trouble with ‘carrots’**

There are several reasons for which carrots have not proven as popular with academics as sticks, and they have to do with perception, as well as political and practical considerations. For one, some scholars have the tendency to associate concessions to adversaries with a policy of ‘appeasement’, thereby hinting to a perception of weakness, option which may not prove palatable to many statesmen (Mastanduno, 2001/1998).

Moreover, as transaction costs for the use of economic inducements are generally higher than those of implementing a temporary prohibition, it is more likely that a sanction will be preferred over engagement at an early stage in the conflict (Drezner, 1999 a, b). Engagement may be pursued through simultaneous exchanges, a this-for-that approach, but in many cases in reality a certain period of time usually elapses between the exchanges, which may lead to friction between the parties especially in cases where there is little trust between them to begin with. This is because setting up a plan for engagement requires a long-term strategy and enough political and financial capital to give the move credibility. A promise of engagement which is only partly carried out, if at all, may have undesired

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<sup>1</sup> For example, the UNSC mandated restrictive economic measures only twice before 1990, while it then adopted no less than 11 sanctions resolutions between 1990-2000.

effects and can even result in a worsening of the initial conflict and further erosion of trust among parties. Further related to this is the likelihood of recurring conflict with the same adversary: in cases where the parties come to expect so-called ‘multi-round’ confrontations, they will exhibit less willingness to cooperate or make meaningful concessions, wary of not losing too much ground to the opponent for the next round (Drezner, 1999 a, b). Accordingly, a state may seek to employ sanctions against an opponent early on in order to convey an illustration of its strength and decisiveness, while the opponent will likely respond in kind, not seeking to settle too early and lose face. In case sanctions do not suffice to curb the opponent’s behaviour, the sanctioning state may consider employing carrots as second option. However, it is also possible that a stalemate will be preferred over a costly carrot. In sum, both transaction costs as the fear of losing strategic ground make it more likely for sanctions to be preferred over engagement strategies.

From here, two hypotheses emerge which will be tested on the case studies which follow:

**H1:** Economic engagement will only be pursued by a state as a second option after the less costly option of sanctions has been tried with little result.

**H2:** In the case of a protracted conflict, none of the parties will be willing to engage early on, as making significant concessions too early would require great (political) costs. Therefore, sanctions will, here too, be the first option to be tried.

In certain instances, however, engagement is the preferred choice of strategy, as was the case of the South Korean *Sunshine Policy*, as well as the Chinese approach to North Korea. Moreover, in the past South Korea has also reached out to the USSR, and

later China, using a similar strategy, and China applies the same theory in its relations with Taiwan. In the absence of conflict, the situation again changes. Here, examples of influence through economic engagement may be found in abundance in Europe, where the success of the European Single Market has spilled over to neighbouring countries through trade, later taking the form of cooperation and association agreements, and in some cases culminating in these countries' accession as full members of the Union.

Based on these examples and others, scholars have identified certain initial conditions in which engagement may be more likely to be employed, as well as conditions in which it may be successful in changing the behaviour of its target as intended. Firstly, the nature of the regime type in both the home country as in its external target has been found to influence the outcome of the exchange (Drezner 1999 a, Kahler and Kastner, 2006). On the side of the home country which seeks to initiate the engagement strategy, one must either have complete control over the industries and businesses which will be employed in the exercise, or have the capacity to coordinate perfectly with their respective leaders, in order for the strategy to be deployed as planned. This would imply that from the practical view of perfect strategy implementation, an authoritarian regime might find it easier to opt for engagement, as it may be better able to guide the process along the desired path. A democratic regime, on the contrary, might find it much more difficult to regulate positive engagement: businesses will likely follow their own interests and, in the absence of restrictions, may or may not invest in the target country out of free volition. This gives rise to a third hypothesis for the present study:

<p><b>H3:</b> Economic engagement is less likely to be successful when the home country is a democracy. An autocratic regime may see better results.</p>
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Furthermore, political decisions require domestic acquiescence in order to be implemented and maintained. In terms of engagement, this has implications both for the home country, as for its external target. Best outlined by Solingen (1994, 2007) but also discussed under the topic of democracy by Drezner (1999 a, b) as well as Kahler and Kastner (2006), this concept, which may be referred to as ‘domestic political support coalitions’ analyses the political elites and interest groups which inform and influence the decisions made by the state’s leadership. Whether conservative or liberal in approach, the nature of these coalitions’ interests may have a make or break effect on the success of an engagement policy.

Certainly, in the case of North Korea as target state, one may identify a ‘closed’, conservative political support coalition unwilling to make concessions which might result in the weakening of their state structure, on which it relies for own survival. This then sets the tone for a particularly difficult road to achieving any concessions, as will be shown in more detail in the following chapters. However, cases do exist when these coalitions are ‘internationally-minded’ and more open to prospects of engagement as a source of revenue. Such coalitions are more likely to engage in reforms and be receptive to inducements which flow forth from economic engagement, either in terms of conditionality or simple practice or norm adoption developed gradually over time.

At home, as well, the nature of the coalitions supporting a regime may influence its ability to pursue and maintain a policy of engagement successfully. A more liberal-minded regime which enjoys broad domestic support may find it easier to start and maintain this policy over a long period of time. This may prove difficult in democracies, where elections bring about policy shifts on a rather frequent basis, potentially not leaving

enough time for an engagement policy to take full root. Such was the case of the *Sunshine Policy* in South Korea, whose implementation was to a large degree ended once a conservative President took office, eight years into its implementation, in response to North Korean provocations and unrelenting pursuit of nuclear weapons (Moon, 2012). Arguably, in this case it was the opposition between the outward-looking coalition in the South and the inward-looking coalition in the North which did not reciprocate the South's goodwill with a more peaceful course of action, that led the engagement to fail. Had the two states had more similar policy conceptions, the strategy might have been more successful. This leads to the final hypothesis of the present study:

**H4:** Economic engagement is more likely to succeed when the political support coalitions in both home and target country have similar orientations (both are conservative, or both liberal).

These four hypotheses will be applied on the two case studies, of China and South Korea's respective engagement of North Korea over the past two decades, to see to what lengths they conform. The findings, however, are meant to contribute to the still limited literature on economic engagement, but should not be viewed as definitive or generalizable at this early stage of research. The work done here is an exercise of understanding some of the dynamics of a very complex case, which is the interaction between North Korea and the international community over the past two decades.

### **3. Looking beyond theory: The North Korean case**

No matter how fragmented the scholarship about them may remain for the time being, many examples of economic engagement and asymmetric economic

interdependence may be found in modern day relations among states. Whether it be the dynamics between China and Taiwan, or China and its most dependent trading partners in continental Southeast Asia or on the African continent, the European Union's appeal to its immediate neighbours, or the United States' cooperation with its global allies, one might argue that in the globalized, interconnected world of today the circumstances are finally in favour of engagement much more than ever before, both in times of peace as in times of conflict.

On the Korean peninsula, as well, engagement has been tried more than once by various parties, perhaps in more different ways than elsewhere. After the beginning of the first nuclear crisis in the early 1990s, the United States first pursued a policy of engagement with North Korea, represented by the terms of the Agreed Framework signed by both parties in 1994. (Solingen, 2007) As the implementation of the Framework did not take place according to the plan and North Korea continued to pursue its nuclear ambitions, the US together with the international community gradually began contemplating the use of sanctions. Between the years 2000-2010, however, notwithstanding two UNSC resolutions mandating the use of targeted sanctions against North Korean actors engaged in the development of nuclear weapons, South Korea and China's overall trade relations with North Korea took a different path and actually increased quite rapidly (Haggard and Noland, 2011; Solingen, 2007).

To learn from these experiences, the focus of this paper over the next chapters will be to analyse the various aspects of engagement as they have been employed in the case of North Korea and test them against the hypotheses formulated above. This is a case of particular interest for scholarship, as it deals with complex, even extreme circumstances in



which neither sanctions, nor inducements, have shown much signs of success to this day. This allows to test hypotheses of engagement with the aim to observe their potential limitations.

Few scholarly articles are written nowadays about China's role towards the DPRK that do not refer to Beijing's policy of engagement perceived as a means to maximize China's influence over the hermit state. Meanwhile, in South Korea critics of President Kim Dae-jung's *Sunshine Policy* attack it for having deliberately supported an antagonistic regime which continues to pose a grave threat to its neighbours, as well as to the international community as a whole. Several questions naturally arise from this combination of issues, which will be addressed in turn in the following chapters:

1. For one, what were the steps taken by South Korea during the *Sunshine Policy* era, and what effects did they have on inter-Korean relations?
2. Moreover, how did China's trade relations with North Korea develop over time, and how, if at all, did these ties influence North Korea's foreign policy?
3. And last but not least, how did these past experiences, combined with the application of multilateral sanctions under UNSC mandate, affect North Korea's behaviour, and what may be a viable way to pursue engagement in the future?

To begin with, the following chapter will provide a brief overview of the evolution of North Korea's trade patterns in the period following the dissolution of the USSR, which had served as Pyongyang's main trading partner up to 1990.

### III. MAIN ANALYSIS

#### 1. A look at North Korea's economy and trade relations

North Korea today exhibits one of the weakest economies in the world, one plagued by mismanagement and resource misallocation, abysmal productivity rates, lacking or otherwise antique infrastructure and machinery, and chronic shortages of primary inputs, as well as energy. In such circumstances, it is difficult to imagine that the country had actually emerged from WWII as ‘the most industrialized and urbanized Asian country’ (Cha, 2012). Indeed, the Japanese occupation had left North Korea infrastructure, factories and hydroelectric plants, enough to confer it a net economic advantage over the South. However, by the end of the Korean War in 1953, much of this advantage had been reduced to rubble. In order to recover, the country relied on the support of its communist neighbours and allies, the USSR and China. At the same time, out of concern for the state’s ever growing dependence on these foreign actors, Kim Il-Sung developed the ideology of *Juche*, or self-reliance, aiming to strengthen the state’s resilience through home-grown technological advances (Cha, 2012). With time, however, the pursuit of self-reliance prescribed by Juche, which in economic terms is tantamount to a rejection of economic specialization, may have even increased the North’s reliance on its partners, instead of reducing it, as the economy slowly became even less efficient as before (Lankov, 2015).

For the period that followed, North Korea relied on heavily subsidized exchanges with both the USSR and China, but also learned over time how to best maximize its gains

by taking advantage of the frictions that were developing between the two<sup>2</sup>. (Xiangming, 2005) By the mid-1980s, as relations with China became more distant following the latter's rapprochement to the West during the post-Mao period of reform and opening up, North Korea's economy was essentially kept afloat by its ties to the USSR, who provided it with military equipment as well as crude oil, machinery, coal and other necessities at heavily subsidized prices or in exchange for what goods Korea could produce (mainly in the field of industrial machinery or textiles) (Cha, 2012). After Michael Gorbachev's ascent to power in Moscow, however, the tides began to turn. Imports from the USSR became more expensive and therefore scarcer, as the new Soviet economic model required hard cash payments instead of substitutes (Lankov, 2015). When the Soviet bloc eventually collapsed in 1991, North Korea was left reeling.

The period which followed after the disintegration of the USSR in 1991 invited the start of a new age in North Korea and a major shift in its relations with the international community. The onset of the first nuclear crisis of 1993-1994 led to the signature of the Agreed Framework with the United States, which was supposed to lead to a normalization of political relations between the two countries as well as multiple economic benefits in exchange for the closure of the Yongbyon nuclear reactor where plutonium could be re-processed for use in nuclear weapons (Buszynski, 2013). The same year, however, Kim Il-sung died, ushering in a period of inward-looking transition while power was being consolidated around his son and appointed successor, Kim Jong-il (Haggard and Noland, 2011). This transition period then coincided with the onset of a prolonged period of famine, as economic mismanagement and falling rates of imports combined with a series of natural

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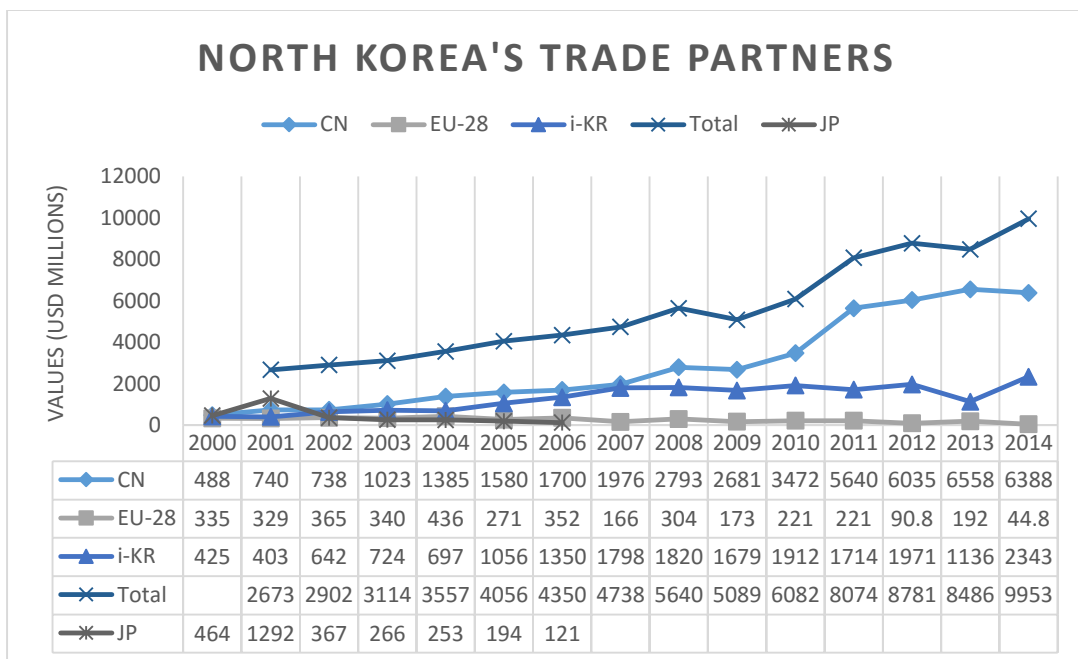
<sup>2</sup> <http://www.dailynk.com/english/read.php?num=13863&cataId=nk00100>

disasters in the form of droughts and floods to greatly limit the availability of staple foods which could be distributed to the population through PDS (the Public Distribution System) (Lankov, 2015; Cumings, 2005). Thousands of people are thought to have perished in the Korean countryside during what is now remembered in North Korea as the period of the ‘Arduous March’. At this time, the international community stepped in to provide emergency food aid and keep the famine from growing into an even graver humanitarian crisis.

- **Trade under a new leadership**

For a brief period between 1998-2002 some initial economic reforms were undertaken, but as the nuclear crisis returned at the forefront in 2003, the military aspect of the regime’s strategy returned to the forefront in accordance with Kim Jong-Il ‘*Songun*’(=military first) doctrine. The need for reforms was arguably balanced out by South Korea’s *Sunshine Policy*, which provided the regime with unconditional economic support (food aid, fertilizer) and later set the seeds for inter-Korean cooperation through the Kaesong Industrial Complex and the Mt Keumgang Tourist Region (Haggard and Noland, 2011).

As clear reflection of a tense international climate, Fig. 2 below illustrates how until 2007 North Korea traded in relatively equal amounts with both China and South Korea, while the share represented by its other trading partners declined from year to year while progress stalled in the multilateral negotiations aimed at denuclearizing the Korean peninsula (the so-called Six Party Talks). Gradually, and particularly from 2009 onwards, China’s dominating share then truly becomes apparent.

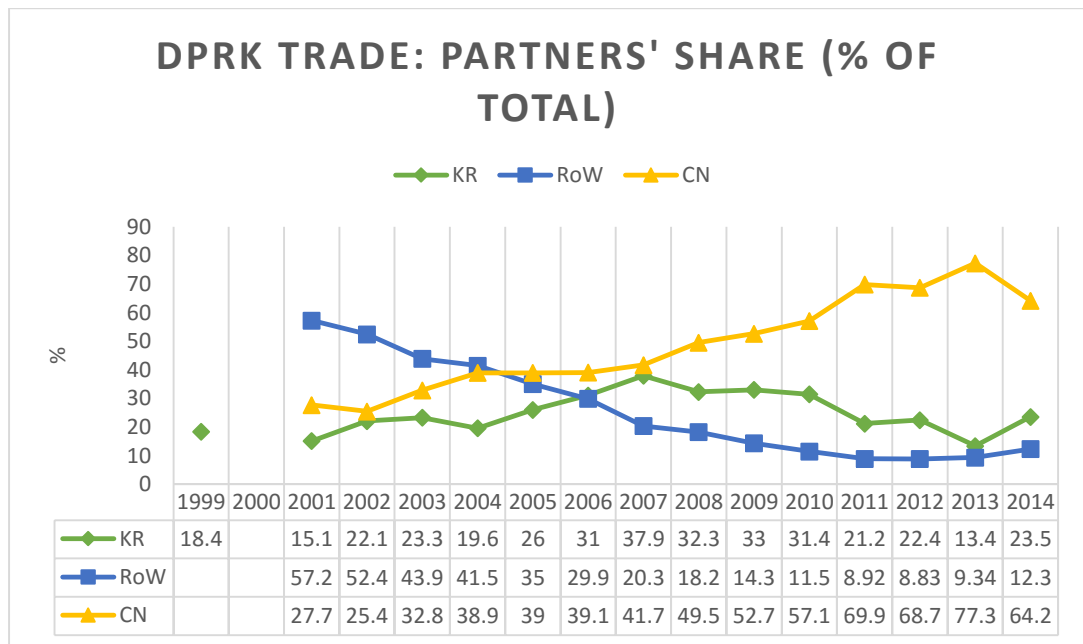


**Fig. 2.** Overview of North Korea's main trading partners, 2000-2014. Author's calculations based on data acquired from the Bank of Korea (for total trade and inter-Korean trade), and UN COMTRADE. Some data was lacking: for Japan, data from UN COMTRADE was unavailable after 2006.

Fig. 2 above illustrates the evolution and changing patterns of North Korean trend from the year 2000 onward. While the exact amounts of trade cannot be fully verified, as North Korea does not publish its own statistics on the matter, mirrored statistics based on the values of trade declared by its trading partners give an idea of the general patterns. In a bird's view, several elements of particular interest can be observed from this graph. Firstly, notwithstanding the adoption of three UNSC resolutions mandating economic and financial restrictions against the state, North Korea's overall trade pattern has continued in an almost uninterrupted upwards trend. Until March 2016 international sanctions did not touch upon main industries which the North Korean economy is dependent on for the bulk of its annual trade revenue (mineral products make up 45% of NK exports, followed by textiles for 26%). Previous sanctions were mainly targeted at individuals, entities or

companies involved in the state's nuclear weapons and ballistic missiles programmes and as such had a limited effect on general trade.

Secondly, up to approximately 2006, which is the year when the North organized its first nuclear test, the state's trading partners were more diversified, and their share in the overall trade remained more equal (see also, Fig. 3 below). After the introduction of sanctions, and especially after North Korea's second nuclear test in 2009, a new, much more imbalanced pattern started to emerge. As the international community gradually began cutting North Korea off from its sources of foreign currency and trade numbers plummeted, trade with China began increasing at tremendous speed, more than making up for the lost trade elsewhere (Haggard and Noland, 2011).



**Fig. 3.** The DPRK's partners' share of trade. Author's calculations based on Bank of Korea data.

In South Korea, while total trade value has continued to increase as shown on the graph, the conservative Presidency of Lee Myung Bak had an impact on the composition of inter-Korean exchanges by limiting the non-trade links in favour of enhanced merchandise and on-commission trade focused on production at Kaesong. After the second nuclear test and the DPRK's withdrawal from the Six Party Talks, all South Korean aid to the North was essentially stopped. (Haggard and Noland, 2011; PIIE Blog) Most recently, as of February this year, the Kaesong Industrial Complex is no longer in operation. The North's 5<sup>th</sup> nuclear test and missile launch undertaken at the beginning of the year have resulted in a complete shutdown of the site by the South Korean government, hereby driving the inter-Korean trade virtually down to zero. This in turn implies that China might come to hold more than 90% share of total trade with the North, given the increased restrictions imposed by other states in application of UNSC resolution 2270<sup>3</sup>.

In addition, the composition of the DPRK's trade seems to have also undergone a significant shift away from industrial products and manufacturing, towards exports of raw materials, in particular coal and minerals for up to 46% of the total trade volume in 2014 (MIT Trade Atlas, 2016). At this rate, North Korea risks becoming a rentier state, selling its resources to others who have the capacity to process them, while it remains at the lowest end of the production value chain and unable to maximize its profits.

In consequence, over the span of just one decade the characteristics of North Korean trade have substantially changed, mainly as fallout from the state's continued pursuit of a nuclear agenda. This provides a clear illustration of how economic statecraft

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<sup>3</sup> [http://english.hani.co.kr/arti/english\\_edition/e\\_northkorea/737868.html](http://english.hani.co.kr/arti/english_edition/e_northkorea/737868.html)

may affect the economy of the target state: sanctions may gradually shrink the pool of countries willing to engage in trade with it, while a quasi-monopoly on economic engagement, represented here by China and South Korea, may allow the engaging state to direct the substance of trade in its own favour and therefore potentially in detriment of the target state's economy. Being overly dependent on the exports of natural resources which are then mainly exported to one single trading partner is by far not an ideal situation for North Korea's economic outlook. As the third generation of Kim leadership comes into its own, it inherits an economy fraught with imbalances, mismanagement and some external limitations resulting from the country's continued pursuit of nuclear weapons. The road ahead is by no means simple, and important choices lie ahead.

- **Many challenges lie ahead**

The period following Kim Jong-Un's ascension to power has come with the introduction of a new concept to continue the legacy of Juche and Songun, which is known by the name of 'Byungjin'. In literal terms this new ideology seeks to combine Kim Jong-Il's focus on the military and acquiring of nuclear weapons, with a renewed focus on economic development (Lankov, 2015). On the military side the quest for nuclear weapons has visibly intensified. In 2012 the state's constitution was revised to describe North Korea as a nuclear-weapons armed state<sup>4</sup>, and new nuclear tests were pursued in 2013 and most recently in January 2016, accompanied by additional advances in ballistic missile technology which would confer the state force projection capacity on a wider scale.

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<sup>4</sup> <http://edition.cnn.com/2012/05/31/world/asia/north-korea-nuclear-constitution/>



On the civilian side, while first-hand, verifiable information on economic policies and possible reform processes is hard to come by, some analyses based on annual FAO reports<sup>5</sup> can be pursued with regards to the state of the agriculture sector. Doing so, it is revealed that crop yields have been generally improving over the past five years, despite an increased occurrence of natural calamities in the shape of prolonged periods of drought and limited access to fertilizers (Haggard and Noland, 2011; PIIE Blog). The June 28<sup>th</sup>, 2012 and May 30<sup>th</sup>, 2014 reforms<sup>6</sup> aimed at reforming the management of the agricultural sector have introduced gradual steps towards a quasi-privatization of the agricultural sector, allowing farmers to organise themselves in ‘production teams’ of up to 6 workers and farm an allocated plot of land for a given number of years. While in the past all produce was to be handed over to the state in exchange for daily grain rations, under the new system the farmers were at first allowed to keep 30% of their yield, and since 2014 they may keep 60% of what they produce for their own consumption or for trade. With this new system in place, 2013 and 2014 became peak years for agricultural production in the DPRK, which is now able to produce almost all minimally required amount of grains to feed its people without having to depend as much on imports from China or food aid provided through international organizations.

To date, however, less advances can be observed from the outside regarding the country’s industrial capacities. While the May 30<sup>th</sup> measures also specify the introduction of a ‘director responsibility system’ which would give managers more control over the running of the plant akin to the responsibilities of private businessmen, including the

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<sup>5</sup> <https://piie.com/blogs/north-korea-witness-transformation/north-korean-food-insecurity-being-hyped-redux>

<sup>6</sup> <http://www.aljazeera.com/indepth/opinion/2014/11/reforming-north-korea-20141117121917871925.html>

ability to hire and fire workers, decide on salaries, and negotiate trade deals with foreign investors independently (Lankov, 2014). In addition, building on initial inter-Korean projects developed at Kaesong and Mt Kumgang, the Rason-Sonbong Special Economic Zone, as well as the close cooperation between the North Korean border town of Sinuiju and the city of Dandong in China, the North Korean government has designated another 14 locations, including Sinuiju, as Economic Development Zones<sup>7</sup>.

The main problems which will continue to plague these projects for the foreseeable future is however the lack of foreign investment, without which no significant progress will be possible. When compared with China's pursuit of reform and opening up, a similar pattern can be observed in the creation of special economic zones and provision of significant incentives to firms looking to invest in a new market. However, North Korea doesn't enjoy the same pull that China had on foreign investors. At the time of the reforms China had been welcome in the international community, it had given up its own nuclear weapons programme and it boasted good relations with the United States as well as its neighbours. One might say that North Korea is the antithesis of what China represented to investors in the 80s and 90s: many of the few firms which have invested in North Korea over the past years have encountered hardship, and some were even expelled from the country on short notice, while their property was retained by the state with no provision of compensation. As will be shown in the next chapter, such was the fate of Hyundai's investments at the Mt. Kumgang tourist resort, as well as of the small South Korean enterprises who were forced to leave Kaesong in a haste earlier this year<sup>8</sup>. With this

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<sup>7</sup> <http://38north.org/2015/11/sez112315/>

<sup>8</sup> [http://english.hani.co.kr/arti/english\\_edition/e\\_northkorea/730130.html](http://english.hani.co.kr/arti/english_edition/e_northkorea/730130.html)

knowledge, combined with the repressive environment one should work in, the violations of international and humanitarian law which have been documented by various NGOs and UN Agencies over the years, and the continued pursuit of nuclear weapons despite five rounds of international sanctions, few significantly large investors are likely to make the jump. As a small comparison, in 2014 alone South Korea received approx. \$9bn USD of foreign investment, while North Korea only cashed in around \$134 million USD (World Bank, 2014). The closure of Kaesong earlier this year and imposition of more stringent sanctions will likely drive the number further down for the period to come.

## **2. Case Study 1: South Korea's Sunshine years**

*“The Republic [of Korea] is now able to push a North Korea policy with self-confidence arising from firm public support. I have been steadfast in advocating what I call a “Sunshine Policy” which seeks to lead North Korea down a path toward peace, reform and openness through reconciliation, interaction and co-operation with the South. As President, I will carry out such ideas step by step.”*

(S. Korean President Kim Dae-jung, speaking at SOAS, London University, 4/04/1998<sup>9</sup>)

The Presidency of liberal-minded Kim Dae-jung represented a break with South Korea's previous approach towards its northern neighbour and promised a new beginning for inter-Korean relations, one which would be defined by trust and cooperation. In these circumstances, the decade spanning from 1997 – 2007 saw an unprecedented boom in 2<sup>nd</sup> track exchanges between the two countries, and laid the groundwork for the most enduring

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<sup>9</sup> Quoted initially in Moon, 2012.

projects of inter-Korean economic cooperation to date: the Mount Kumgang tourist region and the Kaesong Industrial Complex. Unfortunately, at the present time these projects have all been terminated due to renewed hostilities between the two parties stemming from the North's continued pursuit of a nuclear weapons programme.

Nevertheless, the Sunshine Policy provides a prime example of economic engagement suitable for the present analysis. In order to pursue the analysis, we first recall the four central hypotheses which resulted from the theoretic analysis at the beginning of this study:

**H1:** Economic engagement will only be pursued by a state as a second option after the less costly option of sanctions has been tried with little result.

**H2:** In the case of a protracted conflict, none of the parties will be willing to engage early on, as making significant concessions too early would require great (political) costs. Therefore, sanctions will, here too, be the first option to be tried.

**H3:** Economic engagement is less likely to be successful when the home country is a democracy. An autocratic regime may see better results.

**H4:** Economic engagement is more likely to succeed when the political support coalitions in both home and target country have similar orientations (both are conservative, or both liberal).

In the following paragraphs the case will be briefly discussed in terms of its early development, implementation, results, and critique, seeking to paint a brief but balanced understanding of the dynamics which made the pursuit of this policy possible, as well as the reasons why it eventually failed.

- **The Motivation**

The motivation behind the *Sunshine Policy* clearly has its roots in President Kim Dae-jung's personal conviction that it is only through engagement that the two Koreas could move beyond a stance of confrontation and towards the ultimate goal of reunification, as illustrated in the quote included at the top of this section. In accordance with classic liberal tenets of cooperation, the Sunshine Policy was built on the principle of unconditional engagement, where the opposing party was not required to reciprocate the actions immediately. Seen as a proactive policy, a means through which South Korea could lead the process instead of limiting itself to a reactive stance geared primarily towards responding to North Korea's actions in a confrontational manner, this approach would seek to improve inter-Korean relations through patient dialogue, exchanges and co-operation (Moon, 2012). Furthermore, it was also believed that the long-term pursuit of this positive policy would eventually lead to incremental and voluntary changes in North Korean foreign policy, inducing a transformation into a more conciliatory and co-operative attitude with the necessary resolve to settle the existing conflict once and for all (Moon, 2012; Haggard and Noland 2007).

In accordance with the first hypothesis of the present study (H1), engagement was pursued only after decades of confrontation and/or stalemate. Despite initial contact set up through the July 4<sup>th</sup>, 1972 North-South Joint Communiqué addressing the importance of inter-Korean dialogue, cooperation and military de-escalation, as well as the signing in Dec. 1991 of the 'Basic Agreement on Reconciliation, Non-Aggression, Exchanges and Cooperation' and of the 'Joint Declaration on the Denuclearization of the Korean Peninsula' signed in Jan. 1992, little real progress was made towards a normalization of

relations between the two sides and the process became virtually paralyzed by the onset of the first nuclear crisis soon after.

By 1994, however, international moods seemed to have changed. The conclusion of the Agreed Framework between North Korea and the United States promised a long overdue process of denuclearization and normalization of political relations, which, if fully implemented would have had tremendous importance for the prospects of sustainable peace on the Korean Peninsula. The other main regional actors, China, Japan and the Russian Federation showed favourable signs for engagement and worked together towards the implementation of the Agreed Framework, while at the same time providing emergency aid to help the impoverished North escape the great famine of 1997-1998 (Moon, 2012). The international climate allowed South Korea to reach out without fearing interference or opposition from the regional powers. Riding on this wave of positivity greatly reduced the political costs of the Kim Dae-jung administration and ensured a large degree of public support for the initial implementation of the engagement policy. This falls in accordance with the second hypothesis of the present study (H2).

In sum, engagement at the time of the Kim Dae-jung Presidency was enabled by the existence of a supportive political environment both domestically as internationally, and also by the fact that for decades before it confrontation or at best maintaining a status quo had been the preferred policy option and they had failed to secure any progress in either conflict de-escalation or improvement of diplomatic ties. By 1998, there was no other viable option which had not been pursued (Moon, 2012). Launching the new policy, however, is just the beginning of a long journey. As it will emerge from the following

section, for various reasons the implementation and results of the policy did not meet the early expectations and its overall success remained limited.

- **The Practices, Results and Controversies**

Throughout the Sunshine years, Seoul sought to actively engage with Pyongyang at all levels, from people-to-people exchanges and technological cooperation, to providing unprecedented amounts of aid without preconditions, and setting up joint economic activities in economic zones such as Mount Kumgang tourist region and the Kaesong Industrial Complex. Moreover, the improvement of relations was underscored by the organization of two inter-Korean Summits held in Pyongyang in 2000 and respectively 2007, which resulted in the ‘June 15<sup>th</sup> (2000) Joint Declaration’ and the follow-up ‘October 4<sup>th</sup> (2007) Joint Declaration’ through which a clear, official framework for inter-Korean relations was set up.

However, in stark contrast to the seemingly improving relations, North Korea did not hold back from pursuing its own foreign policy and security agenda by holding two nuclear tests in 2006 and 2009, abandoning the Six-Party-Talks framework for negotiations and continuing its provocations towards the South. In the years that followed, the sinking of the South Korean corvette Cheonan by a North Korean submarine (in March 2010) and the shelling of Yeongpyeong island in November the same year reignited the debates about South Korean government’s responses and sealed the fate for most of the Sunshine policy’s legacy (Cha, 2012). In response to the renewed provocations, the conservative administration of President Lee Myung-Bak, which had come into office in 2008, terminated all projects of cooperation between North and South, with the exception

of Kaesong Industrial Complex through what are commonly known as the ‘May 24<sup>th</sup> measures’.

In spite of these matters, however, one aspect which did greatly improve over time was the value of inter-Korean trade and exchanges. As shown on Table 1 below, between the year 2000 and 2008 the total amount of trade increased from \$425 million USD to \$1.8 billion USD. However, this general amount listed at \$2.34 billion USD for the year 2014 hides the reality of a great shift in trade patterns after the inauguration of President Lee Myung-Bak, and again after the sinking of the Cheonan in March 2010.

Type	1980-1999	2000	2001	2002	2003	2004	2005	2006
Inbound	2.101	152	176	272	289	258	340	520
Outbound	635	273	227	370	435	439	715	830
<b>Total</b>	<b>2.111</b>	<b>425</b>	<b>403</b>	<b>642</b>	<b>724</b>	<b>697</b>	<b>1.055</b>	<b>1.350</b>
	2007	2008	2009	2010	2011	2012	2013	2014
Inbound	765	932	934	1.044	914	1.074	615	1.206
Outbound	1.033	888	745	868	800	897	521	1.136
<b>Total</b>	<b>1.798</b>	<b>1.820</b>	<b>1.679</b>	<b>1.912</b>	<b>1.714</b>	<b>1.971</b>	<b>1.136</b>	<b>2.343</b>

**Table 1.** Amount of inter-Korean trade, from RoK Ministry of Unification. (Unit: million dollars USD)

Furthermore, Table 2 contains data published by the South Korean Ministry of Unification breaking down the inter-Korean trade values by type. From this table it can be observed that non-commercial trade, mainly responsible for the provision by the South to the North of food aid and fertilizers for agriculture, was largely discontinued in 2008. Furthermore, revenues from general trade processing plummeted after the adoption of the May 24<sup>th</sup> measures in 2010, when all economic activity linking the two Koreas, except for the KIC were halted after the sinking of the Cheonan. Instead, economic cooperation through the KIC surged.



Type		2004 - 2006	2007	2008	2009	2010	2011	2012	2013	2014
Inbound Trade (N-S)	General Processing Trade	1.091	645	624	499	334	4	1	1	-
	Econ. Cooperation	97	120	308	435	710	909	1,073	615	1,206
	Non- Commercial	-	-	-	-	-	-	-	-	-
	<b>Total</b>	<b>1.118</b>	<b>765</b>	<b>932</b>	<b>934</b>	<b>1,044</b>	<b>914</b>	<b>1,074</b>	<b>615</b>	<b>1,206</b>
Outbound Trade (S-N)	General Processing Trade	305	145	184	167	101	-	-	-	-
	Econ. Cooperation	633	520	596	541	744	789	888	518	1,132
	Non- Commercial	1,048	367	108	37	23	11	9	3	4
	<b>Total</b>	<b>1.984</b>	<b>1,032</b>	<b>888</b>	<b>745</b>	<b>868</b>	<b>800</b>	<b>897</b>	<b>521</b>	<b>1,136</b>

**Table 2.** Amount of inter-Korean trade by type, RoK Min. of Unification. (Unit: million dollars USD)

The two main pillars of inter-Korean economic activity from the early 2000s onwards were a tourist resort built at Mt. Kumgang on the West coast of Northern Korea and the Kaesong Industrial Complex (KIC) built inside North Korea just north of the Joint Security Area (Paju/Panmunjom area) and the Demilitarized Zone. While both projects saw considerable growth during their lifespan, ultimately they both fell victim to the unfortunate mixture of politics with economic and social affairs.

According to data published by the South Korean Ministry of Unification, in the period spanning from 1998 to its closure in 2008, the **Mt. Kumgang Tourist Resort**

received just short of 2 million visitors<sup>10</sup>. Unfortunately, the project was suspended after an incident in which a South Korean tourist was shot and killed by a North Korean guard at the site. The exact circumstances of the incident remain unclear to this day, and no joint inquiry was pursued, leading to an escalation of tensions between the two sides. A month after the incident, the North expelled the South Korean staff at the resort and later decided to seize the grounds along with all the assets owned by Hyundai Asan, the South Korean company originally hired to develop the project<sup>11</sup>. Since then the location has been occasionally used to accommodate tourists, and some unsuccessful attempts were made to secure new sources of foreign investment, essentially seeking funds by leveraging assets previously expropriated from Hyundai<sup>12</sup>.

Moreover, perhaps the most well-known contribution of the Sunshine years to inter-Korean cooperation was the **Kaesong Industrial Complex**, a project through which South Korean companies would be building and running factories within an enclosed zone in the Southern part of North Korea, employing North Korean workers under the supervision of a few South Korean managers, with the goal of producing low-end goods such as clothing, shoes or watches to be sold internationally (Haggard and Noland, 2007). Between its opening in 2005 and final closure in 2016, Kaesong saw the number of South Korean companies active at the site rise from 18 (2005) to 124 (2015), and its production value rise from almost \$15 million USD to \$470 million USD. By 2015, the number of North Korean workers at the site also rose dramatically, from just over 6000 in 2005 to

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<sup>10</sup> <http://eng.unikorea.go.kr/content.do?cmsid=3103>

<sup>11</sup> <http://www.bbc.co.uk/news/world-asia-pacific-14617827>

<sup>12</sup> <https://piie.com/blogs/north-korea-witness-transformation/north-south-relations-update>

54.000 in 2015 according to statistics provided by the South Korean Ministry of Unification<sup>13</sup>.

Although it never reached its full intended potential and the viability of the project loose of government subsidies from Seoul has been put into question (Haggard and Noland, 2012), Kaesong remains to this day the most elaborate project of engagement between the two Koreas and will doubtless inform any future policy and investment decisions to be made in this area. Despite the initial intention, the project has not always been loose from politics, as can be attested by the occasions when tensions between the two countries resulted in a shutdown of activity in the KIC, like in 2012, and most recently since February 2016, despite the issuance of a joint statement last summer which ensured that Kaesong would not be closed in the eventuality of escalating conflict between the two sides<sup>14</sup>.

- **The Setbacks**

As illustrated above, the economic engagement between North and South Korea encountered many challenges starting early on in their development, due to the lack of progress made in parallel on the political track towards a formal improvement of relations. Although it began on an optimistic note, enjoying a high degree of domestic support as well as international agreement, the Sunshine quickly waned, as conflict returned to the scene in the form of nuclear and ballistic missile tests, as well as maritime and border confrontations. Although trade value continued to grow and Kaesong continued to expand

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<sup>13</sup> [http://www.koreafocus.or.kr/design2/layout/content\\_print.asp?group\\_id=103858](http://www.koreafocus.or.kr/design2/layout/content_print.asp?group_id=103858)

<sup>14</sup> <http://foreignpolicyblogs.com/2016/02/25/discarding-kaesong-reviving-the-cold-war-on-the-korean-peninsula/>

until recent months, after the sinking of the Cheonan vessel in March 2010 the mood changed and all engagement aside from KIC was halted by Lee Myung-Bak's conservative government<sup>15</sup>.

In these circumstances, given the lack of reciprocity of engagement and perceived insincerity of the North Korean side, public opinion turned sharply against engagement and the policy slowly became obsolete. This in turn validates hypotheses 3 and 4 of the present study: South Korea being a democracy, its policy choices are informed and shaped by public support as well as the preferences of the political support coalitions closest to the leadership who may lobby or advise for a certain course of action. As predicted by theory, Kim Dae-Jung long-term, unconditional engagement strategy slowly eroded public support as no gains of the policy could yet be seen. While the organization of the first Inter-Korean Summit in 2000 was at first heralded as a great success, subsequent allegations that the North's participation in the talks had been 'bought' with a contribution from Hyundai mired the Summit in controversy and again changed public perception (Moon, 2012). Moreover, the disinterest of the North Korean regime to engage seriously in the reconciliation and cooperation project with the South and its continued military provocations, based no doubt primarily on domestic considerations, emphasize the limitations of engagement with an autocratic regime which has little incentive to cooperate. In such cases, little progress may be expected.

In conclusion, South Korea's Sunshine Policy falls in agreement with the four hypotheses set forth at the beginning of the present analysis. In this particular case

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<sup>15</sup> <http://www.nytimes.com/2010/05/24/world/asia/24korea.html>

economic engagement was pursued at a moment when other policies (shy of sanctions) had already been tried with little success, and at a time when both the domestic as international contexts looked favourably upon engagement. The subsequent failure of the policy was then also due to declining popular support for the measure, a change in leadership which brought with it a different ideological inclination, as well as a mismatch of priorities and interests between North and South.

With regards to the latter point, however, as it will be shown in the second case-study which follows, there are some cases in which a closed, inward-looking regime will respond more positively to engagement, setting the scene for a different course of events. Such is the case of North Korea's alliance with China which will be discussed next.

### **3. Case Study 2: The Supportive Chinese Dragon**

The second case of engagement which will be looked at here is also possibly the one most important external factor enabling North Korea's foreign policy to date. As it has been shown in a previous chapter, the North's relations with China go back to the very foundation of the Democratic People's Republic of Korea (DPRK), the two sides having fought side-by-side during the Korean War, and establishing an alliance soon after. While at times relations have soured, as during China's pursuit of reform and opening up which saw it draw closer to the international community and Western countries and embracing free market mechanisms which would have previously been unacceptable to a Communist country, overall in times of need Pyongyang has been able to rely on Beijing for support. The reasoning behind China's acquiescence to this role rests on several key issues:

Firstly, it's a matter of geography. China and North Korea are neighbours and they share a considerably long border. Their border spans over approximately 1334 km and is represented mainly by the course of the Yalu (Amnok) and Tumen rivers, with a 45 km section of terrestrial border crossing Paektu mountain. This makes China the DPRK's main northern neighbour, while the state also shares a small river border with Russia on the final section of the Tumen river leading to its estuary. The borders, once partly disputed, were officially settled through secret bilateral negotiations and a treaty signed in Pyongyang in late 1962. (Colin, 2006) The Chinese provinces of Liaoning and Jilin, as well as the Yanbian Autonomous Prefecture have access to the border, and through it to trade with North Korea. However, constraints in existing infrastructure and limited development have rendered the city of Dandong and its adjacent port city of Donggang as main trade hub between the two countries, following the old Shenyang-Seoul railroad route built around 1903 under Japanese occupation. (Colin, 2013)

Secondly, it's also a matter of security. From China's perspective, in current circumstances the border it shares with North Korea is not only a business opportunity, but also a potential threat. Any instability affecting the North Korean regime may spill-over into China's North-Eastern provinces, bringing scores of refugees to a part of the country which is economically relatively worse-off than other areas in China (Naughton, 2007; Colin, 2013). Ever concerned with China's own internal stability and push for economic growth, the Chinese government is likely to view its neighbour as a 'problem child', and respond to its needs accordingly in order to keep it, and by extension itself, out of harm's way. Indeed, there was a time when the collapse of the North Korean regime seemed imminent. Chinese scholars feared it would happen during the times of the great famine,

when China, along with many other members of the international community eventually had to step in and provide considerable amounts of food aid to help the country through its worst time<sup>16</sup>. The fear then returned after rumours spread that Kim Jong-Il had suffered a stroke in August 2008, at a time when no clear successor had yet to be officially appointed. Following the DPRK's second nuclear test in 2009 and the enhancement of the international sanctions regime which came soon after, the likelihood of pending regime instability grew even larger and eventually resulted in the enhancement of trade from the Chinese side meant to act as stabilizer (Duchatel and Schell, 2013).

Furthermore, although North Korea's economy is generally believed to be one of the weakest in the world, the reclusive regime in Pyongyang has still resolved to invest considerable shares of its annual budget into the development of nuclear weapons and ballistic missiles, putting itself on a trajectory of conflict with the international community and especially with its neighbours South Korea and Japan, along with their main ally (and DPRK archenemy) the United States. As the search for a solution to the nuclear crisis remains as elusive as ever, each and any strategic balancing act pursued on the Korean peninsula will have spill-over effects for the other big players in the region, with China most likely to be affected early on. In this context, China's expanded economic ties with North Korea might have also been driven in part by China's goal to achieve North Korea's denuclearization, in order to promote stability on the Korean peninsula and lower the direct threat to China's own security (Duchatel and Schell, 2013; Howe and Park, 2014).

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<sup>16</sup> According to statistics published by the World Food Organization, between 1994-2004 North Korea was granted just under 9.5 million tonnes of food aid in total, out of which 6.5 million tonnes were provided under the state of emergency. (Author's own calculations based on data available at: <http://www.wfp.org/fais/reports/quantities-delivered-report> )

Thirdly, China's engagement towards North Korea is clearly also a matter of economics. While the Province of Liaoning ranks towards the top of richest Chinese provinces ranked by GDP, Jilin Province (incl. the Yanbian Autonomous Prefecture) and Heilongjiang Province found further up North both lag behind<sup>17</sup> and have a clear incentive to supplement their revenues through trade (Colin, 2005; Duchatel and Schell, 2013). But how strong is the link between this border trade and the policies of the central government in Beijing? Can it be said that China follows a clear-cut, government directed strategy of engagement or are the Provinces sometimes acting by their own accord? It is time to look once more at the initial hypotheses of economic engagement presented at the beginning of this study as we dig deeper into the mechanisms defining Chinese trade and investment towards North Korea.

- **Friend or foe?**

To begin with, it must be noted that this case varies from the previously studied case of the *Sunshine Policy* in the fact that North Korea and China are allies and not opponents, despite the certain periods when political relations didn't run as smoothly. The mechanisms behind engagement or sanctioning, however, remain the same. Looking at the growth of trade between the two countries (Fig. 2 and Fig.3 in previous chapter) we note that China has constantly traded with North Korea over time, and that the value of their trade has considerably increased once after 2000, and even more spectacularly after 2009, at the moment when already two UNSC sanctions resolutions had been adopted seeking to curb North Korea's pursuit of nuclear weapons (see Annex 1 for a brief summary of the

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<sup>17</sup> [http://www.economist.com/content/chinese\\_equivalents](http://www.economist.com/content/chinese_equivalents)



sanctions measures imposed through the UNSC). This goes against the assumptions that engagement will be sought only after sanctions have been applied: in fact, China is working against the international trend of sanctions, more than making up for the North's loss of revenue from other foreign sources (Haggard and Noland, 2011; Duchatel and Schell, 2013; Reilly, 2014). Hypothesis 1 is hereby rejected.

With regards to the multi-round games and a home state's preference for the use of sanctions over engagement out of interest to prove its strength and decisiveness, China's calculations again seem to differ from other states'. Throughout multiple periods of provocations, while four rounds of UNSC-mandated sanctions were being implemented, China's trade with North Korea continued to grow exponentially, perhaps reaching the point where China's continued backing was taken for granted, allowing the DPRK to feel confident about its chances while it pushed even harder to acquire the much coveted nuclear capability (Howe and Park, 2014; Buszynski, 2013). While China's size and economic pull cannot be questioned, and the Chinese government's frustration at having an unresolved matter of nuclear proliferation at its borders has been visibly mounting over the past years, still something in the nature of its relations with North Korea determined its ever-cautious approach to the troublesome neighbour (Reilly, 2014; Haggard and Noland, 2011). In essence, the Chinese dragon is being held in chess, and this disproves hypothesis 2 of the present study: China did not employ stronger tactics early on in its interactions with North Korea, choosing instead to enhance engagement and prop the regime up in times of need.

- **Successful engagement?**

Moving on to analyse the success of engagement, several aspects must be covered, starting with the nature of the trade relations, as well as the main actors involved. Hypothesis 3 implies that economic engagement might be more successful when applied by autocracies, as an authoritarian state has better control over economic processes as well as a longer-term space for policy implementation. The case of China, however, is more complex: while China is indeed a one-party state, during the reform and opening up period the central government has devolved much of its economic authority to provincial level and opened its system up to market forces and competition, relinquishing the lead of the economy through state-controlled enterprises (Naughton, 2007).

In other words, while China speaks with one central voice to the outside world, internally its economic responsibilities are divided among various levels of authority, as well as among the state and private enterprises. From this perspective, it does not seem to be the case that China is enjoying a strategic advantage over democratic states such as South Korea when applying economic engagement, other than by choosing to direct trade or investment through state-owned enterprises, which to a large extent is not how trade is pursued in the case of North Korea (Reilly, 2014)<sup>18</sup>. In these circumstances the application of hypothesis 3 is limited by the fact that China's internal functioning is neither purely authoritarian, nor democratic, but embodies a mix of the two. Nevertheless, seeing the weight of China's share of trade with North Korea as well as the state's ability to intervene

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<sup>18</sup> Reilly notes that since 2005 China's motto regarding trade with DPRK has been: "Government guidance with companies in the lead; market-based operations and mutual benefit." and that the majority of companies engaged in trade are small in size and privately owned.

through SOEs if it so wishes, it would be expected to see better results from China's economic engagement than South Korea's earlier attempts. Unfortunately, few such instances can be observed so far, as the Chinese government has seemingly resolved not to use its economic clout to influence North Korea's behaviour. This is evidently a reflection of China's respect of the principle of non-interference in another state's internal affairs which limits the applicability of economic engagement.

Taking a closer look at the existing trade relations between China and North Korea at the present day, for as far as information is available, several notable elements may be distinguished. Firstly, there is a remarkable concentration of Sino-Korean trade passing through the border city of Dandong in the Liaoning Province of China. According to one estimate, in 2005 Dandong alone represented a 77% share of all trade registered between the Province and North Korea, and around 40% of China's total trade with the state (Colin, 2005). The value of the trade has certainly changed since then, but Dandong's leading role in Sino-Korean trade has only grown: in 2015 it was reported to have reached over 70% of the total trade between the two countries<sup>19</sup>. Building on these strong foundations, investment continues to pour into developing Dandong as a regional trading hub and a gateway to North Korea.

Moreover, Chinese support of North Korea is pursued mainly through the means of trade and investments and follows commercial considerations. The distribution of North Korean trade between Korean exports and imports, as Noland (2015) shows, exhibits a substantial deficit, i.e. North Korea imports more than it exports. While the gap is most

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<sup>19</sup> [http://english.hani.co.kr/arti/english\\_edition/e\\_northkorea/717354.html](http://english.hani.co.kr/arti/english_edition/e_northkorea/717354.html)

likely filled by Chinese FDI flowing into the country, it is clear that trade in its current form does not provide substantial foreign currency reserves which could be invested (Reilly, 2014).

In consequence, recent infrastructure developments within North Korea have relied to a great extent on Chinese support. One such example is the construction of a new bridge over the Yalu River meant to connect Dandong to its twin city of Sinuiju on the North Korean side and improve transport links between the two sides. As the bridge has yet to be connected to a main road on the Korean side, however, it currently stands unused<sup>20</sup>, perhaps testimony to the past year's chill in relations between Beijing and Pyongyang following Kim Jong Un's accession to power. Further developments can also be observed through the Rason Special Economic Zone (SEZ), as well as the Hwanggumpyong and Wihwa Islands SEZ<sup>21</sup>, both jointly run by China and North Korea, although so far with little progress ( Duchatel and Schell, 2013, Reilly, 2014; Haggard and Noland PIIE Blog). While for a variety of reasons the functionality of the SEZs has remained limited, with foreign direct investment remaining extremely scarce in the highly controlling, authoritarian state, the potential for receiving Chinese investments is at present more likely than from any other foreign source.

It is clear that the North Korean government is dependent on Chinese support and might be more receptive to pressure exercised through economic means, in line also with hypothesis 4 of the present study which prescribes that the existence of political coalitions

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<sup>20</sup> <http://asia.nikkei.com/Politics-Economy/International-Relations/Beijing-s-grand-ambitions-take-shape-with-New-Yalu-River-Bridge>

<sup>21</sup> As of November 2013, a total of 13 economic development zones had been opened by the new North Korean leadership under the guidance of Kim Jong Un.

with similar orientations (open/closed) in both parties to trade may enhance the effectiveness of engagement as tool for persuasion. Both the Chinese elites as the North Korean ones value regime security and domestic stability above all else. Therefore, a sage use of economic inducements presented with a long-term developmental vision should be able to bring upon changes in North Korea's behaviour, and yet so far this has not been tried. The limitations to China's use of such measures are manifold: for one, the ideological aspect of non-interference in a state's internal affairs, by which China (at least overtly) abides, as well as the wider security dilemma unfolding in the region might motivate it to hold back. Moreover, to the extent that economic management is under Provincial control and many of the companies involved in trade with North Korea are private, the Chinese central government's ability to use economic engagement for measures beyond trade may not be as extensive as it may seem from the outside.

To sum up, the case of China's economic engagement with North Korea is one which runs much deeper than South Korea's Sunshine policy, and is ruled by a different type of dynamics. While looking purely at numbers would suggest that China enjoys a great amount of discretion with regards to North Korean policies, as trade between the two parties has reached almost \$6.5 billion USD in 2014, representing a 65% share of North Korea's total trade (and this share is bound to go up in 2016 as South Korea, the North's other substantial trading partner has ended operations at Kaesong Industrial Complex), few indications exist of this economic clout being employed for matters beyond trade. While officially China backs the resumption of the Six Party talks as channel of negotiations for the denuclearization of the Korean peninsula, which it recognizes as a priority, trade

continues largely unhampered by restrictions, through the many private companies engaged in small- and medium- scale exchanges across the border from Dandong.

Arguably in this case our hypotheses on economic engagement can't fully be tested, as long as China has not identified engagement as a tool for transformation. This explains why hypotheses 1 and 2 were rejected through China's pursuit of enhanced trade with North Korea at a time when the international community was enhancing sanctions to curb the regime's nuclear weapons programme. The effectiveness of engagement, as well, can't fully be tested in the circumstances where trade has not been overtly employed to modify behaviour. It might be more likely for North Korea's closed regime to be receptive to inducements coming from its ally and close trading partner, with a large stake in the state's economic welfare, however, at present it is hard to tell whether such an approach has been attempted. Certainly, no Chinese investment into North Korea has been touted as a gateway to gradually opening up the country, as was the case with South Korean media reports on the Kaesong Industrial Complex. In the long term, perhaps China's more gradual, less conspicuous approach may bare more fruit, but for now, there is little hard evidence for it.

#### **IV. CONCLUSION**

Over the past few chapters the employment and efficiency of economic engagement as tool of economic statecraft has been outlined and tested on two recent cases from international politics. To start with, it was shown that the field of economic statecraft is becoming more prominent in today's world affairs, where the costs of military confrontation have rendered it an unfeasible policy option for many. As such, both

sanctions as economic engagement are more frequently employed by states in order to achieve the desired policy changes in the target state by leveraging economic damage or gains. However, the theoretic study of both methods, and especially that of economic engagement, is insufficiently developed. The present study, while not aiming to be a comprehensive study of engagement, lays out some of its most common traits and sets out to test them on two real-life instances of engagement, that of the South Korean Sunshine Policy as well as the Chinese engagement of North Korea.

At the beginning of the main analysis part of the present study, a brief introduction to the state and official mechanisms of the North Korean economy and its external trade was provided, painting a picture of dependency and poverty. It was shown that external factors in the shape of multilateral sanctions motivated by North Korea's pursuit of nuclear capabilities have gradually reduced the DPRK's number of trading partners to just a handful, pushing China at the same time to enhance its cooperation with the reclusive state in order to keep its economy afloat. By April 2016, after the closure of Kaesong Industrial Complex, it was estimated that China alone would come to represent more than 90% of North Korea's trade, compounded to a large share of natural resources exports from the North to China.

Further it was noted that while the potential main goal of economic engagement by China and/or South Korea with the DPRK would be to change its preferences away from the pursuit of nuclear weapons and induce a return to negotiations for denuclearization, at the present stage this goal has not been achieved. For both South Korea and China, North Korea's growing nuclear potential poses a strategic dilemma, in that it continues to act as a catalyst for instability in the region, letting the conflict linger

unresolved, while inviting at the same time a more assertive approach of the United States (alongside its Asian allies) in the Asia-Pacific region. For South Korea, whose ultimate objective is achieving a peaceful unification of the two Koreas, the nuclear arsenal of the North spells with it a postponement in the achievement of this goal, as well as a potential existential threat. The approach of both countries, at a given point in time has been to engage North Korea through economic means, although in China's case, less evidence of the pursuit of engagement for matters beyond trade can be identified in official statements and documentation. According to statistics China has the capacity to exert extensive pressure on the North Korean economy by manipulating its trade, but few indications can be found of it pursuing such a strategy. Moreover, for South Korea, in the absence of reciprocity or de-escalation and due to a gradual loss of public support for the policy at home, all of the progress made in engaging the North through the Sunshine policy has been undone. It would arguably be difficult to equate the two cases for a generalizable comparison, given the separate context in which the two policy decisions for engagement might have been developed in Seoul and Beijing respectively. However, it is undeniable that a policy of engagement relies heavily on a mid- to long term implementation period, as well as on a consolidated base of public and political support to fuel it forward. This may explain why at present engagement has not been effective, or sustainable, as state policy towards the North in South Korea. As shown in the first part of the present study, a democratic system is less likely to support a successful engagement campaign, specifically due to the regular elections and reliance of political parties on short-term gains which translate sooner into political support from the general public. In the case of China, engagement seems to remain a valid and effective option due to the decreased costs



incurred by a centralized government which draws its authority and legitimacy primarily from a different set of issues. In all, the results of the study are mixed, as they emphasize once more the importance of case-bound specificities to the application and effectiveness of pursuing a policy of economic engagement.

## ANNEX I: Overview of UNSC Sanctions resolutions

Year	UN Resolution	Restrictive Measures
10/2006	UNSCR 1718	<ul style="list-style-type: none"> <li>• Export ban on ballistic-missile/dual-use technology, large-scale arms, nuclear-related goods as well as luxury goods.</li> <li>• Calls for cargo inspections (not compulsory).</li> <li>• Asset freeze for individuals and entities connected to proliferation activities.</li> </ul>
06/2009	UNSCR 1874	<ul style="list-style-type: none"> <li>• Expansion of list of individuals and entities covered by assets freeze, weapons-sale ban excluding light arms.</li> <li>• Ban on provision of financial services to DPRK, excluding for humanitarian purposes.</li> <li>• Authorized cargo inspections if suspected of being connected to the state's weapons development programme.</li> </ul>
01/2013	UNSCR 2087	<ul style="list-style-type: none"> <li>• Strengthened sanctions of UNSCR 1874.</li> </ul>
03/2013	UNSCR 2094	<ul style="list-style-type: none"> <li>• Enhanced financial sanctions: prohibited bulk cash transfers to DPRK and the use of international financial networks.</li> <li>• Jewellery, yachts, luxury cars and race cars were added to the list of banned exports of luxury goods.</li> </ul>
03/2016	UNSCR 2270	<ul style="list-style-type: none"> <li>• Further financial restrictions, including on the opening of new branches of foreign banks within DPRK territory. Closure of foreign bank branches in DPRK where reasonable grounds exist that their activity is aiding the nuclear proliferation programme.</li> <li>• Mandatory cargo inspections on all cargo originating from DPRK.</li> <li>• Sectoral sanctions targeting DPRK's trade in natural resources: coal, iron and iron ore, gold, titanium ore, vanadium ore, and rare earth</li> </ul>

		minerals. (*trade for ‘livelihood purposes’ exception) <ul style="list-style-type: none"> <li>• Tightened arms embargo to include small arms and light weapons.</li> <li>• Ban on supply of aviation fuel.</li> </ul>
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## ANNEX II: Overview of Six Party Talks Meetings and main achievements

<b>Round I:</b> Aug. 27-29/2003	No progress.
<b>Round II:</b> Feb. 25-28/2004	No progress.
<b>Round III:</b> June 23-26/2004	No progress.
<b>MEANWHILE:</b>	In Feb. 2005 DPRK announced it has manufactured nuclear weapons: the nature of the talks shifted from preventive action to denuclearization and the talks took on a more urgent nature.
<b>Round IV:</b> July 26-Aug. 7/2005	No progress, talks put on hold for 3 weeks due to ARF meeting.
Sept. 13-19/2005	<b>SEPTEMBER 19<sup>th</sup>, 2005 AGREEMENT &amp; JOINT STATEMENT</b> <ul style="list-style-type: none"> <li>• DPRK agreed to return to NPT and abandon all nuclear weapons &amp; related development programme.</li> <li>• US, RoK provided security assurances, also promised not to deploy nuclear capabilities on KR Peninsula. Agreed to work towards a permanent peace agreement. Provision of energy assistance by RoK.</li> <li>• DPRK, JP pledged to normalize relations.</li> <li>• ‘action for action principle’</li> </ul>
<b>Round V:</b> Nov. 9-10/2005	Agreeing on a timeline & steps for implementation. <ul style="list-style-type: none"> <li>• The lifting of US financial sanctions remained a point of contention which blocked progress for more than a year to come. Most of round V functioned as a forum which enabled intense bilateral negotiations between US and DPRK.</li> </ul>
<b>MEANWHILE:</b>	<ul style="list-style-type: none"> <li>• Oct. 9<sup>th</sup> 2006: DPRK held its first nuclear test, despite its commitments under the Sept. 19<sup>th</sup> agreement.</li> </ul>

	<ul style="list-style-type: none"> <li>Oct. 14<sup>th</sup>: UNSC Res. 1718, first international sanctions prior to return to talks.</li> </ul>
Dec. 18-22/2006	
Feb. 8-13/2007	<p><b>FEBRUARY 13<sup>th</sup>, 2007 AGREEMENT:</b></p> <ul style="list-style-type: none"> <li>Towards implementation of Sept. 19<sup>th</sup> agreement.</li> <li>On basis of a bilateral agreement reached between US-DPRK in Berlin in January.</li> <li>Practical steps for initial phase of denuclearization agreed through the full dismantling of Yongbyon reactor, 'action for action principle'. No further mention of LWR provided in return.</li> <li>No mention of the HEU programme or of second phase of denuclearization, what happens after Yongbyon is shut down?</li> </ul>
<b>Round VI:</b> March 19-22/2007	Phase 1: Implementation of agreements, both at Ministerial level as well as in working groups set to meet regularly to agree on details of the plan.
July 18-20/2007	
Sept. 27-30/2007	Phase 2: working out long term strategy and steps of implementation..
Dec. 8-11/2008	<p>DPRK did submit a list of nuclear facilities to IAEA and allowed inspections, but the most sensitive sites remained restricted. Eventually DPRK requested IAEA inspectors to leave the site in Sept. 2008 when they asked for further access. Verification remained biggest point of contention.</p> <ul style="list-style-type: none"> <li>The parties could still find no solution to how to ensure appropriate <b>verification</b> in accordance to international standards, definitive breakdown of talks. On April 14, 2009 the DPRK announced it would withdraw from the negotiations and restart plutonium processing at Yongbyon.</li> </ul>

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