**Article main title:** Chinese Firms’ Troubled Relationship with Market Transformation in North Korea

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**Abstract:** The coping strategies that small Chinese firms in North Korea have chosen involve insinuating themselves into North Korean political and social networks, and structuring their investments so as to minimize their exposure to North Korean infrastructure, workers, and institutions. As a result, it is unlikely that Chinese firms are the main drivers of market transformation in North Korea.

**Keywords:** North Korea, China, investment, trade, coping strategies, market transformation
INTRODUCTION

Since Japan cut off legal trade with North Korea beginning in 2006, China has become North Korea’s largest trading partner. Based on statistics released by the Chinese government, in 2015, China-North Korea trade reached US$5.5 billion, an estimated 90% of North Korea’s known foreign trade.\(^1\) This increasing trade dependence on China has not gone unnoticed in either China\(^2\) or the West,\(^3\) and has led to no small amount of research on the implications of Chinese trade with and investment in North Korea, the involvement (or not) of the Chinese government in trade and development projects,\(^4\) and the ability of Chinese trade to influence changes in the North Korean economy and North Korean citizens’ thinking,\(^5\) with some analysts suggesting that this cross-border trade and Chinese investment in North Korea can and should be used in an active way by the Chinese government to influence North Korea politically and economically.\(^6\) While this is an appealing argument, the mechanisms by which Chinese influence might work at the operational level to move North Korea toward a more open market economy and North Koreans toward more market-oriented attitudes and behaviors are less clear, and depend to a large extent on how Chinese firms are interacting with North Korean firms.

Based on a unique collection of in-depth interviews with Chinese businessmen engaged in trade with or investment in North Korea, we argue that while China does indeed have a large amount of economic interaction with North Korea, many Chinese firms’ specific methods for coping with North Korea’s business environment mean that it is unlikely they will be a major agent for economic change in North Korea. Chinese businesses survive in North Korea by adapting to North Korean conditions, not transforming them. The more successful Chinese businesses become like North Korean businesses, insinuating themselves into North Korean social, political and economic networks, and minimizing the potential fallout associated with political and economic risk. They also minimize contact with North Korean infrastructure, workers, and institutions, and conclude transactions without making

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1\(^{\text{\footnotesize"ZhongChao mao yi lian xu liang nian jiang di, chao xian dui hua chu kou jian shao shi zhu yin" [China-North Korea trade has decreased for 2 years continuously, the main reason is North Korea’s decreased export to China], Reference News, February 9, 2016, http://news.china.com.cn/world/2016-02/09/content_37761518.htm, accessed December 6, 2016.}}\)

2\(^{\text{\footnotesize"Chaoxian dui wai maoyi jiegou ji qi dui ZhongChao jingmao guanxi de yingxiang" [Features of North Korea’s foreign trade structure and its influences on China-North Korea trade relations], Journal of Yanbian University (Social Science), no. 3 (2011), pp. 72-79.}}\)


6\(^{\text{\footnotesizeHaifeng Man, "Xin shiqi ZhongChao guanxi dingwei yu ZhongChao bianjing didu jingji hezuo fazhan" [The localization of China-North Korea relations in the new era and an analysis on economic cooperative development in China-North Korea border areas], Journal of Eastern Liaoning University (Social Science), no. 6, (2011), pp. 120-125.}}\)
long-term commitments. To the extent that Chinese businesses are coping in North Korea, they are doing so by operating in a way that is likely to minimize the influence Chinese business practices or investments have on North Koreans.

CHINA’S HOPE FOR MARKET TRANSFORMATION IN NORTH KOREA

While the general image of China-North Korea relations in the West is one of unconditional Chinese support even in the face of North Korean provocations, China's relationship with North Korea has become more restrained and conditional since the 1990s, with a shift toward a trade-based relationship rather than a primarily political relationship, one where interests trump any residual ideology that China shares with North Korea. It has continued to send aid, although this aid may not actually be in a form significantly different from that sent by other countries. Moreover, China has become by far the most important player in North Korea’s political economy, with trade skyrocketing since 2006, and an increasingly pervasive presence in North Korea’s informal markets, mining sector, and special economic zones alike.

China's strategy in North Korea's economy

China’s goals in North Korea are up for debate: it could be using trade to bring stability to the region and prop up the North Korean regime, or it could be primarily concerned with developing infrastructure in North Korea to further its own economic agenda. It could also be using aid, trade and investment to attempt to transform North Korea into something more complementary with China’s interests, or at the very least constrain North Korea from engaging in provocative nuclear weapons-related behavior. The desire of China for its trade with North Korea to spur a Chinese-style reform and opening up, with the

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7 Andrew Scobell, China and North Korea: From Comrades-in-Arms to Allies at Arm's Length (Carlisle Barracks, PA: Strategic Studies Institute, 2004).
10 Reilly, "The Curious Case of China's Aid to North Korea."
16 Reilly, "China's Market Influence in North Korea"; Reilly, "The Curious Case of China's Aid to North Korea"; Reilly, "China's Economic Engagement in North Korea."
17 Haggard and Noland, "Sanctioning North Korea".
accompanying economic development and more pacific foreign policy, is not particularly secret, and Chinese newspapers and researchers are always hopefully looking for signs of economic reform in North Korea.¹⁸

How does the Chinese government translate this desire for North Korean market transformation into reality? Reilly argues that China's economic engagement strategy with North Korea is surprisingly subtle in its potential to maximize benefits for China, minimize North Korean leverage, and transform North Korea’s political economy.¹⁹ The Chinese engagement strategy consists of “an array of incentives to encourage investment and trade with North Korea, including diplomatic support, infrastructure projects, foreign aid, capital provision, and supportive domestic policies.”²⁰ As a result, since 2004, when the Chinese government shifted its North Korea policy from political engagement to economic engagement, the Chinese government has invested massively in cross-border infrastructure, provided capital to Chinese businesses wanting to invest in and trade with North Korea, and trained North Korean officials in the ways of market economics.

Yoon and Lee characterize the Chinese government’s strategy vis-à-vis investment in and trade with North Korea as 'government-led, enterprise-based, market-operated, win-win' (zhengfu zhudao, qiye weihu shichang yunzu, huli gongying).²¹ While the Chinese government wanted to encourage trade and investment, it wanted to do so at high, inter-governmental levels, focus that trade on jointly developed resource extraction and infrastructure development projects, and spur growth in northeastern China through (from 2003 to 2005) investment campaigns, private trade and investment (guided by the government), and occasionally state-ordered state owned enterprise investment.²² This has translated into Chinese government-supported infrastructure projects in North Korea such as a new bridge across the Yalu River, and the encouragement of special economic zones such as Rajin-Sonbong and Hwanggumpyong.²³ These projects are more generally part of the central government's plans to develop northeastern China through the Chang-Ji-Tu development initiative and Liaoning Coastal Economic Belt development plan.²⁴

¹⁹ Reilly, "China's Market Influence in North Korea."
²⁰ Ibid., p. 900.
²¹ Yoon and Lee, "From Old Comrades to New Partnerships," p. 23
In both understandings of China's strategy, the central Chinese government expects that much of the drive and innovation in both investing and creating opportunities for trade and investment will come from local governments and private firms. The mechanism for North Korea's transformation comes from a Chinese economic presence in North Korea and interaction between Chinese firms and North Korean economic actors. Reilly argues that North Koreans are gradually adapting their institutions to resemble the Chinese economic institutions that have spurred growth in China, establishing economic projects with China, and changing the ways in which they conduct business (and more generally becoming interested in the trade and markets) as North Koreans increasingly interact with Chinese businesspeople. Chinese businesspeople have served as (brutal but effective) teachers for North Koreans in the way of the market economy and trade. Chinese products flood into North Korea, opening North Koreans’ eyes about the benefits of a market economy. Chinese businesses bring to their transactions with North Korea the Chinese way of doing business, and North Koreans, seeing how Chinese firms have prospered through market-based practices, emulate them. In general, Chinese firms involved for the long term in North Korea demand clear investment laws, predictability in political and economic conditions, reliable dispute resolution mechanisms, and enforcement of contracts, potentially pushing North Korea to reform to keep the firms happy. Chinese firms (and more generally the Chinese government) build infrastructure to and within North Korea to facilitate Chinese trade and investment, and in the process improve the base for North Korean economic development. North Koreans also learn, sometimes too well, how market prices work through dealing with Chinese firms. From our interviews, for example, one Chinese businessman working in the timber business in North Korea since 2007, noted that, “I did make a lot of money through my investments in North Korea before 2012. However, after 2012, my business in North Korea gradually turned out to be unprofitable” partly due to an increase in the knowledge that his North Korean partners have about the market. As they gradually became familiar with market prices for various goods in China, they also increased the rates they charged for the goods he bought, decreasing his profit margin.

Why Chinese firms are not the prime drivers of North Korea’s market transformation

Yet it is not a given that Chinese economic interaction with North Korea will lead to reform and openness that looks anything like China’s. Implicit in the potential for Chinese firms to influence North Korean market transformation is ongoing contact between Chinese firms and North Korean firms (or at least North Koreans), and Chinese firms' penetration into North Korean territory and the North Korean economy. Since the majority of Chinese investment is in natural resource extraction, North Korean economic engagement with China

25 Reilly, "China's Market Influence in North Korea."
28 Reilly, "China's Market Influence in North Korea."
29 Interview with Chinese Businessman #9, Hunchun, July 2014.
has the potential to enrich only the political and military elites.\textsuperscript{30} Chinese companies also resolve issues in their business with North Korean companies almost entirely through personal relationships and informal institutions. Formal institutions within North Korea do not guarantee the validity of contracts or resolve disputes, and as a result, in a low-trust environment both the ability of Chinese-North Korean trade to expand, and of trade to change North Korean business may be limited.\textsuperscript{31}

Indeed, we find in our discussions with private and local state Chinese businessmen involved in North Korea that, largely due to the poor business environment in North Korea and the lack of support from the central Chinese government, the manner in which Chinese firms interact with North Korea minimizes the potential for Chinese actors to be the engine for North Korean market transformation. First, while North Korean business conditions would ideally emulate Chinese business conditions, Chinese firms that have been successful have adapted to North Korean conditions and insinuated themselves into North Korean political and social networks to protect themselves from political and legal risk. Second, while extended and deep Chinese contact with North Koreans would be useful for driving North Korean market transformation, in practice successful Chinese firms minimize their contact with North Korean infrastructure, institutions, and labor through strategic structuring of their investments and the industries they enter, minimizing their logistical footprints within North Korea, and engaging in transactions without extended timeframes. In essence, Chinese firms are not positioned well to serve as the main drivers in North Korean market transformation because they act like North Korean firms and deal as little as possible with North Korea.

\textbf{DATA}

To build our case, we focus on low-level private and state firms because Chinese investment in North Korea is largely but not entirely a phenomenon of local and small companies, with the vast majority of Chinese companies trading with North Korea coming from northeastern China (Liaoning, Jilin, and Heilongjiang provinces), ranging in size from small to medium-sized enterprises, and in terms of joint ventures are concentrated in the mineral exploitation sector.\textsuperscript{32} Few central state-owned enterprises are involved in North Korea,\textsuperscript{33} with more than 70% of Chinese investors and traders surveyed by Haggard and Noland being either private firms or individual businesspeople.\textsuperscript{34} By exposing North Koreans to market forces, interacting with their North Korean partners, and sending money and goods into the country, these firms would logically be one of the drivers for economic change and market transformation in North Korea.

\textsuperscript{30} Balázs Szalontai and Changyong Choi, "China’s Controversial Role in North Korea’s Economic Transformation: The Dilemmas of Dependency," \textit{Asian Survey} 53:2 (2013), pp. 269-91; Thompson, "Silent Partners".
\textsuperscript{32} Open Source Center, "North Korea -- Characteristics of Joint Ventures with Foreign Partners, 2004-2011," (Washington, DC: Open Source Center, March 1, 2012); Thompson, "Silent Partners".
\textsuperscript{33} Thompson, "Silent Partners."
\textsuperscript{34} Haggard, Lee, and Noland, “Integration in the Absence of Institutions”; Haggard and Noland, "Networks, Trust, and Trade."
As part of a larger project on North Korean trade networks, twenty-two interviews were conducted in Dalian, Shenyang, Dandong, Baishan, Changchun, Hunchun, and Yanji in November 2013, July 2014, and February 2015. Each interview took up to two hours, during which at least fourteen basic questions were asked of the interviewees about the specific coping mechanisms they adopt to survive in North Korea. As many interviewees were experienced businessmen who had invested in North Korea for decades, follow-up questions were often asked to obtain more details on their strategies. Interviewees were promised anonymity unless they explicitly asked to be named. The businessmen interviewed were selected partially through the personal networks of the authors and as such do not represent an unbiased sample of the universe of Chinese firms investing in North Korea, although they are largely low-level traders and investors. With that said, they did represent a range of variation in Chinese businesses involved in North Korea, inasmuch as they were from all the main cities doing business with North Korea, and were engaged in a variety of industries: of the twenty-two businessmen, five were involved in import and export, two were in the mining industry, two were in the automobile industry, three were in the food industry, four were in construction, and the balance were involved in clothing, forestry, tourism, and processing of raw goods. Nonetheless, in-depth qualitative interviews are useful in deriving strategies that businesspeople have used to cope with North Korean conditions (although we can say nothing about how frequently they are used), and the process by which those coping mechanisms work.

ADAPTING TO NORTH KOREA

North Korea presents a plethora of problems for Chinese firms. North Korea’s physical infrastructure – water, power, and transport – is dilapidated and often non-functional, communications within the country and between North Korea and the rest of the world remain difficult (although the construction of a mobile phone network has mitigated this problem somewhat), and the quality of the workforce, malnourished, underpaid, and used to a socialist work ethic, is low. Some investors even need to supply food for their North Korean laborers during famines to maintain productivity. A Chinese investor who used to invest in the import-export business in North Korea claimed that before his North Korean workers began work every day, he provided them with food so that they could have enough physical strength to work. All of these problems are compounded by rampant corruption,

36 Wang and Hastings, "North Korea Risky Business for Chinese Investors."
pay-to-play interactions with many government officials, and a high degree of political risk, not to mention the headaches of dealing with trade and financial sanctions, and thus the difficulty of moving goods and money into and out of the country.

Aside from building infrastructure to North Korea and inside special economic zones, the Chinese government has done little to mitigate these problems. For all the Chinese government's encouragement of private dealings with North Korea, the emphasis on ‘enterprise-based, market-operated’ trade and investment means that the Chinese government itself has been unwilling to intervene on behalf of most enterprises in the event of disputes. The perception that the Chinese government leaves Chinese firms operating in North Korea to live or die on their own is a common sentiment, expressed both in Haggard and Noland's 2007 survey (where few firms thought that turning to the Chinese government to resolve disputes was useful) and in the interviews for this article. As such, there is something of a paradox to China's desire for economic engagement with North Korea: the Chinese government encourage private firms to invest in and trade with North Korea so as to encourage Chinese-style economic reform and development, but is in practice willing to let nearly all of the firms that are putatively the agents of this change sink or swim on their own. As a result, firms have developed strategies to adapt to the North Korean business environment on their own.

**Choosing and cultivating the right partners**

Chinese firms are not unaware of the risks and the costs of investing in North Korea, and see informal networks as a way to mitigate those risks (and potentially minimize their costs). From our interviews, Chinese investors often seek embed themselves quickly in North Korean political and social networks, and adapt their business practices to North Korean conditions. Before investing in North Korea, investors often do research to figure out which trade companies possessed power and influence within their business areas and which trade companies were directed by comparatively powerful officials. In doing so, firms are able to apply to cooperate with North Korean trade companies that are relatively immune to political and economic disruption so as to reduce the risk of their investments.

Given the North Korean state's emphasis on bloodlines in determining possibilities for advancement, Chinese investors are not unaware of their partners' place in the North Korean caste system. North Korean companies that may be relatively immune to political and economic risks are often directed by one powerful figure. Such figures often have a strong political background that protects them (to a certain extent) from political reverses. North Korean contacts can also distribute bribes to other officials on behalf of the Chinese firms. Such an approach allows firms to build social networks in North Korea while minimizing their contact with North Koreans. According to one businessmen:

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42 Haggard and Noland, “Networks, Trust, and Trade.”
44 Interview with Chinese Businessman #3, Shenyang, July 2014.
45 Interview with Chinese Businessman #8, Hunchun, July 2014.
46 Interview with Chinese Businessman #3.
I normally just give the bribes to the chief manager of my North Korean partner trading company. Because this trading company is influential in North Korea, they will take care of other relevant North Korean government departments for us. In doing so, we don’t need to worry about how to bribe all the relevant officials.\(^\text{47}\)

Chinese investors generally see cooperating with North Korean trade companies in practice as equivalent to building interpersonal relationships with the North Korean directors.\(^\text{48}\) In North Korea’s decentralized economic environment, these directors are given great autonomy by the North Korean government in cooperating with foreign investors; they are often able to decide the prices and qualities of raw materials and labour that they provide to Chinese investors. Noted one Chinese businessman:

> In theory we cooperate with North Korean trade companies, but I feel like we are actually cooperating with the chief managers of these trade companies in practice. The North Korean government gives significant power to these chief managers, so they can actually control the operation of these trade companies individually.\(^\text{49}\)

As a result, cultivating a high level of social ties between investors and North Korean trade companies’ directors may be the most important strategy that allows investors to maximize their investment returns. For example, one investor engaged in fisheries in North Korea managed to import seafood at a rate approximately one-twentieth of the market price in China: Based on his high-level social ties with the director of his North Korean partner company, the director provided him seafood at a low price, and he in turn gave large kickbacks to the director.\(^\text{50}\)

North Korean trade companies are not simply investors’ cooperative partners, but are also able to serve as conduits between investors and suppliers, collecting raw materials such as coal, food and petroleum from North Korean factories and agricultural cooperatives which are under the jurisdiction of these trade companies, while investors are not permitted to purchase raw materials directly by themselves.\(^\text{51}\) One Chinese trader went even further and cultivated a relationship with a low-level official in a North Korean trading company as the official ascended the ranks. The Chinese investor offered to put up approximately US$100,000 US to buy a colonel-level rank for the North Korean military officer working in the investor’s North Korean partner company. In return, the North Korean official provided concessional terms when doing businesses with his Chinese patron, such as offering the investor raw materials at low rates as well as good business opportunities and good logistics. The Chinese investor is now able to cash in on the North Korean official's influence.\(^\text{52}\)

**Using North Korean networks to deflect risk**

After building up the social network, investors deepen their relationships within the network to minimize risk. For example, one of the most successful investors in North Korea,


\(^{48}\) Interview with Chinese Businessman #1, Shenyang, July 2014.

\(^{49}\) Interview with Chinese Businessman #3.

\(^{50}\) Interview with Chinese Businessman #14, Baishan, July 2014.

\(^{51}\) Interview with Chinese Businessman #3.

a businessman involved in the construction machinery business, claimed that he only took orders from his long-term Korean partners, thus preventing his business from being defrauded by unfamiliar North Korean trade companies. While investors might cooperate with only one or two business partners at one time, everyone in their social network in North Korea becomes their potential partners. One investor running an auto repair business in North Korea commented that, while maintaining a long list of officials who require special treatment has high costs, it is helpful from a long-term perspective. Even though many officials in the favor list may not be helpful to the investment at the time, they might be new business partners or important shareholders in the future, or at least they may be able to bring investors into contact with new business opportunities and market information.

Frequent personnel changes since Kim Jong-un's rise to power at the end of 2011 have necessitated enlarging and diversifying social networks to protect against the risk that one's trading partners are purged or transferred. Investors complained about North Korea’s changes with Kim’s ascendance, such as the intensifying of inspections, frequent changes of personnel and difficulties in obtaining supplies. In the wake of the purge of Kim's uncle Jang Song-thaek in December 2013, North Korea changed regulations on foreign investments, increased taxation rates, and complicated examination and approval procedures for imports and exports. Kim Jong-un also removed a great number of customs and trade officers and appointed his own favorites in their place. These changes had the effect of subverting the ability of many Chinese firms to make a profit, inasmuch as they raised transportation time and costs, cut off the social networks they had built up with North Korea state officials, and raised the amount of red tape they had to deal with.

The need for Chinese firms to insinuate themselves into North Korean social networks is particularly pertinent in dealing with the North Korean state organizations most likely to help (or hinder) business – customs and the military. As most Chinese investors need to import and export raw materials and products between China and North Korea, they have to build up close relationships with North Korean customs officials to ensure their logistics networks are viable. Generally the working efficiency of North Korean customs is low, not only because they often take a long time to check the goods and luggage of investors but also because they sometimes 'lose' investors’ goods and luggage during customs clearance, leading some investors to believe that North Korean customs staff steal their deliveries. As a result, Chinese investors, especially those engaged in import-export whose businesses require quick transit through customs (such as seafood), have to bribe North Korean customs for priority in moving their goods through customs. On a practical level, Chinese businessmen claim that the amount of bribes depends on the category and amount of goods they are importing and exporting. Moreover, different customs officials require different amounts in bribes: some officials can be bribed with only cigarettes and alcohol, while other officials require a large amount of cash. Through constant bribes to North Korean customs officials, investors attempt to ensure that their goods move through customs safely and quickly.

Investors also build up high-level social ties with military officers through bribes because many of these officers are influential in local communities. While the relative power and influence among North Korea's interest groups – the Party, the Cabinet, and the military

53 Interview with Chinese Businessman #15, Baishan, July 2014.
55 Interview with Chinese Businessman #14.
56 Interview with Chinese Businessman #1.
57 Interview with Chinese Businessman #5.
– have waxed and waned as first Kim Jong-il and then Kim Jong-un played them off of each other,\textsuperscript{58} many directors of North Korean trade companies remain military officers, and many officials with military backgrounds are appointed to serve in the police, internal security agencies, and other sensitive organizations. Since North Korean military officers are comparatively immune to political and economic risks, building up close relationships with these officers better inoculates investors’ businesses against possible risks.\textsuperscript{59} Even if investors are not formally partners with the military in their investments, they can use their ties with these officials to ensure protection in local North Korean communities.

**The cost of social adaptation**

It costs investors a great deal of time and money to cultivate high-level social ties through bribes to the relevant cadres. As a practical matter, protecting investments solely through retail bribes is unreliable. Among the interviewees, almost every investor pays bribes to North Korean officials, but most of them are still defrauded by North Koreans, because bribes cannot alone provide protection for the investments.\textsuperscript{60} This lack of predictability was noted by one businessman as an impediment to moving deeper into North Korea:

> Why don’t I choose to enter North Korea? It's because I don’t trust North Korean customs. Paying bribes to them is not a big deal, but they do often lose our goods, sometimes they would also hide part of our goods, and I’m not tolerant of such behavior.\textsuperscript{61}

In addition, many investors do not know the most useful person to bribe, how much they need to bribe, and whether should they bribe with cash or gifts. For example, one Chinese investor selling construction materials to North Korea claimed that even though his company routinely bribes North Korean customs departments with cash, his products are still often detained by customs illegally, commenting: “No matter how much we bribe North Korean officials, they still cannot ensure that my investment operations are able to run smoothly.”\textsuperscript{62} In his case, because this investor has not established high level social ties to the relevant Korean cadres, he finds it difficult to find out who to bribe and how he can cultivate close relationships with relevant cadres through bribes, hence his bribes are less effective.\textsuperscript{63} Even though the ties with North Korea officials built up though bribes can sometimes allow investors access to infrastructure, these ties are still unreliable.

Cultivating social ties through provision of services to the relevant cadres is a more reliable strategy. However, in most cases such strategies can only be adopted in service industries such as auto repair, rather than the production and manufacturing industries. One investor in the automobile repair business provides free auto repair services to North Korean officials to gain their help and protection, and build up his social network:


\textsuperscript{59} Interview with Chinese Businessman #7, Hunchun, July 2014; Interview with Chinese Businessman #6, Hunchun, July 2014.

\textsuperscript{60} Interview with Chinese Businessman #8.

\textsuperscript{61} Interview with Chinese Businessman #6.

\textsuperscript{62} Interview with Chinese Businessman #1.

\textsuperscript{63} Interview with Chinese Businessman #1.
Occasionally there are some North Korean customs officers who come to my auto-repair shop to fix their vehicles. After we got familiar with each other, they told me that I could have priority when transporting my goods through the customs, and I didn’t need to worry about bribing other customs officers who have lower rank than them. Even though they told me this, I still bring some gifts to customs officers every time I need to go through customs—-it is vital to maintain good relationships with customs officers.\(^\text{64}\)

Besides directly providing services to North Korean cadres, Chinese businessmen also cultivate relationships with cadres through providing services to their families. One investor involved in the forestry business in North Korea, for example, maintains his social networks through offering free tours for North Korean cadres’ families.\(^\text{65}\) Compared with pure bribery of North Korean officials, provision of services to cadres not only has a lower cost, but also has more stable expected returns. Because these cadres are mostly frequent customers, as vehicles often need to be maintained (or families often need to be entertained), the cadres become dependent on their services, and it is comparatively unlikely that they will refuse to provide investors with protections and help.

Far from bringing Chinese business practices to North Korea, and acculturating North Koreans to the market economy, the Chinese investors we interviewed have survived North Korea by analysing the North Korean business environment, hitching their wagons to the right patrons, building their social networks through a combination of service provision and bribery, and to the extent possible, becoming like North Korean businesses. While North Koreans can learn about many aspects of the market economy from Chinese partners such as these—-the Chinese companies still have access to foreign markets, still attempt to negotiate prices and contracts, and still function like private firms (because they are, unlike most North Korean businesses)---the experiences above suggest that Chinese firms are being shaped by North Korean business culture rather than the other way around.

**MINIMIZING CONTACT WITH NORTH KOREA**

Besides strategies to build up and strengthen social networks and adapt to the North Korean way of doing business, Chinese firms also adjust the nature of their business to minimize their exposure to poor infrastructure, low labour quality, and poorly functioning political and economic institutions. They accomplish this by focusing on trade rather than investments with large capital expenditures in North Korea, minimizing their logistical and labor footprint inside of North Korea (even if investing), and structuring their investments and trade terms to minimize chances for North Koreans to take advantage of them.\(^\text{66}\)

**Trade as risk mitigation**

Haggard and Noland divide the activities of Chinese businesses dealing with North Korea into three general but not mutually exclusive categories: exports to North Korea, imports from North Korea, and investments in North Korea (ideally to produce goods that are then sold within North Korea or are exported from North Korea to China). Not surprisingly, investment exposes firms to the highest potential risk for disputes and expropriation. Firms thus might avoid investment entirely by engaging only in trade, especially exports where they

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\(^{65}\) Interview with Chinese Businessman #9, Hunchun, July 2014.

are not required to be in North Korea at all (and indeed, in their sample, only 70 out of 250 firms surveyed had invested in North Korea).  

From our interviews, some of those Chinese firms that have done business in North Korea for years and are familiar with the North Korean market do indeed choose to go into import-export to mitigate political and economic risk. According to traders, import-export businesses are more flexible than businesses that require significant in-country investment, because the trader can shift trade in response to changing conditions. While some capital investment in North Korea is inevitable for certain enterprises, particularly those involved in mining and transportation within North Korea, this investment is susceptible to North Korean official expropriation, as happened with Xiyang Corporation's doomed mining project.  

To minimize the possibility of expropriation and to deal with risk, these investors often invest in small-scale import-export businesses such as rice, vegetables, seafood, electronic products, and the like because such businesses do not require them to invest large amounts of capital in any one area. They might also diversify their trading portfolio, with each individual investment requiring little capital that could be trapped in North Korea. For example, one Chinese investor noted that his business covered a wide variety of goods, including producing packing boxes, wigs, and electronic products, as well as processing herbs. As such, he could take full advantage of cheap North Korean labor so as to maximize his investment return relative to risk with a diverse portfolio.

Maritime transit trade is another example of a business with a minimal footprint inside of North Korea. Particularly in Dalian, the main Chinese transhipment port for North Korea, the maritime transit trade has become prevalent in recent years, as Chinese transshippers generally do not need to enter North Korea or deal with the onward logistical issues. In the interviews, Chinese transshippers noted that in most situations, they only transport goods to North Korean ports such as Nampo and then wait for their clients to examine and claim the goods. As transhipment businesses mostly only transport goods en masse, sometimes these traders take several orders simultaneously, allowing their freighters to ship different clients’ goods in one voyage. As a result, the North Korean clients must deal with onwards deliveries themselves, not only because transit trade companies are not authorised to transport goods in North Korean territory, but also because clients would like to examine the goods at the port. 

**Staying out of North Korea**

Chinese businesses also minimize their footprint in North Korea by buying and selling goods at the border. In some cases, they go into industries, aside from import-export, that do not require entering North Korea. Operating tours, for example, essentially forces the North Korean partner companies to arrange everything inside of North Korea:

67 Haggard, Lee, and Noland, "Integration in the Absence of Institutions"; Haggard and Noland, "Networks, Trust, and Trade."


69 Interview with Chinese Businessman #13; Interview with Chinese Businessman #4, Shenyang, July 2014.


71 Interview with Chinese Businessman #17, Shenyang, February 2015; Interview with Chinese Businessman #19, Dalian, February 2015.

72 Ibid.
They [the North Koreans] will send tour guides and buses to pick up our customers (tourists) from the border. They will arrange accommodations, catering and sightseeing, they will also tell the tourists about lots of things that they need to know, such as what kind of things that they can take pictures of, and what they can't. After the tourists return from North Korea, we will just go pick them up at the border.\(^{73}\)

Engaging in import-export makes staying out North Korea especially straightforward, with investors being able to pick up and deliver goods at the border, with at least partial payment made on the spot. For example, a Chinese businessman engaged in importing timber from North Korea claimed that unlike most other investors, he does not need to enter North Korea to pick up his goods. Instead, North Korean trade companies provide the means to transport their timber to the border.\(^{74}\) Refusing to enter North Korea also solves many problems associated with customs. As one businessman noted:

> Previously, when we transported our equipment through the customs or our workers go through the customs, we always needed to bribe customs officials with alcohol and cigarettes. But now it is the North Koreans who take care of the transportation, so we don’t need to bribe customs to transport equipment any more.\(^{75}\)

This was corroborated by another businessman who likewise refused to enter North Korea:

> I only need to transport the goods from Dandong to the border, they [the North Koreans] will send trucks to pick the goods up, and then they give me a certain amount of money for payment. After the goods arrive at the final destination, they then give me the rest of the money for total payment.\(^{76}\)

In this way, both labour and transportation become the problems of Chinese firms' North Korean partners.

Exporting raw materials and processing them in China is another strategy used by Chinese companies, including in the food processing industry. Investors make deals with North Korean trade companies at Chinese trading ports and thus do not even need to enter North Korean territory. North Korean trading companies collect unprocessed food (in most cases seafood and herbs) from North Korean farms and bring them to the port to sell them to Chinese companies. As soon as investors have bought these unprocessed foodstuffs, they either sell the food to other buyers or process them into finished products in their factories near the border, because these foods rot within a short time.\(^{77}\)

**Short-term financial settlements**

If possible, Chinese firms also engage in trade that does not require long-term financial settlement.\(^{78}\) Generally speaking, businesses involved in trading enable Chinese investors to collect payment without entering North Korea, because import-export businesses are able to take place in border areas, especially in trading ports between China and North Korea.

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\(^{73}\) Interview with Chinese Businessman #12, Hunchun, July 2014.

\(^{74}\) Interview with Chinese Businessman #9, Hunchun, July 2014.

\(^{75}\) Interview with Chinese Businessman #15, Baishan, July 2014.

\(^{76}\) Interview with Chinese Businessman #13, Yanji, July 2014.

\(^{77}\) Interview with Chinese Businessman #14, Baishan, July 2014.

\(^{78}\) Haggard and Noland, "Networks, Trust, and Trade."
Traders can thus largely avoid the risk of going unpaid or pursing back payments. For example, a Chinese investor importing scrap steel from North Korea explained that every time he transacted with North Korean trade companies, he insisted on border trade ports as the location for the transaction, and insisted that deals be based on the cash-on-delivery principle. In this way, there is no need for the investor to collect his payments from inside North Korea. Meanwhile, investors engaging in businesses that deliver goods to North Korea have increasingly demanded deposits from North Korean partners to minimize the chance of default. Noted one businessman:

North Korea pays us with coals and iron materials because they have a very low level of foreign currency reserves. We do require a certain amount of deposit before we start every project, and the deposit must be paid in cash in Chinese yuan or US dollars.

One Chinese businessman exporting auto parts to North Korea held his North Korean partners to strict settlement terms, including a deposit:

Here, I need to emphasize, usually the North Koreans don’t pay Chinese businessmen deposits because they don’t have such a business tradition. But I do require a deposit, which is normally 10% out of the total profit of each deal. After receiving the deposit, I transport the goods to Quanhe treaty port as they require, then they will come to pick these up.

Strategically locating labor and the production chain

Investors also choose businesses that require minimal logistics or labour presence within North Korea itself. Investors complain that the working efficiency of North Korean labour is extremely low because North Korean workers are physically weaker than Chinese workers due to the low standard of living in North Korea. The low efficiency of North Korean workers also arises from North Korea’s payment system: North Korean authorities stipulate that no matter what a labourer’s output is, he is paid the same amount of money every day without bonuses or fines, resulting in little passion for productivity by the workers. Investors resolve this problem by minimizing their use of North Korean labour. While North Korean workers are much cheaper than Chinese workers, they are unqualified to do work which requires high working efficiency or advanced techniques. For instance, a Chinese investor in the auto repair business in North Korea declared that he only used Chinese labor in his repair shops in North Korea, allowing him to provide his customers with quick and high quality services.

For industries that do require footprints and substantial investments, investors attempt to minimize the proportion of the production chain inside North Korea. In mining and infrastructure investments, for example, the most frequently used strategy is locating factories and mines near the borders. In one interview with mining investors in North Korea, the investors noted that their partner, the North Korean trade company, is unable to provide them with enough trucks to transport their products and equipment. Locating mines and factories near the border thus minimizes the logistical challenges because such industries require

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80 Interview with Chinese Businessman #15.
82 Interview with Chinese Businessman #4; Interview with Chinese Businessman #5.
significant movement of equipment and materials between the two countries.\textsuperscript{84} Mining investors must bring their own equipment from China and transport most of their products back to China to further process and sell.\textsuperscript{85} North Korea is purely an exploitation area rather than a market for Chinese mining companies, hence the location of a mine close to the border is essential in reducing logistical costs, which are a large percentage of their total costs. The seafood industry also incentivizes investors to locate their factories or facilities near the border to minimize the use of infrastructure. As North Korea does not currently possess reliable storage technology to keep seafood fresh, Chinese investors who import seafood from North Korea must build their seafood processing factories close to the border. According to one of these investors, they have to process or sell the seafood to restaurants within twenty-four hours to prevent it from being tainted; hence many processing factories are located in close proximity to the customs checkpoint.\textsuperscript{86}

When they have had a choice, Chinese firms have often chosen to do business with North Korea by minimizing their contact with North Korean workers, their logistical footprint inside of North Korea, their dependence on long-term contracts with North Korean firms, and the extent to which they are subject to North Korean laws and institutions. Many Chinese businesses have decided that the best way to survive in North Korea is not to be there at all. Such a strategy is unlikely to serve as a driver of market transformation given that Chinese firms have refrained from extended and deep contact with North Korean firms and the North Korean population.

\textbf{IMPLICATIONS}

Based on our findings, China’s policy of encouraging private firms to do business with North Korea but letting them sink or swim on their own may be working at cross-purposes with hopes of instigating market transformation in North Korea, inasmuch as Chinese firms survive in North Korea by becoming like North Korean firms and not being in North Korea at all.

Several implications present themselves. First, the Chinese government may see Chinese firms’ involvement in North Korea as a way for the firms themselves to find investment and trade outlets, and infrastructure improvements in North Korea as a way to support Chinese economic development. In this reading, while China hopes for North Korean ‘reforming and opening up,’ the first priority is to serve Chinese economic interests. Second, China may hope that the North Korean state itself makes a strategic decision to engage in market transformation. In this sense, while Chinese firms may not be positioned to have an influence on North Korean economic changes, the fact of the potential for economic growth through dealing with Chinese firms may serve as a lure for North Korean state to make a commitment (however tentative) to reform. Unfortunately for China, this has so far not been the case. In either reading, it may behove the Chinese government to provide more support for private Chinese firms (in terms of political support for dispute resolution with North Korea, rather than financial incentives for investment) to push deeper into North Korea, although this necessarily means greater political risk for China as well.

\textsuperscript{84} Interview with Chinese Businessman #16, Changchun, July 2014.
\textsuperscript{86} Interview with Chinese Businessman #14; Hastings, \textit{A Most Enterprising Country}, pp. 167-168.
Our findings also have larger implications for North Korea itself. North Korea is clearly trying to attract foreign investment;\textsuperscript{87} the North Korean state’s two-track *byungjin* policy of simultaneous economic and military development practically demands it. Yet the tactics used by Chinese firms to survive in North Korea indicate that until the North Korean regime can create a trade and investment environment that is enticing to foreign companies -- predictable regulations and laws, reliable contract enforcement and dispute resolution, usable infrastructure, productive labor -- North Korean economic growth will not come through foreign investment, and any trade will primarily benefit only a few connected officials in North Korea rather than the general population. If foreign firms continue to avoid actually being in North Korea, any upside from trade is likely to be limited.

Yet this is not to say that North Korea is destined to resist market transformation. Instead, the drivers are likely to come from elsewhere. North Korea’s economic changes have been largely driven domestically and arise from the changes that have occurred, with great reluctance and ambivalence on the part of the North Korean central government, since the depths of the Arduous March's famine and economic collapse in the mid-1990s.\textsuperscript{88} Without prodding from China or even the North Korean government,\textsuperscript{89} the North Korean formal economy was eclipsed by an informal 'second economy' that operated on market principles (subject to rent-seeking by North Korean officials) and actually provided North Koreans who participated in it the ability to survive the depredations of the Arduous March. Private North Koreans not only looted the resources of the state, they grew food and traded for goods themselves, set up informal markets, and even developed rudimentary trade networks,\textsuperscript{90} with a portion of the goods sold in North Korean markets coming from China or further abroad.\textsuperscript{91} Gradually, most activities in North Korean life have become marketized, with opportunities available for those with sufficient money, entrepreneurial drive, and connections.\textsuperscript{92} If Chinese firms are unwilling or unable to change the North Korean economy, it is possible that North Koreans will do so in a much more fundamental way themselves.

\textsuperscript{91} Joo, "Visualizing the Invisible Hands"; Habib, "North Korea's Parallel Economies"; Lankov and Kim, "North Korean Market Vendors."