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China's economic engagement strategy towards Special Economic Zones: from North Korean experiences to CPEC

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Abstract

Unveiled in 2013 by Chinese leader Xi Jinping, the One Belt One Road Initiative (BRI) aims at fostering economic integration in the Indo-Pacific Region and in Eurasia through infrastructural developments and policy transfers. In recent years, Chinese economic engagement patterns have been met with increasing skepticism due to their lack of transparency, their sino-centric as well as politically intrusive character. On the other hand, China remains a major contributor to economic and infrastructural development for numerous countries and has proven to be a reliable partner able to deliver on complex projects in limited time. As a consequence, many countries face internal political dilemmas regarding Chinese economic engagement, leading governments and decision-makers to adopt a wide range of attitudes towards Chinese capital and expertise.

This paper aims at identifying political dilemmas created by Chinese investments by comparing Chinese economic engagement strategies in BRI's flagship project, the China Pakistan Economic Development Corridor, and the ones that failed in BRI's "dead-end": North Korea. While Pakistan and North Korea are very different economies, examining reasons that led the Pyongyang leadership to refuse to join the BRI initiative with current political debates in Pakistan around the CPEC and the "Pak-China Friendship" could help identifying and analyzing some salient features of Chinese economic engagement strategies abroad and the political dilemmas they imply for host countries.

Keywords: CPEC, North Korea, Special Economic Zones, Economic corridor, BRI

Introduction

The China-Pakistan Economic Corridor (CPEC) is the flagship project of China's trumpeted "One Belt, One Road" initiative, a large-scale political initiative aimed at developing connectivity between China, the Eurasian continent and East Africa. CPEC is thus of critical strategic importance for Beijing as it would provide Western China with a direct access to the Indian Ocean circumventing the straits of Malacca and allowing shorter trade routes towards Asian, the Middle East and Europe. The CPEC is developed as an integrated "economic development corridor" where Chinese companies, among many other development projects, will establish and operate Special Economic Zones (SEZs) in Pakistan. Although SEZs are most well-known for the role they played in China's spectacular economic rise, they have had a mixed success in triggering sound economic growth in South and East Asia. In addition to divided views on the economic potential of SEZs in Pakistan, scholars and analysts have expressed concerns about the terms of cooperation of China-Pakistan SEZ-based

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economic cooperation programs. Chinese economic engagement patterns worldwide have raised controversy due to their sino-centered nature, lack of transparency and for generating large debts in unsolvable developing countries. Some neighbouring countries with extensive ideological and political ties to China, like the Democratic People's Republic of Korea (DPRK, North Korea), while in dire need of investments in its dilapidated infrastructure, have prioritized protection from political interference to influx of Chinese capital.

By analysing why North Korea refused to enter into a SEZ-based pattern of economic cooperation designed by Beijing, we aim at highlighting potential issues that might arise during the gradual development of SEZ along CPEC. We argue that although Pakistan and North Korea are very different countries with very different expectations, the example of failed China-DPRK integration programs can provide useful insights for the future of Chinese SEZs along the CPEC. It proceeds in three stages: it will first describe how Special Economic Zones have been used, with mixed results, as a tool for economic growth in developing countries. It will also detail the potential role of SEZs in CPEC. The second part will then show that attempts at developing SEZs in North Korea have failed due to the refusal of North Korea to enter into a sino-centered pattern of economic cooperation that it deemed detrimental to its economic development and political interests. The last part addresses how the failed attempts at economic integration at the China DPRK border could offer valuable insights for Pakistani policy-makers on how to design economic cooperation patterns with China that would enable Islamabad to achieve autonomous growth using Chinese capital and involvement in SEZ development.

I/ Introduction: Special Economic Zones, accelerators of economic growth and tools of political dominance

One of the main tropes about the spectacular Chinese economic development since the beginning of the Chinese "open and reform" movement (1978) is the rapid mutation of the small fishing town of Shenzhen in Guangdong Province into one of the most successful Special Economic Zone in the world (Yeung Gee, Kee, 2009). Opened in 1980, Shenzhen has been used as a "testing ground" by Beijing to experiment with economic reform policies that could eventually being expanded to the rest of the Chinese economy. Farole and Akinci [2011] have defined SEZs as

"*demarcated geographic areas contained within a country's national boundaries where the rules of business are different from those that prevail in the national territory. […] The zone is given a business environment that is intended to be more liberal from a policy perspective and more effective from an administrative perspective than that of the national territory*" (Farole, 2011).

Beyond the spectacular success of the Shenzhen SEZ, however, most economists and historians tend to agree that other SEZs of that era (Zhuhai, Shantou, Xiamen) have had limited impact on Chinese economic development, although some did create very active but easily controllable economic interfaces between China and the rest of the world. Among the 1750 SEZs currently in operation in China (Khan, 2016), most have not made a name for themselves, and studies have shown that while a small selection of East Asian SEZs has encountered quite spectacular success, most SEZ programs in Africa, the Middle East and India have ended in failures [Farole 2011].

At the theoretical level, SEZs are considered to be beneficial for host economies in several ways: by facilitating inward Foreign Direct Investment flows, SEZs do not only generate "static benefits" such as employment, foreign exchange earnings (especially in the case of export-processing zones) or investments in infrastructures, but also "dynamic benefits" that include worker's skills upgrading, technology transfers and others that contribute to host countries diversification of exports and the evolution towards more value-added activities [Zeng 2010]. As it has been well-established, China was particularly successful in using some of its SEZs as tools to gradually integrate global value chains and climb up the technological ladder. In a very classical fashion, following Akamatsu's "flying geese paradigm" of economic integration in East Asia, China, in recent years, started to outsource some of its production capacities in lower income countries, providing important opportunities for struggling neighbouring countries especially in strategically- located Southeast or South Asian neighbouring countries. However, facing "immature" markets in lesser developed countries, especially in terms of infrastructure and business climate, China embarked on an economic engagement strategy based on the development of six economic corridors (六大经济走廊, *liuda jingji zoulang*) linking China with Pakistan, Bangladesh, Russia and Europe, the Middle East and the Indochina Peninsula [Ministry of Commerce, 2016]. These economic corridors are aimed at achieving two different economic policy objectives. By relying mostly on Chinese State-owned bank lending and Chinese State-owned Enterprises to develop the necessary infrastructure (transportation infrastructure, power supply, telecommunications, etc.), economic development corridors offer large business opportunities that alleviate the Chinese over-capable industry in the context of lessening domestic demand. Second, these investments aimed at facilitating the economic expansion of China, as Chinese companies face often difficult business conditions in lesser developed countries, especially in terms of lack of critical infrastructure that raise transaction costs and limit market size. SEZs developed along these economic corridors, as the concentrate *ad hoc* infrastructure in small areas, are key policy tools to be implemented to accelerate trade relations between China and foreign countries. In the case of several of the six economic corridors developed by China, they also allow not only better market access but also the development of new strategic trade routes for strategic supplies. CPEC, as of offers a much more direct route from the gulf of Aden to China than via the Indian Ocean and the South China Sea, is especially designed to facilitate Chinese imports of oil and gas from the Middle East by linking China's Westernmost province of Xinjiang to the port of Gwadar on the Gulf of Aden. Starting in 2013, these different projects were regrouped under Xi Jinping's signature concept of "one Belt, one Road" initiative (BRI).In Pakistan, along the China-Pakistan Economic Corridor (CPEC), China plans to develop nine Pakistani Special Economic Zones, there are plans to develop up to 46 zones as the CPEC unfolds [Times of Islamabad 2018]. The China-Pakistan Economic Corridor being one of the most central project of BRI, Beijing officially aims at investing no less than $60 billion in Pakistan, roughly the equivalent of Croatia's GDP.

While investments of such magnitude in developing countries offer interesting economic growth perspectives, BRI and the Chinese pattern of economic engagement have been criticized for several reasons. CPEC, among others, has been the focused of criticism from within Pakistan but also from other powers due to: 1) a general lack of transparency on the terms of CPEC-related projects and the exact amount debt generated by Islamabad as well as its capacity to reimburse Beijing; 2) an extensive Chinese control on critical infrastructure in Pakistan as well as on technology and industrial production facilities, which could eventually lead to an increased economic and political dependence on Beijing (CPEC as a "New East India Company" [Dawn 2016;3) General lack of coordination with neighbouring powers, including Pakistan's rival India, while CPEC-linked infrastructure goes through disputed (Kashmir) or unstable regions (Balochistan), with potential major impacts of the whole security of the region.

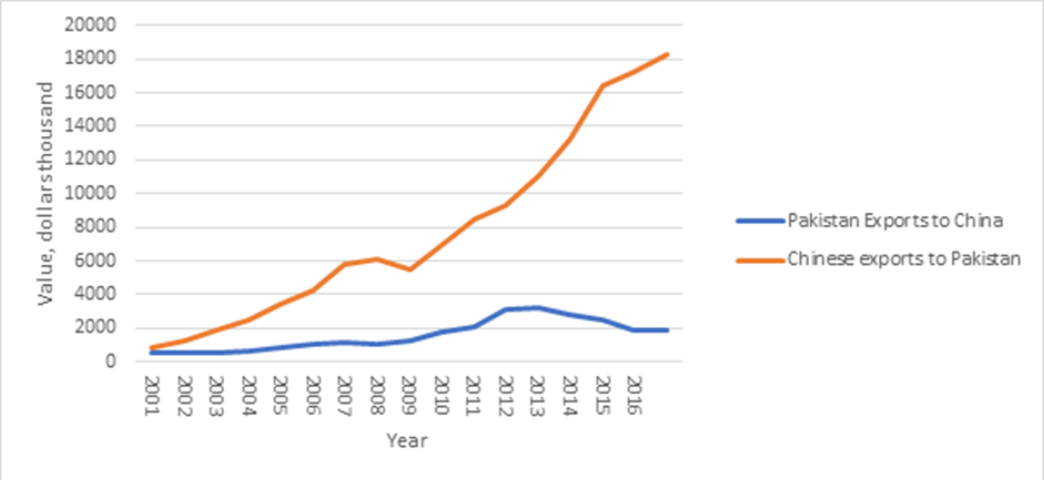
Even before the BRI initiative was launched, voices denouncing what were perceived as a lack of balance in China-Pakistan trade rose in the context of signing of the China-Pakistan Free Trade Agreement (FTA), which entered into effect in 2007. While this FTA facilitated the quick rise of Pakistani exports to China (from around $1 billion dollar in 2007, see table 1), the least that can be said is that it benefited more China than Pakistan. The 2007 FTA in fact aggravated the already skewed Pakistani trade balance, accelerating the growth of Islamabad's trade deficit from around $3,7 billion in 2007 to $14 billion in 2017 (see table 3). In other words, while the FTA clearly accelerated existing trade patterns, it did not really alter them, allowing China to give full play to its economic dominance, as illustrated by a growing trade dependence on China (see table 4).

In this context, foreign-invested SEZs could offer positive economic impact, as they can be useful in enhancing national export performance by upgrading local production capacities, allow the production of competitive and more value-added goods. However, several countries have decided not to follow the economic integration pattern followed by China, and rather design SEZ programs themselves, without Chinese input.

Table 1: Pakistan's exports to China (USD, thousands)

Source: International Trade Center

Table 2: China-Pakistan bilateral trade (USD, thousands)



Source: International Trade Center

Table 3: Pakistan Trade Deficit with China (USD, thousands)

Source: International Trade Center

The Democratic People's Republic of Korea is one of them. North Korea is often seen as a close ally of China, with deep historical links between communist and anti-colonialist movements in both countries that predate the official foundation of the DPRK and the People's republic of China, respectively in 1948 and 1949. China and North Korea have a long history of political and economic cooperation, as China greatly contributed to the rebuilding of the North Korean economy after the Korean War, and offered Pyongyang friendly trade policies that allowed it to export value-added goods at above market prices until the 1980's [Agov 2010]. After Deng Xiaoping seized power and unfolded his signature "open and reform" policy (改革开放, *gaige kaifang*), Chinese private and public profit-seeking actors took the lead in the formidable expansion of Chinese foreign trade, which had for major consequence a gradual decrease in China-DPRK exchanges and a rapid rise in China-South Korea economic ties, the latter surpassing the former for the first time in 1985. The disappearing of the USSR is often credited for being the main reason, in addition to a series of natural disasters, that drove the North Korea economy to collapse in 1995. However, it should be also pointed out that in 1992, Beijing demanded the DPRK to use hard currency instead of North Korean won or barter agreements, leading North Korean foreign currencies reserves to plummet and contributing to the lack of North Korean responsiveness to the economic crisis. After the North Korean economy went back on track towards the end of the 1990's, and took steps to implement some degree of economic reform in 2002 and facilitate its economic cooperation with profit-seeking actors, China embarked on an ambitious economic integration program with North Korea, and worked with Pyongyang to jointly develop Special Economic Zones.

Indeed, over the last 30 years, but especially since Kim Jong-un took power in 2011, North Korea has been actively promoting a SEZ program that is mostly aimed at deeper economic integration with China. This economic engagement program is however being developed with extremely limited attention to China's economic interests. Unsurprisingly, this very cautious and paradoxical attitude, a *de facto* refusal of Chinese engagement terms, has caused the DPRK's SEZ program to fail.

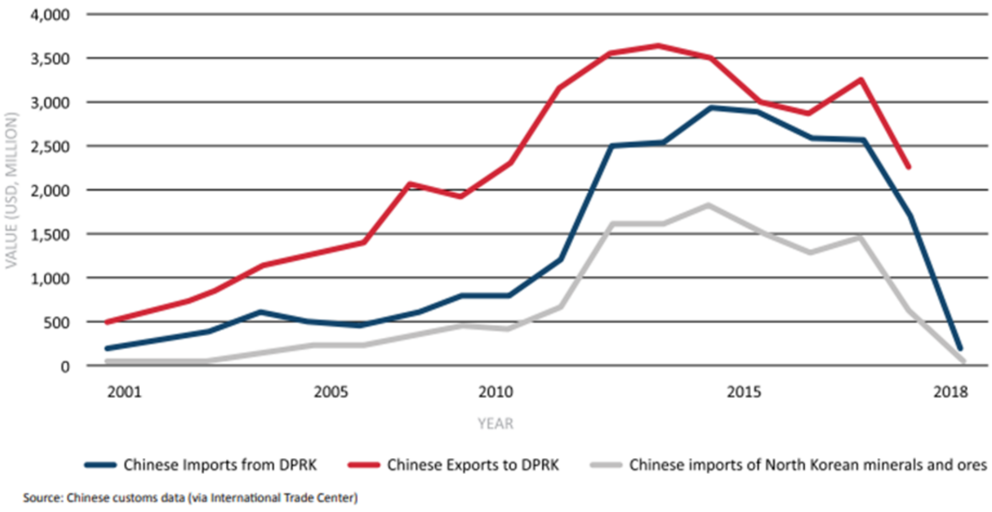
II/ The story of failed Sino-North Korean economic integration programs

Following the early stage of the reform era (1980-2000) that was dominated by the expansion of China's processing and manufacturing capacities and the consequent spectacular boost of its trade performance, the Chinese government encouraged Chinese companies to invest abroad, a policy known as "going abroad" (走出区 ; *zouchuqu*) policy. Rationales for this policy were two-fold. Facing rising wages, China was nearing a point when the most low-value added sectors were bound to become unprofitable, which resulted in the need to find cheaper supply of raw materials and to outsource some of its productive capacity to lower-income countries in its immediate periphery. This was especially true for neighbouring provinces of the DPRK, which were performing relatively less well than southern and coastal provinces in China. This lack of economic vitality in Northeast China led Beijing to aggressively develop transportation infrastructure links between the provincial capitals of Liaoning and Jilin province and North Korea, under the "Revitalize the Northeast" (振兴东北 ; *zhenxing dongbei*) program [Chen 2003].

The second set of reasons for increased economic integration between China and North Korea is rooted in Beijing's increased need for stability in its immediate strategic environment. By moving forward with the economic integration of the DPRK, Beijing aimed at mitigating Pyongyang's brinkmanship behaviour by increasing the role of foreign actors in North Korea's economic development. Besides, as a rising economic power and diplomatic stakeholder, China sought to appear as a "responsible stakeholder" (负责人大国; *fuzeren daguo*) that was contributing to the stability of the Asia-Pacific and use its unique relationship with North Korea to influence its economic and diplomatic policy-making.

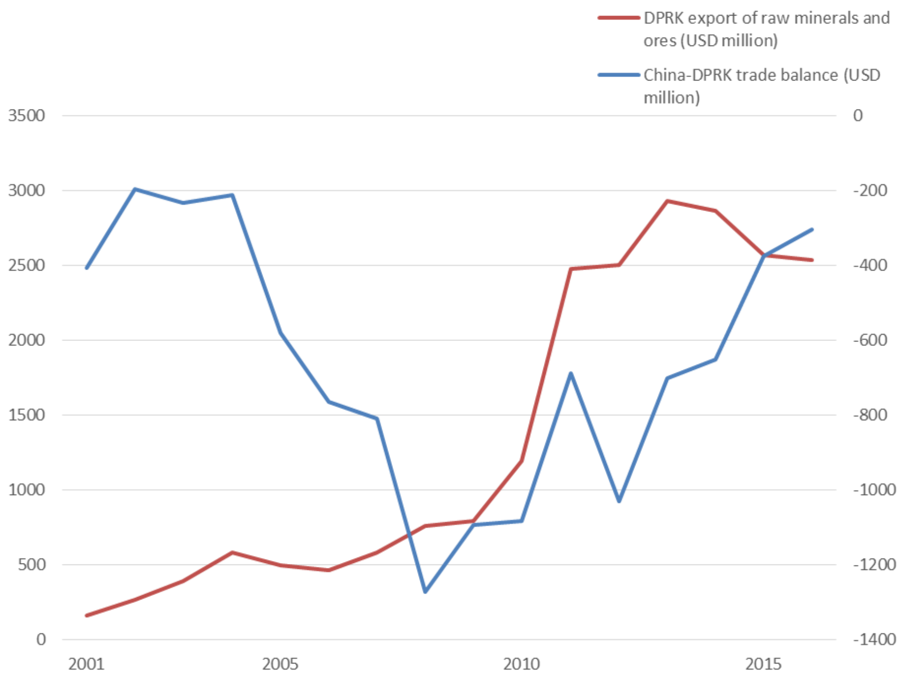
After 2002, bilateral trade ties between the DPRK and the PRC started to rise to unprecedented levels (see table 4), following a small wave of Chinese investment in the mining and manufacturing sector. After North Korea vainly attempted to develop a Special Economic Zone on its own in Sinuiju in 2002, heavily based on Hong Kong's "one country to systems" (一国两制 ; *yiguo liangzhi*), China and DPRK decided to jointly develop North Korean SEZs on Hwanggumphyong and Wiwha islands immediately opposite the China-DPRK trade hub, the border city of Dandong. This project was piloted by North Korea's number two, Jang Song-thaek, a close relative of the Kim ruling family with extensive experience in dealing with China. The Hwanggumphyong and Wiwha economic model was mostly based on accelerating existing trade and economic integration patterns, with Chinese outsourcing to the SEZ its production capacity of very low value-added goods such as textile and agricultural products [Choson Exchange 2014].

Figure 4: China-DPRK trade



However, after Kim Jong-un took power, Pyongyang's China policy shifted and it became much more concerned about the Chinese economic embrace, and Jang Song-thaek was publicly purged, leading the Hwanggumphyong-Wiwha project and other integration programs to lie in state. While the expansion of trade ties allowed the DPRK to restart its stalled economic development during the 2000's and greatly improve its trade performance, it also came with important downsides. Particularly irritating for the DPRK, during these years, Pyongyang developed a large trade deficit with China (see table 4), which it was only able to partially counterbalance by exporting raw, unprocessed resources extracted by Chinese mining companies active in North Korea. In the context of stringent economic sanctions, North Korea was already extremely dependent on China, with which it conducts more than 90% of its foreign trade. But the terms and nature of China's economic engagement patterns towards North Korea, based on imports of cheap unprocessed natural resources while exporting more value-added items offered limited prospects for autonomous economic development in North Korea. This *de facto* added a *qualitative* character to an established relation of *quantitative* dependence.

Figure 4: China-DPRK trade balance (USD, thousands)



Source: International Trade Center

In reaction, following Jang's purge, Pyongyang tried to alter the terms of its economic partnership with the DPRK, by implementing a SEZ strategy that was not modelled after China's needs and approaches to economic cooperation but based on more traditional, DPRK-centric economic policies. Revealingly, the 24 Special Economic Zones that opened between 2013 and 2018 were designed, developed and established without China's assistance and resources, and mostly likely without coordination with foreign partners [Mimura 2015]. However, during several research interviews, several North Korean officials explained to the author that they expected Chinese companies to develop all necessary infrastructures, as confirmed by the publishing of call for investments in even the most basic infrastructure of SEZs. Besides, while the DPRK clearly has a relative competitive advantage in mining and low-end manufacturing, later generations of SEZs precisely aim at attracting investments in sectors where the DPRK does not have a clear competitive advantage, especially in more sophisticated manufacturing or more capital-intensive sectors. This very peculiar and paradoxical economic development strategy is in line with former economic cooperation policies of the DPRK, which are aimed at strengthening the economic and political independence of the DPRK instead of fostering economic integration and interdependence. By leaving all infrastructure development to potential Chinese partners, and by developing SEZs focused on higher-end, sophisticated products, Pyongyang's aim is to impose to Beijing a specific China-DPRK economic cooperation pattern that first and foremost benefits North Korea while not impacting its own economic policies.

Without surprise, this very self-centered economic opening has led the overwhelming majority of North Korean Special Economic Zones to attract limited attention from foreign investors. This is due to several factors including economic sanctions, the extremely difficult business environment of the DPRK but also and especially a lack of Chinese interest in such an economic integration pattern. Economic sanctions that could prevent further development in North Korean SEZs are very recent (2016 and 2017) and SEZs opened in 2013, for instance, did not see any substantive economic activity even before United Nations Security Council resolutions banning joint-ventures and targeting the DPRK's financial system were adopted. Although the DPRK has a long history of failed deals and definitely constitute a case in point of a difficult business environment, it should however be noted that China has a well-established tradition of making large investments in countries that rank very low in most "economic freedom" or "ease to do business" indexes. For instance, China is a large investor (if not the largest) in places like Venezuela, Sudan, Democratic Congo, Bangladesh etc. Pakistan itself ranks quite low (147th rank) in the World Bank "ease of doing business" ranking, which does not prevent China from implementing grandiose plans to develop an extremely costly economic development corridor running through several disputed and potentially unstable regions (Balochistan, Northern territories). It can thus be argued that China's unwillingness to invest in the DPRK was thus caused by Pyongyang's reluctance to be involved in a Chinese-led economic division of labour. The DPRK's fears of Chinese economic, political and technological dominance and this story of failed projects are of significant importance for Pakistan and the CPEC.

III/ The CPEC and SEZs at the center of China-Pakistan geoeconomic competition

Besides all generic benefits of SEZs listed above, it is obvious that the CPEC could bring extraordinary benefits to the economy of Pakistan, especially in terms of infrastructure development, trade performance and technological upgrading. But as the North Korean example has shown, economic integration led by China has been considered as potentially thwarting further economic development. Several issues thus need to be addressed by Pakistan in order to find the adequate balance between successfully attracting Chinese investments in SEZs, benefiting from their potential catching-up effect but without to trump long-term prospects for more autonomous development. The task is particularly challenging for Pakistani policy-makers since the CPEC constitutes a prominent Chinese answer to several economic, political and geostrategic issues and its success is of paramount importance not only for Chinese private and public businesses but also for the credibility of the top leadership of the

Chinese State. One the one hand, this means that Beijing's need for control is especially strong, but on the other hand it theoretically also provides Islamabad with relatively important leverage on China. Indeed, as CPEC constitutes the flagship projects of the BRI initiative, open local resistance to the project would be devastating for the initiative as a whole and for Beijing's international prestige.

Among the most frequent criticisms addressed to CPEC-related projects such as SEZs are related to the funding of infrastructure projects. Besides and internal Province-Central State debate on who should finance development projects along the CPEC, some voices in the Pakistani Senate State Planning Committee have advocated for China to assume the entire funding of SEZs, which is understandable in the context of Pakistan's already heavy debt burden but also since many already existing local SEZs projects have failed to attract significant FDI. This position bears similarities with Pyongyang's unwillingness to invest its own resources in local SEZs, although the rationales behind it are quite different. Nevertheless, in the context of the much more flexible and liberal Pakistani economy, having China entirely fund Special Economic Zones and their related-programs could also provide China with extensive control on the nature of businesses and production being outsourced to SEZs in Pakistan and thus eventually enhance the country's dependence on China. It would further submit the future of the Pakistani economy to China's ability to successfully achieve its transition from a labour-intensive economy to a capital-intensive one, an obviously challenging task for a 1.4 billion people country struggling with structural development inequalities, a growing debt problem and an aging population. While the very unique nature of the Chinese economy makes it very hard to draw prospectives conclusions, all these factors could impact China's ability to further develop its economy in the medium-to-long term future.

This enhanced dependence is particularly problematic because if China is to build all necessary infrastructure and controls technological transfers and technological upgrading processes in Pakistan, it will leave central and provincial authorities with an only passive role and limited ability to "embed" Chinese investments, infrastructure and technology in the Pakistani economy. In order to create socio-economic spill-overs, or positive externalities indirectly generated by SEZs such as employment, training, know-how transfers, and more generally perspectives for more autonomous economic development, host countries indeed need to implement policies that will enable them to more easily benefit from "dynamic" impacts instead of merely benefiting from "static" ones. Education policies and more generally speaking policies aimed at developing local human capital are for instance critical in SEZ programs because while China can and will train the Pakistani labour force "on the job", only educated Pakistani entrepreneurs and engineers will be able to adapt and disseminate more advanced technologies and know-how to local market actors. It would necessarily takes years to create tailor-made education programs designed to bridge gaps between the industries that Chinese are interested in outsourcing to Pakistan and sectors that might have a strategic interest for long-term, more autonomous economic development in Pakistan (key technologies, goods in high demand outside China). Islamabad thus requires a substantial amount of certainty about the short-to-medium term future of Chinese economic engagement programs and Beijing's commitment towards Pakistan in order to prevent potential mismatches between domestic investment in human capital and technological upgrading processes.

The marble industry in Pakistan constitutes a concrete example of this dilemma. As explained in recent report published by the Bank of Pakistan as well as numerous press articles [Bank of Pakistan 2017], Pakistani marble is in high demand abroad, especially in China after the 2008 financial crisis hit the European and American markets. Pakistani marble is often processed and transformed in Chine for the local market but also sometimes re-exported to customers in Pakistan. Pakistani actors involved in the marble industry have long complained about this state of fact that has hurt the marble industry to a significant extant, the increasing dependence on Chinese imports of raw, freshly excavated large marble blocks having led to a "race to the bottom" among Pakistani exporters and prices to decrease. It might be argued, with some reason, that the transfer of processing capacities from China to Pakistan in the larger framework of the CPEC could benefit the Pakistani economy by developing more value-added activities in Pakistan instead of China. Unsurprisingly, Chinese partners have already expressed their interest in developing SEZs focused on marble-processing activities within Pakistan, potentially in what would become the "Mohmand Marble City" in the Federally Administrated Tribal Areas. However, as the failed cooperation projects in Sino-DPRK borderlands detailed above have shown, SEZ programs can be interpreted as detrimental, in the longer term, to host economies. This is especially the case if they seek establish patterns of economic cooperation that prioritize economic integration programmes that merely provide "static" benefits to the host countries and enshrine skewed economic cooperation patterns with limited opportunity for catching-up. One common example is the development of bonded-warehouse zones by Chinese actors where companies run factories in duty-free SEZs. These bonded-warehouses do contribute to an improvement of the trade performance but provide Chinese actors with great control over the value chain and processing technologies that are being transferred and used in Pakistan, once again limiting the scope of technology transfers from China. Businessmen involved in the marble industry of Pakistan have already expressed their fears that bonded-warehouse SEZs would constitute an ill-adapted solution to the crisis of the marble industry and be further detrimental to the Pakistani economy.

Due to its very peculiar and consistent insistence in developing economic cooperation programmes that do not translate into political influence from foreign actors, the Democratic People's Republic of Korea decided to design its own economic integration project with China. This bold attempt at coercing potential Chinese investors at following North Korea's preferred patterns of economic integration was vain, as China has so far refused to massively invest in the DPRK. Given the DPRK's isolation and its lack of alternative trade partners, Beijing has extensive leverage over North Korea and rather expects Pyongyang to show more sensitivity to Chinese expectations and more flexibility in terms of business environment. Pakistan seems to be in a different situation as it has much more diverse trade relations, a much more flexible policy environment and currently has an extremely important strategic status for China. Beijing has a crucial political agenda in Pakistan and absolutely needs bilateral economic relations and the China-Pakistan Economic Corridor to move forwards, theoretically providing Islamabad more leverage on economic issues. This is especially true since China itself promoted the CPEC, a *geostrategic* initiative for China, as an *economic* opportunity for Pakistan: the least that can be said is that a necessary precondition for these grandiose plans to be sustainable in a longer-term perspective, from a political but also security standpoint, is that economic benefits for Pakistani companies, provinces and State institutions should be as important as the immense strategic leverage gained by China. It is therefore advisable for political stakeholders of Pakistan, at all level, to insist on establishing economic cooperation patterns with China that enable Pakistan to achieve autonomous economic growth, contribute technology to Pakistani businesses, and remain open and compatible with other foreign actors and contributors interested in the Pakistani market.

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