

STATEMENT OF

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HEARING ON

NORTH KOREA: ILLICIT ACTIVITY FUNDING THE REGIME

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The views expressed in this statement are those of the author and do not necessarily reflect the views of individual members of the Institute for International Economics' Board of Directors or Advisory Committee.

It is an honor to be invited to testify before this subcommittee. Former Vice President Walter Mondale once told me that “anyone who calls themselves an expert on North Korea is a liar or a fool.” His cautionary admonition is particularly apt when discussing the netherworld of illicit activities. At the outset we should acknowledge that there is much that we do not know, and much of what we think we know is of uncertain reliability.

In this testimony, I would like to make a few basic points:

- The marketization of the North Korean economy over the past decade is best understood as a bottom-up process driven by the trauma of the famine. The government’s responses have been reactive and ambivalent.
- Illicit activities have long been part of the North Korean economy, but they appear to have intensified in the 1990s, as the North Korean economy went into decline and central government control began to fray.
- One can imagine several motivations for the US policy of impeding illicit activities by North Korea: upholding the law, increasing negotiating leverage in the context of the Six Party Talks, and encouraging regime change. Achieving the first goal is straightforward, but attaining the second depends on North Korea’s reaction, and attaining the third is subject to massive coordination problems, particularly with respect to China and South Korea.
- Inclusion of the Kaesong Industrial Complex in the upcoming free trade agreement (FTA) negotiations between the United States and South Korea will raise thorny issues related to the treatment of labor.

## **Context**

Historically North Korea maintained a centrally planned economy along Soviet lines, remarkable only in the extent to which markets were repressed internally and its autarky. A famine in the 1990s killed up to 1 million North Koreans—nearly 5 percent of the pre-crisis population—equivalent of more than 13 million Americans today.

As North Korea's centralized system broke down and the state was no longer able to supply food, small social units—families, enterprises, and local political and military organs—began to exhibit a variety of coping behaviors to obtain food. The authorities responded by tolerating the development (and/or expansion) of informal markets. The market became the primary institutional mechanism through which most North Korean families obtained food.

Over time the institutional infrastructure of a market—wholesalers, middlemen, retail vendors, and others—emerged, and what began with food gradually encompassed a broader range of household goods. As this process developed, and consumer goods from China began to enter the market, opportunities for arbitrage arose and the central planners lost control over the economy.

This phenomenon had profound implications for the state because it had been raising revenue primarily through transaction taxes administered through the central plan. The government faced a fiscal crisis created by the collapse in revenue combined with high expenditures including on a bloated military—over 1 million troops in a country of perhaps 22 million people, making it the world's most militarized society. In July 2002

the government introduced a system of direct taxation to reconstruct its fiscal base, but implementation has been problematic, and the country remains plagued by high, sustained inflation.

North Korean policymakers have continued to extend these reforms, and it would not be correct to leave you with a completely negative impression, but it is fair to say that the reforms have been a mixed bag, not delivering as expected and contributing to increasing social differentiation and inequality. Like a surfer, the North Korean state is perched precariously atop a dynamic, changing foundation.

### **Role of Unconventional Activities in the North Korean Economy<sup>1</sup>**

After defaulting on international creditors in the 1970s, North Korea was frozen out of international capital markets, and came to rely increasingly on aid from fraternally allied socialist states, remittances from ethnic Koreans in Japan, and illicit activities such as drug trafficking and counterfeiting to generate foreign exchange. Aid declined from the mid-1980s on, as did remittances, which are likely to be well under \$100 million today.

As these sources of hard currency revenues withered during the 1990s, North Korea's dependence on a variety of illicit activities intensified. One could interpret them as either a grasping response to deteriorating economic conditions or a loss of government control permitting the rise of non-state sanctioned activities, or both. While the bulk of these illicit activities appear to have been undertaken at the direction or with

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<sup>1</sup> This section draws on Stephan Haggard and Marcus Noland, *Famine in North Korea: Aid, Markets, and Reform*, Columbia University Press, forthcoming, Appendix A.

the knowledge of the top leadership, more recent episodes suggest that at least some of these activities are more decentralized and involve complex transnational relations between various state entities and criminal networks.<sup>2</sup>

North Korea's diplomatic corps has long been under pressure to support the maintenance of foreign missions by earning foreign exchange. One of the simplest ways of doing so is to exploit diplomatic immunity, including most importantly the international conventions that protect the secrecy and integrity of the diplomatic pouch. During the 1970s, police in all four Scandinavian countries found that North Korean embassies were using their diplomatic tax exemption to purchase alcohol and cigarettes in large quantities and then reselling them on the black market.

Far more lucrative, however, was trafficking in drugs—in essence acting as couriers for drugs produced by others.<sup>3</sup> Sheena Chestnut documents not only how total drug seizures went up sharply after 1996—the peak of the famine—but also how the personnel involved in seizures came to include officials outside the foreign ministry (economic and intelligence officials) or without any clear official designation (employees of trading companies) as well as members of Asian criminal organizations that were acting as partners or intermediaries. Also, North Korea began to produce drugs for export

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<sup>2</sup> See Sheena E. Chestnut, 2005. “The ‘Soprano State?’: North Korean Involvement in Criminal Activity and Implications for International Security,” Honors Program for International Security Studies, Center for International Security and Cooperation, Stanford University, May 20, for an exhaustive overview culled from public sources. For earlier documentation, see Marcus Noland, *Avoiding the Apocalypse: The Future of the Two Koreas*, Washington: Institute for International Economics, 2000.

<sup>3</sup> See Noland, *op cit.*, and Raphael Perl, 2005. “Drug Trafficking and North Korea: Issues for U.S. Policy,” *CRS Report to Congress*. Washington: Congressional Research Service (March 4).

from the mid-1990s, beginning with opium but diversifying into methamphetamine and other synthetics following the floods of 1995.

Although drugs almost certainly dominate North Korea's smuggling activity, there is evidence—in the form of diplomatic expulsions—of trade in other sanctioned items, including conflict diamonds, rhino horns, and ivory.<sup>4</sup> To my knowledge, North Korea is the only government to ever be issued a formal demarche by the secretariat of the Convention on International Trade in Endangered Species for its diplomats' activities in this regard.

The second major form of illicit activity is counterfeiting. US government officials had long suspected North Korea to be the origin of the so-called supernotes, very high-quality counterfeits of \$100 bills, which began to appear in 1989.<sup>5</sup> As with drug smuggling, the sale of supernotes involves a complex “wholesale” and “retail” distribution chain. Seminal developments were two sting operations in the United States and the 2005 indictment of Sean Garland, leader of an IRA offshoot, and a Treasury Department finding that Banco Delta Asia in Macau was a financial institution of “primary money laundering concern” under the 2001 USA Patriot Act. In the wake of the finding, pressure from correspondent banks in Japan, Korea, and Europe, and a run on the bank, Banco Delta Asia severed connections with 40 North Korean individuals or businesses, replaced several managers, and allowed a panel named by Macau's

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<sup>4</sup> See Noland, *op. cit.*, and David L. Asher, “The North Korean Criminal State, its Ties to Organized Crime and Possibility of WMD Proliferation,” *Nautilus Institute Policy Forum Online 05-92A* (November 15), available at <http://www.nautilus.org/fora/security/0592Asher.html>

<sup>5</sup> See Noland, *op. cit.*, and Raphael Perl, 2006. “North Korean Counterfeiting of U.S. Currency,” *CRS Report to Congress*. Washington: Congressional Research Service (March 22).

government to administer its operations. Counterfeiting has not been limited to currency: Evidence also exists of North Korean involvement in counterfeiting of cigarettes and pharmaceuticals.

North Korea's weapons trade has attracted considerable scrutiny, though it is arguably not "illicit." North Korea sells missiles and base technologies for them that fall under the Missile Technology Control Regime, but it is not a party to that agreement. Customers of North Korean missiles or missile technology include Libya, Pakistan, Iran, Egypt, Syria, and Vietnam.<sup>6</sup>

Calculating the size of these unconventional activities is difficult. Such trade is likely to be more volatile than other economic activities, thus an estimate for any given year can be highly misleading. Seizures and arrests that appear to show very large amounts of trade—such as Japanese seizures of methamphetamine in 1998–2002 with a wholesale value of \$75 million or the Garland indictment—can be followed by the breakup of networks and a sharp fall in trade. Large military sales are "lumpy" as well; successful exports to a particular country do not necessarily generate ongoing business of the same magnitude. A reported statement by a US official in 2002 put sales in 2001 alone at \$560 million, but it is unclear how the US government estimates the value of such transactions or associated after-sales service, and the customer base may have subsequently shrunk as well.

David L. Asher concludes on the basis of an analysis of North Korea's external accounts that total criminal activity and military sales in 2003 could have accounted for

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<sup>6</sup> See Noland, *op. cit.*, and Bertil Lintner, *Great Leader, Dear Leader: Demystifying North Korea under the Kim Regime*. Chiang Mai, Thailand: Silkworm Books, 2005.

as much as 35 to 40 percent of all North Korean trade and an even higher share of total cash earnings. This number is broadly in line with my earlier estimate of about one-third of all balance of payments revenue, derived in declining order of importance from military sales (undesirable from a US policy standpoint though not illegal), drug trafficking, counterfeiting, and smuggling.

Finally, the invitation letter to testify at this hearing mentions “slave labor” as one of the Subcommittee’s concerns. Apart from abysmal practices internally, North Korea “exports” labor, primarily to logging camps in Russia and manufacturing establishments in Eastern Europe. Working conditions are dire.

Probably the largest potential source of labor-related income however, comes from the Kaesong Industrial Complex, where the North Korean government derives hard currency revenues from leasing income, taxes, and workers’ wages paid by South Korean firms. Thus far the North Korean government has probably earned less than \$20 million from these revenue streams, the bulk derived from the land lease agreement, but if the South Korean government is successful in realizing its ambitious expansion plans, taxes alone could rise to nearly \$1.8 billion by 2017, and would dwarf the illicit revenue streams discussed today.<sup>7</sup>

### **Implications for US Policy**

Anecdotal evidence suggests that the US policy of impeding illicit transactions is having some effect on legitimate commerce, if not the illicit activities themselves: foreigners

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<sup>7</sup> Mark Manyin, presentation at KEI/AEI conference “Strategic Implications of Economic Engagement with the DPRK: Kaesong and Beyond,” April 18, 2006.



engaged in business in North Korea report increasing difficulty in executing financial transactions due to the reluctance of foreign financial institutions to deal with North Korean counterparties, and the decline in the black-market value of the North Korean won has accelerated, suggesting that the supply of foreign exchange—derived from both these licit as well as illicit activities—is drying up.

If law enforcement is the sole aim of US policy, then the collateral damage done to legitimate commerce is regrettable—inflicting pain indiscriminately, reducing sources of wealth, power, and influence beyond direct central control, and creating diplomatic tensions with third parties. Such concerns are equivocal if the goal is to encourage North Korea to negotiate more seriously in the context of the Six Party Talks. If the idea is simply to strangle the North Korean economy in an attempt to induce regime change, then maximal damage is desirable.

My research demonstrates that the North Korean regime is susceptible to external economic pressure; such coercion in combination with positive incentives may elicit the desired reaction in terms of North Korean negotiating behavior.<sup>8</sup> However, a more ambitious policy of seeking regime change through economic distress immediately runs into obstacles, particularly with respect to China and South Korea. These countries prefer the maintenance of the status quo to instability and can offset pressure from the United States and others. In the absence of some kind of coordination with these countries, US pressure is unlikely to achieve its political goals, while inflicting misery on North Koreans, who have no control over their government, and worsening diplomatic relations with other countries. Moral outrage—however justifiable—is not a policy.

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<sup>8</sup> Marcus Noland, *Korea After Kim Jong-il*, Washington: Institute for International Economics, 2004.

Labor issues could arise in US policy in the context of the upcoming FTA negotiations with South Korea. South Korea has requested duty-free treatment for products produced in the Kaesong Industrial Complex in prior FTA negotiations with other trade partners. If included in the upcoming negotiations, it will create a thorny issue with respect to labor standards. The issues are twofold.

The first is substantive: North Korea does not meet internationally recognized core labor standards—rights to associate, organize, and bargain collectively are absent entirely. At Kaesong, workers are not hired directly—instead they are hired through a North Korean government agency, which, according to South Korean government sources, retains \$22.50 of a worker's \$57.50 monthly pay to cover social security payments as well as transportation and other in-kind benefits.<sup>9</sup> However, while South Korean firms pay in hard currency, North Korea pays the workers in North Korean won converted at the wildly overvalued official exchange rate. Evaluated at the more realistic black-market rate, North Korean workers net less than \$2 per month. The real problem is that while conditions in Kaesong may be exploitative, they probably are considerably better than those existing elsewhere in North Korea, and there may be no shortage of North Koreans willing to work on these terms.

The second issue is procedural: While the FTA will presumably include a labor standards chapter, South Korea has no way to enforce such commitments in Kaesong, where North Korea is sovereign. One possible solution would be to involve a third party

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<sup>9</sup> This figure is for a 48-hour workweek. The South Korean government reports that with overtime, the actual workweek averages 55 hours and workers on average receive \$67 dollars of gross pay, before deductions.

such as the International Labor Organization (ILO) to monitor conditions in the zone and certify compliance with agreed standards as was done in the Cambodian textiles case and has been floated by Jay Lefkowitz, President Bush's special assistant for North Korean human rights. But even this solution would require the cooperation of the North Korean government, which is not a member of the ILO, has a track record of noncooperation in other spheres of international engagement, and to date has restricted access to the zone by third-party observers.

In sum, the controversy over Kaesong, and in certain respects the related concerns about illicit activities addressed in the hearings today, echo the practical and ethical dilemmas that the humanitarian community has confronted for more than a decade in responding to hunger issues in North Korea: namely how to do right by the North Korean people who are victimized by a political regime over which they have no control and that in large part embodies values antithetical to our own and how to devise effective policies in a context in which the national priorities of some influential countries differ from those of the United States.