

**NORTH KOREA:**  
**CAN THE IRON FIST ACCEPT THE INVISIBLE HAND?**

25 April 2005

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## NORTH KOREA: CAN THE IRON FIST ACCEPT THE INVISIBLE HAND?

### EXECUTIVE SUMMARY

Despite the deepening nuclear confrontation between North Korea and the world, the North is undergoing the most profound economic changes since the founding of the state 57 years ago. It is unclear if the regime is capable of fully embracing the market; the final outcome cannot be predicted, and no major new economic engagement should be attempted until the nuclear issue is resolved. Nevertheless, the international community has an opportunity to increase the chances that North Korea will make a successful transition from a Stalinist command economy to one that is more market-driven and integrated into the global economy. Facilitating its economic reforms remains the best strategy for pushing the North towards more acceptable international conduct. There are some important preliminary steps not involving the transfer of meaningful resources that ought to be undertaken immediately both in order to prepare for what should be done if a nuclear deal is struck and to show Pyongyang why it needs to make that deal in its own interest.

The most important changes since July 2002 are that gradual marketisation and incipient entrepreneurship are creating semi-private markets, shops and small businesses across the country; and economic ties with China and South Korea are deepening in unprecedented ways, giving a growing number of North Koreans their first unfiltered taste of the outside world.

Deeper institutional reform is still constrained by the regime's overriding obsession with its survival. Economic growth is also hindered by the degeneration of the industrial, transportation and energy infrastructure and the bureaucracy's lack of understanding of basic market economic concepts. Corruption is rampant, and many state officials have already learned how to tilt the market for their own enrichment. Even if the regime can overcome these obstacles, the reform process will ultimately fail unless it can proceed in an international environment that is conducive to providing the necessary technical and financial assistance.

Economic sanctions, though they may well become necessary if the nuclear issue remains unresolved, would

have little impact on the North Korean economy, particularly if its two largest trade partners, China and South Korea, were not to participate. The economic changes underway are also unlikely to lead to the toppling of the regime any time soon, but as they take hold, the pressure for political change will increase. The international community can start to improve North Korea's chances of making a successful transition by:

- ❑ taking advantage of the new opportunities to train North Koreans in financial, technical and market economic skills, both inside and outside the country;
- ❑ addressing infrastructural constraints, particularly in the power and transportation sectors; and
- ❑ undertaking comprehensive needs assessments to prepare for the next stage of reform.

North Korea will not and should not receive significant international development assistance until it gives up its nuclear weapons, but it would be worthwhile trying already to develop a better understanding of the country's economy and what it will require in the way of help. Whether the regime survives or not, North Korea will need officials who are better versed in economic matters and have a greater exposure to the world. Increasing knowledge about the economy would also likely improve the prospect that any deal reached on the nuclear issue would lead to transformation of the economy and improved living standards rather than simply channel resources to the elite.

**Seoul/Brussels, 25 April 2005**

## NORTH KOREA: CAN THE IRON FIST ACCEPT THE INVISIBLE HAND?

### I. INTRODUCTION

North Korea's provocative behaviour makes it difficult for countries seeking engagement to facilitate reform. It is difficult to argue other than that most direct international assistance should remain unavailable until the nuclear crisis is resolved. Moreover, if that crisis grows worse, it may well become necessary to move in the opposite direction -- to sanctions -- as the only measure short of force available to persuade Pyongyang to reverse course.<sup>1</sup> However, resolving that crisis is only the first step. For North Korea eventually to become a more stable and normal country, it also needs to complete the transition from a command economy to a market economy. It is unclear if the present regime is up to the task. The country's population, isolated for 60 years, also faces immense challenges to adapt. Yet, it is in the best interest of the international community to help North Korea make that transition as smoothly as possible.

North Korea has relaxed its Stalinist economic model, authorised some markets and entrepreneurship, and sought foreign trade and investment. These changes have been overshadowed by the crisis over Pyongyang's nuclear weapons program, but they have created unprecedented opportunities for engaging one of the world's most repressive and opaque regimes. To help policy makers put them in context, this report focuses on what is known about North Korea's economy, the reforms undertaken since 2002 and the obstacles to deeper change and economic growth. Finally, it evaluates what contributions the international community can make to move that process forward.

North Korea does not lend itself to comprehensive reporting. It frequently ranks at the bottom of human rights indexes for restricting almost all freedoms, not least information flows and foreign interaction with its citizens. Moreover, it has not published any statistics since 1965. Nevertheless, the economy is not a complete mystery, and analysis using a range of sources is possible.

Anecdotal evidence from the hundreds of foreign aid workers, diplomats and government officials who have been granted access to the North allows for corroboration of many details provided by North Korean officials and the state-run media. North Korea has also allowed international agencies and experts to conduct detailed in-country studies ranging from the state of the environment to nutritional standards and management techniques. Interviews with refugees and defectors have been documented. The Bank of (South) Korea and the Korea Trade Promotion Agency (KOTRA) both produce data on the economy,<sup>2</sup> and trade statistics can be extracted from those of North Korea's trade partners.

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<sup>1</sup> This is the position taken in Crisis Group Asia Report N°87, *North Korea: Where Next for the Nuclear Talks?*, Seoul/Brussels, 15 November 2004.

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<sup>2</sup> The Bank of Korea inputs raw data provided by the National Intelligence Service into a model to arrive at its growth estimates for North Korea. A combination of satellite imagery and eyewitness accounts are used to measure agricultural activity and factory utilisation rates. Nevertheless, some analysts question the accuracy of the statistics. Crisis Group interviews, Bank of Korea and South Korean government officials, Seoul, December 2004.

## II. THE NORTH KOREAN ECONOMY

For at least a decade after the Korean War (1950-1953), North Korea achieved remarkable growth, outstripping the South and rapidly improving the living standards of its people. Decline started in the 1970s as inefficiencies in the socialist system became apparent. Gradual policy changes and massive Soviet aid through the 1980s curbed the slide into poverty. However, when the Soviet Union dissolved in 1991, overnight removing the country's biggest export market and primary food and fuel supplier, the economy spiralled into crisis. Industrial and agricultural output fell by more than half between 1992 and 1998, and famine may have killed as many as 2 million people. Changes in internal policies and external relations have generated annual GDP growth of between 1 and 2 per cent since 1999, with GDP reaching \$22 billion in 2003. The North's per capita GDP of approximately \$1,000<sup>3</sup> is equivalent to that of Kenya in Africa and Tajikistan in Central Asia -- a far cry from South Korea's \$14,000.

### A. ORIGINS

Ironically, the northern half of Korea received the lion's share of manufacturing investment during the Japanese colonial period (1910-1945).<sup>4</sup> Chemical, fertiliser, steel and war materiel industries were located mainly there in order to take advantage of natural resources (mines, forests and hydroelectric power) and the proximity to Manchuria. Light industries including textiles, printing and machine tools were established in the southern provinces.

After the division of the Korean peninsula in 1945, North Korea, led by Soviet protégé and former anti-Japanese guerrilla Kim Il-sung, implemented a Stalinist model of centralised economic management.<sup>5</sup> Kim also

introduced a self-sufficiency ideology called *juche*. The term had existed in Korean anti-colonialist vocabulary for several decades but Kim Il-sung adapted it to create a philosophy, rallying call for nationalists, legitimisation of his own position, and tool to justify non-alignment with either Russia or China.<sup>6</sup> *Juche* never precluded foreign trade, and from the outset, foreign procurement of essential food, fuel and technology that could not be produced domestically was permitted.<sup>7</sup>

### B. RISE AND FALL OF THE COMMAND ECONOMY

After the Korean War, communist North Korea excelled at "extensive growth" -- rebuilding infrastructure and coal, steel, chemical and machine tool industries. In the 1950s and early 1960s, the economy, financed and directed almost entirely by the Soviets and benefiting from a forced labour (*chollima*, or "flying horse") campaign, achieved average annual growth of 14 per cent.<sup>8</sup> Mechanisation, collectivisation and increased use of fertiliser enabled the harvest to double, from 3.5 million tons in 1966 to 7.7 million tons in 1984.<sup>9</sup> The government was able to deliver all basic foodstuffs through a centralised network, the Public Distribution System (PDS). In theory workers could earn extra money to spend in state-run shops through bonuses, but this happened infrequently, and there was little to buy.<sup>10</sup> The PDS became the lynchpin of social control.

At least until 1975, North Korea grew faster than South Korea. However, the same quality and incentive problems that dogged other command economies, combined with cuts in Soviet aid in the 1960s, affected industrial development. It failed to move into the second phase of growth, the construction of light consumer industries, and rapid industrial growth became unsustainable.<sup>11</sup>

<sup>3</sup> Bank of Korea estimate, <http://www.bok.or.kr>. Given an extremely centralised government, high military spending, and significant urban-rural inequality in North Korea, living conditions are likely far worse than in countries with similar per capita GDP. Figures denoted in dollars (\$) in this report are in U.S. dollars.

<sup>4</sup> Sang-Chul Suh, "Growth and Structural Changes in the Korean Economy Since 1910", Ph.D. dissertation, Harvard University, 1966 in Eui-Gak Hwang, *The Korean Economies: A Comparison of North and South* (New York, 1993), p. 17.

<sup>5</sup> All private enterprise was appropriated by the state, labour was collectively organised, and production and distribution were governed by a centralised allocation system. All decisions on output, targets, prices and distribution of national income were dictated by short-run and seven-year plans. Joseph Sang-hoon Chung, *The North Korean Economy: Structure and Development* (Stanford, 1974), p. 90.

<sup>6</sup> Han S. Park, "The Advent and Evolution of *Juche* Philosophy", in *North Korea: The Politics of Unconventional Wisdom* (London, 2002), pp. 17-31.

<sup>7</sup> Chung, *The North Korean Economy*, op. cit., p. 143.

<sup>8</sup> Eui-Gak Hwang, *The Korean Economies: A Comparison of North and South* (New York, 1993).

<sup>9</sup> Geir Helgesen and Nis Høyrup Christensen, *North Korea's Economic, Political and Social Situation*, Nordic Institute of Asian Studies (Copenhagen, 2004), p. 16.

<sup>10</sup> Helen-Louise Hunter, *Kim Il-sung's North Korea* (Westport, 1999), pp. 141-184.

<sup>11</sup> Eastern European diplomats resident in Pyongyang in the 1970s observed that each project was planned separately, and development was fragmented. For example, the construction of new industries was not coordinated with increased energy production. Erik Cornell, *North Korea Under Communism* (London, 2002), p. 71.

Economic slow-down and the threat of South Korean growth overtaking its own sparked the first major policy change. In the late 1970s, North Korea started procuring foreign technology and equipment.<sup>12</sup> Although industrial output in the 1970s did increase, poor central planning and insufficient supplies of electricity meant many of the imported inputs were never properly utilised.<sup>13</sup> In 1975, North Korea defaulted on its international debt.<sup>14</sup> That same year, South Korea for the first time recorded a higher growth rate.

Unable to finance more technology infusions, North Korea's leaders in the 1980s instead started emphasising financial accountability, limited autonomy of enterprises, labour incentives and reduced central planning.<sup>15</sup> In 1983, after Kim Il-sung travelled to China and saw the dramatic effects of gradual opening to foreign investment, North Korea announced it would encourage foreign investment. It promulgated joint venture laws in 1984<sup>16</sup> and urged especially the expatriate Korean community in Japan but also investors in Western Europe and the rest of Asia to put money in.<sup>17</sup> Most of these changes were curtailed, however, after the Soviet Union -- seeking to rebuild its alliance with Pyongyang during a time of renewed tension with the West -- returned aid to levels not seen for two decades.<sup>18</sup>

### C. COLLAPSE AND CHANGE

The collapse of the Soviet Union in 1991 and Russia's withdrawal of trade, technical and financial assistance, followed in 1993 by China's demand for hard currency settlement for oil previously provided in barter exchange, was catastrophic for North Korea's economy. The loss of energy hit the hardest, with total supply dropping from 24 million tons of oil (or the equivalent) in 1990, to a low

of around 14 million tons in 1998.<sup>19</sup> Rare visitors to Pyongyang in 1991 found a country almost completely at a standstill, without operating machinery or construction projects, and few moving vehicles.<sup>20</sup> Through the 1990s, the state permitted only minimal energy to be dedicated to coal mining, construction, electricity, steel production and transport.<sup>21</sup>

The slowdown in industry and fuel shortages in the 1990s, compounded by floods in 1995-1996 caused by extensive soil degradation and deforestation, also resulted in a rapid decline in agricultural output.<sup>22</sup> By 1996, the PDS no longer functioned adequately, and food shortages forced the government to declare all citizens responsible for feeding themselves.<sup>23</sup> Droughts in 1997 and 2001 made the situation worse.<sup>24</sup> By 1999, North Korean agriculture had been in decline for nine years.<sup>25</sup> The number of North Koreans who died of malnutrition-related illnesses is unknown, as North Korea has not allowed sufficient monitoring, but comparative studies estimate anywhere from several hundred thousand to up to 2 million, potentially 10 per cent of the 1995 population.<sup>26</sup>

The vacuum left by the state was partly filled by international aid agencies, including the World Food Program (WFP), the Food and Agriculture Organisation (FAO) and international NGOs, which started providing

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<sup>12</sup> Bon-Hak Koo, *Political Economy of Self Reliance: Juche and Economic Development in North Korea, 1961-1990* (Seoul, 1992), pp. 125-167.

<sup>13</sup> Erik Cornell, *North Korea Under Communism* (London, 2002), p. 71.

<sup>14</sup> South Korea's National Intelligence Service estimates total North Korean debt to be \$11.9 billion. Of this, \$7.5 billion is owed to Russia and China and \$4.6 billion to Japan and Western governments and banks. "North Korea Country Profile 2003", The Economist Intelligence Unit, p. 75.

<sup>15</sup> Myoung-Kyu Kang and Keun Lee, "Industrial Systems and Reform in North Korea: A Comparison with China", *World Development*, Vol. 20, No. 7, 1992, pp. 947-958.

<sup>16</sup> For analysis of North Korean corporate laws see Eric Yong-Joong Lee, *Legal Issues of Inter-Korean Cooperation Under the Armistice System* (The Hague, 2002).

<sup>17</sup> Kang and Lee, "Industrial Systems and Reform in North Korea: A Comparison with China", op. cit., pp. 947-958.

<sup>18</sup> Crisis Group interview, Andrei Lankov, Australia National University, Seoul, 14 February 2005.

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<sup>19</sup> David von Hippel, Timothy Savage and Peter Hayes, "The DPRK Energy Sector", Nautilus Institute, 13 September 2002.

<sup>20</sup> Don Oberdorfer, *The Two Koreas* (Basic Books, 2001), p. 233.

<sup>21</sup> Von Hippel, Savage and Hayes, "The DPRK Energy Sector", op. cit.

<sup>22</sup> UN figures show a precipitous drop in cereal production from 4 million tons in 1995 to 2.8 millions tons in 1996 and 1997. <http://www.humanitarianinfo.org/DPRK/default.asp>.

<sup>23</sup> The number of people relying on the PDS went from 61 per cent in 1994 to 6 per cent in 1997. Meredith Woo-Cumings, "The Political Ecology of Famine: The North Korean Catastrophe and Its Lessons", Asian Development Bank Institute (Tokyo, 2002), p. 34.

<sup>24</sup> On the confluence of political, industrial and environmental factors, see "Natural Disasters in Complex Political Emergencies", report on a seminar funded by the UK Department for International Development (DfID) and hosted by the British Red Cross Society, <http://www.redcross.org.uk/temp/naturalspdisasters.pdf>.

<sup>25</sup> Bank of Korea data. <http://www.bok.or.kr>.

<sup>26</sup> Marcus Noland, "Famine and Reform in North Korea", Institute for International Economics (Washington DC, July 2003), pp. 12-13. North Korea has not allowed sufficient monitoring to determine more precise figures. Also see Sue Lautze, "The Famine in North Korea: Humanitarian Responses in Communist Nations", Feinstein International Famine Centre, School of Nutrition Science and Policy, Tufts University, June 1997, <http://famine.tufts.edu/pdf/nkorea.pdf>.

food aid in 1996.<sup>27</sup> Levels of emergency assistance since then have fluctuated according to climate conditions, donor constraints, and the extent of North Korean interference in monitoring.<sup>28</sup> However, the country has consistently shown a food deficit of between 1 and 2 million tons, and by 2003 had received approximately \$2 billion in food aid.<sup>29</sup> According to WFP, in 2004 6.5 million North Koreans -- 28 per cent of the 23.3 million population -- still relied on international feeding programs.<sup>30</sup> At present approximately 100 Western aid agency personnel are in North Korea, a situation that was unthinkable a decade ago.

The production void was also filled by an informal economy. Money, mainly Chinese yuan, U.S. dollars, and euro, became increasingly important as rampant corruption fuelled the transfer of resources away from factories and collective farms into informal markets. Families started travelling in search of food, growing products for their own use and for barter trading among themselves. As many as 200,000 North Koreans near the northern border also started trading and working inside China.<sup>31</sup>

After the height of the famine passed in 1998, Kim kept pressure on his economic policy makers to devise new strategies. Although the government started restricting entry into China, issuing new identification cards and re-imposing restraints on internal movement, most of the market-oriented changes remained in place, as the state's ability to provide basic essentials through the PDS was still limited.

North Korean officials made enquiries about different European models for organising economies,<sup>32</sup> and visitors in 2000 detected a hard-fought debate between those within the establishment who wanted a repeat of the 1970s technology imports, and those who preferred a more fundamental policy change.<sup>33</sup> The government also started adapting *juche* to the changes that had occurred during the famine.<sup>34</sup>

In 2001, Kim made his first trip since 1983 to Shanghai, during which he visited the stock exchange and a General Motors joint-venture plant, commented on the city's rapid development since China began liberalisation, and, according to Beijing's foreign ministry, praised the achievements of the economic reforms.<sup>35</sup>

Since July 2002, the North has announced the most sweeping changes in the economy since the founding of the regime in 1948. These include the following:

- ❑ official prices and wages were increased to come closer to the black market levels. Food, fuel and electricity prices rose by 26 times on average, and rice prices by 550 times.<sup>36</sup> Public transport fares increased by up to twenty times in order to reflect the real cost of the service;<sup>37</sup>
- ❑ to meet the rise in prices, wage levels were raised by an average factor of eighteen. Different categories of workers received increases based on the importance and skill of their work, with soldiers, miners, and scientists receiving larger increases than office workers, for example.<sup>38</sup> Teams on cooperative farms were to be paid allowances based on what they produced, not on the number of hours worked.<sup>39</sup> These differentiated wages broadly followed preferences formerly reflected in the PDS, not relative values placed on labour;
- ❑ the North Korean won was devalued from an artificially high 2.15 to the U.S. dollar to a more realistic 150:1, although the black market rate reportedly was around 230:1 and has continued to rise, reportedly reaching 2,400 won to the U.S. dollar in March 2005;<sup>40</sup>

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<sup>27</sup> L. Gordon Flake and Scott Snyder, *Paved With Good Intentions: The NGO Experience in North Korea* (London, 2003).

<sup>28</sup> Humanitarian agencies in North Korea will be the subject of future Crisis Group reporting.

<sup>29</sup> "47<sup>th</sup> Visit to the DPRK/North Korea (11 to 22 September 2004)", Trip Report by Kathi Zellweger, Caritas-Hong Kong.

<sup>30</sup> [http://www.wfp.org/country\\_brief/index.asp?region=5](http://www.wfp.org/country_brief/index.asp?region=5).

<sup>31</sup> Woo-Cumings, "The Political Ecology of Famine", op. cit.

<sup>32</sup> Crisis Group interview, Ambassador Börje Ljunggren, Embassy of Sweden, Beijing, 20 October 2004.

<sup>33</sup> Crisis Group interview, business consultant, Seoul, 12 October 2004.

<sup>34</sup> Although still learned by rote by all and paid lip-service by leaders, *juche* today is a rallying point but not a threat to

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development. North Korea scholar Bruce Cumings noted: "Ideologically [*juche*] isn't an obstacle to change because it can always be creatively reinterpreted. Change and reform will happen, and *juche* will be adjusted accordingly". Crisis Group interview, Bruce Cumings, University of Chicago, 11 November 2004.

<sup>35</sup> Oberdorfer, *The Two Koreas*, op. cit., p. 441. Kim has subsequently made trips to Beijing and Shenzhen.

<sup>36</sup> Kim Yeong-yun, "North Korea's Economic Improvement Measures and Reorganisation of Collective Farms" (in Korean), *The North Korean Economic Review*, August 2002, pp. 45-48.

<sup>37</sup> "Consolidated Inter-Agency Appeal for DPRK", Annex IV, 28 October 2002, p. 129.

<sup>38</sup> "FAO/WFP Crop and Food Supply Assessment Mission to the DPRK", 22 November 2004, p. 18.

<sup>39</sup> Kim, "North Korean Economic Improvement Measures", op. cit., pp. 47-48.

<sup>40</sup> Crisis Group interviews, Seoul, October/November 2004 and *Vantage Point*, April 2005.

- ❑ the amount of individual farmland which state farmers and members of production cooperatives are allowed to cultivate themselves was increased;<sup>41</sup>
- ❑ land was de-collectivised and farmers given the right to sell excess produce. Farming methods were liberalised and removed from the central planning system;<sup>42</sup>
- ❑ informal farmers markets which had emerged in the 1990s were officially recognised;
- ❑ managerial decisions for industry and agriculture were placed formally in the hands of local production units and removed from the political decision making process;<sup>43</sup>
- ❑ government subsidies were cut and hard budget constraints imposed on enterprises.<sup>44</sup> Only strategic items like electricity, coal and products with direct relevance to defence are now supposed to be centrally controlled;<sup>45</sup> and
- ❑ all enterprises were authorised to sell surplus on the open market or to other enterprises.<sup>46</sup>

#### D. INCIPENT ENTREPRENEURSHIP AND MARKETISATION

Since the government sanctioned trade and entrepreneurship, the appearance of North Korea's public spaces, especially in Pyongyang, has dramatically changed. According to economist Yang Moon-soo of the University of North Korean Studies in Seoul, formal markets and shops with high quality products and correspondingly high prices have emerged, distinguished from the sometimes large but makeshift farmers markets formed in the 1990s by their permanency and prominence.<sup>47</sup>

The Tong-il Market in Pyongyang, which sells a range of meats, vegetables and other foodstuffs, as well as electronics and consumer goods, is often shown to visitors and is the best known example of the newly authorised markets.<sup>48</sup> According to a diplomat based in the capital, it is now being replicated on a smaller scale around the country.<sup>49</sup> Defectors say these are examples of "managed marketisation" and that most merchants are representatives of state-owned firms and cooperative farms, paying 5 per cent sales tax and monthly rent to the government, but retaining profits for their cooperative. Prices fluctuate, suggesting that market forces are at work, but the upper limit is fixed by the government and is heavily influenced by prevailing prices in China.<sup>50</sup>

In April 2004, North Korean authorities also changed the rules applying to state-run stores to make them more competitive with the private markets.<sup>51</sup> These stores now rent space to import companies and have relaxed their regulations on which citizens can use them.<sup>52</sup> In most cities there is also a town market, at which the county authorities determine who can sell produce.<sup>53</sup>

As the larger, quasi state-run markets have grown, informal local markets selling garden plot products, second-hand clothes and household goods, usually laid out on blankets or cardboard, are being forced into hiding. Nonetheless, they are still extensive, and according to the WFP, shopping at them forms an important part of sustenance for most families.<sup>54</sup> Estimates put the current number of *jonghap shijang* (general or private markets) at more than 300 country-wide.<sup>55</sup>

As state employment has shrunk and workers have learned that the time of "shared hardships" is over, entrepreneurship has blossomed. At a semi-formal level, local cooperatives are authorised to start small market-oriented economic activities, such as shoe shine services and bicycle repair stands. These are evident throughout the country. The WFP in late 2004 noted: "The scale of

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<sup>41</sup> Kwon Kyeong-bok, "Individual Farming System Implemented in Hamkyung Province Suggests Possibility of Market Economic Reform" (in Korean), *Chosun Ilbo*, 22 August 2002.

<sup>42</sup> Ji Hae-beom, "The North Applies Land Contract System" (in Korean), *Chosun Ilbo*, 5 March 2001.

<sup>43</sup> Kim Bum-seok, "North Korean Economic Reforms and Special Economic Zone Policy" (in Korean), *Unification Studies*, Vol. 8, Issue 1, 2002, p. 92.

<sup>44</sup> Park Soon-sung, "North Korean Economy Since the Economic Reforms" (in Korean), North Korean Economic Forum, Article 361, <http://www.nkef.re.kr>.

<sup>45</sup> Crisis Group interview, North Korean official, 15 December 2004.

<sup>46</sup> Yang Moon-soo, "North Korean Economy Since the Economic Improvement Measures" (in Korean), *National Reconciliation*, January/February 2005, pp. 20-23.

<sup>47</sup> Yang Moon-soo, "North Korea's Private Markets: Reality and Ripple Effect" (in Korean), *The North Korean Economic*

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*Review*, February 2005, pp. 1-21. As part of his research, Yang interviewed twenty North Korean defectors who left after the 2002 reforms were announced.

<sup>48</sup> Xinhua News Agency (China) photographs of the Tong-il Market, [http://news.xinhuanet.com/photo/2004-03/25/content\\_1383725.htm](http://news.xinhuanet.com/photo/2004-03/25/content_1383725.htm).

<sup>49</sup> Crisis Group interview, European diplomat based in Pyongyang, March 2005.

<sup>50</sup> Yang Moon-soo, "North Korea's Private Markets", op. cit.

<sup>51</sup> ministry of unification, "Overview of North Korea in 2004 and Prospects for 2005", <http://www.unikorea.go.kr>.

<sup>52</sup> Yang Moon-soo, "North Korea's Private Markets", op. cit.

<sup>53</sup> "WFP/FAO Crop and Food Supply Assessment Mission to the DPRK", op. cit.

<sup>54</sup> Ibid.

<sup>55</sup> Yang Moon-soo, "North Korea's Private Markets", op. cit.



informal and semi-informal initiatives has skyrocketed over the past year, to the point where the appearance of public spaces has visibly changed".<sup>56</sup> An increasing number of individual businesses are run from leased, state-owned buildings, including billiard halls, karaoke bars and inns.<sup>57</sup> Restaurants are staying open much later to earn more income -- a change from when early closings were the rule.<sup>58</sup> Defectors say that many skilled labourers have left their state jobs to set up independent enterprises.<sup>59</sup>

There is also entrepreneurial activity entirely outside the realm of the state. In the commercial fishing sector, for example, although in theory the state owns all inputs, operations are run by individuals, including paying the crew and choosing fishing schedules. The catch is sold on the dock at auction -- a normal sight in fishing ports worldwide, but a novelty in a country where until the 1990s the government set all prices and distributed all food.<sup>60</sup>

That some North Koreans have prospered under the new system is readily apparent in Pyongyang. Cars assembled by South Korea's Pyonghwa Motors Corporation and recent models imported from Japan and Europe are no longer rarities.<sup>61</sup> There are now more than 300 expensive restaurants,<sup>62</sup> as well as Internet cafés and a Chinese-run department store selling a range of foreign electronics and consumer goods.<sup>63</sup>

Nonetheless, conditions have become worse for most North Koreans. Price and wage increases pushed inflation above 100 per cent, the definition of hyperinflation. According to the WFP, the price of free market rice, the staple of the Korean diet, jumped by more than 50 per cent in most parts of the country in 2003 and tripled in others, a trend that continued through 2004.<sup>64</sup> Based on personal visits to North Korean markets and data collected from defectors, (South) Korea University economist

Nam Sung-wook estimates prices for some essentials rose 1,000 per cent between July 2002 and May 2004.<sup>65</sup> Humanitarian agencies estimate that since hyperinflation began, most families have had to spend at least 80 per cent of household income on food.<sup>66</sup>

Although prominent, the state-run markets with quality products and high prices cater only to the small portion of North Koreans with access to foreign currency from foreigners and business partners, government or military connections, or remittances from family members abroad.<sup>67</sup> Markets and entrepreneurship for most North Koreans still means survival, not profit.

## E. TENTATIVE OPENING

Before 1991, North Korea's trade was almost exclusively with China and within the Socialist trade grouping, the Council for Mutual Economic Assistance (COMECON), although it was not officially a member. Both were subsidised barter networks, to which North Korea's main input was coal, minerals and low-quality semi-processed goods. In exchange it received higher-quality consumer products, energy and food.<sup>68</sup> COMECON was dissolved in 1991 with the fall of the Soviet Union, which also meant the end of Soviet subsidies. China ended subsidised and barter trade in 1993 and started demanding hard currency. North Korea's imports fell from around \$2.8 billion in 1990 to a low of \$900 million in 1998, and exports declined from around \$2 billion in 1990 to \$600 million in 1998.

1998 was the year in which North Korea started readjusting its external relations to open up new markets and sources of foreign capital. It started diplomatic relations with several European countries and improved its relationships with China, Russia and South Korea. By 2003, it had successfully grown total trade back to approximately \$3 billion, with China, South Korea and Japan together accounting for 64 per cent, and Thailand, India and Russia<sup>69</sup> most of the remainder.<sup>70</sup>

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<sup>56</sup> "WFP/FAO Crop and Food Supply Assessment Mission to the DPRK", op. cit.

<sup>57</sup> Lee Dong-hyeon, "The North's New Code of Laws" (in Korean), *Joongang Ilbo*, 17 February 2005.

<sup>58</sup> Crisis Group interview, Moon Chung-in, Chairman, Presidential Committee for Northeast Asian Cooperation, Seoul, 17 January 2005.

<sup>59</sup> Yang Moon-soo, "North Korea's Private Markets", op. cit.

<sup>60</sup> Crisis Group interview, Erica Kang, Jungto Society, Seoul, 25 January 2005.

<sup>61</sup> Crisis Group interview, diplomat, Seoul, November 2004.

<sup>62</sup> Christopher Torchia, "Dining Well in Famine-Ridden North Korea", Associated Press, 29 January 2004.

<sup>63</sup> The department store even offers a "VIP Gold Card" loyalty scheme. Philippe Pons, "Fragile Thaw in North Korea" (in French), *Le Monde*, 15 December 2004.

<sup>64</sup> Crisis Group interview, Gerald Bourke, World Food Program, Beijing, 18 October 2004.

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<sup>65</sup> Nam Sung-wook, "North Korea in 2004: Military First Policy Obscures the Economy" (in Korean), *North Korea*, Vol. 396, pp. 76-84.

<sup>66</sup> Crisis Group interview, Kathi Zellweger, Caritas-Hong Kong, Seoul, 15 November 2004.

<sup>67</sup> Crisis Group interview, South Korean government analyst, Seoul, 17 January 2005.

<sup>68</sup> Marina Ye Trigubenko, "Industry of the DPRK: Specific Features of the Industrial Policy, Sectoral Structure and Prospects", Centre of Asian Studies, Institute of International Economic and Political Studies, USSR Academy of Sciences, 1991.

<sup>69</sup> North Korea imported \$116 million of oil, coal and iron from Russia and exported \$3 million of pork and cement, in

## 1. Trade

**China.** After officially ending subsidised trade in 1993, China announced modest contributions of grain to North Korea in 1997, although it was believed to be supplying much greater amounts at subsidised prices and through private barter deals. Customs data suggested at least 1.2 million tons of grain entered North Korea from China that year, as well as 1 million tons of oil.<sup>71</sup> According to the Korea Trade Investment Promotion Agency (KOTRA), China is now North Korea's largest trade partner, in 2003 accounting for a total trade volume (including unilateral and subsidised transfers) of over \$1 billion.<sup>72</sup> Exports to China accounted for \$395 million, an increase of 46 per cent over 2002, attributed to more transfers of marine products, metals and textiles. Chinese (reported) exports amounted to \$628 million, a 42 per cent rise on 2002, due to a hike in exports of energy resources (crude oil and coke) and foodstuffs, including meat, rice and wheat.<sup>73</sup> Trade with and assistance from China is believed to account for up to 80 per cent of North Korea's essentials and the bulk of its consumer goods.<sup>74</sup> Lack of transparency makes determining the difference between China's assistance and genuine trade impossible but Beijing is believed to liaise frequently with Pyongyang and to adjust its donations so as to top-up whatever bilateral donors and the WFP provide, month by month.<sup>75</sup> Preliminary figures suggest bilateral trade increased to \$1.3 billion in 2004, up 35 per cent from 2003.<sup>76</sup>

**South Korea.** North-South economic exchanges have blossomed since the election of President Kim Dae-jung in South Korea in 1997, and his successor, Roh Moo-

hyun, in 2002.<sup>77</sup> The high point in bilateral relations came with the June 2000 North-South summit, which was also a watershed for trade. Non-existent before 1989, and just \$2.1 billion between 1988 and 1999, in the year after the summit 672 South Korean companies started importing or exporting goods to and from North Korea, and total trade reached \$425 million. Although most companies quickly lost interest -- a survey in October 2001 found only 171 were still involved -- inter-Korean trade reached \$724 million in 2003.<sup>78</sup> Around 65 per cent are exports from South to North, making South Korea the second largest exporter to North Korea, after China.<sup>79</sup> South Korea exports chemical and agricultural products, textiles and electronics to the North but food and other in-kind assistance are 80 per cent of the total -- \$167 million in 2003. The North's main exports are agricultural, forest and fishery products, followed by textiles, and steel and metal products. Over 30 per cent of its trade involves commission-based processing, for which South Korean businesses provide the production facilities and raw materials and take back the end products.<sup>80</sup>

**Japan.** While representing only 8 per cent of North Korea's total trade, Japan is the only country with which North Korea has a trade surplus and so is an important source of foreign currency.<sup>81</sup> Since peaking in 1980 at around \$500 million, bilateral trade has been steadily falling, with a 28 per cent drop from \$370 million in 2002 to \$265 million in 2003 -- a reflection of worsening political relations.<sup>82</sup> Japan's exports of rice, vehicles and wool fell from \$175 million in 1998 to \$91 million in 2003, though its imports of marine products, processed goods and textiles have held relatively steady, dropping only from \$218 million to \$173 million in the same period.<sup>83</sup> However, those imports will likely fall sharply following the passage of the Compensation for Sea Pollution Law in March 2005, which prevents most North Korean boats from calling at Japanese ports. Ethnic Koreans in Japan provide roughly \$100 million dollars in cash transfers to North Korea annually, but this figure has been falling rapidly since 2001.

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2003. Preliminary figures for 2004 showed a rise of 78 per cent in North Korean imports from Russia and 157 per cent in exports. "North Korea-Russia Trade Jumps in 2004" (in Korean), Korea Trade Investment Promotion Agency, <http://globalwindow.org/front/main.html> If present trends continue, Russia will replace Japan as North Korea's third leading trade partner.

<sup>70</sup> All data from the Korea Trade Investment Promotion Agency, <http://crm.kotra.or.kr/main/info/nk/eng/main.php3>.

<sup>71</sup> Oberdorfer, *The Two Koreas*, op. cit., p. 398.

<sup>72</sup> Data from the Korea Trade Investment Promotion Agency, <http://crm.kotra.or.kr/main/info/nk/eng/main.php3>.

<sup>73</sup> Data from the Korea Trade Investment Promotion Agency, <http://crm.kotra.or.kr/main/info/nk/eng/main.php3>.

<sup>74</sup> Crisis Group interviews, business consultant, Seoul, 12 October 2004 and Cho Myung-chul, Korea Institute for International Economic Policy, Seoul, 25 February 2005.

<sup>75</sup> Crisis Group interview, aid agency official, Beijing, 18 October 2004.

<sup>76</sup> Korea International Trade Association data, <http://global.kita.net/>.

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<sup>77</sup> Yang Un-chul, "South-North Economic Cooperation and Comparative Developmental Studies", unpublished manuscript, Sejong Institute (Seoul, March 2005).

<sup>78</sup> Korea Development Institute survey detailed in Richard Tait, "Playing By the Rules in Korea", *Asian Survey*, Vol. XLIII, No. 2, March/April 2003, p. 311.

<sup>79</sup> Data from the Korea Trade Investment Promotion Agency (KOTRA), South Korea, <http://crm.kotra.or.kr/main/info/nk/eng/main.php3>.

<sup>80</sup> Ibid.

<sup>81</sup> Data provided to Crisis Group by the Japan External Trade Organisation (JETRO), 18 January 2005.

<sup>82</sup> Data from KOTRA, op. cit.

<sup>83</sup> Ibid.

**Illicit trade.** Though difficult to measure, North Korea has a reputation for selling almost anything to any country. North Koreans have been apprehended trafficking narcotics, arms and missiles, passing counterfeit U.S. currency, trading in copyrighted products, and fencing duty free cigarettes, cars, perfume and liquor imported through their embassies.<sup>84</sup> The U.S. Department of State concluded in March 2005 that "it is likely, though not certain, that the North Korean government sponsors such illegal behaviour as a way to earn foreign currency for the state and for its leaders".<sup>85</sup> U.S. officials estimate that weapons sales might bring in between \$100 million and \$500 million per year, while North Korean defectors estimate they are as much as 40 per cent of total exports.<sup>86</sup> Former Kim Il-sung University Professor Cho Myung-chul says that much of the revenue from missile and drug sales goes directly to the military, not the government. Some of the trade also reflects corruption by local elites and businessmen.<sup>87</sup>

Press reports suggest that North Korea's illicit trading activities are continuing. In March 2005 counterfeit \$100 bills were discovered on a North Korean cargo ship making a port call in Japan.<sup>88</sup> On two occasions in 2004, North Korean diplomats were arrested for involvement in narcotics smuggling. In June, Egyptian authorities detained two diplomats attempting to deliver 150,000 tablets of Clonazepam, a drug used to treat seizures and anxiety. In December, Turkish authorities arrested two diplomats carrying over half a million Captagon tablets, a synthetic drug taken as an aphrodisiac, worth \$7 million dollars.<sup>89</sup> In April 2003 a North Korean boat carrying 125 kilograms of heroin was interdicted by Australian authorities. Those arrested included a Korean Worker's Party official. In December 2002 a consignment of North Korean scud missiles bound for Yemen was intercepted by Spanish authorities.<sup>90</sup> In August 2002, Slovak police uncovered two North Korean agents in Bratislava selling

missile components to Egypt.<sup>91</sup> Defectors and informants also report that large-scale opium poppy cultivation and production of heroin and methamphetamine occurs in North Korea.<sup>92</sup>

In December 2001 the Japanese coast guard chased and sank an armed North Korean vessel believed to be involved in drug running. Since 2003, Japan and the U.S. have led efforts in the region to curtail North Korea's illegal trade through the Proliferation Security Initiative, in October 2004 holding a three-day training exercise in Japanese waters.

## 2. Direct investment

Since official approval was given to profit making, and restrictions on foreign trade were lifted in 2002, North Korean companies have been actively seeking joint ventures with foreign partners.<sup>93</sup> As Caritas-Hong Kong Director Kathi Zellweger noted on a trip in September 2004, "There is a tangible spirit of entrepreneurship. Suddenly people present name cards, ask for business connections, and want to trade and deal".<sup>94</sup>

Foreign business consultants promoting and facilitating investment in North Korea are bullish about the opportunities, especially in the mining and mineral sectors and processing-on-commission trade. There are also opportunities in the service and support industries, including banking, legal, accounting and financial services, tourism, education, and medical and insurance services. Roger Barrett, a full-time North Korea business consultant based in Beijing, says North Korea offers a low-wage, highly educated and motivated workforce, an improving legal environment, attractive tax breaks and business counterparts "genuinely motivated to achieve success".<sup>95</sup>

**China.** Chinese business representatives are able to visit North Korea with few formalities and travel relatively

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<sup>84</sup> Presentation by Jane's Consultancy Senior Analyst Bertil Linter, "North Korean Companies and Commercial Activities in Southeast Asia", Tokyo, October 2003.

<sup>85</sup> U.S. Department of State, bureau for international narcotics and law enforcement affairs, "International Narcotics Control Strategy Report 2005", March 2005.

<sup>86</sup> Bertil Linter and Steve Stecklow, "Paper Trail Exposes Missile Merchants", *Far Eastern Economic Review*, 13 February 2003.

<sup>87</sup> Crisis Group interview, Cho Myung-chul, Korea Institute for International Economics, Seoul, 25 February 2005.

<sup>88</sup> "\$100 Bills Suspected to be Bogus Found on N. Korean Ship", Kyodo News Agency, 30 March 2005.

<sup>89</sup> U.S. Department of State, op. cit.

<sup>90</sup> The boat was allowed to continue its journey after Yemen gave assurance the missiles would not be transferred to a third party. Greg Sheridan, "Interdicting North Korea", *Asian Wall Street Journal*, 6 August 2003.

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<sup>91</sup> Linter and Stecklow, "Paper Trail Exposes Missile Merchants", op. cit.

<sup>92</sup> A defector identified as a former North Korean high-level government official wrote in the February 2004 Jamestown Foundation publication *North Korea Review* that poppy cultivation and heroin and methamphetamine production were conducted in North Korea by order of the regime, which then engaged in drug trafficking to earn foreign currency. Kim Young-il, "North Korea and Narcotics Trafficking: A View from the Inside", *North Korea Review*, Vol. 1, Issue 1, March 2004.

<sup>93</sup> Nam Moon-hee, "North Korea Bets on the Success of Reform" (in Korean), *Sisa Journal*, 14 October 2004.

<sup>94</sup> "47<sup>th</sup> Visit to the DPRK/North Korea", op. cit.

<sup>95</sup> Presentation to Crisis Group by Roger Barrett, Korea Business Consultants, Beijing, 20 October 2004.

freely in the country. Data about the size and value of investments is limited.<sup>96</sup> However, during the North Korean prime minister's visit to Beijing in March 2005, an investment guarantee, guarantees on profit remittances and double taxation agreements were signed.<sup>97</sup>

**South Korea.** The first South Korean company to invest directly in North Korea was Daewoo in 1992. There was little further development until October 1998, when the then-chairman of the South Korean conglomerate Hyundai, Chung Ju-yung, met Kim Jong-il in Pyongyang. Hyundai, which created the subsidiary Hyundai-Asan to manage projects with North Korea, was granted rights the following year to bring tourists from South Korea to the famed Mount Kumgang, in exchange for payments totalling in excess of \$942 million over six years.<sup>98</sup> (The total amount transferred by February 2005, however, was considerably less -- \$430 million.)<sup>99</sup> Hyundai-Asan's physical investment in the project is now \$187 million, exceeding by a factor of ten any other South Korean investment in North Korea.<sup>100</sup> By 2005, 50 South Korean companies had registered for investment, although at least fifteen -- 30 per cent of the total and representing half the investments larger than \$1 million -- are in the low-tech, low-revenue processing-on-commission enterprises that are also responsible for the growing trade figures.

Only a handful of South Korean companies have actually made a profit. In fact, many investments have non-profit motives. In 2001, 50 per cent of all South Korean companies engaged in business with the North were motivated by humanitarian and nationalistic aims.<sup>101</sup> A prominent example is the Pyonghwa Motors Corporation, which employs North Koreans in a factory at Nampo assembling models of Fiat cars, which it then sells in North Korea. Pyonghwa sees its role as "investing money and asking for nothing in return".<sup>102</sup> The operation is underwritten by a South Korean religious organisation, Moon Sun-myung's Unification Church.

Making a profit is not impossible, however. A South Korean computer monitor manufacturer, IMRI, was identified in 2001 as the first South Korean IT firm to do so manufacturing in North Korea.<sup>103</sup> But even though Kim Jong-il himself is believed to be in favour of more South Korean investment -- he reportedly told the late Hyundai-Asan Chairman Chung Mong-hun in June 2003, "South Korean businessmen can provide the North Korean people with an effective shortcut for understanding what capitalism is"<sup>104</sup> -- since July 2004, many South Koreans have been refused entry to the North, including those with ongoing investments, without explanation.

**Japan.** Ethnic North Koreans residing in Japan were the focus of North Korea's 1984 foreign investment law.<sup>105</sup> By 1991, 85 joint ventures had been agreed on, and 39 were actually implemented. However, most of these turned out to be loss-making, and Japanese motivated by business, not nationalistic, aims have since consistently invested in China rather than North Korea. More extensive investment by Japanese businesses is constrained by large trade debts run up during technology transfers in the 1970s. North Korea received in excess of \$450 million in credit from Japan, but failed to make even interest payments. In 1986, the Japanese government paid 32 affected Japanese export insurance companies \$196 million compensation.<sup>106</sup>

**Europe.** Leveraging good diplomatic relations between the European Union (EU) and North Korea, a growing number of European investors have emerged. In 2004, branches of the Seoul-based European Union Chamber of Commerce in Korea (EUCCK),<sup>107</sup> Korea Business Consultants (a British-owned consultancy)<sup>108</sup> and a foreign law firm all opened offices in Pyongyang.<sup>109</sup> Also, the first foreign-invested gold mining joint venture, including Singaporean, Australian, British and North Korean partners and using \$3 million of invested technology, went online;<sup>110</sup> A mid-size British oil and gas

<sup>96</sup> Nam Moon-hee, "North Korea Bets on the Success of Reform" op. cit.

<sup>97</sup> Yoo Kwang-jong, "North Korea signs investment guarantee agreement with China" (in Korean), *Joongang Ilbo*, 23 March 2005.

<sup>98</sup> The \$150 million in unrestricted money in the first months (reduced by agreement later) provided a huge windfall for North Korea. Its single largest export, textiles, had been worth only \$184 million in 1997. Oberdorfer, *The Two Koreas*, op. cit., pp. 415-416. By March 2005 more than 860,000 South Koreans had visited the resort.

<sup>99</sup> Information provided by Hyundai-Asan, 1 April 2005.

<sup>100</sup> KOTRA, op. cit.

<sup>101</sup> Tait, "Playing By the Rules in Korea", op. cit., p. 313.

<sup>102</sup> Crisis Group interview, John Kim, Pyonghwa Motors Corporation, Seoul, 8 December 2004.

<sup>103</sup> Tait, "Playing By the Rules in Korea", op. cit., p. 318.

<sup>104</sup> Quoted in Cho Dong-ho, "A Study of Kim Jong-il as CEO: Reform and Anti-Reform", *Chosun Ilbo*, 3 February 2005.

<sup>105</sup> Article 5 of the "Joint Venture Law of the Democratic People's Republic of Korea" says: "Korean[s] overseas including Korean traders and manufacturers in Japan may participate in joint ventures with companies and enterprises of our country under this law".

<sup>106</sup> Bon-Hak Koo, *Political Economy of Self Reliance*, op. cit., pp.190-204.

<sup>107</sup> <http://www.eucck.org>.

<sup>108</sup> <http://www.kbc-global.com>.

<sup>109</sup> "External Economic Legal Advice Office", *Vantage Point*, Vol. 27, No. 11, November 2004, p. 20.

<sup>110</sup> Kumsan Joint Venture Company Press Release, 16 October 2004.

company, Aminex Plc, signed a twenty-year agreement to develop North Korea's petroleum industry;<sup>111</sup> and the UK-based Global Group of Companies took over the majority stake in Daedong Credit Bank, the only foreign joint-venture bank in North Korea.<sup>112</sup> The parcel company DHL has had a presence in North Korea since 1997. Diplomats well acquainted with these investments say the operations are very small-scale and tentative, with potential first-mover gains hedged against high political and economic risk.<sup>113</sup>

### 3. Special Economic Zones

After a 1991 trip to view the economic changes in China, including Special Economic Zones (SEZs) conceived as laboratories for testing the impact of capitalism, Kim Il-sung authorised the creation of a special free trade and investment zone at Rajin-Sonbong on the north east coast. Two further zones have been created since 1998, at Sinuiju on the north western border with China, and Kaesong on the southern border with South Korea. North Korea has gradually learned that SEZs are one of the most effective means for introducing foreign investment and capitalism in limited doses. For North Korea, this has been an evolutionary process.

**Rajin-Sonbong.** On 28 December 1991, North Korea declared the adjacent fishing ports of Rajin and Sonbong and their surrounding territory of 641 square kilometres in the northeastern-most corner of the country a Free Economic and Trade Zone. Preferential laws, regulations and taxation measures were drawn up, and an intensive promotional campaign and a series of investment forums were held.

Although more than \$250 million was pledged, by 1998 only \$88 million had been invested at Rajin Sonbong. This was primarily in infrastructure projects, hotels, the installation of 5,000 phone lines, a shipping company and tourism facilities. Of the 113 completely foreign-financed firms in the zone, 56 per cent are Chinese, but many of these are small and trade-related, and they account for just 20 per cent of the total investment value. Twenty Japanese companies have invested in hotels, catering and marine processing and timber processing facilities. South Korean companies showed considerable interest; several processing-on-commission businesses registered for investment permission with the South Korean authorities but none actually put money

into the zone.<sup>114</sup> Larger scale projects include the Emperor Casino Hotel (Hong Kong), which began operating in October 2000,<sup>115</sup> and a communications system project financed by Loxley (Thailand). A Hong Kong-based financial group, Peregrine Holdings, established a joint venture bank with the Korea Daesong Bank in 1995.<sup>116</sup>

Investment figures for 1999 onwards have not been published, but the North Korean authorities have reported that as of July 2000, contracts worth a total of \$5.2 million had been concluded, with implemented investment quoted at \$2.2 million.<sup>117</sup> The period 1995-1996 was the height of Rajin-Sonbong's success. The primary problems cited by foreign investors include:

- ❑ remote location far from North Korean or Chinese population centres;
- ❑ extremely poor infrastructure, with many roads still unpaved and areas inaccessible by car;
- ❑ border-crossing difficulties;
- ❑ excessive bureaucratic red tape to receive investment permission from the central government; and
- ❑ foreign companies forced to employ staff via the zone authority's labour office, which dictates who is employed and what they are paid.

This first attempt at creating a special investment zone was deemed a failure by most observers, but provided North Korea with valuable experience.

**Shinuiju.** In July 2002, Shinuiju on the frontier facing the bustling Chinese city Dandong, was designated a Special Administration Region (SAR), to be developed as a regional hub for finance, trade, commerce, industry, advanced science, entertainment and tourism.<sup>118</sup> Like the Hong Kong SAR, the region was to fly its own flag, issue its own passports, and be run under liberal economic and

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<sup>114</sup> Hisako Tsuji, "The Tumen River Area Development Program: Its History and Current Status as of 2004", Economic Research Institute for Northeast Asia (ERINA), Niigata, April 2004.

<sup>115</sup> The hotel closed in late 2004, officially for renovation, but rumoured as part of a wider Chinese crack down on border casinos in Russia, Myanmar, Laos and Vietnam after excessive gambling of official funds by Chinese state officials. Zach Coleman, "Emperor Casino Closure Tied to Graft Crackdown", *The Hong Kong Standard*, 20 January 2005.

<sup>116</sup> Peregrine Investments Holdings went bankrupt in 1997 at the start of the Asian financial crisis.

<sup>117</sup> Hisako Tsuji, "The Tumen River Area Development Program", op. cit.

<sup>118</sup> Jong-Woon Lee, "Current Status and Future Tasks of the New SEZs in North Korea", *Journal of International Economic Studies*, Vol. 8, No. 2, December 2004, p. 125.

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<sup>111</sup> Aminex Plc Press Release, 20 September 2004.

<sup>112</sup> Tom Tobback, "Global Player Wins N Korea's Only JV Bank", *Asia Times Online*, 20 May 2004.

<sup>113</sup> Crisis Group interview, European diplomat, Seoul, 10 March 2005.

political policies.<sup>119</sup> A Dutch-Chinese entrepreneur and tycoon, Yang Bin, was appointed minister and chief executive officer, and a plan to replace the entire 500,000 population with skilled labour was announced.<sup>120</sup> China - - at which the zone was aimed -- was informed only on the day it was publicly announced.<sup>121</sup> Following rumours the zone would in fact be an "adult playground" for entertainment and gambling, Yang Bin was arrested in China on corruption charges.<sup>122</sup> He was replaced in September 2004 by a Chinese-American businesswoman. There was no further progress towards opening the zone, and late in the year North Korean officials said plans had been abandoned.<sup>123</sup> In early 2005 North Korea started discussing opening other cities on the border to trade.<sup>124</sup>

**Kaesong.** Also in 2002, North Korea agreed to the construction of a third SEZ, at Kaesong, 69 kilometres north of Seoul and just north of the Demilitarised Zone (DMZ).<sup>125</sup> Hyundai-Asan and South Korea's state-run land developer, Korea Land Corporation, signed a 50-year leasehold. Ground was broken by Hyundai-Asan in June 2003, and in December South Korean staff started living full time in the zone. In December 2004, South Korean kitchenware manufacturer Living Art became the first South Korean company to start production. By February 2005, over 1,800 North Korean staff were employed at Kaesong, managed by 300 South Koreans.<sup>126</sup> When the first phase of development is complete, the complex is to include 300 factories and employ 75,000 North Koreans. Later stages are to add more plants, a golf course, and apartments.

North and South Korea's interest in the zone is for more than political or symbolic reasons. Yonsei University economist Lee Young-sun says the zone provides the North with "an opportunity to learn about the market economy and a means to effectively utilise its abundant labour force".<sup>127</sup> An employee in the zone says he hopes

it will "change the North Korean mindset gradually, while imposing modernisation", comparing it to Japanese investment in South Korea in the 1960s and 1970s.<sup>128</sup>

For the South, the zone offers a low wage processing area close to its largest market, Seoul, and its major freight terminal, Incheon. North Korea has agreed on a basic monthly wage of \$57.50, a maximum wage increase of 5 per cent per year, and a 48-hour work week.<sup>129</sup> This makes labour more competitive than China (\$400-\$1,200 per month), and seventeen times less than the average manufacturing wage of \$1,000 in South Korea.<sup>130</sup> The Hyundai-Asan official in charge of the complex believes it has the potential to become a "global export platform", much like China's most successful SEZ at Shenzhen, which has thrived partly due to the proximity of its low-cost workforce to capitalist hub Hong Kong.<sup>131</sup>

The prospects for success at Kaesong are better than for either of North Korea's previous SEZs:

- there is bipartisan consensus in South Korea in favour of the zone.<sup>132</sup> Even the leading conservative newspaper, *Chosun Ilbo*, supported the March 2005 linking of power lines to the North to provide power for the industrial complex;<sup>133</sup>
- transportation to South Korea is by a road cutting through the DMZ, along which daily bus service from downtown Seoul has run since August 2004, and road access to the Incheon port is provided. Telecommunications are provided by South Korea's Korea Telecommunications Company;
- there is considerable scope for expansion. The pilot project was fifteen times oversubscribed, with 230 applicants for the fifteen pilot factories. At least 1,800 South Korean companies have expressed interest in moving into the complex;<sup>134</sup>

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<sup>119</sup> Yeo Si-dong, "Interview with Yang Bin, minister of the Special Zone" (in Korean), *Chosun Ilbo*, 28 September 2002.

<sup>120</sup> David Murphy, "Own Goal", *Far Eastern Economic Review*, 10 October 2002.

<sup>121</sup> Ibid.

<sup>122</sup> Nailene Chou Wiest, "City on a Road to Nowhere No More", *South China Morning Post*, 4 May 2004.

<sup>123</sup> Jong-Woon Lee, "Current Status and Future Tasks of the New SEZs in North Korea", op. cit., p. 125.

<sup>124</sup> "N. Korea to Open Border Wider", Yonhap News Agency, 31 January 2005.

<sup>125</sup> For detailed analysis of this project see "Unification White Paper 2005" (in Korean -- forthcoming in English), ministry of unification, 2005.

<sup>126</sup> Information provided to Crisis Group by Hyundai-Asan, March 2005.

<sup>127</sup> "Kaesong is the First Step Toward Unification" (in Korean), presented at the Hankyoreh Unification Foundation seminar, 11 March 2005.

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<sup>128</sup> Crisis Group interview, Korean Land Corporation employee, Seoul, 2 November 2004.

<sup>129</sup> Hyundai-Asan does not pay workers directly. Money equivalent to the wages is transferred to a North Korean government agency which then makes the distribution. Crisis Group interview, Hyundai-Asan official, Seoul, 15 April 2005.

<sup>130</sup> Lee Moo-young, "Kaesong Gets Going" (in Korean), *Joongang Ilbo*, 3 January 2005.

<sup>131</sup> Shim Jae-won, "Making the Kaesong Industrial Complex into a Global Export Platform" (in Korean), presented at the Hankyoreh Unification Foundation seminar, 11 March 2005.

<sup>132</sup> "Can You Hear the Sound of Ice Breaking?" (in Korean), *Sisa Journal*, 6 January 2005.

<sup>133</sup> "South Korean Electricity Flows to the North for the First Time in 57 years" (in Korean), *Chosun Ilbo*, 11 March 2005.

<sup>134</sup> Lee Moo-young, "Kaesong Gets Going", op. cit.

- the North has not halted progress at the zone despite the nuclear crisis and a chill in official North-South discussions; and
- the final phase allows for a 26.4 million square metre complex, which will block one of the few north-south routes along which a ground invasion could be launched, making this a mutual strategic concession.<sup>135</sup>

### III. OBSTACLES TO REFORM

Despite the profound economic changes under way, the obstacles to implementing the reforms necessary for a successful transition are formidable. Although growth appears to have been positive since 1999,<sup>136</sup> this is largely because of unilateral transfers by China and South Korea and international aid, not agricultural rehabilitation or marked industrial recovery. Anecdotal evidence suggests that more factories are closing than opening. 2 per cent growth is also a fraction of that achieved in other transition economies. In Vietnam, GDP grew an average of 4 per cent per year from 1986 to 1990 and over 8 per cent from 1990 to 1997. China, with a population 60 times North Korea's, a less educated workforce, geographical imbalances, and dangerous ethnic and religious differences, has achieved average annual growth of more than 8 per cent since 1978.

This is not to denigrate what is being done or what has been accomplished. While there are limitations in the North Korean approach, the overall commitment to change is clear.<sup>137</sup> The willingness to stay the course despite the worsening international environment and to challenge some core ideological tenets is encouraging. However, if North Korea is to achieve sustainable growth and a reasonable degree of self sufficiency, more sweeping reform is necessary. For that to be possible, several obstacles must be overcome, including the prevailing attitude of the ruling elite, the shortage of hard currency, a hardening international environment, lack of knowledge about transition, and worsening corruption.

#### A. THE RULING ELITE

In North Korea political legitimacy has been achieved almost exclusively through ideological means and forced indoctrination.<sup>138</sup> Kim Il-sung maintained his authority by using a combination of a cult of personality reinforced by Confucian traditions, and brainwashing in *juche*, his home-grown ideology emphasising near religious adherence to codes of conduct laid down by the state.<sup>139</sup>

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<sup>136</sup> "S Korea: N Korea Econ Likely Grew More Than 1.8% In 2004", Dow Jones Newswires, 30 December 2004.

<sup>137</sup> For a detailed study of North Korean official announcements about economic reform, see Ruediger Frank, "A Market Economy in North Korea? Systemic Restrictions and a Quantitative Analysis", Columbia University, unpublished paper, 2003.

<sup>138</sup> Han S. Park and Kyung Ae Park, *China and North Korea: Politics of Integration and Modernization* (Hong Kong, 1990).

<sup>139</sup> Han S. Park, *North Korea: The Politics of Unconventional Wisdom*, op. cit.

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<sup>135</sup> Crisis Group interview, South Korean government analyst, Seoul, 17 January 2005.

Kim Jong-il has continued his father's legacy. He successfully completed the hereditary succession process, a first for a communist regime, by elevating his father to the status of "eternal president" of North Korea, idolising his achievements and policies, and assiduously cultivating his own connections with the military and leadership.<sup>140</sup>

The dilemma is essentially the same now as when North Korea's leaders first realised the shortcomings of communism in the late 1960s. Systemic reform is inconsistent with the ideological, political, and power structure and with the personality cult of the present ruler. The North Korean leaders may have decided that continuation of centralised economic decision-making is a sure avenue to centralised political control and, perhaps, the only road for the perpetuation of the regime.<sup>141</sup>

The way this problem manifests itself varies within the leadership but ultimately the basic dilemma is the same for all: how to reconcile the overwhelming need for systemic change, with the threat that change poses to the regime's security.

**Kim Jong-il.** The North Korean leader is believed to make all major political and economic decisions and has the most to lose if the current system ends. His autocratic position would be untenable in a fully open and accountable society. His hereditary succession also makes the repudiation of past policies much more problematic, so he lacks the revisionist power of authoritarian reformers like China's Deng Xiaoping or South Korea's Park Chung-hee.

**The bureaucracy.** The direct policy-making influence of the 1,000-plus North Koreans who constitute the bureaucratic elite is almost certainly limited to providing a rubber stamp for Kim Jong-il's decisions.<sup>142</sup> However, with regular opportunities for travel and communication abroad, this group is the most aware of the country's shortcomings and isolation. They must balance this awareness against the personal jeopardy in which reform would place them, while considering the fates of former dictatorship elites in some Central European countries. Former Kim Il-sung University Professor Cho Myung-chul says there is a generational clash in the North,

similar to that in the South,<sup>143</sup> between older scholars and officials who stress the need to place security first, and the younger generation, many of whom have studied in China, Russia and beyond, who emphasise the need for economic reform: The halting and often contradictory policy changes reflect this conflict.<sup>144</sup>

**The military.** Counterbalancing whatever pro-reform constituency might exist in the bureaucracy is North Korea's military, an imposing bloc of more than 1 million. Military spending accounts for as much as 30 per cent of GDP.<sup>145</sup> Many analysts believe the military's goal of maintaining North Korea as a "strong and cohesive state" (*kangseong daeguk*) means, above all, maintaining its physical integrity and internal security.<sup>146</sup> If so, and if analysts are right that Kim Jong-il tilted the balance of power in the military's favour by strengthening its grip on policy in the mid-1990s,<sup>147</sup> it is likely to be a major impediment to deeper reform.<sup>148</sup> Even if the military's sense of domestic and international insecurity can be decreased, the reduced social control that would inevitably accompany liberalisation would be difficult to reconcile with its security goals.<sup>149</sup> Experiences in China and Vietnam suggest that support for reform might only be achieved by encouraging the military to engage in manufacturing, service industries, joint ventures, and exports for its own advantage.<sup>150</sup>

<sup>140</sup> David I. Steinberg, "On Patterns of Political Legitimacy in North Korea", in Samuel S. Kim (ed.), *The North Korean System in the Post Cold War Era* (New York, 2001), p. 87.

<sup>141</sup> Joseph S. Chung, "North Korea's Seven-Year Plan (1961-70): Economic Performance and Reforms", *Asian Survey*, June 1972, p. 545.

<sup>142</sup> Crisis Group interviews, South Korean academics, Seoul, January 2005.

<sup>143</sup> Crisis Group Asia Report N°89, *Korea Backgrounder: How the South Views its Brother From Another Planet*, Seoul/Brussels, 14 December 2004.

<sup>144</sup> Crisis Group interview, Cho Myung-chul, Korea Institute for International Economics, Seoul, 25 February 2005.

<sup>145</sup> "The Military Balance 2004", International Institute for Strategic Studies.

<sup>146</sup> Crisis Group interview, Moon Chung-in, Presidential Committee for Northeast Asian Cooperation, Seoul, 17 January 2005.

<sup>147</sup> Kim Jong-il's visits to defence-related installations jumped from 34 in 2002 to 60 in 2004. "Analysis of Kim Jong-il's activity (2001-2004)" (in Korean), *JoongAng Ilbo Unification Research Institute*, January 2005, pp. 10-12.

<sup>148</sup> Crisis Group interview, Moon Chung-in, Presidential Committee for Northeast Asian Cooperation, Seoul, 17 January 2005. The shift in balance was formalised in January 1995 with the announcement of the "Military First" (*seongun*) policy, which came at the height of the famine and was reaffirmed in early 2005. See Park Hyeung-jung, "North Korea's Economic Policy in the Era of "Military First", *International Journal of Korean Unification Studies*, Vol. 12, No. 1, 2003.

<sup>149</sup> Crisis Group interview, Yoon Dae-kyu, Kyungnam University, Seoul, 26 January 2005.

<sup>150</sup> Organisation for Economic Cooperation and Development (OECD), "Dynamics of Development in China", Paris, 1998.



## B. CAPITAL DECLINE

With a collapsed economy, high military spending, dependence on imported food and energy, and a rock-bottom credit rating that bars it from international borrowing, North Korea's government faces major fiscal challenges. This cash-flow crisis compounds the difficulties faced by reformers.<sup>151</sup>

**Enterprise failure and unemployment.** Investing in state-owned enterprises to increase employment and living standards during the first fifteen years of reform guaranteed the Chinese state a certain level of income and postponed many of the harder, socially destabilising and unpopular changes until the economy was larger and policymakers more experienced.<sup>152</sup> North Korea's government has had no choice but to impose hard budget constraints on enterprises since at least the mid-1990s.<sup>153</sup> By late 2004, the WFP estimated that at least 30 per cent of the working age population was either under-employed or unemployed and that while some continued to receive salaries, these had often been reduced to below subsistence levels.<sup>154</sup> This means growing social instability and unpredictability -- a worst case scenario for nervous bureaucrats.

**The poverty trap.** Economists believe that steady deterioration in capital stock since at least the 1980s, exacerbated by the collapse of Soviet assistance in the 1990s, is the main reason for North Korea's economic decline, and that its economic situation fits the definition of a "poverty trap".<sup>155</sup> The economy has grown since 1999 primarily as a result of assistance from China and South Korea. It does not have large enough production capacity to satisfy domestic demand on its own or to compensate for capital depreciation.<sup>156</sup> A lack of statistics precludes specific knowledge of the extent of industrial degeneration but recent visitors report seeing closed

factories throughout the country.<sup>157</sup> It is believed that a large portion of the infrastructure was stripped and sold for hard currency during the famine.<sup>158</sup>

North Korea's energy capabilities are severely constrained, with major deficiencies in fuel, power plants, transmission and distribution, and end-use efficiency. In 2000, according to in-country assessments by U.S. energy experts, only 62 of more than 500 electricity generating facilities were functioning, and many coal mines were unworkable due to flooding and the breakdown of machinery.<sup>159</sup> In 2002 it was believed that coal production was less than 50 per cent of capacity due to degeneration, breakdowns and inefficient use.<sup>160</sup> During the winter of 2004/2005, according to Russian reports from Pyongyang, energy supply and fuel shortage problems were comparable to those at the height of the energy crisis in the early 1990s.<sup>161</sup>

North Korea has a large and operational rail system, but rolling stock is run down, the trains and stations use outdated control and communications equipment, and lines need to be revamped to allow for increased freight movement.<sup>162</sup> Road transport has been given relatively little priority, and in most outlying areas there are few paved roads or bridges.<sup>163</sup> North Korea has also invested relatively little in the eight sea ports suitable for freight shipment, relying on overland routes with China instead.<sup>164</sup> Since 2002, it has carried out basic research and discussions on connecting the Trans-Korean Railway

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<sup>151</sup> Kim Young-yoon and Choi Soo-young, "North Korean Economic Reform Trends" (in Korean) *Korea Institute for National Unification*, March 2005, pp. 39-43.

<sup>152</sup> Barry Naughton, "China's Emergence and Prospects as a Trading Nation", *Brookings Papers on Economic Activity*, No. 2, 1997, Washington DC.

<sup>153</sup> Park Sun-seong, "North Korean Economy Since the 2002 Reforms" (in Korean), *North Korean Economic Forum*, Article 361, <http://www.nkef.re.kr>.

<sup>154</sup> "WFP/FAO Crop and Food Supply Assessment Mission to the DPRK", op. cit.

<sup>155</sup> The poverty trap occurs when the supply of domestic and foreign savings is so low that the depreciation of physical stock is not being replaced. Robert Barro and Xavier Sala-i-Martin, *Economic Growth* (New York, 1995).

<sup>156</sup> Bradley O. Babson and Yoon Deok Ryong, "How to Finance North Korea's Capital Requirements for Economic Recovery", *East Asian Review*, Vol. 16, No. 2, Summer 2004.

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<sup>157</sup> Crisis Group interviews, Russian, South Korean, Chinese, Japanese and European government, academic, NGO and private sector representatives with recent experience in North Korea, October-December 2004.

<sup>158</sup> Von Hippel, Savage, and Hayes, "The DPRK Energy Sector", op. cit.

<sup>159</sup> David F. von Hippel and Peter Hayes, "North Korean Energy Sector: Current Status and Scenarios for 2000 and 2005", <http://www.nautilus.org>.

<sup>160</sup> "EC-DPRK Country Strategy Paper 2001-2004", p. 11.

<sup>161</sup> Itar-Tass (in Russian), Pyongyang, 14 January 2005.

<sup>162</sup> Jae-Hok Oh, "Strategies for Developing Transport Infrastructure in North Korea", Chang-Ho Yoon and Lawrence J. Lau (eds.), *North Korea in Transition* (Cheltenham, 2001), p. 219.

<sup>163</sup> Observations by former World Food Program North Korea Program Adviser Hazel Smith, in Hazel Smith, "Threat or Opportunity?", *The World Today*, Vol. 58, Issue 1, January 2002, p. 21.

<sup>164</sup> Crisis Group interview, Korea Development Institute, Seoul, October 2004. South Korean researchers estimate the cost of shipping a container from Nampo in North Korea to Incheon in South Korea exceeds that of sending the same container from Incheon to Los Angeles in the U.S. or Hamburg in Germany.

with the Trans-Siberian Railway<sup>165</sup> but though the talk has been promising, little actual progress has been made.

### C. INTERNATIONAL ENVIRONMENT

Even if the North Korean leadership can fully embrace reform and select the right policies, the reform process will fail without a conducive international environment. The two countries most important for access to international assistance and financing, the U.S. and Japan, have also been the most vigorous in confronting North Korea's nuclear activities.

Most of the educational and financial benefits of more normal relations with the West were lost in October 2002, when the U.S. informed North Korea that it had discovered its covert uranium enrichment program. In January 2003, North Korea became the first country to renounce its adherence to the Nuclear Non-Proliferation Treaty (NPT). States including Australia and the UK, and the EU immediately suspended plans for training and assistance programs, including a four-year development assistance package ready for implementation by the EU.

As well as the nuclear crisis, tension with Japan over the abductees issue is further complicating North Korea's access to economic assistance. Kim Jong-il's confession in 2002 that North Korea had kidnapped thirteen Japanese in the 1970s and 1980s was intended to pave the way to normalization and financial support for the economic reforms being undertaken, but instead opened a Pandora's Box that many analysts think the country is incapable of closing. Japanese popular opinion has swung against North Korea, and opinion has also hardened among Japanese politicians.<sup>166</sup> Resolving this issue as well as the nuclear crisis is central to securing the estimated \$8 billion to \$10 billion in reparations Japan is expected to pay Pyongyang for its colonisation of the northern half of Korea.

### D. THE KNOWLEDGE DIVIDE

In many other transition economies, previous positive experiences of capitalism still in the collective memory have been important catalysts for change.<sup>167</sup> North

Korea's colonisation by Japan, followed by 60 years of Stalinist command economics and communist orthodoxy, has not prepared either bureaucrats or citizens for adapting to a market economy. According to aid agency officials, some North Korean officials already openly long for a return to the international barter system and command economy.<sup>168</sup>

**Capitalism and market economics.** Among middle and senior level officials, knowledge of the theoretical and technical details of market economics, the functioning and operation of the international economy, and the roles of basic government institutions, is minimal or, in many cases, nonexistent.<sup>169</sup> Even senior policy makers permitted to travel to South Korea and known to be involved in authoring or orchestrating the reforms have been found to lack basic knowledge of a market economy.<sup>170</sup> Ahn Choong-yong, president of the Korea Institute for International Economic Policy, described discussions with high-ranking North Korea officials during a 2001 visit to Pyongyang:

They were interested in capitalism rather than displaying hostility. However, they were sceptical about capitalism's proficiency, confident that there would be disequilibrium if the economy were left to market mechanisms. They accepted that socialism has its weaknesses but were sure that capitalism would be more flawed.<sup>171</sup>

**Investment promotion.** The United Nations Transnational Corporations and Management Division (UNCTM) conducted missions to North Korea in the early 1990s, and identified the absence of clear regulations and procedures for foreign exchange transactions, labour-management relations, import-export operations, banking and financial arrangements and approval and monitoring mechanisms of joint ventures as the main regulatory obstacles to development. It also noted insufficient skills in the government and state enterprises to identify suitable investment projects, prepare and evaluate feasibility studies, and negotiate with foreign enterprises.<sup>172</sup>

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<sup>165</sup> "Russia, North Korea develop plan for railroad link" (in Korean), *Joongang Ilbo*, 10 October 2004.

<sup>166</sup> Japan-North Korea relations will be the subject of future Crisis Group reporting.

<sup>167</sup> In China in the late 1970s, for example, frequent reference was made to the "golden age", pre-1956, when a vigorous and dynamic private sector coexisted alongside state ownership.

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Chris Bramall, *Sources of Chinese Economic Growth, 1978-1996* (Oxford, 2000), p. 41.

<sup>168</sup> Crisis Group interview, UN official, 10 March 2005.

<sup>169</sup> Crisis Group interviews, Beijing/Seoul, October/November 2004.

<sup>170</sup> Crisis Group interview, Korea Development Institute researcher, Seoul, October 2004.

<sup>171</sup> Jae Bong Ro and Choong Yong Ahn, "North Korea's Tasks for Economic Reconstruction" in Choong Yong Ahn (ed.), *North Korea Development Report, 2002/03* (Seoul, August 2003), p. 535.

<sup>172</sup> Frederick Nixson and Paul Collins, "Economic reform in North Korea", Hazel Smith, Chris Rhodes, Diana Pritchard,

The regulatory environment has not improved. Seoul-based business consultant Tony Michell noted in a speech delivered in Pyongyang in September 2004: "High transaction costs due to poor understanding of investors' needs are a greater impediment to growth and investment than the lack of a strong economic framework".<sup>173</sup> Surveys of South Korean investors in 2001 found that in every investment, ignorance or unwillingness by North Korean officials and joint venture partners to follow accepted international trade practices, or to understand market forces, negatively affected the projects.<sup>174</sup>

**Resource allocation and management.** Needs assessments conducted by United Nations Development Program (UNDP) missions in the late 1980s found that poor management techniques and systems in strategic North Korean enterprises were obstructing growth. The surveys identified poor management control over production activity, lack of strategic planning, and inefficient use of existing production capacities, investments, personnel and materials as the most important factors.<sup>175</sup> An EU survey in 2001 likewise concluded that many of North Korea's power and transportation problems relate to institutional and technical failures as much as infrastructure problems. It estimated that training in modern network management could potentially save 25 to 30 per cent of energy now being wasted.<sup>176</sup>

## E. CRONY CAPITALISM

At the macro level, the government tends to treat trade more as a tribute to the success of its political manoeuvring than as a mutually beneficial economic transaction. In the long run, North Korea will need to adhere to international business standards if it wants to attract capital from foreigners who are more motivated by profit than politics.

Endemic corruption in virtually every area of the economy is equally pernicious. Increased market activities since the famine have allowed party and security officials to use rank and social position for preferential access and rent seeking.<sup>177</sup> Hazel Smith, Professor of International Relations at Warwick University and former WFP Coordinator for North Korea, believes the estimated 150,000 state security service operatives use their education, knowledge of how the state operates, and privileged access to contacts and transportation to benefit from illegal operations, including smuggling, customs evasion, and assistance to those illegally entering China.<sup>178</sup>

Residents in Pyongyang say a web of informal contacts and corruption is already deeply ingrained in the new system. One diplomat, unwilling to use the word "reform" in the context of North Korea, said: "The measures are simply designed to allow the elites to take their cut from the markets that they are now officially allowing. The regime is building itself a web of patronage. Crony capitalism is rampant".<sup>179</sup>

Even Chinese who do business in North Korea express frustration at having to deal with government officials instead of business partners and being constantly shaken down for gifts and kickbacks.<sup>180</sup> Likewise, NGOs and emergency aid organisations are expected to go through a lengthy process of "confidence building" involving expensive gifts. One humanitarian worker noted: "There is no distinction between hard-liners and soft-liners. Just those that take bribes and those that don't".<sup>181</sup>

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and Kevin Magill, *North Korea in the New World Order* (London, 1996), p. 165.

<sup>173</sup> Presentation by Tony Michell, Managing Director, Euro-Asia Business Consultancy, at "Workshop on Economic Reform and the Development of Economic Relations Between the EU and the DPRK", Pyongyang, 2 September 2004. <http://www.delkor.cec.eu.int>.

<sup>174</sup> For a summary of the findings of two research projects on investor experiences in North Korea, see Tait, "Playing by the rules in Korea", op. cit.

<sup>175</sup> Nixon and Collins, "Economic reform in North Korea", op. cit., p. 159.

<sup>176</sup> "EC-DPRK Country Strategy Paper 2001-2004," op. cit., p. 22.

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<sup>177</sup> Rebecca MacKinnon, "Interview with Hazel Smith: A view from inside", 5 February 2004, <http://nkzone.typepad.org>.

<sup>178</sup> Hazel Smith, "Brownback bill will not solve North Korea's problems", <http://www.janes.com>, 21 January 2004.

<sup>179</sup> Crisis Group interview, European diplomat based in Pyongyang, Seoul, March 2005.

<sup>180</sup> "PRC Businessmen Cite Corruption as Major Obstacle to DPRK Investment", FBIS translated text, 4 February 2005.

<sup>181</sup> Crisis Group interview, Washington DC, 2003.

#### IV. POLICY RESPONSES: COERCION OR COOPERATION?

Much of the value of international engagement depends on North Korea's leadership being willing to entertain new ideas and endorse deeper systemic change, rather than to abuse assistance for rent-seeking and regime enrichment, as has too often been the case. It is readily apparent from its interactions with aid agencies,<sup>182</sup> South Korea, and private sector investors that the regime's strategy is still to seek external resources while resisting economic reform or openness. Provocative behaviour over its nuclear weapons programs makes it harder still for even sympathetic donors to respond with emergency assistance programs, let alone the development assistance North Korea needs.<sup>183</sup>

It is widely recognised that even if there are changes in the regime's attitude, there cannot be sustainable development without a commitment to improving human rights and to growing democratic, market-oriented institutions.<sup>184</sup> The U.S. and EU have taken strong positions on North Korea's human rights record.<sup>185</sup> Washington has sought to broaden the six-party nuclear talks to include human rights and humanitarian concerns and to push for democratic change, thereby undermining

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<sup>182</sup> North Korea has further aggravated the situation for aid agencies since September 2004, underscoring its demand for a transition from emergency food aid to technical assistance programs by restricting the monitoring of emergency relief, refusing to reissue visas to some NGO staff, and restricting the movement of others.

<sup>183</sup> On 10 February 2005, North Korea announced for the first time that it has nuclear weapons. Its most explicit previous reference was to a "nuclear weapons program". It also suspended indefinitely its participation in the six-party talks intended to resolve the crisis.

<sup>184</sup> Amartya Sen, *Development as Freedom*, (Arrow, 2000) is the best known example. Dani Rodrik, "TFPG Controversies, Institutions and Economic Performance in East Asia", National Bureau of Economic Research Working Paper No. 5914, Cambridge, Massachusetts, 1997, shows that an index of institutional quality performs extremely well in explaining growth differentials across East Asian countries. Robert E. Hall and Charles I. Jones, "Why Do Some Countries Produce So Much More Output Per Worker Than Others?", *Quarterly Journal of Economics*, Vol. 114, February 1999, pp. 83-116 presents findings of a 133-country study, concluding that institutions favouring production and private ownership will foster the accumulation of human and physical capital, eventually increasing total productivity and expanding domestic output.

<sup>185</sup> "The North Korean Freedom Act" was presented to the U.S. Senate by Senator Sam Brownback in November 2003, and the slightly softer North Korean Human Rights Act was signed by President Bush in October 2004.

the regime, by making it easier for North Koreans to gain asylum in the U.S., supporting organisations promoting human rights in North Korea, and promoting freedom of information by smuggling radios into the country.<sup>186</sup>

Despite the problems of engagement, doing nothing to reverse North Korea's steady economic decline is unlikely to be acceptable to some of the governments in the region, especially China and South Korea. As North Korea's trade figures show, economic engagement with the regime has been growing even while the nuclear crisis has worsened.

Given the already tenuous and complex nature of the nuclear talks, the regime's almost total monopoly on foreign interaction with its citizens, and the complete absence of civil or political society inside the country, options for responding meaningfully to North Korea's economic transition are essentially limited to coercion, engagement, or muddling through. Even though it is the most likely policy course for the foreseeable future, muddling through would neither resolve the nuclear threat nor improve the economy. Sanctions would make economic matters worse. Meaningful engagement involving serious transfer of resources will not and should not happen while the nuclear crisis is acute but some preliminary steps could make Pyongyang more aware of what it needs, what it has to gain from striking a nuclear deal and what it will lose if it does not do so.

#### A. SANCTIONS?

Given the weakness of the North Korean economy, it is tempting to believe faster and more satisfactory change could be achieved through sanctions. Since at least 1991, imposing a blockade on all North Korea's interactions with the outside world has been advocated, especially by some circles in Washington (though not successive administrations), with the stated goal of promoting not so much a change in North Korea's behaviour as a complete "regime collapse".<sup>187</sup> This would mean restricting economic aid, business, energy, and exports, to break the regime's contentment with the status quo, ultimately leading to the installation of a new leadership, either by military coup, popular uprising, or capitulation.<sup>188</sup>

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<sup>186</sup> H.R. 4011, "The North Korean Human Rights Act".

<sup>187</sup> American Enterprise Institute (AEI) researcher Nicholas Eberstadt is the most prolific advocate of collapse. His work on the subject includes, "The Coming Collapse of North Korea", *Wall Street Journal*, 26 June 1990, and *The End of North Korea* (Washington DC, 1999).

<sup>188</sup> Nicholas Eberstadt, "The Persistence of North Korea", *AEI Policy Review*, 7 October 2004. For a detailed interview with Eberstadt, see "Korea Expert Says Seoul Must End

It is unlikely that sanctions could achieve the goals of nuclear disarmament and systemic change simultaneously. Sanctions tend to be effective only when their goals are relatively modest.<sup>189</sup> In setting goals for North Korean behaviour, the overriding security and proliferation threat posed by its nuclear programs means resolving that crisis should take precedence over achieving systemic change, even if trading the weapons for economic resources to ensure longer survival of the current leadership has to be part of the deal -- as it likely would.<sup>190</sup> If sanctions are to be used, therefore, their immediate goal should continue to be North Korea's denuclearisation.

Even without the added complexity of the nuclear crisis, the structure of North Korea's economy presents unusual challenges to a sanctions regime.<sup>191</sup> As Crisis Group reporting on Myanmar shows, when the costs of the sanctions do not outweigh the costs the country expects to incur from complying with the demands, change in the status quo is unlikely.<sup>192</sup> Largely by its own choosing, North Korea is still among the most closed economies in the world. Although its high dependence on foreign fuel and food means there is greater opportunity for leverage than its low aggregate trade figures suggest, cutting these supplies would impact catastrophically on industry, agriculture, the population, and the nascent market economy, but probably do very little to unsettle the leadership. This was demonstrated by the famine in the mid-1990s.

North Korea's trade figures show it would be impossible to craft a meaningful sanctions policy without the full cooperation of South Korea and China, both to curtail their aid and trade and to help blockade drugs and weapons transfers. Unilateral sanctions imposed by the U.S. would have a negligible economic impact, and minimal effectiveness.<sup>193</sup> This also highlights another

obstacle that often limits the effectiveness of sanctions: the prospective cost on the sanctioner.<sup>194</sup> Both China and South Korea favour a more open and free North Korea but shy away from any policy with the explicit or implicit goal of North Korean collapse. They fear sudden change would at best result in a large and highly destabilising outflow of economic migrants, at worst put a heavily armed failed state on their doorsteps.<sup>195</sup> In South Korea especially, there are certainly divergent views about the extent to which cooperation should be pursued with the North, and large parts of South Korean society retain considerable fear and scepticism about the North's motives. However, there is bipartisan consensus that collapse and rapid reintegration is a worst-case scenario to be avoided at all costs.<sup>196</sup>

Japan does not offer a much more realistic avenue for pressure. As already noted, it is the only country with which North Korea has a trade surplus so the relationship is an important source of hard currency for Pyongyang. Japan could also obstruct remittances of money and technology to North Korea by the *Chosen Soren*, the organisation of ethnic Koreans supporting the North in Japan.<sup>197</sup> However, North Korea has already shown itself capable of circumventing unilateral Japanese sanctions by shipping via Hong Kong, Macao and Bangkok, using foreign-registered ships, and remitting money unofficially

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'Masquerade' of Bilateral Relations", *Chosun Ilbo*, 13 December 2004. <http://english.chosun.com/w21data/html/news/200412/200412130026.html>.

<sup>189</sup> Gary Clyde Hufbauer et al, *Economic Sanctions Reconsidered* (Washington DC, 1998), and Kimberley Ann Elliott, "Economic Leverage and the North Korean Nuclear Crisis", *International Economics Policy Briefs*, No. PB03-3, Institute for International Economics, April 2003.

<sup>190</sup> Crisis Group Report, *North Korea: Where Next for the Nuclear Talks?*, op. cit.

<sup>191</sup> The appropriate use of sanctions on North Korea will be the subject of a future Crisis Group report.

<sup>192</sup> Crisis Group Asia Report N°78, *Myanmar: Sanctions, Engagement or Another Way Forward?*, Yangon/Brussels, 26 April 2004.

<sup>193</sup> This assertion is born out by statistical evidence from detailed studies of sanctions regimes, which finds that sanctions episodes that had the most profound economic impact were the ones most likely to achieve their goals. Meghan L. O'Sullivan,

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*Shrewd Sanctions: Statecraft and State Sponsors of Terrorism*, (Brookings: Washington DC, 2003), p. 27.

<sup>194</sup> Elliott, "Economic Leverage and the North Korean Nuclear Crisis", op. cit.

<sup>195</sup> Recognising the threat North Korean collapse poses to the economic development of South Korea -- the tenth largest economy in the world -- ratings agencies take North Korea's perceived economic stability into account when calculating South Korea's credit ranking. In November 2003 Standard & Poor's downgraded South Korea's long-term foreign currency debt to an A minus rating -- the same grade then as Hungary, Malaysia and Israel -- in anticipation of high reunification costs. "S & P Warns of N. Korea Failure", <http://www.cnn.com> 3 November 2003.

<sup>196</sup> Crisis Group Briefing, *Korea Backgrounder*, op. cit. Some Washington observers believe, however, that should the nuclear crisis become more acute in coming months and the U.S. place pressure on it, South Korea would in the end support sanctions with the expressly limited objective of producing nuclear concessions, not regime collapse, lest it put the U.S. security guarantee at risk.

<sup>197</sup> In April 2002 the Japanese government pressured one of the few banks through which remittances were possible, the Ashikaga Bank, to suspend remittances to North Korea. In April 2003 it implemented strict surveillance of cargo transport to North Korea from Japan. Bertil Linter, "Tokyo Begins to Apply Pressure to the North Koreans in Japan", *Wall Street Journal*, 25 March 2003.

or in cash.<sup>198</sup> A case in point involves the passage in March 2005 of the Compensation for Sea Pollution Law, prohibiting ships over 100 tons without sea pollution insurance from calling at Japanese ports. Although not explicitly a sanction, North Korea's \$72 million trade in marine products with Japan will likely be hardest hit, since over 95 per cent of the North Korean fleet is now banned from calling at Japanese ports.<sup>199</sup> However, China had already increased its imports of North Korean marine products by \$77 million between 2002 and 2003,<sup>200</sup> more than what Pyongyang is likely to lose in exports to Japan.

Even making the unlikely assumption that cohesive regional support for sanctions could be mustered, it is hard to see the virtue of strangling the incipient market activity taking place in North Korea. The only justification would be as an escalation of pressure on the North, still short of the use of force, to give up its nuclear weapons programs.

## B. FACILITATING REFORM

While direct technical and especially financial assistance is impossible without resolution of the nuclear standoff and a deeper commitment to reform by the regime, there are important opportunities to provide assistance that would do little to support the regime now but would help considerably in strengthening the nascent market mechanism. The growth of the private sector and the legitimacy afforded to it since 2002 mean for the first time there are opportunities to direct support to individuals and groups outside the elite, including to pro-reform constituencies.

### 1. Build a vanguard for change

While the decision for deeper reform will have to come from Kim Jong-il himself, and North Korea experts see little political space for a bottom-up reform much less a popular revolution,<sup>201</sup> experience in other potential transition countries shows that building pro-change constituencies contributes directly to the speed and

success of reforms when the decision for change is eventually made.<sup>202</sup>

Since 2002, North Korean bureaucrats and officials have been authorised to seek and accept training from abroad in some economic-related subjects. This is an important difference. Previously, the regime encouraged foreign financial and technical engagement only in areas expected to enhance its legitimacy and the stabilisation of the ruling system. Social sciences training (including finance and business management) was permitted only in politically friendly countries.<sup>203</sup> As a Western diplomat noted:

The approach before was that Kim Il-sung had created the perfect society, and change was politically suspect. You could not talk about change with North Koreans because they were not allowed to be interested in change. Also there was nothing that could be taught to North Koreans as they knew it all already and had the perfect system. By mid-2002, suddenly everyone was talking about change, and it was quite acceptable to learn from other countries.<sup>204</sup>

Anecdotal evidence from regular visitors to and residents of Pyongyang suggests that many exchange candidates return as firm advocates for deeper systemic change.<sup>205</sup> Among groups that have studied, travelled or conducted business in China and Russia, have had access to foreign media, or live close to the Chinese border, knowledge and appreciation of alternative systems and the world and news outside North Korea is growing.<sup>206</sup>

Significant programs and exchanges successfully run by non-governmental and academic organisations, mostly without government funding, include:

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<sup>198</sup> "North Korean Companies and Commercial Activities in Southeast Asia", presentation in Tokyo by Bertil Lintner, Jane's Consultancy Senior Analyst, October 2003.

<sup>199</sup> All but seventeen North Korean cargo ships -- 2 per cent of its fleet -- fail to meet this requirement. According to the Japanese land, infrastructure and transport ministry, only 29 North Korean ships made port calls in Japan in March 2005, down from 115 in March 2004. Kanako Takahara, "Veiled North Korea sanction takes toll on port calls", *Japan Times*, 6 April 2005.

<sup>200</sup> Data from KOTRA, op. cit.

<sup>201</sup> John Feffer, "The Forgotten Lessons of Helsinki", *World Policy Journal*, Fall 2004.

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<sup>202</sup> Many of the thousands of Soviet cultural, academic and scientific exchange candidates during the Cold War played critical behind-the-scenes roles in advocating for and supporting change, and filled key positions after the Soviet Union dissolved. Yale Richmond, *Cultural Exchange and the Cold War: Raising the Iron Curtain* (Penn State Press, 2003). China's Deng Xiaoping spent the early 1920s -- his formative years -- in France.

<sup>203</sup> Kyung-Ae Park, "North Korea's Non-Governmental Foreign Contacts", *The Korean Journal of Defence Analysis*, Vol. XII, No. 2, Winter 2000.

<sup>204</sup> Crisis Group interview, diplomat, Seoul, November 2004.

<sup>205</sup> Crisis Group interviews, cooperation program organisers, diplomats, NGO staff and academics, Seoul and Beijing, October 2004-March 2005.

<sup>206</sup> Crisis Group interview, South Korean businessperson, Seoul, December 2004.

### NGO Programs

- ❑ The California-based and Congressionally-funded Asia Foundation held training seminars for around 50 North Koreans in Beijing and Shanghai between 1999 and 2002 and has expressed a willingness to do more.<sup>207</sup>
- ❑ The California-based Nautilus Institute hosted delegations of North Korean energy specialists for conferences and training courses in the U.S. and China between 1997 and 2001.<sup>208</sup>
- ❑ The German Friedrich Naumann Foundation ran a five-day workshop on economic reform in cooperation with the EU in July 2004. It was attended by a delegation of European economists who had worked in transition economies in Europe and Asia, business representatives already active in North Korea, European diplomats, and over 70 North Korean officials from a range of ministries and institutions handling economic affairs. The foundation has also run smaller, short training courses in accountancy and banking.<sup>209</sup>
- ❑ The Centre for Applied Studies in International Negotiations (CASIN) in Geneva hosted fourteen mid-career and senior diplomats from the ministry of foreign affairs, the ministry of procurement, the ministry of foreign trade, and the ministry of light industry in 2004, a much wider range of participants than in the seven previous years.<sup>210</sup> CASIN included for the first time training in commercial diplomacy, the UN, the principles of market economics, international trade and sustainable development, bilateral and multilateral trading systems and regional trade agreements, and conditions attached to development assistance from international financial institutions.<sup>211</sup>

### Academic Exchanges

- ❑ North Koreans have studied short courses and degree programs at the University of Essex, the University of Warwick, the University of Sydney,

and the Australian National University, as well as at other Western institutions, in subjects ranging from human rights to MBA programs.

- ❑ Since 2002, the German Academic Exchange Service (DAAD) has sponsored exchanges between German universities and several institutions in Pyongyang.<sup>212</sup>
- ❑ North Korean bureaucrats and academics have been trained in the principles of economics in Pyongyang, Hanoi and Stockholm by Stockholm School of Economics scholars and transition economics experts.<sup>213</sup>
- ❑ In 2003 an exchange program with Kim Il-sung University was launched by the Far Eastern National University (Vladivostok), which includes both North and South Korean students.<sup>214</sup>
- ❑ Syracuse University in the U.S. and Kim Chaek University of Technology in Pyongyang are engaged in joint research, and North Korean students are studying in New York. The project is funded by the Henry Luce Foundation and the Ford Foundation.<sup>215</sup>

North Korea's receptivity to training programs is not always positive, despite its more open attitude. Some institutions offering training have found their North Korean counterparts unwilling to provide enough commitment or transparency, and naive about the opportunities available. English language education is still the most requested program.<sup>216</sup> North Korea has funded students to follow architecture courses in Italy but is still reluctant to sponsor economics-related programs.<sup>217</sup> Even when programs are successfully arranged, North Koreans travelling abroad are required to be accompanied at all times by a minder and to be housed apart from other students. Attendance at programs ranges from perfect, to not at all, and "disappearances" of students recalled to Pyongyang and never heard

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<sup>207</sup> Asia Foundation President Doug Bereuter says the Foundation is prepared to restart training if it is invited by North Korea." Continue Supporting Training Programs for North Korean Scholars in the U.S." (in Korean), *Joongang Ilbo*, 29 March 2005.

<sup>208</sup> <http://www.nautilus.org>.

<sup>209</sup> Crisis Group interview, Ulrich Niemann, Friedrich Naumann Foundation, Seoul, 15 October 2004.

<sup>210</sup> Crisis Group interview, Jung Seung-ho, Korea Development Institute Knowledge Cooperation Program, Seoul, 7 December 2004.

<sup>211</sup> Centre for Applied Studies in International Negotiations, <http://www.casin.ch/news/cds/presentationdprk04.html>.

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<sup>212</sup> Richard Stone, "A Wary Pas de Deux", *Science*, Vol. 315, 17 September 2004, p. 1,703.

<sup>213</sup> Crisis Group interviews, Swedish diplomats and Stockholm School of Economics officials, Beijing/Seoul, October/November, 2004.

<sup>214</sup> Stone, "A Wary Pas de Deux", op. cit.

<sup>215</sup> "The KUT/SU Research Collaboration Project Status Report: July 2004", <http://www.nautilus.org/DPRKBriefingBook/economy/30-KoreaSociety.html>.

<sup>216</sup> "Report on a visit to the Democratic People's Republic of Korea", part of the University of Cambridge East Asia Institute's constructing confidence project on economic and academic engagement with the DPRK, 22-29 May 2004.

<sup>217</sup> Crisis Group interview, European academic, Seoul, 26 January 2005.

from again are not uncommon.<sup>218</sup> Despite the obstacles, this is an important avenue into the heart of North Korean decision making, and it should not be overlooked.

## 2. Support the market economy

Building the market system adds momentum for deeper reform. A Hanoi-based economist noted of the early stages of Vietnamese transition: "The key later was opening up to get the market access and technology, the big things that had a big impact. But a lot can also be achieved just by making it easier for the household enterprise sector to work properly".<sup>219</sup> North Korea achieved much higher centralisation and authoritarianism than Vietnam and has a much smaller agricultural sector. However, the two share large workforces prepared to work for subsistence wages in low-skilled industries and pre-reform outputs far below their productive potentials.

Foreign investment in North Korea is also important for diminishing the government's ability to restrict the flow of news and information, expanding interactions with foreigners, and highlighting the shortfalls of the current system. The clearest example of this corrosion is the introduction of mobile phones by Chinese traders, which they use in the absence of reliable landline communications to conduct business. As many as 20,000 North Koreans -- including the officials supposed to be keeping them out -- are believed to have access now to these phones.<sup>220</sup> In 2003, Chinese cell phone companies began building relay-stations along the North Korean border, meaning penetration now extends deep inside the country, and unregulated, unmonitored calls are frequently made to Japan, China, and South Korea.<sup>221</sup>

Supporting the economy does not necessarily mean delivering ready-made enterprises to run vocational training schemes, as several South Korean charities and companies have already done. If investment seemingly arrives from the sky, it risks creating a "cargo cult" mentality -- a lack of appreciation for how goods and value are actually made. A more practical short-term contribution could be made by concentrating on resolving the major infrastructure obstacles to industrial output: energy and transport. Examples of low-cost infrastructure

improvements that would improve operating conditions and output fast include:

- Refurbishment. North Korean power plants were mostly built in the 1950s and 1960s and are reaching the end of their natural life cycle. The problems of aging facilities are exacerbated by the use of low-quality fuels and the lack of spare parts to replace broken equipment. New power plants, both thermal and hydroelectric, are desperately needed. Additionally, North Korea's power distribution system has suffered from decades of neglect and, scavenging for spare parts and will need to be rebuilt almost in its entirety, from transmission lines to relay stations.
- Efficiency. Electricity has traditionally been provided by the state free of charge. Installing metering equipment and requiring customers to pay for energy used would go a long way toward discouraging waste. Other low cost efficiency measures include better insulation and providing modern, more efficient end-use equipment.<sup>222</sup>
- Renewables. North Korea has significant potential for renewable energy, including hydro, wind, thermal, and tidal energy. Other than hydropower, very little of this potential is utilised. Renewable energy sources also have the advantage of being difficult to divert to military uses.<sup>223</sup>
- Training. As already noted, an EU survey in 2001 estimated that training in modern energy and transport network management could potentially yield a 25 to 30 per cent efficiency savings.<sup>224</sup>

## 3. Begin comprehensive needs assessments

In other countries where commitment to reform was weak, support for change and for foreign assistance has been built by focusing on developing domestic capacity to undertake substantive analysis of the economy and institutional constraints on growth.<sup>225</sup> In Vietnam this approach meant that by the time international inputs into capacity building were politically possible, officials had

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<sup>218</sup> Crisis Group interview, Christopher Hughes, University of Warwick, Coventry, 21 December 2005.

<sup>219</sup> Crisis Group interview, IFI consultant, Hanoi, 16 March 2005.

<sup>220</sup> Rebecca MacKinnon, "Chinese Cell Phone Breaches North Korean Hermit Kingdom", *YaleGlobal Online*, 17 January 2005, <http://yaleglobal.yale.edu>.

<sup>221</sup> Donald Kirk, "New Agent of Change in N. Korea: cell phones", *Christian Science Monitor*, 15 December 2004.

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<sup>222</sup> David von Hippel et al., "Modernising the Agreed Framework", Nautilus Institute, 16 February 2001, <http://nautilus.org/archives/papers/energy/ModernizingAF.PDF>.

<sup>223</sup> David Von Hippel and Peter Hayes, "North Korea and Renewable Energy", *Science*, Vol. 307, 14 January 2005, p. 207.

<sup>224</sup> See Section III D and fn. 173 above.

<sup>225</sup> Raymond Mallon, "Managing Investment Climate Reforms: Viet Nam Case Study", draft case study prepared as input for the World Bank's World Development Report 2005 on Investment Climate, Growth and Poverty, 17 January 2005.



in many cases already achieved a good appreciation of their needs and of which institution would be best able to provide assistance.<sup>226</sup>

North Korea's long-term need is for a comprehensive economic assessment, to be completed collaboratively with international financial institutions.<sup>227</sup> To prepare for that, it should conduct detailed surveys at the national, sectoral and household levels. These would be of significant value in helping the regime understand the condition of the economy and investment priorities.

The experience of humanitarian agencies in North Korea since 1995 indicates the problems of dealing with a government that has "viewed all data through a national security prism, which considered that even basic micro socio-economic statistics could be useful to its adversaries".<sup>228</sup> The humanitarian experience also shows that improved working relationships can be achieved through long-term, patient engagement.<sup>229</sup> Since 2002 the WFP, FAO and the United Nations Children's Fund (UNESCO) have gained unprecedented access for household surveys. As early as 1997, UNDP was able to work with the North Korean authorities to gather basic macro-economic data that could be presented to the International Monetary Fund (IMF).

## V. PREPARING FOR THE FUTURE

Despite the obstacles, there are compelling reasons for the main UN agencies, international financial institutions, and bilateral donors to start preparing now for the tasks ahead. The extent of North Korea's institutional weakness and its officials' poor appreciation of international standards mean even the most basic assistance will go a long way to making future cooperation easier. Recent development agency visitors report that their interlocutors had very little understanding of the processes involved in transition and development, suggesting considerable familiarisation will be required before on-the-ground assistance is possible.<sup>230</sup> Insecure North Korean elites are very unlikely to make decisions about deeper systemic change without assurance of meaningful support afterwards. Demonstrating that the international community is serious about supporting a long-term transition once the nuclear issue is settled, will be an important step to achieving progress.

### A. UNITED NATIONS

There are important parallels between the role played by the UN in Vietnam and its potential role in North Korea. Since 1986, Vietnam has made the institutional transition from a centrally planned to a market economy, while remaining a one-party, communist state. Like North Korea, it was initially dependent on "learning by doing" and incremental change rather than following a long-term structured program, and it was also barred from wider interaction with the international financial institutions by U.S. sanctions. Between 1975 and 1993 the UN, through UNDP, was the main source of technical assistance, training, and capacity building for the Vietnamese government.

Until 1990, UNDP in Vietnam concentrated on economic rehabilitation. In that year it embarked on a "Strengthening Economic Management" project, to support economic reform by familiarising senior policy makers with the functioning of a market economy. This was followed by projects on education sector review, gender, public administration reform, and industrial strategy.<sup>231</sup> UNDP, with the Vietnamese government, produced 28 economy-wide and structural reports before 1993 and spent over \$700 million on training and capacity building between 1985 and 1997. These contributions

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<sup>226</sup> Crisis Group interview, IFI consultant, Hanoi, 16 March 2005.

<sup>227</sup> Bradley Babson, "The International Financial Institutions and the DPRK: Prospects and Constraints", Institute of Asian Research, University of British Columbia, 2002, p. 22.

<sup>228</sup> Hazel Smith, "Overcoming Humanitarian Dilemmas in the DPRK (North Korea)", United States Institute of Peace Special Report, Washington DC, July 2002.

<sup>229</sup> Ibid.

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<sup>230</sup> Crisis Group interview, Department for International Development (DfID) official, London, 15 December 2004.

<sup>231</sup> Gus Edgren and Dharam Ghai, "Capacity Building for Eradicating Poverty in Vietnam: An Impact Evaluation of UN System Activities in 1985-1997", UNDP, Hanoi, February 2001.

laid the groundwork for a relatively fast and successful stabilisation and transition of Vietnam's economy once wider multilateral engagement became possible in the early 1990s.<sup>232</sup>

UNDP has had a presence in North Korea since 1979. When North Korea joined the UN in 1991, it opened the door for the involvement of other agencies, including UNESCO, the United Nations Industrial Development Organisation (UNIDO) and, since 1995, WFP and FAO. In 1993 UNDP and UNIDO launched together a Management Development Program. However momentum was lost during the famine, and since that time donors have focused on emergency aid and relief work, with UNDP working mostly on agriculture projects.<sup>233</sup>

In early 2005, UNDP started negotiations with the government to implement initial stages of a \$20 million transition program. If the agency is to influence North Korea's potential for more stable transition directly, it will need to:

- build a close relationship with the government and bureaucracy. The Resident Representative should become a trusted advisor to key North Korean decision makers, and UNDP should be the "go to" organisation for technical assistance, training, and consultations. It could also be the facilitator for high-level training programs, for example visits to Pyongyang by leaders from the corporate sector and other Asian governments;<sup>234</sup>
- build capacities for preparing the documentation, surveys and planning necessary for basic sectoral programs at the ministry of finance, central planning bureau, and statistical bureau; complete a census and quality of life report for North Korea; and use in-country workshops as well as generate opportunities for overseas training. The United Nations Institute for Training and Research (UNITAR) in Hiroshima could have an important part in this process;<sup>235</sup> and

- focus assistance on how to use trade to further reform and the role of sustainable and renewable energy production.

## B. INTERNATIONAL FINANCIAL INSTITUTIONS

Direct contact between the international financial institutions (IFIs) and North Korea started in 1997 when the IMF sent a fact-finding mission to Pyongyang. This was followed in February 1998 by an introductory mission from the World Bank. Contact since then has been sporadic and informal.

In the short to medium term, the Asian Development Bank (ADB), IMF, and World Bank all have the potential to play important non-lending roles in North Korea. These include economic evaluation, policy advice, and technical assistance. IFIs also advise on specific industry issues and adoption of international standards and codes of good business practice and provide grants for technical assistance and training.<sup>236</sup>

There are legal and political obstacles to the direct development of IFI activities with North Korea. The U.S. does not support IFI efforts to help North Korea improve its economy before there has been satisfactory progress on the nuclear issue. The U.S. Treasury is precluded by domestic law from supporting any IFI actions that could assist North Korea until the country has been removed from the U.S. list of state sponsors of terrorism. The worsening nuclear crisis has meant direct IFI involvement has been relegated to the list of incentives on offer.<sup>237</sup>

These obstacles do not preclude informal discussions between IFI and North Korean officials, informal studies of North Korea's economy, and the provision of information and training on market economics.<sup>238</sup> Efforts in all these areas could be improved.

- Staffing on North Korea is inadequate at all the IFIs. At the ADB the official in charge estimates he spends ten minutes each month on the country and says he has never communicated with a North Korean.<sup>239</sup> The World Bank position covering North Korea has been vacant since 2003. Even if there is no immediate potential for collaboration, there should be greater institutional understanding

<sup>232</sup> Crisis Group interview, IFI consultant, Hanoi, 16 March 2005.

<sup>233</sup> Crisis Group interview, former UN official, 8 December 2004.

<sup>234</sup> In Vietnam in the late 1980s, UNDP successfully organised visits to Hanoi by prominent reformers from Singapore and South Korea and by the CEOs of multinational companies.

<sup>235</sup> UNITAR is a training, capacity building, and research institute that provides education in international affairs management and economic and social development through programs, seminars and workshops for participants from developing countries and countries in transition, <http://www.unitar.org/hiroshima>.

<sup>236</sup> Babson, "The International Financial Institutions and the DPRK", op. cit., p. 22.

<sup>237</sup> Crisis Group Report, *North Korea: Where Next for the Nuclear Talks?*, op. cit.

<sup>238</sup> Babson, "The International Financial Institutions and the DPRK", op. cit.

<sup>239</sup> Crisis Group interview, ADB official, 17 March 2005.

of the country and its problems and consideration of the IFIs' eventual role.

- North Korea needs to be made aware of the benefits of IFI memberships and given realistic expectations about the demands these will involve. This can be achieved by inviting North Korean officials to IFI events (although IFIs will not be able to pay) and working with UNDP to provide training on IFI policies and programs and preliminary economic surveys.
- IFIs should take the lead on discussions of international economic engagement policy, drawing in perspectives from elsewhere in the region and promoting the potential of multilateral and regional economic cooperation.<sup>240</sup>

### C. SOUTH KOREA

South Korea's direct contribution to technical assistance and capacity building in North Korea is made problematic by the political and historical dynamic of North-South relations. The most sensitive stages of transition may be better handled by the UN and IFIs. South Korea has, however, been a core source of much of the economic and political engagement that has taken place with North Korea in recent years, creating new opportunities for interaction and reducing tensions on the Peninsula. Continuing this will be essential to building an enabling environment for change. In the context of movement toward resolving the nuclear stand-off, South Korea could improve its contribution by:

- continuing to support expansion of the Kaesong SEZ, while encouraging more profit-oriented direct investment in North Korea by South Korean companies, for example, by offering incentives for investing in the North instead of China. Making a profit in North Korea is not impossible, but so long as engagement by loss-leading NGOs and South Korea's major conglomerates (the *chaebol*) provide the best-known examples of what is possible, there will be little chance of North Korean growth, or generation of wider international interest;
- emphasising transparency in financial transactions with North Korea, to support the growth of effective institutions; and
- coordinating more closely with the U.S., China, Japan and Russia on the technical assistance it could deliver as part of a schedule leading to North Korea's denuclearisation.

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<sup>240</sup> Regional cooperation with North Korea will be the subject of a future Crisis Group report.

### D. JAPAN

While two-way trade has fallen dramatically, Japan could have considerable scope for exerting economic leverage over North Korea. It is likely to become North Korea's biggest aid donor when the two countries normalise relations, with reparations payments alone of up to \$10 billion. Resolving the abductions issue and the nuclear crisis are the two biggest obstacles to this. However, there is urgent need for more advance planning as to where and how Japanese economic input can best be made when normalisation is achieved. Steps that should be taken now include:

- sending Japan External Trade Organisation (JETRO) researchers to study the North Korean economy. The Japanese government will likely have to offer significant incentives to lure Japanese private sector investments away from China and South Korea to North Korea. It needs more information about available opportunities;<sup>241</sup>
- starting to research the country's infrastructure and industry. Possibly more than half the reparations would be paid "in kind" through contracts to Japanese infrastructure contractors to work in North Korea but there is still no planning about how this money could best be spent and little awareness of the areas of the economy most in need of assistance;<sup>242</sup> and
- initiating discussions at the ministry of foreign affairs on how best to clear North Korea's debts. Options include either total forgiveness, or transfer of the debt to an IFI.

### E. OTHERS

**United States.** The Bush Administration has made known that it will not stand in the way of aid by others if a deal on denuclearisation can be reached<sup>243</sup> but limits imposed by the legislative branch severely restrict the technical and financial assistance the U.S. itself could provide. Nevertheless, the U.S. could still promote and help facilitate economic reform in North Korea, assuming a nuclear deal, by channelling assistance through the National Committee for North Korea (NCNK), which is administered by the American NGO Mercy Corps and

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<sup>241</sup> Crisis Group interview, JETRO officials, Tokyo, 24 January 2005.

<sup>242</sup> Ibid.

<sup>243</sup> Crisis Group Report, *North Korea: Where Next for the Nuclear Talks?*, op. cit., pp. 15-16.

acts as a clearinghouse for information on facilitating training and exchange programs.<sup>244</sup>

**China.** As its leverage grows, it is already using business people to nudge Pyongyang toward further reform. "They are compassionate to the North's position, as they were there themselves once, but are still quite harsh", said the representative of a Chinese agency who has worked in North Korea. "They won't just give them money for anything. They want North Korea to put money in too, to contribute and learn themselves".<sup>245</sup>

**EU.** Although many North Koreans still study in China, when its officials speak of needing modern skills, languages and experience to help with their reforms, they are obviously also interested in Western experiences.<sup>246</sup> North Korea's diplomats are now proactively pursuing new avenues for training overseas, and Europe is among their preferred destinations.<sup>247</sup> "Europeans are seen as non-threatening", explained a South Korean analyst involved in knowledge cooperation projects.<sup>248</sup> In the short term, this makes European countries best suited to provide more opportunities for latent capacity building. Long-term, the EU will be well placed to implement a major training and capacity building program inside North Korea, as it was set to do before the nuclear crisis began in 2002.<sup>249</sup>

## F. CONSULTATIVE GROUP

Coordination of all these actors is essential to ensure their policies are complementary. One way could be by creating a Consultative Group or Roundtable, as has been done to coordinate donor assistance to Vietnam, Sri Lanka, Indonesia, and elsewhere. Typically, this is chaired by the World Bank and/or the UNDP. Representatives of all the IFIs, the six parties to the nuclear talks, the Korean Peninsula Energy Organisation (KEDO), which manages the half-finished light water reactor project that resulted from the 1994 Agreed Framework, and the EU, as well, possibly, as second-tier actors like Australia, Germany, the UK, Sweden, Italy, New Zealand, and Canada, should also participate.

## VI. CONCLUSION

Economic reform in North Korea is real -- too real for many people in that country. Most enterprises have already been removed from the state planning system and land has been de-collectivised. Markets stocked with consumer goods and burgeoning foreign investment are changing how the country looks and the way its people think. South Korea is still North Korea's enemy, but also its second largest trade partner. South Koreans can catch a bus from downtown Seoul to manage their North Korean employees working at a special economic zone north of the DMZ. The time of shared hardships is long gone: North Koreans doing best now are the ones who are quickest to adapt to the new system, but most people inside and outside the bureaucracy are struggling to keep up.

Although much has changed, North Korea's leadership, aware of the economic rationale for reform but personally dependent on the old system, is still obstructing deeper change. It no longer believes the command system is the best way to run a country but neither does it yet believe it can exist without it. It has accepted some of the ideological and social repercussions necessary to move the economy back to growth, but has stopped short of reforming the institutions needed to manage and sustain a market. So long as deeper institutional reform is ignored, North Korea will experience worsening economic instability and stay dependent on handouts from China and South Korea.

Even while the nuclear crisis is ongoing, some preparatory work should begin both to bring the North Korean bureaucracy to a better appreciation of international standards and the tasks ahead and to prepare the organisations that will be called on to respond to change if and when a nuclear deal is struck. So long as North Koreans lack the analytical skills, experience, and knowledge to make the changes their country needs, and the international community is too disorganised and unprepared to respond meaningfully, North Korea's economy will remain fragile and dysfunctional, and the chances of successful transition will be limited. The regime has proven since 2002 that gradual and cumulative change is possible. Given all that is at stake, the time to react is not at that indefinite point when the regime falls -- a week, a year, a decade, a generation hence -- but now.

**Seoul/Brussels, 25 April 2005**

<sup>244</sup> <http://www.mercycorps.org>.

<sup>245</sup> Crisis Group interview, Kosimu Weber Liu, Environmental Education Media Project, Beijing, 20 October 2004.

<sup>246</sup> Crisis Group interview, North Korean official, 15 December 2004.

<sup>247</sup> Ibid.

<sup>248</sup> Crisis Group interview, Jung Seung-ho, Korea Development Institute, Seoul, 7 December 2004.

<sup>249</sup> "EC-DPRK Country Strategy Paper, 2001-2004", op. cit.

APPENDIX A  
 MAP OF NORTH KOREA



## APPENDIX B

### ABOUT THE INTERNATIONAL CRISIS GROUP

The International Crisis Group (Crisis Group) is an independent, non-profit, multinational organisation, with over 100 staff members on five continents, working through field-based analysis and high-level advocacy to prevent and resolve deadly conflict.

Crisis Group's approach is grounded in field research. Teams of political analysts are located within or close by countries at risk of outbreak, escalation or recurrence of violent conflict. Based on information and assessments from the field, it produces analytical reports containing practical recommendations targeted at key international decision-takers. Crisis Group also publishes *CrisisWatch*, a twelve-page monthly bulletin, providing a succinct regular update on the state of play in all the most significant situations of conflict or potential conflict around the world.

Crisis Group's reports and briefing papers are distributed widely by email and printed copy to officials in foreign ministries and international organisations and made available simultaneously on the website, [www.crisisgroup.org](http://www.crisisgroup.org). Crisis Group works closely with governments and those who influence them, including the media, to highlight its crisis analyses and to generate support for its policy prescriptions.

The Crisis Group Board -- which includes prominent figures from the fields of politics, diplomacy, business and the media -- is directly involved in helping to bring the reports and recommendations to the attention of senior policy-makers around the world. Crisis Group is chaired by Lord Patten of Barnes, former European Commissioner for External Relations. President and Chief Executive since January 2000 is former Australian Foreign Minister Gareth Evans.

Crisis Group's international headquarters are in Brussels, with advocacy offices in Washington DC (where it is based as a legal entity), New York, London and Moscow. The organisation currently operates seventeen field offices (in Amman, Belgrade, Bishkek, Cairo, Dakar, Dushanbe, Islamabad, Jakarta, Kabul, Nairobi, Port-au-Prince, Pretoria, Pristina, Quito, Seoul, Skopje and Tbilisi), with analysts working in over 50 crisis-affected countries and territories across four continents. In Africa, this includes Angola, Burundi, Côte d'Ivoire, Democratic Republic of the Congo, Eritrea, Ethiopia, Guinea, Liberia, Rwanda, the Sahel region, Sierra Leone, Somalia, Sudan, Uganda

and Zimbabwe; in Asia, Afghanistan, Indonesia, Kashmir, Kazakhstan, Kyrgyzstan, Myanmar/Burma, Nepal, North Korea, Pakistan, Tajikistan, Turkmenistan and Uzbekistan; in Europe, Albania, Armenia, Azerbaijan, Bosnia and Herzegovina, Georgia, Kosovo, Macedonia, Moldova, Montenegro and Serbia; in the Middle East, the whole region from North Africa to Iran; and in Latin America, Colombia, the Andean region and Haiti.

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Foundation and private sector donors include Atlantic Philanthropies, Carnegie Corporation of New York, Ford Foundation, Bill & Melinda Gates Foundation, William & Flora Hewlett Foundation, Henry Luce Foundation Inc., Hunt Alternatives Fund, John D. & Catherine T. MacArthur Foundation, John Merck Fund, Charles Stewart Mott Foundation, Open Society Institute, David and Lucile Packard Foundation, Ploughshares Fund, Sigrid Rausing Trust, Sasakawa Peace Foundation, Sarlo Foundation of the Jewish Community Endowment Fund, United States Institute of Peace and Fundação Oriente.

**April 2005**

## APPENDIX C

### CRISIS GROUP REPORTS AND BRIEFINGS ON ASIA SINCE 2002

#### CENTRAL ASIA

*The IMU and the Hizb-ut-Tahrir: Implications of the Afghanistan Campaign*, Asia Briefing N°11, 30 January 2002 (also available in Russian)

*Central Asia: Border Disputes and Conflict Potential*, Asia Report N°33, 4 April 2002

*Central Asia: Water and Conflict*, Asia Report N°34, 30 May 2002

*Kyrgyzstan's Political Crisis: An Exit Strategy*, Asia Report N°37, 20 August 2002

*The OSCE in Central Asia: A New Strategy*, Asia Report N°38, 11 September 2002

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