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## **Hard Target: Sanctions, Inducements, and the Case of North Korea**

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**Stephan Haggard and Marcus Noland**

October 18, 2016

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## Preface and Acknowledgements

This book addresses the debate over economic sanctions and inducements in the context of North Korea's nuclear weapons and missile programs. The focus on the country's external economic relations that runs through it can be regarded as a complement to our previous work, *Famine in North Korea: Markets, Aid and Reform* (2007) and *Witness to Transformation: Refugee Insights into North Korea* (2011), which centered on the country's internal political economy.

Methodologically, that latter work was built on surveys of North Korean refugees undertaken with the support of the Smith Richardson Foundation. We were fortunate that the foundation was willing to support further activity in this vein. In this book we extended our analysis of the political economy of North Korea by surveying Chinese and South Korean businesses operating there. Our thanks to the Horizon Group and Milward Brown for their conduct of the Chinese and Korean surveys, respectively.

From those surveys, which make up the backbone of chapter 5, our focus was subsequently widened to encompass North Korea's broader foreign economic and political relations with the other five parties in the Six Party Talks. Al Song, our interlocutor at Smith Richardson, was endlessly patient as we reformulated what we were doing and delayed drawing the story to a conclusion. Workshops convened at the Asia Society by Chuck Kartman and Susan Shirk in 2009 (Asia Society 2010) and by Etel Solingen (Soling 2012) at the Woodrow Wilson International Center for Scholars in 2010 sharpened our focus on the logic of sanctions and engagement.

In addition to his affiliation with the Peterson Institute for International Economics, Noland is a Senior Fellow at the East-West Center. Haggard also benefitted from a POSCO Fellowship there in 2015; thanks to Denny Roy for his support. The Center graciously provided support during multiple occasions of joint residency and published a monograph (Haggard and Noland 2011b) that was a test run for some of the ideas here.

One reason for the delay in bringing the book to a conclusion was that we simply started to learn more. At the time our refugee book was published, we launched the Witness to Transformation blog at the Peterson Institute for International Economics (<http://blogs.piie.com/nk/>). Initially tied to the theme of refugees and the humanitarian and human rights issues surrounding them, the blog ultimately became a site where we analyzed current events, published interim findings of various sorts, and kept up with other research and writing on the Koreas. We consider the blog as a kind of repository that pursues many issues we address here in more detail than we can address in the text. We would like to thank the Peterson Institute for International Economics for graciously supporting our work on North Korea. Special thanks are due to its publications department and web team, for their support in hosting and promoting the blog.

Needless to say given the long-gestation and wide-ranging nature of this project, we have benefitted from interaction with innumerable colleagues, students, and conference and seminar participants. Like breathless Academy Award winners, we would like to thank everyone for everything, particularly the numerous colleagues from both academia and the policy world where we presented this work over the years. We will surely forget some and not get to others before the exit music starts playing. So instead of even trying to go down that road, we would like to keep things short and sweet and recognize some of the people without whom the book would not exist.

At the Peterson Institute, research analysts Erik Weeks, Jennifer Lee, Alex Melton, Kevin Stahler, and Kent Boydston, all contributed to various aspects of the project. It should also be noted that all are graduates of Graduate School at the University of California San Diego where Haggard teaches. Dan Pinkston, Dave Kang and Chung-in Moon deserve particular mention, as they are fonts of useful analysis and information on the peninsula as well as good friends; all three have commented on various aspects of this evolving project over time. Haggard would also like to thank colleagues and former students from the Graduate School at UCSD, including

TaiMing Cheung, Luke Herman, Jihyeon Jeong, Euijin Jung, Miles Kahler, Eddy Malesky, Barry Naughton, Jaesung Ryu, Susan Shirk, and Yu Zheng.

Once the manuscript exists, it takes yet another team of dedicated individuals to turn it into the book that you are holding in your hands. We are particularly grateful for the efforts of Jenny Gavacs and the staff at Stanford University Press.

Finally, our biggest debts are owed to our families who sometimes had to endure life with what must have seemed like absentee husbands and fathers. This book is little recompense for that lost time, but it is the best that we can do.

## Chapter 1

### Introduction:

### The Political Economy of Engagement

North Korea is routinely ranked among the most economically distorted, closed and politically anachronistic authoritarian systems in the world. If located elsewhere, interest in the country would be limited to its chronic humanitarian problems: pervasive human rights abuses, food shortages and even outright famine. But North Korea's geographic position and nuclear ambitions have forced the major powers in Northeast Asia—China, Japan, South Korea, Russia and the United States—to pay attention.

Most analysis of the extended nuclear crisis that first broke in 2002 has focused, quite legitimately, on the realm of high politics: the diplomatic and military strategies of the contending parties and their consequences (for example Cha and Kang 2003; Funabashi 2007; Pritchard 2007; Chinoy 2008; Bechtol 2010; Pollack 2011; Cha 2012). What has driven North Korea to acquire nuclear weapons? What role do security concerns play in the regime's calculations? What military or political pressures might be brought to bear on it? What are the risks of war?

But the course of the crisis, and the prospects for reaching a durable settlement, have rested in no small measure on economic issues. Could economic engagement and side payments moderate North Korean behavior? Are sanctions a more effective route to getting North Korea's attention? To what extent do economic inducements or constraints affect the North Korean leadership one way or another?

These questions are ultimately tied to a host of important domestic political economy issues that have received far less attention than they should. How willing is the North Korean leadership to continue to pay the tremendous opportunity costs of autarky? Could the regime be induced onto a reform path that would also push the country toward a settlement of the nuclear issue? Or is a settlement of outstanding security issues a political precondition for coaxing North Korea out of its economic shell?

In *Famine in North Korea*, we took a first cut at the political economy of the post-1990 period, focusing on the economic and humanitarian consequences of North Korea's

isolation (Haggard and Noland 2007). Highly dependent on support from Moscow—claims of self-reliance notwithstanding—the North Korean economy experienced a full-blown economic collapse following the demise of the Soviet Union. The country experienced one of the great famines of the 20<sup>th</sup> century; we estimate that between 600,000 and a million people died in this tragedy. Although external shocks and adverse weather played a role in this calamity, at root the famine was the manifestation of profound state failures. These failures included not only lack of accountability and unequal distribution of food through the public distribution system but also the unwillingness of the regime to tap foreign sources of food supply. We showed that with relatively minor adjustments to its economic strategy, the famine could largely have been avoided.

The famine had wide-ranging economic and social consequences; we focused on two. First, the central planning system effectively collapsed and the North Korean economy underwent a largely unplanned and unintended process of marketization and privatization from below. Small-scale social units—households, work units, local government and party offices, and even military units—adopted entrepreneurial coping strategies to secure food and survive. Farmers took advantage of the dramatic shift in relative prices to work on private plots and engage in market-related activities as well.

As we show in Chapter Two, the reaction of the regime to these new economic and social forces was ambivalent at best. The leadership initially acquiesced in the marketization process, decriminalizing coping behaviors, ratifying the changes taking place on the ground and even initiating tentative reforms in 2002. Following the onset of the second nuclear crisis in October 2002, the government oscillated between stricter and expansive controls on market forces and periods of relaxation and pilot reforms. But at no point did it signal a willingness to undertake the types of reforms China pioneered in the Deng era.

The second effect of the economic crisis of the 1990s was a fundamental change in North Korea's foreign economic relations. Throughout the Cold War, North Korea's trade, investment and aid ties centered largely on the socialist countries. Tentative forays into Western product and capital markets were limited in part by sanctions, but more

fundamentally by North Korea's autarkic economic strategy. Many contacts ended in mutual disappointment and recrimination (Cornell 2002).

The crisis of the mid-1990s did not result in a liberalizing shift in foreign economic *policy*. Nonetheless, the country saw substantial changes in its foreign economic *relations*. The famine triggered a massive international aid effort, at its peak feeding more than one third of the population (Haggard and Noland 2007). In addition to the massive influx of aid, the famine also triggered a slow but steady growth of foreign trade and an effort to diversify trading partners and the composition of exports. These developments sprang in part from new diplomatic initiatives, in part from efforts to secure foreign exchange through both licit and illicit means. But the growth of foreign economic ties, particularly with China, also reflected spillover from the process of de facto marketization triggered by the famine. An array of actors sought out commercial opportunities—and foreign exchange—in the interstices of the great wall the regime had constructed around the country. Cross-border exchange, in turn, further fed the domestic marketization process.

In this volume, we draw on a growing theoretical and empirical literature on economic statecraft to connect marketization processes, changing foreign economic relations and the strategic interplay around the North Korea's nuclear program. The ultimate objective is not only to understand North Korea but to address the debate over the merits and demerits of “engagement” with adversaries.

As we show in Chapter Three, it is no simple matter to document the country's external economic relations; even the simplest national accounts information is treated as a state secret and the regime similarly controls information on foreign trade and investment. Moreover, it has been engaged in a variety of illicit activities, from drug smuggling to counterfeiting. Export revenue derived from the sale of weapons and associated consulting services have also played a critical role in the country's economy.

However, North Korea's external relations leave at least some traces with the country's foreign partners. Economic forensics allow us reconstruct the country's growing economic relations with its major trading partners—particularly South Korea and China—and a broader balance-of-payments accounting as well. We assess the extent to which North Korea is becoming more open, the identity of the North Korean entities—

public and quasi-private—engaged in cross-border trade and investment and the nature of the activities in which they are engaged, including with respect to illicit activities. In Chapter Five, we explore these issues at the firm level by drawing on two original surveys of Chinese and South Korean firms doing business in North Korea.

However, this book is not simply about North Korea. It also seeks to address the broader theoretical and empirical question of how and whether “engagement” with adversaries—and economic engagement in particular—can mitigate security dilemmas, induce cooperation and even transform recalcitrant states. The question first became a salient one in US foreign policy with the efforts of the Nixon administration to reach détente with the Soviet Union, building on ideas pioneered by West Germany’s *Ospolitik*. These same ideas were subsequently appropriated by South Korean presidents Kim Dae Jung’s “sunshine policy,” by Roh Moo Hyun and are visible in Park Geun-hye’s *Trustpolitik* as well. The debate with respect to US foreign policy has continued in discussions about China (for example, Shinn 1996) and the other so-called “rogue regimes” with which the US has had to deal, including Cuba, Iraq, Libya, Iran and Myanmar (Littwak 2000; Rotberg 2007; Nincic 2005, 2011; Solingen 2012).

The debate on these issues is nested in the larger question of how economic statecraft, including both sanctions and engagement, work. As David Baldwin (1985) noted in his classic work on the topic, sanctions have multiple objectives ranging from outright denial of economic gains, to controls on prescribed and illicit trade, to signaling third parties of intent. Yet sanctions are typically undertaken with the strategic objective of linkage: changing the behavior of the target state.

In contrast to the voluminous literature on sanctions, less has been written on the political logic of positive inducements or “engagement” (exceptions include Baldwin 1971, Baldwin 1985, Crumm 1995, Long 1996, Drezner 1999/2000, Brooks 2002, Kahler and Kastner 2006; Solingen 1994, 2007, 2012; Nincic 2010, 2011; Verdier and Woo 2011). Clearly, the logic of engagement is by no means limited to the economic sphere (Haas and O’Sullivan 2000). For example, engagement entails the commitment to talk and negotiate in the first place. Yet economic inducements play a central role in the debate over engagement. We thus define engagement as the promise or extension of economic exchanges—including trade, investment, aid and other transfers—as an

instrument of foreign policy.<sup>1</sup> How, and to what extent might such engagement work, both in general and with respect to North Korea and other nuclear proliferators in particular?

We begin in this Introduction with an outline of the core theoretical issues before turning to the complications humanitarian considerations pose for economic statecraft, including both sanctions and inducements. We then set the stage for the chapters that follow with a brief political history of the post-Cold War period on the Korean peninsula, including the so-called second nuclear crisis from 2002 to the present that is the focus of the volume. We close with an outline of our empirical strategy and a description of the contours of the book.

### **The Political Economy of Sanctions and Engagement I: Economic Statecraft as Linkage**

There are two quite distinct conceptions of how engagement affects the behavior of the target state (Nincic 2010, 2011). First, engagement can be modeled as a tool in a bargaining game in which inducements are offered in exchange for policy quid-pro-quo. Keohane (1986) has called such exchanges narrow or specific reciprocity. In this model, engagement—like sanctions--“works” by changing the cost-benefit calculus of the leadership of the target state. But economic engagement has also been theorized to have broader transformative effects (Solingen 2007), such as strengthening political coalitions with more moderate foreign policy preferences or socializing the target’s political leadership to new opportunities and norms. At the extreme, engagement may result in fundamental changes in the nature of domestic politics, a stated objective of Kim Dae Jung’s “sunshine policy.” We take up each of these two models in turn.

Theoretically, the logic of inducements as a quid-pro-quo should not differ fundamentally from the logic of sanctions. Both involve the manipulation of costs and benefits in the context of a bargaining game. In fact, there are a number of potential differences between the logic of imposing constraints and extending rewards. These

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<sup>1</sup> . It is important to note that engagement as we define it thus encompasses the relaxation of prior sanctions or controls.

include psychological differences in how individuals—and presumably countries—view the prospects of gains versus losses (Kahneman and Tversky 1984; Levy 1997). Sanctions and inducements also have quite different signaling effects; sanctions are a more hostile and threatening action than the offer of a reward.

At the same time, there are a number of similarities in the use of economic inducements and sanctions that have been overlooked in the highly-polarized policy debate over the merits of engagement. For example, inducements no less than sanctions can be undermined by coordination and bargaining problems. And while it is widely noted that sanctions are much less likely to have their desired effect if leaders can impose the costs on their citizenry with relative impunity, domestic political factors may also influence the efficacy of inducements. Imagine, for example, the efficacy of promises of greater trade and investment with a state that is wary of economic engagement to begin with.<sup>2</sup>

As the sanctions literature shows, it is highly doubtful that we can reach a blanket judgment on the efficacy of sanctions and inducements. The early debate on whether sanctions worked or not (for example, Pape 1997, Elliott 1998, Baldwin and Pape 1998) has rightly given way to a more nuanced discussion of the conditions for success. We follow a similar line here, focusing on three central parameters that have been shown to influence the efficacy of sanctions, but which we show can also affect engagement strategies as well. These factors are the domestic political economy of the target state, problems of coordination, and credible commitment problems that emerge in the process of negotiating quid pro quos. We take up the first issue in more detail in Chapter Two, and the last two points in Chapters Three, Six and Seven.

### *North Korea as a Hard Target*

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<sup>2</sup> During the Kim Jong-il era, foreign influences were likened by the leadership to “germs,” “mosquitoes,” and other vermin to be kept at bay. “Reform” was described as “honey-coated poison” and “opening” as “a Trojan horse tasked with destabilizing socialism” (Noland 2001). Similar metaphors have been used by Kim Jong-un who, for example, was quoted by the official press agency as stating “We must set up mosquito nets with two or three layers to prevent capitalist poison being persistently spread by enemies after seeping across the border into our territory.” “N. Korean leader condemns cultural 'invasion'” Global Post, February 26, 2014 at <http://www.globalpost.com/dispatch/news/afp/140226/nkorean-leader-condemns-cultural-invasion> Accessed 25 March 2015.

Early theoretical papers modeled sanctions as a bargaining game between the sender and target (Eaton and Engers 1992), but these models quickly gave way to a consideration of the domestic political economy of the target (particularly Kirshner 1997; Kaempfer and Lowenberg 1988, 1992). Sanctions can work by imposing *direct* economic costs on the leadership of the target state—for example, by freezing government or personal assets--or *indirect* political costs by affecting the welfare of constituent groups or broader publics, for example through trade embargoes. These costs, in turn, are presumed to induce political leaders to cooperate.

One of the more robust findings in the literature is that the regime type of the target is an important determinant of sanctions success (Brooks 2002, Kahler and Kastner 2006; Allen 2005, 2008a, b; Letzkian and Souva 2007; Hufbauer et. al. 2007; Escriba-Folch 2012). Because authoritarian regimes can repress and impose costs on their populations—and may even be incentivized to do so by sanctions (Allen 2008s, b; Wood 2008, Escriba-Folch and Wright 2010, Escriba-Folch 2012; Major 2012)—they constitute “hard targets,” vulnerable only under highly specific circumstances. Needless to say, these arguments are highly germane to North Korea. The North Korean regime survived a famine that likely killed between three and five percent of the population in the mid-1990s. It is doubtful that the major parties could coordinate on actions that would be nearly as consequential, nor that the North Korean government would necessarily respond if they did. Sanctions are only likely to work in such a setting if they can be targeted quite narrowly at the leadership, a recurrent preoccupation both in the broader sanctions literature (Cortright and Lopez 2002).

However, we must consider whether domestic political characteristics of the target state constrain the efficacy of inducements as well. Sanctions have effect through their adverse welfare effects; inducements operate by providing welfare gains. Advocates of engagement argue that inducements influence the internal decision-making processes in favor of “doves” (for example, Harrison 2001; Moon and Bae 2003 on North Korea). But it is by no means clear that authoritarian decision-making can be modeled as the resultant of interest group politics (although a number of accounts have tried; for example, McEachern 2010 on North Korea). The stylized quid-pro-quo envisions prospective economic benefits flowing to reformers, enterprises and individuals that

stand to gain from greater openness. The political leadership reaps some political gain from the welfare gains of these groups and is thus either induced or constrained to behave in a cooperative way. Concessions are made by those opposed to cooperation, presumably including some portions of the military.

Yet as we show in Chapter Two, the evidence that Kim Jong Il and Kim Jong Un saw major economic or political gains from expanded trade and investment relations is mixed at best. The hesitancy of the government with respect to “reform and opening” is clear, and at least to date stands in contrast with the reform paths of China and Vietnam. Moreover, the forms North Korea’s engagement has taken—including illicit activities and weapons sales—hardly comports with transformative models.

Indeed, the main lesson that Kim Il Sung, Kim Jong Il and Kim Jong Un appear to have drawn from the collapse of European communism was that it resulted from political and economic opening. Following the collapse of the Soviet Union, the regime redoubled its emphasis on ideology and leadership, particularly the latter’s dynastic features (Quinones 2002). Kim Jong Il’s main ideological innovation after taking office from his father in 1994 was “military first” (*songun*) politics; the claim that the military is the exemplary institution of the revolution and by implication a key pillar of the regime’s support. The military and national security tropes continued to play a central role in governance under Kim Jong Un, most notably in the articulation of the so-called *byungjin* line of 2013 emphasizing the simultaneous pursuit of economic development and nuclear weapons. To the extent that Kim Jong Un relies on the military or is constrained by it, marginal inducements are unlikely to result in a wholesale shift in political alignments or public policies in favor of reform.

Paradoxically for advocates of engagement, positive economic inducements are most likely to have effect in authoritarian regimes when they mirror the structure of “smart sanctions,” that is, when they directly pay off the leadership and its core supporters. The problem, of course, is that paying off objectionable dictators and their cronies and tolerating illicit forms of engagement is politically unpalatable. As we will see repeatedly, the nature of “engagement” that the North Korean leadership favors is heavily skewed toward transfers that can be directly controlled by the regime; it is lukewarm at best towards those forms of engagement that would have wider social effect.

### ***Coordination.***

In addition to the domestic political context, the international environment of sanctions also plays a crucial role in their success or failure. It is an often-repeated finding in the sanctions literature that they are more likely to be effective when coordinated (Martin 1992; Hufbauer, Schott, Elliott and Oegg 2007).<sup>3</sup> But a simple and obvious point is that engagement can be undermined by failure to coordinate as well. Throughout the course of the nuclear crisis—and even before—those parties that sought to engage the North—South Korea, China and Russia—found themselves in conflict with a US strategy that emphasized the imposition of constraints. As we show in Chapter Six on the political economy of the Six Party talks, there was at least somewhat greater progress in the negotiations when North Korea was facing economic distress. But North Korea never simply capitulated to sanctions; progress typically hinged on combining constraints with offers of some quid-pro-quo in return for North Korean cooperation.

We also find evidence of what we call a “dynamic” coordination problem. There is a growing body of empirical work examining how sanctions have the effect of changing patterns of trade away from the sanctioning country (Caruso 2003; Kaempfer and Ross 2004). Differences across trading partners in the extent to which they use economic inducements will also have a bearing on the direction of trade. *Ceteris paribus*, target countries should gravitate toward those trading partners that place the least restrictions on trade, are least demanding with respect to policy quid-pro-quos and that offer more in return for them. As we show in Chapter Three, this is exactly what happened with North Korea, where trade increasingly focused on the most pro-engagement of its partners, particularly China and—at least during certain periods—South Korea. Inducements no less than sanctions face a “weakest link” problem

### ***Engagement Bargaining and Bargaining Failure***

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<sup>3</sup> . Drezner (2000) has added some nuance by distinguishing bargaining over sanctions from the enforcement phase and showing that the *nature* of coordination matters. Ad hoc coalitions—such as those forged through the Six Party Talks convened to address the North Korean nuclear issue—may face greater challenges than those organized through enduring multilateral institutions.

A second and closely related international policy problem has to do with important time-inconsistency or credibility issues in the quid-pro-quo model of engagement, problems that can easily generate bargaining failures (Fearon 1995, 1998). Important differences exist in the sequence of moves in sanctions and inducement games. Sending states can threaten as well as impose sanctions, a realization that drew attention to important strategic issues in sanctioning games as well as possible selection effects in any empirical analysis (Drezner 1999, 2003; Nooruddin 2002; Lacy and Niu 2004; Y. Li and Drury 2004; Drury and Li 2006). But once sanctions are imposed there are immediate costs for the target whether it complies or not.

Sequencing in inducement games operates somewhat differently. If the inducements are offered and granted first, the target state may subsequently have little incentive to cooperate. Critics of North Korea have long focused on these moral hazard problems associated with engagement (Downs 1999; Eberstadt 1999; Bolton 2007). In his memoir, President Bush (2010) draws an analogy between Kim Jong Il and a spoiled child throwing food on the floor. “The United States is through picking up [Kim Jong Il’s] food.” He recounts a March 2001 meeting where he decided the basic mode of dealing with North Korea would change: “From then on, North Korea would have to change its behavior *before* we made concessions” (emphasis in original).

However, the opposite problem also exists: if economic inducements are made conditional on some action and only promised in the future, the initiating or sending state has the credibility problem. Will it deliver on its promises? And will it have incentives to deliver on promises if the target state takes actions that are not easily reversible, such as dismantling its nuclear capability?

These time-inconsistency or sequencing problems can generate a very narrow conception of reciprocity that in turn creates additional bargaining problems. In the favored terminology of the North Koreans, negotiations require “words for words, actions for actions.” The result, however, is that the goods to be exchanged are sliced into finer and finer tranches. Exchanges may be made more comparable and less time-inconsistent. But, as in Zeno’s paradox, the ultimate goal to be achieved can easily recede. One effect of this bargaining problem is the periodic attraction of “grand bargains” that would cut

through these sequencing issues through large deals that put everything on the table at once. But because these various goods cannot be delivered on similar schedules—in part for physical reasons, such as the time to build a light-water reactor—the bargaining problems remain. To date, “grand bargains” have had no greater success than more incremental and phased approaches.

### **The Political Economy of Sanctions and Engagement II: Engagement as Transformation**

The idea that interdependence can have transformative effects is an offshoot of the liberal tradition in international relations (Schumpeter 1919; Polachek 1980; O’Neal and Russett 1997, Russett and O’Neal 2001; Morrow 1999; Mansfield and Pollins 2003; Copeland 2014; for a theoretical and empirical critique, Barbieri 1996, 2002). Regardless of the initial intentions of the political leadership in the target state, the very expansion of economic raises the cost of conflict, bolsters interests that are more amenable to international cooperation and provides opportunities for credible signaling (Gartzke, Lie and Boehmer 2001).

However, the openness of the economy and the level of trade are at least partly endogenous to politics and policy. Etel Solingen, following Gourevitch (1986), gives the fundamentally economic argument of the liberal peace a coalitional foundation. She argues that the chances for regional stability (Solinigen 1998), the nature of grand strategies (2001) and even the pursuit of nuclear weapons (Solinigen 2007) are related to the strength of what she calls “statist” or “backlash” as opposed to “liberalizing” coalitions. Solingen summarizes the logic in a passage with obvious relevance to understanding North Korea:

“Backlash grand strategies seek to preserve state entrepreneurship and military-industrial allocations, resist external pressures for economic liberalization and intrusions on sovereignty, and target internationalizing adversaries at home and abroad. Regional insecurity and competition is a natural side-effect at best, and a dominant requirement at worst, of this grand strategy. Regional cooperation

threatens backlash coalitions because it scales back military imperatives, erodes statist privileges, and devalues nationalist and confessional myth-making as a political currency” (Solingen 2001, 524).

Despite the claim that grand strategy is partly endogenous to politics, Nincic (2010, 2011) and Solingen (2012) nonetheless argue that external inducements may have political effects, at least over the long-run. It is worth walking through the mechanisms through which such transformation is supposed to occur as they will be central to the empirical tests that the book offers.

We begin with a closed economy, and therefore with a political leadership that pays little economic cost—except an ongoing opportunity cost—for aggressive or bellicose foreign policy positions. The initiating state offers to lift sanctions and therefore permit expanded trade, investment and aid relations with the target. These new economic relations create stakeholders in the target state who now risk losses from bellicose behavior and thus act as a political constraint on the government. Interdependence can gradually shift the overall political balance—the ruling political coalition—in favor of reform. Unless this be thought far-fetched, consider the case of China where a nominally Communist party not only opened its economy but subsequently moderated its foreign policy and even welcomed capitalists into its ranks. International ties can also have socializing and learning effects. Individuals, firms, officials, and even high-ranking politicians will reassess their grand strategies in light of new information provided through increasing political and economic integration.

It is worth underlining that this transformative conception of engagement was clearly central to Kim Dae-jung’s “Sunshine Policy” and appears to be a staple of the current Chinese approach to the country as well.<sup>4</sup> Beijing has not hidden its preference

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<sup>4</sup> This statement by Kim Dae-jung is exemplary in this regard: “With deepening economic exchanges and cooperation...the North Korean economy will...show greater vitality in its economic relations with the outside world. As the planned economic system gradually turns toward a market economy, the North Korean economy is expected to experience rapid growth, and the economic disparity with South Korea will begin to narrow. When and if such developments occur, along with improved living standards for its citizens and the inevitable change in their world view and/or perception of the outside world, we would project that there would inevitably be demands for changes even in their political system. As these trends take root, it would be unavoidable for the North Koreans to tolerate or even accept the multi-party system and the principle of free elections” (Kim, 1997, p.121). Although the policies of the two “progressive” governments of Kim Dae Jung and Roh Moo Hyun bore significant similarities, there were differences as well. The Sunshine policy of the Kim era which derived its name from the Aesop fable of the sun and the

that the leadership in Pyongyang pursue a more reformist route (Snyder 2009; International Crisis Group 2009; Szalontai and Choi 2013, Reilly 2014a, b).

Yet the conditions for this benign circle to operate may be more restrictive than proponents of engagement suggest. An ample theoretical and empirical literature shows how sanctions have the effect of creating rents that leaders in the target country can exploit, thus offsetting their adverse effects on core constituencies (Kaempfer and Lowenberg 1988, 1992; Andreas 2005; Gibbons 1999 on Haiti; Rowe 1999 on Rhodesia; Niblock 2001 on the Middle East). However, it is wrong to believe that economic integration through engagement will necessarily take place in a way that dissolves rent-seeking opportunities. While governments intent on reform may provide opportunities for such engagement strategies, partial reforms provide opportunities for rent-seeking and corruption that are no different than those associated with the imposition of sanctions. Moreover, this partial reform path may constitute a political equilibrium (Hellman 1998).

A particularly important empirical issue is whether foreign transactions are effectively captured by the state- or military-controlled enterprises in the target state. Think, for example, of an engagement strategy with a country in which a monopoly is allowed to capture the rents from trade. Rather than inducing transformation, such a strategy would have the effect of empowering a strong, status-quo force with limited interest in further economic opening. In Chapter Five, we use firm-level surveys to consider whether cross-border transactions between North Korea and China and South Korea resemble the kind of commercial relations postulated by the engagement model. As expected, the findings provide limited support for this proposition at best.

A final consideration has to do with the types of economic activity in which hard targets such as North Korea are engaged. In Chapter Three, we trace the country's long history of illicit activities and weapons sales, hardly a type of engagement that we would associate with a moderate foreign policy. Yet these types of activities are in fact quite typical of difficult regimes that pose challenges to the international community; put differently, foreign economic ties not only reflect the inward orientation highlighted by

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wind and saw engagement as a means to transform North Korea. The "peace and prosperity" strategy of the Roh era policy was explicitly non-instrumental and sought to defuse tension via reassurance (Ra 2013).

Solingen but types of “engagement” that other parties would view as having negative rather than positive externalities.

### **Humanitarian Dilemmas**

Were these constraints on the success of an engagement approach not enough, we must also consider the humanitarian dilemmas that arise in dealing with “hard targets.” As sanctions grew in popularity, initiators had to address the problem of collateral humanitarian damage; sanctions against Iraq, Yugoslavia and Haiti all raised these issues in stark terms. Moreover, the adverse effects of sanctions were not only economic but extended to the risk that repressive governments would get “rally around the flag” benefits and exploit external pressure to repress oppositions; a wide-ranging theoretical and empirical literature emerged around these potentially perverse effects (Kirshner 1997; Kaempfer, Lowenberg and Mertens 2004; Wood 2008; Peksen 2009; Escribà-Folch and Wright 2010; Peksen and Drury 2010; Escribà-Folch 2012). Such concerns also had policy effects, giving rise to the concept of “smart” or targeted sanctions (Cortright and Lopez 2000, 2002, Drezner 2011).

Yet engagement strategies—and particularly those driven by humanitarian rationale—face their own distinctive policy dilemmas. The literature on foreign aid has long noted the so-called Samaritan’s dilemma (Gibson et. al. 2005). Knowing that the donor will continue to provide support on humanitarian grounds, there is little reason for the recipient to change behavior, particularly in ways that will reduce support over the longer run. Similarly, increased access to foreign resources allows targets of engagement strategies not only to remain intransigent but has the larger effect of sustaining both the regime and the economic order that gives rise to conflictual behavior in the first place (Kalyvitis and Vlachaki 2011; Ahmed 2012). These issues have been raised forcefully by critics of extending humanitarian aid to North Korea (for example Hill 2014).

As we showed in some detail in *Famine in North Korea*, the international community responded generously to North Korea’s food shortages. Donors also sought periodically to use humanitarian assistance for political ends, a phenomenon we label “food for talks.” Yet precisely because of the compelling quality of the humanitarian

concerns, and the coordination problems that surrounded a multiplicity of donors, the North Korean leadership was able to maximize aid while gaining substantial leverage over the terms on which it was offered.

Over time, an opposite set of risks emerged which parallel quite closely the humanitarian dilemmas associated with sanctions. Impatience with North Korea's nuclear ambitions and diversion of aid generated political backlashes among donors. Donors either explicitly linked humanitarian assistance to progress on the nuclear issue or established much tougher ex ante conditions with respect to humanitarian access and monitoring. We show that this was not only true of the US but of South Korea and possibly even of China as well. Given the failure of the regime to adequately prioritize commercial imports, the predictable result of recurrent backlashes was a failure of the international social safety net. During the 2007-2012 period in particular, North Korea reverted to chronic food insecurity, with shortages equal to any since the famine of the mid-1990s.

### **The Political Economy of Engagement: A Reprise**

The debate on sanctions has clearly evolved toward more conditional statements of their effects, and similar caution is required with respect to the use of inducements and engagement as well. Our review suggests that engagement as a source of leverage or transformation is also subject to limiting conditions, and is less likely to be effective:

- With respect to authoritarian regimes;
- With respect to statist economies—and coalitions--that directly control production and trade, including in illicit activities and weapons;
- Where the beneficiaries of any inducements are state or military as opposed to private actors;
- Where humanitarian problems induce outside parties to extend unconditional or less conditional aid and subsidies;
- Where “engagement” must be coordinated across countries with different strategic approaches to the target state.

All of these constraints have pertained with respect to North Korea. The processes of marketization have clearly spilled over into the foreign sector but have nonetheless taken place in an authoritarian state-socialist context. At least through 2016, the leadership had not openly embraced the concept of opening in the same way China or Vietnam had even in the early, more experimental phases of their reforms or that Myanmar and even Cuba and Iran have more recently. De jure reforms have been halting at best, with the state retaining substantial control. With respect to South Korea—and even with respect to China—the government has shown a penchant for an “enclave” strategy at sites such as the Kaesong Industrial Complex (KIC) and the Rason Special Economic Zone in which foreign firms are isolated from the domestic economy in ways that limit the “spread” effects of commercialization and marketization.

The evidence with respect to transformation is therefore mixed. We do see evidence of commercial and quasi-commercial cross-border activities. Yet we need to consider very carefully whether investment, trade and aid channeled through central government and state-controlled enterprises will have the transformative effect postulated by the engagement-as-transformation approach.

In addition to these political constraints on engagement strategies, we have also noted several acute bargaining problems surrounding engagement approaches. First, no less than with sanctions, engagement faces coordination problems and is less likely to have effect in the context of divergent preferences and policies across the countries with strategic interests in the target.

In addition, engagement faces the same credible commitment problems as sanctions do. On the one hand, moral hazard problems abound where engagement is extended prior to compliance. On the other hand, promises of inducements may lack credibility to the target, particularly where compliance involves measures that are irreversible.

We elaborate on these bargaining dynamics in Chapters Six and Seven. However, we set the stage for the remainder of the book with a brief overview of the military, strategic and political setting on the peninsula and the broad role that economic statecraft played in it. We begin with an overview of the period from 1990 to the onset of the second nuclear crisis in 2002, a period that encompasses the first nuclear crisis and the

conclusion of the Agreed Framework. We then divide the second nuclear crisis into two periods: the first and second Bush administrations (2001-2009), which correspond almost exactly with the onset of the crisis and the rise and fall of the Six Party Talks (Chapter Six); and the period from 2009 to mid-2016, the bulk of the Obama administration, when the Six Party Talks were in abeyance (Chapter Seven).

## **The Korean Peninsula 1990-2016: A Brief International History**

### ***From the End of the Cold War to the Second Nuclear Crisis***

Prior to 1990, North Korea's foreign economic relations were a function of the Cold War system, although complicated by the Sino-Soviet split (Chung 1978). Socialist patrons provided exports and aid and absorbed—sometimes reluctantly (Szalontai 2005, 46-52)—North Korea's export offerings. The United States maintained an effective embargo through a complex, multi-tiered sanctions regime (Kim and Chang 2007; Lee and Choi 2009), as did its alliance partners in the Pacific (Noland 2000, 87-132). Japan permitted somewhat greater interactions because of the historical artifact of a large Korean community, but the two countries did not enjoy diplomatic relations. Neither did the Western European countries, whose interest and engagement with the country was, with a few interesting exceptions (Cornell 2002), sporadic at best.

The waning of the Cold War held out the promise of quite fundamental political and economic changes in Northeast Asia. South Korea underwent a democratic transition in 1987-88. President Roh Tae Woo's *Nordpolitik* sought to use economic inducements to de-escalate tensions on the peninsula. In late 1991, Seoul and Pyongyang signed a benchmark "Agreement on Reconciliation, Nonaggression and Exchanges and Cooperation between the South and the North." This "Basic Agreement" was a crucial document, foreshadowing virtually all elements of the Sunshine policy including:

- Mutual recognition of each other's political systems, and a promise to forego interference and subversion;
- A promise to forego the use of force and to transform the armistice system into a more durable peace regime;

- The initiation of economic and social exchanges.

In addition, the Basic Agreement was followed closely in 1992 by the Joint Declaration of the Denuclearization of the Korean Peninsula, in which both sides foreswore nuclear ambitions.

But the very dynamism of the South Korean economy made it more and more difficult—and costly—to maintain military parity; newly-declassified documents suggest that Kim Il Sung was well aware of this fact by the 1980s (Weathersby 2005). Moreover, the success of the South posed ideational and legitimation challenges: how to justify a system that by all objective metrics underperformed its neighbor.

The Soviet Union normalized relations with South Korea in January 1991 and China followed suit in less than a year. These important diplomatic breakthroughs were not only political in nature; they also reflected reform processes in both China and Russia, the desire to trade more extensively with South Korea and to transform economic relations with their North Korean client. Following normalization of relations with South Korea, both countries sought to shift from the “friendship prices” and implicit subsidies that had characterized their exchanges with North Korea to trade based on convertible currencies at world market prices.

These events, and the revolutions in Eastern Europe, were deeply unsettling for the North Korean regime (Moltz and Mansourov 2000). The end of the Cold War spelled the demise of fraternal Communist regimes in the Soviet Union and Eastern Europe. Soviet and Chinese recognition of South Korea did not imply political abandonment or external pressures for political reform; to the contrary, both countries proved exceedingly tolerant of the Kim dynasty and made efforts to provide assurances. But as we show in Chapter Three, the shift to market prices in trade with its two most important socialist partners was a tremendous shock.

Given its extraordinary level of militarization, the end of the Cold War and the olive branch extended by the South offered North Korea a larger peace dividend than any other country in the world (Noland, Robinson, and Wang, 2000; Noland 2000). But a significant shift in the regime’s grand strategy was required to exploit the new geostrategic terrain. This challenge proved too great for a leadership in transition. By

evading its commitments under the Non-Proliferation Treaty, North Korea triggered the first nuclear crisis of 1992-94.

The most obvious explanation for North Korean behavior would be a classic realist one: that a nuclear program provided a relatively inexpensive hedge against the manifold insecurities associated with the end of the Cold War. But nothing is simple, because of a central analytic problem we will confront throughout this volume: that the predictions of different theories about North Korean behavior are often observationally equivalent and thus difficult to adjudicate. The sharply conflicting lines of interpretation with respect to the first nuclear crisis and its aftermath make this point clearly, and have persisted to this day.

One group of scholars have focused on North Korean insecurities and argued that tough US and International Atomic Energy Agency (IAEA) responses to North Korean derogations served to exacerbate the crisis (Harrison 2005, Cha and Kang 2003, chs 2 and 4; McCormack 2004). An extensive body of analysis by Sigal in particular (1998, 2002, 2005, 2009, 2010, 2016) concludes that Pyongyang was driven by insecurity and more responsive to inducements than hawks believed (even if he acknowledges the regime's effort to extort resources from the concerned parties). In effect, Sigal argues the country was playing a tit-for-tat strategy.

On the other hand, both new historical materials and alternative theoretical approaches have suggested that the pursuit of a nuclear option politically hard-wired and thus more impervious to either external sanctions or inducements. It is now clear that North Korea had long sought a nuclear option (Szalontai and Radchenko 2006; Clemens 2010). Some—including prominent US policymakers (Bolton 2007)—drew the inference that the country never had any intention of giving up its quest for nuclear weapons. The sources of this pessimism are ultimately to be found in the North Korean political system, including the core family-party-military coalition at the heart of the regime (Solingen 2007; Smith 2015), its authoritarian political structure (Haggard and Noland 2007, 2011; Lind and Byman 2010) and ideological constraints and strategies of legitimation that relied on mobilizing against external enemies (Hymans 2006; Myers 2010, 2015; Habib 2011).

Whatever the source of the bargaining failure of the early 1990s, the result was a prolonged crisis in 1992-94 that came dangerously close to war and was avoided largely by the unscripted intervention of former president Jimmy Carter (Oberdorfer 1997; Witt, Poneman and Galucci 2005; Creekmore 2006). The subsequent negotiation of the Agreed Framework included a number of important quid-pro-quos, including important economic ones. The North agreed to freeze and eventually dismantle its nuclear program in return for inducements that included two light-water reactors (LWRs), the interim supply of heavy fuel oil, some relaxation of sanctions, and, above all, progress in normalizing political relations with the U.S.

Progress on normalization of relations—the political lynchpin of the deal from North Korea’s perspective—quickly stalled. The Korean Peninsula Energy Development Organization (KEDO) orchestrated the early work on the LWR construction and with occasional delays the United States met its commitments with respect to heavy oil shipments and the partial easing of sanctions. But the Clinton administration and the Agreed Framework came under increasing pressure from Republican hawks in Congress after the mid-term elections of November 1994 (Hathaway and Tama 2004).

North Korea’s internal problems were even more profound, including the political transition following the death of Kim Il-sung in July 1994 and the extreme economic conditions that characterized the peak famine period. Once these immediate challenges had passed, Pyongyang dragged its feet on negotiations that would have institutionalized a final settlement to the Korean War (the so-called Four-Party Talks, 1997-99) while engaging in a string of conventional military provocations, most notably the failed attempt to place a small satellite into orbit in August 1998 (Michishita 2010, 117-137). Pakistani intelligence uncovered through the A.Q. Khan network suggests that it was almost certainly during this period—well prior to the election of George W. Bush—that North Korea also moved to acquire technology and equipment for enriching uranium, in direct violation of a number of its international commitments (Albright 2010).

The missile launch of 1998 triggered a wide-ranging review of US policy conducted by former Defense Secretary William Perry (1999) that reiterated the engagement logic, but nested it in what was subsequently known as a two-track approach (see also Perry 2015, 103-109, 160-171). The US was willing to trade security guarantees

and the economic benefits associated with normalization for denuclearization, but was also willing to ramp up sanctions if North Korea proved recalcitrant.

The key factor in pushing toward a more forthcoming US policy toward North Korea was clearly the election of President Kim Dae Jung in December 1997 and his articulation of the Sunshine policy. Although subsequently diminished by revelations of illicit payments, the June 2000 North-South summit between Kim Dae Jung and Kim Jong Il marked the high point of a common engagement strategy between the US and South Korea, capped by a visit to Pyongyang by Secretary of State Albright. Economic inducements, a diffuse conception of reciprocity, and a belief in the transformative effects of engagement were the hallmarks of the Kim Dae Jung era. But time had run out on the outgoing Clinton administration and American policy subsequently took an altogether different course that severely complicated Kim Dae Jung's chosen approach; it is this subsequent period that is the focus of this volume.

***The Contours of the Second Nuclear Crisis I: The Rise and Fall of the Six Party Talks (2001-2008)***

The Bush administration quickly backed away from the Perry approach well before 9/11, but the attacks had important implications for the Korean peninsula. In rapid succession, North Korea was dubbed a member of the Axis of Evil, the U.S. outlined a new counter-proliferation strategy that justified pre-emption, and showed that the threat was not empty by confronting Saddam Hussein over weapons of mass destruction and ultimately going to war.

The second nuclear crisis that is the focus of this book broke in October 2002 when the US confronted North Korea with evidence of a clandestine uranium enrichment program that violated a number of North Korea's international commitments. North Korea quickly escalated the crisis through a series of calculated steps, including the expulsion of IAEA inspectors from Yongbyon and threats to reprocess plutonium. While escalating the crisis, North Korea was relatively consistent in stating its preferred terms for a settlement. In return for addressing the nuclear question, Pyongyang sought provision of a negative security guarantee from the United States, an end to Washington's

“hostile policy” and a normalization of relations. But the quest for aid—euphemistically “economic cooperation”—was a persistent leitmotif as well.

Influenced both by Bush’s own personal priors on North Korea (Bush 2010) as well as the post-9/11 environment, the new administration was in no mood to negotiate with North Korea let alone offer additional inducements. In this context, China brokered a face-saving solution for both the United States and North Korea by hosting three-party talks that gelled into the Six-Party Talks in August 2003, including South Korea, Japan and Russia.

A salient feature of these negotiations from their inception through their collapse in 2008 was divergence in strategy *among* the five parties, a classic example of a coordination problem. In the first Bush administration, the US saw the Six Party Talks as a means of reaching a common stance and coordinated set of constraints on North Korea; the Six Party Talks were designed to line up the five against the one. The U.S. did not even table a meaningful proposal through the Six Party Talks until June 2004. Japan’s policy went through numerous oscillations but increasingly converged around a relatively hard line. South Korea, by contrast, was on a completely different political cycle during the 1998-2008 period of progressive governments, pursuing an open-ended strategy of engagement with the North. China and Russia also consistently expressed doubts about the wisdom of using sanctions to bring North Korea to the bargaining table, leaving US strategy floundering.

During his second term, the Bush administration shifted course. A combination of multilateral pressure and economic inducements brought the North Koreans back to the negotiating table in July 2005 and produced a statement of principles in September—the so-called Joint Statement--that contained many of the quid pro quos that had been implicit up to that time: a promise to dismantle the nuclear program in return for security guarantees, future steps toward normalization and economic assistance.

At almost exactly the same time the United States began to target North Korea’s illicit economic activities, focusing on a small Macau bank called Banco Delta Asia (BDA). North Korea responded to the actions against BDA—which it considered illegitimate sanctions--by walking away from the talks and ultimately with missile and nuclear tests in July and October 2006. Nonetheless, the US and North Korea resumed

bilateral talks surprisingly quickly and the Six Party Talks generated a pair of implementation agreements in February and October 2007 that outlined a roadmap for denuclearization. In addition to longer-run promises of normalization, short-term economic assistance and the lifting of some sanctions played a role in this stage as well. This positive movement was re-enforced by a highly ambitious joint statement following a second North-South summit between Kim Jong Il and Roh Moo Hyun that outlined a wide array of economic cooperation projects.

The year 2008 proved fateful and disappointing, and conflicting interpretations of the ultimate breakdown of the talks abound (Chapter Six). North Korea failed to produce an accurate accounting of its nuclear activities, new information on proliferation activities emerged, and by the end of the year the country was preoccupied by Kim Jong Il's health problems. The Bush administration remained internally divided over strategy and faced unexpected diplomatic constraints on engagement from the fact that governments and public opinion had changed in both South Korea and Japan. When the two sides failed to reach agreement on a verification mechanism at the very end of the Bush administration, the Six Party talks effectively collapsed.

### ***The Contours of the Second Nuclear Crisis II: "Crisis" without End? (2009-2016)***

The Obama administration came to office expressing a willingness to extend an olive branch to adversaries. Before the new administration could settle on the details of a new engagement strategy, the North Koreans attempted a long-range missile test in April 2009 and a second nuclear test in May.<sup>5</sup> The tests were a clear setback for the new administration's engagement approach and it quickly orchestrated support for a new Security Council sanctions resolution.

From this point forward, the Obama administration's approach was dubbed "strategic patience," and it involved a combination of both constraints and inducements, with the latter largely prospective ones contingent on North Korean behavior. Sanctions

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<sup>5</sup> The timing of the nuclear test was particularly inopportune, coming the same day Obama gave his nuclear speech in Prague and while the South Korean public was mourning the death of former President Roh Moo-hyun.

were deemed necessary not only to signal displeasure and move North Korea back to the negotiating table, but also to protect the U.S. and its allies from missile and nuclear proliferation. At the same time, the U.S. repeatedly restated its willingness to re-engage through the Six Party Talks. The parties started to circle back to negotiations in late 2009 and early 2010 but progress was interrupted by another round of provocations in 2010, including the sinking of a South Korean naval vessel, the *Cheonan*, in March and the shelling of a South Korean island in November. New South Korean sanctions, known as the 24 May measures, quickly followed. From these two crucial incidents through the death of Kim Jong Il in December 2011, the Six Party Talks were foreclosed by tensions on the peninsula and North Korean preoccupation with the succession.

During the first year of the Kim Jong Un government, domestic political imperatives and a defensive posture toward potential threats drove North Korean foreign policy. The period was marked by long-range missile tests configured as satellite launches in April and December 2012, the abnegation of an aid deal with the US, and a third nuclear test in February 2013 followed by a period of particularly tense relations on the peninsula. Despite—or perhaps in response to—a new round of sanctions, the North Korean regime rolled out its *byungjin* line, enshrining in its constitution the simultaneous pursuit of economic development and nuclear weapons. These moves did not appear tactical, as the cycle of nuclear and missile tests, new sanctions and an escalation of tensions repeated in January and February 2016 in advance of a crucial Korean Workers Party Congress in May.

We fill in important details of these last two periods in Chapters Six and Seven, examining particular offers and counteroffers in much more detail and seeking to disentangle their effects. However, two simple points already emerge from this briefer narrative. First, how to balance the instruments of economic statecraft—sanctions and inducements—has been a recurring issue both within countries and among the five parties. Second, neither set of instruments—at least as deployed—succeeded in securing a more lasting settlement to either the nuclear question or the longer-standing political-military issues on the peninsula. Had strategy gone wrong or were advocates of both sanctions and engagement overestimating their effects?

## **Empirical Strategy: An Outline of the Book**

It seems difficult if not impossible to test conditional claims about engagement strategies in the context of a single case. At best it would appear that we can only use the details of the case to confirm or modify some of the broader theoretical arguments advanced above or provide anecdotal support. However, this assumption about the limits of case studies is not true; an analysis of the crisis provides ample opportunity for comparisons. First, five major powers have had to reach decisions on North Korea and the alignment—and misalignment—among them varies over time; we focus particular attention on the US, China and South Korea. Second, the policy instruments deployed by these actors--the mix of inducements and sanctions and the types of each used—have also shifted over time, allowing us to consider whether different strategies worked.

Third, there is important if subtle variation in North Korea's stance over time. The famine of the mid-1990s gave way to a brief reformist moment from 1998 through the onset of the second nuclear crisis. During this period, there is at least some evidence that the regime was contemplating an alternative strategy and this crucial window was not fully exploited. In the wake of the second nuclear test in 2006, another promising window of negotiation opened and then shut as it did again immediately following the inauguration of Barak Obama in 2009. Following Sigal (1998)—but reaching somewhat more pessimistic conclusions—we exploit within-case comparison of diplomatic moves in Chapters Six and Seven, showing the extent to which sanctions and inducements generate cooperative responses.

Finally, we exploit data that are typically not used in the study of sanctions and inducements, at least not at the country level. Most econometric work on sanctions has been cross-national. Case studies of sanctions have not typically sought to reconstruct the shifting political economy of economic statecraft in the target country nor empirically modeled the effects—and non-effects—of sanctions on the target; we undertake such exercises in Chapter Three by looking more closely at the DPRK's trade with China and South Korea. We also use novel firm-level surveys in Chapter Five to provide insight into what we call the microeconomics of engagement: the nature of the cross-border exchanges that have emerged between Chinese and South Korean firms and their North

Korean partners and the extent to which those relationships confirm or disconfirm the transformative engagement logic.

We approach the issue in a number of discrete, overlapping steps. In Chapter Two we start with the domestic political economy of North Korea. We consider formal political institutions, and what they tell us about the composition of the ruling coalition, the coercive apparatus, and the economic strategies the country has pursued over time. That North Korea is authoritarian and capable of extraordinary control and repression is no surprise, but the extreme narrowness of the ruling coalition is. A highly personalist regime, the top leadership has relied to an extraordinary extent on the military and security apparatus, even at the expense of the party. The succession crisis of 2008-2011 only exacerbated these tendencies but problems of consolidation persisted into 2016. The implications of this political configuration for sanctions are obvious; this is not a regime that is likely to fold under pressure. But the coalitional and ideological foundations of the regime also cast doubt on the prospects for effective engagement as well.

Chapter Two also addresses the country's economic policies. The leadership failed to prevent the famine and showed extreme ambivalence toward the marketization processes that followed in its wake. Nonetheless, the country did undergo a brief reformist moment in 1998-2002. Although the lines of causation are no doubt mutual, we show an association between the reforms and a marginally more accommodating shift in the country's foreign policy. Not coincidentally, the onset of the nuclear crisis was associated with an assault on the market, culminating in the disastrous currency conversion of 30 November 2009. It is impossible to tell whether this "right turn" can be attributed to external pressures—which could vindicate the advocates of engagement—or simply reflected a return to a longer-standing political equilibrium. But despite policy experimentation, strong ambivalence about reform clearly persisted into the Kim Jong Un era. Moreover, the regime embraced a strategic concept, the so-called *byungjin* line, that appeared to reject any tradeoff between pursuit of nuclear weapons and economic development.

Chapter Three reports our efforts to reconstruct North Korea's direction of trade and balance of payments. During the 1990s North Korea diversified its foreign economic relations, normalizing relations with most European countries and deepening its

economic relations with South Korea following the inauguration of Kim Dae-jung in 1998. The direction of North Korea's trade subsequently changed quite dramatically after 2000, with the varied sanctions and engagement strategies of the five parties playing a central role in this process. Economic relations with Japan dropped sharply and trade with China and South Korea increased equally dramatically.

We then report on our effort to reconstruct North Korea's balance of payments through the end of the Kim Jong Il era. This exercise in economic forensics requires an estimate of the relative magnitude that unconventional activities play in North Korea's external relations, including weapons exports, illicit drug trade, and counterfeiting. Even taking into account estimates of these illicit transactions, several important conclusions emerge. First, the country consistently ran current account deficits throughout the entire Kim Jong Il period, implying difficult-to-observe sources of foreign financing, almost certainly coming mainly from China. This finding comports with the trade data, but is a reminder of the additional coordination problems that arise as a result of capital flows. Second, as illicit activity and aid shrunk, the country adjusted by pursuing new commercial activities. These included exporting and hosting foreign direct investment, in extractive industries, raising the question of whether North Korea's political economy should be seen through the lens of the resource curse (Ross 2013). Not surprisingly, this particular pattern of commercialization—including initial reliance on aid and illicit activities and then on extractive industries--was not been associated with any significant modification of North Korea's foreign policy.

In Chapter Four, we analyze the country's recurrent food shortages during the nuclear crisis and the humanitarian dilemmas the country posed—and continues to pose—for donors. We show that as aid flowed in at the end of the famine period, commercial imports fell. Rather than contributing to improved food security, aid was used as implicit balance of payments support, freeing up resources for other expenditure priorities. Aid continued to generate substantial moral hazard problems for donors thereafter as well. During the Kim Dae Jung and particularly Roh Moo Hyun governments, the North Korean regime enjoyed substantial food and fertilizer aid from the South and sustained support from the World Food Program. Yet humanitarian aid failed to achieve the political objectives to which it was often linked nor to fully mitigate

ongoing humanitarian stress in the country, particularly during the international price shocks of 2012-13. We track increasing aid fatigue as the regime sought to limit monitoring of aid distribution and persisted in its bellicose foreign policy.

Chapter Five shifts to the micro-level and reports on the results of two firm-level surveys of Chinese and South Korean firms doing business in North Korea. These unique surveys provide information on what we call the “microeconomics of engagement” that are directly germane to arguments about the transformative effects of increased economic interdependence. First, we find that at the time of the surveys, state-owned enterprises played a dominant role as the counterparty to Chinese investors and traders.

Second, we find that the Chinese and South Korean firms operated in quite different environments. Chinese firms appeared to receive little support from official sources and thus operate in an environment characterized by weak institutions. The surveys provide ample evidence that formal dispute settlement mechanisms do not work, inter-firm trust is low, and bribery is pervasive. The suboptimal nature of these arrangements is clear. Institutional weakness deters integration, deters investment relative to trade, and inhibits normal trade finance quite apart from the uncertainties created by the larger political milieu.

Until 2016, by contrast, many South Korean firms operated within the context of the relatively institutionalized export processing zone at Kaesong, protecting them to some extent from the political risks Chinese firms face. But this protection was bought by confining firms to an enclave over which North Korean authorities exercise substantial authority and from which they extract significant rents; if anything, the potential for transformation arising from South Korean investment seemed even more limited than that associated with the Chinese presence. Moreover, the apparently insulated enclave of Kaesong did prove immune from the broader political setting and was closed temporarily by North Korea in 2013 and shuttered more permanently in 2016 by South Korea following the fourth test, showing clearly how deeply trade and investment with North Korea are politicized.

Chapters Six and Seven focus on the “quid pro quo” elements of engagement with North Korea since the onset of the second nuclear crisis, focusing particular attention on the United States, China and South Korea. We divided the narrative into two parts: the

rise and fall of the Six Party Talks (2002-2008) and the period of what we call “permanent crisis” following their collapse (2009-2013).

In general, the evidence provides little support for the claim that hard-line policies or sanctions worked, at least through the more wide-ranging sanctions attempted in early 2016; to the contrary, they tended to generate escalatory responses from North Korea. We have already noted the coordination problem in orchestrating commercial sanctions, and the political imperviousness of the regime even were they to be successfully coordinated. The narrative account confirms the econometric analysis of DPRK trade with China and South Korea presented in Chapter Three: that multilateral sanctions had scant effect on Chinese trade and investment and thus on the willingness of the North Korean regime to negotiate.

So-called “smart sanctions” (Cortright and Lopez 2002)—and particularly financial measures undertaken in 2005 against Banco Delta Asia—fared somewhat better in gaining the regime’s attention and overcoming the coordination problem as well. However, the economic effects of these measures did not automatically translate into the desired political response; they only influenced the negotiations when coupled with a willingness to negotiate, including over inducements.

However, it is important to underline that these skeptical findings with respect to sanctions do not imply that inducements worked either. Coordination problems plagued efforts to offer inducements throughout the history of the Six Party Talks, albeit with shifting alliances depending on the partisan identity of the governments in office in South Korea, the US and Japan at any given moment. In contrast to the United States, South Korea under Kim Dae Jung and Roh Moo Hyun provide textbook examples of a “diffuse reciprocity” approach to engagement in which quid-pro-quo were sacrificed in favor of trust building and hopes for transformation. These hopes were dashed in part by coordination problems; both governments were at odds—sometimes very pointedly—with the Bush administration over engagement with North Korea.

But South Korean engagement also faced a number of the moral hazard problems we have outlined above. We focus particular attention on how the North Korean regime successfully manipulated the terms of engagement with the South to maximize transfers

over which the regime had the greatest discretion while both limiting their transformative effects and minimizing policy concessions.

These problems spilled over into the effort to extend inducements in the context of the Six Party Talks. North Korea exhibited many of the behaviors that its critics have catalogued: inducements were periodically demanded simply to talk; inducements were offered in exchange for declaratory statements of intent; or North Korea only acceded to actions that were easily reversible, most notably a freeze of existing activities. North Korea also sought discrete payments for highly disaggregated actions—a variant of the “salami” tactic—with the effect that important stages in the denuclearization process were effectively put off into the distant future. In the interim, North Korea retained its nuclear deterrent.

Yet we also show that the United States faced recurrent credibility problems during the Bush era as well, as the administration wrangled internally and with its allies over the appropriate course of action. When the US did seek to negotiate, progress was at least partly affected by political constraints in the US, South Korea and Japan as well as by North Korean behavior.

When the talks broke down in 2008, the incoming Obama administration shifted back towards an approach subsequently labeled “strategic patience,” in which the US held out the promise of negotiations and future benefits, but only on the condition that North Korea undertook concrete steps signaling its intent to denuclearize. Neither this approach—what might be called “prospective engagement”—nor more direct inducements (most notably in the failed Leap Year Deal of 2012) had any more success in steering North Korea back to the bargaining table than the Bush administration did. Similar strategies of prospective engagement yielded little fruit for the Lee Myung Bak or Park Geun Hye governments either.

China’s increasingly explicit focus on fostering closer commercial ties after 2009 holds a cautionary tale with respect to engagement as well. China’s strategy toward North Korea during the late Hu Jintao era mirrored the long-run transformative approach of South Korea’s sunshine policy. Whatever the longer-run transformative effects of the Chinese approach—and they may ultimately prove large—its diplomacy toward North Korea has to date provided little evidence for the political benefits of the engagement

approach. Running out of patience following the fourth nuclear test of January 2016, China appeared finally to tire of its old approach and supported a more wide-ranging UN sanctions resolution.

In the Conclusion, we undertake a more prospective analysis. First, what might happen were domestic political and economic conditions in North Korea to change? Would it be more vulnerable to the effects of sanctions or inducements? And second, what might happen if the five parties were to pursue somewhat different sanctions and engagement approaches than they have to date, for example coordinating more effectively on commercial sanctions, multilateral economic inducements or negotiations on a peace regime? Our conclusions are that economic statecraft may simply be less effective than its proponents think, depending most centrally on future developments in North Korea itself.

## **Chapter Two**

### **The Political Economy of North Korea: The Paradigmatic Hard Target**

As we argued in the Introduction, one of the more robust findings in the sanctions literature is that their effectiveness will depend on political and economic characteristics of the target state. *Ceteris paribus*, sanctions are less likely to be effective against authoritarian regimes, and particularly those with narrow political support coalitions and the capacity to repress. If leaders do not face significant domestic audience costs from broader publics or if they have the capacity to ignore or repress dissent, sanctions are unlikely to have much bite (Brooks 2002, Kahler and Kastner 2006; Allen 2005, 2008a, b; Letzkian and Souva 2007; Hufbauer et. al. 2007; Folch and Wright 2010; Major 2012; Solingen 2012).

From a political economy perspective, economic policy is endogenous to the political order just described (Solingen 1998, 2007, 2012) and we consider the actual extent of economic openness in Chapter Three. Nonetheless, we would expect targets to be more accommodating in the face of sanctions to the extent that they show an interest in economic reform and opening. The pursuit of more outward-oriented strategies in particular should create vested interests both in a more open economy and a more accommodating foreign policy as well. Sanctions will be less effective against countries pursuing inward-oriented and more autarkic economic strategies and that are therefore less exposed.

The central argument of this chapter, however, is that these political and economic characteristics are not only relevant to understanding the likely effect of sanctions; they affect their sensitivity to economic inducements as well (Brooks 2002; Milner and Kubota 2005; Kahler and Kastner 2006; Solingen 2012). Indeed, if inducements empower groups outside the regime's core supporters or foster unwanted reform and opening, they can pose obvious political challenges.

How can we measure these mediating political and economic conditions that affect the responsiveness of target states to sanctions and inducements? In authoritarian

systems, both the nature of political institutions and the identity of the “selectorate” (Shirk 1993; Bueno de Mesquita et. al. 2003; Solingen 2007)—the coalition to which the leadership is accountable—can be used to identify the interests leaders must take into account. Authoritarian regimes vary in institutional design.<sup>1</sup> Some rely on control and repression; others permit limited pluralism and even submit themselves to controlled elections. Authoritarian regimes have also rested on a wide variety of coalitional foundations, from mass publics in populist regimes such as Chavez’ Venezuela to more narrow constituencies of economic elites, narrow ruling parties, state elites and militaries.

With respect to economic policy, some authoritarian regimes have undertaken economic reform and opening, widening the scope for private actors and the market; China and Vietnam are the most relevant Communist comparators in this regard. Others have suppressed markets and private actors and pursued more autarkic policies. In theory, more open economies would be more vulnerable to sanctions than more closed ones.

Where does North Korea sit in this distribution of authoritarian regimes? We show that North Korea constitutes the virtually paradigmatic “hard target” on virtually all of these dimensions.

At the formal political level, the regime has shown no interest in the institutional reforms—such as legislatures or other representative bodies—that would widen its accountability and relied on an extraordinarily narrow ruling coalition. An analysis of core political institutions in North Korea’s reveals a hybrid authoritarian structure, part personalist, part single-party and part military (Gause 2015, Smith 2015). Yet close analysis of membership in these institutions shows they overwhelmingly represent the personal and familial retinues around the ruler, the military, security apparatus, military-industrial complex and control-oriented party functionaries at the expense of the cabinet, economic and social ministries and those with technocratic or diplomatic backgrounds. In such a political system, key bases of political support either are indifferent to economic constraints and inducements or have strong material as well as policy interests in the uncooperative foreign policies—including weapons programs—that such sanctions and

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<sup>1</sup> . The literature on authoritarian regimes is vast but Bueno de Mesquita et. al. 2003; Gandhi and Przeworski 2007; Myerson 2008; Magaloni and Kricheli 2010; Levitsky and Way 2010; Svobik 2012, and Geddes 2016 are exemplary of recent efforts to categorize such systems. Weeks (2012) and Weeks (2014) consider the effects of regime type on foreign policy behavior.

inducements are designed mitigate. Increased trade, investment and even aid can pose risks, for example by threatening existing rents, empowering competing factions and constituencies that would benefit from a more open political economy, and increasing the flow of independent information.

Given this coalitional foundation, sanctions could work if narrowly targeted at the leadership and these core groups of supporters (Cortright and Lopez 2000, 2002, Drezner 2011). In Chapters Six we document an important episode—the freezing of assets in the Macau-based Banco Delta Asia in 2005—that directly targeted foreign exchange under the leadership’s control and appears to have had at least some effect. Subsequent targeting of luxury goods trade and particular entities and secondary sanctions were also designed to have this effect. Yet to date, the autarkic nature of the regime’s economic strategy and its reliance on China have made the top leadership less vulnerable to such targeting.

Perversely, this analysis of the coalitional foundations of the state suggests that inducements—like sanctions—are more likely to be attractive to such authoritarian regimes when they are targeted as well; when they provide material benefits or rents directly to the leadership and core constituencies. In Chapters Six and Seven we show a strong revealed preference on the part of the regime for direct side-payments, which for quite obvious reasons are not politically appealing for the external parties seeking to change North Korea’s behavior.

This analysis of North Korea as a “hard target” is confirmed if we look at the instruments of social control. The North Korean regime is legendary in this regard. As we noted in the Introduction, the regime survived a famine that probably killed between 600,000 to 1 million people; even Pyongyang and the lower levels of the military and party were not spared.<sup>2</sup> The regime survived by maintaining a complex system of surveillance down to the household level, exercising control over all social organizations, and maintaining an internal security apparatus and prosecutorial, judicial and penal systems capable of swift and harsh punishment of even the most modest infractions

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<sup>2</sup> For the debate over estimates of famine deaths, see Goodkind and West (2001), Lee (2003, 2011), Haggard and Noland (2007), Goodkind, West, and Johnson (2011), Spoorenberg and Schwegendiek (2012).

(Haggard and Noland 2011, Chapter 4; Gause 2013, 2015; Lankov, Kwak and Cho 2012). These controls are not limited to political activity alone; they extend to economic activity, movement—including cross-border movement—and flows of information. Given this capacity to repress and control, outside pressures are not likely to generate parallel domestic political pressure on the regime; to the contrary, they are likely to generate more repressive responses.

The very apparatus of social control also tends to limit the appeal of certain types of economic inducements, particularly those that might decentralize economic decision-making, increase the independence of firms and households or loosen the regime's control over the flow of information. Just as the greater economic openness associated with economic inducements threatens the integrity of ruling coalitions at the top, so it also poses challenges for the capacity of the regime to control civil society.

North Korea's claims to self-reliance (*juche*) have always had a fictive component (Myers 2015) and economic policy has by no means been static. As we will show in Chapter Three, the informal marketization process has extended across the Chinese border and the economy became decidedly more open after 2000, potentially increasing its vulnerability to both sanctions and inducements.

However, a review of the country's flirtation with reform suggests that the leadership's interest in it has been halting at best, subject to political reversal and repeatedly subordinated to the dictates of the country's confrontational military and foreign policy. A detailed consideration of the regime's efforts to attract foreign direct investment shows a fundamental failure to understand the basic policy, property rights and credible commitment issues required to integrate into global production networks.<sup>3</sup>

Moreover, the fashion in which the economy has internationalized—including through illicit activities, weapons sales, and complex strategies designed to evade sanctions—is hardly indicative of Solingen's outward-oriented coalition. In 2013, the government demonstrated this point with an exclamation point by promulgating a strategic line (*byungjin*) that explicitly sought to combine economic reconstruction with

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<sup>3</sup> . As we show in Chapter Three, the result has been a surprising reliance on exports of raw materials, mainly from larger Chinese investments that can secure political protection and mitigate financial risks through countertrade.

the maintenance and development of its nuclear arsenal. Whether such a strategy is ultimately sustainable or not is debatable, but it suggests strongly that the regime does not see the tradeoff between the two objectives.

## **The Political System**

### *The Political Foundations of Personalist Authoritarianism: Identifying the Ruling Coalition*

North Korea routinely falls at the extreme authoritarian end of cross-national codings of regime type.<sup>4</sup> Yet such rankings do not fully convey the hybrid nature of the regime nor its coalitional base of support. The personalist features of the North Korean system and the cult of personality have been well-documented and are often portrayed as the defining feature of the political system and with reason (for example, Cheong 2000; Martin 2006; Lim 2009; Jang 2014). From virtually the outset of the regime, Kim Il Sung designated himself as the leader (*suryong*) and subsequent propaganda work emphasized that the political system was a leader-dominated (*suryongje*) monolithic (*yuil cheje*) one. The system was cemented by ideological innovations combining residual Marxist-Leninism with familialism and even outright racism in the form of myths of national purity (Myers 2010). Although these formulations underwent subtle shifts following the two successions (Kim 2006, Kim 2008, Lim 2009, Gause 2015, Myers 2015), the emphasis on the leader as the center of the system remained intact and references to the familial nature of the regime became if anything more explicit.

However, no dictator, no matter how much discretion he wields, can rule alone. Authoritarian regimes thus differ significantly in their institutional form and in the size of the selectorate and its constituent base; we consider each here in turn.

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<sup>4</sup> For example, the well-known Polity IV dataset codes all regimes on a scale from -10 to +10 on the basis of a number of discrete institutional features, including the competitiveness and openness of leadership selection, constraints on the executive, and the competitiveness, regulation or control of political participation. From 1948 through 1956, the country was ranked at -7, from 1957 through 1966 at -8, and since 1967 at -9.

As in other Communist systems, the core institutions of government—particularly the Supreme People’s Assembly (SPA) and cabinet--were subordinated to the party shortly following independence and quickly declined into irrelevance.<sup>5</sup> The SPA—the formal channel of representation—became the proverbial rubber-stamp institution: voting is compulsory but the party nominates single candidates for each seat and SPA sessions last only a few days, a channel for disseminating information on the party line but hardly a deliberative body. The cabinet did not wield much influence either, subjected not only to control by the party but a leadership preference to manage government through different organizational channels.

What is peculiar about North Korean communism is that party organs also atrophied over time as contending factions were purged in the late 1950s and early 1960s and the base of the regime narrowed. Power was increasingly concentrated in the hands of Kim Il Sung and the faction around him: a group of guerillas who had fought in Manchuria during the war and subsequently assumed the leadership of core military and security positions (Suh 1988; Buzo 1999; Lankov 2002, 2007; Szalontai 2005). Following the 4th Party Congress in 1961 (and an ad hoc Party Conference in 1966), for example, only two more formal party congresses were ever held, in 1970 and 1980; not until the succession process from Kim Jong Il to Kim Jong Un were these organs tentatively revived.<sup>6</sup> In December 1993—six months prior to Kim Il Sung’s death--the last Central Committee Plenum was held. Power in the party was exercised, rather, by narrow bodies chaired by Kim Il Sung,<sup>7</sup> by the party Secretariat but also by the leader’s personal secretariat and by informal institutions and networks that Bermudez (2004) calls “close aid rule.” By the time of the first hereditary succession from Kim Il Sung to Kim

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<sup>5</sup>. The Supreme People’s Assembly (SPA) is nominally an elected legislative body and the ultimate source of state power. In line with the concept of democratic centralism, however, the party nominates a single slate of candidates that is then elected with virtual unanimity. The SPA is undoubtedly one of the more minimalist legislatures in the world, in recent years meeting for no more than a couple of days a year.

<sup>6</sup>. The regime held ad hoc party conferences in 2010 and 2012 to anoint Kim Jong Un as the successor, but the first formal party congress was not convened until 2016.

<sup>7</sup>. The Political Committee (renamed the Politburo in 1980); the Central Military Affairs Commission; and the Standing Committee (replaced by the Secretariat in 1966). The core governing body under the 1972 Constitution was the Central People’s Committee (CPC) but that body was dominated by party officials, thereby weakening ministerial and technocratic influence (Yang 1999).

Jong Il in 1994, key features of the North Korean political order were in place: centralization of political power in an exalted and even deified leader; an extremely narrow ruling elite, with strong representation of military and security personnel; an increasingly hierarchical as opposed to deliberative party structure; and a weak cabinet and even weaker legislature.

Nonetheless, the challenges in orchestrating hereditary successions are not trivial (Brownlee 2007) and generated ample analysis in North Korea as the second succession began in 2009 (Lim 2009, 2012; Gause 2011, 2012, 2015; Mansourov 2013, 2014; Haggard, Herman and Ryu 2014). How could Kim Jong Il—and later Kim Jong Un-- assure that the bases of support and lines of command and compliance that his father had constructed would hold up? The short answer is that they couldn't: both institutional innovations and personnel changes were required to build independent bases of support.

In a 1992 constitutional revision, the status of the National Defense Commission (Chapter 3, Articles 111-117) was dramatically upgraded and placed under Kim Jong Il's control allowing him to assume formal, independent control over the military apparatus from his father while providing an institutional instrument for building a base of support.<sup>8</sup> Control over a powerful Organization and Guidance Department—one of the most crucial institutions in any communist system--solidified Kim Jong Il's personal dominance over the party and military by allowing him to use both purges and appointments to build networks of loyalists (Lim 2009, 67-69; Jang 2014); Kim Jong Un proved even more aggressive in turning over top personnel (Haggard, Herman and Ryu 2014; Gause 2015).

Following his father's death, Kim Jong Il did not immediately assume the position of President nor of General Secretary of the KWP, ruling through other bodies.<sup>9</sup> The most distinctive features of the new political order was not in its formal institutional

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<sup>8</sup> The 1992 Constitution separated command over the military from the President and stipulated that the NDC was "the highest military leadership body of state power" (Art. 111) and that its chairman "commands and directs all the armed forces" (Art. 112).

<sup>9</sup> At the time of his father's death, the three most significant positions held by Kim Jong Il were the chairmanship of the National Defense Commission, his position as commander-in-chief of the KPA and his effective control of the Organization and Guidance Department; he probably ruled through his personal secretariat and ad hoc structures consisting of select members of the Politburo and those military and security apparatus leaders who belonged to the KWP Central Military Affairs Committee and the NDC (Koh 1997, 5).

arrangements: it resided in the continuing narrowing of the top leadership and the overt turn to the military and security apparatus for support (Koh 2005, Lim 2009, 2012; Smith 2015). Heightened attention to the military not only guaranteed a smooth process of succession; it was also designed to deter external challenges and to compensate for the dramatic weakening of the state and party apparatus during the economic collapse of the 1990s. “Military-first politics” also had important ideological implications, and Kim Jong Il ultimately elaborated the concept of “military-first politics” (*songun*) as his distinct ideological contribution (Koh 2005). *Songun* elevated the military—and military-style discipline—into the leading and exemplary social force that would achieve the new state doctrine of “building a strong and prosperous country” (*gangseong daeguk*). These institutions and doctrines were formally inaugurated at the first session of the 10th Supreme People’s Assembly in September 1998 when yet another constitutional revision broadened the powers of the NDC Chairman; it is this political order that constitutes the immediate backdrop to the onset of the second nuclear crisis in the fall of 2002 and the period analyzed here.

In Figure 2.1, we show the total number of members on each of the core political bodies—the NDC, the Politburo and the party Secretariat--from the first familial transition in 1994 through the second in 2011-2013.<sup>10</sup> All of these bodies gradually shrank over the 2000s, becoming more and more gerontocratic over time and bottoming out at only 25 members between them--with an average age of 80 in 2008--before expanding again as the succession went into full swing. Yet even these counts overestimate the size of the very top leadership, since a number of individuals—including most obviously Kim Jong Il—held positions in all three. Indeed, prior to the death of Kim Jong Il “interlocking directorates” among top leaders even increased as the system became more fused (Table 2.1).

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<sup>10</sup> Membership in each body for Figure 2.1 and Tables 2.1 and 2.2 for a given year is as of December 31.

[INSERT FIGURE 2.1 HERE]

[INSERT TABLE 2.1 HERE]

These bodies not only speak to the breadth of the ruling coalition but to its social and professional composition as well. Again, it is important to restate that actual decision-making may well have been concentrated in narrower bodies, including informal meetings of key personnel and the personal secretariat of the leader. But these formal institutions can nonetheless be read as a proxy for the coalitional base of the regime.

We start with the NDC.<sup>11</sup> Although designed to oversee core military issues, the body was also granted much wider political authority in the constitutional revision of 1998, was nominally the platform from which Kim Jong Il ruled and was also headed by Kim Jong Un following the actual succession. We consider the membership of the NDC at three points in time that are of particular relevance given our focus on the second nuclear crisis: September 2003, a year after the onset of the conflict and following an SPA meeting that produced the first significant turnover since 1998; April 2009, when the body was significantly expanded during the early phase of the succession, a period also marked by the onset of the succession and a particularly confrontational external stance; and April 2012, following Kim Jong Il's death in December 2011 and immediately after the 2012 Party Conference that anointed Kim Jong Un as the successor. In each period, we note four mutually-exclusive and exhaustive categories of members: those in which the position and the person occupying it were unchanged from the previous period; the addition of new positions; positions that remained in the NDC but with changes in their occupants; and positions that were removed altogether.

Except for the inclusion of one provincial secretary, all of the personnel sitting on the NDC in 2003 at the onset of the nuclear crisis were connected with the military and the military industrial complex (for example, the chairman of the Second Economic Committee which oversees military production). Moreover, the one provincial secretary was from Jagang where much of the military-industrial complex is located. The expansion of 2009 brought in two high-ranking party officials, including Kim Jong Il's

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<sup>11</sup> . We show elsewhere that the trends toward increased military participation in core institutions even extended to the Party Secretariat (Haggard, Herman and Ryu 2014).

brother-in-law Jang Song Thaek. In addition to the family connection, Jang headed the Administration Department of the party, which also had oversight of the Ministry of State Security and Ministry of People's Security. The other new entrants were the second-in-commands at three organizations that were crucial for the success of transition: the Ministry of the People's Armed Forces, the Korean People's Army General Political Bureau, and the Ministry of State Security. The transition was associated with substantial personnel turnover at the top of the military and security hierarchy, reflecting an interest on the part of Kim Jong Un in appointing a new retinue (Haggard, Herman and Ryu 2014; Gause 2015). But despite these changes, the interests represented on this core body does not change fundamentally nor widen to incorporate broader interests, for example of technocrats; if anything representation during the last period we analyze here is even more dominated by military and security personnel.

[INSERT TABLE 2.2]

We would expect the Politburo to have a more diverse membership, but trends in the composition of the body are surprisingly similar. We look over a longer time frame at representation from six mutually-exclusive career backgrounds, recognizing that subjective assessments are necessary where individuals have moved between categories over their career: the central party; officials with diplomatic backgrounds; officials with economic backgrounds; central state officials (excluding those with diplomatic or economic backgrounds); provincial officials; and the military (Figure 2.2). We also use a more expansive measure of the military by including officials in the internal security apparatus (who do not hold positions in the KPA) and officials in charge of the military-industrial complex.

Party officials and those with diplomatic backgrounds jumped in significance on the “transition Politburo” at the expense of those with economic and provincial backgrounds. By 2012, a total of 15 top party positions had entered the Politburo (compared with the composition before September 2010), including powerful figures such as Jang Song Thaek and virtually all heads of the Secretariat portfolios. But using the slightly expanded definition, the increase in military representation starts earlier is even more pronounced; this finding holds if we discount the fact that several high-ranking “military” officers were in fact civilians appointed laterally (Foster-Carter 2012; Mansourov 2012; Haggard, Herman and Ryu 2014). Among the altogether new positions represented in the Politburo following its expansion were the Ministries of the People’s Armed Forces, State Security and People’s Security as well as the Chief of the KPA General Staff.

[INSERT FIGURE 2.2]

Although institutional representation can be taken as a proxy for the ruling coalition, it does not fully capture the way in which the regime favored the military during the second familial transition. As Ghandi and Przeworski (2006) point out, dictators secure support not only through institutional representation but through the distribution of rents and patronage as well; indeed, in a non-market economy such as North Korea these career opportunities—controlled by the Organization and Guidance

Department and ultimately by the top leadership—are even more crucial than in market economies where there are outside options. Between 1991 (when he took over as Supreme Commander) and the 1998 SPA meeting, Kim Jong Il promoted a staggering number of officers. According to South Korean assessments, 1,023 of 1400 general officers were turned over during this period (Gause 2011). While the numbers do not appear as large since the succession to Kim Jong Un began in earnest, the regime nonetheless saw expected waves of military promotions (Gause 2015).

Several important conclusions emerge from our discussion so far with respect to the breadth and identity of the regime's coalitional base, an important domestic variable affecting the efficacy of both sanctions and inducements. Before outlining them, however, it is important to note that there was substantial turnover in personnel as a result of the succession both before and after Kim Jong Il's death. Purges even included the surprising arrest and execution of Jang Song Thaek in December 2013 (Mansourov 2013). This turnover—the ups and downs in the occupants of particular positions—is a preoccupation of North Korea watchers and has been analyzed deeply for signs of waning and rising influence (for example, Park 2011, Mansourov 2013, 2014; Haggard, Herman and Ryu 2014 and particularly Gause 2011, 2015).

But purges and new appointments did not mark a generalized reign of terror. Rather, they were calculated tools of building new networks of loyal supporters that extended from the bottom of the system all the way up to top party, military and security personnel. Moreover, there is no indication that the fundamental organizational features of the regime that we are highlighting for our purposes here—the narrowness of the ruling group and its socio-political foundation—fundamentally changed as a result of the succession; rather, the system was effectively reproduced. As Figure 2.1 shows, despite the churning with respect to the occupants of particular positions, the military appeared to be a major beneficiary of the expansion of formal institutions, matched by major promotions within the military itself. These persistent trends suggest a regime which though highly personalist and nominally party-dominant is nonetheless characterized by an unusual dependence on military interests. We would expect such a coalition to be particularly immune either to economic sanctions or to economic inducements.

*The Mechanisms of Social Control*

Arguments about the effects of sanctions on regime stability or its propensity to respond to outside incentives hinge critically on the relationship between the state and citizens. Two arguments are germane. The first is the claim that sanctions can generate political pressures in the target state and may even produce regime change. The second is the obverse: that inducements serve indirectly to loosen the bonds of social control by strengthening social forces that benefit from engagement.

Our review of a number of indicators, including the control exercised over civil society, the repressive apparatus, the penal system and the criminalization of economic activity casts strong doubt on the first proposition. Despite the famine of the mid-1990s, North Korea is by no means a weak or failed state; rather, as numerous human rights studies have shown in detail,<sup>12</sup> it maintains an extraordinary repressive apparatus.

The second argument is more complex and we suggest in the Conclusion how this claim for engagement might work looking forward. But here we underline two major analytic points that are frequently missed in the engagement literature. First, authoritarian regimes often retain substantial control and discretion over market-oriented activity. When they do, such control typically extends to cross-border transactions and communication in particular. Second, even when controls are relaxed such reforms do not necessarily have subversive effect. Rather—as Dimitrov (2013) and his colleagues argue strongly—such adaptations help account for the resilience of the remaining communist systems.

We look first at the so-called “organizational life” and the monopolization of social organization and then at the instruments of repression and control. We pay particular attention to how the government has managed the emergence of economic crimes, including border crossing, since these policies are directly relevant to our consideration of the possible effects of greater economic openness and at least some economic inducements such as increased trade and investment.

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<sup>12</sup> Among the most comprehensive treatments of the repressive apparatus are the annual Korean Institute for National Unification (KINU) *White Paper on Human Rights in North Korea*. See also the Report of the Commission of Inquiry on Human Rights in the Democratic People’s Republic of Korea (2014).

The so-called “organizational life” (OL) refers to a network of surveillance and indoctrination practices conducted under the aegis of five, top-down social organizations: the Korean Workers’ Party (KWP) itself, the Youth Union, the Trade Union, the Farmers’ Union, and the Women’s Union (Hunter 1999 60–65; Sung Chull Kim 2006, 65–75; Lankov, Kwok and Cho 2012). All adults are sorted into one—and only one—of these five organizations, which serve the purpose of both indoctrination and surveillance.<sup>13</sup>

For our purpose, two features of these organizations are of interest. First, they are encompassing; no other independent civil society organizations exist. As our refugee interviews also attest, this pervasive, omnipresent top-down organization has an atomizing effect, limiting the incentives or ability to organize outside of the state (Haggard and Noland 2011). Second, the OL serves the purpose not only of indoctrination and the communication of directives, but also provides an ongoing means of surveillance. This system operates not only through the party and the OL—with their time-consuming indoctrination and self-criticism sessions—but also through the so-called *In-min-ban* system. This system reaches down to the smallest residential unit—the *In-min-ban*, consisting of 30-40 households—and links the head of each neighborhood with the security apparatus, permitting extraordinary ability to monitor the population (Demick 2010; Gause 2013).

Social control is by no means limited to coercive mechanisms; the state also maintains a large and highly elaborated internal security apparatus. The Ministry of State Security (MSS) is the equivalent of a secret police focused on the government’s expansive conception of anti-state activities, political and economic crimes; it has an estimated 50,000 personnel and runs an elaborate network of informers. Since about 2000, the MSS also conducts the first screening process of those apprehended for border crossing or repatriated by Chinese authorities, a reflection of the seriousness of illicit

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<sup>13</sup>. By comparison with other communist systems, the North Korean party is relatively large, with membership estimated as about 12 percent of the population (Lankov, Kwok and Cho 2012); the party can by no means be equated with the elite. However, recruitment into the party is selective, subject to rigorous screening and particularly close oversight. Membership is a prerequisite for access to the perks and rents of higher office; recruitment into the party thus generates high-powered incentives for loyalty.

border crossing. The Ministry of People's Security (MPS) conducts basic police functions but is also responsible for internal security. With an estimated force of 210,000 personnel (Gause 2013, 11), it conducts surveillance that extends down to unannounced household visits.

The organization of the penal and criminal justice system provides a particularly useful indicator of the repressiveness of the regime. The most notorious component of the prison system is the massive *kwan-li-so* administered by the SSD and variously translated as political prison camps, labor colonies, or concentration camps (Kang 2005). Incarceration for standard criminal offenses, as well as economic crimes, is distributed through the remainder of the penal system. Of particular interest for our purposes is the explosive growth of *ro-dong-dan-ryeon-dae* or labor-training centers, a network of local facilities that dates to the 1990s. The labor-training centers emerged as an ad hoc response on the part of authorities to the fraying of socialist control during the famine and in its immediate aftermath, including unauthorized movement, black market activity, border-crossing and the other economic crimes (Noland 2000). In the 2004 revision of the penal code—and as an indicator of what we call “reform in reverse”—“labor training sentences” were explicitly introduced as a new form of punishment and the existence of the *ro-dong-dan-ryeon-dae* labor training centers therefore institutionalized (Han 2006, Yoon 2009, KINU 2009, B. Kim 2010, Haggard and Noland 2011).

Labor-training centers have played a particularly important role in the management of those caught crossing the border or repatriated from China given that unauthorized exit from the country is criminalized (Muico 2007; Haggard and Noland 2011). Leaving the country without permission was initially considered equivalent to treason. The 1999 criminal law revision first distinguished defectors leaving the country for purely economic reasons and those engaged in subversive activities including contact with South Koreans while in China or even exposure to South Korean propaganda, broadcasts, movies or music. But since the onset of the Kim Jong Un era, there is ample evidence of a sustained effort to crack down on illicit border crossing and communication, including with cell phones (for example Human Rights Watch 2015). As we will show, this has occurred even as the border has become more open to trade, investment and official cross-border movement.

Of particular interest to an understanding of economic statecraft is how the government dealt with the process of de facto marketization. Political authorities in fraying and marketizing state socialist systems face a number of challenges to the integrity of the state sector, including the outright theft or destruction of government property. As the planning process collapsed, both acquisition of inputs and sale of final output increasingly took place through informal exchanges, making it more and more difficult for lower-level planning bodies to exercise effective oversight. Given the inefficiency of the planning process, managers can earn enormous rents by allocating resources more efficiently, engaging in trade—including foreign trade—and under-reporting earnings (Yang and Shepard 2009). Households and work units have also engaged in income-earning activities that pose economic as well as political challenges. Individuals engaged in unauthorized private enterprise and trading do not show up at their work units and are difficult to tax. In addition, such individuals risk slipping through the elaborate net of political surveillance and monitoring of the OL and *Im-jin-ban* system.

The evolution of economic crimes in North Korea exhibits a complex dialectic related to the government's tacking between reform and retrenchment that we outline in the next section (Yoon 2009). In the 1998 revision of the constitution, the government took the step of recognizing income earned through legal economic activities as private property (Article 24); for a socialist system, this was potentially a major breakthrough (Frank 2005). Yet the combination of system fraying and the partial economic reforms themselves gave rise to a variety of activities that went beyond what the state allowed. In the 1999 criminal code, the "Chapter on Offenses against the Management of the Socialist Economy" included eight articles; in 2004, it was re-titled "the Chapter on Offenses against the Management of the Economy" and included seventy-four. If taken literally, these crimes prohibit a wide array of standard commercial activities.<sup>14</sup> Of particular interest for our purpose is the fact that violations of trade and foreign exchange controls receive particularly detailed attention (Article 104; Articles 1065-107; 116-117;

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<sup>14</sup>. For example, Articles 110 and 111 of the 2004 criminal code provide for up to two years of labor training for individuals and firms who engage in "illegal commercial activities, therefore gaining large profits." Article 118 extends similar punishment to "gaining large profits through usury." Article 119 prohibits "illegally giving money or goods in exchange for labor."

125-126). However, virtually all aspects of economic activity—commerce, financing, hiring of labor, foreign trade and acquisition of foreign exchange—are potentially criminal activities. In 2007, a series of “additional clauses” (*bu-chik*) singled out a number of economic crimes such as theft of state property for more severe punishment, including fixed prisons terms and even death.

Particular mention should be made of efforts to control information flows, both internal and external.<sup>15</sup> Increasing marketization from below was associated not only with economic activity and movement but with increasing access to outside media, both through broadcasting efforts from the South and elsewhere and trade with China in IT and cultural products: USB drives, MP3 players, and CDs and DVDs of Korean music and films. Smuggled Chinese cell phones also permitted those close to the border to contact relatives, even in the South, and for outside organizations to secure information. Yet the regime has maintained its own closed intranet, without access to the worldwide web, and partly as a pre-emptive move and to assure control, the regime also rolled out its own cellular network in 2008 with foreign investment from an Egyptian firm. This network subsequently underwent significant although still limited growth.<sup>16</sup> Yet even as it introduced these controlled information flows, the regime has also sought to assure that they would not be used for subversive purposes, particularly with respect to the border. Ample news reports note increasing surveillance in the Kim Jong Un era, and even the use of new technologies to track cellphone use and identify and arrest those engaged in illicit border crossing and communication (Human Rights Watch 2015).<sup>17</sup>

In sum, not only is North Korea’s ruling coalition incredibly narrow and skewed toward the military, but it has also maintained a remarkable capacity to control and repress. The implications for economic statecraft are clear. First, as the economy becomes more open, sanctions potentially expose both elites entities and citizens to costs.

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<sup>15</sup> See Haggard, Noland, and Ryu. “Cells Phones and Jamming Failures: A Combustible Mix,” North Korea: Witness to Transformation blog. February 28, 2012 at <http://blogs.piie.com/nk/?p=5145>.

<sup>16</sup> See Kevin Stahler, “North Korea’s Cell Phone Growth in Context,” North Korea: Witness to Transformation blog. September 30, 2014 at <http://blogs.piie.com/nk/?p=13504>

<sup>17</sup> See Stephan Haggard, “Controlling the Border,” North Korea: Witness to Transformation blog. August 21, 2014 at <http://blogs.piie.com/nk/?p=13432> and Stephan Haggard, “Slave to the Blog: IT Edition,” North Korea: Witness to Transformation blog. August 8, 2014 at <http://blogs.piie.com/nk/?p=13391>

But these economic costs must be weighed against the capacity of the state to control and repress. Unless targeted at elites, sanctions in such a system can impose costs on the wider population without necessarily having the intended political effect. But second, many of the “inducements” on offer from the international community—in the form of trade, investment and even aid—is not necessarily appealing to a regime that seeks to exercise control over economic activity, movement and particularly foreign links. It is possible that “stealth engagement” may have subversive effects and we return to it in the Conclusion. But as with our analysis of the political system, consideration of the system of social control suggests the constraints on both sanctions and engagement strategies.

### **The Political Economy of North Korea**

Our portrayal of the political system suggests a virtual textbook example of Solingen’s (2007) inward-looking coalition exercising tight control over polity, society and economy. The analysis of economic reform in this section extends this analysis and has several analytic purposes. First, interest in reform—including of the foreign sector—is an important proxy for and even determinant of regime intent. Is the government placing emphasis on economic issues and growth? Or is it wedded not only to control but an allocation of resources that favors the military? But second, reform is of interest precisely because it can have the effect of both making countries more vulnerable to sanctions and inducements, thus sending a costly signal to foreign audiences.

For the bulk of the period under review here, the North Korean stance on reform was ambivalent at best. A period of policy immobilism in the wake of the collapse of the Soviet Union contributed to the famine followed by a period of ad hoc crisis management in the immediate aftermath of Kim Il-sung’s death (1994-1997). The famine was ultimately followed by a brief period of cautious economic reform in the 1998-2002. However, this brief reformist moment was limited in scope and followed by a swing back in a more closed direction over much of the period considered here, roughly 2005 through the death of Kim Jong Il in December 2011. In back-and-forth fashion the regime does appear to have launched de facto if not de jure reforms under Kim Jong Un. However, these occurred in the context of a new ideological doctrine—the *byungjin*

line—that explicitly repudiated any connection between reform and a moderation of foreign policy behavior.

We undertake this review in four steps, beginning with a brief outline of the country’s notoriously complex and fragmented economic structure which includes not only the formal planned economy rooted in state-owned enterprises but an emerging market economy, a “court economy” servicing the personal and political interests of the top leadership and significant economic activity under military control as well. We then turn to the course of economic policy under Kim Jong Il more recent developments under Kim Jong Un. Finally, we consider in more detail the country’s stance toward foreign direct investment, a particularly interesting indicator of its ambivalence toward economic opening.

### *Economic Structure and Decision-Making: The Multiple North Korean Economies*

North Korea appears to have a highly orthodox state socialist economy, dominated by the planning apparatus, state-owned enterprises and agricultural collectives and cooperatives. To this, as we will show, has been added a substantial shadow or market economy that grew up in the interstices of the famine. As both the state sector and the emerging private economy engage in cross-border transactions, North Korea’s vulnerability to sanctions should increase, *ceteris paribus*.

However, it is important to note that the economy also includes at least two other distinct spheres which, while internationalized, have always operated in the international gray zone of black markets and illicit activity: the court economy; and a complex of firms under control of the military and military-industrial complex.

Given the personalist nature of the North Korean political system, the lines between the public and private spheres are necessarily blurred. This is partly due to outright corruption—the maintenance of Kim family assets—in part because of the need for ongoing sources of revenue that can be used for the distribution of rents to the regime’s inner circle. The notorious Offices 38 and 39 are charged with the tasks of managing the Kim family’s funds and assuring that a share of all foreign exchange earnings are remitted to the direct control of the top leadership. Office 39 has also been

implicated in a variety of illicit activities that we seek to document in Chapter Three (Chestnut 2007, 2014; Bechtol, Kan and Collins 2010; North Korea Leadership Watch 2012; Hastings 2015; Gause 2015). In addition, the military controls a variety of companies directly, including not only those involved in weapons sales and procurement but in more purely commercial activities as well (Park 2009; Pollack 2011).

The activities of the court and military economy have quite naturally been the target of sanctions over the years. Yet both spheres have accumulated substantial experience in avoiding detection and possible sanction, in part because of the political geography of North Korea's trade that we take up in more detail in Chapter Three.<sup>18</sup> Moreover, the "openness" associated with these types of activity hardly reflects the coalition of interests that would see advantages from reform, opening or a moderation of North Korea's foreign policy; to the contrary. Put differently, it is quite possible for an economy such as North Korea's to "internationalize" in ways that are not only at odds with the logic of transformative engagement but actively hostile to it.

### *Reform and Reversal under Kim Jong Il*

The starting point for North Korea's reform efforts was an unusually orthodox command economy. In contrast to the Soviet Union and its Eastern European wards, the regime rejected the path of de-Stalinization following purges of more moderate factions in the period from 1956-61. Rather, it pursued heavy industry, collectivized agriculture, and suppression of private production and trade. Claims of self-reliance notwithstanding, this development strategy relied on imported Soviet oil and other inputs, which proved a fatal vulnerability. Frustrated by North Korean unwillingness to repay accumulated debts, the Soviets started to limit its exposure as early as 1987 and the country was hit by a massive trade shock in 1990. As the Eastern bloc disintegrated, access to subsidized inputs disappeared. At this critical juncture—and in the years that followed—the regime

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<sup>18</sup> An example is provided by the leaked "Panama Papers." A British banker resident in Pyongyang allegedly set up a shell company in the British Virgin Islands which in cooperation with several North Korean state entities was used to evade international sanctions. Juliette Garside and Luke Harding, "British banker set up firm 'used by North Korea to sell weapons'," *The Guardian*, 4 April 2016 <http://www.theguardian.com/news/2016/apr/04/panama-papers-briton-set-up-firm-allegedly-used-by-north-korea-weapons-sales> accessed 9 April 2016. See also UN Security Council 2016.

faced fundamental policy choices. Would it seek to defend or revive the command economy or loosen the reins of government and experiment with reforms, including those that would allow it to expand exports to finance imports, including of food? The regime chose to maintain the broad contours of policy and suppress consumption, cutting rations delivered through the PDS and initiating a “let’s eat two meals a day” campaign. It was not until the spring of 1995, with the famine in full force, that the regime belatedly exploited floods and a natural disaster narrative to appeal for assistance.

One result of the famine was a considerable decentralization of the entire economy (Haggard and Noland 2007). The marketization that began with food gradually encompassed a broader range of household goods, in part building upon officially sanctioned cottage industries for consumer goods that began in 1984 (“the August 3 campaign for people’s goods”), in part a result of entrepreneurial activity. Marketization was not limited to households; local government and party officials, enterprise managers and military units also scrambled to survive. Entrepreneurs affiliated with SOEs or other institutions, including government agencies, used official connections to obtain political protection for quasi-private production, marketization of inter-firm relations and even direct sales to the public at non-controlled prices.

Emerging from the famine with a mortally-wounded planning mechanism and an economy and state marketizing beyond central control, the government belatedly began a cautious reform around 1998. The 1998 constitution included provisions that nominally granted greater scope for private activity (Article 24), for incentives within the state sector (Article 33) and for foreign trade and investment (Article 36 and 37). These measures were a prelude to the announcement of a package of reforms in 2002 that were substantial by North Korean standards (Frank 2005). Analyses of subsequent official economic discourse document an ongoing debate over economic strategy that persisted until mid-decade when—as we will see—reforms were slowed down and reversed (Carlin and Wit 2006, Haggard and Noland 2010a, Choi and Lecy 2012).<sup>19</sup>

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<sup>19</sup> . Choi and Lecy (2011) mention a wonderful bit of historical engineering. In order to justify discussion of reform—however marginal—the argument was advanced that Korea had begun to develop capitalism as early as the 17<sup>th</sup> century before its evolution was disrupted by Japanese colonialism.

The 2002 reforms had four components: microeconomic policy changes, including alteration of administered prices and wages; macroeconomic policy changes, including the introduction of direct taxes; an effort to revive special economic zones as a source of scarce foreign exchange; and aid-seeking. We focus here on the first of these and take up the reform of the external sector and aid below and in Chapters Three and Four. That the reforms were tentative, experimental and somewhat incoherent is to be expected; few state socialist systems went the route of “big bang” reforms, and those that did typically did so in the context of more fundamental political change. But components of the reform suggest that they were motivated in part by an effort to re-establish rather than relinquish state control and by the middle of the decade the regime started to reverse them.

The microeconomic reforms involved several distinct price changes, each with its own political economy implications. Changes in relative prices and wages could be interpreted as an attempt to increase the role of material incentives. But these occurred in the context of a 10-fold increase in the price *level* and an ongoing inflation that exceeded 100 percent annually between 2002-2005. The engineering of a dramatic inflation appears to have had as its objective the effective confiscation of cash holdings held by the newly-emerging trading class, or at least that portion of it that were lacking political connections.

In the industrial sphere, North Korean enterprises were instructed that they were responsible for covering their own costs; they would no longer receive state subsidies. But at the same time, the state administratively raised wage levels, with certain favored groups such as military personnel, party officials, scientists, and coal miners receiving supernormal increases. Despite some changes in relative prices the state continued to maintain an administered price structure, which tended to lag the inflation in market prices. In sum, enterprise managers were told to meet hard budget constraints, but were given little scope to really manage. In the absence of any formal bankruptcy or other “exit” mechanism, enterprises remained in operation at extremely low levels of capacity utilization supported by a variety of state subsidies.

In the agricultural sector, finally, the government increased the procurement price of grains to incentivize farmers and increase the volume of food entering the public

distribution system (PDS). It also engineered a dramatic increase in PDS prices to consumers. However, procurement prices did not keep pace with rising market prices, and the policy was not successful in coaxing the local harvest back into the PDS system. These agricultural reforms were one of the first to be explicitly reversed.

In sum, rather than “leading” the transition, the reforms of the 1998-2002 years were a rearguard response to a *de facto* process of marketization. One can develop economic explanations for each of these microeconomic policy changes, and the reform may simply have reflected lack of knowledge about likely market consequences of government actions. But the reforms clearly rewarded friends and punished enemies. Favored groups such as the military received supernormal wage increases, but incentives to managers, farmers and traders had limited effect because of the failure to adjust prices and because of the government’s lack of credibility. The enormous jump in the price level could even be interpreted as an assault on the class of traders and black marketers that had sprung up over the previous decade.

The timing of the reform proved highly inauspicious and raises an issue to which we return repeatedly in the volume: the ongoing tension between military and economic imperatives. Within months of the launching of the 2002 reforms, the second nuclear crisis had broken. The October revelation of an HEU program, the escalatory response to the charges, and the revelation that North Korea had indeed abducted Japanese citizens all had the effect of cutting off possible sources of trade, investment, and aid. As a result, the regime was left with the problematic legacy of the partial economic reforms of July 2002, but without the complementary political and economic payoffs that were needed to make the reforms work.

A number of policy measures taken from 2005 forward suggest a reversal of reform (Haggard and Noland 2010a; Choi and Lecy 2012). During the 2005 harvest, the government engaged in confiscatory grain seizures, renegeing on commitments to the farmers. Buoyed by support from China and South Korea—and demonstrating the perverse effects engagement can have--the regime subsequently announced that it was banning private trade in grain, resuscitating the PDS, and expelling the WFP and NGOs engaged in humanitarian operations.

The post-reform effort to re-assert state control was by no means limited to the food economy, but included a wider assault on market activity and the cross-border trade.<sup>20</sup> The reactionary tenor of government policy was vividly represented by a revival of the 1950s Stalinist “Chollima” movement of Stakhanovite exhortation and the initiation of “speed-battle” mobilization campaigns. In 2009, revisions to the planning law overturned reforms introduced in 2001 and 2002, codifying a more top-down planning process (Institute for Far Eastern Studies 2010a).

The culmination of the anti-reform drive came on November 30, 2009, with the introduction of a surprise confiscatory currency reform aimed at crushing market activity and reviving orthodox socialism (Haggard and Noland 2010a). The move had a chilling effect on virtually all economic activity, both public and private, and ushered in a period of acute shortage and an enormous rise in prices, most importantly of food. The government was ultimately forced to accommodate itself to economic realities by acquiescing in the re-opening of previously banned markets and allowing the use of foreign currency. The government also sought to revive and deepen the China trade, which has important implications for the Six Party Talks as we show in Chapter Seven. But the currency reform was the last significant economic initiative of the Kim Jong Il years and as we will see corresponded with a more belligerent foreign policy stance from the start of 2009 as well.

Why reverse the reform process? The government might have reversed course in a misguided effort to restore the social safety net or as an anti-inflation policy.<sup>21</sup> The onset of the nuclear crisis might also have provided an entry point for hardliners who were opposed to the reforms in any case; we pursue this possibility in more detail in Chapter Six. But the alternative is that the authorities were simply uncomfortable with the bottom-up marketization of the economy in any case, particularly as the political system

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<sup>20</sup> The anti-market campaigns began with the imposition of escalating age restrictions on market traders in the fall of 2007, and were followed by stepped up inspections on the general markets and a dramatic reduction in their days of operation. Haggard and Noland 2010.

<sup>21</sup> This explanation rests on the idea that authorities were spooked by the ongoing inflation associated with the reforms. They had no ability to control the prices on consumer goods entering the country from China, but did believe that they could control the price of grain, which loomed large in the consumption basket.

entered a highly uncertain transition. Whatever the cause, the reversal clearly reflected the triumph of statist thinking within the regime over a reformist path.

### *Economic Policy Under Kim Jong-un*

After the death of Kim Jong-il, there was hope that a more cosmopolitan outlook or simple desperation would lead Kim Jong-un to implement reform. In his first significant policy speech on April 15, 2012, against a backdrop of worsening economic conditions, Kim Jong-un stated that “it is our party’s resolute determination to let our people who are the best in the world — our people who have overcome all obstacles and ordeals to uphold the party faithfully — not tighten their belts again and enjoy the wealth and prosperity of socialism as much as they like.”<sup>22</sup> The new leader also suggested that subtle institutional changes were afoot. Most notable in this regard were statements suggesting an elevation of the status of the cabinet; as we saw above, the weakness of the cabinet and the representation of technocrats was a defining features of the system.<sup>23</sup> Even the purge of important military hardliners was read through a “reform” as well as “succession” lens.

The details of the reform effort were not publicly announced, however. Rather analysts discerned pilot measures emanating from a 2012 directive called “On the Establishment of a New Economic Management System in our Own Way” that leaked out of the country via information channels and defectors; this directive came to be known as the “28 June [2012] measures” for the date it was purportedly announced to party cadre (Park 2013; Nolan 2013). These pilot policy changes were somewhat more clear in the agricultural sector, where the state planned to reduce the size of work teams on the cooperative farms, which would approximate the household responsibility system

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<sup>22</sup> See “Kim Jong Un Speaks at Military Parade,” April 15 2012. at <http://www.kcna.co.jp/index-e.htm>

<sup>23</sup> According to the official Korean Central News Agency, on April 6, 2012, in a meeting with the Central Committee of the Korean Workers’ Party, Kim Jong-un stated that “[we should focus] all the issues arising in the economy on the Cabinet and establishing strict discipline and order of solving them under the unified command of the Cabinet.” KCNA. April 19, 2012. <http://www.kcna.co.jp/item/2012/201204/news19/20120419-07ee.html> accessed 31 October 2012.

introduced in China in the late 1970s, allow greater access to private plots and allow cultivators to consume their surplus, barter it, or sell it back to the state at an administratively determined price. In 2015, officials stated privately that the laws against selling grain in the market had been relaxed, a potentially significant shift in policy.

Similar though less specific reforms were vetted with respect to manufacturing and services, where activity was dominated by state-owned enterprises. Under the so-called May 30 [2014] measures—again, after the date they were purportedly introduced—enterprise managers would pay a fixed share of revenues to the state as a tax and would be able to retain the remainder. State-owned enterprises would be permitted to purchase inputs at market prices from their suppliers of choice; hire and fire labor at prevailing wages; sell excess output not specifically dedicated under plan commitments; and enter into joint ventures with registered investors, including domestic partners. By providing a greater degree of freedom to SOE managers the reforms, if fully implemented, would effectively recognize the role of an emerging class of private business people capable of mobilizing cash and inputs, including through cross-border trade.<sup>24</sup>

The course of actual policy proved anything but straightforward and was influenced by broader political developments. Within weeks of reaching the so-called Leap Year deal with the US in February 2012, the regime blew up the agreement by announcing its intention to launch a long-range satellite (Chapter Seven). This decision set in train a long cycle of confrontation that ran through a second satellite launch in December 2012, the third nuclear test in February 2013 and two fraught months of tension on the peninsula in the wake of the test (Chapter Seven). These external moves appeared to have internal political roots. Less than six weeks after Kim Jong Un's speech cited above, the *Rodong Sinmun* (May 30), the official newspaper of the Central Committee of the Workers' Party of Korea reintroduced the idea of belt-tightening in an editorial that explicitly highlighted the “guns vs. butter” tradeoff, but in favor of guns: “reinforcing military power, however...[requires] funds, as well as up-to-date technology.... The work of reinforcing the military power is one that cannot succeed

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<sup>24</sup> For example, Choi Song Min, “Rich Traders Invest in Chongjin Construction,” *Daily NK*, 10 August 2012, <http://www.dailynk.com/english/read.php?cataId=nk01500&num=9662> accessed 31 October 2012.

without a firm determination and tightening one's belt." A much-anticipated SPA meeting (6<sup>th</sup> Session of the 12<sup>th</sup> SPA) in September 2012 came and went with only a modest educational reform-- the expansion of universal, compulsory education from 11 to 12 years—and deafening silence on the June 28 measures. By the end of the year, more systematic external assessments, most notably the FAO/WFP (2013) crop assessment, pulled little punches on the absence of agricultural reform.

The overall policy direction of the new regime was clarified with the roll-out of the *byungjin* line, but in a direction that directly contradicted the theoretical expectation that economic reform would moderate foreign policy behavior.<sup>25</sup> The new policy line—announced in the midst of the most significant crisis on the peninsula since the onset of the nuclear crisis in 2002--committed the country to *both* economic reconstruction and the pursuit of its nuclear program. There is little question that it reflected a major statement of the overall grand strategy of the new regime: a political compromise seeking to split the difference between a focus on economic issues and the *songun* or “military first” approach.

However while the economic components of the new line appear to have been undertaken on a pilot basis and by acquiescence to developments on the ground, the military component of the strategy was highly explicit. Nuclear weapons were never to be bargained away “as long as the imperialists and nuclear threats exist on earth.” Moreover, “the DPRK’s possession of nukes should be fixed by law and the nuclear armed forces should be expanded and beefed up qualitatively and quantitatively until the denuclearization of the world is realized.” A separate edict committed the country to its space program, and set up a Space Development Bureau, suggesting an institutionalized commitment to a long-range missile capacity as well.

[INSERT FIGURE 2.3]

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<sup>25</sup> . The new line was rolled out at the plenum of the Workers’ Party Central Committee at the end of March 2013 and institutionalized in a number of laws passed in the Supreme People’s Assembly (SPA) meetings which followed immediately. “Report of Plenary Meeting of WPK Central Committee,” KCNA March 31, 2013 and “Seventh Session of the 12<sup>th</sup> SPA of DPRK Held,” April 1, 2013 and on nuclear weapons in particular: “Law on Consolidating Position of Nuclear Weapons State Adopted,” KCNA April 1, 2013 and particularly “Nuke and Peace 1” and “Nuke and Peace 2,” KCNA April 26 and 27, 2013.

As with the 2002 reforms, political economy factors may have limited the scope of the reforms in the short-run in much the same way that had after 2002 (Park 2013). Figure 2.3 traces the path of North Korean *won* prices for rice, the black market exchange rate, and the (resulting) dollar prices of rice in the aftermath of the November 2009 currency reform. The reform wiped out the savings and working capital of many North Korean households and businesses and damaged the credibility of the North Korean *won* as a currency; the result was a steep depreciation and the onset of high inflation noted above. But around the briefings on the reforms in mid-2012, the trends in rice prices and the *won* depreciation accelerated and did not moderate until 2015. As a result, when pilot reforms were rolled out in select cooperatives, they appeared to generate adverse short-term effects.<sup>26</sup> These problems were only compounded by institutional features of the cooperatives and collectives, which are top heavy with state and party personnel with little interest in shifting incentives toward farmers (Park 2013).

Somewhat different problems emerged with the enterprise reforms. Those sectors where there was effective demand for surplus output—such as cement—boomed and wages rose sharply. But the resultant increase in demand simply generated price increases for basic consumer goods, and of course did nothing for sectors in which longer-term prospects were unfavorable. Moreover, the reforms faced fundamental supply constraints: even if factories could generate profits, they needed inputs. Social infrastructure—power, raw materials, intermediates, transport—remained in disarray as investment was poured into elite ventures in Pyongyang, white elephants such as the Masik Pass ski resort and continuing demands coming from the military. Yet despite these demands on state resources, the government was unable to establish an effective tax system and could not float bonds since the country had no real financial sector—or even banking system—to speak of.

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<sup>26</sup> . Shortages of food and rising prices meant that enterprises could not pay adequate wages, and of course the agricultural reforms could not be expected to yield short-term payoffs given that planting decisions had already been made for the crop cycle.

Viewed over the longer-run, the *byungjin* line could prove a tactical concession that will permit reform to be pursued by stealth; by acquiescing to continuing marketization rather than undertaking de jure policy reforms. We explore this possibility in the Conclusion. But whatever the future path of reform, the *byungjin* line cut directly against the expectation that that a reformist impulse would moderate foreign policy behavior. Rather the opposite occurred, with military and security concerns dominating economic ones. As of mid-2016, the regime had still not public announced its overall intentions with respect to economic reform.

### *The External Sector and the Quest for Foreign Investment*

Opening to foreign direct investment is a particularly telling signal that the regime is willing to partially forego control over foreign transactions in order to reap the benefits of engagement. Integration into complex production networks has been a hallmark of both the capitalist economies in the region, including South Korea, and of reforming socialist systems such as China and Vietnam as well. But attracting foreign investment requires credible commitments to investors, including with respect to the overall policy and political environment. How has policy with respect to foreign investment evolved?

Our answer is simple: although we can trace recurrent efforts to attract foreign investment—and an uptick in these efforts under Kim Jong Un—these efforts have suffered from what might be called the “parchment illusion.” The government has written numerous laws governing foreign investment. But these efforts have repeatedly fallen victim not simply to infrastructure deficiencies or poor economic performance but to political and foreign policy risk, including outright default on foreign borrowing, effective expropriation of foreign assets and recurrent crises associated with the country’s weapons program. Rather than the demand for investment driving foreign policy in a more moderate direction, foreign and domestic policy priorities have repeatedly undermined the credibility of the government’s efforts to attract foreign investment, and particularly in larger projects in which the hold-up problem is most acute. The one exception to this finding proves the rule. North Korea has been able to attract large-scale Chinese investments in resource extraction, precisely because such firms can generally

secure political protection. The result, however, is a pattern of specialization that looks more like that of a rentier state than the other small open economies in the region.

The limited historical interest in attracting foreign investment initially reflected the broader pursuit of self-reliance and initial reliance on trade with the Soviet bloc. However, North Korea never even joined the Soviet-era Council of Mutual Economic Assistance and went so far as to time its central plans to frustrate linkage with the fraternally allied socialist states. During the 1970s, North Korea followed a number of other developing countries in borrowing money from Western banks looking to recycle petrodollars; some of this borrowing was used to import turnkey factories (Cornell 2002). But the country subsequently defaulted on those loans, the only communist country to do so. In addition to market perceptions of risk, unresolved debt has effectively barred North Korea from international capital markets ever since.

The first expressed interest in attracting foreign direct investment came with the establishment of a special economic zone in the extreme northeast corner of the country in Rajin-Sonbong, later rechristened Rason. But the sheer isolation of the zone reflected the caution with which the government approached the project. The unwillingness to invest in refurbishing port facilities or transportation links between the zone and neighboring China and Russia initially prevented the initiative from taking off (Noland and Flake 1997).

As will be documented in Chapter Three, the 1998 election of Kim Dae-jung in South Korea and the inauguration of the Sunshine Policy was accompanied by a growth inter-Korean trade. Investments in a processing-on-commission business were small and did not face significant expropriation risk. However, the overwhelming share of total South Korean direct investment in North Korea came through a tourist project around Mt. Kumgang and particularly in the Kaesong Industrial Complex (KIC). The KIC was the result of a private political initiative by the Hyundai Group in the heyday of the Sunshine Policy, but ultimately involved substantial government financing. Partly because of subsidies and guarantees against political risk, the KIC attracted investment from small- and medium-sized enterprises and began to export from 2006.

As we show through firm level surveys in Chapter Five, Chinese investment has a somewhat longer history. But investment accelerated over the second half of the 2000s

and particularly from 2009-10 as a result of an opening on the part of North Korea to raw materials investments, a series of political-cum-economic initiatives on the part of China (Chapter Seven) and growing interest on the part of provincial governments and firms in the northeast of China in the economic opportunities provided by North Korea's proximity, lower-wages and economic backwardness. Exemplary of these initiatives was commitment to build two export-processing and industrial zones on the islands of Hwanggumpyong and Wihwa Island with significant Chinese financing and joint project management.

Attracting foreign investment seemed to constitute one of the defining features of the late Kim Jong Il and Kim Jong Un regimes, and even of the *byungjin* line. Between 2010 and 2013 the government established a State Development Bank, announced a decision to initiate a "10-Year State Strategy Plan for Economic Development" in which foreign investment played a prominent role, and tasked rival organizations with the job of encouraging and screening foreign direct investment. In 2014-15, the government made a series of announcements regarding the establishment of new special economic zones throughout the country, supported by detailed legal reforms and the suggestion that the zones would enjoy at least a degree of autonomy.

These initiatives did result in a significant increase in foreign investment during the latter half of the nuclear crisis period, most notably in resource investments from China that could be collateralized through the underlying trade generated. Kaesong also continued to boom.

However, both foreign and domestic policies continually served to undercut the effort to attract foreign investment. The Mt. Kumgang tourist resort was effectively shuttered following the shooting death of a tourist in 2008. North Korean unwillingness to issue security assurances stalled talks to reopen the project, which were effectively ended when the zone was expropriated outright in an apparent bargaining ploy to secure South Korean concessions. Kaesong initially survived the sinking of the *Cheonan*, but South Korea imposed sanctions on all trade and investment outside the zone, effectively putting an end to the processing-on-commission trade. Further expansion of Kaesong was also put on hold. Amidst the spike in tensions on the peninsula in the spring of 2013—and in apparent effort to show resolve—North Korea chose to withdraw all workers from

the zone, setting in train a prolonged closure that was only resolved when the Park administration sent signals of a willingness to close the zone. Following the nuclear and missile tests of January and February 2016, the Park administration finally made the decision to close Kaesong altogether.

Investment conflicts were by no means limited to South Korea; even Chinese mining operations were not altogether immune.<sup>27</sup> Efforts to develop export-processing zones appealing to Chinese manufacturing or service firms also yielded limited results. As of mid-2016, the Hwanggumpyong and Wihwa Island zone projects remained fallow, following years of stalled negotiations over protections for investors.<sup>28</sup> An ongoing dispute with the Egyptian telecomm giant Orascom centered on the exchange rate that would be used for the repatriation of capital, tying up hundreds of millions of dollars and going to the very heart of the investment process.<sup>29</sup> And despite the conspicuous involvement of foreign advisors in Kim Jong Un's zone initiative, none had attracted any investment as of mid-2016. Only Rason appears to have made any sustained progress integrating into regional production networks, a result of location, subtle differences in the way that it was managed and no doubt strong Chinese and Russian pressures associated with substantial infrastructure investments in the zone.<sup>30</sup> However even the fate of this enclave was threatened by the new round of sanctions in early 2016.

We have looked at policy toward foreign investment as a proxy for regime intent with respect to economic opening. The pattern that emerges is relatively clear and

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<sup>27</sup> The most celebrated of these expropriations was of the operations of the Chinese mining firm Xiyang. See Stephan Haggard, "Chinese Investment in the DPRK: Shanghaied!," Witness to Transformation blog, August 12, 2012 at <http://blogs.piie.com/nk/?p=7158>; Stephan Haggard, "Ripping Off Foreigners II: China Edition," Witness to Transformation blog, October 24, 2015 at <http://blogs.piie.com/nk/?p=7909>.

<sup>28</sup> The effort to establish multiple channels for the approval of foreign direct investment was reversed, raising doubts about which agencies were actually in charge of the investment screening process and in a position to make authoritative commitments. See Institute of Far Eastern Studies, "North Korea to Announce New Economic Development Plan and Organizational Restructuring," February 29, 2012. [http://ifes.kyungnam.ac.kr/eng/FRM/FRM\\_0101V.aspx?code=FRM120229\\_0001](http://ifes.kyungnam.ac.kr/eng/FRM/FRM_0101V.aspx?code=FRM120229_0001)

<sup>29</sup> . Orascom accumulated significant cash balances in North Korea as a result of its operation of the cellphone network, but faced effective expropriation of these profits when the North Korean government sought to allow repatriation only at the market rather than official exchange rate.

<sup>30</sup> A revised law governing the Rason zone gave extraordinary power and discretion to the Rason City People's Committee relative to the previous rules. In 2012, the Chinese surfaced the dirt road linking Hunchun with Rason, are extending the four-lane road to Chongjin and have discussed investment in powerlines into the zone. The Russians have refurbished the rail link connecting Rason and Russia and both countries have invested in improving the harbor.

comports with the broader message of other indicators. Stated intentions to attract foreign investment have repeatedly run up against not only domestic political and policy risks but foreign policy risks as well. Whatever the intention of reformers within the government, the regime has never been able to close the gap between statements of intent—the “parchment institutions” —and the complex of policy and ultimately political commitments required to secure robust foreign investment.

## **Conclusion**

This chapter sought to identify the political constraints that operate on both sanctions and engagement strategies with respect to “hard targets” such as North Korea. Following the theoretical literature on the topic, we looked at the constraints posed by regime type and the capacity to exercise control, the breadth and composition of the regime’s support base and the country’s economic, and particularly foreign economic, policy. Using the composition of formal institutional bodies, we demonstrate the core constituency of the regime—the selectorate—is both extremely narrow and biased in favor of the court retinue of the leader, the military, security apparatus, and military-industrial complex. This group is capable of commanding resources from the system and thus appears relatively impervious—if not outright hostile—to either sanctions or many forms of economic engagement.

With respect to the broader civil society, the mechanisms of social control have been well-documented and do not require extensive comment. The regime may face some constraints from the emergence of a quasi-independent civil society and market economy when compared to the all-encompassing control it could exercise through the workplace when the planning system was more functional; we return to this possibility in the Conclusion and consider possible effects of more tightly coordinated sanctions negotiated in early 2016.

To date, however, these constraints have been met not with concessions but with innovations in the internal security system, including the expansion of economic crimes and the development of low-level labor training camps that have been used to effectively intimidate and extort. As in other authoritarian regimes under the threat of sanctions, the

leadership seems more than willing to impose the costs of international isolation on a vulnerable domestic population. Indeed, as we show in more detail in Chapter Four the regime was even able to turn domestic deprivation into a tactical advantage by extorting aid—at least for a while—from the international community.

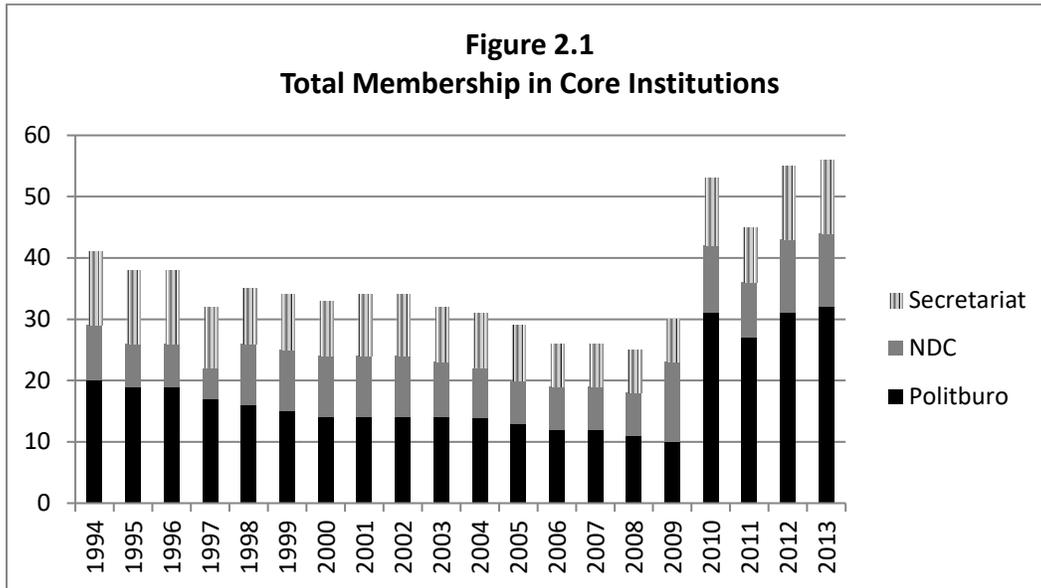
Finally, we traced the course of economic reform and found an extraordinary reluctance to reverse economic course or to sustain reformist experiments. Even in the face of the extraordinary collapse leading to the famine, the regime squeezed consumption rather than undertaking relatively modest and simple reforms that would have altered the state's relationship with either society or the world economy. Although we do find important windows of experimentation in 1998-2002 and again under Kim Jong Un (2012-2015), these reforms were not only partial but raised fundamental questions about whether they were aimed at relaxing state control or rationalizing it.

The separate analysis of the external sector is particularly revealing. Although the regime has shown a recurrent interest in attracting foreign direct investment, cross-border exchange is increasingly oriented toward China, a theme we pick up in more detail in Chapter Three. This integration with a socialist mixed economy raises the important analytic question of whether deeper integration generates either leverage—in the quid-pro-quo model of engagement—or the liberalizing effects postulated in “transformative engagement” models. Any understanding of the political effects of growing economic openness must address a crucial point raised by Solingen (1998, 2012): that statist political coalitions are perfectly aware of the potentially corrosive effects of market-oriented engagement and, for that reason precisely, seek to limit or control it. Thus the apparent preference for a rentier strategy centered on raw materials over integration into global production networks that would require surrender of control and credible commitments to investors.

This penchant for control imposes enormous economic costs. But the *byungjin* line should give pause both to advocates of sanctions and to those who expect that engagement will foster reform or moderate the country's foreign policy behavior. Indeed, in the Conclusion we raise an important possibility that cuts strongly against transformative engagement models: that the pursuit of incremental reform—including of the external sector—may prove an adaptive response that increases support for the regime

rather than exposing it to risk (Dimitrov 2013). Before turning to those issues and the foreign policy dimensions of the crisis, we turn to a closer examination of the effects of the policy choices pursued here with respect to the external sector. Despite the record to date, has growing economic openness possibly exposed the regime to greater vulnerability going forward? As will become clear, the answer to this question hinges crucially on the geography of North Korea's foreign economic relations and the coordination problems raised in the Introduction.

Chapter 2 Figures and Tables



**Table 2.1**  
**Inter-Locking Directorates During the Transition**

	2008	2009	2010	2011
Member of all three	2	2	1	1
Politburo and Secretariat	2	2	10	8
Politburo and NDC	0	0	8	6
Politburo Only	7	6	12	12
Secretariat Only	3	3	0	0
NDC Only	6	12	2	2

**Table 2.2**

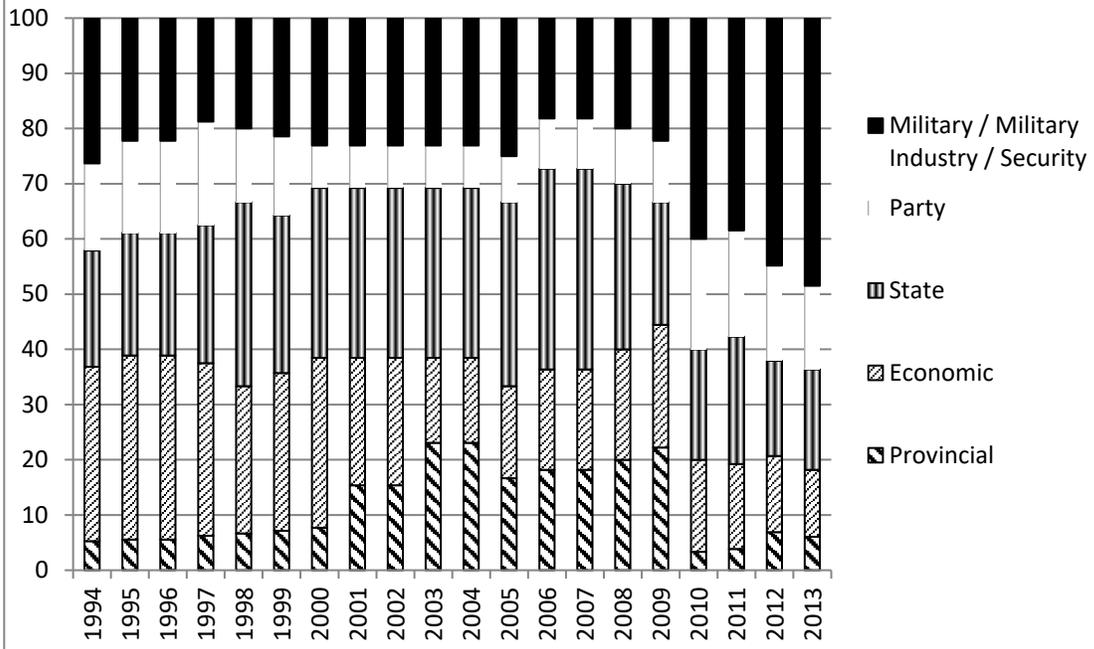
**Membership of the National Defense Commission by Position**

**2003, 2009 and 2012**

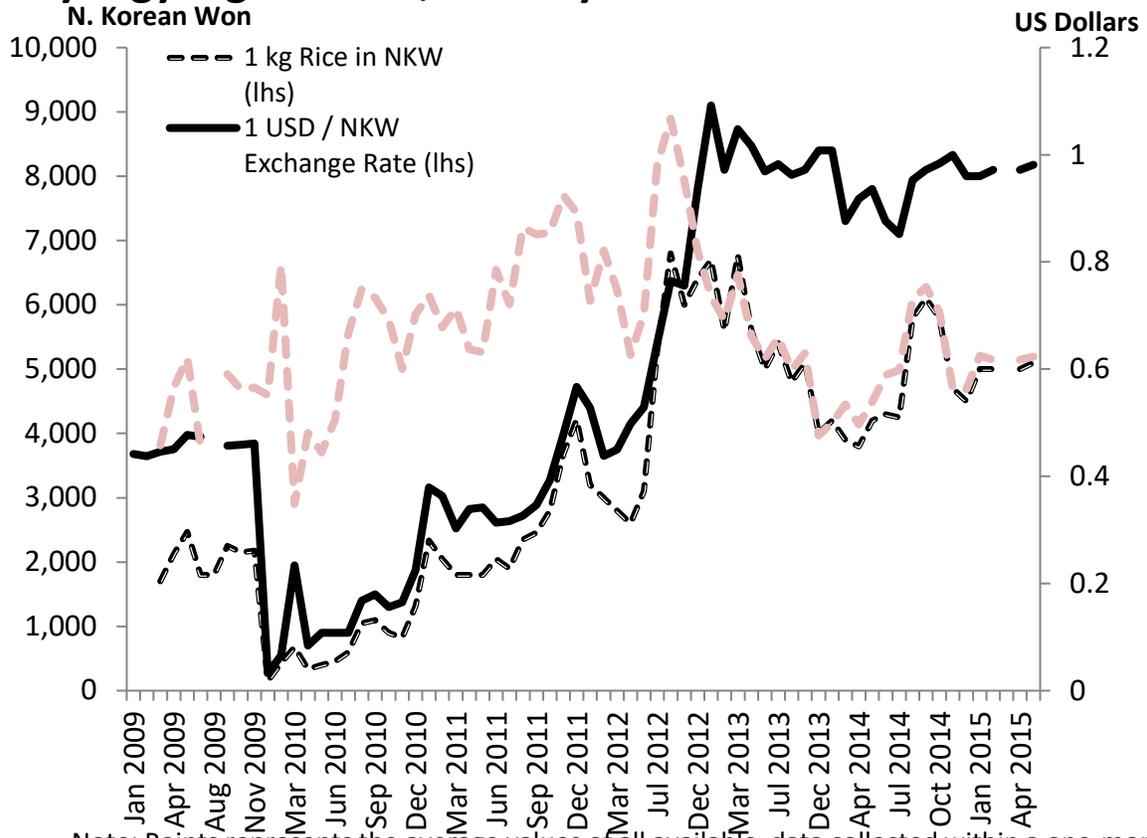
	<b>September 2003</b>	<b>April 2009</b>	<b>April 2012</b>
<b>Unchanged</b>	<ul style="list-style-type: none"> <li>• Supreme Commander (Kim Jong Il)</li> <li>• Director of KPA General Political Bureau (Jo Myong Rok)</li> <li>• Minister of the People's Armed Forces (Kim Il Chol)</li> <li>• Chief Secretary of Jagang Province (Yon Hyong Muk)</li> <li>• Chief of the KPA General Staff (Kim Yong Chun)</li> <li>• Secretary of Munitions and Industry (Jon Pyong Ho)</li> </ul>	<ul style="list-style-type: none"> <li>• Supreme Commander (Kim Jong Il)</li> <li>• Director of KPA General Political Bureau (Jo Myong Rok)</li> <li>• Secretary of Munitions and Industry (Jon Pyong Ho)</li> <li>• Chairman of the Second Economic Committee (Paek Se Bong)</li> </ul>	<ul style="list-style-type: none"> <li>• Director of KWP Administration Department (Jang Song Thaek)</li> <li>• Director of KWP Operations Department (O Kuk Ryol)</li> <li>• Chairman of the Second Economic Committee (Paek Se Bong)</li> </ul>
<b>Positions Added</b>	<ul style="list-style-type: none"> <li>• Minister of People's Security (Choe Ryong Su)</li> </ul>	<ul style="list-style-type: none"> <li>• Director of KWP Operations Department (O Kuk Ryol)</li> <li>• Director of KWP Administration Department (Jang Song Thaek)</li> <li>• Deputy Director of KWP Military Industry Department (Ju Kyu Chang)</li> <li>• First Vice Minister of the People's Armed Forces (Kim Il Chol)</li> <li>• First Deputy Director of KPA General Political Bureau (Kim Jong Gak)</li> <li>• First Vice Minister of State Security (U Tong Chuk)</li> </ul>	<ul style="list-style-type: none"> <li>• Director of KWP Civil Defense Department (Kim Yong Chun)</li> <li>• Director of KWP Machine-Building Industry Department (Ju Kyu Chang)</li> <li>• Minister of State Security (Kim Won Hong)</li> </ul>
<b>Personnel Replaced</b>	<ul style="list-style-type: none"> <li>• Chairman of Second Economic Committee (Paek Se Bong)</li> </ul>	<ul style="list-style-type: none"> <li>• Minister of the People's Armed Forces (Kim Yong Chun)</li> <li>• Minister of People's Security (Ju Sang Song)</li> </ul>	<ul style="list-style-type: none"> <li>• Supreme Commander (Kim Jong Un)</li> <li>• Director of KPA General Political Bureau (Choe Ryong Hae)</li> <li>• Minister of the People's Armed</li> </ul>

			<p>Forces (Kim Jong Gak)</p> <ul style="list-style-type: none"> <li>• Minister of People's Security (Ri Myong Su)</li> <li>• Secretary of Munitions and Industry (Pak To Chun)</li> </ul>
<b>Positions Removed</b>	<ul style="list-style-type: none"> <li>• Deputy Commander-in-Chief of KPA</li> <li>• Guard Commander</li> </ul>	<ul style="list-style-type: none"> <li>• Chief Secretary of Jagang Province</li> <li>• Chief of the KPA General Staff</li> </ul>	<ul style="list-style-type: none"> <li>• Deputy Director of KWP Military Industry Department</li> <li>• First Vice Minister of the People's Armed Forces</li> <li>• First Deputy Director of KPA General Political Bureau</li> <li>• First Vice Minister of State Security</li> </ul>
<b>Share of personnel holding military positions and KPA rank</b>	<p>5/8</p> <p>Marshal (1), Vice Marshal (4)</p>	<p>9/12</p> <p>Marshal (1), Vice Marshal (4), General (3), Colonel General (1)</p>	<p>10/11</p> <p>Vice Marshal (4), General (4), Colonel General (2)</p>
<b>Notes</b>	<p>Ri Yong Mu, Vice Chairman of the NDC, is also a Vice Marshal and member of the Politburo, but holds no other position.</p>		

**Figure 2.2**  
**Politburo Membership by Career Affiliation: 1994-2013 (%)**



**Figure 2.3 Price of rice and US dollar exchange rate in Pyongyang markets, January 2009 - 2015**



Note: Points represents the average values of all available data collected within a one-mor

Source: Daily NK, NKT, Author Calculations

## Chapter Three

### North Korea's External Economic Relations, 1990-2015

Since the onset of the nuclear crisis in 2002, North Korea has been subjected to an array of multilateral and bilateral sanctions. Before we can assess their *political* effect—a task we take up in Chapters Six and Seven—we must first attempt to assess their *economic* effect on the country's trade, investment and aid relations. Is North Korea constrained by the variety of sanctions it has faced, including those imposed since the onset of the second nuclear crisis in 2002? Or has it managed to limit the damage by courting new partners and diversifying? Has the regime been able to finance imports with new streams of export revenues and capital inflows? Or has it become more vulnerable over time to foreign exchange constraints and—as a result—more likely to respond to sanctions or inducements? These questions go directly to the long-standing observation that effective economic statecraft hinges crucially on solving coordination problems (for example, Martin 1992).

Answering these questions is not straightforward. North Korea's external economic relations are astonishingly opaque: even international trade statistics are regarded by the North Korean regime as state secrets (Noland 2001; Eberstadt 2007). However, by using so-called “mirror statistics” collected from North Korea's trading partners, and undertaking some financial forensics, we can not only reconstruct the magnitude and direction of North Korea's trade but can provide estimates of its aggregate balance of payments position as well.

We begin with a simple, even naïve test, of the effects of sanctions by considering North Korea's merchandise trade since the onset of the nuclear crisis. A full understanding of the opportunity costs that North Korea pays as a result of sanctions—or as a result of its autarkic economic strategy and provocative foreign policy behavior—would require a more sophisticated counterfactual analysis, and we have attempted such an exercise elsewhere (Noland 2014). Nonetheless, we can show through simple descriptive statistics, a statistical model of the China-DPRK trade and a case study of

luxury goods that multilateral sanctions appear to have had surprisingly little effect on the country's commercial trade, and have certainly not kept it from increasing steadily.

A consideration of the country's merchandise trade also permits a brief digression on the commodity composition of North Korea's trade; that analysis re-enforces our findings with respect to overall economic strategy and foreign direct investment in Chapter Two. North Korea's trade expansion has been driven to an underappreciated extent by extractive industries as opposed to the manufactured exports that fueled Asia's rapid growth. These findings confirm the regime's reluctance to integrate with regional production networks and even raise the question of whether North Korea's political economy should be seen through the lens of the resource curse.

The third section offers an explanation for the puzzle of tightening multilateral sanctions and consistent trade growth by addressing the question of coordination more directly. We do this by examining the political geography of North Korea's trade. We place economic developments since 1990 into a political context that begins with the collapse of the Soviet Union, the famine, and the gradual and erratic recovery from it.<sup>1</sup> This analysis shows that North Korea diversified away from countries more likely to impose sanctions, such as Japan, including toward the developing world. But the most significant share of the country's trade growth came with South Korea during the engagement era and with China.

The analysis of observed merchandise trade ignores other sources through which North Korea can access foreign exchange, including services exports, foreign investment, aid but also illicit activities. Providing a coherent estimate of these activities is a much more complicated task and requires that we construct, from the bottom up, a balance of payments for North Korea; we do this for the period from 1990 to 2011, the end of the Kim Jong Il period. This exercise is crucial for understanding exactly how North Korea

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<sup>1</sup>. A more complete version of this exercise, with a full discussion of sources and the basis of the estimates contained here, can be found in Haggard and Noland 2007b.

earns foreign exchange and the nature of its vulnerability to external pressures. Yet it also provides crucial evidence on the precise nature of the links that North Korea has established with the world economy. Of particular interest is the country's history of illicit activities—weapons exports,<sup>2</sup> illicit drug trade, and counterfeiting--that hardly conform with liberal arguments about the beneficent effects of trade. Our account also underlines the extent to which aid-seeking has been a central component of the country's grand strategy, despite its provocative behavior, an issue we take up more extensively in Chapter Four.

A variety of estimates of these activities exist, but none have been constrained to fit within a simple balance of payments accounting framework. Putting these estimates into a consistent framework generates the finding that reliance on these activities is not trivial but probably more modest than often thought. Moreover, sanctions and interdiction have probably affected them. But a further implication of this finding is that disruption of these activities, while justified on other grounds, is unlikely to have a decisive impact on the regime's behavior, in part because of a revealed capacity to adjust through new export activities, in part because of capital inflows.

North Korea appears to have historically run current account deficits. The implications of this simple finding are underappreciated as they imply that the country has been able to finance its deficits with capital inflows. We show that these are almost certainly dominated by capital inflows from China, probably in the form of foreign direct investment, and perhaps implicit aid in the form of accumulated arrears on loans and cross-border transactions between state-owned enterprises. A crucial question following the new round of sanctions in 2013 and 2016—which included new financial provisions--is whether such capital inflows would persist.

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<sup>2</sup>. It is important to underscore that not all of North Korea's military exports can be technically considered "illicit." Large-scale military exports and imports were proscribed by UN Security Council resolutions after 2006 and small weapons sales were banned by UNSC Resolution 2270 in 2016.

## Sanctions and North Korea's Foreign Trade

North Korea's observed licit merchandise trade from 1990 through 2014 is shown in Figure 3.1, with vertical lines inserted to show the timing of multilateral sanctions efforts. As noted, the data are derived not from North Korean sources, but from the "mirror statistics" of its trade partners.<sup>3</sup> The descent of the North Korean economy into the mid-1990s famine is reflected in the sharp decline of both observable exports and imports in the first half of the decade. But the decline continues thereafter, reaching a nadir in the late 1990s at less than 40 percent of 1990 values.<sup>4</sup> Despite the onset of the second nuclear crisis in 2002, North Korea's foreign commercial relations expanded during the 2000s and 2010s— even if it took over a decade for trade volumes to return to their pre-famine levels.

[INSERT FIGURE 3.1 HERE]

From mid-2006, North Korea was subject to a succession of ever-tightening multilateral sanctions contained in a succession of UN Security Council resolutions: UNSC 1695 of July 2006; UNSC 1718 of October 2006; UNSC 1874 of June 2009 and UNSC 2094 of February 2013 and—after the period covered here—UNSC 2270 of March 2016 which we take up in the Conclusion. We describe these earlier sanctions later in this chapter and their political context in Chapters Six and Seven. It is sufficient to note here that due to the Chinese veto on the Security Council, the sanctions were initially defined relatively narrowly around WMD-related materiel, major weapons systems and—as we show in the next section—a weakly-enforced ban on luxury good

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<sup>3</sup> . In using mirror statistics, one uses the bilateral exports (imports) of a partner country as an estimate of North Korea's imports (exports) from that partner (Noland 2000).

<sup>4</sup> . The timing of this trough in trade corresponds to the Asian financial crisis and a slowdown in Japan, but given the closed nature of the North Korean economy it is not clear that the regional financial crisis mattered; political factors seem more significant.

exports. The gradual introduction of complementary multilateral sanctions on financial flows in later resolutions was similarly tied to WMD and weapons related activities and did not, in principle, affect the financing of commercial trade. Not until UNSC 2270 of 2016 was commercial trade targeted directly for the first time, and as of this writing uncertainty about implementation of that resolution remains.<sup>5</sup>

Despite these limits on the scope of sanctions, there are several reasons why they may have broader effect. First, the multilateral sanctions were accompanied by other forms of collective enforcement. Interdiction activities were conducted not only under the aegis of the UN resolutions but through the US-led Proliferation Security Initiative (PSI) as well; examples of interdiction efforts are provided in Table 3.1 and provide a sense of the range of proscribed activities. Second, a number of other countries not only imposed sanctions in line with the UNSC resolutions but added further bilateral controls as well. Japan was particularly important in this regard, with trade gradually falling to zero. Third, in addition to their direct impact on arms and luxury goods, sanctions might also drive up the risk premium on all exchange with North Korea by introducing uncertainty and deterring commerce in areas not directly subject to them.

[INSERT TABLE 3.1 HERE]

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<sup>5</sup>. Such collateral damage is a theme of Abt 2014, which describes efforts to do business in the country.

However, multilateral sanctions quite clearly did not stop aggregate trade from expanding, as Figure 3.1 shows. After a downturn during the global financial crisis in 2009 when world trade contracted sharply, North Korea's trade continued to grow and particularly as a result of relations with China as we will see, albeit moderating somewhat during the Kim Jong Un era.

We conducted a more sophisticated econometric test of the effect of sanctions by modeling China-DPRK trade from 2000 to the beginning of 2012 controlling for the level of economic activity, the exchange rate, and the seasonality of trade as well as period dummies for the introduction of sanctions (See the appendix to this chapter). The analysis failed to uncover any evidence that sanctions depressed Chinese exports to North Korea; indeed, we obtain the perverse result that the 2006 sanctions appear to have *increased* trade. In effect, China was consciously or unconsciously compensating for whatever losses might have occurred vis-à-vis other countries, including an initial decline in trade with South Korea following the imposition of new sanctions in 2010.<sup>6</sup> Of course, we cannot assess what trade might have been in the absence of all sanctions, but they did not lead either directly or indirectly—through an increase in the risk premium—to a decline or even pause in China-North Korea trade. As we detail later in this chapter and in Chapters Six and Seven, the non-effect of sanctions is related both to the design of the sanctions regime and to ongoing problems of non-enforcement and leakage that are a leitmotif even of official reporting on implementation.<sup>7</sup>

### *Luxury Imports: A Sanctions Case Study*

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<sup>6</sup>. A similar modeling of the North-South trade relationship found that the 2006 sanctions did not have an effect on trade, in part because the North-South relationship improved somewhat in 2007 and through early 2008. However unilateral sanctions imposed by South Korea following the sinking of the *Cheonan* in 2010 did have a depressing effect on trade.

<sup>7</sup>. See UN Panel of Experts reports from 2010, 2012, 2013, 2014, 2015, and 2016.

One small category of commercial imports provides an opportunity to consider the coordination problems in defining and enforcing sanctions; it also provides insight into the priorities of the regime as well. Following its October 2006 nuclear test, UNSCR 1718 banned both direct luxury exports to North Korea and transshipment of luxury goods to the country; this second injunction is important given the substantial transshipment of goods across the Chinese-North Korean border that emanate from elsewhere. However, the task of defining “luxury goods” was left up to individual member states. Some states developed relatively extensive and precise lists and then enforced them; South Korea, the United States, and Japan report no such trade. Other countries such as Russia defined them quite narrowly or—in the case of China—avoided a commitment to restrict this trade altogether. A significant number of states did not report to the UN Sanctions Committee at all.

In the absence of a Chinese list of sanctioned luxury goods, Figure 3.2 reports trends in Chinese exports of luxury goods to North Korea from 2000 to 2013 using three different product definitions of these items.<sup>8</sup> It is clear from Figure 3.2 that the Security Council resolutions have had no discernible effect on Chinese exports of luxury goods.<sup>9</sup> Despite the sanctions China continued to export a variety of products that other countries defined as luxury goods including certain electronic products, vehicles, food and tobacco products; indeed, China became the sole supplier of many of these products. The

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<sup>8</sup>. “Australian list—SITC 3” takes the Australian list and maps the verbal description of the sanctioned luxury products to Standard International Trade Classification (SITC 3) categories. “Japanese list” is based on KOTRA, which attempted to map the Japanese sanctions list to detailed product categories using the Harmonized System (HS) (Kim 2006). The third variant (“Australian list—HS 2”) reconstructs the Australian list using KOTRA’s HS codes, which tend to be more narrowly drawn than the SITC-based categories used to construct the Australian SITC list. An important caveat is that this analysis is that it is based on UN Comtrade-reported data. If trade is intentionally misclassified (luxury watches labeled as industrial machinery) then it will not be detected in this analysis. However, the extraordinary laxity of China in implementing these sanctions suggests that such subterfuge would not be necessary. For parallel exercises on Russia and the EU, see Haggard and Noland 2011b.

<sup>9</sup> It is worth noting that the drop in luxury exports in 2009 under the Australian HS designation is less steep than the drop in overall Chinese exports during that year. Put differently, the *share* of luxury goods in overall Chinese exports—which constitute 5 to 7 percent of Chinese exports to the DPRK—actually *increased* in that year.

European Union is presumably the original source of many luxury products that do find their way into North Korea. We conducted a similar exercise for European luxury goods, and found that they were trending down even before sanctions were imposed and have since fallen to low levels.<sup>10</sup> In effect, the decline in direct European export of luxury goods may be offset in whole or in part by a substitution of Chinese for European luxury goods or—more likely--the transshipment of European luxury goods through China and to a lesser extent Russia.

[INSERT FIGURE 3.2 HERE]

In short, this simple descriptive analysis of merchandise trade shows that overall trade volumes do not appear to be greatly affected by the sanctions regime. This is in part because the design and enforcement of the sanctions regime. First, until UNSC Resolution 2270 of 2016, sanctions failed to penalize commercial trade. Second, despite multilateral sanctions on luxury goods, no common definition of these products emerged until UNSCTR 2094, adopted following the third nuclear test in 2013. At Chinese insistence that resolution was limited to an extremely narrow range of products (jewelry, yachts, luxury and racing cars). As a result, increasing volumes of luxury goods, largely electronics and other vehicles, continued to enter North Korea from China. The luxury goods case is an example in microcosm of how China can undermine the efficacy of sanctions both by limiting the definition of sanctions in the first place and then by serving as a transshipment point for goods that would otherwise have been banned.

### **The Commodity Composition of North Korean Exports**

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<sup>10</sup> See Marcus Noland, “European Luxury Goods Exports to North Korea,” North Korea: Witness to Transformation blog, 18 October, 2012 at <http://www.piie.com/blogs/nk/?p=7867>.

Figure 3.1 outlines North Korea's aggregate trade, but the commodity composition of the country's trade is also revealing of North Korea's foreign economic policy. As we noted in Chapter Two, North Korea has appeared unwilling or unable to integrate fully into the region's dense international production networks, in part because of the difficulties in providing credible commitments to investors. Although there is nothing in the composition of North Korean imports that is particularly striking, Figure 3.3 provides information on the commodity composition of North Korea's exports.

With respect to manufactured exports, we have noted how other economies in the region—from Japan, to South Korea, China and Vietnam—got rich by integrating tightly into global value chains organized by multinational corporations and buying groups and specializing in manufactured exports. An unusually detailed analysis of the performance of North Korean manufacturers in the Chinese, South Korean and Brazilian markets (Jing and Lovely 2015) finds little evidence of indigenous manufacturing activity capable of meeting international standards, and inadequate engagement with multinational firms to compensate for this domestic weakness; this is reflected in Figure 3.3 in the continued decline in the export share of some intermediates and manufactures such as machinery. However, it does show that North Korea has adjusted to external constraints by shifting into textile exports, probably from Rason and other processing-on-commission activities. As of this writing, how this activity will be affected by the closure of Kaesong and a tightening of South Korean sanctions remains to be seen. To date, however, the fact that North Korea has shown an unwillingness or inability to pursue a light, labor-intensive manufacturing model speaks directly to the regime's reluctance to engage with the world economy and the corresponding lack of an export-oriented coalition—even if tacit or informal—that would serve to offset biases in favor of autarky and statism.

At the same time, the figure shows that licit exports are increasingly concentrated in mining products: by 2014 natural resource-based products accounted for about fifty percent of North Korea's exports.<sup>11</sup> Several features of this development are striking. These resource exports are largely controlled by state-affiliated entities, an issue we address through firm surveys in Chapter Five, and raise the broader issue of whether North Korea's political economy shouldn't increasingly be seen through the "resource curse" lens. As a wide-ranging literature has shown, resource dependence not only has potentially adverse economic effects, but in the words of one recent study (Hendrix and Noland 2014, vii) has "weakened domestic institutions, undermined democratic governance produce corruption and enrichment of elites, and finally led in many cases to devastating violence and war."

Second, the rise in export values appears to be driven not only by Chinese growth but by the rise in global prices during the period (Figure 3.4). The figure shows trends in North Korean merchandise exports against two commonly used indices of world commodity prices. The close correlation suggests that North Korea's trade was driven by an increase in prices as much as quantities, and that the rentier strategy pursued by the regime may be vulnerable as those prices fall. We revisit this possibility in the Conclusion.<sup>12</sup>

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<sup>11</sup>. North Korea's largest imported commodity group has been mineral products, which includes crude oil. Textiles and machine/electronic appliances, made up the second and third largest import categories, respectively, in 2013.

<sup>12</sup> Kevin Stahler "How Has the Commodity Bust Affected North Korea's Trade Balance? (Part 1)," Witness to Transformation blog 20 January 2015 <http://blogs.piie.com/nk/?p=13778> and Kevin Stahler "How Has the Commodity Bust Affected North Korea's Trade Balance? (Part 2)," Witness to Transformation blog 21 January 2015 <http://blogs.piie.com/nk/?p=13796> accessed 16 June 2015.

[INSERT FIGURE 3.3 HERE]

[INSERT FIGURE 3.4 HERE]

### **The Political Geography of North Korea's Foreign Trade**

What accounts for North Korea's trade growth despite the imposition of sanctions? The answers can be found in the changing direction of North Korea's trade, which in turn has reflected pivotal changes in the diplomacy surrounding the Korean peninsula. We start with the profound shock of the collapse of the Soviet Union and subsequent relations with Russia. We then turn to an overview of North Korea's trade with the five parties—China, Russia, the US, South Korea and Japan—and its efforts to diversify its political and economic relations during the Kim Jong Il era. These overviews demonstrate clearly the centrality of South Korea and China to North Korea's foreign economic relations and go along way to explaining the coordination problems sanctions have faced.

#### *The Shocks of the Early 1990s: The Demise of the Soviet Union and the Re-Emergence of a Russian Card*

Notwithstanding its pursuit of self-reliance, North Korea had long been deeply dependent on the Soviet Union and to a lesser extent on support from other Warsaw Pact countries in Eastern Europe as well. Not only did the Soviet Union effectively finance North Korea's recurrent current account deficits with a combination of loans and arrears—

visible in the large bilateral trade deficits of the late 1980s in Figure 3.5—but Soviet pricing of coal and oil exports reflected additional subsidies (Eberstadt, Rubin, and Tretyakova 1995).

[INSERT FIGURE 3.5 HERE]

Facing economic constraints of its own and seeking to define a new foreign policy in the Asia Pacific, the Soviet Union under Gorbachev began to cut aid and reduce its support to North Korea beginning in 1986 (Noland 2000 table 3.13). In 1990 Moscow initiated a diplomatic breakthrough with South Korea and simultaneously demanded that North Korea pay world market prices—and in foreign exchange—for Soviet goods.<sup>13</sup> This fundamental change in North Korea's external relations represented a profound political shock (see Oberdorfer 1997: chaps. 9 and 10). But the end of barter and debt financing, and the subsequent collapse of the Soviet economy, constituted a profound economic shock as well. By 1993 imports from Russia were only 10 percent of their 1987–90 average and subsequently declined to near irrelevance (Figure 3.5; Eberstadt, Rubin, and Tretyakova 1995).

Following a Kim-Putin summit in 2001—and accelerating in the 2010s—Russia took new diplomatic initiatives with respect to the peninsula, raising the question of

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<sup>13</sup>. The Soviets also began to terminate technology transfer in the military sphere; this proved important because the export of arms based on Soviet designs had constituted an important source of foreign exchange earnings during the 1980s.

whether the Soviet-era relationship might be at least partly revived (Vorontsov 2007; Zakharova 2016). One barrier to closer cooperation was accumulated North Korean debt from the Soviet era estimated at \$11-14 billion, though this valuation seems somewhat arbitrary since the debts were incurred in the form of nonconvertible Soviet rubles. After years of failed attempts to resolve the issue, Russia and North Korea came to an agreement that effectively wrote off the debt in 2012.<sup>14</sup>

In the early-2010s, a combination of economic interests and geostrategic dynamics combined to boost Russian interest in North Korea: national and regional interests in pivoting toward Asia more generally (for example Bauer 2009; Lee 2013; Federovski 2013; Zakharova 2016); the benefits of extending land transport and pipeline networks, including through North Korea; and President Putin's push for a more prominent Russian role in the post-Soviet space following growing tensions with the West over NATO expansion, Georgia, the Crimea and Ukraine.

The first concrete step in this cooperation was a €150m joint venture rail project reconstructing track between the Russian border and the port of Rajin-Sangbon or Rason. This project was accompanied by investments in the port and the development of a land terminal for the transshipment of Russian coal—which began in earnest in 2014—negotiation of an agreement allowing settlement in rubles, and the formation of a joint business council. However, these initial investments were to be only the opening wedge on a more ambitious cluster of projects dubbed *Pobeda*, or Victory, that would include refurbishment of the entire North Korean rail network, investment in mining and possible construction of oil and gas pipelines. These projects were accompanied by a stated objective of reaching \$1 billion in two-way trade. This goal was ambitious given the limited complementarities outside of raw materials trade, much of which took the form of

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<sup>14</sup> See Stephan Haggard, "More Debt Follies: DPRK Debt to Russia" North Korea: Witness to Transformation blog <http://www.piie.com/blogs/nk/?p=6718> accessed 19 July 2012 for details. A by-product of the debt was the development of institutionalized export of labor, initially to logging camps in the Soviet Far East, as a mechanism of repayment. This model of organized export of labor was subsequently expanded and generalized as we discuss below.

Russian transshipment. High financing costs, constraints on Russian capabilities following the Crimean and Ukrainian crises and the collapse of oil prices, and high hold-up risks all suggest limited possibilities for growth. Despite declaring 2015 “The Year of Friendship,” there is little evidence that bilateral trade will exhibit sharp departure from the post-Soviet patterns visible in Figure 3.5.

*Trade with the Other Five Parties: An Overview*

In his memoir, George W. Bush recalls his response to revelations that North Korea was pursuing an enriched uranium program in 2002; in doing so, he outlined his rationale for the Six Party Talks. “The United States was done negotiating with North Korea on a bilateral basis. Instead, we would rally China, South Korea, Russia and Japan to present a united front against the regime” (Bush 2010, 423-4). As we show in more detail in Chapter Six, this strategy was not successful. However, President Bush saw clearly that coordination was necessitated by the nature of North Korea’s economic as well as political relations with the five parties.

Figure 3.6 is based on data taken directly from the Korea Trade-Investment Promotion Agency (KOTRA) and South Korea’s Ministry of Unification (MOU), among other trade databases, and shows shares of North Korea’s total trade with the five interlocutors in the Six Party Talks--the US, China, Japan, South Korea and Russia—for 2000 through 2013, two years into the Kim Jong Un era.<sup>15</sup> These estimates should be viewed as at the high-end of the likely range for China and South Korea, especially since we include so-called non-commercial trade with South Korea. But as we will show in considering North Korea’s trade with the rest of the world, the trends are clearly correct.

[INSERT FIGURE 3.6 HERE]

<sup>15</sup> . KOTRA has a reasonable track record in eliminating obvious discrepancies but it probably underestimates the growth of North Korea’s trade with the developing world. For example, we add North Korea’s bilateral trade with Myanmar to KOTRA-reported total trade data from 1990 to 2011. In a separate exercise (Haggard and Noland 2010b), we developed some alternative estimates based on KOTRA, IMF Directions of Trade Statistics (DOTS) and UN Comtrade for the period 1990-2008.

If we set aside the case of Russia discussed above, the countries—or more accurately governments within them—fall into two groups: those inclined to sanction the regime and those more willing to engage. Those countries more inclined to sanction North Korea either have negligible economic exchange with the country (the US) or have seen the significance of their economic ties shrink as a result of bilateral sanctions (Japan; Korea under Lee Myung Bak 2008-2013 and extending into the Park Geun Hye administration 2013-2018). Although the United States subsequently devised new financial sanctions against North Korea, including secondary sanctions in 2016, there was little room among these “high sanctions” countries to further curtail commercial trade. This dilemma was increasingly visible in South Korea. After the post-Cheonan sanctions, trade outside of the Kaesong Industrial Complex fell to zero and the Kaesong trade was also shut down in 2016. The only way South Korea could use trade was as an inducement in the form of the promise to *lift* sanctions.

*Trade with the Rest of the World: the Failure to Diversify*

What about trade with the rest of the world? Since trade in a state-socialist country is likely to follow the flag, Figure 3.7 tracks diplomatic ties between North Korea and the rest of the world since independence; it also tracks the parallel South Korean process, encapsulating in a single figure the intense competition for diplomatic recognition (Armstrong 2013). North Korea’s tight dependence on the communist world can be seen in the surprisingly low number of countries that established diplomatic relations with the DPRK following its independence in 1948, only eight (Russia, Mongolia, Poland, Yugoslavia, Romania, Hungary, Bulgaria and Albania). Subsequent expansion reflected in part decolonization and was of more political and symbolic than

economic significance. The vast majority of new diplomatic ties in the 1960s and 70s were in the developing world, with Africa heavily represented and only a few European exceptions (mostly the Scandinavians).

After a pause in the 1980s the burst of new ties in the early 1990s reflects in large part the collapse of the Soviet Union and the emergence of the successor states. But the 2000s saw a re-engagement with the world following the “arduous march” of the famine years. North Korea mended fences with China following a period of some tension and hosted summits with South Korea (June 2000), Russia (August 2001) and Japan (September 2002). Many European countries recognized Pyongyang during this period as did significant Middle Eastern oil producers (Kuwait, Bahrain and the UAE) and major emerging markets such as Brazil and Turkey.

Did these diplomatic efforts yield economic fruit? The answer is supplied by Figure 3.8. It is important to underline that a number of potentially important countries such as Iran are missing from this exercise; we show elsewhere in more detail how ties with the Middle East may be underestimated (Haggard and Noland 2011b). The trade data also does not capture other ways North Korea may secure support by reaching out to developing countries that are less likely to impose or enforce sanctions. Particularly interesting in this regard is North Korea’s relationship with the Egyptian company, Orascom Telecommunications. Orascom put over \$200 million in the country after it was given a 25-year license to operate a nationwide cell phone network before halting further investment as a result of disputes with the government over the repatriation of profits and capital (Noland 2009).<sup>16</sup>

[INSERT FIGURE 3.7 HERE]

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<sup>16</sup> . Stephan Haggard 2013. “Orascom in North Korea: Don’t Leave Me Hanging”. North Korea: Witness to Transformation Blog. 10 December. <http://blogs.piie.com/nk/?p=12505>.

[INSERT FIGURE 3.8 HERE]

Yet as Figure 3.8 shows clearly, these diversification efforts were not matched by robust trade growth. The figure shows both trade and trade deficits, which can be treated as a rough proxy for the financing North Korea is receiving from the rest of the world. On average over the 1990s, the rest of the world accounted for about 40% of North Korea's trade, although with declining trade deficits—and financing—during the famine and immediate post-famine period. From 2000, however, trade with the rest of the world fell steadily to virtual insignificance by 2012 before turning up slightly as the country once again came under pressure to diversify.

*Twin Pillars: the Role of China and South Korea and the Aid Question*

Both Figure 3.6 and the evidence of declining trade and trade deficits with the rest of the world in Figure 3.8 underscore the central significance of China and South Korea to North Korea's foreign economic relations. Despite the high partner concentration of North Korea's trade, its vulnerability to sanctions did not necessarily increase over time, however. Such vulnerability hinges on the likelihood that your trading partners will impose sanctions. China's share of North Korea's trade has grown steadily through the nuclear crisis period, underscoring its strategy of what might be called “deep engagement” and at least until new sanctions in 2016, its relative disinterest in a wider-ranging sanctions regime; we trace these initiatives in more detail in Chapter Seven.

In the case of South Korea, the inauguration of the conservative Lee Myung Bak government ushered in a more conditional approach to engagement with the North. Following the sinking of the *Cheonan*, South Korean trade with the North outside of the Kaesong Industrial Complex contracted dramatically, generating recurrent South Korean concerns about China's "economic colonization" of the northern part of the peninsula. Kaesong remained significant in North Korea's total foreign exchange earnings, however, until it was closed in the first half of 2013 and again in 2016.

A crucial issue in the engagement debate is whether these increased economic ties might have socializing or transformative effects. An important issue in this regard is the extent to which such interaction is on market-conforming terms or represents aid. Figure 3.9 provides a comparative estimate of aid flows from the two countries for the period from 1998 through the end of the Kim Jong Il era.

The extent of Chinese aid is hard to gauge as the country does not provide data on aid flows (Reilly 2014c, Yan 2016). Following the recognition of South Korea in 1992, China shifted its trade relations from "friendship prices" onto a more commercial foundation. The shift to a more commercial stance was rolled out more formally in 2005 under the slogan of "government guidance with companies in the lead; market-based operations and mutual benefit" (Reilly 2014c, 1164) and we detail in Chapter Seven how that political line persisted into the Kim Jong Un era.

Nonetheless, a combination of subsidized exports, humanitarian assistance and politically-timed gifts have persisted (Reilly 2014c); the latter were probably substantial around the time of the transition from Kim Jong Il to Kim Jong Un (Cathcart and Madden 2012; Yan 2016). Infrastructure investment projects such as the paving of North Korean roads into Rason or the construction of export-processing zones Huangjinping and Weihua islands are also a form of aid, although these projects increasingly appear to be focused on upgrading infrastructure on the Chinese side of the border in line with Xi Jinping's Belt and Road initiative (Li 2016)

[INSERT FIGURE 3.9 HERE]

In order to draw comparisons with South Korea, we set a high estimate for Chinese support at 25 percent of all fuel and food shipments; as can be seen South Korean aid substantially outstripped this high estimate over most of the period. But there is some reason to doubt that even our modest “best guess,” let alone our high estimate, is correct. To test for whether Chinese trade is conducted on commercial terms, we compare Chinese export prices for food and fuel with world market prices (see also Manyin 2013).<sup>17</sup> Figure 3.10 shows the monthly price of rice exports since 2002 against two international benchmark prices: the Thai A1 Special grade; and the Thai 25 % grade. China’s exports trended between these two benchmark prices between 2002 and 2008, when world food prices spiked. Data on Chinese exports to the DPRK then disappears, but when the data resumes, the tracking of China’s export prices against Thai A1 special is very tight and North Korea might even be paying a premium. We find similar patterns with respect to corn and wheat (not reproduced here). We repeated the exercise with fuel, using three world benchmarks: West Texas Intermediate, Brent, and Dubai Arab Gulf crude (Figure 3.11). There is some seasonality, but the story is consonant with that reported for food. Chinese export prices track three world-market benchmarks in lock-step through the price spike and subsequent collapse of 2008-9. From the start of 2011 until the beginning of 2014, when Chinese customs officials abruptly stopped reporting crude shipments, Chinese prices exceeded world benchmark prices by non-trivial amounts, between 20 and 30 percent.

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<sup>17</sup> These two commodities are appropriate for several reasons. First, both are relatively undifferentiated commodities that permit such head-to-head comparisons. Second, if the Chinese are extending support to North Korea it is typically assumed to take the form of “friendship prices” on key commodities of central concern to the regime.

It is important to underline the caveats. There is no consistent series of Chinese aid to the North. Our measures of the commercialization of trade in food and fuel could be masking internal subsidies from the government to exporters. But two conclusions emerge from this review. First, as a matter of policy China has increasingly sought to emphasize the commercial nature of the relationship. Second, despite that focus and increasing pressure for more robust sanctions, China still probably does provide humanitarian assistance, politically-timed gifts and infrastructure investment, although as we show in Chapter Four this assistance has not been of adequate level of stave off periodic distress.

[INSERT FIGURE 3.10 HERE]

[INSERT FIGURE 3.11 HERE]

While we do not have reliable information on Chinese aid to North Korea, we have quite detailed data on the role that South Korean assistance plays in total trade with the North.<sup>18</sup> Figure 3.12 divides South Korean exports into three, mutually-exclusive categories: processing on commission trade (and general trade); what the South Koreans call “economic cooperation”; and non-commercial trade. General trade is negligible. The most significant component of the commercial trade before falling off around 2011 was processing-on-commission trade, which excludes the firms in the Kaesong Industrial Complex (KIC). Although nominally commercial, trade from the KIC has benefitted

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<sup>18</sup> . For more on South Korean assistance to North Korea see North Korea: Witness to Transformation blog four-part series from Haggard, Boydston, and Ryu. “South Korean Aid to the North I: An Accounting 1991-2015,” July 20, 2015 at <http://blogs.piie.com/nk/?p=14284>; “South Korean Aid to the North II: An Accounting, 1991-2015,” July 21, 2015 at <http://blogs.piie.com/nk/?p=14289>; “South Korean Aid to the North III: An Accounting, 1991-2015,” August 12, 2015 at <http://blogs.piie.com/nk/?p=14365>; “South Korean Aid to the North IV: An Accounting, 1991-2015,” September 1, 2015 at <http://blogs.piie.com/nk/?p=14424>.

from a myriad of subsidies, from financial support to firms, political insurance and the provision of infrastructure and power; as a result, it is classified as “economic cooperation.” Finally, purely non-commercial trade encompasses a succession of aid efforts, from the construction of the light-water reactor in connection with the Agreed Framework, to shipments of heavy fuel oil during the Six Party Talks, to the extensive food aid that we take up in more detail in the next chapter.

[INSERT FIGURE 3.12 HERE]

What is striking is that at no point does the general and processing on commission trade outstrip the sum of exports related to economic cooperation or on non-commercial terms. Non-commercial exports were high during the Kim Dae Jung and particular Roh Moo Hyun years, but fell off under Lee Myung Bak. But through 2015, the decline in aid was more than offset by the dramatic increase in the KIC-related trade.<sup>19</sup>

In sum, in the aftermath of the famine, North Korea sought to diversify its foreign economic relations, normalizing diplomatic relations with a number of European and major middle-income developing countries. With the onset of the nuclear crisis, trade with countries disposed to impose sanctions fell (Japan and South Korea under Lee Myung Bak), creating strong incentives for North Korea to seek out trading partners unlikely to impose sanctions for nonproliferation ends. This adjustment process was not costless; North Korea paid a cost for the loss of trade and remittances from Japan and the

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<sup>19</sup>. The KIC was closed by President Park following the nuclear test and satellite launch of early 2016, with the implication that North-South trade should fall to nothing, except for possible humanitarian assistance.

end of aid, and later some commercial trade, with South Korea as well. But these costs should not be exaggerated, as trade with China quickly substituted for that lost with the sanctioning countries. Moreover, there is no doubt some leakage as trade with both Japan and South Korea was partly re-routed through willing intermediaries in China. The well-known coordination problems with respect to imposing sanctions are not merely static, but dynamic and endogenous to the shifting nature of sanctions and engagement coalitions.

A second major point to emerge from this analysis is the somewhat unexpected nature of the trade with North Korea's two largest trading partners during the crisis. We cannot rule out Chinese aid, and it continued through the nuclear crisis. But the exercises we present on prices suggest that aid should not be exaggerated; trade with China appears largely commercial and we confirm this disposition in our analysis of Chinese policy in Chapter Seven. Trade with South Korea is characterized by a strong aid component during the Kim Dae Jung and Roh Moo Hyun years but with continued indirect state support via the Kaesong project until the ultimate closure of the zone in 2016. As we will also discuss in more detail in Chapter Seven, these findings have major implications for "transformative" engagement arguments.

### **Beyond the Merchandise Trade I: Illicit Activities**

The data in the foregoing sections was based on reported merchandise trade. But North Korea has derived additional revenues from unobserved trade transactions. These include both illicit activities, which we take up in this section, as well as legal activities such as services exports, aid and foreign investment that generate resources for the regime; these activities are discussed in the next section. We have grouped arms sales, drug trafficking and counterfeiting together as "illicit" activities although technically

some of them do not violate international law.<sup>20</sup> In this section we attempt an estimate of these activities through the end of the Kim Jong Il era in 2011.

At a loss to explain how North Korea managed to survive its isolation, a number of analysts have advanced the idea that the regime had come to rely heavily or even preponderantly on these activities; in the words of one well-documented study, the country had become a “Soprano state” (Chestnut 2005, 2007, 2014). While this trade was not the object of sanctions in the traditional sense, it received increasing scrutiny after the onset of the nuclear crisis in 2002 and became a target of US and multilateral sanctions and interdiction efforts.

The very existence of the trade is a reminder that not all external transactions are benign and that countries like North Korea generate a number of negative externalities for the international system. However, the various point estimates offered with respect to this trade are rarely constrained to fit within a balance of payments framework and thus are almost certainly exaggerated. It may appear obvious that arms sales and illicit activities are non-recorded activities and thus should simply be added to the balance of payments as exports, thus reducing the country’s financing gap.<sup>21</sup> However, this assumption is erroneous; it is also possible and indeed probable that illicit trade is misreported in other commodity categories and therefore does not represent a dollar-for-dollar addition to North Korea’s net exports. Missiles, for example, could be misreported as fabricated metal products, illicit drugs as medicine, or, as in one infamous case, honey. But most analysts probably overstate their contribution (by assuming that they are entirely additional) than understate it (by making corrections for the likelihood that they are partly captured elsewhere in the trade data). While increased surveillance and

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<sup>20</sup>. For example, North Korea is not a member of the Missile Technology Control Regime and has a right to export weapons. However, such sales are a violation of sanctions subsequently passed by the UN Security Council in 2006, 2009, and 2013 described in more detail below.

<sup>21</sup>. It should be noted, however, that this trade is not necessarily entirely under the central government’s control. It may be a net addition to foreign exchange earnings when viewed from the perspective of the country as a whole, but accrue, for example, to individual military units, trading companies, or rogue drug dealers.

interdiction probably curtailed the growth of this illicit trade, North Korea adjusted by shifting into commercial trade, albeit commercial trade also very much under the control of the regime. Nonetheless, the history of illicit activity constitutes an important chapter in the country's economic history and is directly germane to ideas about the relationship between trade, engagement and foreign policy behavior.

### *Military Hardware*

In the 1980s, North Korea emerged as a significant player in the global arms market, supplying conventional arms based on Soviet designs including short-range ballistic missiles, which we focus on here. According to the 1997 Arms Control and Disarmament Agency report, sales in the second half of the 1980s (1986-1990) averaged over \$500 million a year (in constant 1996 dollars) or just under 20 percent of total exports for that period. In the first half of the 1990s, however, sales fell as a result of the collapse of the Soviet Union and its technological support, the emergence of new suppliers, and a reduction of tensions among key customers; the end of the Iran-Iraq war was particularly consequential in this regard (Pollack 2011). After a lull during the famine period, North Korea sought to revive missile sales to the Middle East, much to the consternation of both the Clinton and Bush administrations (Grimmett 2006; Pollack 2011). From 1997 to 2002, North Korea also established a controversial set of exchanges with Pakistan that involved the barter of missiles and missile technology for uranium enrichment technology (Bhatia 2008; International Institute for Strategic Studies 2007; Corera 2006; Albright 2010).

Yet the onset of the nuclear crisis in 2002 and the missile and nuclear tests of 2006, 2009, and 2013 served to bring this trade under much closer international scrutiny. The multilateral interdiction of a Cambodian-flagged vessel (the *So San*) carrying North Korean missiles to Yemen in November 2002 provided the impetus for President Bush's

Proliferation Security Initiative (PSI) in 2003.<sup>22</sup> The PSI sought to provide a framework for international cooperation around interdiction of WMD-related trade (Wolf, Chow and Jones 2008; Valencia 2010; Nitikin 2011).<sup>23</sup>

The first UN sanctions resolution, UNSCR 1695 (2006) focused narrowly on missiles and trade directly related to weapons of mass destruction. UNSC 1718 (following the first nuclear test in October 2006), expanded proscribed imports and exports, authorized—but did not obligate—parties to stop and inspect shipments going to and from North Korea that were suspect of carrying prohibited items, and permitted targeted financial sanctions on individuals and companies involved with the DPRK's weapons programs. In 2009, UNSCR 1874 came close to making the PSI a formal multilateral effort.<sup>24</sup>

UN Security Council Resolution 2094 (March 2013, following the third nuclear test) included for the first time language urging member states to prohibit any financial flows that might be associated with weapons programs. For example, states could block the establishment of correspondent relationships with banks in their jurisdictions, setting the stage for US sanctions against North Korea's Foreign Trade Bank. The new

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<sup>22</sup> . The *So San* was interdicted on the high seas by a Spanish warship and the boarding itself was legal because there was no ship under that name in the North Korean registry. However, U.S. and Spanish authorities had no legal basis to seize the cargo, which included Scud missiles purchased by Yemen—an American ally—and the ship had to be released.

<sup>23</sup> . The PSI was not based on any fundamental changes in international law, but developed common principles, sharing of intelligence and protocols, full exploitation of national legal authorities and ship-boarding agreements with major flag-of-convenience countries. The US also pursued diplomatic efforts to restrict overflight by aircraft suspected of carrying North Korean weapons. From an initial membership of 11, the PSI had nearly 100 members by 2013 albeit with predictable holdouts including not only China, Iran and Syria but other potential intermediaries such as Malaysia and Pakistan (Pollack 2011, 414; UN Panel of Experts 2010, 2013; Table 3.1 above).

<sup>24</sup> . The resolution “called upon” (but again did not require) member states to inspect all cargo on their territory, including at both seaports and airports, if it was believed to contain prohibited items. Moreover, it authorized members to inspect vessels on the high seas or to escort them to port if there are reasonable grounds to believe that they are carrying prohibited cargo. It also precluded the provision of bunkering services to any ship suspected of prohibited trade, placing an additional constraint on any suspect ship. An important loophole is that such interdiction must have the consent of the country under which the vessel is flagged. If the flag state does not consent, then “the flag state shall direct the vessel to proceed to an appropriate and convenient port for the required inspection.”

resolution also called on member states to deny ports or over-flight rights to ships and airplanes believed to be involved in the military programs or evasion of sanctions.

These measures all suffer from a “credible information” clause; a government that does not want to enforce them can say that they lack credible information, or that the information that they were provided did not meet the standard of “reasonable grounds.” On the other hand, the measures gradually expanded from a narrow focus on WMD and missiles to the two-way traffic in other weapons systems, including even small arms in UNSC 2270 (2016). The resolutions have come to encompass financial as well as trade sanctions, and have been matched by more invasive means of enforcement, particularly from the time of the second nuclear test in 2009.

As this review notes, proliferation concerns surrounding North Korea are by no means limited to its own nuclear and missile programs. However, from a very robust source of foreign exchange in the 1980s, North Korean weapons exports faced a variety of demand and supply side constraints beginning in the 1990s and increased multilateral vigilance from 2006. Yet despite this heightened scrutiny, two caveats are worth noting. Although a number of North Korea’s traditional customers peeled away, the interest of a small number of states in acquiring weapons did not abate. Iran, Syria and their proxies in Hezbollah and Hamas headed this list (Bechtol 2009), but interdictions revealed efforts to sell to a number of other states including Egypt and Yemen but also Myanmar and Syria as well. Second, the scrutiny given to direct weapons sales is harder to extend to weapons-related service contracts, technology transfer and a variety of other cooperative activities that North Korea has undertaken with Iran and Syria (Noland 2000, ch. 3; Bechtol 2009). The discovery—and subsequent bombing by Israel—of a reactor in the Syrian desert in 2007 was a stark reminder of this fact. Nevertheless, from an overall balance of payments perspective, we estimate that the role of arms sales and other associated activities in overall exports declined in the 1990s and probably did not fully revive.

## *Drugs*

Drugs constitute a second source of illicit income. Initially, drug exports appear to have been limited to trafficking in drugs secured elsewhere, but in the mid-1990s North Korea began to produce drugs for export as well. This effort began with the export of opium and heroin but quickly diversified into methamphetamines (Perl 2005:7-10; Chestnut 2007, 2015; Zhang 2010; Yun and Kim 2010; Lankov and Kim 2013; Hastings 2014).<sup>25</sup> As with weapon sales, interdictions and particularly Chinese efforts to stem the trade have probably slowed larger-scale shipments. But unlike weapon systems, small-scale production and proximity to China has facilitated ongoing trafficking, facilitated by links with Chinese, Russian and Japanese gangs (Hastings 2014); these earnings need to be estimated and incorporated into any analysis of the current account.

Because the networks through which drugs are sold involve extraordinary mark-ups as one moves down the distribution chain, estimates of the drug trade are easily inflated as analysts confuse street or retail prices with the wholesale prices that North Korean suppliers can command.<sup>26</sup> David Asher (2005), who coordinated the North Korean Working Group at the Department of State, offered an estimate of \$100-200 million a year from drug sales based at that time largely on estimated export of opiates. However, some simple calculations of estimated acreage under cultivation, likely output and wholesale prices suggest that this estimate is exaggerated as well.<sup>27</sup> Satellite imagery

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<sup>25</sup> . Although drugs almost certainly dominate North Korea's smuggling activity, there is evidence—in the form of diplomatic expulsions—for trade in other sanctioned items, including so-called “conflict” diamonds from civil war zones in Africa, rhino horns and ivory (Noland 2000, Asher 2005, Prahar 2006). North Korea has also been accused of committing insurance fraud as well (Kim Kwang-jin 2011).

<sup>26</sup> . For example, Peter Prahar (2006) testified before Congress on both the purchase of 60 kilos of amphetamines by Japanese crime syndicates for \$1 million (or \$17,000 a kilo) in 1998 and a Japanese seizure of 565 kilograms in 1999 with a street value of \$347 million (or \$615,000 a kilo)! Clearly, the former rather than the latter are closer to what we would consider export prices.

<sup>27</sup> . The State Department's International Narcotics Control Strategy Report (INCSR) estimated the area under opium cultivation in North Korea at 4,200 to 7,000 hectares in 1998, which would yield 30 to 44 metric tons of opium, or 4.6 to 6.8 metric tons of heroin at a conversion rate of 6.5 to 1. In 2002, according

has not supported claims of large-scaled cultivation (Sovacool 2009) and seizures have dropped to relatively low levels.<sup>28</sup>

The decline in seizures could reflect alternative means for bringing drugs into major export markets, including Japan, Russia, South Korea and particularly China where press reports of shipments of “ice” from North Korea increased sharply in the second half of the 2000s (Lankov and Kim 2013). However, the decline in seizures also reflects more effective surveillance and interdiction of North Korea’s activities, including by China and Japan. Moreover, the decline in interdictions may also reflect a diversion of output to domestic demand. The North Korean regime itself has begun to show signs of concern over drug trafficking because of the penetration of drugs into domestic use (Department of State 2005, 68; Lankov and Kim 2013).

### *Counterfeiting*<sup>29</sup>

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to the World Drug Report, the farmgate price of opium ranged from a low of \$142 a kilo (in Afghanistan) to \$234 a kilo (in Myanmar). If we take the generous estimate of \$200 a kilo, this would yield a total farmgate value for opium production of \$6 to 9 million. The United Nations Drug Control Program (2003) reports wholesale prices of heroin in China for 2001 at approximately \$20,000 a kilo, which would yield a total value of approximately \$92-135 million. But this would assume North Korea is capable of collecting street prices for wholesale transactions and prices of heroin on other markets underwent a sharp decline following the collapse of the Taliban regime in Afghanistan and the resurgence of production in that country.

<sup>28</sup>. Sovacool (2009) estimates annual average seizures involving North Korea between 1996 and 2006 of only 30 kg of heroin, 2 kg of opium, and 120 kg of methamphetamine. The INCSRs for 2004 through 2011 report no “large-scale drug trafficking involving the DPRK state or its nationals,” and the 2011 World Drug Report makes no mention whatsoever of North Korea in its detailed discussion of the international heroin and opium markets.

<sup>29</sup>. In addition to the sources cited below, this section draws on outstanding reporting by Kevin Hall for McClatchy, including “Treasury casts a wide net under Patriot Act,” McClatchy Newspapers, March 12 at [http://www.realcities.com/mld/kwashington/news/columnists/kevin\\_g\\_hall/](http://www.realcities.com/mld/kwashington/news/columnists/kevin_g_hall/); “U.S. challenged on action against key bank,” McClatchy Newspapers, April 16 at [http://www.realcities.com/mld/kwashington/news/columnists/kevin\\_g\\_hall/](http://www.realcities.com/mld/kwashington/news/columnists/kevin_g_hall/); “Money laundering allegations by U.S. false, report says,” McClatchy Newspapers, April 16 at [http://www.realcities.com/mld/kwashington/news/columnists/kevin\\_g\\_hall/](http://www.realcities.com/mld/kwashington/news/columnists/kevin_g_hall/); “Gold sales may have spurred Macau bank’s blacklisting,” McClatchy Newspapers, April 17 at [http://www.realcities.com/mld/kwashington/news/columnists/kevin\\_g\\_hall/](http://www.realcities.com/mld/kwashington/news/columnists/kevin_g_hall/); “Bank owner disputes money-laundering allegations,” McClatchy Newspapers, May 16 at [http://www.realcities.com/mld/kwashington/news/columnists/kevin\\_g\\_hall/](http://www.realcities.com/mld/kwashington/news/columnists/kevin_g_hall/).

A final major form of illicit activity is counterfeiting. US government officials have suspected North Korea to be the origin of the so-called “supernotes,” very high-quality counterfeits of \$100 bills, which began to appear in 1989. The issue gained more attention after 2005 with a series of criminal cases and Treasury enforcement actions against Banco Delta Asia as a financial institution of “primary money laundering concern” (Chestnut 2007, Ch. 4; Demick and Meyer 2005; Fifield 2006; Weisman 2006; Perl 2006; Nanto 2009); as we will show in Chapter Six, this action played a central role in the breakdown of the Six Party Talks in late 2005 and their ultimate revival in early 2007.<sup>30</sup>

As with other illicit activities, estimating the value of counterfeit currency is difficult. As of 2010, US government officials estimated that \$63 million of supernotes had been seized worldwide since 1989 and that the total amount of counterfeiting is very much larger than that, even in the hundreds of millions of dollars (Department of Treasury 2010). However as with drugs, producers of supernotes do not earn 100 cents on the dollar from their sale; production costs may be relatively low but the notes are typically marketed wholesale at a discount to their face value. Moreover, there remains substantial uncertainty about whether North Korea is the actual source of the supernotes. The Congressional Research Service (Nanto 2009) has estimated that North Korea earned \$15-25 million a year from counterfeiting “over several years,” but we would take this as a generous estimate; recent press reports suggest that supernotes may have dried up altogether.<sup>31</sup>

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<sup>30</sup> . In the wake of the finding, the bank experienced a severe run on deposits. Under pressure not only from the US but from correspondent banks in Japan, Korea and Europe, Banco Delta Asia severed connections with 50 North Korean individuals or businesses—many believed to be military-, or party-related--replaced several managers and allowed a panel named by Macau’s government to administer its operations (Demick and Meyer 2005).

<sup>31</sup> . There have been no fresh discoveries of North Korean US dollar supernotes in recent years leading some experts to conclude that North Korea has significantly scaled back its counterfeit currency operations (Walter 2016). However, counterfeiting has not been limited to currency; evidence also exists of North Korean involvement in counterfeiting of cigarettes and pharmaceuticals (Chestnut 2007, 2014; Asher 2006). In the mid-2000s, the US tobacco industry puts potential gross revenues from counterfeiting on the

*Illicit Activities: Putting it All Together*

As can be seen, there is extraordinarily high variation in the valuation of illicit sales. Many estimates make reference to prior periods, or peak levels of the given activity, and few make any adjustments at all for whether foreign exchange earnings from the activity are truly additional to the balance of payments or hidden in other exports. Above all, past estimates generally do not consider the likely effect of closer scrutiny of North Korea's economic activity that has occurred since the onset of the crisis in October 2002 and particularly since the US Treasury actions of 2005 and ever-tightening formal sanctions in the wake of the missile and nuclear tests of 2006.

Figure 3.13 shows our estimates of all illicit revenues (inclusive of arms sales) as a share of merchandise exports for the period from 1990 through the end of the Kim Jong Un era in 2011.<sup>32</sup> These are admittedly highly speculative and as a consequence we include high and low estimates as well as a best guess. As one can see, this share has been drifting down for more than a decade as both legitimate trade has expanded, and intensified interdiction efforts have crimped criminal activities. We estimate that at the end of the Kim Jong Il era in 2011, the illicit share of exports was in the range of 5-20 percent, with our best guess at roughly 10 percent, and it is possible that not all of these earnings flowed directly into state coffers.<sup>33</sup>

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order of \$520 million to \$720 million annually based on the prices of counterfeit cigarettes in Asian ports such as Pusan, Manila, and Kaohsiung (Coalition of Tobacco Companies, 2005). However, this estimate is also a wild exaggeration of North Korean export earnings from them, reflecting street value of the cigarettes once they have been sold to criminal gangs.

<sup>32</sup>. For precise details on the estimates for each category of illicit trade by year, see Haggard and Noland 2007b.

<sup>33</sup>. Some illicit activities are almost surely subject to central control, others are probably conducted by state entities but without direction from central authorities (or perhaps without even their specific knowledge) and some may well be conducted by what amount to local criminal

[INSERT FIGURE 3.13 HERE]

In sum, North Korea did have its “soprano state” moment when these activities loomed larger in its overall balance of payments; this history is revelatory of the nature of international commercial networks that North Korea has forged in the past and could choose to rebuild in the future. The country appears to have adjusted to the successful tightening of interdiction efforts aimed at its illicit activities. The expansion of legitimate trade has made North Korea less dependent on criminal activities and therefore less vulnerable to their disruption; it is unlikely that honing in on these activities—despite the merits of doing so--will have significant material effect on the regime’s behavior or capacity to generate foreign exchange. Yet continued interdiction noted in Table 3.1 suggests that North Korea is still engaged in illicit trade that seeks to circumvent sanctions.

#### *Services Exports, Aid and Foreign Direct Investment*

Unobserved merchandise exports do not exhaust North Korea’s current account transactions. The country has also diversified into a variety of services activities, including the tightly-supervised export of contract workers and a limited amount of tourism. In addition, North Korea has become an aid-seeking state, and transfers to the country have become one of the more significant points of controversy surrounding engagement with it as we will show in more detail in Chapter Four.

North Korea also conducts cross-border financial transactions, although of fairly limited magnitude. Given the country’s virtually complete isolation from international

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gangs. As a result, even our best guess of the total returns to the *country* should be further discounted by the fact that not all of those resources flow to the *regime*.

financial markets, much of the capital inflow likely takes the form of foreign direct investment. For the most part isolated in a few small enclaves—the export-processing zones and mining investments in particular--the scope of this investment has grown dramatically in recent years with China playing the dominant role.

*Remittances, Labor Exports, and Services Transactions: New Forms of Commercialization*

Revenues generated by North Koreans abroad come primarily through channels: remittances and organized export of labor.<sup>34</sup> These two channels are distinct both in balance of payments accounting terms and in their very different political economies. We also consider the checkered history of North Korean tourism.

Private voluntary remittances generated by the North Korean diaspora are similar to remittance flows in many other countries. The magnitude of these remittances to North Korea—particularly from the Korean community in Japan--has been the subject of substantial controversy in the past (Eberstadt 1996; Lind 1997; Noland 2000, 130-133, and Hughes 2005). Yet as with illicit activities, a string of events combined to reduce Japanese remittances quite dramatically by 2004-2006, including the gradual shift to a virtual embargo on the country described above.<sup>35</sup>

Japan is not the only source of remittances, however. There is a population of North Koreans in China that has been estimated as ranging from as few as 20,000 to as

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<sup>34</sup>. In addition to remittances, labor exports and tourism, North Korea earns an unknown revenue from other service sector activities such as animation, overseas construction, and the activities of the Mansudae Studio which has produced statues, murals, and other cultural artifacts overseas.

<sup>35</sup>. These remittances were initially funneled through credit unions and firms affiliated with the Chosen Soren, a powerful organization of Korean residents in Japan with a decidedly pro-Pyongyang tilt. The dominant financial channel for remittances from 1975-2002, the Ashikaga Ginko, canceled its correspondent relations with the Foreign Trade Bank of North Korea in 2002 and failed in the following year. As a result, remittances had to rely either on transfers through third parties, such as the Macao banks that were targeted by the US after 2005, or on cash carried by travelers that was subject to a ¥1 million limit.

many as 400,000 people (the South Korean government estimates 100,000) that send money back to North Korea (Chang, Haggard, Noland 2006). The amounts that they are transferring back to North Korea are probably small, and may well be declining as increased policing has discouraged cross-border transit. There is also a Korean-Chinese community in the Chinese border provinces that provides some support to extended family members on the North Korean side of the border. This non-refugee channel is probably more important in financial terms.

South Korea is another source. A 2010 survey conducted by the Organization for One Korea, which supports North Korean defectors in the South, found that nearly 80 percent of those surveyed had sent money back to relatives in the North, with individuals surveyed on average remitting between 1.5 and 2 million won a year (\$1350-1800).<sup>36</sup> Another press report cited an unnamed South Korean government official claiming that remittances had reached \$10 million a year; this amount would have to be discounted by commissions of up to 30 percent that end up in the hands of Chinese brokers.<sup>37</sup> The share going to the state, whether through official taxes, predation or both, is almost certainly higher; as little as one out of every two won sent may reach its intended recipient.<sup>38</sup> Yet from a balance-of-payments perspective, all such remittances should be counted as income.

In addition to voluntary private remittances, North Korea operates a variety of organized labor export programs. In contrast to remittances, where at least some share of the revenues go to recipients chosen by the sender, the North Korean state receives the overwhelming share of the revenue generated by the organized export of labor.

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<sup>36</sup>. Lee Tae-hoon "Most N. Korean defectors send money home," *Korea Times*, 10 October 2010. [http://www.koreatimes.co.kr/www/news/nation/2010/10/116\\_74335.html](http://www.koreatimes.co.kr/www/news/nation/2010/10/116_74335.html) Accessed 31 July 2013.

<sup>37</sup>. "Defectors Send \$10 Million a Year to N. Korea," *Chosun Ilbo*, 7 February 2011. [http://english.chosun.com/site/data/html\\_dir/2011/02/07/2011020700405.html](http://english.chosun.com/site/data/html_dir/2011/02/07/2011020700405.html) Accessed 31 July 2013.

<sup>38</sup>. A recent defector account suggested predation is not only personal but reflects quotas allocated to NSA agents to secure desirable luxury items for higher-ups. Im Jeong Jin, "Defector Families Are Moneybags for NSA Agents," *DailyNK*, 27 January 2011. <http://www.dailynk.com/english/read.php?cataId=nk01500&num=7303> Accessed 31 July 2013.

Originally conceived as a mechanism for helping the North pay off Soviet-era debts, North Korea has been replicating the model of organizing contract workers in a much wider array of countries, including China, Kuwait, Mongolia, Qatar, and the United Arab Emirates (Cho and Kim 2007). Recent estimates have been on the range of 50,000-81,000 workers (Shin 2014, Weissman 2014, Lee 2015), although these estimates extend beyond the time frame of our analysis here. Yet even this range may be too low. In 2013, before the purge of Jang Song-taek, China and North Korea were expanding the program of legal work visas, with some reports putting the number of such workers as high as 120,000.<sup>39</sup> As with illicit activities, estimates of the value of these remittances have frequently been exaggerated, even wildly so.<sup>40</sup> If one assumes that these workers cannot earn more than the average income in the host countries, then the estimated revenues are in the hundreds of millions of dollars, and certainly less than a half billion dollars.

A brief word should be said about tourism, because it figures quite prominently in the politics of North-South relations. The Mount Kumgang tourist project had its origins in two agreements—one in October 1998, the second in August 2000 immediately following the summit of that year-- between the Hyundai group and the North Korean government. These agreements called for Hyundai to make \$942 million in payments to North Korea over a 75 month period for exclusive rights to develop the Mount Kumgang area as well as seven other projects including the industrial park which eventually became the Kaesong Industrial Complex. At its peak, North Korea received \$72 million annually in rent for Kumgang, plus an additional fee per visitor that ran between \$9 and \$14 million a year.<sup>41</sup> These fees had fallen even prior to the July 2008 killing of a tourist

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<sup>39</sup> . Marcus Noland, “Spiritual Pollution and the Export of Labor,” North Korea: Witness to Transformation blog, August 7, 2013 at <http://blogs.piie.com/nk/?p=11127>.

<sup>40</sup> . Lee (2015) asserts that the revenues earned by these workers amounts to \$1.2-2.3 billion per year, implying revenues of \$20,000-46,000 per worker, between two and four and a half times world per capita income of roughly \$10,000.

<sup>41</sup> . After an initial boom, the flow of visitors slackened—in part in the wake of North Korean provocations—and Hyundai was unable to make the payment schedule specified in the original agreement. In 2001 the contract was renegotiated, effectively cutting Hyundai’s obligation in half. The South Korean

by North Korean guards, which essentially shut down earnings from the project altogether.<sup>42</sup>

In addition to these large scale projects aimed at South Korean tourists, the late Kim Jong Il and Kim Jong Un eras have seen an effort to expand tourism from other sources. One of the country's many foreign tour operators estimates that about 2000 Western tourists visit every year, but notes that as many as 20,000-30,000 may visit from China as well as from the Japanese-Korean community.<sup>43</sup> An industry source privately indicated to us that revenues from Western tourists are approximately \$250 per day but revenues from Chinese tourists are likely to be considerably lower.

### *Aid*

North Korea first opened itself to humanitarian assistance from outside its prior network of communist allies during the famine of the mid-1990s. Aid-seeking subsequently became a significant aspect of the country's foreign economic relations, and indeed of its grand strategy as well. The nuclear negotiations that followed the onset of the second economic crisis—just like those surrounding the resolution of the first in 1994<sup>44</sup>—rotated in no small measure on the economic inducements or transfers that the

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government, in the form of the Korean National Tourism Organization, assumed a greater role in the operations by effectively providing a subsidy.

<sup>42</sup>. There has been some Chinese activity in the zone since 2008, but the legal ramifications of using Hyundai Asan's property appears to have deterred both China and private operators from entering; in any case, the location of the site and poor transportation deter serious Chinese tourism.

<sup>43</sup>. Koryo Group provides these estimates on its Travel Advice FAQ page:

<http://www.koryogroup.com/tips/>

<sup>44</sup>. A brief word should be said about the aid associated with the 1994 Agreed Framework and the Korea Energy Development Organization (KEDO). KEDO's remit was to construct two nuclear reactors to replace the nuclear facilities shut down under the Agreed Framework. In addition, it provided 500,000 metric tons of heavy fuel oil a year to compensate for the loss of electricity generation capacity from the operating reactor closed under the agreement. More than \$4 billion was pledged to this effort, principally by the governments of South Korea and Japan. The US was principally responsible for the provision of heavy fuel oil. However, the lion's share of KEDO funds were both raised and spent outside of North Korea, for example for the design and procurement of reactor components. In considering the capital account, we are interested solely in what was actually transferred to North Korea. This would appear to consist only of the heavy fuel oil and whatever funds were used for site construction, including payment for

international community was willing to make in return for concessions on the nuclear issue.

As we have already suggested, much of this aid was supplied by South Korea and China sometimes in rather opaque ways, and generally outside of organized multilateral efforts. For the rest of the world, however, the overwhelming majority of aid, reported in Table 3.2, has been in the form of in-kind transfers of food and other humanitarian items. Aid cannot be used to finance the trade deficit directly. But as we have documented elsewhere (Haggard and Noland 2007) commercial imports of food dropped as aid increased following the famine, allowing the government to conserve on foreign exchange previously spent on food. Money is ultimately fungible and aid did in fact serve indirectly as balance of payments support. Despite claims that humanitarian aid should not be linked to politics, however, aid has clearly fallen since the onset of the nuclear crisis and become much more erratic; we explore this issue in more detail with respect to food aid in Chapter Four.

[INSERT TABLE 3.2 HERE]

### *Foreign Direct Investment*

North Korea has been effectively excluded from international capital markets since defaulting on bank loans in the late 1970s, the only communist country to do so. Its ability to borrow internationally is limited to a relatively low volume of short-term trade credits and transactions taking place through informal credit markets along the border

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workers and shipped construction materials such as cement. The project was effectively suspended with the onset of the nuclear crisis in October 2002. Heavy fuel oil shipments were stopped in December 2002. LWR construction slowed to a halt in 2003-4 and KEDO itself was formally terminated in 2005.

with China. The major sources of capital inflow appear to be aid and other official transfers, outlined above. However, when we account for these sources of income to the extent we can, for many years a significant funding gap remains; we infer that inflows of FDI have almost certainly become a more important component of the overall balance of payments picture.

The quality of data on FDI flows into and out of North Korea is quite poor. The standard source is UNCTAD's annual World Development Report (Figure 3.14). These data probably miss some investment via China, and do not appear to capture Orascom's investment (at least the scale of its claimed investment). In short, these data should probably be considered as defining a floor on actual inflows.

[INSERT FIGURE 3.14 HERE]

The data broadly confirms our review of North Korea's policy toward foreign investment in Chapter Two. Investment under Kim Jong Il prior to the onset of the nuclear crisis was highly erratic. In most years it was effectively zero or even negative as frustrated investors disinvested and withdrew. After the crisis, investment is again erratic before starting to trend up later in the decade. Chinese official sources which we have analyzed in more detail elsewhere, also show an increase in FDI flows after the tests of 2009, much of it going into the mining sector.<sup>45</sup>

Outside of mining and some other extractive sectors, South Korea and increasingly China, appear to be pursuing a strategy of creating enclaves where the more effective business-enabling institutions of South Korea or China are substituted for North

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<sup>45</sup> . See Haggard and Shi, "Chinese investment in North Korea: some data (part 1)". North Korea: Witness to Transformation blog. June 30, 2014 at <http://blogs.piie.com/nk/?p=13223>; and Haggard and Shi, "Chinese investment in North Korea: some data (part 2)" North Korea: Witness to Transformation blog. July 1, 2014 at <http://blogs.piie.com/nk/?p=13265>.

Korea's weak institutional framework. KIC and Rason are the main examples, although the former was finally closed in 2016.

If, as we suspect, the UNCTAD series underestimates actual inflows into North Korea, and if outflows are modest, then we will have underestimated the credit side of the current account balance. The implications, taken up in the next section, are that North Korea has been running an even larger current account surplus than we estimate, and/or has been running a surplus in additional years. It also means that the “errors and omissions” residual may be even larger than estimated, implying an even bigger “missing spending” result than we calculate.

### **Adding It All Up: North Korea's Balance of Payments under Kim Jong Il**

In the previous sections, we have provided an overview of North Korea's external economic relations, considering each item in isolation. Yet a central weakness of this approach—most visible in various estimates of the country's illicit activities—is that they are not constrained by the underlying identity in balance of payments accounting: that the current account deficit (or surplus) is the counterpart of a capital account surplus (or deficit); put differently, deficits must be financed and surpluses are matched by corresponding capital flows. In this section, we report on our efforts to “add it all up” by seeing what insights can be gained about the Kim Jong Il era by placing these estimates together and meeting the crucial accounting condition that the capital account and the current account should—in theory at least—perfectly offset.<sup>46</sup>

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<sup>46</sup> In theory the current account and capital account should sum to zero; any imbalance in transactions in goods and services is exactly offset by a corresponding financial flow. In reality this identity never holds, generating a balancing term known as “the statistical discrepancy.” Unsurprisingly, in the North Korean case at times this discrepancy has been large (1990 at the onset of its financial crisis and in 1997 at the peak of the famine), in most years taking a negative value, implying that North Korea seemingly has unaccounted-for resources, that is it seems to generate more revenue than is accounted for by spending and saving (Haggard and Noland 2007b). If correct, there are a variety of possible explanations, none mutually exclusive. The

Figure 3.15 displays data on total current account credits and debits inclusive of unconventional sources of revenue. We report three series on each side of the ledger. The first is our baseline, or “best guess,” that includes both observed trade, transfers and service flows and our judgments about the likely magnitude of non-reported trade, including missiles and illicit transactions (for a full discussion of sources and the basis of our estimates, see Haggard and Noland 2007b). We also provide both high and low estimates, which we generate by applying the extreme estimates in the literature that we have reviewed.

Our estimate of North Korean credits on the current account, which includes exports, broadly follows the pattern visible in the official data reported in Figure 3.1 that is based on mirror statistics. Trade collapses in the early 1990s, bottoming out in 1998 before beginning a revival. Uncertainty about the magnitude of these revenues increases in the wake of the famine, due in our view to an intensification of non-conventional activities in the mid- to late 1990s. Nonetheless, our estimates begin to diverge more sharply from the high estimates during that period because of our belief that illicit activities face increasing constraints. Our best guess figure for 2011 current account credits, \$4.8 billion, is roughly midway between our low estimate, \$4.2 billion, and our high estimate, \$5.6 billion. The uncertainty surrounding debits on the current account, which is comprised mostly of imports, is considerably narrower in part because there is

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North Korean central bank may be accumulating official reserves. We may have overestimated revenues: even our skeptical guesses about unconventional revenues may be generous, and the earnings generated by these activities are even less than our best guesses. Spending may have been underestimated: that is, imports are undercounted. It is quite possible that North Korea is importing dual-use technologies or even weapons systems that go unreported, or that other items—for example luxury goods—are not accounted for in existing statistics.

Another possibility is that we have underestimated saving and investment abroad. There could also be unaccounted-for capital outflows. We have assumed that North Korea is not engaged in any substantial FDI of its own, but there is certainly some, such as the establishment of trading companies engaged in labor contracting or North Korean-themed restaurants. More significantly, it is highly likely that the top circles of the North Korean elite—and particularly the Kim family—have accumulated foreign assets, perhaps substantial. The location of these assets remains one of the most intriguing puzzles of North Korea’s external economic relations, and of great interest to future sanctions efforts.

no precise equivalent of illicit imports (although North Korea may want to conceal some weapons-related imports and exports across the Chinese border may not be perfectly captured by Chinese customs). Overall debits rise to \$4.5 billion in 2011.

Figure 3.16 combines the estimates of the current account balance derived from our analysis of exports, imports, income and current transfers; we return in a moment to the statistical discrepancy. The extreme bounds of the current account balance are calculated by combining the maximum (minimum) estimate of credits to the current account and services with the minimum (maximum) estimate of debits to the current account.

[INSERT FIGURE 3.15 HERE]

[INSERT FIGURE 3.16 HERE]

The uncertainty about the size of the current account deficit has increased in the last decade due to the increased uncertainty about export revenues just noted. Nonetheless, our best guess is that North Korea ran a current account deficit until 2011, with the cumulative deficit summing to \$5.3 billion, before shifting to a modest surplus.<sup>47</sup> If FDI inflows are underestimated, a surplus might have emerged in earlier years.

This analysis helps explain the apparent ability of North Korea to finance its current account deficits during this period. Following the onset of the second nuclear crisis in 2002, the current account deficit does narrow somewhat. However, it remains substantially larger than it was in the mid-1990s and even widens again in 2008 before the 2009 provocations. The implied increase in the availability of external financing comes in part from North Korea's transactions with what we have called "the rest of the world": the countries outside of the Six Party Talks. However, as we saw in Figure 3.8

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<sup>47</sup>. Our low and high estimates are an aggregate deficit of \$13.0 billion and a surplus of \$ 4.2 billion, respectively, underlining the uncertainty in these efforts.

these deficits contracted over time, which can be interpreted as reflecting a declining capacity to borrow as the nuclear crisis drives away trade finance.

Rather, North Korea is initially sustained by bilateral aid from South Korea until the inauguration of Lee Myung Bak. After that point, we suspect Chinese FDI is playing an increasing role in financing the North Korean current account deficit.

### **Conclusion: Into the Kim Jong Un Era**

Our review of North Korea's foreign economic relations during the Kim Jong Il era reveals clearly the dynamic nature of economic diplomacy: how the country has adapted to external shocks, including multilateral and bilateral sanctions, by seeking out new sources of trade, investment and aid and innovating into new activities as old sources of revenue—including illicit ones—were sanctioned. These dynamics, as well as the design of the sanctions regime, help explain why multilateral sanctions have had such a marginal effect.

The first, and by far most substantial shock North Korea faced in the post-Cold War period was the collapse of the Soviet Union itself. Despite good intentions, Russia has never succeeded in playing a significant economic role with respect to North Korea since, hobbled by lack of complementarities and its own financial distress.

Even before the missile and nuclear tests of 2006, Japan had drifted toward a de facto sanctions policy as well and both trade and remittances had fallen sharply (Hughes 2006); these trends became even more pronounced in the second half of 2006 and particularly following the tests of 2009 as Japan opted for a near-complete embargo in the wake of the missile and nuclear tests.

Likewise, North Korean diplomacy placed great effort into establishing diplomatic, trade and investment relations with Europe and emerging markets in the developing world in the mid- to late-1990s, and with some success. But these relations stalled in the early 2000s even before the onset of the crisis in October 2002, and

stagnated thereafter. The EU in particular strongly backed sanctions against North Korea in the wake of the missile and nuclear tests in 2006. The rounds of nuclear and missile tests in 2009, 2013 and 2016 have simply reinforced these trends.

US trade and investment ties with North were always minimal, but it was a large aid donor in the aftermath of the famine. After 2002, humanitarian assistance trended down as well. The capacity of the US to impose sanctions would thus appear limited, although the actions taken against Banco Delta Asia (BDA) in September 2005 might have deterred trade and investment from third countries and complicated North Korea's external financial transactions.

But these adverse trends in North Korea's environment were offset by developments with respect to South Korea and China. What are the prospects that these props will continue to sustain the Kim Jong Un regime going forward?

The more volatile of these two partners has been South Korea. From accounting for nearly 40 percent of North Korea's trade at the end of the Roh Moo-hyun era, inter-Korean trade has proven vulnerable to a lack of reciprocity by the North, changing political dynamics in the South and a succession of North Korean provocations. The Park Geun Hye government came to office in 2013 showing a willingness to engage. But by 2016, her initiatives were rebuffed, post-Cheonan sanctions remained in place, and Kaesong—the surviving symbol of North-South détente--was closed altogether in 2016 following the fourth nuclear test. Even under the most auspicious circumstances it is unlikely that South Korea will be a significant source of trade, investment and aid for North Korea in the absence of a fundamental turn in its grand strategy, and is certainly unlikely to return to the open-ended engagement characteristic of the Roh Moo Hyun years.

This has left North Korea more dependent on China than ever. North Korea's vulnerability is not simply political. The slowdown in China and weakening of global commodities prices are starting to weigh on merchandise exports as well (Hendrix and

Noland 2014).<sup>48</sup> But political calculations in Beijing will be determinative of whether the coordination problems we have highlighted persist. In the immediate aftermath of Kim Jong Il's death, China moved with alacrity to support the succession of Kim Jong Un (Cathcart and Madden 2012). But as we will detail in Chapter Seven, patience waned in the wake of the February 2013 nuclear test when China supported further restrictions on North Korea in UNSC Resolution 2094. As we discuss in the Conclusion, new sanctions imposed in the wake of nuclear and missile tests in January and February 2016 had the potential—if fully exploited—to force fundamental political choices on the North Korean regime.

Although focused primarily on outlining the economic terrain that has generated coordination problems among the five parties, the findings of this chapter also have important implications for arguments about the transformative effects of engagement. Even under the conservative governments of Lee Myung Bak and Park Geun Hye, South Korea's economic ties continued to be characterized by a relatively high level of state involvement, either directly (in the relatively high share of aid and financial transfers in total bilateral transactions) or indirectly (through subsidies to, or guarantees on, nominally commercial transactions). As trade dwindled to the export-processing zone in Kaesong, it became harder and harder to claim that the zone could become the locus of a wider economic and social—let alone political—transformation.

China's economic relations with North Korea, by contrast, are increasingly conducted on a commercial basis. Even when large projects involve complementary investments in infrastructure by larger Chinese firms, these activities do not appear to be subsidized by the central government in Beijing and are thus struck with an eye to their profitability. As we argue in the Conclusion, it is at least possible that such ties could—if sustained—gradually pull North Korea into a more reformist course.

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<sup>48</sup> See Marcus Noland, "Hugely important: North Korea running a current account surplus?" North Korea: Witness to Transformation Blog, March 18, 2013 at <http://blogs.piie.com/nk/?p=9647>

Yet we noted that the composition of North Korea's trade also speaks directly to arguments about transformation. First, we noted the long history of illicit and weapons-related trade, hardly a form of engagement with the world economy likely to generate transformation. As those activities waned in significance, we see a shift toward extractive exports, which remain largely under state control. As we show in Chapter Five, the failure to develop formal business-enabling institutions, or even robust second-best informal institutions, mitigates against the development of more complex forms of exchange. It similarly has mitigated—at least to date--against the emergence of groups within North Korea whose interest in maintaining external economic ties would temper the regime's bellicosity. To the contrary, the so-called *byungjin* line discussed in Chapter Two reflects the apparent belief that economic development and the maintenance of the country's nuclear capacity can go hand-in-hand, calling into question not only the effectiveness of sanctions but of engagement as well.

### Appendix 1

Data on bilateral trade between China and the DPRK illustrates an upward trend during the course of the nuclear standoff starting in 2002, albeit with strong seasonality; trade volumes drop off in the winter probably due to slowdowns of economic activity and/or the impassibility of unpaved roads on the North Korean side of the border. However, simple statistical models can be used to detect the impact of the imposition of sanctions and the more general increase in political risk that might not be apparent to the eye. In this appendix, we report the results of such models of monthly exports and imports from January 2000-February 2012—the end of the Kim Jong Il era--incorporating only a time trend, seasonal dummies, and dummy variables for sanctions resolution periods (table A.1).

There are positive time trends in all of the regressions and some evidence of the seasonality noted above; in the monthly data there does appear to be a significant decline in activity in the winter months. Given the simplicity of these models, we must approach them with caution.<sup>49</sup> Nonetheless, these regressions provide no evidence that either the 2006 or 2009 sanctions had a depressing effect on trade. Regressions A1.4 and A1.6 show no effect of the 2006 sanctions on Chinese imports from North Korea. To the contrary, the regressions (with the exception of model A1.4 that includes a dummy for

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<sup>49</sup>. In some of the regressions there is evidence of autocorrelated residuals, which means that the estimated standard errors are likely to be downwardly biased, and as a consequence the reported level of statistical significance is exaggerated. For obvious reasons this is a bigger issue for the regressions on monthly data.

the 2006 sanctions only) actually show an *increase* in trade following the imposition of sanctions, with the technical reservation noted above.<sup>50</sup>

Due to data limitations, the regressions on monthly trade data are very spare, including only a time trend, controls for seasonality and the sanctions dummies. A more complete characterization of trade behavior would take the level of economic activity and price effects into account. Doing this for North Korean exports poses some serious analytic and data constraints.<sup>51</sup> However, North Korea can be considered a “small country” with respect to its imports. Imports are so small relative to the exports of either of its principal partners (less than 0.25 percent of total exports in both cases) that it is a “price taker” facing a perfectly elastic supply of exports and a parametrically given price. This justifies single-equation reduced form estimation.<sup>52</sup> Moreover, the fact that the UN sanctions were largely on exports to North Korea--not imports from North Korea--provides further justification for focusing on this side of the trade equation.

Table A.2 reports regressions incorporating these two additional variables, estimated on a quarterly basis due to the availability of some of this data only at that frequency. The North Korean economic activity term is derived by quarterly interpolations of Bank of Korea annual GDP growth estimates.<sup>53</sup> Getting at prices is

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<sup>50</sup> . Although the estimated effects may be overstated, there is no reason to believe that the signs of the coefficients would be biased.

<sup>51</sup> . Trade with China (and South Korea) looms sufficiently large in the North Korean economy that China (and South Korea) presumably face an upward-sloping North Korean supply curve (i.e., the magnitude of their demands are such that external demand shifts actually affect North Korean internal prices). In modeling terms this possibility implies the need to estimate demand and supply simultaneously.

<sup>52</sup> . This model can be formulated algebraically as:

$$\log Mtd = \alpha_0 + \alpha_1 \log(PM/P)_t + \alpha_2 \log Y_t \quad (1)$$

where

Mtd = quantity of imports demanded

PM/P = relative price of imports

Yt = an index of domestic activity

<sup>53</sup> . One technical benefit of including this term is that it renders the time trend insignificant and reduces the autocorrelation of the residuals to an acceptable level.

more complicated. For North Korea, the relative price of imports is a function of foreign prices converted to North Korean won via an exchange rate,  $P^*E/P$ . The problem is that we cannot observe  $P$ , North Korean prices, directly, only  $E$ , the exchange rate. We use the log inverse black-market exchange rate on the hope that exchange rate movements dominate relative price changes. We expect that appreciation would be associated with a larger volume of imports and depreciation the reverse.

Even with this more realistic specification, sanctions do not depress Chinese exports to North Korea; to the contrary, we again obtain the perverse result (in regressions A2.1 and A2.3) that the 2006 sanctions appear to have increased trade! At best the imposition of sanctions did not increase the risk premium to the extent that it led to a broader decline in trade, and by implication, this attempt at “smart sanctions” did not appear to have broader spillover effects that might harm the general population.

The estimated income elasticities are extremely large; changes in economic activity have large effects on imports. There are two possible interpretations, both with implications for sanction strategies. The first is that the behavior of North Korean households and importing firms has been changing during the sample period and that exposure to new products from China has in effect shifted demand away from domestic production toward imports. A second related possibility is that the development of new institutional channels of trade has greatly reduced transactions costs and that these institutional developments are being captured in the activity term. In either case, however, the regressions support what is obvious from the descriptive statistics: that during the sanctions period, North Korea’s economic integration with China has deepened significantly.

As a kind of robustness check on the findings in table A.2, we conducted the same exercise using data on North-South trade. As can be seen in figure A.2, prior to the sanctions, trade was trending up, though the inter-Korean data shows somewhat more volatility related to security and political developments on the peninsula. The impact of UN sanctions is not obvious, though there appears to be a trend break associated with the

imposition of unilateral sanctions measures following the 2010 sinking of the *Cheonan*, which is confirmed by the econometric estimates.

This simple visual interpretation is confirmed by the regressions on quarterly data 2001:1-2011:4 reported in table A.3. In addition to evidence of income and price effects, the results are consistent with our observation of a more politicized North-South relationship.<sup>54</sup> Both the 2009 multilateral sanctions and the 2010 unilateral sanctions do have a depressing effect on trade. These coefficients may be capturing the wider effects of the Lee Myung Bak's new approach to the North. But that interpretation would not be mutually inconsistent. The fact that we do see a dampening effect of sanctions in this case gives us greater confidence in the models' ability to detect such effects if they existed in the Chinese data. This should increase confidence in the non-findings with respect to the effects of sanctions on the bilateral trade with China.

*i. Data and data sources*

Sample periods:	ROK	2001 Q1 – 2011 Q4
		2001 Jan – 2012 Feb
	PRC	2000 Q1 – 2011 Q4
		2000 Jan – 2012 Feb
Trade:	ROK	Ministry of Unification, Korea Investment Trade Agency (KITA)
	PRC	Ministry of Commerce of the People's Republic of China International Monetary Fund Direction of Trade Statistics (IMF DOTS)
Income	DPRK	Bank of Korea Economic Statistics System (ECOS)

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<sup>54</sup> . Tests for autocorrelation suggest that we can take the significance levels as indicated.

Exchange rate: Good Friends, *North Korea Today*, various issues; NK Net, *NK In & Out*, various issues; Daily NK, *Daily NK*, various issues; Open Radio for North Korea, *Open Radio for North Korea*, various issues; Institute for Far Eastern Studies – Kyungnam University, *NK Brief*, various issues ; IMF *International Financial Statistics (IFS)*

Nuclear Sanctions: UN Resolution 1718 (2006)  
<http://www.un.org/News/Press/docs/2006/sc8853.doc.htm>

14 October 2006

UN Resolution 1874 (2009)

<http://www.un.org/News/Press/docs/2009/sc9679.doc.htm>

12 June 2009

South Korea Unilateral Sanctions

<http://www.cfr.org/north-korea/south-korean-president-lees-national-address-may-2010/p22199>

24 May 2010

## *ii. Data preparation*

Trade data: Trade with North Korea is recorded from North Korea's trading partners' perspective, in this case either China or South Korea. Trade data were originally recorded in monthly increments and were summed over quarters to get the quarterly numbers. The natural log of these quarterly totals was taken for use as the dependent variable in the trade equations.

Income data: Annual observations from the Bank of Korea on North Korea's real GDP were interpolated to generate quarterly data. Following normal procedures, once quarterly real GDP has been calculated, an index is formed in which the first observation is set equal to 100, and the natural log is used in the trade equations.

Exchange rate data: Exchange rate data come from various sources and are originally priced in either USdollars (US\$) or renminbi (RMB). We have found in the past that implied US\$–RMB exchange rates, in terms of relative won prices, tend to be very close to actual dollar–RMB rates and are therefore willing to use the NK won–US\$ exchange rate data to determine both RMB (where NK won–RMB data are not available) and NK won–SK won exchange rates. NK won is always in the numerator for our samples, and the exchange rate is indexed to 100 for the first observation of each sample. For use as an explanatory variable, in the absence of a relative price term, we take the natural log of this index used in the trade equation.

Nuclear sanctions: UN Resolution 1718 (UN 2006) went into effect in October 2006. This dummy variable is equal to zero from the beginning of the sample through the third quarter of 2006 and equal to one from the fourth quarter of 2006 through the end of the sample period. The monthly dataset sets the binary equal following October 2006. UN Resolution 1874 (UN 2009) went into effect in June 2009. This dummy variable is equal to zero from the beginning of the sample through the second quarter of 2009 and equal to one from the third quarter of 2009 through the end of the sample. The monthly dataset sets the binary equal to one following June 2009. The South Korean unilateral sanctions dummy (2010) were announced in late May 2010. This dummy variable is equal to zero from the beginning of the sample through the second quarter of 2010 and equal to one from the third quarter of 2010 through the end of the sample period.

[INSERT TABLE A.1 HERE]

[INSERT TABLE A.2 HERE]

[INSERT TABLE A.3 HERE]

[INSERT FIGURE A.1 HERE]

[INSERT FIGURE A.2 HERE]

## Chapter Four

### Humanitarian Dilemmas: The Political Economy of Food

Despite the onset of the nuclear crisis, we saw in the last chapter that the government was able to tap external resources that equaled or exceeded those available to the country at any time since the famine; indeed, trade—and particularly with China—grew apace. Yet despite this de facto economic opening, the regime was unable to avoid recurrent food shortages during the nuclear crisis period. These shortages created significant policy and moral dilemmas for donor governments and NGOs. As we outlined in the Introduction, the use of sanctions raises well-known humanitarian concerns. Experience in the 1990s in Haiti, the former Yugoslavia and Iraq demonstrated these risks and how target governments could use the existence of sanctions and alleged humanitarian affects to its own diplomatic or propaganda ends.<sup>1</sup>

Yet the provision of assistance raises its own policy dilemmas, including the potential to undercut the effect of sanctions. When used as a tool of diplomacy, inducements resting on humanitarian assistance also raise their own moral hazard problems. Does the extension of assistance simply encourage bad behavior, reward the regime or even contribute to its longevity? And if it does, is such aid vulnerable to political backlashes? Reluctance to extend aid of any type to an adversary—and particularly an isolated one—run the risk of underestimating the humanitarian fallout from failing to act.

The North Korean case illustrates these dilemmas in spades. The international community responded relatively generously to the famine, and for a number of years after it North Korea managed to maintain substantial levels of assistance. In a near-classic example of the coordination problems outlined in the Introduction, disenchantment on the part of some donors was offset by successful aid-seeking from others, particularly from

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<sup>1</sup> This is seen most clearly in the case of Saddam Hussein-era Iraq. See Marcus Noland, “Sanctions and the Ghosts of Iraq, Part 1,” North Korea: Witness to Transformation blog, April 16, 2013 at <http://www.piie.com/blogs/nk/?p=10076>.

South Korea during the Kim Dae Jung (1998-2003) and Roh Moo Hyun (2003-2008) years and possibly from China thereafter.

Yet North Korea's foreign policy behavior ultimately had negative effects on both the level and volatility of aid flows and as a result on human welfare in the country. The reasons were two, both related to moral hazard problems. From the very beginning of the aid effort in the mid-1990s, North Korean authorities made it clear that they were unwilling to acquiesce to standard norms governing humanitarian assistance: donor access to target populations; transparency of aid operations; non-discrimination in distribution and a focus on the most vulnerable groups (Flake and Snyder 2003; Smith 2005; Haggard and Noland 2007). Unaccountable to its population, the regime was slow to acknowledge need and each program required extensive—and frustrating--negotiation over terms of access that were ultimately under the authority of the Ministry of Foreign Affairs. Monitoring and assessment arrangements played a central role in these negotiations, since they guarantee the integrity of the aid program and limit diversion; they are thus crucial to maintaining political support for humanitarian assistance. Rather than treating these arrangements as a common interest between donor and recipient, North Korea would modulate the level of transparency to the aid effort, compounding informational problems for outsiders and eroding trust in the integrity of programs.

But it also appears that the country's foreign policy behavior mattered to donor support as well. North Korea's self-imposed isolation during the first nuclear crisis of 1993-94 was a contributing factor to the "arduous march" of the famine years (Natsios 2001; Haggard and Noland 2007). During the famine and its aftermath, as we saw in Chapter Three, the country began to diversify its foreign economic relations, including the pool of donors on which it could draw. However, the onset of the nuclear crisis, the missile and nuclear tests of 2006 and 2009, the military provocations of 2010 and the recurrence of tests in 2012-13 repeatedly complicated the regime's ability to tap external sources of supply.

These political constraints on aid were most evident with respect to South Korea, which saw a permanent reduction of aid following the election of Lee Myung Bak in 2007 that persisted into the Park Geun Hye era. However, the abrupt turn in South Korean aid policy was only the most extreme example of heightened attention to moral

hazard problems across the major donors. To varying degrees, multilateral organizations, governments and NGOs all faced increasing political resistance to the provision of assistance. In arguments that parallel quite precisely those for sanctions, some critics of aid to North Korea even argued that the pain inflicted on civilians by withholding needed assistance could be positive if it forced the regime to accommodate or generated protest from below (for example Hill 2011). As a result, the subsequent ability of the North Korean government to substitute multilateral or other bilateral sources of aid for South Korean support also diminished over time, undercutting the crucial safety net function of international humanitarian assistance and contributing to distress during the nuclear crisis period.

We consider these dilemmas in two steps. In the first section, we provide a brief overview of the food economy and the recurrence of shortages. In the second, we turn to the political economy of food aid, which oscillated sharply between periods when aid was extended on both political and humanitarian grounds and periods when it was held in abeyance. We consider both the political economy of multilateral assistance, and the politics of food aid in the US, South Korea and China. In all cases, the regime's nuclear priorities and/or acute bargaining problems around the monitoring of assistance resulted in delays in reaching needed agreements, shortfalls in the delivery of assistance and acute humanitarian distress.

### **The Perils of “Self-Reliance”**

Given North Korea's high ratio of population to arable land and its inauspicious growing conditions, the pursuit of self-sufficiency in agriculture has always been fundamentally misguided. Weather-related shocks have played a recurrent role in North Korea's food problems, to be sure, most notably floods in 1995 and 1996 during the famine period, and more recently bad floods in both 2006, 2007 and 2012 and drought conditions in 2012 and 2014-15 as well. Rising world market prices were also a plausible contributing factor in the recurrent crises of the early 2000s, affecting both the ability to import on commercial terms and to access aid.

But weather is consistently adverse and volatile in North Korea, and the rational strategy for the country is thus to *reduce* dependence on domestic sources of supply, not increase it. The ultimate solution to the country's chronic food problems lies not solely in the reform of the agricultural sector, but in the reform, revitalization and reorientation of the industrial economy as well. These reforms include opening to trade and foreign direct investment that would permit a more export-oriented growth strategy. Such a strategy would enable the country to earn the foreign exchange needed to import bulk grains on a commercially sustainable basis and also reduce the country's reliance on aid. Facing similar constraints, this is the strategy that South Korea, Japan, and even China adopted as their economies took off.

Despite the de facto opening noted in the previous chapter, we begin with a brief overview of how this opening was inadequate to forestall chronic food problems. We review evidence derived from examinations of grain quantities and prices and nutritional surveys; the latter are particularly important in showing sharp differences within the country in access to food.

### *Grain Balances*

The logic of a quantity balance is simple: the gap between domestic needs and production is the uncovered food balance that must be met through imports, which can come either in the form of commercial purchases or aid. The figures most commonly cited in public discussions are those produced by the FAO. But components on both the supply and demand sides of the balance sheet are subject to significant uncertainty.<sup>2</sup> Data on production is prone to politicization. When North Korea seeks aid, the government exaggerates shortfalls to generate external support, and the FAO is under some diplomatic pressure to accept North Korean official data. Shortfalls in official harvest data may simply reflect weak infrastructure for storage and transport and post-harvest losses or the fact that the state is having a harder time getting access to grain; the

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<sup>2</sup> For a more detailed discussion of the difficulties in estimating food balances, see Haggard and Noland 2007, 41-49, and Haggard and Noland 2008a.

confiscatory measures we reported in Chapter Two certainly would buttress this interpretation.

In addition to these factors influencing domestic supply, the extent of Chinese aid is also uncertain. We suggested in Chapter Three why we thought that aid might be exaggerated; trends in prices did not appear to indicate subsidies. But the lack of transparency makes it difficult to know whether North Korea has access to Chinese grain on concessional or only on commercial terms; we return to this issue in more detail below.

The demand side is not much better: there is uncertainty about the size and demographic composition of the North Korean population, and per Smith (1998) the validity of the FAO's estimate of the role of grains in their diets, and the magnitude of grain diverted to use as livestock feed.

In response to these considerations, we present two grain balance series through the 2013-14 harvest cycle (Figure 4.1). The first is the official FAO-WFP figure. In the second, we use US government grain production estimates and adjust the demand estimate for possible overestimation of the role of grains in the North Korean diet. The zero balance point is defined in terms of minimum human needs, though it should be recognized that total consumption at this highly compressed level would not avoid hunger and even starvation; food would have to be distributed with utmost precision across the entire population.<sup>3</sup>

[INSERT FIGURE 4.1 HERE]

The UN figures imply that since the 1995-96 harvest cycle, North Korea was chronically in food deficit. This is clearly implausible. No credible observer believes that North Korea was in continual famine over this whole period. According to our preferred estimate of grain needs, the peak of the mid-1990s famine is reflected in the very large

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<sup>3</sup> In addition to the logistical problems of moving and distributing grain in this fashion, we know food is not distributed equally in North Korea because of the political claims of the regime and the military. Widening inequality coupled with an increasing reliance on the market for food also means that some are better positioned to gain access to food than others.

uncovered deficit in the first two years of the series. The country achieved a surplus in the late 1990s as it pulled out of the famine and through the period of reform, available supply exceeded minimum grain requirements. After the onset of the nuclear crisis the surplus narrowed and ultimately disappeared in the early 2010s. More recently, the overall food balances have improved, perhaps reflecting some marginal effect of pilot reforms. But the use of a more expansive notion of consumption than minimum human needs would generate more dire results, and in 2014-15 the balance probably worsened marginally again with the FAO-WFP estimating a modest uncovered deficit of 107,000 MMT.<sup>4</sup>

As Figure 4.1 demonstrates, North Korea is not comfortably self-sufficient in grain production. Imports—commercial and concessional—are therefore essential in meeting human needs on a sustained basis. Again, there are significant uncertainties, but it is possible to track most commercial import and most aid, at least the share passing through the WFP and South Korea. It is difficult, if not impossible, to decompose imports from China into commercial and aid components; we suggested in Chapter Three that the concessional component is probably limited. In this analysis, we use the figures found in the WFP’s International Food Aid Information System (INTERFAIS). Figure 4.2 displays the aggregate amount of grain entering the country broken down into commercial import and aid components.

[INSERT FIGURE 4.2 HERE]

During the 1990s, North Korea was able to use aid as implicit balance of payments support, offsetting commercial imports.<sup>5</sup> As shown in Figure 4.2, as aid flowed in, commercial imports fell. It is important to underscore that this development was not simply a matter of aggregate imports collapsing: starting in 1998, overall imports began to recover, but food imports remained flat. Rather, this appeared to reflect a strategy on

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<sup>4</sup> See The Democratic People’s Republic of Korea Outlook for Food Supply and Demand in 2014/2015 (November/October). UN Food and Agriculture Organization (FAO) at <http://www.ncnk.org/resources/publications/20150203DPRK.pdf>

<sup>5</sup> See Haggard and Noland (2007) for a fuller treatment of this point.

the part of the regime to cut commercial imports as aid rose, despite ongoing shortages. It is particularly striking that this period of high dependence on aid and low commercial imports overlaps almost exactly with the Roh Moo Hyun administration, during which food and fertilizer aid underpinned efforts at political engagement.

However, following the nuclear test of 2006, donors tired of provocations and the lack of commitment to reform and aid declined, forcing a greater reliance on commercial imports during the second half of the 2000s and into the 2010s. Unfortunately, this increased reliance coincided with a period of rising global grain prices. In the context of a development strategy characterized by chronic balance of payments constraints (Chapter Three) and a regime with limited commitment to—or accountability for—basic human needs (Chapter Two), recurrent humanitarian problems were to be expected and did in fact materialize.

### *Evidence from Prices*

Just as the poorest members of society are most vulnerable when shortages appear, so too are the poorest countries most vulnerable when global markets are under stress. Beginning in 2005 world grain prices began rising, spiking in 2007-08 and again in 2011 and 2012. A number of developments drove these outcomes<sup>6</sup> but none are likely to be reversed, at least in the short-run and North Korea will likely face continuing pressure on food availability emanating from the global market going forward.

These price trends have had three disadvantageous effects:

- Rising prices have made it more difficult for North Korea to import grain on commercial terms, in part because of the proliferation of export controls on the part of major suppliers, including China;
- Adverse price trends have made it more difficult for multilateral and bilateral aid agencies to access grain and to meet their commitments;

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<sup>6</sup> . These include increases in prices for oil, water, and fertilizer which are inputs to food production; increased demands for grain directly and indirectly through higher meat consumption in many emerging markets, most notably China; diversion of stocks to the production of ethanol; the growth of financial speculation in food commodity markets; and disruption of international trade, primarily due to export embargos, to name a few (Hendrix 2011).

- Price inflation has had a direct effect on North Korean households, which have become more dependent on markets for food over time because of ongoing problems in the public distribution system (PDS).

North Korean authorities do not provide information on market prices; to the contrary they have acted to squelch the outflow of such information. Nonetheless, the growth of trade across the Chinese border, the operation of NGOs out of China, and the spread of technologies such as illicit cell phones in the border areas have allowed outside researchers to assemble data on prices.<sup>7</sup> These data—fragmentary and imperfectly observed—indicate that in the years following the currency reform of November 2009, rice and corn prices rose at a rate well in excess of 100 percent annually until finally starting to moderate in 2013

One explanation for these price movements is that North Korean markets are surprisingly integrated with the trends in global market prices; as we saw in Figure 2.3, rice prices are highly correlated with the black market exchange rate. The co-movement of the black market exchange rate and grain prices would be consistent with a small, open economy in which prices are roughly constant in hard currency terms, but are skyrocketing in terms of the rapidly depreciating domestic currency. This is an important finding, indicating that the North Korean market is increasingly integrated with the global market.<sup>8</sup>

### *Direct Observation*

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<sup>7</sup> . Our data are assembled primarily from observations reported in Good Friends' publication *North Korea Today*, *DailyNK*, and other Korean-language academic and media sources. As with all data on and from North Korea, these series too should be treated with caution. Markets are fragmented, and we have little information on quality differences, and prices may vary depending on such factors as proximity to the Chinese border or rice-growing areas. See Haggard and Noland (2009) for a more complete exploration of these issues

<sup>8</sup> . This is not to say that prices in local currency terms are determined entirely in the global market, as the North Korean authorities have at times alleged. The domestic food price inflation was clearly driven in the first instance by the badly-managed November 2009 currency reform and may have subsequently been influenced by the extended period of military tensions that followed the breakdown of the Six Party Talks as well.

The North Korean government systematically impedes access of foreign observers, rendering their efforts to collect systematic data on conditions suspect. Nonetheless, we have access to assessments carried out by the WFP and/or UNICEF from 1998-2009 as well as a UNICEF Multiple Indicator Cluster Survey from 2012, all of which depict ongoing distress.<sup>9</sup> Table 4.1 reports 2009 stunting and underweight numbers by province along with the figures for 1997, 2002, and 2004 from earlier surveys. The change in global acute malnutrition between 2009 and 2004 is also reported.<sup>10</sup> The overall trends provide evidence of continuing distress in the second half of the 2000s. Countrywide rates for stunting (low height-for-age) declined by less than 7 percent between the 2002 and 2009 surveys. National rates for underweight (low weight for age) fell by just over 1 percent. Rather than declining, malnutrition was only leveling off at the time of the 2009 survey. Much of this can be attributed to the lack of improvement in the northeast, but Pyongyang itself was hardly spared; according to the UNICEF survey, 22 percent of children in the capital were stunted at the end of the period and 14 percent were underweight.

Unfortunately, conditions worsened after 2009, confirming the tightening of grain balances reported above and—not coincidentally as we will see--overlapping with an intensification of conflict on the peninsula that further isolated the country. Despite an emergency operation launched by the WFP in April 2011, large swaths of the population experienced prolonged food deprivation from May through to September 2011.<sup>11</sup> With the usual caveats about potential biases in surveys conducted in North Korea, the 2012

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<sup>9</sup> . The UNICEF survey reported several measures of childhood malnutrition: wasting (low weight-to-height), stunting, and underweight. The two age-related measures (stunting and underweight) can be interpreted as reflecting the effects of chronic malnutrition. Wasting, the low weight-to-height, measure, can be interpreted as signaling immediate, acute malnutrition. This measure tends to be more volatile and may fluctuate with seasonal variability in food availability. For a discussion of possible sources of bias in the 2012 survey see Marcus Noland, “UNICEF 2012 Nutritional Survey,” North Korea: Witness to Transformation blog, January 3, 2013 at <http://www.piie.com/blogs/nk/?p=8768>.

<sup>10</sup> . The 2009 survey reports relevant population percentages in three groups: moderate malnutrition, severe malnutrition and the global rate that sums the two. Global acute malnutrition is defined as an individual being 2 standard deviations or more below the median. Moderate acute malnutrition is defined as being between 2 and 3 standard deviations. Severe acute malnutrition is defined as being more than 3 standard deviations below the median.

<sup>11</sup> . Screenings in the most seriously-affected counties showed 14.6 percent of adults showing moderate and 2.8 percent severe acute malnutrition; this compares with the 2009 survey estimating 4.7 percent of moderate and 0.5 per cent severe acute malnutrition.

UNICEF exercise painted a dismal picture. Focusing on the height-for-age measure, a long-term indicator relatively unaffected by seasonal nutritional swings, nearly 10 percent of this generation appears to be severely stunted. Although the overall average for the sample is only 7.2 percent, the incidence of stunting accumulates through the successive age cohorts until reaching a peak of roughly 10 percent at age two. At this age, stunting is irreversible and confers a lifelong set of physical and mental challenges that are passed on across generations.<sup>12</sup>

[INSERT TABLE 4.1]

*The Perils of Self-Reliance: A Reprise*

Evidence from grain balances, prices, and direct observation confirm a gradual deterioration in the food situation in North Korea from the middle of the 2000s forward, moderating only somewhat in 2012-5. The causes of this deterioration are multiple, ranging from structural issues in the agricultural sector to weather shocks. But the evidence suggests that policy choices and broader political circumstances were in play. The government failed to prioritize commercial imports of food and the bungled currency reform of 2009 had dire consequences for food prices. Yet these developments also followed closely on the heels of the collapse of the Six Party Talks and a resumption of tensions on the peninsula that had implications for the aid regime as well.

### **Humanitarian Dilemmas: The Political Economy of Food**

Claims of self-sufficiency notwithstanding, North Korea has long been dependent on aid. Yet the reliance on aid replaced one potential source of vulnerability—the heavy reliance on domestic sources of supply—with another, namely reliance on the kindness of strangers. From the onset of the famine-related assistance of the mid-1990s through the

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<sup>12</sup> . Predictably, the data shows strong regional effects. The privileged capital city of Pyongyang had a severe stunting rate of only 4 percent. Ryanggang is the worst affected province with an overall stunting rate of more than 12 percent. The low scores for Ryanggang, the sort of the Appalachia of North Korea, can be rationalized by its isolated rural population. But not so South Hamgyong. Moreover, it is notable that South Hamgyong does worse than North Hamgyong which is farther from Pyongyang—but closer to China. These general patterns were confirmed in a post-harvest security assessment in 2013 (WFP 2013a).

early 2000s, aid accounted for a rising share of total supply (Figure 4.2). Despite conflicts with individual donors—most notably Japan—North Korea was able to exploit coordination problems to sustain relatively high aggregate aid flows; the rise of the Sunshine policy in South Korea was particularly important in this regard. As we saw, the government even exploited the increase in aid to curtail imports rather than augmenting aid with commercial sources of supply to more fully achieve food security.

Aid became more erratic in the 2000s and overall levels began to decline (Figure 4.2). Were this the result of a sustained agricultural recovery and improving nutrition, it would have been a welcome development. Almost exactly the opposite is the case as we have seen; overall food balances were worsening over time.

Rather, political conflicts between donors and North Korea played a prominent role in the volatility of aid, and at two levels. First, food aid was increasingly politicized, related to progress in the Six Party Talks and in subsequent bilateral negotiations once they broke down in 2008. During some periods, including 2005, 2008 and 2012, progress in the talks was associated—as both cause and effect—with increases in promised assistance. But at other moments, including the aftermath of the 2006 tests, with respect to South Korea from 2008, and more generally in the 2009-16 period, the country's overall foreign policy stance undercut the willingness of donors to extend humanitarian assistance. In 2009, and again in 2012, the regime even walked away from large food aid packages in the context of deteriorating political relations with the US, despite ongoing evidence of distress.

Second, the course of aid was also adversely affected by conflicts with donors over the design of humanitarian programs. As in the past, the North Korean regime was slow in acknowledging its need for food assistance, failed to provide adequate or accurate information to potential donors, and was unwilling to guarantee the integrity of its aid programs; aid was periodically roiled by evidence of diversion to both the military and the market.<sup>13</sup> Moreover, North Korea always treated negotiations over food in a strict

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<sup>13</sup> . Haggard and Noland 2007 provide estimates of the extent of diversion. Haggard and Noland (2011) found that in two large scale surveys, refugees overwhelmingly believed that the aid went primarily to the military. A more recent survey of 500 refugees conducted by a South Korean NGO found that 78 percent of the respondents reported not receiving international food aid while in North Korea and some said that after they received aid they were forced to return it following the departure of monitors. When asked where the aid went, large majorities thought that the aid went to the military or other connected groups. Chosun Ilbo,

quid-pro-quo fashion. When aid increased, so did access for aid workers. But when aid decreased—and for any reason whatsoever--North Korean authorities reduced access. This manipulation of access only magnified doubts about the aid program, generating opposition to continued assistance among major donors.<sup>14</sup>

We begin by looking at the coordinated multilateral aid effort through the WFP. We then consider the policies of the US, South Korea, and China.

### *The WFP*

The World Food Program is the multilateral organization with primary responsibility for humanitarian food assistance.<sup>15</sup> Despite its central role, the WFP does not directly control stocks of food; rather, it serves a coordinating function by negotiating agreements with recipients, issuing appeals and coordinating the subsequent contributions from donors, and overseeing logistics, monitoring of delivery and assessment. Without political support from key donors, it is impossible for the WFP to operate.

For our purposes, the existence of the WFP can be turned to methodological advantage. Shortfalls in meeting WFP appeals may reflect in part divergent assessments of need on the part of major donors and constraints on aid budgets; we do not rule these factors out altogether. But the WFP typically does not launch an appeal unless there is defensible evidence of need and at least some hope of gaining political support for it. As a result, the extent to which appeals are realized reflects the revealed willingness of donors to assist North Korea.

Table 4.2 summarizes the history of WFP programs with North Korea; recall from Figure 4.1 that at virtually no time during this period—with the exception of the 2005/6, 2006/7 and 2013/14 crop cycles did UN assessments suggest the absence of humanitarian need and even then the margin of safety was razor thin. Until the very end of the period,

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“78% of N.Korean Defectors Never Saw Foreign Food Aid,” 6 April 2011. [http://english.chosun.com/site/data/html\\_dir/2011/04/06/2011040600985.html](http://english.chosun.com/site/data/html_dir/2011/04/06/2011040600985.html) accessed 12 July 2012.

<sup>14</sup> . A 2014 WFP audit provides the latest recitation of the monitoring problems (WFP 2014).

<sup>15</sup> . In the wake of the famine, the early WFP appeals were formally nested in a broader combined humanitarian appeal under the OCHA. But food was always the overwhelming share of total aid extended to North Korea, in part because of concerns that more fungible forms of assistance would be diverted.

food balances were steadily deteriorating. Nonetheless, we see an increasingly erratic trend in aid commitments. Particularly after 2008—when the Six Party Talks broke down—the ability of the WFP to secure funding commitments fell off sharply. A brief overview of these programs suggests that North Korean policy choices and the resulting political constraints on donors combined to generate this result.

[INSERT TABLE 4.2 HERE]

After the flood of assistance in the immediate aftermath of the famine, North Korean authorities began to curtail monitoring visits in 2004. In the summer of 2005 they announced they would not participate in the UN's annual consolidated appeal, requested the dissolution of the UN's Office for the Coordination of Humanitarian Affairs (OCHA) in Pyongyang and threatened to expel NGOs that did not bring in sufficient volumes of aid. These developments were partly the result of improved agricultural conditions and access to external sources of supply, but as we argued in Chapter Two they also had to do with a more wide-ranging reversal of reform.

In the fall of 2005, North Korea experienced its best harvest in a decade and South Korea ramped up its aid efforts, weakening the bargaining power of the WFP and its ability to monitor and assess assistance. The WFP suspended its operations in North Korea at the end of 2005 and then initiated a greatly scaled-down program in February 2006.<sup>16</sup> From the outset of this program, however, board members expressed reservations about monitoring arrangements (WFP 2006).<sup>17</sup> Moreover, outside agencies openly voiced concerns that the government was not doing its part to prioritize commercial food imports, in effect seeking foreign exchange support indirectly through its appeals for

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<sup>16</sup> . Initially designed to run through March 2008, the program was subsequently extended through the end of August 2008. The program would feed roughly 1.9 million beneficiaries, less than one-third of the previously targeted population, requiring 150,000 metric tons of commodities at a cost of approximately \$102 million. Distribution focused on 50 vulnerable counties jointly selected by WFP and the government. Vitamin-and-mineral enriched foods produced at WFP-supported factories are being given to young children and pregnant and nursing women, and cereal rations to underemployed workers through food-for-community-development schemes aimed at rehabilitating agricultural and other infrastructure.

<sup>17</sup> . North Korea demanded a reduction in staff to ten or fewer, closure of the regional offices outside Pyongyang and confinement of this staff to Pyongyang with only quarterly opportunities to visit project sites in the field.

assistance (WFP-FAO 2008, 20). As can be seen from Table 4.2, even scaled-back targets were not met.

Not coincidentally, these difficulties in securing support overlapped with a period of heightened tension over US financial sanctions (September 2005), missile and nuclear tests (July and October 2006), and a break in the Six Party Talks that would last for just over a year (November 2005-December 2006). Moreover, the US had committed itself to securing much more robust monitoring arrangements prior to extending any further assistance. By April 2008—just prior to the announcement of a new food aid package from the US—the 2006 program was still only half funded and about 30 percent of that funding came from an injection of South Korean assistance that followed the breakthrough in the nuclear talks (WFP 2008).

Progress in the nuclear talks in early 2007 provided the political foundation for a resumption of aid.<sup>18</sup> In 2008, the FAO (2008) and other observers (Haggard, Noland, and Weeks 2008) were once again issuing warnings about the food situation in the DPRK, with evidence that conditions were worse than they had been at any time since the great famine of the mid-1990s. In May, the DPRK and the US announced an agreement in principle that allowed for the distribution of up to 500,000 tons of food assistance<sup>19</sup> Although not formally a quid pro quo, it was clear that the humanitarian opening ran in parallel to the halting progress on the nuclear implementation agreements that had been reached in February and October 2007 (Chapter Six).

The political breakthrough also provided the context for FAO-WFP and NGO assessment missions in June 2008 (Anderson and Majorowitz 2008; WFP-FAO 2008). These assessments confirmed outside suspicions about the state of North Korea's food economy: yawning aggregate food deficits (Figure 4.1); progressive reductions in PDS rations; a decline in dietary diversity; and coping strategies that signaled pre-famine conditions such as an increased proportion of respondents collecting wild foods.

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<sup>18</sup> . Devastating floods in major cereal-growing provinces in August 2007 provided an opening for a short-term emergency program to the country, but this program was small and targeted at those directly displaced.

<sup>19</sup> . The bulk of the US contribution was to be channeled through the WFP (up to 400,000 tons) with the remainder distributed by a consortium of five US NGOs (up to 100,000 tons); the US contribution constituted over 60 percent of the WFP program and nearly 80 percent if the NGO contribution is included.

Moreover, although the North Koreans blocked the assessment teams' access to markets, the WFP was openly monitoring outside information on prices, which also provided ample signs of distress (WFP-FAO 2008, p. 14).

The food assessments of 2008 became the formal basis for a new WFP program, initiated in September 2008.<sup>20</sup> Core to this agreement were new monitoring and assessment protocols.<sup>21</sup> Table 4.3 outlines the terms of the 2008 agreement, the decline in access that followed the collapse of the program in 2009, and the initial letter of understanding that was negotiated in 2011, when North Korea once again made an open appeal for assistance. These negotiations demonstrate the difficulty humanitarian agencies face in gaining access to North Korea and in guaranteeing the integrity of their programs.

North Korean authorities had vociferous objections to the 2008 program from the outset and refused to fully adhere to its terms. Although accounts differ, WFP management explicitly or implicitly signaled that strict adherence to the protocols was not necessary, in part because of the fear—and implicit threat—that strict enforcement of the protocol would result in reduced access.<sup>22</sup> As donors failed to make good on contributions, distributions dropped to 30 percent of what was originally planned in November 2008 and 12 percent by January 2009. Negotiations in December to resolve outstanding differences failed, just as discussions of the nuclear program were also collapsing. In March 2009, North Korea terminated the NGO component of the food

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<sup>20</sup>. The program was designed to provide food assistance to an estimated 6.2 million beneficiaries in 131 counties/districts in eight provinces.

<sup>21</sup>. Since the NGOs were completely dependent on US approval for access to the 100,000 MT of food they were to deliver, the US Agency for International Development coordinator effectively exercised a veto over the negotiations between the NGOs and its North Korean counterpart organization, the Korea-America Private Exchange Society (KAPES). This agreement would become the foundation for the WFP's negotiation with the more hardline National Coordinating Committee (NCC); revealingly, both of these organizations fell under the Ministry of Foreign Affairs.

<sup>22</sup>. Information from a variety of sources had already suggested an aggressive push on the part of North Korean embassies to secure grain in the face of increasing foreign exchange constraints and high world market prices. As a WFP official put it privately, "[WFP] policy is: No access, no food. But the North Koreans are saying: No food, no access."

program and in June introduced new operating conditions that further limited access. At the time of this announcement, the WFP reported that the existing program—which had not formally been canceled—was less than 15 percent funded.

[INSERT TABLE 4.3 HERE]

The cycle of delay in identifying need, under-subscription in funding and program revision followed again over the course of 2009-10 through 2015-16 crop cycles. After the collapse of the nuclear talks, the international community once again detected signs of distress related not only to weather (rains and flooding in both periods, a particularly severe winter in 2010-11) but to policy shocks, most notably the currency conversion of November 2009. In June 2010, a Protracted Relief and Recovery Operation sought to address the targeting and monitoring problem by focusing on nutritional support for women and children (WFP 2010). Yet by early 2011 this program too was less than 20 percent funded and had to be drastically revised in response to a new emergency appeal by the North Korean government in January.<sup>23</sup> No fewer than four food security assessments in the first half of 2011--by the UN, the US, US NGOs and the EU--painted a common picture of severe distress, with a particularly sharp fall-off in PDS rations early in the crop cycle. A controversial program of grain exactions for the military also suggested the depth of shortages.<sup>24</sup>

The World Food Program launched its appeal for a new emergency program in April 2011. Yet commitments to the emergency program were slow in coming (WFP 2012) as were commitments to its successors. It is hard to avoid the conclusion that the tensions around the satellite launches and nuclear tests in the winter of 2012-13 played a role. By January 2013 breaks in the pipeline had emerged and the organization was forced to triage (WFP 2013b). As political tensions continued, only Russia and Switzerland supported the program in the spring of 2013; the remainder was made up by internal funding from the multilaterals themselves. Yet another program negotiated in

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<sup>23</sup> . Marcus Noland, "Slave to the Blog: More Updates!" North Korea: Witness to Transformation Blog. March 26, 2011 at <http://blogs.piie.com/nk/?p=720>; Good Friends, *North Korea Today* 413, July 27, 2011

<sup>24</sup> Good Friends, *North Korea Today* 387, January 26 2011; *North Korea Today* 395, March 23 2011.

mid-2013 faced the same fate. Extended twice (at this writing scheduled to run through June 2016), the program has received less than half its programmed funding and the WFP has been forced to scale back operations accordingly. Except for a small handful of countries—Switzerland, Russia, South Korea, and Australia—support for WFP programming in North Korea has virtually evaporated.<sup>25</sup>

Without descending to the donor country level—which we do in the following sections—we cannot demonstrate definitively that the difficulties the WFP faced in funding were due to the ongoing nuclear confrontation and North Korean failures to assure donors about the integrity of food aid. But several crucial shifts in WFP programming appear to be linked to strategies of the major donors and coordination problems among them, most notably the US and South Korea.

Declining US commitment to multilateral assistance from the beginning of the George W. Bush administration corresponded with a period during which North Korea believed it did not need multilateral or NGO assistance. An important factor in this calculus was clearly the willingness of the Roh Moo Hyun government to provide massive aid on an ongoing basis, with the important exception of a brief reaction to the missile tests in 2006; as we saw in Figure 4.2, commercial imports contracted to virtually nothing during this period.

The tentative progress on disabling Yongbyon over the course of 2007-8 and new monitoring protocols once again opened the door to multilateral and bilateral assistance. Yet progress on the nuclear front quickly stalled, and with Kim Jong Il's stroke in August 2008 North Korean policy entered a different phase. The missile and nuclear tests of April and May 2009, the sinking of the *Cheonan* and the shelling of Yeonpyeong Island in March and November of 2010, and the satellite launches and third nuclear test of 2012-13 all served to heighten tensions between North Korea and potential donors and create more pointed political opposition to food aid. Moreover, these connections were well-understood by the humanitarian community (UNDP 2009).<sup>26</sup> We can see these political dynamics more closely by considering the approaches of the US, South Korea and China.

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<sup>25</sup> For details on this last program see WFP, "Korea, DPR Country Brief," n.d. <http://documents.wfp.org/stellent/groups/public/documents/ep/wfp276263.pdf> Accessed 10 April 2016.

<sup>26</sup> . A memo written to the UN Emergency Relief Coordinator covering events in July 2009 makes the perceived links clear. "There has been a general slow-down in funding for all agencies since the May

### *US Policy*

It is ironic that despite the enmity between the United States and North Korea, the US has been by far North Korea's largest donor. Table 4.4 outlines the U.S. contribution from the onset of famine-related assistance in 1995 through the end of the first Obama administration in 2012; no aid was provided in 2011 as the Leap Year Deal was being negotiated and none after the agreement fell apart in 2012. Nearly half of total aid was the result of U.S. commitments under the Agreed Framework of 1994 through the Korean Peninsula Energy Development Organization (KEDO) and the subsequent Six Party Talks process.<sup>27</sup> The bulk of US aid, however, more than \$700 million, took the form of food assistance, mostly channeled through the WFP.

[INSERT TABLE 4.4 HERE]

Table 4.5 traces the diplomatic context of various US aid initiatives over the period. Humanitarian motives played a central role in mobilizing US assistance in the wake of the great famine. But from the outset aid was closely tied with the efforts of the Clinton administration to engage North Korea, and particularly during the "high engagement" period of 1998-99. The Clinton administration extended food as a lubricant for talks, generating opposition from both the NGO community and Republican critics (Aaltola 1999; Manyin and Jun 2003; Schloms 2004; Haggard and Noland 2007). In the face of these domestic political constraints, the administration shifted to a more conditional approach in which substantive progress in negotiations and improved access and monitoring were given greater weight (Hathaway and Tama 2004).

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nuclear tests and the July missile launch...In addition to calls from some donors on making humanitarian aid conditional on political progress, more conservative media outlets have started to question the role of the UN in DPRK. Some traditional donors to operations in DPRK are currently stalling contributions in part due to domestic concerns about providing resources to DPRK."

<sup>27</sup>. This aid ended with the decision in December 2002 to terminate heavy oil shipments in response to intelligence on North Korea's HEU program. KEDO was dissolved in 2005.

[INSERT TABLE 4.5 HERE]

The Bush administration pulled back from this engagement strategy and sought to make the provision of aid more sharply conditional on improved access and monitoring agreements. In June 2002, USAID outlined a new approach under which the U.S. would provide a “baseline” amount of food aid of 155,000 metric tons with additional amounts conditional on improved access. Following the onset of the nuclear crisis, the Bush administration continued to make commitments but at a much more modest level.<sup>28</sup>

In the fall of 2004—just as the WFP and North Korean authorities were entering their standoff over monitoring—the 108th Congress passed and President Bush signed the North Korean Human Rights Act. The legislation sought to institutionalize this more conditional approach to humanitarian assistance by requiring the United States Agency for International Development (USAID) to report on any changes in the transparency, monitoring, and access of food aid and other humanitarian activities. Moreover, it included “sense of Congress” language that any “significant increases” in humanitarian assistance be conditioned on “substantial improvements” in transparency, monitoring, and access. Although the administration announced another 50,000MT contribution in June 2005, the same level that had been offered in 2003 and 2004, the US suspended further aid commitments later in the year pending the outcome of negotiations between the WFP and North Korea over continuing operations.

The overall strategy of the US began to shift during the second administration toward more active engagement (Chapter Six). The Bush administration tabled a number of possible inducements, although again conditional on North Korea being more

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<sup>28</sup> . In each announcement, the administration emphasized that food aid decisions would be made on the basis of demonstrated need, competing demands and “donors’ ability to access all vulnerable groups and monitor distribution” (US Department of State 2004). In February 2003, the administration promised 40,000 MT of food, with another 60,000 MT conditional on further progress with respect to monitoring. In December 2003, and again in July 2004, the State Department announced contributions to the WFP (the proposed 60,000 MT and a 50,000 MT contribution to the 2004 appeal respectively).

forthcoming in the nuclear negotiations.<sup>29</sup> Progress was interrupted by conflicts with North Korea over financial sanctions and the missile and nuclear tests of 2006. It was not until January 2007 that these issues were resolved and until August 2007, under the political cover of the floods, that the administration offered small amounts of humanitarian assistance. Following the floods, the administration signaled that it was “prepared to engage with North Korean officials on arrangements for a significant food aid package” contingent on “appropriate monitoring procedures.”<sup>30</sup> An intra-agency delegation visited Pyongyang in December and in June the two countries signed the letter of understanding described above (Table 3.3).

To what extent was progress and regress on the nuclear question linked to the rise and fall of food aid during the Bush administration? At no point were they explicitly linked. Moreover, the Bush administration continued to deliver at least some—but not all—of the aid after the Six Party Talks had collapsed. However, the negotiations over food aid that began in late 2007 overlapped with the intense diplomacy around the implementation of disablement agreements reached in February and October 2007. These agreements did include explicit *quid pro quos*--albeit on fuel oil not food—and it is probable that North Korea saw the nuclear issues and aid as linked even if the United States sought to keep them separate.

The missile and nuclear tests of 2009 and the military provocations around the Northern Limit Line in 2010 made it politically difficult to provide assistance, despite ample evidence of distress. Critics of food aid gained traction on both political and humanitarian grounds.<sup>31</sup> Continuing budget resolutions passed in 2010 and 2011 stipulated that no aid should be extended unless specifically legislated. In June 2011, Representative Ed Royce (California, 40th) offered an amendment that passed on a voice

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<sup>29</sup> . These included removal from the State Department’s terrorism list, lifting of the restrictions under the International Emergency Economic Powers Act, successor to the Trading with the Enemy Act, and a resumption of heavy-fuel oil shipments.

<sup>30</sup> . State Department Press Statement, “North Korea: Response to Flooding,” August 31, 2007 <http://2001-2009.state.gov/r/pa/prs/ps/2007/aug/91669.htm>

<sup>31</sup> . At the end of 2009, Congress went so far as to require that expended food aid that was deemed unmonitored at the end of the NGO and WFP programs either be paid back or deducted from any future aid on offer! (Public Law 111-117 [2010 Consolidated Appropriations Act], Sec. 7071 (f) (6), December 16, 2009)

vote that would prevent any aid going to North Korea. The justification for the amendment relied not only on monitoring arguments but on moral hazard grounds: that providing food aid “delays the day when real, structural reform will come to North Korea.”

Despite these domestic constraints, the Obama administration gambled on the offer of an extensive food aid program totaling 240,000 MT, officially announced on February 29, 2012, the so-called Leap Day Deal. Although based on well-documented need, the finalization of the program occurred in the context of the negotiation of a major agreement on a nuclear issues, including a moratorium on long-range missile launches, nuclear tests and nuclear activities at Yongbyon. The DPRK also agreed to the return of IAEA inspectors. Despite denials of a quid-pro-quo, the language of the parallel announcement by North Korea strongly suggested that Pyongyang saw a linkage. Nonetheless, the new leadership decided to go ahead with a planned “satellite” launch, despite being warned that the launch would scuttle the aid package. The United States called off the deal, underlining the extent to which the freeze and food aid were in fact linked. But the case also demonstrated that the regime’s military priorities trumped humanitarian concerns.

### *South Korea*

South Korea’s strategy of engagement with North Korea had important antecedents in Roh Tae Woo’s Nodpolitik, and the Kim Young Sam government made a large, one-off humanitarian contribution in 1995.<sup>32</sup> But as we saw in Chapter Three (Figure 3.9) and will detail in Chapter Six, the pattern of humanitarian assistance from South to North followed closely the rise and fall of the so-called sunshine policy under the Kim Dae-jung (1998-2003) and Roh Moo Hyun (2003-2008) administrations. During both administrations, food and fertilizer aid clearly sought to address humanitarian concerns

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<sup>32</sup> . The Kim Young Sam administration had agreed to provide 150,000 MT of food aid in unmarked bags and acquiesced to Japanese support as well. However, North Korean authorities forced the ship carrying the first load of rice to fly a North Korean flag and even detained the crew. The administration shifted to making all aid conditional on the opening of talks—which did not transpire—until relenting in 1997 as evidence of distress mounted (Noland 2000, 194-196).

but was also rooted in a highly diffuse conception of reciprocity that was designed to gradually transform North-South relations in a more cooperative direction. Despite one important episode of linkage--when aid was cut in the summer of 2006 in the wake of missile tests--the two liberal South Korean administrations did not link aid directly to military or political quid pro quos or even to make it conditional on compliance with humanitarian norms.

But partisan consensus on North Korean policy in South Korea was even thinner than in the US. As a result, the election of a conservative president in December 2007 resulted in a hard swing in policy. Conditionality and explicit linkage came to infuse all aspects of South Korea's policy toward the North, including with respect to humanitarian assistance. As Figure 3.9 shows, large-scale assistance fell off sharply from 2008 and by no means recovered under the administration of Park Geun Hye (2013-18).

Several overall features of the food aid effort during the engagement period are worth noting because they have implications for the coordination problems facing the five parties. The first is that while the government made modest contributions through the WFP, the overwhelming majority of food aid passed through bilateral channels in the form of concessional loans for both food and fertilizer. Since this aid did not pass through the WFP—and indeed was not technically aid at all, but loans—it was not subject to any of the WFP's protocols with respect to targeting, access, monitoring or assessment. In July 2004, North Korea finally agreed to establish a monitoring regime for South Korean food assistance but it was substantially weaker than the WFP regime and made no pretense of population targeting. Food aid essentially went directly to the regime, with the bulk of it probably going into the PDS.

The second characteristic of South Korean aid was that a large share passed through qualified NGO channels, approximately one third over the entire period.<sup>33</sup> In contrast to the larger US and European NGOs, these support groups were smaller, Korea-

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<sup>33</sup> . Under the Kim Dae Jung administration, NGOs that managed to establish a consistent record of raising funds and conducting humanitarian operations for a year were entitled to apply for a license that designated them as a “North Korea support group” eligible for support through the Inter-Korean Cooperation Fund. Over time, the relationship between the government and the NGOs became more institutionalized, including through the formation of a policy council that sought to identify joint projects among NGOs and with the government.

specific organizations—some supported by local governments in the South--that were generally more intent in establishing working relationships with their counterpart organizations than in hewing to humanitarian norms (Flake and Synder 2003)

The Kim Dae Jung strategy with respect to food aid was articulated in 1999, and from the outset included both food aid and fertilizer, seeds and pesticides. As the administration stepped up its multi-faceted push to orchestrate a summit meeting between Kim Dae Jung and Kim Jong Il in the spring of 2000, bilateral food and fertilizer aid increased dramatically; there can be little doubt that these efforts were related to a broader “food for talks” strategy. South Korea provided 200,000 tons of fertilizer aid to the North in 1999, 300,000 tons in 2000, 200,000 tons in 2001 and 300,000 tons in 2002, the final year of the Kim Dae-jung administration.

The election of Roh Moo Hyun occurred just as the second nuclear crisis was breaking in late 2002, and his commitment to maintain the sunshine approach quickly became an issue of contention with the Bush administration (Chapter Six). On coming to office, the Roh administration quickly made a contribution (100,000 tons of maize) through the WFP, but aid policy reverted to the bilateral format that developed since the 2000 summit. The bilateral Inter-Korean Economic Cooperation Promotion Committee became the venue for the discussion of aid commitments. In May 2003—while the nuclear standoff with the United States was continuing—the North Koreans requested 200,000 tons of fertilizer, which the South Koreans delivered, and a total of 500,000 tons of grain, approximately 400,000 tons of which South Korea ultimately supplied for the year, an amount equal to nearly half of the country’s uncovered food deficit for the year. Requests to maintain these levels of support were subsequently made in the June 2004 meetings of the bilateral economic cooperation committee and approved by the South Korean side.

After this meeting, bilateral relations fell into a freeze that would not thaw until nearly a year later when a high level South Korean envoy met directly with Kim Jong Il in May 2005. The Sunshine approach was particularly tested by the February 10, 2005 announcement that North Korea was suspending its participation in the Six-Party Talks and had nuclear weapons; only a month before this announcement, the North Korean government had placed its largest aid request to the South Korean government ever,

500,000 tons of fertilizer. The government was divided over how to respond to the February 10 statement and the aid request, and was pressured by the U.S. not to grant it. Nonetheless, the administration stuck to the strategy of separating humanitarian engagement from politics and extended even more assistance as a component of the strategy of getting North Korea back to the talks that led to the important September 2005 Joint Statement.

Following the bumper harvest of fall 2005, North Korea initially limited its aid requests to South Korea to fertilizer (450,000 tons). By April, however, the public distribution system (PDS)--the state-run rationing system on which roughly two-thirds of the population theoretically depends--was once again under stress and the DPRK came back to the South with a request for 500,000 MT of food and a resumption of fertilizer shipments.<sup>34</sup> In an important *volte face* from previous policy, South Korean foreign minister Ban Ki Moon warned in July that the Roh government would suspend further humanitarian assistance if North Korea proceeded to conduct missile flight tests. With the exception of a one-off aid package following the floods in August, the administration carried through on that threat and even interrupted deliveries under the emergency flood program following the nuclear test in October.<sup>35</sup>

Within a month of reaching the first implementation agreement in February 2007, North-South inter-ministerial meetings started up, and the Roh administration once again offered commitments equal to those discussed in the past.<sup>36</sup> Serious flooding in August once again generated new emergency commitments, and in the run-up to the inter-Korean summit meeting in October, the Roh administration outlined a wide array of economic inducements.

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<sup>34</sup> . At the time of the April request, the Roh government had committed to shipping 150,000 tons of fertilizer but had not taken a decision on the remaining 300,000 tons included in Pyongyang's initial request.

<sup>35</sup> . The \$230 million aid package included 100,000 MT of rice, which accounted for just over \$200 million of the total. The North Koreans responded to the regular aid cutoff by suspending ministerial talks and halting family reunions.

<sup>36</sup> . The resumption of rice aid initially proved contentious, but the final resolution of the Banco Delta Asia problem and apparent progress in the Six Party Talks led to a resumption of large-scale aid (400,000 MT of rice) in July, for the first time sent overland.

These commitments did not bind the incoming government, however. Lee Myung Bak had run on a platform of reciprocity: that both aid and other forms of economic cooperation would be conditional. His wide-ranging “Vision 3000” program offered a plethora of incentives to the North, but all were prospective: contingent on progress with respect to commitments under the February and October 2007 Six Party agreements and progress on North-South relations.

After his inauguration, there was uncertainty about whether this concept of reciprocity extended to humanitarian assistance. Not until late March 2008—over a month into his presidency and with rapidly mounting signs of distress--did President Lee clarify that he would extend humanitarian assistance regardless of progress in the nuclear talks. However, the humanitarian offer came with its own set of conditions, including that the North make a formal request for aid that would reactivate the diplomatic channels that had been severed by the North following his inauguration. The North Korean regime vigorously rejected these conditions and decided to pursue a highly confrontational policy toward the South. In early April, despite clear signs of a deterioration in the food picture, Pyongyang announced it would not seek aid from South Korea, turning almost immediately to China for assistance.

At various points during Lee Myung Bak’s tenure, the administration sought to outline principles for humanitarian assistance, but they largely codified the policy that emerged in the early months of the administration. First, the administration’s protests to the contrary, it is hard to avoid the conclusion that humanitarian assistance was contingent on progress on the nuclear issue and particularly on North-South relations.<sup>37</sup>

Second, humanitarian assistance was both defined more narrowly—for example in response to the floods of 2010--and linked to a wider agenda of humanitarian issues.<sup>38</sup> The humanitarian agenda was consistently defined to include family reunions, POWs, abductees and even human rights. Even if the Lee administration did not expect North

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<sup>37</sup> . For example, in the spring of 2011, a period of acute distress, a spokeswoman for the Ministry of Unification could state that “decisions on large-scale aid funded by the government would be made not only on the basis of humanitarian situations in North Korea (DPRK) but also on our assessment on inter-Korean relations in general.” The administration subsequently sought to tie US food aid to a resumption of North-South talks. “S. Korea remain (sic) lukewarm on food aid to DPRK,” Xinhua May 18, 2011 at [http://news.xinhuanet.com/english2010/world/2011-05/18/c\\_13881050.htm](http://news.xinhuanet.com/english2010/world/2011-05/18/c_13881050.htm)

<sup>38</sup> . For example, KBS World, “UM Opposes Large Scale Food Aid to NK” at [http://world.kbs.co.kr/english/news/news\\_IK\\_detail.htm?No=75763](http://world.kbs.co.kr/english/news/news_IK_detail.htm?No=75763)).

Korea to respond to prospective inducements with respect to the nuclear issue and high politics, it continually suggested that humanitarian assistance required reciprocity on humanitarian issues of interest to the South; the first initiative noted above sought a resumption of family exchanges in return.

Finally, the Lee administration not only sought to minimize South Korea's public aid commitments but acted to curtail growing NGO activity as well. This activity included aid funded by the Inter-Korean Cooperation Fund (IKCF), which collapsed to virtual insignificance. Even during periods of extreme distress, such as the spring of 2011, permission to provide assistance was parceled out to only a limited number of NGOs conditional on adequate distribution and monitoring plans.

The election of Park Geun Hye marked another shift in the approach to humanitarian assistance, attempting to straddle the engagement and Lee Myung Bak approaches. The core concept of *Trustpolitik* was incrementalism: to offer small, but reciprocated steps, of which limited humanitarian support would be one instrument. But through 2016, her *Trustpolitik* approach remained hostage to tensions generated by the satellite launch of December 2012, the third nuclear test of February 2013, sanctions inherited from the Lee Myung Bak government and her own stated commitment to unification on South Korean terms, most notably in her Dresden speech of March 2014. The aid actually provided was a modest departure from the Lee administration, but was of inadequate scale to provide a focal point for sustained North-South talks let alone rapprochement. Despite the attempt to outline a conceptually different approach, and several modest aid initiatives over the course of 2014 and 2015, the Park administration's overall approach ended up resembling Lee Myung Bak's in its policy of tightly coupled quid-pro-quo and sharply defined humanitarian need.<sup>39</sup>

## *China*

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<sup>39</sup> . For more on South Korean assistance to North Korea see North Korea: Witness to Transformation blog four-part series from Haggard, Boydston, and Ryu. "South Korean Aid to the North I: An Accounting 1991-2015," July 20, 2015 at <http://blogs.piie.com/nk/?p=14284>; "South Korean Aid to the North II: An Accounting, 1991-2015," July 21, 2015 at <http://blogs.piie.com/nk/?p=14289>; "South Korean Aid to the North III: An Accounting, 1991-2015," August 12, 2015 at <http://blogs.piie.com/nk/?p=14365>; "South Korean Aid to the North IV: An Accounting, 1991-2015," September 1, 2015 at <http://blogs.piie.com/nk/?p=14424>.

China's trade in food with North Korea has historically involved a number of components that are both difficult to separate and virtually impossible to measure with any confidence. These include large-scale trade, mostly from state-licensed entities, several in the Northeast of the country, as well as a border trade that involves small traders, families and North Koreans moving across the border. As we saw in Chapter Three, in aggregate it appears to be largely on commercial terms. However, it is possible that larger firms receive subsidies from the central government. It is widely suspected that there is a "gift economy" of discretionary commitments associated with high-level diplomatic meetings (Reilly 2014b) and provincial governments in the Northeast have also given aid (Yan 2016). A number of foreign NGOs run their food operations through China as well, although the number doing so rises and falls with North Korea's openness to such operations and at least some of this trade is captured in multilateral aid data (Yan 2016).

Given the fact that the Chinese treat their aid to North Korea as a state secret, public statements and reports with respect to it are wildly contradictory: some suggest only limited assistance; other sources claim a long history of regular food aid.<sup>40</sup> However, we can ask two questions: whether the timing of Chinese aid shipments suggest the willingness to act as a supplier of last resort during period of shortages; and whether

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<sup>40</sup>. At a press conference in April 2011, China's Vice Commerce Minister Fu Ziyang claimed that China had provided support for North Korean agriculture in the form of fertilizer and fuel, but made no explicit mention of food and specifically denied any cash assistance. "China Released Details on Aid to North Korea," Arirang News, April 27, 2011 at [http://www.arirang.co.kr/News/News\\_View.asp?code=Ne2&nseq=115383](http://www.arirang.co.kr/News/News_View.asp?code=Ne2&nseq=115383). At the other end of the spectrum are claims of regular assistance of 100,000 tons of grain a year, which exceeds annual total quantities shipped over the entire crisis period. "Scale of Yearly Unconditional Aid to N. Korea Unveiled," *Dong-a Ilbo* June 24, 2012, at <http://english.donga.com/srv/service.php3?biid=2012062508548> citing unnamed sources. However, multiple sources did confirm that there were large shipments made in the immediate aftermath of Kim Jong Il's death and this is confirmed in the data. For example, Kim Tae Hong, "China Aids North Korea," *DailyNK* January 30, 2012 at <http://www.dailynk.com/english/read.php?cataId=nk00100&num=8736>. For a review of conflicting Chinese statements by Yan 2016.

the price data suggests subsidy, with the caveat noted above about possible hidden subsidies. To do this, we combine a consideration of total reported shipments from the onset of the nuclear crisis through the first year of Kim Jong Un's rule (Figure 4.3), while also reconsidering our findings on prices from Chapter Three (Figure 3.10). Recall that from the 2006/7 crop cycle through 2011/12, North Korean total food balances show a steady deterioration—with the exception of 2008/9—before improving marginally (Figure 4.1).

[INSERT FIGURE 4.3]

The quantity of Chinese exports is characterized by a number of spikes, typically driven by increase in corn shipments. These come in 2005, during the major run-up in world prices in 2007-8 (although reporting was interrupted), and again in late 2010 and late 2012, also a period witnessing notable increases in global prices. There is therefore at least suggestive evidence that China may have been responding to the distress in those periods and that they were providing aid in support of the succession. However, when we consider the price data in Chapter Three, we do not see evidence of increased support; to the contrary. Missing data precludes a firm judgment of whether there was a subsidy component to shipments during the price spikes in 2008, but there is suggestive evidence that there was for rice: when reporting resumes in 2009, Chinese export prices for rice appear well below world benchmarks. But in parallel exercises on prices to that shown in Chapter Two on rice, we found this was not true for corn or wheat and if anything Chinese export prices actually *exceeded* world market prices in the early 2010s.

The data needs to be considered in the context of what we know about the course of Chinese policy, both with respect to North Korea—detailed in our discussion of the diplomacy in Chapters Six and Seven--and with respect to agricultural exports (USDA Foreign Agricultural Service 2012; International Crisis Group 2006, Bonnie Glaser, Scott Snyder and John S. Park 2008, Snyder 2009).<sup>41</sup> The export of both wheat and rice is

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<sup>41</sup> . The most intriguing source to emerge in this regard is the publication in Japanese of *China's Secret File on Relations with North Korea (Takitachosen Chugoku Kimitsu Fairu)* edited and translated by Satoshi Tomisaka and purportedly written largely by an official of the International Department of the Chinese

controlled by the licensing of a very limited number of state-trading organizations—only two in the case of rice—as well as discretionary use of VAT rebates and export quotas. Following closely on the Department of the Treasury designation of Banco Delta Asia as a money-laundering concern, Hu Jintao visited North Korea in October 2006. The meeting followed the signing of a new economic cooperation agreement that likely included aid as well as agreements facilitating transport links and other joint infrastructure projects, Chinese investment, and joint exploration of oil.<sup>42</sup> The agreement established a formal consultative mechanism in the form of a DPRK-China Economic, Trade and Scientific and Technological Cooperation Committee. The “mutual benefit” approach rested on three pillars, including not only strengthened government-to-government relations but expanded reliance on the market and a leading role for Chinese firms in the process (Snyder 2009, 126-27; Reilly 2014a, b, c).

The effort to use aid as an inducement to progress in the Six Party Talks was strained by the missile and nuclear tests of 2006 (Chapter Six); China even voted for the UN Security Council sanctions on North Korea although the sanctions did not include commercial trade or humanitarian assistance. Moreover, North Korean practices on the ground continually challenged the “mutual benefit” concept. In an infamous 2007 episode, China halted railroad shipments to North Korea in response to North Korean theft of Chinese rail wagons.<sup>43</sup>

From 2008, the food trade was further complicated by a broader set of policy concerns in China. As world prices began to rise in 2007-8, concerns about inflation led Chinese authorities to impose a succession of controls over food exports.<sup>44</sup> Informal

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Communist Party’s Central Committee. Regardless of the veracity of this report, its findings comport closely both with other academic studies and contemporaneous press accounts and Chinese statements.

<sup>42</sup> . Yonhap, “China Ships China ships 10,000 tonnes of heavy oil to North Korea,” October 26, 2005; KCNA, “North Korea, China sign economic cooperation agreement,” October 11, 2005; Yonhap, “North Korea Agrees to open all railways to Chinese train companies,” October 25, 2005.

<sup>43</sup> . Starting on 30 September UN relief agencies, which warehouse supplies in China, were not allocated the wagons required to make aid shipments in the wake of the August floods because of the loss of 1800 rail wagons in North Korea. Beginning on the weekend of 13-14 October North Korea began returning the cars and Chinese authorities began allocating them to the relief agencies on a one-for-one basis before aid finally resumed in more substantial quantities.

<sup>44</sup> . In mid-December 2007, China’s Ministry of Finance announced it was eliminating a 13 per cent tax rebate on grain exports; the change in policy affected 84 categories of grain and included wheat, corn, rice and soy beans. At the end of December it went further, declaring that over the course of 2008 it would impose further export taxes ranging from 5 to 25 percent on grain exports. In early January 2009, the

reports suggest that the Chinese did step in to provide emergency assistance during the spring of 2008 and high level diplomatic initiatives by the North Koreans, including from Kim Jong Il himself, sought to ingratiate the regime to Beijing as the crisis broke (Snyder 2008).<sup>45</sup> But we cannot rule out that the “assistance” that China provided during the crisis was largely in the form of assuring adequate supplies, not in large-scale aid or subsidies. This would comport with the conceptual framework laid down by the Chinese following the important visit of Wen Jiabao to Pyongyang in October 2009, which initiated an intense period of diplomatic exchanges at the highest level including three visits by Kim Jong Il to China (Chapter Seven). Despite the announcement of a number of joint projects, the approach articulated by the Chinese followed the Hu Jintao line of “government-guided, enterprise-based, market oriented, mutually beneficial” cooperation. Outside a one-off infusion of aid following the death of Kim Jong Il to assure a smooth transition, there is no indication that this framework has changed in the Kim Jong Un era. If anything, the execution of Jang Song Thaek--suspected of managing what Li (2016) calls a number of “cooperation platforms” between the two countries--appears to have had a material effect. In 2015, food shipments fell sharply although in a context of mildly improved domestic supply of grains.

With the substantial uncertainties noted, several points emerge from this overview of Chinese food trade with North Korea. China has almost certainly used material inducements—including food aid--to advance its diplomatic objectives, including in the Six Party Talks. But there is a tendency for Korea-watchers to overemphasize foreign policy concerns in the bilateral aid relationship and overlook its commercial dimension. First, we can see a long-run effort—dating to the early 1990s—to gradually shift the nature of Chinese-DPRK relations onto a more commercial footing. This can be seen most strongly in the 1992 decision to price exports and imports in convertible currency and in the renewed push for a “mutual benefit” approach to bilateral relations under Hu Jintao.

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Ministry of Commerce announced that it would exercise discretionary quotas over the export of milled grain.

<sup>45</sup> . “Kim Jong Il Restores North-China Relations,” *Daily NK*, March 3, 2008. See also USDA 2012.

Second, we have documented an overlooked feature of the aid relationship: the extent to which it is driven by domestic preoccupations within China with respect to harvests, prices and self-sufficiency. Elsewhere, we documented how a sharp decline in agricultural exports from China in 1994 was an important proximate cause of the famine as China gave priority to its own domestic needs (Haggard and Noland 2007, p. 154-160). More recently we have seen that while China has certainly continued to export grains to North Korea since the global food price increases of 2008 and deteriorating food balances in the DPRK, those exports have clearly not been adequate to forestall recurrent distress.

### *Conclusion*

A consistent challenge posed by both sanctions and engagement strategies is humanitarian. Strategically withholding humanitarian aid contributes to distress but open-ended provision invites moral hazard. We have shown that North Korea's foreign policy behavior ultimately had negative effects on both the level and volatility of aid flows and as a result on human welfare in the country.<sup>46</sup> The reasons were two. First, the country's adversarial stance with respect to donors, consistent violation of humanitarian norms and unwillingness to undertake needed agricultural reforms made it politically difficult for donors to sustain large-scale aid programs; this appears to be the case with respect to China as well.

But it is also clear that the country's foreign policy behavior mattered too. Notwithstanding humanitarian norms, food aid was periodically used as a bargaining chip in the nuclear negotiations. The downside of this linkage, however, was that the collapse of talks or provocative behavior was followed by aid reversals.

These reversals suggest some fundamental limits on the use of inducements. The ethical case is strong that outside donors should not tie humanitarian assistance to

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<sup>46</sup> An alternative paradigm in international relations, largely from Canada, Northern Europe and the developing world, has emphasized that "security" should be reconceptualized to focus on "human security," taking the individual rather than the state or regime as the unit of analysis (UNDP 1994; Buzan, Waeber and de Wilde 1998; Smith 2005 on North Korea; Paris 2001 for a critique).

political objectives. But in a number of episodes—some of stunning magnitude—the North Korean regime preferred to walk away from proffered food aid rather than make even marginal concessions in the conduct of its foreign policy. Moreover, it is clear that the regime is unwilling to import adequate supplies on commercial terms to forestall recurrent distress, particularly during the 2006-2012 period (Figure 4.1). Sanctions can be crafted to permit continuity in humanitarian operations, and have been. But outside donors cannot force the regime to prioritize the feeding of its population. North Korea's foreign policy is ultimately responsible for the fact that the country receives less aid than it could and that it is unable—or unwilling—to finance adequate commercial imports to meet human need.

## Chapter Five

### The Microeconomics of Engagement

As we argued in the Introduction, advocates of engagement have long argued that increased cross-border exchange can moderate a target country's foreign policy. Such moderation could arise either from quid-pro-quo (which we consider in Chapters Six and Seven) or through broader transformative effects on the economy, politics, and eventually, the foreign policy of the target state. Increased economic integration either gives influential groups a direct material stake in external economic relations that they did not previously have or strengthens groups within the polity that have such stakes. New stakeholders would not only constrain or encourage the target regime to undertake further economic reform and develop supportive market-conforming institutions,<sup>1</sup> but would ultimately act as a political constraint on the foreign policy choices of the government as well. Over time, international ties may have socializing and learning effects; individuals, firms, officials, even high-ranking politicians come to reassess their strategies in light of new information provided through increasing political and economic integration.

Yet the conditions for this benign circle to operate may be more restrictive than proponents of engagement suggest. The precise mechanisms through which this sequence of economic-cum-political changes would occur are seldom if ever spelled out, let alone analyzed empirically.<sup>2</sup> Target governments may have little interest in the development of markets outside their control nor in the development of either informal or formal market-supporting institutions that would strengthen the hand of private actors. Such developments might threaten the state's capacity to maintain control—including over information—and to extract rents through corruption. Indeed, authoritarian targets are likely to structure economic exchanges precisely so they maximize such control and limit the risks associated with the emergence of markets, informal and formal institutions. As we have seen, the regime has been constrained to tolerate what we call marketization from below, but it has only sporadically endorsed these processes officially through policy reforms.

These claims and counterclaims are amenable to test, although there are few if any efforts that we know of to subject them to scrutiny. The first question is a straightforward empirical one: whether foreign transactions are effectively captured by the state- or military-controlled enterprises in the target state. We provide evidence that at least for those of significance, the

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<sup>1</sup> See Johnson, Ostry, and Subramanian (2007) for an example of the claim of the institution-enhancing impact of international trade in a non-North Korean context.

<sup>2</sup> For example, see Moon (2008).

answer is “yes.” As we argued in Chapter Three, the market—including the growth of the border trade with China—emerged in part as an unintended consequence of state failure. Rather than reforms building on the process of marketization from below, North Korean authorities have responded to the market with recurrent efforts to control decentralized cross-border trade. They have also centralized the investment approval process, and channeled economic integration with China and South Korea through entities under more direct central political control. Indeed, the existence of sanctions may act as an enabler in this regard: there is an ample theoretical and empirical literature showing how sanctions have the effect of creating rents that leaders in the target country can exploit, thus offsetting their adverse effects on core constituencies (Kaempfer, Lowenberg and Mertens 2004; Andreas 2005).

A second question is whether cross-border trade has spilled over into the evolution of market-enabling institutions that would favor private exchange. It is well-established that institutional quality has a significant impact on cross-border trade and investment (Wei 2000; Levchenko 2007, 2011; Anderson and Marcoullier 2002; Moenius and Berkowitz 2011; Feenstra et al. 2012). Trade would be severely limited were all transactions consummated at the time of sale; rather, trade and investment rest on the expectation that counterparties will fulfill contractual obligations that unfold over time: the fulfillment of orders and payment for product and investment relationships that yield a stream of income. Particularly important to such exchanges are the extension of credit and the institutions that support it. The policy environment and formal institutions, including dispute settlement mechanisms, obviously matter to enforcing such contracts. The development of market-supporting institutions—even if informal—might thus also constitute a measure of whether engagement strategies work.

It goes without saying that North Korea’s institutional environment is extraordinarily weak. In the most recent Transparency International survey on corruption, North Korea placed dead last, tied with Somalia in 167<sup>th</sup> place (Transparency International 2015). But we provide additional evidence from the perspective of the firms that market-supporting institutions were not emerging even when the nuclear negotiations were going well in 2007. The actors in question report that the nature and volatility of the regulatory environment constituted a barrier to trade and investment and that corruption was high, a finding in line with our overview of policy in Chapter Two.

As a second-best, informal institutions can also complement formal institutions or even substitute for them altogether where they are lacking. In well-functioning market economies, recourse to the legal system is core to enforcing contracts. However, a growing body of literature, much of it derived from the experiences of other transitional economies, has looked at alternative

means through which exchange might be supported in the absence of institutions. These mechanisms include collective action on the part of merchants themselves or other forms of personal networks rooted in kinship or family that can generate trust (Milgrom, North, and Weingast 1990; Greif 1993; Greif, Milgrom, and Weingast 1994; Clay 1997a, 1997b; Johnson, McMillan, and Woodruff 1999, 2002; McMillan and Woodruff 1999a, 1999b). As we show, these mechanisms appear weak as well, and trust—as measured by indicators such as the willingness to extend credit—is low. Rather, we find a bifurcated structure to economic exchange, anchored at one end by dyads of large-state owned enterprises that are protected by higher-level political exchanges and at the other by smaller firms that seek to fly underneath the regulatory radar.

It is important to underscore that our skeptical conclusions are subject to revision; as of this writing, *de facto* marketization continues apace and we take up its possible effects in the Conclusion. Moreover, we must entertain the possibility that state-controlled entities and a hybrid state-private capitalist class may themselves come to constrain the regime's foreign policy behavior. But both in theory and for the period covered by this study, it may be wrong to believe that economic integration will necessarily improve the regulatory environment or dissolve rent-seeking opportunities in "hard targets." As Solingen (1998, 2012) argues, statist political coalitions are perfectly aware of the potentially corrosive effects of market-oriented engagement and, for that reason precisely, seek to control it.

To address these questions we draw on two unprecedented surveys of firms based in China and South Korea engaged in trade and investment with North Korea to examine both the nature of cross-border exchange as well as the formal and informal institutions that underpin it; a full description of the survey can be found in Appendix Two. The China survey was conducted in late 2007—near the apex of the Six Party Talks process—and involved 250 firms or enterprises doing business in North Korea at the time. The South Korea survey was conducted in of 200 firms doing business in North Korea was conducted in November 2009 and March 2010.<sup>3</sup> The timing of the South Korea survey was also auspicious, conducted just before the fallout from the sinking of the *Cheonan* in March 2010. At that time we estimate that about 400 South Korean firms were engaged in economic activities in the North outside of KIC, meaning that our sample constituted a significant share of the universe.<sup>4</sup>

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<sup>3</sup> . We also surveyed a control group of firms in both countries that were not conducting business in North Korea at the time: 53 in the Chinese survey and 50 in the South Korean survey.

<sup>4</sup> . It is important to note the political context of the timing of the two surveys. The 2007 survey was done at a high-point in the Six Party Talks process; the South Korean survey was conducted in November 2009 and March 2010, around the same time of the sinking of the *Cheonan* (March 26, 2010) and the shelling of Yeonpyeong Island in November 2010.

We start in the first two sections by detailing the participants and their mode of entry into North Korea; the characteristics of the Chinese, South and North Korean firms engaged in cross-border trade and investment. Not surprisingly, state entities figure prominently on the North Korean side of these cross-border exchanges. The designation of firms as state-owned enterprises (SOEs) cannot be taken at face value and it is increasingly possible that a gradual de facto privatization of trade may be occurring. But at least as measured by ownership, the North Korean regime seems intent on trying to maintain control over foreign-exchange-generating activities.

An important finding on entry pertains to the role that government support plays in these exchanges and the extent to which engagement has taken a commercial form. In the case of China, there were basically two sorts of Chinese enterprises doing business in North Korea at the time of the survey: large state-owned enterprises with long-standing relationships with their North Korean counterparts; and a larger number of small, essentially private businesses that restrict themselves primarily to trading activities. Neither type of firm reports receiving much support from the Chinese government.

South Korea, by contrast, has attempted to circumvent the North Korean system by adopting an enclave model, particularly through the Kaesong Industrial Complex (KIC). We find that public policies play a much more central role in inducing South Korean firms to enter North Korea. In effect, the state has partly socialized the risk of commercial exchanges with the North, a finding that comports with our analysis in Chapter Three of the non-commercial nature of much of the trade. This fact calls into question the extent to which such exchanges will have transformative or socializing effects.

We then turn to subjective assessments of the business environment. Most respondents indicated that they regarded the trend toward liberalization as irreversible, possibly an effect of the timing of the survey noted above.<sup>5</sup> Nonetheless, Chinese appraisals of the actual North Korean business environment were generally negative. A large majority of the respondents complained not only about infrastructure issues but the nature of the regulatory environment, the risk of arbitrary changes in rules, lack of reliable dispute adjudication and outright expropriation. Nearly the same share of South Korean firms see the lack of infrastructure and the risk of asset appropriation as problems for business, but because of the controlled institutional environment are less inclined than their Chinese counterparts to complain about labor quality or the regulatory environment.

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<sup>5</sup>. More recent case studies of Chinese firms investing in North Korea suggest that the basic findings from our formal survey still hold. See Marcus Noland, "Case Studies on Chinese Business in North Korea," North Korea: Witness to Transformation, February 5, 2014 at <http://blogs.piie.com/nk/?p=12854>; we discuss the continued Chinese policy of "deep integration" with the North in Chapter Seven.

We then turn to the question of dispute settlement, corruption, and market-supporting institutions. Not surprisingly, the formal mechanisms for settling disputes were seen as limited; firms operating in North Korea are on their own. Bribery and corruption are also pervasive features of the business environment, and might be seen as a rational response to the lack of property rights protection. If bribe payments result in credible provision of protection, they are one political mechanism for assuring trade and investment. However, there is some evidence that firms face a greater likelihood of economic predation as their size increases. As a result, Chinese enterprises and Korean firms outside of Kaesong limit their exposure by generally choosing trading over investing, conducting transactions in China (in the case of Chinese firms), holding their North Korean counterparts to tight settlement terms, and demanding payment primarily in US dollars or Chinese *yuan*.

Finally, we consider the evolution of informal institutions and trust. Although there is some evidence of such mechanisms, trust was found to be extraordinarily low as measured by some standard proxies such as the willingness to extend credit. The rapid growth in trade and investment up through the time of the survey appears to have rested on a distinctly bimodal set of relationships in the Chinese case: short-term and smaller-scale exchanges that resembled a spot market; and SOE-to-SOE relationships embedded in higher-level political relationships and the voracious Chinese appetite for minerals and coal.

The findings have wider theoretical and methodological implications for the debate about sanctions and engagement. In the absence of formal institutions and policy reforms, cross-border integration with “hard targets” such as North Korea may be self-limiting rather than self-reinforcing. Even with China, the absence of institutions deters integration, deters investment relative to trade, limits the extent of purely private exchange and inhibits the development of informal networks and relational contracting. These results are consistent with our findings in Chapter Three that North Korea’s trade and investment is increasingly concentrated on China and—until the closure of Kaesong in 2016—South Korea. Trade and investment with these two countries has probably grown as a result of other enforcement mechanisms and complementary public and private investments that substitute for the weakness of North Korean institutions. In the absence of further reforms—and a moderation of the country’s foreign policy behavior—these institutions may not be available with other partners or have the desired effect.

### **Who Are the Participants?**

Ironically, Chinese enterprises have much more direct exposure to the North Korean policy environment than their South Korean counterparts, some which operated in the Kaesong Industrial Complex. Not surprisingly, these differences in institutional setting are reflected not only in the perceptions of the firms, but in the very composition of the sample.

### *The Chinese Firms*

The Chinese firms doing business in North Korea are engaged in importing, exporting, investment and the permutations and combinations of these three activities.<sup>6</sup> Pure exporters make up the largest group. Most of these exporters are relatively small private enterprises (figure 5.1). If the processes of marketization implicit in the engagement model are likely to hold, they would be most likely to occur among this group of enterprises.

[INSERT FIGURE 5.1 HERE]

With respect to ownership, 58 percent of the firms doing business in North Korea were private enterprises, and another 14 percent sole proprietorships; only 3 percent are foreign firms operating in China. There is a distinct minority of a dozen large SOEs, some of which have been doing business with North Korea for more than a quarter century but over 80 percent of the firms in the sample entered in the ten years prior to the survey.<sup>7</sup>

Core activities vary. More than half the Chinese enterprises doing business in North Korea reported that they are involved principally in trading; another 5 percent identified themselves as diversified groups that have trading operations. The traders were asked about the most important product that they exchanged with their largest customer or supplier and the findings comport broadly with what we know about bilateral trade at the time of the survey from

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<sup>6</sup> . The vast majority of the enterprises in the sample doing business in North Korea are Chinese (98 percent), though around 20 percent of the control group report being headquartered outside of China, mostly in Japan or South Korea. Forty percent of the respondents report that their chief executive officer (CEO) can speak Korean. This share is virtually identical across both the firms currently doing business in North Korea and those which are not.

<sup>7</sup> . By contrast, the not-doing-business sample includes a different mix of ownership structures, with 38 percent reporting foreign ownership, mostly Japanese or South Korean, and only 28 percent accounted for by private enterprises and sole proprietorships. Interestingly, there were not many pure SOEs in either sample (5 percent in the “doing business” sample, 4 percent in the “not doing business” sample) although joint stock companies—which frequently have government participation—accounted for about 21 percent of the first group and 26 percent of the second group.

aggregate trade data.<sup>8</sup> On the import side, the product mix is much more concentrated, with aquatic products (30 percent), metal and metal products (27 percent) and wood and wood products (18 percent) accounting for almost 75 percent of the top imports from the dominant supplier. Beyond trading, other activities represented include construction (16 percent), services (10 percent), and agriculture (6 percent); larger mining firms were also represented but accounted for a smaller share of the sample.

Among investors, the most frequently cited motivations are to expand business in the domestic market (29 percent), to sell there (21 percent), or to exploit natural resources (27 percent). Only 23 percent are locating in North Korea as an export platform, either back to China (13 percent) or to third markets (10 percent). We interpret these results to reflect in part weak infrastructure, in part prevailing policies and incentives that limit opportunities for export-oriented investment. However, as we argued in Chapter Two we cannot rule out political risk, including through sanctions. The scope for the expansion of processing-on-commission trade, including through export-processing zones, remained relatively untapped at the time of the survey.

While our understanding of the Chinese participants is relatively complete, our understanding of their North Korea counterparts is much weaker. Figure 5.2 reports the Chinese firms' responses to a question about the legal status of their primary North Korean counterparty, broken down by importers, exporters, and investors. In all three types of cross-border exchange, the majority of respondents reported that SOEs were their main counterparties. Nonetheless, important distinctions emerged across types of exchange. Importers, and particularly investors, report a much greater dependence on official entities: overwhelmingly SOEs but also government bureaus and the military; eleven of the twelve Chinese SOEs in the sample report that a North Korean SOE is their primary counterparty. Pure exporters report a wider array of North Korean counterparties, including Chinese brokers, private firms, and individual entrepreneurs; again, if there is evidence for the engagement model it is more likely to be found among this group. Yet even among this group, official entities—SOEs, urban and rural collective enterprises, government bureaus, and the military—very clearly dominate.

[INSERT FIGURE 5.2]

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<sup>8</sup> . For exporters, the major products were quite diversified and included construction materials (including upholstery; 13 percent), apparel and clothing (11 percent), grain and edible oils (10 percent), and chemicals and electrical equipment (8 percent each).

These findings about the identity of the counterparties would suggest some important limits on the spread effects of cross-border marketization. However, caution is warranted because the SOE category encompasses entities and economic behaviors of at least three different types, some of which reflect the process of marketization from below. The first are SOEs engaged in their traditional, legally sanctioned lines of business, presumably subject to extensive direct political control. The second are SOEs whose managers have exploited the company's legal status and resources to initiate non-traditional and in some cases completely unrelated (and even illicit) lines of business. Third, entrepreneurs affiliate with SOEs for political protection (Kim 2007); the SOE may in fact be a shell for an effective joint venture partnership. Thus while the majority of counterparties are identified as SOEs, de facto privatization of exchange was probably occurring under the mantle of the state, including through corruption; we return to this in more detail in the Conclusion.

### *The South Korean Firms*

South Korean involvement in the North was a direct outcome of the gradual political relaxation of relations that followed democratization in the South and the gradual unwinding of the Cold War. The earliest any respondent indicated entering the North Korean market was 1986, but the political breakthrough of the 2000 summit was clearly critical. The majority of firms entered since 2004, which corresponds to the initiation of activities at KIC.<sup>9</sup>

South Korean engagement with North Korea has a different profile and raises somewhat different issues. Most of the South Korean firms surveyed were small (less than 10 employees), and relatively young (established within ten years of the survey), though there were a handful of large firms (more than 1000 employees) and established firms (more than 50 years old) in the survey as well. The firms include listed public companies, private enterprises, and individual proprietorships. Most reported access to outside finance via commercial banks (58 percent), but 7 percent identified public sector financial institutions as their primary source of funding. However, the role of the public sector is probably larger than these answers would suggest as the government has offered a loan guarantee program for KIC entrants that went through commercial banks.

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<sup>9</sup> A similar pattern of responses was obtained to a question asking when the respondent established a relationship with their most significant counterparty—most of these relationships were established after 2004.

The South Korean firms doing business in North Korea had surprisingly diverse operations and were by no means limited to the KIC; the zone accounted for 33 of the 199 respondents or 17 percent. South Korean firms were engaged in importing, exporting, and investment through either arm's-length transactions and POC trade, as well as through the KIC. In contrast to the Chinese case, however, nearly all of the firms in the sample (92 percent) were involved in importing, either directly from North Korean counterparties (59 percent) or via some kind of processing relationship (33 percent). By contrast, less than half the sample—45 percent—were involved in exporting with the bulk of the exporting firms operating in the context of processing relationships (33 percent); only 12 percent sold to North Korean counterparties outside of POC relationships, suggesting that the regime may exercise particular scrutiny over South Korean exports.

When asked about their motivation for investment, most established operations aimed at selling to the South Korean market; the remaining responses were equally divided among selling to the North Korean market, exporting to third country markets, or exploiting natural resources. Sales to the South occurred either through arms-length importing, POC trade or export-oriented foreign direct investment. Thirty-two firms, or 16 percent of the sample, had invested in North Korea. Much of this investment occurs at Kaesong, so in stark contrast to the Chinese enterprises which are largely forced into joint ventures, most of these firms reported stand-alone investments without North Korean partners (72 percent). A plurality of the firms doing business in North Korea were engaged directly in manufacturing (47 percent) followed by trade (33 percent), agriculture, forest, and fisheries (13 percent), and other activities. Not surprisingly POC firms are more concentrated in manufacturing (89 percent), and the KIC firms were engaged exclusively in this sector. This pattern contrasts with the China survey where pure trading activities were more prevalent.

On the export side, trade is concentrated in textiles and clothing, particularly among firms engaged in processing activities, including at KIC (table 5.1). On the import side, food and fisheries products are most important, followed by textiles and apparel; this latter category of imports reflecting the return-side of POC relationships, as well as assembly activities at KIC. However, among arm's-length exporters, industrial equipment and intermediates are more prominent.

As in the case of the China survey, we have less information on the primary counterparties of the firms having done business in North Korea, but location provides some clues. The plurality of the respondents report their main location in North Korea as Pyongyang (29 percent) followed by the KIC (26 percent)—where there are no North Korean counterparties--

and North Hamgyung (20 percent), with other locations less frequently cited. More than 80 percent of the respondents report involvement with only a single North Korean counterparty.<sup>10</sup> Moreover, nearly half of both exporters and importers report that a majority of their revenues are accounted for by transactions with North Korea (figure 5.3); this subsample of firms is clearly dominated by small firms that are largely dedicated to doing business with North Korea. This dependence on the North Korea trade appears to be particularly large for firms engaged in processing activities.

[INSERT FIGURE 5.3 HERE]

[INSERT FIGURE 5.4 HERE]

One of the critical differences between the two samples is the much more prominent role of non-North Korean counterparties in the South Korea survey (figure 5.4). Pure importers and exporters report that a majority of their counterparties are North Korean entities, mostly state-owned enterprises (SOEs), followed by governmental units. The other modalities report a more diverse set of counterparties but firms operating in KIC appear particularly distinct as they have no involvement with North Korean SOEs; rather, they do business to a much greater extent with South Korean or third party firms, a factor which no doubt also influences the risk environment.

### **Entry and Modality**

Choices about entering North Korea and the types of activity in which firms engage are revealing of perceptions of political and policy risk and the nature of the operating environment. Our control group of firms not engaged with North Korea allows us to distinguish enterprises that enter the market from those that do not. Our survey also allows us to examine why firms choose to export and import only, or to invest or engage in some more complex combination of business activities. We would therefore expect property rights, contracting and the regulatory environment to matter more to investing firms. Not surprisingly, given the differing institutional set-ups and degrees of state involvement, the apparent determinants of entry and choice of modality differ considerably across the China and South Korea survey. We start with the China survey.

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<sup>10</sup> . The number of firms that reported KIC as their main location of business in North Korea (26%) exceeded the number of firms answering that they “operated a factory” in the KIC (17%). Given that there were not—to our knowledge—any other economic activities at Kaesong outside the zone, we interpret the 26% of the firms in the sample as all operating in KIC.

*The Chinese Firms*

Econometric estimates reported in Haggard, Lee, Noland (2012) indicate that ownership type and size matter with respect to propensity to initiate business with North Korea. Private ownership is positively associated with entry, and size, as measured by number of employees, is negatively associated with entry. Chinese firms choosing to engage in business with North Korea are smaller and more likely to be private than their counterparts.<sup>11</sup>

We would like to know how *ex ante* appraisals of the North Korean business environment affect the likelihood of entry, but we face a specification problem in teasing this out of our survey data. The 260 enterprises with current or past experience in North Korea have appraisals that are informed by experience *ex post*. This situation creates a statistically insoluble problem with respect to determining the direction of causality. Nevertheless, one particular null finding deserves mention. The belief that bribery is necessary to do business with North Korea was uncorrelated with entry. Approximately 70 percent of both Chinese firms that entered and did not enter North Korea believed that bribery was required to operate in the country, but this information did not constitute a deterrent. Indeed, expectations of the need to bribe were even positive and significant in some of the regressions reported by Haggard, Lee, and Noland (2012). For the reasons of simultaneity outlined above, these results should not be given a causal interpretation; bribery does not lead to more investment. Nonetheless, the results suggest that firms that have a more extensive understanding of the North Korean economy also have a more keen appreciation of the ubiquity of corruption than their presumably less well-informed peers. As we will see below, however, there is evidence that the respondents' *ex ante* assessments may have underestimated the actual extent of corruption in North Korea.

Investment in a setting such as North Korea involves substantial risk. We found that in contrast to entry of any type, size did influence the propensity to invest, perhaps for purely economic reasons, perhaps because of the political weight and connections larger firms can bring

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<sup>11</sup> Also of interest is what does *not* appear to matter. Variables relating to enterprises' sources of funding were statistically uncorrelated with entry. Neither provincial location of the firms' headquarters nor having a headquarters in a border town are significantly correlated with entry. Nor is having a chief executive officer (CEO) who speaks Korean. These characteristics—proximity and language skills—might be associated with being more informed about the North Korean business environment or the ability to make more nuanced risk assessments, yet they neither incline firms toward or away from doing business. With respect to business activity, service providers are deterred from entry. This could be because of North Korean regulations that create explicit entry barriers, but it could also be because service activities require a local presence that is riskier than arms-length trade transactions.

to bear to protect their stakes. But we also wanted to know whether the perceived ability to resolve disputes through different channels influenced the decision to invest? We considered four broad paths of dispute resolution: informal North Korean resolution through direct appeals to North Korean officials; formal North Korean resolution through the courts; official Chinese resolution, including through both the courts and political appeals; and informal resolution through Chinese third party networks such as industry associations. The expectation that one could appeal to North Korean officials for dispute resolution is positively associated with investing; firms that feel they can get a dispute resolved through appeal or connection to officials are more likely to invest. But interestingly, neither formal institutions in North Korea nor formal or informal Chinese institutions matter. Although China-North Korea trade is often treated as highly political, the firms that have invested appear to recognize that they are on their own. They recognize the need to engage in bribery, appear to have accepted corruption as part of the operating environment and rely not on formal dispute settlement mechanisms or even informal ones involving other Chinese firms, but their connections with North Korean officials.

### *The South Korean Firms*

Status as a small- or medium-sized enterprise (SME) is positively related to the entry of South Korean firms as well (Haggard and Noland 2012a). More weakly, firms listing trade as their primary activity are also more likely to enter; those citing manufacturing as a principal activity are less likely. But the most interesting comparative finding between the two surveys centers on the role of public policy: that access to public support, including in the form of lending, is a significant determinant of entry of the South Korean firms.<sup>12</sup>

A closer examination of this finding reveals that 70 percent of the firms report receiving no direct support (table 5.2), capturing the many smaller enterprises working outside of Kaesong. Among those who did report assistance, it took the form of trade preferences (23 percent), special financing (8 percent), export-import insurance (4 percent), and investment guarantees (3 percent). But when the responses are disaggregated two results emerge. First, the financial support tools are directed largely at firms operating at KIC, a majority of which report receiving some kind of policy support. As we noted in Chapter Three, the Kaesong trade as well as some joint

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<sup>12</sup> . Among the variables that appeared uncorrelated with the decision to enter the North Korean market or were correlated but not robustly so in a multivariate context as reported by Haggard and Noland (2012a) were legal status of the firm (listed, unlisted, sole proprietorship, foreign); sources of private funding; major product revenue share; location of headquarters other than Seoul; and the ability of the CEO to speak languages other than Korean and Chinese.

cooperation projects initiated under the Roh Moo Hyun government operate in a distinctly gray area between commercial and non-commercial trade.

Conditional on entry, we similarly asked whether firms engaged in arm's-length trade and investment, POC trade, or production in the KIC. These distinctions are interesting because they can be thought of as embodying a categorical choice ordered by decreasing exposure to North Korean policy and infrastructure (i.e. arm's-length being the most-exposed followed by POC, followed by KIC).<sup>13</sup> The findings confirm the point: the availability of commercial bank finance, finance via state-affiliated institutions, and access to special financing opportunities, all are associated with a reduced likelihood of choosing arm's-length transacting and toward a greater likelihood of locating in KIC. Econometrically, it is unclear whether this is a matter of these financing opportunities pushing firms away from arm's-length transacting and toward KIC, or whether the business activity less exposed to North Korean policy (and infrastructure) attracts financing. However, it is certainly plausible that the manufacturing firms that enter North Korea require state support to invest, and the KIC both provides assurances to creditors and a more secure institutional environment.

It is again important to underline the contrast between the two samples in this regard. Few Chinese businesses (and none of the SOEs, surprisingly) report any support from the Chinese government for their activities, which comports with Chinese government policy toward North Korea noted in Chapter Three and elaborated in more detail in Chapter Seven. Seven percent of the respondents indicated that they received special tariff reductions or exemptions, presumably under Chinese provisions for preferences for local firms engaged in small-magnitude "border trade." A handful of firms report receiving trade insurance, investment guarantees, or preferential finance. But government support, narrowly construed, does not appear to play a significant role in China's trade with North Korea; the Chinese policy of promoting commercial relations, as opposed to aid or commercial activities appears in the firm level data.

### **Subjective Assessments of the North Korean Business Environment**

Chinese and South Korean firms generally have a negative assessment of the business environment in North Korea, with the Chinese holding somewhat more negative views (see figure

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<sup>13</sup> An interesting finding in the South Korean sample was that the CEO's ability to speak Chinese was a significant correlate of entry, in part because most of the POC trade runs through China. As shown in table 5.3, Chinese networks play some introductory role.

5.5).<sup>14</sup> The pattern of responses across the Chinese and South Korean firms are correlated. Large majorities identified the inadequate infrastructure (79 percent in the Chinese survey, 78 in the South Korea survey) and the ban on cell phones existing at the time the survey was conducted (86 percent in the Chinese survey, 62 percent in the South Korea survey) as constraints.<sup>15</sup> However, the policy environment was also identified as a major hindrance to doing business. Changing regulations (79 percent China survey, 66 percent South Korea survey), the nature of regulations (70 percent China survey, 50 percent South Korea survey), and threat of expropriation (62 percent China survey, 63 percent South Korea survey) are all cited as major obstacles.<sup>16</sup>

[INSERT FIGURE 5.5 HERE]

An apparent surprise emerges when the responses from the South Korean survey are disaggregated between those inside and outside the KIC (figure 5.6). Relative to firms operating outside the zone, KIC firms had *more* negative appraisals of the regulatory environment, risks created by capricious regulation, and the possibility of expropriation. Why would firms in the KIC—at least partly sheltered from North Korean institutions—have a more negative view of them, particularly given that these responses are informed by experience and not *ex ante* expectations prior to entry? A plausible interpretation is that the KIC firms chose to use this modality precisely because they had relatively negative appraisals of conditions outside the zone.<sup>17</sup>

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<sup>14</sup> . Among the control groups of Chinese and South Korean firms not doing business in North Korea at the time of the surveys, by far the most frequently cited reason was lack of familiarity with North Korea (55 percent agree or strongly agree in the China survey, 58 in the South Korea survey) or with the North Korean market (87 percent agree or strongly agree in the China survey, 48 percent in the South Korean survey). In the China survey, 57 percent cited the weakness of the North Korean economy, 51 percent the poor reputation of DPRK policies, and 45 percent cited the poor reputation of North Korean firms. These concerns were more muted in the South Korea survey: 34 percent cited the poor situation of the North Korean economy, 40 percent the poor reputation of North Korea's policies, and 38 percent the poor reputations of North Korean firms.

<sup>15</sup> . Since the survey was conducted, the ban on domestic use of cell phones has been lifted with the Egyptian firm Orascom introducing domestic cellular service through most of the country (Noland 2009). Whether the foreign firms' needs for international connections have been fully addressed by subsequent relaxations is unknown. China has made cross-border use of cell phones a negotiating demand in establishing the rules for China-oriented special economic zones.

<sup>16</sup> . Problems with arbitrary and capricious implementation of regulations parallel the responses reported by North Korean market participants in refugee surveys (Haggard and Noland 2011).

<sup>17</sup> . Relative to firms outside the zone, they quite naturally did not regard the quality of infrastructure as much of an issue. But even on this question, 70 percent indicated that they

[INSERT FIGURE 5.6 HERE]

We can see similar differences in perceptions by comparing the attitudes of Chinese firms doing business in North Korea with those not doing business there, using simple t-tests. Perceptions on some issues do not exhibit significant differences between the two sets of firms; companies of both sorts have similarly negative assessments along these dimensions. For example, perceptions of the quality of infrastructure and barriers posed by weak telecommunications do not show significant differences. However, there are statistically significant differences in views of North Korea's institutional environment. Chinese firms not doing business with North Korea are more likely to see high taxes and the regulatory environment (at the 1 percent level) and the perceived difficulty of doing any business outside the special economic zones (at 5 percent level) as barriers. Perceptions of a problematic business environment likely deter entry.

But cognizance of risks is by no means limited to firms that have chosen to stay out. The Chinese trading firms doing business in North Korea are more likely to agree (at the 5 percent level) with the statement that is it too risky to invest because of potential expropriation, suggesting that such fears push firms away from investment and toward trading modalities. This finding confirms that the overall investment climate—and even the fear of outright expropriation of assets—serves as a deterrent to longer-run investment relations. Likewise compared to those not doing business, investors complain even more frequently (at the 5 percent level) than traders about high taxes (at the 10 percent level), which could be interpreted broadly as a proxy for government-related costs of doing business.

### **Dispute Resolution and Corruption**

Respondents' answers to questions about the legal and regulatory environment suggest that cross-border integration has taken place in a setting characterized by an unfavorable and capricious policy environment and the absence of conventional property rights protections (Chapter Two). In this section, we extend this finding to the weakness of dispute settlement mechanisms and the likely role played by corruption in protecting firm interests. Corruption is simultaneously a

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viewed it as a problem; again, this could be interpreted as a motivation to avoid North Korean risk by locating in the KIC.

deterrent to entry but also an informal mechanism through which firms seek protection from the weak policy environment.

### *Dispute Settlement*

A critical feature of any cross-border institutional environment is the capacity of investors and traders to resolve disputes. Formal institutions of dispute settlement, typically courts or other means of formal arbitration, are often seen as the very cornerstone of a market economy even if those formal institutions are supplemented with informal ones. Courts have been found to improve the functioning of relational contracts and contribute to expanded trade and investment. Indeed, such institutions appear to be most important at the start of a trading relationship and in economies in transition (Johnson, McMillan, and Woodruff 1999, 2002).

How do actors assess the opportunities for dispute settlement? The China survey reveals that disputes are not uncommon. Twenty-one percent of these relationships had generated disputes but with differences depending on the nature of the business relationship. Fully 41 percent of investors report disputes, an indication of the extent of hold-up risk. Only 4 percent of pure exporters do. Weak dispute settlement appears to push firms back to less risky, “cash and carry” transactions.

When asked how they would resolve a dispute, the pattern of responses across Chinese exporters, importers and investors differed in predictable but interesting ways; we focus here on the differences between exporters and investors. More than one-quarter of exporters indicated that there were no third parties from which they could seek help. To the extent that they did believe there was recourse, it was entirely on the Chinese side of the border: twenty percent indicated that they would seek help from Chinese government officials, 19 percent would look to other Chinese companies or business associations, and 17 percent would use the Chinese court system.<sup>18</sup> Although the number of disputes reported on the part of pure exporters was small (only 5 of 113 pure exporters), their pessimism was warranted; none of the five reported they were satisfied with the process of dispute resolution.

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<sup>18</sup> Multiple responses for dispute resolution modalities were permitted. If the modality figures are calculated as a share of total responses (not number of enterprises), the exporter results are: Chinese government officials (13 percent), other Chinese firms or business association (12 percent), and Chinese courts (11 percent). For importers the results are: private negotiation (23 percent), North Korean local officials (12 percent), and Chinese officials (9 percent). For investors the results were: private negotiation (21 percent), local North Korean officials (18 percent), and Chinese officials (13 percent). In no case did the North Korean court system’s share of responses reach 10 percent.

For the investors, more than one-third would try to settle matters privately (35 percent), 31 percent would appeal to North Korean local officials, and 22 percent to Chinese officials, presumably reflecting the far greater importance of North Korean officials in settling investment disputes that involve the foreign investor's physical presence in North Korea. It is also notable that the share reporting that they would appeal to local officials (31 percent) exceeded that of provincial officials (16 percent) and central government officials (12 percent). This pattern is consistent with the fact that investors may see local officials as more forthcoming.

Whatever the investors thought *ex ante*, their disaffection after the fact is high; 77 percent reporting disputes also report that they were not satisfied with the way their dispute was settled; recall that the share of investors reporting disputes was also much higher than firms involved in export only. When asked about how they would settle disputes in the future, respondents suggest that local and provincial officials may be more willing to protect property rights than their higher ups.<sup>19</sup>

Taken together, these results suggest that “marketization from below” may have at least one political correlate supportive of the transformation model. As local officials seek to attract trade and investment, firms may see local officials as more forthcoming. This is particularly true as the central government remains cautious about loosening controls. However as we noted in Chapters Two and Three, this positive development may be partly offset by central government efforts precisely to recentralize decision-making *vis-à-vis* foreign investors.

In contrast to their Chinese counterparts, the South Korean firms reported relatively few disputes. The survey permitted respondents engaged in multiple types of business to characterize each of their principal business relationships separately, for example, allowing a single firm to report on relations with its main import, export, and investment partner. Overall, 6 percent of investors, 7 percent of exporters, and 11 percent of importers reported disputes with their primary counterparties—far below the rates reported in the China survey.<sup>20</sup>

However, this relatively sanguine picture changes if the respondents are disaggregated by modality and counterparty. Twenty-five percent of exporters and 20 percent of importers doing arm's-length transactions with North Korean counterparties reported disputes, comparable to the figures obtained in the China survey. Disputes were less frequent for firms involved in POC and

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<sup>19</sup> . Investors who experienced disputes showed a greater proclivity to pursue resolution of future disputes through appeals to local officials (32 percent for those experiencing disputes v. 19 percent of those who didn't) and provincial officials (25 percent v. 7 percent).

<sup>20</sup> . For the importers, the most frequently cited reason for a dispute was defective goods (43 percent), followed by declining quality (33 percent), and late shipments (14 percent).

KIC activities, or for those transacting with non-North Korean counterparties.<sup>21</sup> For example, the rates at which disputes were reported for non-North Korean counterparties were 14 percent of arm's-length exporters, and 5 percent for arm's-length importers. In short, disputes are less common for firms that are less exposed to the North Korean economy.

On one point, however, the Chinese and South Korean firms converge: of those Korean firms experiencing disputes, only a minority reported satisfaction with the resolution. Among importers for example, 57 percent reported that they were "not satisfied at all" with the resolution of the dispute, 33 percent were "not satisfied," and only 10 percent were "basically satisfied." Interestingly, while the incidence of disputes was lower for POC and KIC firms than for firms engaged in arm's-length transactions, they reported no higher rate of satisfaction in resolving their disputes.

What recourse did South Korean firms believe they had? Among the subsample of firms that had experienced disputes, nearly all indicated that they would either settle matters privately or had no access to third-party intervention. In the China survey, firms expressed a much greater willingness to use contacts in North Korean local and provincial governments to resolve disputes, and indeed, indicated that disputes were less likely to be resolved successfully as they were escalated from local to provincial to central government connections. By contrast, the only third-party dispute settlement mechanism that received any support in the South Korean sample was appeal to the North Korean central government and that was mentioned by only 7 percent of respondents who had disputes.

This finding has important implications for arguments about engagement as well. South Korean firms are under much closer political scrutiny by the North Korean authorities than their Chinese counterparts, and as a consequence less able than Chinese enterprises to work out disputes at lower political levels. Additionally, most of the South Korean firms, even ones in the KIC, report that they are required to get permission or approval from some level of the North Korean government (generally the central government) to do business in North Korea. At least as political relations between the North and South were structured at the time of the survey, firm-level data shows strong North Korean intent to control the relationship with South Korean entities. Since then, trade and investment relations have collapsed as a result of sanctions and the closure of Kaesong in 2016.

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<sup>21</sup> One possible reason for the lower dispute rates for KIC firms is the frequency of contact with their counterparty. Nearly all the KIC firms indicated that they communicated with their primary counterparty on a daily basis; for a handful of the non-KIC firms communication was as infrequent as once a year.

## *Corruption*

A standard result in economics is that the nature and extent of regulation can create rents and hence opportunities for bribery and corruption. Before turning to our findings on corruption, it is worthwhile considering the regulatory controls on foreign business that give rise to the need to bribe in the first place, filling in detail to our general account in Chapter Two. Most of the Chinese firms report that they are required to get permission or approval from some level of the North Korean government to do business in North Korea, though there are differences across types of firms. All of the Chinese SOEs report having obtained permission before starting a business. Only 9 percent of investors—six firms—report that they have no need of government approval. But 29 percent of the private businesses report that they did not obtain any permission or approval by the North Korean government. Twenty-nine percent of traders and 47 percent of those who are engaged only in exports to North Korea report that they have no need of government approval to operate. Small private businesses engaged largely in trade seek to fly below the radar, but once in they are also more likely to fear predation.

Given the institutional setting, it is not surprising that a majority of the firms in our China survey report a need to bribe to do business (55 percent). These findings are consistent with evidence from refugee surveys, including testimonies of former state and party officials, of high—and possibly rising—levels of corruption in North Korea, (Haggard and Noland 2010b, Kim 2010).

Which firms are most at risk of being preyed on for bribes? Despite the fact that small firms are more likely to enter, and despite the fact that they engage in activities that reduce risk, such as focusing solely on exports and avoiding contact with officials, they are nonetheless more likely to find the regulatory environment a problem. In contrast, large SOEs appear relatively untroubled, which may reflect size or the ability of such firms to draw on their political connections in order to operate. However, investors are significantly more likely to report a need to bribe (73 percent) than traders (54 percent) or those engaged in exporting only (44 percent). Despite the fact that smaller firms have more adverse views of the business environment and are more likely to fear expropriation, larger firms perceive a greater need to bribe (Haggard and Noland, 2012c). Given weak property rights, larger firms and those involved in more complex investment relationships are clearly more vulnerable to the hold-up problems associated with a weak institutional environment.

We also asked about actual bribe costs, and the differences between investors and traders are once again clear. Nineteen percent of the firms report spending more than 10 percent of

revenues on bribes, but more than half of investors (53 percent) report spending more than 10 percent of annual revenues on bribes.

The views of Chinese and South Korean firms diverge strongly on the extent of corruption. A majority of the South Korean respondents strongly disagreed with the claim that bribery was necessary to conduct business, a view that was shared widely across firms engaged in arm's-length transactions, POC trade, and KIC activities; to our surprise, institutional setting did not appear to matter in this regard. Not surprisingly, investors, who are more exposed to regulatory and direct expropriation risk, have slightly less sanguine views on this topic. But even this group regards the phenomenon as much less of an issue than either the Chinese enterprises or the North Korea refugees previously surveyed. This apparent lack of vulnerability could be related to a combination of better language and cultural skills that would allow firms to more effectively avoid disputes in the first place and to fend off predation more adroitly than their Chinese counterparts. However, the pattern of responses could also reflect a reluctance on the part of the respondents to address this sensitive topic truthfully given the sensitivity of the corruption issue in the South.

### **Risk, financial settlement terms, and trust**

A final indicator of the nature of the trade and investment networks at the time of the survey can be found in indicators of inter-firm trust. In previous research on transitional economies in Europe and Asia, the extension of credit and financial settlement terms more broadly provide insight into the credibility of the operating environment, the nature and extent of risk and the evolution of trust (Johnson, McMillan, and Woodruff 1999, 2002; McMillan and Woodruff 1999a, 1999b).

With respect to settlement currencies, none of the respondents in either survey report doing any business in North Korean *won*. While this might reflect simple exchange rate risks, a long history of currency revaluations—culminating in the conversion of November 2009—suggests that the risk is also political. Most Chinese exporters to North Korea use Chinese *yuan* as the settlement currency (55 percent), possibly reflecting the preference of small traders to be paid in local currency, followed by US dollars (34 percent), and barter (8 percent). Imports, by contrast, were settled primarily in US dollars (52 percent), followed by Chinese *yuan* (29 percent), and barter (15 percent).<sup>22</sup> Similarly, most South Korean respondents indicate that most

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<sup>22</sup> The more frequent use of US dollars in the import trade may reflect the preferences of sellers who want to get paid in home or conveniently usable currencies; it could also reflect the

transactions were done in US dollars, with barter and the euro distant second and third respectively.

More important than the settlement currency per se is that settlement terms are typically very tight, reflecting lack of trust and credit. As one would expect, there is a positive relationship between the length of the relationship between firms and their clients and settlement terms. Nonetheless, in the China survey, less than 5 percent of the traders report extending credit to their suppliers. Of these, 60 percent were SOEs—an enormously disproportionate presence relative to their occurrence in the sample (5 percent). Outside of these inter-SOE interactions and some relationships of longer standing, economic transactions are cash-and-carry. Most trade is settled at time of delivery; the next most frequently occurring moment of payment is at time of order placement. Less than 10 percent of import and 5 percent of export transactions occur more than 30 days after delivery. Particularly given dissatisfaction with dispute settlement and the broader institutional environment, it is not difficult to understand why credit is limited.

The South Korea survey also reveals an almost complete absence of lending between counterparties: Only a single South Korean importer out of 136 reported extending loans to its North Korean counterparty.<sup>23</sup> However, relaxed settlement terms can be interpreted as an indirect form of financial support. While the overall numbers suggest that counterparties are permitted lax payment terms, it is clear that North Korean counterparties—as distinct from South Korean or third-country counterparties—are discriminated against in this regard (tables 5.4 and 5.5). Moreover, the provision of loose settlement terms is greatest with KIC, next for POC firms, and the least for arm's-length transactions. In this regard, institutional setting clearly matters. Two-thirds of pure exporters demand payment from their North Korean customers when the order is placed or at time of delivery. By contrast, none of the South Korean firms reporting imports via KIC paid less than 30 days after delivery.

Elsewhere (Haggard and Noland 2012b) we report multivariate analyses of the determinants of trust as proxied by the financial terms on which exchange occurs. There is evidence that firm characteristics and the nature of inter-firm relationships are related to trust. In the China survey, the most highly correlated variable with trade credit is the respondent's status as a Chinese SOE. This is a striking result insofar as the primary counterparty of every Chinese

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distinctive preferences of North Korean SOEs (more highly represented among Chinese importers' counterparties) and/or the North Korean government which may desire to earn convertible currency that does not have to be spent in China.

<sup>23</sup> These results parallel those obtained in the China survey where less than 5 percent of the firms reported extending credit to their partners, with most of these cases (60 percent) involving Chinese SOEs extending loans to their North Korean SOE counterparties.

SOE in the sample save one is a North Korean SOE. In essence, trust as measured by both extension of credit and by settlement terms is most robust in inter-SOE interactions: Chinese SOEs extend credit to their North Korean counterparts or allow them to run up arrears. Trust—at least as measured by the extension of credit—does not emerge in the market but is most in evidence in economic relations that are embedded in the higher-order political relationship between the two countries.

The South Korean survey provides another perspective on these issues given the variety of institutional settings and the much higher incidence of non-North Korean counterparties. Clearly, North Korean counterparties are considered risky (or simply have little negotiating leverage): South Korean exporters received statistically significantly more relaxed payment terms than did North Korean exporters, and transactions that involved a North Korean counterparty (some transactions involved South Korean or third country counterparties operating in North Korea) are associated with more demanding terms than those that did not (Haggard and Noland 2012a).

We are particularly interested in the effects of institutions and the public policies of the South Korean government. Activity in KIC was associated with looser settlement terms than the other two modalities, even controlling for the absence of North Korean counterparties in the KIC relative to the other two modalities. Transactions with firms that had access to South Korean government support were also looser, although the precise causality is not clear.<sup>24</sup> Correlation between payment terms and South Korean public policy and the lack of correlation with indicators of the institutional environment such as introduction networks, duration of relationship, and bribery suggests strongly that the South Korean government has socialized risk.

## **Conclusion**

This chapter has used two firm-level surveys, one conducted in China, the other in South Korea, to explore whether the nature of observed cross-border exchange supports the transformative case for engagement. The evidence is mixed at best. Much of the North Korea-China economic relationship rests on a self-interested commercial logic. The Chinese firms

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<sup>24</sup> It could be that having access to state support makes firms more relaxed about payment terms, or it could be that counterparties, recognizing the state backing, are more relaxed about eventual payment. Intriguingly, transactions involving firms that had access to South Korean dispute resolution were associated with relatively stricter terms. It is worth noting what was not robustly correlated with payment terms: firm size, CEO ability to speak Chinese, introduction networks, duration of the relationship, views on bribery and perceptions of the business environment.

engaging in cross-border trade are largely private, do not appear to have substantial support from the Chinese government, and have a limited belief in the ability of their government to protect them in the face of disputes.

But at the time of the survey, the counterparties of both the China- and South Korea-based firms surveyed were largely the core institutions of the North Korean state, either directly as revealed by the China survey, or indirectly at KIC, the centerpiece of North-South engagement. This is particularly true for enterprises that have established an investment presence: either they are in joint ventures with government, party, or military entities or SOEs, or they are in KIC, a zone ultimately subject to North Korean sovereignty as Pyongyang showed when it closed the KIC in 2013. Chinese traders do interact with a wider array of North Korean counterparties, including private firms, and such wholesale trade no doubt feeds the retail “marketization from below,” supporting the engagement-as-transformation approach. But most transactions that generate foreign exchange for the regime—namely, North Korean exporters and joint ventures with Chinese firms—are dominated by state entities. At least as measured by ownership of North Korean counterparts, the cross-border trade remains largely in state hands.

Despite the fact that Chinese and South Korean firms report the ability to make a profit, they offer a uniformly negative appraisal of the North Korean operating environment, including with respect to economic regulation. In response these firms have adopted various market and political strategies to reduce risk. In the case of the private Chinese enterprises, such hedging strategies include limiting their activity to trading and to exporting in particular. Such strategies are particularly prevalent among small and small private enterprises and firms that do not believe that they can call upon political connections in North Korea. Transactions are undertaken in ways that limit risk but also trust, including not only settlement in hard currencies but very stringent payment terms and limited credit, in effect “cash-and-carry” business. All of these strategies limit cross-border integration from what it might be.

The large natural resource investments have different strategies for protecting themselves. But our findings raise the issue of whether North Korea’s export specialization in natural resources exports—also noted in Chapter Three—is less a manifestation of underlying comparative advantage than a signal of institutional weakness impeding the emergence of more complex forms of production. In these sectors, control by the state and the rentier nature of investments is particularly marked, and with potentially adverse rather than beneficial effects for policy as a large literature has shown (Ross 2013, Hendrix and Noland 2015).

In the absence of formal institutions, Chinese firms devise political strategies for reducing the risks of predation. There is some evidence that they seek to protect themselves via

informal networks capable of imposing reputational penalties on North Korean actors. But they mainly rely on personal connections in North Korea including through pervasive corruption and bribery of public officials. Obviously, these strategies are decidedly second-best; there are clearly gains to be had from stronger institutions in North Korea. This is particularly the case when we consider the fact that predation is correlated with size, which could add a self-limiting aspect to the expansion of cross-border integration. Firms appear to limit the scale of involvement in order to fly beneath the radar of a predatory state.

In sum, despite the rapid growth of trade and investment with China, the weakness of the institutional environment deters North Korean integration with the world economy, deters more complex investments relative to trade and natural resource ventures, probably limits the extent of purely private exchange and inhibits the development of informal networks and relational contracting. The surveys certainly demonstrate that some process of marketization was occurring. But they cast doubt on the expectation that engagement between China and North Korea, at least during the period covered here, would foster the internal changes in North Korea that would lead either to further economic reform or a moderation of the country's external behavior. To the contrary, the country appeared caught in a partial-reform equilibrium.

Since these surveys were conducted, there have been changes in North Korea's foreign economic relations, but they do not necessarily overturn our findings. After the currency reform, North Korea initially moved to further strengthen the state role, centralizing the investment approval process, and channeling cross-border economic integration through entities under even more direct central political control. In 2010, North Korea established a State Development Bank. Late the following year, the government announced a decision to initiate a "10-Year State Strategy Plan for Economic Development" and designated a supra-cabinet body to oversee foreign direct investment under the 10-year plan. The Taepung Group was established at the same time as a holding company for joint ventures and other initiatives outside the central plan. The group was headed by a Chinese-Korean businessman with ties to the North Korean military and had a board consisting of regime heavyweights. However, the creation of this group generated uncertainty about the investment approval process, since the mandate of the Taepung Group appeared to conflict with the authority of the Joint Venture and Investment Commission (JVIC), something akin to a conventional investment promotion agency operating under the cabinet. The two organizations were merged in February 2012 (IFES 2012), apparently in part at Chinese instigation to deal with the problem of cascading corruption. But as we noted in Chapter Two, this move did not appear to have substantial effect on investment given the foreign policy constraints the regime created for itself following the breakdown of the Six Party Talks in 2008

Additional uncertainties were created for Chinese firms with the December 2013 purge and execution of regime heavyweight Jang Sung-taek, who played a central role in investment institutions and had served as the chief interlocutor in North Korea's economic relations with China. Given the absence of well-functioning institutions and the reliance on political connections to resolve disputes that we have documented, Jang's ouster was surely disruptive to economic relations in the short-run, particularly with respect to investment (Li 2016).

At the time of this writing, there was growing evidence on both the Chinese and North Korean sides of the border of an interest in the "enclave" solution to the problems we have identified here. After languishing for years, the Chinese surfaced the dirt road linking Hunchun with Rason, the Russians refurbished the rail link and promised further investment in Russian-linked infrastructure. Transmission lines now bring electricity in from China (Abrahamian 2012). North Korea will make pure rents off the port, particularly in the transit trade with Russia. But North Korean law now gives extraordinary power and discretion to the Rason City People's Committee relative to the previous rules. Such localization of decision-making may encourage greater pragmatism.

A test of the possibility that North Korea's SEZ strategy will spread can be found in the China-focused initiatives center on the Hwanggumpyong and Wihwa Island zone, however, and it has proven unsuccessful to date. China initially rejected North Korean statute on the zones, complaining about problems relating to taxation, accounting, the security of investment, management autonomy, and the remittance of profits. These complaints were lodged despite the fact that the terms under discussion for Chinese activities in the zones--the right to use Chinese currency and cell phones; the establishment of independent banks; internet access; and the right to lend and sub-lease leased land--compared favorably to both the KIC and Rason. The Hwanggumpyong and Wihwa Island regulations were far more detailed, more clearly delineating the responsibility of the zone's management committee, the provincial People's Committee, and the central government, as well as affording foreign investors greater investor rights. Yet as of this writing in mid-2016 the two island zones remained stalled and none of the new zones announced in 2014 had attracted outside investment. Kaesong itself was finally closed in the wake of the fourth nuclear test, a test which demonstrated clearly the priority the regime gave to its nuclear program over policies of reform and opening. In any case, the expansion of such enclaves appeared to be driven by the opportunity to increase foreign exchange earnings channeled directly into government coffers.

In the Conclusion we consider the possibility of a more fundamental reform of North Korea's foreign economic policy and what its implications may be for strategies of engagement.

But for the period covered by this study, pursuit of enclave strategies by both of North Korea's major trade partners can be regarded not as a signal of success of the engagement approach but rather an admission of failure: a sign of the fundamentally control-oriented approach of the North Korean regime toward trade and investment.

## Appendix Two

This appendix describes the two firm-level surveys reported in Chapter Five.

### *The China Survey*

A pilot survey was conducted in September 2007 using a survey instrument designed by the authors with the actual interviews conducted by the Horizon Research Consultancy Group. Horizon was responsible for securing any local permits and ensuring that the survey was conducted according to the European Society for Opinion and Market Research (ESOMAR) rules (<http://actrav.itcilo.org/actrav-english/telearn/global/ilo/guide/iccmar.htm>). The final survey was conducted during October and November 2007. The predominant means of conducting the survey was through face-to-face interviews, though some interviews were conducted by telephone. The success rate in conducting the interviews was around 7 percent. Among the reasons that interviews could not be conducted were refusal by the enterprise to participate prior to or during the interview, inability to establish contact with the enterprise, and the unavailability of the person within the enterprise eligible to respond according to the survey instrument (chairman, manager, etc.). The data—and particularly firm addresses—were subject to post-survey verification by random spot-checking.

Given that there are no known or available registries of all Chinese firms doing business with North Korea, the sample of firms doing business with North Korea was of necessity a sample of convenience. The sample was developed using North Korean, Chinese, and Western press accounts, authors' interviews in Northeast China in the summer of 2007 as well as information gathered by the Horizon Group in the process of the pilot and interviews with other

firms. The sample was drawn from enterprises operating in two border provinces—Jilin and Liaoning—due to the practical impossibility of implementing the survey on a nationwide basis, particularly with respect to the control group of firms not doing business in North Korea.

The design involved a survey of 300 firms, with 250 doing business in North Korea and 50 not doing business in North Korea; in the end, we had 53 responses from firms not doing business in North Korea. We defined firms doing business with North Korea to include those that were involved in trading (import, export, or both), investment, or that maintained representative offices in North Korea. Those not doing business included 10 firms that had done business and had quit (“the quitters”) and 43 that had never done business with North Korea (“the never-weres”).

The survey began with a pilot of 30 firms from Jilin and Liaoning provinces (20 firms doing business in North Korea and 10 firms not doing business in North Korea). Although it was understood this was a sample of convenience, enterprises reflecting a broad distribution of size, sector, and provincial location were targeted. Following the successful completion of the pilot—which did not require fundamental modification of the survey—we were able to transit directly to the full survey and all of the pilot firms were included in the final 300 firms. Once the sample of 250 enterprises operating in North Korea was completed, the control group was selected by randomly sampling business registries for Jilin and Liaoning provinces.

### *The South Korea Survey*

A pilot survey was conducted in November 2009 using a survey instrument designed by the authors with the actual interviews conducted by the Millward Brown Media Research.

Millward Brown was responsible for securing any local permits and ensuring that the survey was conducted according to the [European Society for Opinion and Marketing Research](http://actrav.itcilo.org/actrav-english/telearn/global/ilo/guide/iccmr.htm) (ESOMAR) rules (<http://actrav.itcilo.org/actrav-english/telearn/global/ilo/guide/iccmr.htm>).

The final survey was conducted during November 2009 and March 2010. The predominant means

of conducting the survey was through telephone interviews, though some interviews were conducted face to face. Among the reasons that interviews could not be conducted were refusal by the enterprise to participate prior to or during the interview, inability to establish contact with the enterprise, and the unavailability of the person within the enterprise eligible to respond according to the survey instrument (chairman, manager, etc.). The data—and particularly firm addresses—were subject to post-survey verification by random spot-checking.

Given that there are no known or available registries of all firms doing business with North Korea, the sample of firms doing business with North Korea was of necessity a sample of convenience. The sample was developed using North Korean, South Korean, and Western press accounts, as well as information gathered by Millward Brown in the process of the pilot and interviews with other firms. The sample was drawn from enterprises operating throughout South Korea including the control group of firms not doing business in North Korea.

The design involved a survey of 250 firms, with 200 doing business in North Korea and 50 not doing business in North Korea; in the end, we had 50 responses from firms not doing business in North Korea and 199 firms doing business in North Korea. We defined firms doing business with North Korea to include those that were involved in trading (import, export, or both), investment, processing on commission activities, or that maintained representative offices in North Korea, as well as the 18 firms that had done business and had quit. The control group consisted of 50 firms that had never done business with North Korea.

The survey began with a pilot of 50 firms from throughout South Korea. Although it was understood this was a sample of convenience, enterprises reflecting a broad distribution of size, sector, and provincial location were targeted. Following the successful completion of the pilot—which did not require fundamental modification of the survey—we were able to transit directly to the full survey and all of the pilot firms were included in the final 249 firms. Once the sample of 199 enterprises operating in North Korea was completed, our aim was to select 50 firms without business relationships with North Korea but with similar qualities with the firms in our treatment

group, the firms engaged in business with North Korea (198 firms excluding 1 foreign-owned firm). Not all quality variables were available for comparison—we first teased out the firms engaged in manufacturing sector since the majority of our treatment group was in the manufacturing sector. The variables of the two groups were then adjusted so that their categorizations would be comparable with each other. The variables (regions, firm ownership, and firm size) were dummified and we applied the CEM (Coarsened Exact Matching) method in STATA to identify 199 matching firms. We provided a list of 199 firms as lower response rates were expected, and of those, 50 firms were ultimately selected for our control group.

[INSERT TABLE 5.1]

[INSERT TABLE 5.2]

[INSERT TABLE 5.3]

[INSERT TABLE 5.4]

[INSERT TABLE 5.5]



## Chapter Six

### **Negotiating on Nuclear Weapons I: The Rise and Fall of the Six Party Talks (2001-2008)**

As we argued in the Introduction, the effectiveness of sanctions and inducements in securing policy changes are conditional both on features of the target and the wider strategic setting. North Korea's status as a "hard target" is relatively constant, but we can nonetheless trace the ways in which the authoritarian and statist nature of the country's political economy affected responses to both sanctions and inducements.

We place particular attention here, however, on problems of coordination and bargaining. In Chapter Three we outlined the broad contours of North Korea's foreign economic relations, noting how the country's trade and investment relations shifted with the imposition of sanctions and the gradual reopening to China after 2000. In this chapter and the next, we move from these broad economic parameters to how sanctions and economic inducements were used during the negotiations over North Korea's weapons programs, both within the Six Party Talks and outside of them after the talks collapsed in 2008.

We break the analysis into two distinct phases. The two administrations of George W. Bush correspond to the rise and fall of the Six Party Talks process, initiated in 2003 following the onset of the second nuclear crisis and ultimately breaking down in the last year of the second Bush term in 2008; we address that history in this chapter. In the second period (2009-2014), formal negotiations were in abeyance but the six parties nonetheless engaged in an intricate set of strategic interactions in which sanctions and inducements continued to play a significant role. By coincidence, this period largely corresponds with the two administrations of Barack Obama; we review this period in Chapter Seven.<sup>1</sup> During this second period, multilateral sanctions deepened in the wake of further missile tests and three additional nuclear tests in May 2009, February 2013, and January 2016 but with little effect on reopening negotiations.

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<sup>1</sup> We now have numerous accounts of the progress and lack of progress in the Six Party talks. But several accounts stand out for the thoroughness of their reporting including Sigal 2005, Funabashi 2007, Pritchard 2007, Mazarr 2007, Chinoy 2008, Bechtol 2010 and Pollack 2011.

Our approach takes a narrative format in which bargaining episodes involving sanctions and inducements are analyzed for their effects. The approach follows the work of Nincic (2005) and an extensive body of analysis on North Korea by Sigal (1998, 2002, 2005, 2009, 2010, 2016) as well as the wider literature on sanctions reviewed in Chapter One. Choosing which moves in the game to treat as the starting point is no easy task: what some view as a North Korean “provocation” others might view as a rational response to a prior US move. However, given the centrality of the US-North Korea relationship to the course of the negotiations, we focus particularly attention on US strategy, considering how its efficacy is influenced by the responses of North Korea as well as the behavior of other parties in the talks.

The broad outlines of the negotiations are provided in schematic form in Tables 6.1 and 7.1 in the next chapter. We find little evidence that sanctions “worked” in the immediately instrumental sense of advancing the course of negotiations; to the contrary, they tended to generate escalatory responses from North Korea. So-called “smart” or targeted sanctions (Cortright and Lopez 2002) did not fare much better. Sanctions on weapons sales and particularly financial sanctions no doubt had effects on both commercial trade and foreign accounts under the leadership’s control and may have had both signaling and purely defensive value. However, these material effects did not translate into the desired *political* response. To the extent that financial sanctions worked, they did so only when coupled with a willingness to negotiate and offer inducements that went beyond the promise of terminating them.

[INSERT TABLE 6.1 HERE]

Beyond the underlying political issues raised in Chapter Two about the nature of the regime, two further bargaining issues outlined in Chapter One help account for these suboptimal outcomes: coordination problems and problems of credibility and sequencing. The U.S. strategy of putting pressure on North Korea was strongly affected by the behavior of China and South Korea, not only in the talks but in their broader bilateral relations with North Korea. The South Korean governments of Kim Dae Jung (1997-2002) and particularly Roh Moo Hyun (2003-2008) had little interest in pursuing a comprehensive sanctions strategy; neither did China throughout the entire period. To the contrary, their diplomacy tended to limit the scope of possible sanctions, including the multilateral ones put in place after 2006, or to undermine them indirectly through the maintenance of commercial economic ties and the provision of foreign aid.

The United States thus entered the Six Party Talks with surprisingly little economic leverage. Its long-standing and wide-ranging sanctions regime had already reduced trade with North Korea to a trickle; oil shipments under the Agreed Framework and humanitarian aid were the only leverage directly under US control and for reasons outlined in Chapter Four it was initially reluctant to exploit the latter. Until it stumbled on new financial instruments in 2005, the US could only put pressure on North Korea by getting other parties to act, by threatening military options that were ultimately not credible or by turning back to a diplomacy of inducements and quid-pro-quo.

However, an equally if not more important finding is that such inducements did not appear to work any better; it is a faulty inference to jump from the mixed record with respect to sanctions to the presumption that engagement fared any better. First, the extension of inducements faced a panoply of credibility and sequencing problems as well, both in negotiation and in implementation. Would inducements be extended in advance of, simultaneously with, or only after North Korea had fulfilled stipulated obligations? Given the mutual belief that important commitments had not been met in the past,<sup>2</sup> both sides sought to “front load” the benefits of interest to them. As the North Koreans insisted

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<sup>2</sup> Following the onset of the crisis, the US clearly had reason to doubt North Korean commitments under the Agreed Framework. But the Agreed Framework also called for a process of normalization of relations with the United States that made limited progress during the Clinton administration.

throughout the negotiations, denuclearization should proceed on the basis of “words for words (or “commitments for commitments”), actions for actions.” North Korea had a revealed preference for immediate transfers such as the delivery of fuel oil, electricity, food or even cash, as occurred in the context of the 2000 North-South summit and again during 2007-8. South Korean food and fertilizer aid under Roh Moo Hyun also provided clear, tangible and fungible benefits.

Promises of future payoffs were less appealing, in part because of credibility problems, in part because of their ambiguous economic benefits to an authoritarian regime sitting atop a fraying state socialist economy. North Korean statements were consistent in arguing that the lifting of sanctions was a crucial signal of US intent. However, the material effect of lifting sanctions depended both on complementary economic policies in North Korea and on the reaction of private actors, who might still be deterred from trade and investment as a result of the general uncertainty surrounding North Korea’s economic policy.<sup>3</sup> From the perspective of North Korea, resources in the hand—the sorts of direct transfers visible under both the Agreed Framework and the 2007-8 “road map” agreements--were preferable to promised benefits that might only materialize if North Korea’s own policies underwent quite fundamental change.

For its part, we find ample evidence in the empirical record that the United States was concerned about the moral hazard problems of extending aid and being played for the sucker. The North Korean regime frequently sought inducements simply to talk, in exchange for declaratory statements of intent, or to take actions that were easily reversible, most notably a “freeze” of existing activities. North Korea also sought discrete payments for highly disaggregated actions—the “salami” tactic--with the effect that important stages in the denuclearization process were effectively put off into the distant future. On some issues, including a full and accurate declaration of its nuclear activities and submission to a robust verification regime, the North Korean regime seemed disinclined to make concessions altogether. In the interim, North Korea retained and even expanded its nuclear capabilities. As a result of these difficulties, critics of the negotiations argued repeatedly that the US and the other parties to the talks should extract meaningful concessions in advance of—or more

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<sup>3</sup>. Similarly, admission into the international financial institutions (IFI’s) does not necessarily ensure lending because of the conditional nature of IFI programs. The problem with these inducements is even more pronounced if we believe that important actors in North Korea are simply seeking delay or are indifferent or even hostile to increased trade, investment or involvement with the IFIs in the first place.

tightly coupled with—any inducements. The talks ultimately broke down precisely over the failure to extract just such a concession with respect to verification.

#### **Stalemate: 2001-2004**

The deep divisions that existed within the first Bush administration with respect to North Korea policy have now been thoroughly documented (Mazarr 2007, Pritchard 2007, Chinoy 2008; Cha 2012). On the one hand, there was a willingness—albeit grudging—to abide by formal commitments made by the Clinton administration. Inducements under the Agreed Framework—fuel oil shipments to North Korea and efforts through KEDO to complete the long-delayed construction of the promised light-water reactors—remained intact despite efforts from within the administration to kill them (Bolton 2007, 99-129; Chinoy 2008, 75-77; see also Cheney 2011, 473-475). The US also initially maintained its commitment to provide humanitarian assistance and Secretary of State Colin Powell signaled his support for a continuation of the talks initiated by the Clinton administration.<sup>4</sup>

However, hawks within the administration bitterly opposed the Agreed Framework or any negotiations with Pyongyang at all, let alone additional inducements. The president himself expressed doubts about the utility of engagement. This occurred most notably in his repudiation of Powell's stated intention to pursue the Clinton negotiations on missiles, in the open clash with President Kim Dae-jung over the utility of the sunshine approach during his state visit in March 2001 and in the infamous "Axis of Evil" comment in the 2002 State of the Union address. The difference in approach between the Clinton and Bush administrations is clearly visible in a speech by Colin Powell before the Asia Society in June 2002.<sup>5</sup> Although nominally endorsing the sunshine approach, the speech made progress in bilateral relations conditional on a number of prior actions by the North Koreans: on humanitarian issues; conventional force deployments; missiles; and the country's obligations under both the Agreed Framework and the NPT, including IAEA inspections.

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<sup>4</sup> On the eve of Kim Dae-jung's visit to Washington, Powell told reporters that the Bush administration would build on the Clinton momentum on North Korea. The White House publicly rebuked Powell, who later admitted that he had leaned "too forward in my skis." The first statement of a willingness to engage, however vague and hedged, came following the completion of the policy review. See "Statement of the President," June 13, 2001 at <http://georgewbush-whitehouse.archives.gov/news/releases/2001/06/20010611-4.html>

<sup>5</sup> Remarks at Asia Society Annual Dinner, June 10, 2002 at <http://asiasociety.org/policy-politics/colin-powell-remarks-asia-society-annual-dinner-2002>.

The approach to humanitarian aid also underwent a gradual transformation under the Bush administration (Haggard and Noland 2007, Ch. 5). Effectively linked to a broader engagement approach under President Clinton—what we have called “food for talks”—the Bush administration showed an increasing tendency to see aid in more narrow terms, emphasizing the risks of moral hazard and seeking more effective monitoring and even progress with respect to human rights.<sup>6</sup> Although nominally delinked from the breaking nuclear crisis, aid fell in both 2003 and 2004. In the fall of 2004—as the WFP and North Korean authorities were entering a standoff over monitoring—the US Congress passed and President Bush signed the North Korean Human Rights Act. The bill required that non-humanitarian assistance be contingent on North Korea making “substantial progress” on a number of specific human rights issues and required the United States Agency for International Development (USAID) to issue a report to Congress that included any changes in the transparency, monitoring, and access of food aid and other humanitarian activities. Any “significant increases” in humanitarian assistance would be conditioned on “substantial improvements” in transparency, monitoring, and access.

Internal discussions in the US did consider possible inducements: replacing the light-water nuclear reactors promised under the Agreed Framework with thermal and hydropower plants, aid for infrastructure, construction of schools and hospitals and support for admitting North Korea into the World Bank and Asian Development Bank (Sigal 2005). But these were publicly outlined only in prospective terms; in Powell’s words in the speech cited above, “the United States is prepared to take important steps to help North Korea move its relations with the US toward normalcy.” But such actions would come only *after* satisfactory steps were taken on the US agenda.

In addition to the shift in strategy with respect to North Korea policy itself, the attacks of 9/11 resulted in a much more aggressive posture toward proliferators more generally, including the assertion of a right of pre-emption.<sup>7</sup> Victor Cha (2012, 310-317) has outlined in some detail public statements on the part of the administration—including the president himself—to assure North Korea that it did not harbor hostile intent. But when coupled with the Bush administration’s initial unwillingness to reiterate the Clinton

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<sup>6</sup> . In the words of Manyin and Jun (2003:17) the administration “gave conflicting signals about whether it would continue donating food aid to North Korea, and if so, how much and whether aid should be conditioned on North Korean actions in the humanitarian and/or security areas.”

<sup>7</sup> Most notable in this regard was the Nuclear Posture Review submitted to Congress in December 2001—to which the North Koreans responded strongly--and the National Strategy to Combat Weapons of Mass Destruction, issued in December 2002.

administration's statement of peaceful intent and public speeches by members of the administration outlining North Korean derogations on its obligations under the Agreed Framework,<sup>8</sup> it was plausible for Pyongyang—and the North Korean military--to draw the conclusion that North Korea required a strengthened deterrent. The invasion of Iraq, which occurred precisely as the crisis was breaking, no doubt only deepened these concerns.

Did the Bush administration's hardened stance—the drift away from inducements and the imposition of more constraints, including economic ones--have effect? The short answer is “no.” The North Koreans responded negatively to the Bush initiatives. Pyongyang sought to focus any discussion around full implementation of the Agreed Framework, including the completion of the LWRs and compensation for lost electricity. Nonetheless, they also signaled a willingness to negotiate a broader agreement.<sup>9</sup> These overtures were ignored.

*From the Onset of the Crisis to the Six Party Talks: October 2002-August 2003*

It was not until the ASEAN Regional Forum meeting in July 2002—a year and half into office--that Secretary Powell communicated US willingness to send an envoy to Pyongyang. At that point, however, any interest in broader negotiations was derailed by intelligence regarding North Korea's clandestine HEU program. Although there is still debate about how far along the program was, the fact that at least some centrifuges as well as designs had been transferred from the Pakistanis now seems beyond dispute.<sup>10</sup> Such transfers would have constituted a clear breach of a number of North Korea's international

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<sup>8</sup> Particularly John Bolton, then Undersecretary of State for Arms Control and International Security, “Beyond the Axis of Evil: Additional Threats from Weapons of Mass Destruction,” The Heritage Foundation, May 6, 2001, at <http://www.heritage.org/Research/Lecture/Beyond-the-Axis-of-Evil> and “North Korea: A Shared Challenge to the U.S. and ROK,” Korean-American Association, Seoul, August 29, 2002.

<sup>9</sup> “Spokesman of DPRK Foreign Ministry on Bush's statement on resuming negotiations with DPRK,” June 21, 2001 and “KCNA on U.S.-proposed resumption of DPRK-U.S. negotiations,” June 28, 2001 at <http://www.kcna.co.jp/index-e.htm>

<sup>10</sup> Moreover, such transfers took place well before the Bush administration came to office. On the debate over the extent of the program, see Hersh 2003; the exchange between Harrison and Reiss and Galucci (2005); Zhang 2009. In Pervez Musharraf's memoir (2006, 296), he states that a 1996 deal included “nearly two dozen P-1 and P-2 centrifuges,” specialized equipment such as a flow meter and oils, and training at Pakistani facilities. Other intelligence in the public domain includes purchases of equipment, including aluminum tubes, that could have been used in an HEU program as well as traces of HEU on documents subsequently submitted to the US in 2008 (Zhang 2009).

commitments, including to the Nonproliferation Treaty (NPT), the 1992 Joint [North-South] Declaration on the Denuclearization of the Korean Peninsula, and the Agreed Framework.

To this day, what happened during the Kelly visit remains the subject of dispute even to those who were present.<sup>11</sup> But the key issue for our purposes is not how far along the North Korean program was, but what mix of sanctions, engagement and inducements the US would pursue to blunt it. The Bush administration opted for a punishment strategy. It exerted strong pressure on both Japan and Korea to concur with a KEDO resolution condemning the HEU program as a violation of the Agreed Framework, cutting off fuel oil shipments and ultimately rescinding its commitment to the Agreed Framework altogether (Pollack 2003).

The North Korean response combined a stated willingness to negotiate with escalation. In October, North Korea had proposed the negotiation of an agreement that would resolve all outstanding nuclear issues in return for three concessions: respect for North Korean sovereignty; a binding US commitment to nonaggression; and that the United States not “hamper” the country’s economic development, presumably a reference to the lifting of sanctions and perhaps economic assistance.<sup>12</sup> This proposal was revived by the North Koreans following the cutoff of oil shipments in November.

When the US failed to respond, Pyongyang escalated in a series of steps. In December 2002, Pyongyang asked the International Atomic Energy Agency (IAEA) to unseal the Yongbyon facilities, and when the agency asked the government to reconsider, the inspectors were ejected. An IAEA board statement condemning the move was followed by North Korea’s formal renunciation of its obligations under the NPT on January 10, 2003. Shortly thereafter, the regime resumed reprocessing spent nuclear fuel rods and took steps to generate new fissile material by refueling and restarting the reactor. At several points during the spring, North Korea either stated or hinted that they already had a nuclear capability or saw it as their right to develop one (for example, Pritchard 2007, 65).

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<sup>11</sup> Did the North Koreans admit to having an HEU program, only claim the right to have one, or did they deny it altogether? And even if they did deny it, was an opportunity missed because of tight instructions that prohibited the US from signaling a willingness to negotiate? Jannuzi (2003) reports a North Korean version of the Kelly visit, and Pyongyang’s expectation of an offer to negotiate. See also Doug Struck, “North Korean Program Not Negotiable, U.S. Told N. Korea,” *Washington Post*, October 20, 2002, p. A-18 and Pritchard 2007, 34-40.

<sup>12</sup> Interestingly, this proposal made explicit reference to the economic reforms of 2002 as a sign of the regime’s good intent. See the Foreign Ministry statement at “Conclusion of non-aggression treaty between DPRK and U.S. called for,” KCNA, October 25, 2002 at <http://www.kcna.co.jp/index-e.htm>.

The US subsequently undertook other actions designed to pressure the North Koreans to reconsider, including the mobilization of military assets in the region. Two sets of economic measures are particularly relevant for our purposes. The first was the strengthening of inter-agency efforts to deter and stop North Korean engagement in illicit activities, including counterfeiting, drug trade and the financial transactions and money-laundering associated with the country's weapons trade.<sup>13</sup> These efforts involved substantial financial forensics and ultimately rested on the ability of the Treasury to cut off foreign banks from correspondent banking relations in the US, a set of tools that were brought into full play against North Korea in 2005 with the designation of Banco Delta Asia.<sup>14</sup> Although not initially linked to the nuclear issue, the progenitors of these programs were well aware of their potential uses in the nuclear negotiations (Zarate 2013, 229, 232).

The second set of measures was the initiation of the Proliferation Security Initiative (PSI) in May 2003, a multilateral effort to cooperate around the interdiction of trade in WMD-related materials (Winner 2005; Wolf, Chow, and Jones 2008; Valencia 2010). Although the PSI did not specifically target North Korea, the December 2002 interdiction of a North Korean vessel transporting scud missile parts to the Middle East provided an example of the type of activity the administration wanted to stem.<sup>15</sup> Although multilateral cooperation on interdiction was targeted at what was deemed illicit trade,<sup>16</sup> these measures were no doubt seen as sanctions on legitimate activity by the North Koreans and had little effect on the nuclear negotiations.

Effectively stymied, the administration undertook a third policy review in which divergent strategies from engagement through regime change were tabled (Funabashi 2007, 138-9; Chinoy 2008, 145-147). The chosen middle-ground approach--"tailored containment"--explicitly eschewed any direct negotiation with North Korea while seeking to orchestrate economic and political pressure against the regime. Thanks to papers released

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<sup>13</sup> This set of measures came to be called the Illicit Activities Initiative. See Asher 2007 and particularly Zarate 2013, 219-237 for an overview of the program.

<sup>14</sup> The core authority for undertaking these actions was Section 311 of the USA Patriot Act. See "Fact Sheet: Overview of Section 311 of the USA Patriot Act" at <http://www.treasury.gov/press-center/press-releases/Pages/tg1056.aspx>

<sup>15</sup> The *So San* had been tracked by the United States and when off the coast of Yemen, the US sought cooperation from Spain in boarding the ship and inspecting it. Scud missile parts were found hidden under cement, but the ship was released when Yemen—a U.S. ally in the war on terror—acknowledged it was the purchaser.

<sup>16</sup> . An early case of success was the Australian interdiction of the *Pong Su*, carrying an estimated \$50 million of heroin. Michael Richardson, "Crimes Under Flags of Convenience," Yale Global May 19, 2003 at <http://yaleglobal.yale.edu/content/crimes-under-flags-convenience>.

by former Secretary of Defense Donald Rumsfeld, we have insight into the logic of the “tailored containment” approach.<sup>17</sup> In a memo dated December 26, 2002,<sup>18</sup> Rumsfeld argued that “getting to the table is what Pyongyang seeks; for us to grant it in response to the latest nuclear provocations would only reinforce Pyongyang’s weak hand and prove that bad behavior pays.” Rumsfeld argued for new multilateral and bilateral sanctions and “pressing China and Russia to ratchet up diplomatic pressure and constrict economic aid and development projects.” The ultimate objective of these sanctions was to “train Kim Jong Il to understand that blackmail tactics that worked with the previous administration will no longer work.” However, as we will see—in a classic example of the coordination problem—Beijing and Moscow did not share Rumsfeld’s priors about how to deal with North Korea, dooming such efforts to failure.

In sum, the Bush administration’s punishment strategy did not have the intended effect; following the termination of heavy fuel oil shipments, North Korea escalated in ways that did not leave the US easy and effective responses. Given the trade patterns we described in Chapter Three, the sanctions strategy could only work by coordinating a multilateral approach. The Six Party Talks, which had their origin in a trilateral meeting hosted by Beijing in April 2003, appeared to serve American interests by providing a venue through which the five parties could coordinate pressure on the North. However, the new South Korean government of Roh Moo-hyun had doubts about the utility of pressure and was wedded to a wide-ranging engagement approach. Despite recurrent frustrations, China shared these views with respect to strategy (International Crisis Group 2006, 2009; Snyder 2009). Russia had doubts about the utility of pressure as well (Funabashi 2007, 166-196; Taloraya 2008). Rather than marshaling collective pressure on North Korea, the lack of success at the Six Party Talks gradually forced the Bush administration to consider the inducements it would be willing to offer for a settlement; to understand why, it is necessary to consider in more detail the Chinese and South Korean approaches to the North Korean issue at the outset of the Six Party talks. The strategic choices taken by both countries not only had political effect in the negotiations but help explain the increases in trade, investment and aid that we documented in Chapter Three (see Figures 3.1, 3.6, 3.9).

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<sup>17</sup> . The release of Rumsfeld’s 2011 memoir was accompanied by the launch of a website—the Rumsfeld Papers at <http://www.rumsfeld.com/--with> a searchable database of documents.

<sup>18</sup> . Donald Rumsfeld to Richard Cheney, Colin Powell, George Tenet, Spencer Abraham, and Condoleezza Rice, “Remaining Firm on North Korea,” December 26, 2002.

*Coordination Problems I: Chinese Strategy Toward the DPRK*

China's approach to the three- and then Six Party Talks was initially facilitative.<sup>19</sup> After unsuccessful efforts with Russia to resolve the crisis in late 2002, Beijing's conception was that the talks would provide a cover for the US and North Korea to undertake the bilateral negotiations that the Bush administration was unwilling to conduct directly. Quite early, the Foreign Ministry made clear that China was opposed North Korea's nuclear ambitions. Moreover, it backed that claim with multilateral diplomatic action, for example voting in February 2003 for an IAEA resolution that identified North Korea's actions as a violation of NPT obligations and referring the issue to the UN Security Council (Liu 2003, 358).

However, China had a very different approach to how this objective was most likely to be achieved. Although the motives for Chinese behavior are subject to debate (Glaser, Snyder and Park 2008; International Crisis Group 2006, 2009; Liu 2003; Wu 2005; Shambaugh 2003; Scobell 2003, 2004; Snyder 2009), China consistently questioned the maximalist nature of US demands in the Six Party Talks, was opposed to the use of sanctions on both principled and pragmatic grounds and argued that they United States needed to formulate effective quid-pro-quo.

However, the details of Chinese strategy toward the nuclear talks—including its use of both inducements and sanctions (Funabashi 2007, 320-21)--were not the only development affecting negotiations. Just as the second nuclear crisis was breaking, bilateral China-DPRK relations improved significantly following a period of stress that began in the early post-Cold War period and continued after the death of Kim Il Sung in 1994. The recognition of South Korea in 1992 and the demand for hard currency payment for exports was a major shock and the first nuclear crisis strained China-North Korea relations as well.<sup>20</sup> Whatever aid China extended during the early Kim Jong Il period for political purposes was clearly not adequate to blunt the ravages of the famine. There is even

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<sup>19</sup> . On China's early approach to the talks, see Scobell 2003; Liu 2003; International Crisis Group 2004, Wu 2005; and particularly Funabashi 2007, 300-346 and Acuto 2012.

<sup>20</sup> . Although China took a similarly critical position during the first nuclear crisis with respect to the utility of sanctions, it showed increasing exasperation with North Korea as the crisis escalated in the spring of 1994. China acquiesced to strong UN Security Council statements and sought to exercise influence bilaterally to get North Korea to stand down (Lee 1996, Wit, Poneman and Galucci 2004, 196-199, 209; Kim 2007; Oberdorfer and Carlin 2014, 251-2).

evidence that a fall in Chinese exports in 1994, probably to conserve domestic supplies, was a precipitating cause of the famine before Chinese Premier Li Peng and North Korean Vice Premier Hong Song-nam signed an agreement in May 1996 promising aid and wider economic cooperation (Noland 2000; Haggard and Noland 2007, 156).<sup>21</sup> Despite this initiative, however, and the growth of the informal border trade during the famine, overall trade between the two countries mirrored the decline in diplomatic interaction, falling steadily over the second half of the 1990s.

A spate of high-level diplomatic exchanges in 1999 reversed the diplomatic freeze and set the stage for Kim Jong Il's first visit to China in May 2000, just prior to the North-South summit.<sup>22</sup> The visit was clearly aid-seeking, but China had its objectives as well: to nudge North Korea toward a more rational economic strategy. The Xinhua account of the visit quotes Kim Jong Il as lavishing praise on the Chinese economic model.<sup>23</sup> Kim Jong Il's second visit in January 2001 was similarly scripted to include visits to the Shanghai Stock Exchange, the Zhangjiang High-Tech Science Park, the Pudong development area and even a Chinese joint venture with General Motors. Chinese and North Korean officials engaged in discussions over the possible opening of a trade office in Shanghai and Kim Jong Il was quoted as expressing the intent of opening an export-processing zone in Sinuiju mimicking Chinese zones he had seen on his state visit.<sup>24</sup> As we noted in Chapter Two, 2002 was probably the highpoint—however brief—of open reformism in North Korea.

These developments in bilateral relations were not entirely Korea specific, but were embedded in broader trends in China's domestic and foreign economic policy (Reilly 2014b). These included the "Go Out" (*zou chuqu* 走出去) policy encouraging Chinese SOE's to invest abroad, the "Revitalize Northeast China" (*zhenxing dongbei* 振兴东北) push, which envisioned a deepening of trade with North Korea, and the diplomatic effort to create a "an

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<sup>21</sup> . Japan Economic Newswire, "China's Li Pledges to Help Flood-Stricken North Korea," July 9, 1996.

<sup>22</sup> In June, Kim Yong Nam, a member of the Politburo and chairman of the Supreme People's Assembly, visited Beijing. In October, Chinese foreign minister Tang Jiaxuan reciprocated by visiting Pyongyang, setting the stage for the first informal summit: Kim Jong Il's visit of January 2000. Overall, during the 1990s Chinese officials made nine official visits to North Korea and North Korea only seven to China; in the 2000s, by contrast these numbers rose to 33 and 27 respectively. Reilly 2014b, 4.

<sup>23</sup> . Xinhua, "President Jiang Holds Talks with Visiting North Korean Leader," June 1, 2000.

<sup>24</sup> . Joongang Ilbo, "Kim Jong-il said to order development of Sinuiju special economic zone," January 31, 2001.

amicable, tranquil and prosperous neighborhood” (*mulin, anlin, fulin* 睦邻安邻富邻) through trade and investment on the principle of “mutual benefit” (*shuangying* 双赢).

Not surprisingly, Kim Jong Il’s 2004 visit replayed economic themes. But these visits now occurred in the context of an economic relationship that had begun to revive significantly and had even captured the attention of the South Korean government, which noted the tendency of greater North Korean integration with China (Ministry of Unification 2004). During the 2004 summit, Wen Jiabao publicly declared that the Chinese government positively encouraged investment in North Korea. This was followed by a bilateral investment agreement, formation of a joint committee on economic cooperation in March 2005 and the explicit articulation of a new framework for bilateral relations. This framework was summarized in the complex phrase “government guidance with companies in the lead; market-based operations and mutual benefit” (Park 2009, 90; Freeman and Thomson 2009; Reilly 2014a, b). In his fourth trip to China in January 2006, Kim sought large-scale “cooperation” in the face of financial sanctions that we discuss in more detail below. Wen Jiabao responded by restating the new principles, which implied that government support was designed as a complement rather than a substitute for commercial engagement. North Korea would need to reform, Chinese firms would be the lead players, and they would need to profit from their ventures (Park 2009, 91; Reilly 2014a, b). This message was again delivered pointedly during Jang Song Thaek’s 11-day “study tour” later in the year, accompanied by over thirty high-ranking officials.

In sum, while the US was seeking to form a multilateral coalition of restraint that included China as a crucial player, Beijing’s diplomacy was moving in an altogether different direction. Although not extending aid on a large scale, it was pursuing a strategy of “deep engagement” that had striking similarity to South Korea’s Sunshine Policy.

### *Coordination Problems II: The Sunshine Policy*

South Korea’s strategy with respect to North Korea posed significant diplomatic and economic challenges as well. These constraints on American strategy were rooted in divergent partisan cycles, beginning prior to the onset of the second nuclear crisis with the well-documented differences between the administrations of Kim Dae Jung (1998-2003) and President George W. Bush (2001-2009; Lee 2006, 210-223; Oberdorfer and Carlin 2014, 249-251, Levin and Han 109-113). The Sunshine Policy has been subjected to extensive commentary (inter alia, Moon and Steinberg 1999, Levin and Han 2002, Kirk

2009, Moon 2012) as well as statements by the principles (Kim 1997, Lim 2012). We focus here on some of its distinctive economic components, how they related to conceptions of engagement outlined in the Introduction and how they contributed to the coordination problems we have noted.

As Levin and Han (2002, 25-26) document, the Kim administration came into office with a quid-pro-quo conception of engagement in line with the principle of “mutual benefit.” Yet as North Korea derided efforts to exchange humanitarian assistance for family reunions as “horse-trading,” the Kim Dae Jung administration gradually shifted to a conception of “flexible reciprocity” that eschewed explicit quid-pro-quos. Nonetheless, the wider conception of engagement was defended—albeit delicately--on transformational grounds. The Sunshine Policy took its name from the Aesop fable about the debate between the north wind and the sun about which was more efficacious in getting a traveler to remove his coat; sunshine—a metaphor for persuasion—trumped the brute force represented by the wind. Although explicitly denying any intention to undermine or absorb the North Korean government, the underlying assumption of the Sunshine Policy—based in part on Kim’s reading of the effects of the Helsinki Final Act (1975)<sup>25</sup>--was that gradual engagement would not only moderate North Korean behavior, but also foster favorable policy and even institutional and cognitive shifts.

Economic exchanges played a critical role in this process. The idea of the “separation of politics and economics” was a crucial component of the Sunshine Policy. Private actors would have increasing freedom to engage in trade and investment with the North without government approval—or backing. Lim Dong-won’s epigrammatic explanation of the policy to a Chinese audience used 16 characters to summarize it, and they focused heavily on diffuse reciprocity and economics: “easy tasks first, difficult tasks later; private channel first, government channel later; economy first, politics later; give first, take later” (Lim 2012, 213). Yet Kim Dae Jung was consistent in his belief that the effect of such exchanges was “nudging North Korea towards a market economy and the democratic elements and environment (sic)” (Kim 1997, 131).

The separation of politics and economics proved extremely difficult to sustain, and for reasons pertaining to politics in both the South and North. First, the very backwardness

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<sup>25</sup>. The “third basket” emphasized human rights, including freedom of emigration and reunification of families, cultural exchanges and freedom of the press. Derided as a sop by the Soviets that it had not intention of honoring, it played an embarrassing role as groups formed in Eastern Europe to pursue its premises. Author interview with Kim Dae Jung, July 15, 2008.

of the North Korean economy immediately raised the question of the requisite infrastructure investment to facilitate deeper integration. In his Berlin speech President Kim noted that despite the separation of economics and politics, “to realize meaningful economic collaboration, the social infrastructure, including highways, harbors, railroads and electric and communications facilities, must be expanded.” Early projects in this vein included expensive road and rail links on both sides of the peninsula. Second, the humanitarian dilemmas outlined in Chapter Three operated in force; a policy that sought to signal compassion with Korean compatriots was necessarily drawn to the extension of aid, which expanded sharply in the late Kim Dae Jung years (Figure 4.4).

However, even achieving the separation of economics and politics required an overarching political-legal framework and rested on a conception of North Korean counterparties that proved unrealistic if not dangerously misleading. The passage of the Inter-Korean Exchange and Cooperation Act in 1990 was the first effort to establish a legal foundation for North-South trade and investment, and was followed by the negotiation of a number of additional protocols that facilitated basic commercial exchanges (Chi 2004). But the National Assembly failed to ratify four key North-South agreements (on investment guarantees, avoidance of double taxation, procedures for resolution of commercial disputes, and clearing settlements), substantially reducing private sector interest in pursuing commercial relations with the North.

In 2003, information broke about the negotiation of the summit. It became clear that the government had extended large-scale cash assistance in anticipation of it. Early business ventures in the North led by the Hyundai Group were in fact not profitable but rather embedded in a complex maze of subsidies if not outright bribery. Kim Dae Jung’s policy and his award of the Nobel prize became mired in scandal (Kirk 2006, 190-208). A number of small- and medium-sized firms did commercial business with the North as we showed in Chapter Five, But pre-summit transfers and even some of those associated with Hyundai’s business were channeled through South Korean government entities directly to accounts under the control of Bureau 39 and thus the Korean Workers Party and ultimately the Kim family itself. It became increasingly clear that were commercial relations to deepen, they would require a new model—exemplified in the Kaesong Industrial Complex—in which the government would need to invest in both the physical and legal infrastructure required for firms to operate.

Finally, the shift toward “flexible reciprocity” almost of necessity was vulnerable to political challenges, which surfaced in the last year of Kim Dae Jung’s presidency, continued throughout the Roh Moo Hyun administration and culminated in the election of Lee Myung Bak in 2007. Not only did Pyongyang fail to reciprocate South Korean largesse, for example, failing to rebuild its side of the North-South rail links and missing scheduled meetings. It also made clear that it had no intention of discussing security issues with Seoul and even escalated tensions by provoking an incident along the Northern Limit Line in June 2002 in which six South Korean sailors were killed.

Moreover, conservatives suspected—and at least one North Korean source subsequently confirmed—that this escalatory response constituted a self-conscious strategy of extortion. Jang Jin-sung’s memoir *Dear Leader* (2014), based on his work in the United Front Department, argues that Kim Jong Il faced a dilemma at the outset of the engagement period. In desperate need of aid, he was concerned that pressure to pursue a more reciprocal approach might force him to choose between aid and political or even military concessions. To avoid this tradeoff, the regime adopted the “NLL strategy” of self-consciously using provocations as blackmail. “The underlying logic was simple: South Korea must continue to provide unconditional aid and keep their engagement with the North separate from political issues, or give up peace again (256).”

Just as the nuclear crisis was breaking in December 2002, South Korea went to the polls and elected a reformist human rights lawyer, Roh Moo Hyun, as president. The election reflected both longer-run generational shifts and a sharp uptick in anti-Americanism following a tragic accident in which two Korean middle school girls were run over and killed by a US army vehicle. However, the US approach to both South and North Korea in 2001-2 was also implicated in how the electoral campaign was framed and arguably even in the outcome. The Bush administration did not hide its preference for the conservative candidate Lee Hoi-chang (Pritchard 2007, 74-76) and the American challenge to the Sunshine Policy became one of the dominant issues in the campaign. In a notorious speech in Los Angeles in 2004, President Roh stated openly that he believed that North Korea acquired nuclear weapons out of a sense of insecurity—emanating quite clearly from the United States—and that if that insecurity were addressed the nuclear weapons issue could be resolved (Roh 2004).

Roh thus ran on a platform not only of continuing the Sunshine policy of his predecessor but of deepening South Korean commitment to the North in significant ways.

Interestingly, the first principle of his so-called Peace and Prosperity Policy, enunciated in his inaugural speech, was a commitment to resolve all outstanding issues through dialogue. This priority was a sharp departure from the first principle of the Sunshine Policy, which was no tolerance of provocations and maintenance of a robust deterrent. The commitment to dialogue was not simply a matter of principle: the administration sought to build a complex institutional structure of dialogues, from the ministerial level down to functional working groups on particular issues.<sup>26</sup> Table 6.2 summarizes this heyday of North-South talks, which began following the 2000 summit but accelerated in 2002, were sustained through the Roh administration, and culminated in the 2007 summit.

According to the Korean ambassador at the time, the accommodating nature of Roh's approach to the North stemmed directly from the fear that the United States might attack North Korea and precipitate a conflict that would engulf the peninsula (Han 2009, 194-196). But the approach was not simply the result of short-term concerns. At least some of Roh's top advisors believed that the transformative aspects of engagement should be abandoned altogether, that unification was a chimera and that the purpose of engagement was to foster peaceful coexistence, in short, a policy that might well be considered a strategy of pure appeasement (Ra 2013).

[INSERT TABLE 6.2 HERE]

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<sup>26</sup> . The main forums included so-called inter-ministerial talks, inter-ministerial defense talks—which were largely moribund—economic talks that addressed aid and cooperation projects, and working-level talks on particularly projects including Kaesong, rail and road links, Imjin River flood control, and maritime agreements.

As with the Sunshine Policy, however, the currency of the Peace and Prosperity Policy was clearly economic. These efforts at North-South cooperation included ambitious and ultimately stillborn plans to embed North-South cooperation in a wider regional integration framework called the Northeast Asian Cooperation Initiative. Aid in the form of food and fertilizer were the most tangible and immediate ways of signaling continuity with the Kim Dae Jung years. Despite the onset of the nuclear crisis, the new administration almost immediately committed 100,000 tons of food through the WFP before reverting to the bilateral Inter-Korean Economic Cooperation Promotion Committee for the discussion of aid commitments (Chapter Four).

After June 2004, bilateral relations fell into a freeze that would not thaw until a year later when a high level South Korean envoy met directly with Kim Jong Il in an effort to restart North-South talks and the broader Six-Party effort. In a striking indicator of the disconnect between the nuclear and engagement tracks, North Korea placed its largest aid request to the South only a month before its February 10, 2005 announcement that it was suspending its participation in the Six-Party Talks and had nuclear weapons. Despite pressure from the United States and statements by President Roh that *additional* aid should await progress in the talks, *humanitarian* assistance—in which the government counted both its fertilizer and food aid shipments—was not made conditional.

The shift in US strategy in the second Bush administration that we describe in more detail below and the June 2005 resumption of both the bilateral and Six-Party Talks aligned incentives between the US and Korea and thus mitigated the coordination problems that had plagued the talks up to that point. Inducements to North Korea played a role in this process.<sup>27</sup> These efforts continued and even expanded into 2006 (Agence France Press 2006). Not until the missile and nuclear tests of July did the Roh administration condition aid on North Korean behavior and given the quick resumption of the talks on BDA that period was short-lived.

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<sup>27</sup> . The restart of negotiations was facilitated by promises of generous economic assistance, including commitments to provide energy in the form of electric power, deepening of commercial relations and expansion of government-to-government projects. These commitments can be seen in the agreement reached following the 10<sup>th</sup> meeting of the economic cooperation committee described in Rhee (2005), which also contains quite frank assessments of the continuing limits on commercial relations.

In addition to outright aid, the Roh administration remained strongly committed to a number of “cooperative projects” with the North, including most significantly the Mt. Kumgang tourist project and the Kaesong Industrial Complex. Kaesong had its origins in the vision of Hyundai chairman Chung Ju-yung and his 1998 visit to North Korea, but its realization was a direct outgrowth of the 2000 summit and was announced immediately following it in August 2000. The initial business model was for Hyundai to lease the land rights in the zone for 50 years, develop the complex and then sell or on-lease land or facilities to South Korean and other firms interested in locating there. At the October 2007 summit Roh agreed to an agenda of additional joint projects such as an industrial park at Haeju. But by this point he was a lame duck and his successor Lee Myung-bak did not honor this commitment when he took office four months later.

The South Korean government was intimately involved in the Kaesong project virtually from the outset, in part because of financial constraints at Hyundai Asan associated with the project. The government provided an estimated \$223 million of the \$374 million cost for the first stage alone (Nanto and Manyin 2008), and this does not take into account indirect support for the project. The channels of government involvement were multiple, ranging from the direct participation of the state-owned Korea Land Corporation and the Korea Electric Power Corporation and the provision of both financial incentives and political risk insurance for firms entering the zone.

By June 2004, lots were on sale and by the end of the year products were rolling off the assembly lines of the first investors. Again, it is important to underscore the timing of the project, which started to generate significant foreign exchange earnings for the North just as negotiations in the Six Party talks were stalling out. Although the government placed a brief moratorium on new entrants into the zone following the missile tests of 2006, the project proved a significant source of foreign exchange for the North Korean regime. Indeed, after the 2010 sanctions associated with the sinking of the *Cheonan* until the closure of the zone in 2016, it was virtually the only North-South trade left

In sum, the Bush administration strategy of seeking to pressure the North Korea regime not only faced headwinds in the very different preferences of China and South Korea with respect to *diplomatic* engagement. US strategy also faced the constraint that both China and South Korea were pursuing strategies of deep *economic* engagement with North Korea. These strategies exhibited subtle—and ironic—differences. China sought to emphasize the significance of market-oriented reforms, commercial principles and a lead role for firms.

South Korean strategy—partly by design, partly of necessity—placed more weight on aid and joint projects such as infrastructure and the enclaves at Kaesong and Kumgang. Yet both had the similar effect of providing an important economic lifeline to Pyongyang that effectively offset the sanctions the US sought to mobilize.

*The First Three Rounds of the Six Party Talks: August 2003-January 2005*

The United States came to the first round of the Six Party Talks (August 27-29, 2003) with a list of demands embodied in the acronym CVID; the US was seeking a *complete* (meaning plutonium and HEU), *verifiable* (meaning a return to the NPT and IAEA inspections), *irreversible dismantlement* of all facilities at Yongbyon (in distinction to the Agreed Framework, which had frozen North Korea's nuclear program but left it intact). Although inducements for compliance were not made explicit—in part because ongoing disagreements within the administration<sup>28</sup>--the sequencing of them was clear: any concessions from the United States would come only *after* these actions had been completed.

Pyongyang was willing to negotiate to get to CVID but had a very clear view of how the sequencing of inducements should unfold.<sup>29</sup> As a first step, the North Koreans would declare their intention to abandon their nuclear program—a costless step--in return for Washington's resumption of fuel oil supply and expanded humanitarian food aid. In the second phase, North Korea would freeze its nuclear activities—but not dismantle them--and allow inspections if the United States signed a legally binding non-aggression treaty and compensated the North for lost energy supplies. In the third step, Pyongyang would accommodate US concerns about missiles in return for establishing diplomatic relations. Finally, at the point of completion of the two light-water reactors promised under the

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<sup>28</sup>. Again, the Rumsfeld papers provide interesting insight. In a memo with wide distribution among the top leadership, NSC advisor Condeleeza Rice outlines a broad strategy for dealing with North Korea. Her draft says "We have proposed multilateral talks to North Korea and remain prepared to engage in such talks. In this multilateral format, we are prepared to discuss all issues, including DPRK interest in security assurances." Rumsfeld responds by striking out the second sentence. Even Rice's inducements are couched in vague terms: "Should North Korea verifiably eliminate its nuclear weapons program...it will find that the international community, including the United States, is prepared to respond." Condeleeza Rice to Vice President Richard Cheney et. al., "North Korea Policy Points," March 4, 2003.

<sup>29</sup> Ser Myo-ja, "North Korea Details Its Plan to End Crisis," *Joongang Daily*, August 28, 2003, at <http://joongangdaily.joins.com/article/view.asp?aid=2025739>

Agreed Framework, the North Koreans would verifiably dismantle the Yongbyon facilities. In a virtual mirror image of US proposals, the North Korean approach frontloaded inducements while delaying irreversible actions until the distant future.

With US negotiators given little discretion to negotiate, the first talks ended with so little progress that the Chinese had to extend additional bilateral inducements of their own to get the North Koreans to even return to the next round (Funabashi 2007, 320-21). This became a pattern, as China, South Korea (through the Kaesong project) and Japan (through a second Koizumi-Kim summit) extended various inducements to North Korea, both to improve the prospects of the talks and for diplomatic objectives altogether independent of the Six Party process.

Not until the third round of talks (June 23-26, 2004) did the United States place an offer on the table, and it constituted a virtual mirror image of the North Korean approach. North Korean commitments were heavily front-loaded, while American inducements would not be forthcoming until progress was made on a wide agenda of bilateral issues. In return for a North Korean statement of its willingness to dismantle all nuclear programs, South Korea and Japan would resume shipments of heavy fuel oil in line with the Agreed Framework commitments. The North would institute a freeze on all nuclear activities and provide the five parties with a detailed plan for disabling, dismantling and eliminating all of its nuclear activities, including its HEU program, existing stocks of fissile material, weapons, and components. All of this work would take place under the auspices of international inspections. Once agreement on the plan was reached, the United States and others would provide security assurances. Other economic inducements such as meeting longer-run energy needs or removing sanctions would be phased and subject to further negotiation. The path to normalization was more distant still and would require progress on the widened agenda of the June 2001 policy review and so-called “bold approach.”

The North Koreans had little interest in these proposals, and no doubt wanted to see the outcome of the US presidential election. The fourth round of talks scheduled to take place prior to September 2004 failed to materialize.

### **From Movement to Collapse: The Second Term of President George W. Bush**

In her memoir, *No Higher Honor*, Condoleezza Rice (2012) offers a surprisingly candid assessment of the limitations on the strategy of the first Bush administration and the

thinking that lead to a change of course in the second. She noted the sour taste left by the Kim Dae Jung-Bush summit, the costs of the “Axis of Evil” characterization, and how the divisions within the administration had made policy-making difficult. She focused in particular on the dilemmas posed by dealing with a particularly “hard target” and a multilateral diplomatic setting in which the US did not hold all the cards. Sanctions, she concluded, were unlikely to be effective: “If Kim Jong-il had to freeze his people to death in the face of a cutoff of fuel assistance, his view was ‘So be it.’ North Korea had plenty of ways to buy, steal and smuggle what it needed to ensure the relative comfort of the regime and its military” (159). Moreover, she was cognizant of US isolation and the coordination problem: “a U.S. policy of complete isolation of North Korea in the service of regime change was not, in the long term, one that others in the region, particularly China and South Korea, would likely abide (159).” She was also quite clear that the handling of the intelligence on the HEU program was not only a missed opportunity, but contributed to the problem. By constraining Kelly’s opportunity to “fully explore what might have been an opening to put the program on the table” and moving to cut off heavy fuel oil shipments, the administration had contributed to the crisis (162-3). Although she recognized that the President was sympathetic to the hawks, she had come to the conclusion that in the absence of a military option, negotiation—and the requisite *quid pro quo*—were necessary.

On becoming Secretary of State, Rice sought “a longer-term framework that pointed the way toward denuclearization *and* a resolution of the underlying tensions in the region” (167). Rice contemplated the development of multilateral institutions for Northeast Asia that would complement alliance relationships, including a peace treaty (523-4). To pursue this path, she had to make the President comfortable with a diplomatic approach to North Korea and secure the latitude to negotiate without her envoy being “micromanaged.”

The strategy involved three components. The first was more effective coordination among the five parties, meaning at least some accommodation to the positions of China and South Korea. Second, the US would pursue sanctions—including financial ones—but primarily as defensive measures to block proliferation rather than as tools that would necessarily bring pressure to bear; indeed, she worried about the politicization of sanctions in a way that would scuttle diplomacy. Finally, Rice had to convince the president that a policy of seeking regime change was unlikely to work: “one can hardly negotiate successfully with a regime if one is publicly committed to its destruction” (159). Despite

extraordinarily tough rhetoric from the North Koreans,<sup>30</sup> the second Bush administration was clearly more willing to engage North Korea. Chief US negotiator Christopher Hill was granted greater latitude to pursue the specific quid-pro-quos that had previously been lacking in the talks (Hill 2014 197-204).

*Through the “Roadmap” Agreements of 2007*

The September 2005 Joint Statement, the outcome of the prolonged fourth round of Six Party talks,<sup>31</sup> constituted a breakthrough and remains the touchstone document of the Six Party Talks process to this day. The statement of principles lays out the broad quid-pro-quo that had been implicit in earlier rounds of negotiations. The statement is unambiguous that the denuclearization of the peninsula is a shared goal and that North Korea is committed to “abandoning” its nuclear program, rejoining the NPT, and readmitting IAEA inspectors. In return, the US affirmed that it had no intention of attacking or invading North Korea. Both the US and Japan committed to “take steps” to normalize relations. The statement made reference both to the negotiation of a peace regime on the Korean peninsula and the exploration of wider multilateral cooperation on security issues.

The document also outlines the inducements on offer. First, the five parties would provide energy assistance, and South Korea reaffirmed its commitment to a very specific proposal made in July 2005 providing 2 million kilowatts of electric power to the DPRK. The document also contained a euphemistic reference to the lifting of sanctions and the provision of other economic assistance (“the Six Parties undertook to promote economic cooperation in the fields of energy, trade and investment, bilaterally and/or multilaterally.”) Light water reactors entered late in the negotiations, and threatened to derail them (Funabashi 2007, 398-402). The statement finessed the issue by affirming North Korea’s right to a civilian nuclear program, but the provision of such reactors by the five parties would only be discussed “at an appropriate time.”

How would the exchange of inducements for policy actions actually work? The document is explicit on this point: the proposed measures would be implemented in a phased fashion “in line with the principle of “commitment for commitment, action for

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<sup>30</sup> The North Koreans greeted the new administration with a statement of their intent to withdraw from the Six Party Talks and stating their possession of nuclear weapons (February 10) followed by an offer to negotiate “disarmament” with the US “on an equal footing” (March 31).

<sup>31</sup> The fourth round of talks consisted of two phases, July 26-August 7 and September 13-19, 2005.

action.” The sequencing problems of “big deals” and “grand bargains” would be solved through incremental steps.

The implementation of this strategy was almost immediately muddled by ongoing differences within the administration over the appropriate mix of inducements and sanctions and particularly their timing (Hill 2012, 241-244; Zarate 2013, 219-237). Hawks within the administration crafted a statement following the fourth round of talks that parsed the agreement in a highly restrictive way, appearing to require full compliance with NPT obligations *prior* to the provision of any meaningful inducements.<sup>32</sup> Discussion about LWRs would only occur after these actions had been taken, and normalization of relations remained contingent on discussion of the full range of issues vetted in the 2001 policy review and “bold approach.” It took less than 48 hours for the North Korean foreign ministry to reject this approach.<sup>33</sup>

The gradual refinement of the Illicit Activities Initiative into a host of new financial restrictions on North Korea further complicated negotiations since they were interpreted by North Korea as little more than additional sanctions.<sup>34</sup> The most significant of these new measures was the so-called “bad bank” strategy. The Treasury Department's named Banco Delta Asia as a “primary money laundering concern” on September 15, 2005, at almost the exact moment that the fourth round of the Six Party talks were reaching a conclusion.

The “bad bank” strategy was a very different approach than traditional sanctions. Despite the fact that United States conducts very limited direct trade, investment or financial relations with North Korea, the US could leverage the need for correspondent

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<sup>32</sup> The statement noted that the benefits promised to North Korea “will only accrue in the context of the denuclearization of the Korean Peninsula,” the meaning of which was outlined in detail: that the DPRK would return, at an early date, to the NPT and come into full compliance with IAEA safeguards, including by taking all steps that may be deemed necessary to verify the correctness and completeness of the DPRK's declarations of nuclear materials and activities.” “Statement of Assistant Secretary of State Christopher R. Hill's Statement at the Closing Plenary of the Fourth Round of the Six-Party Talks,” September 19, 2005.

<sup>33</sup> The DPRK issued its own poison pill by threatening that the U.S. “should not even dream of the issue of the DPRK's dismantlement of its nuclear deterrent before providing LWRs....” “Spokesman for DPRK Foreign Ministry on Six-Party Talks,” September 20, 2005, KCNA at <http://www.kcna.co.jp/index-e.htm>.

<sup>34</sup> Executive Order 13224 of September 2001 and Title III of the USA Patriot Act were crucial statutory starting points. These were followed by Executive Order 13382 of June 2005 which authorized seizure of any U.S. assets of WMD proliferators and their supporters, named three North Korean entities and authorized executive agencies to list others as warranted. On October 21, 2005, the U.S. Treasury Department added eight North Korean entities to the sanctions list, and on April 6, 2006, the department issued a provision prohibiting any U.S. person from “owning, leasing, operating or insuring any vessel flagged by North Korea.” See National Committee on North Korea 2009.

banking relations with American financial institutions to bring pressure to bear on North Korea. It remains unclear what share—if any—of Banco Delta Asia’s North Korean accounts—totaling about \$25 million—were in fact illicit; some portion of the assets, at least, were held by entities engaged in commercial ventures with the North. Nonetheless, by April 2006 BDA had been driven into receivership by its designation as an entity of money-laundering concern. Moreover, the effects of the designation were by no means limited to BDA. Other banks—from Europe to Southeast Asia—quickly saw the writing on the wall and moved to close North Korean accounts as well. In his account of the episode, Juan Zarate (2013) notes that even Chinese banks did not want to participate in a resolution of the issue for fear that they would be held liable. A short, one-page notification had essentially isolated North Korea from international financial markets.

Despite the fact that BDA is frequently seen as a success, the North Korean response to the restricted interpretation of the Joint Statement and Treasury actions was in fact escalatory. North Korea quickly abandoned the Six Party negotiations, which did not convene between November 2005 and December 2006. The BDA measures were sufficient to inflict significant financial and macroeconomic distress on North Korea. However, they were not adequate to deter North Korea from producing fissile material and undertaking the missile and nuclear tests of June and October 2006, even at the cost of a strongly-worded Security Council resolution on its missile program (UNSC 1695) and the first set of multilateral sanctions following the nuclear test (UNSC 1718). Indeed, in a pattern that would repeat in 2009, 2013 and 2016, the imposition of multilateral sanctions was a prelude—in clear stimulus-response fashion—to the conduct of either nuclear or missile tests.

In what sense, then could we say that the BDA actions and multilateral sanctions “worked”? The initial multilateral sanctions embodied in UNSC Resolution 1718 did not have much material effect, as we showed in Chapter Three. This was due to the fact that the sanctions required Chinese acquiescence and were limited to large-scale conventional weapons systems and WMD-related trade. But there is ample evidence that the BDA action had material effect, either on elite assets or—more probably given the small amount of money at stake—because of their wider consequences for North Korea’s foreign economic relations. Victor Cha (2012, 268), a participant in the negotiations, reports that a North Korean delegate admitted openly that “you have finally found a way to hurt us.” The markets’ reaction was evident in a rapid collapse in the North Korean exchange rate at the

time that BDA went into receivership. The importance of the issue was also signaled by a North Korean statement in April 2006 that publicly tied a resumption of the talks to a resolution of the BDA issue. As we will see, a resolution of BDA was indeed required to move from the 2005 Joint Statement to operational agreements reached in 2007 to implement it.<sup>35</sup>

But it is hard to make the case that the BDA actions alone were able to secure North Korean concessions; the US had to reciprocate as well. Bilateral talks on BDA were held in March 2006 and resumed quickly following the October 2006 nuclear test in December 2006 and January 2007, when a final deal was struck on the BDA funds (National Committee on North Korea 2007; Hill 2014, 245-262). Moreover, the BDA and UN sanctions worked only by promising a return to the tightly-phased “actions for actions” approach contained in the Joint Statement of September 2005. This approach was elaborated in the two “roadmap” agreements of 2007.<sup>36</sup> These agreements require scrutiny, since they embody a highly elaborate and phased set of inducements; an analysis of this episode shows that the limitations on a sanctions strategy by no means guaranteed that inducements would work either.

*Action for Action? The Roadmap Agreements of 2007 and their Implementation*

The United States had an array of concerns with respect to North Korea’s nuclear program. These included not only existing stocks of fissile material and the opportunities for reprocessing spent fuel from the Yongbyon reactor but also the verification regime, the HEU program and possible proliferation activities as well. Given the fact that the most immediate challenge was to slow the accumulation of fissile material, the administration developed a strategy that focused in the first instance on Yongbyon.

The “Initial Actions for the Implementation of the Joint Statement” of February 13, 2007 outlined a series of very short-run measures—inducements for actions--designed to build confidence while having material effect on the visible program. In the first 60 days, a freeze on Yongbyon—an agreement to “shut down and seal [the facility] for the purpose of

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<sup>35</sup> “North Korean Offers Nuclear Talks Deal,” BBC News, April 13, 2006, <http://news.bbc.co.uk/2/hi/asia-pacific/4905308.stm>

<sup>36</sup> “Initial Actions for the Implementation of the Joint Statement,” February 13, 2007 and “Second-Phase Actions for the Implementation of the September 2005 Joint Statement,” October 3, 2007.

eventual abandonment”—and the return of IAEA inspectors was to be exchanged for delivery of oil. North Korea also agreed to begin discussions on a declaration of its activities, although not to complete it or provide it in full. The US committed to set in motion a number of diplomatic processes, although also not necessarily to complete them: to “start” bilateral talks aimed at normalization; to “begin” the process of removing North Korea from the list of state sponsors of terrorism; and to “advance the process” of lifting sanctions under the Trading with the Enemy Act. During the first phase and the next phase, a complete declaration of all nuclear programs and disablement of all existing nuclear facilities would be exchanged for economic, energy and humanitarian assistance up to the equivalent of 1 million tons of heavy fuel oil (HFO). But this large package—in excess of what was offered under the Agreed Framework—would depend on the full disablement the nuclear facilities at Yongbyon; in the short-run, the only actual inducement on offer was a shipment of 50,000 tons of HFO.

The October 2007 agreement—the “Second-Phase Actions for the Implementation of the September 2005 Joint Statement”—reiterated these commitments and set out a more precise timetable. The agreement appears to state that the disablement of the reactor, reprocessing plant and fuel fabrication facility would be completed by the end of 2007 and North Korea would provide a full declaration. The October agreement also states explicitly that removing North Korea from the list of state sponsors of terrorism would be conditional on actions with respect to disablement. Not stated explicitly, although implied by the “actions for actions” approach, is that the North Koreans expected disablement to also be phased to the provision of the HFO shipments, suggesting a timetable likely to run well past the end-2007 deadline.

As we saw in Chapter Four, a major food aid package with the United States—including new monitoring arrangements--was finalized during this phase of the negotiations. The package suggested a tacit linkage between progress in the talks and humanitarian assistance, albeit it under cover of a World Food Program appeal.<sup>37</sup> To meet domestic requirements that there be a “substantial improvement in monitoring and access” for the aid package to go ahead, North Korea negotiated the new monitoring regime outlined in detail in Chapter Four.

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<sup>37</sup> The appeal provided cover for the US to provide a very large-scale and rapidly-disbursing aid program of 500,000 MT over the course of one year beginning in June 2008400,000 MT would be channeled through the WFP with 100,000MT going through a consortium of NGOs.

The United States also responded as required by proceeding to lift restrictions applied to North Korea associated with the Trading with the Enemy Act and through President Bush's formal notice to Congress of his intention to remove Pyongyang from the list of state sponsors of terrorism after 45 days. During the July 2008 round of talks, the six parties each agreed to fulfill "in parallel" their agreed commitments with respect to HFO shipments and complete disablement by the end of October.

Did the phased inducements in the "actions for actions" approach work? The February 2007 agreement to freeze the North's nuclear facilities was delayed as a result of technical difficulties in resolving the BDA issue but oil shipments commenced in July and the freeze was in place by October 2007 when second phase actions were to commence. North Korea began implementing the October 3 Agreement by shutting down the five-megawatt nuclear reactor at Yongbyon and although it missed the year-end deadline for disablement—completing 8 of 11 steps designed to make it inoperable for at least a year—this deviation was partly technical and not viewed as particularly serious on the part of the US.<sup>38</sup>

Two issues—the North Korean declaration of its programs and the linked issue of verification—ultimately posed stumbling blocks. An early declaration provided in November fell well-short of US and other intelligence estimates of the likely stock of fissile material. The declaration was lacking in detail and made no mention of either HEU or proliferation activities. These activities had become an increasing issue of concern following the Israeli bombing of a reactor in the Syrian desert in September 2007 that had been constructed with North Korean support. In the absence of a robust declaration, verification and monitoring became more important both politically and substantively.

Following three further rounds of negotiations in early 2008, the US and North Korea reached a face-saving agreement in Singapore in April 2008. North Korea promised a new declaration of the plutonium-based program. The US would provide a bill of particulars on its suspicions with respect to proliferation activities and HEU—which the North Koreans continued to deny—and North Korea would confidentially "acknowledge" them, an

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<sup>38</sup> . The North Koreans would subsequently modulate their disablement efforts, complaining about the pace that fuel oil was being delivered. The shipments of 1 million metric tons (MT) of heavy fuel oil or equivalent were to be divided equally by the five parties: 200,000 MT each. Over the next fourteen months, HFO shipments were slowed in part by disagreements among the parties and in part by logistical issues; see Appendix 3 for information on the delivery of HFO by the five parties and the timing of oil shipments. By March 2009, the DPRK had received 500,000 MT of heavy fuel oil and equipment and 245,110 MT of fuel equivalent assistance (Manyin and Nikitin 2010).

approach that might be described as “we didn’t do it and we are not going to do it again.” A massive compilation of documents was delivered to the US in May and formally to the Chinese as chair of the Six Party talks in June.

The statement of principles of September 2005 made reference to the fact that denuclearization would be “verifiable” and that North Korea would return to the NPT and IAEA inspections. However, the management of verification issues had been delegated to the nuclear working group in the February 2007 agreement, implying that it was not a component of the first two phases of implementation that were outlined in the two 2007 roadmap agreements. Following bilateral negotiations on the issue, the parties issued a joint communiqué on July 12 outlining broad principles, including agreement that at least the initial inspection mechanism would involve experts from the six parties with the IAEA limited to “consultancy and assistance.”

Both domestic political constraints within the US and increasing disaffection on the part of South Korea and Japan (which refused to supply fuel oil at all because of the failure to address the abductee issue)—in short both credibility and coordination problems--undermined the tightly-scripted exchange of inducements and North Korean actions. As criticism mounted about the integrity of the North Korean declaration and the utility of the entire Six Party process, the administration sought to mollify critics by undertaking an outside review of the declaration that the North Koreans had provided and by moving verification efforts into phase two.<sup>39</sup> Moreover, the US demanded that IAEA inspectors would ultimately lead the implementation of the protocol, in line with expectations stated in the September 2005 joint statement that North Korea would return “at an early date” to the NPT and to IAEA safeguards. When North Korea rejected these efforts, claiming that full verification would come only at the end of the denuclearization process, the administration chose to step back from an important inducement: to rescind North Korea’s designation as a state sponsor of terrorism.

These events occurred exactly at the time that Kim Jong Il was subsequently believed to have suffered a stroke, compounding the difficulty of reaching any agreement.

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<sup>39</sup> Following the July 12 joint communiqué the US circulated a very tough draft verification protocol that included full access to all materials and all sites regardless of whether included in the North’s declaration or not, in effect, the equivalent of the IAEA special inspections protocol. A sense of the intense political pressure on the administration’s policy and a clear statement of the use of verification to address it can be found in Condoleezza Rice’s “Remarks at Heritage Foundation on U.S. Policy in Asia,” June 18, 2008 at <http://www.america.gov/st/texttransenglish/2008/June/20080619140227eafas0.8862574.html>

On August 26, a foreign ministry statement announced that North Korea would stop and then reverse the disablement process at Yongbyon and, in a thinly veiled reference to the military, restore facilities “as strongly requested by its relevant institutions.”<sup>40</sup> On September 24 it removed IAEA seals and surveillance cameras from its reprocessing facility and restricted international inspectors from its reactor site in a virtual replay of the events of early 2003. South Korean intelligence leaks also suggested that North Korea was restoring an undeclared underground nuclear site at Punggye and the ballistic test site in Musudan, suggesting a hard-line response to the US change in course that would extend into the Obama administration.

Realizing that the entire Six Party process was now in jeopardy, the administration reversed course and sent Christopher Hill to Pyongyang to negotiate a face-saving protocol in early October that would permit Pyongyang to be taken off the terrorism list.<sup>41</sup> But nearly a month after this last minute concession was granted, North Korea questioned its precise terms with respect to the taking of samples, once again providing an entry point for critics of the deal. Two further rounds of negotiations in December proved unsuccessful. The US believed that the North Koreans had reneged on verbal assurances on verification that had been given in October and stated that further energy assistance under the agreement would not be forthcoming, effectively ending the implementation process. The Six Party Talks—and the implementation agreements they had ultimately generated in 2007—were dead.

### **Conclusion: Inducements and Constraints in the Six Party Talks**

Several conclusions emerge from this consideration of the rise and fall of the Six Party talks. First, the history of the talks confirms the significance of the coordination problems outlined in the Introduction. The United States had limited success in turning the Six Party Talks into a five party cartel that would use economic-cum-political pressure to bring North Korea to the table and elicit concessions. China’s commitment to deep engagement was a constant, and exercised influence both within the Six Party Talks and through its capacity to influence UN Security Council action in 2006. Japan (roughly through

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<sup>40</sup> “Foreign Ministry’s Spokesman on DPRK’s Decision to Suspend Activities to Disable Nuclear Facilities,” August 26, 2008 at <http://www.kcna.co.jp/index-e.htm>

<sup>41</sup> The new agreement—critical components of which were transmitted only in verbal form--allowed “sampling and other forensic measures” at the three declared sites at Yongbyon--the reactor, reprocessing plant, and fuel fabrication plant—and access to undeclared sites but only on mutual consent.

the second Koizumi summit in 2004) and particularly South Korea (though the end of the Roh administration in 2007) were also seeking to engage North Korea, even at times when the talks were not progressing. As Rumsfeld himself was forced to admit in a memo to the president in October 2006—only days before the first nuclear test—“it is not only difficult, but possibly impossible, for the US to gain the international diplomatic support sufficient to impose the leverage on Iran and/or North Korea required to cause them to discontinue their nuclear programs.”<sup>42</sup> As we have seen Secretary of State Rice had already reached this conclusion based on her analysis of the first administration’s record.

The strategy of pressuring North Korea was not only futile; it was counterproductive. North Korea responded to both military threats and economic pressure by accelerating their pursuit of weapons, most notably in early 2003, in 2006 and again in 2009 in a second round of missile and nuclear tests in the first year of the Obama administration.

This conclusion about the counterproductive nature of sanctions is more complicated with respect to the use of financial instruments, but ultimately appears to pertain as well. We have evidence that the BDA actions had diplomatic effect because of the weight that the North Koreans put on them in the resumption of negotiations. But these apparent gains were fleeting. The timing of the BDA announcement undermined the momentum of the September joint statement and resulted in a suspension of the talks for over a year, during which the North Koreans tested both missiles and nuclear weapons. The BDA sanctions and the multilateral UN sanctions that followed only had effect because the United States was willing to resolve the BDA issue and resume negotiations by returning to an “action for action” inducements approach.

Were those inducements successful? On the positive side of the ledger, they appear crucial to the negotiations leading to the 2005 breakthrough, the resumption of talks in 2006, and the two roadmap agreements of 2007. Critics such as Sigal (2009a, b) subsequently argued that the problem was not that inducements did not work; it was that the US did not follow through on its commitments. Sigal argues that the US moved the goalposts by including issues that were assigned to a third phase and then punished North Korea by renegeing on the lifting of sanctions when Pyongyang balked. Domestic political constraints in the US and the increasing divergence between US strategy and the changed

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<sup>42</sup> . Rumsfeld to Bush, “Declaratory Policy and the Nuclear Programs of North Korea and Iran,” October 5, 2006 at <http://www.rumsfeld.com/>.

foreign policies of the Lee Myung-Bak and Abe, Fukuda and Aso governments also impinged on the ability of the US to maintain its commitments.

But this begs the question of whether North Korea was ultimately interested in negotiating and implementing the agreements. Christopher Hill's strategy in 2008 was to focus on the inducements required to stop production of plutonium in Yongbyon through an agreement on disabling the facility. He self-consciously sought to finesse the issues of proliferation, HEU, accumulated stocks of fissile material and the weapons themselves. Once the North Koreans saw the benefits to be gained from making concessions, and once trust was built, it was hoped that they would then be willing to deal on these questions as well.

But it is not clear that North Korea was willing to deal on these questions. A less charitable interpretation of the events of 2008 suggests that North Korea was divided on the issue, engaged in strategic deception or perhaps rendered incapable of action by the deterioration in Kim Jong Il's health and a preoccupation with the succession. North Korea never publicly acknowledged either its proliferation activities—despite overwhelming evidence on the Syrian reactor—nor its HEU program. If taken in good faith, the deal made with respect to proliferation and HEU could be treated as an acknowledgement that North Korea had engaged in such behavior in the past, but would not do so in the future. But the bitter fight over verification, even though technically not a part of phase-two implementation, raised broader questions about North Korean intentions.

Even had the 2007 agreements been fully implemented, a prolonged round of further negotiations—and side payments—would be required to address verification, re-entry into the NPT, the readmission of IAEA inspectors, the question of existing stocks of fissile material and weapons, as well as HEU and nuclear cooperation with Syria, Iran and other states. During these negotiations, North Korea would effectively maintain a nuclear capability. The least charitable interpretation is that the North Koreans sought throughout these negotiations to maintain at least a minimal nuclear deterrent.

It is impossible based on the evidence on offer from the negotiations to distinguish between these more and less charitable interpretations of North Korean intent; they are observationally equivalent. But the North Korean reaction must be read not only against the evidence from the negotiations, but the domestic developments in North Korea described in Chapter Two, particularly in the wake of Kim Jong Il's stroke and the onset of the succession process. Internal political developments provided no evidence of more accommodating political forces within the regime nor of complementary actions with respect to reform and

opening that would have sent credible signals of North Korea's type. Further evidence for this more skeptical interpretation of the utility of inducements can be found by outlining developments during the first Obama administration.

Chapter 6 Figures and Tables

<p align="center"><b>Table 6.1</b></p> <p align="center"><b>U.S. Economic Statecraft 2001-2008:</b></p> <p align="center"><b>The Six Party Talks Phase</b></p>			
	<b>Economic and other inducements</b>	<b>Sanctions and constraints</b>	<b>North Korean response</b>
Pre-crisis. January 2001-October 2002	Continuation of food aid as well as oil shipments under Agreed Framework.  Internal discussion of extending prospective benefits, but in return for a widened agenda.	Assertion of right to pre-empt against proliferators.  Unwillingness to negotiate.	Proposal to negotiate a wide-ranging settlement, June 2001.
From the onset of the crisis to the Six Party Talks. October 2002-August 2004.	None.	Suspension of HFO shipments under Agreed Framework.  Initiation of Proliferation Security Initiative  Strengthening of illicit activities initiatives.  "Tailored containment."	Restatement of willingness to negotiate followed by escalation including ejection of IAEA inspectors, withdrawal from NPT, reprocessing of spent fuel.
First three rounds of Six Party Talks, August 2003-January 2005  (Scheduled 4 <sup>th</sup> round of talks do not take place).	First offer of inducements at 3 <sup>rd</sup> round of talks, June 2004. Offer of security guarantees, but economic inducements would follow North Korean compliance.	Continuation of existing initiatives.	Proposed exchange, with economic inducements for declaratory commitments that would precede irreversible North Korean actions. Dismantlement only with provision of LWRs.

<p>To the “roadmap” agreements. January 2005-October 2007</p>	<p>Statement of Principles offers broad economic quid pro quos but wholly prospective: lifting of sanctions, aid, normalization and discussion “at appropriate time” of LWRs.</p> <p>South Korea provides electricity.</p> <p>Resolution of BDA case permits February and October 2007 agreements, which offer tightly coupled economic inducements in the form of oil shipments.</p>	<p>Refinement of Illicit Activities Initiative, Banco Delta Asia (BDA) and other financial sanctions.</p>	<p>Escalatory response to BDA action, including missile and nuclear tests in 2006.</p> <p>Settlement of BDA issues followed by return to negotiations and February and October 2007 agreements.</p>
<p>Implementation and the collapse of talks. October 2007-January 2009</p>	<p>Step-by-step approach with HFO shipments, food aid, and initial steps toward lifting of sanctions conditional on North Korean performance including with respect to verification.</p>	<p>US chooses not to rescind North Korea’s designation as a state sponsor of terrorism as a result of conflict over verification.</p>	<p>Mixed compliance. Most disablement steps completed, but questionable declaration of nuclear activities and programs. Initially accepts compromise with US on verification but escalates in response to US reversal on terrorism list and ultimately quits the talks.</p>

<b>Table 6.2</b>								
<b>North-South Talks, 2000-2007</b>								
	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
<b>Total Number of Talks</b>	26	9	33	38	25	36	24	20
<b>Joint Declaration</b>	1	0	0	0	0	0	0	0
<b>Joint Statement</b>	7	2	7	10	6	8	2	8
<b>Agreement</b>	3	1	10	17	10	10	4	3
<b>Agreement &amp; Joint Statement</b>	1	0	0	0	0	0	0	1
<b>Agreement or Joint Statement</b>	12	3	17	27	16	18	6	12
<b>No Agreement or Joint Statement</b>	14	6	16	11	9	18	18	8
<b>Share with Declaration, Agreement or Statement (%)</b>	46.1	33.3	51.5	71.1	64.0	50.0	25.0	60.0

Source: Ministry of Unification, At <http://eng.unikorea.go.kr/content.do?cmsid=3033#>



**Chapter Seven**  
**Negotiating on Nuclear Weapons II:**  
**Permanent Crisis, 2009-2016**

The Obama administration came to office committed to a strategy toward its foreign adversaries almost diametrically opposed to that of the first Bush administration. At least as a matter of declaratory policy, the new administration signaled a willingness to engage, including with North Korea. In his inaugural address, President Obama offered to “extend a hand” to adversaries willing to “unclench their fist.” In an important interview in 2015, the President elaborated on the so-called Obama Doctrine, arguing that the overwhelming capabilities enjoyed by the United States substantially reduced the risks of such engagement.<sup>1</sup>

Did this strategy have effect with respect to North Korea? The short answer is “no.” The initial North Korean response to the new administration was escalatory, quickly launching a satellite in April 2009 that was widely seen as a stalking horse for the country’s long-range missile program. North Korea undertook a second nuclear test in May and then withdrew “permanently” from the Six Party talks. With the effective collapse of the Six Party Talks, negotiations moved from the more-or-less institutionalized format of the 2003-8 period—albeit with significant pauses—to less structured diplomatic signaling and recurrent crisis bargaining (Table 7.1).

These episodes unfolded in recurrent cycles during the 2009-2015 period. In response to the early 2009 tests, the Obama administration resorted to a two-track policy reminiscent of the so-called Perry approach of the late Clinton years, albeit with greater emphasis on constraints (Perry 1999, 2015). On the one hand, the US orchestrated a tightening of multilateral sanctions against North Korea through the UN Security Council, as had occurred following the 2006 test. On the other hand, the US stated its willingness to re-engage through the Six Party Talks on the basis of the September 2005 Joint Statement; this basic stance persisted through the entire period examined here. But except for the failed Leap Year Deal of February 2012, the benefits on offer were all prospective. The administration specifically rejected additional incentives solely for talks or for any North

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<sup>1</sup> . In an interview with New York Times correspondent Thomas Friedman, the approach was subsequently dubbed “the Obama Doctrine.” See Thomas Friedman, “Iran and the Obama Doctrine,” *New York Times*, April 2, 2015.

Korean actions that were viewed as obligations under UN Security Council resolutions or prior agreements. Indeed, the administration even insisted that a return to talks would require advance or “up front” actions on the part of North Korea to show seriousness of intent. Once again, the negotiations faced the credibility or sequencing problems we outlined in the Introduction.

The Lee Myung Bak government—which came to office in February 2008—took a similar approach to engagement. It made promises of substantial assistance, but conditional on a settlement of the nuclear issue and the pursuit of reforms by the North; in the short-run, as we saw in Chapter Three (Figure 3.9), aid dropped to virtually nothing. Although nominally different, President Park Geun Hye (coming to office in February 2013) pursued quite similar policies. In principle, her conception of *Trustpolitik* involved small reciprocal steps, but also rested largely on benefits that were contingent on North Korean moves.

This two-track strategy—dubbed “strategic patience” in the US—had little success in resuming talks. At each step that sanctions were imposed or aid withdrawn, North Korea responded by escalating tensions. The DPRK largely eschewed the Six Party process altogether or advanced proposals at complete odds with the American approach. These included parallel or even prior negotiation of a “peace regime” that would replace the armistice or a resumption of the Six Party Talks “without preconditions,” meaning that North Korea would take no actions prior to the talks. In the interim, North Korea would remain—de facto if not de jure—a nuclear power. In early 2013, the roll-out of the so-called *byungjin* line formally committed the regime to the twin goals of both economic development and continued pursuit of its nuclear weapons program. Not surprisingly, this approach was a political non-starter from the perspective not only of the US but of the other five parties as well.

The pattern of escalation, mutual recriminations, sanctions and further escalation unfolded in several cycles during the second Obama administration. Following a naval skirmish along the Northern Limit line in November 2009, Pyongyang undertook one of the more egregious provocations of the post-Korean War period by sinking a South Korean naval vessel, the *Cheonan*, with the loss of 46 sailors in March 2010. In November, North Korea undertook the shelling of Yeonpyeong Island, sovereign territory of the Republic of

Korea. Both of these events shifted the policy focus for the US and South Korea from negotiations back to sanctions and strengthening the deterrent.<sup>2</sup>

During 2011, the US pursued a modest softening of strategic patience through the negotiation of a “food for freeze” deal, an agreement finalized just before Kim Jong Il’s death on December 17, 2011 and announced publicly on February 29, 2012. Yet this so-called Leap Year Deal fell apart almost immediately with the announcement by Kim Jong Un of the intention to launch a satellite that was seen as a thinly-veiled step in the country’s long-range missile program. Although the test of April 13, 2012 failed, it set in train a sequence of events that bore an uncanny similarity to those of early 2009: international condemnation and sanctions; a second, more successful satellite launch in December 2012; another expression of multilateral concern and sanctions; a third nuclear test in April 2013; a third UNSC sanctions resolution and a taut period of military confrontation in the spring of 2013. Although the level of tensions subsequently subsided from their early 2013 peak, little progress was made during 2013-15 in resuming negotiations and both the North Korean nuclear and missile programs continued to march forward. In early 2016, this cycle repeated yet again with the fourth nuclear test in January, another successful satellite launch in February and passage of the most sweeping UN Security Council resolution to date in March; we take up this last episode in more detail in the Conclusion.

As during the Bush era, both the policy and scholarly debate during the two Obama administrations rotated around the utility of sanctions and inducements. Sigal (2009) argues that North Korea’s behavior in the first half of 2009 was largely a response to the failure of the negotiations in late 2008. Just as North Korea had taken an escalatory response to the cutoff of heavy fuel oil shipments in 2002, it responded similarly to the joint decision of the United States, South Korea and Japan to suspend HFO shipments in December 2008. According to Sigal, these problems were compounded by the failure of the Obama administration to engage North Korea with sufficient alacrity and by the “crime and punishment” strategy of imposing sanctions in the wake of the missile test of April.<sup>3</sup> The bellicose language, missile and nuclear tests by the North Koreans were simply tactics designed to increase bargaining leverage. Subsequent analyses in this vein repeatedly

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<sup>2</sup> . North Korea contests the legal status of the islands, arguing that both the drawing of the Northern Limit Line and the inclusion of the islands to the south of it were unilateral actions by the UN Command. See International Crisis Group 2011.

<sup>3</sup> Sigal 2009 notes open references by Secretary Clinton to the succession, labeling North Korea a “tyranny,” and appointing a special envoy—Stephen Bosworth—who concurrently held a full-time position outside government.

returned to the failure of sanctions and the unwillingness of the Obama administration to take initiatives or to offer inducements of adequate scope to influence North Korean behavior (for example, Asia Society 2009, Wit 2009, Lewis, Hayes and Bruce 2011, Sigal 2012 and 2016, Hayes and Tanter 2012, Halperin 2012, Moon 2012, Frank 2013, Gurtov 2014, Hippel and Hayes 2014).

[INSERT TABLE 7.1 HERE]

The evidence that sanctions did not have their intended effect is fairly ample, and once again both coordination and sequencing issues appear to play a crucial role. China maintained its declaratory commitment to denuclearization and even sharpened it following the 2013 and 2016 nuclear tests. China also signed on to new multilateral sanctions during this period (2009, 2013 and 2016), implementing some of those in a high-profile way. However, whatever constraints China might have used quietly in its bilateral diplomacy vis-à-vis North Korea, our analysis of this period complements the findings in Chapters Three and Six. When challenged, Beijing generally came to North Korea's defense and following an important high-level visit in 2009 even deepened its strategy of economic engagement with North Korea.

We can say with some confidence that the prospective approach of the Obama and Lee administrations did not prove effective. Offering vaguely-worded inducements did not get North Korea back to the table. But we do have the important episode of the Leap Year Deal, and not enough has been made of what it reveals about the effectiveness of inducements. A modest trust-building exercise fell apart when the new regime chose to prioritize a satellite test over a significant humanitarian aid package and return to the talks. Similar conclusions can be drawn about the modest efforts of the Park Geun Hye administration (inaugurated February 2013) to pursue so-called *Trustpolitik* and a partial lifting of Japanese sanctions over the abduction issue in mid-2014. Nor did China's efforts at deep engagement secure North Korean cooperation or serve to restart the Six Party Talks; to the contrary, the period under consideration here was punctuated by the fourth nuclear test and another satellite launch in early 2016.

It is hard to avoid the conclusion that domestic political dynamics in North Korea associated with the succession—both before and after Kim Jong Il's death--had pushed the regime toward a harder line that made it impervious to both sanctions and inducements, at least of a largely prospective sort. These domestic political constraints included, inter alia, continuing insecurity following Kim Jong Il's stroke in August 2008 and the complex politics of the succession itself, which demanded careful attention to the interests of the military and security apparatus (Chapter Two). However, we do not need to rely on speculation about the internal dynamics of the regime to draw conclusions about North Korean intent. By early 2013, North had rolled out the *byungjin* line committing the country to pursuit of

its nuclear and missile program and had written these commitments into its constitution. The only offer by the North Koreans through this period was for bilateral negotiations on a peace regime, an offer it was impossible for the US to take up for both domestic and international political reasons.<sup>4</sup>

### **Engagement Manque: January 2009-March 2010**

In a controversial CNN/YouTube debate in July 2007, Barack Obama answered affirmatively to a question of whether he would be willing to meet “separately, without preconditions, in the first year of [his] administration with the leaders of Iran, Syria, Venezuela, Cuba, and North Korea.” Of political necessity, that position was subsequently modified (Bader 2012, 29). But the administration signaled at least a general willingness to build on the engagement strategy that the Bush administration had pursued prior to the breakdown of the Six Party Talks in 2008. According to Stephen Bosworth, the President’s North Korean envoy, this commitment was not only made through public statements but was communicated directly to North Korea in the President’s first few days in office.<sup>5</sup>

The stated willingness to talk did not imply the extension of concessions *ex ante*; in the words of Jeffrey Bader (2012, 7), senior director for Asian affairs at the National Security Council, policy required “breaking the cycle of North Korean provocation, extortion and accommodation (by China, Japan, Russia, South Korea and the United States), and reward.” A crucial issue that was to persist throughout 2009-10 was therefore the sequencing of the Six Party Talks and any *quid pro quos* that might be associated with them. At her nomination hearings, Secretary Clinton suggested—although she did not state--that the United States would not negotiate normalization of relations prior to complete denuclearization. The North Koreans responded furiously that normalization was not a reward for disarming and that the DPRK’s “status as a nuclear weapons state” would remain

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<sup>4</sup> . In addition to the domestic political constraints of negotiating a peace regime with a *de facto* nuclear North Korea, bilateral negotiations for a peace regime would have sidelined South Korea’s role in the process.

<sup>5</sup> . See Stephen Bosworth, Special Representative for North Korea Policy Remarks at the Korea Society Annual Dinner, Washington, DC, June 9, 2009, Secretary Clinton’s statement for her confirmation hearings on January 13 (<http://www.state.gov/secretary/rm/2009a/01/115196.htm>) and her interview with Yoichi Funabashi and Yoichi Kato of Asahi Shimbun Tokyo, Japan February 17, 2009 at <http://www.state.gov/secretary/rm/2009a/02/117626.htm>. See also Sigal 2016.

unchanged as long as North Korea was exposed “even to the slightest U.S. nuclear threat.”<sup>6</sup> Even before the missile test of April, North Korean statements introduced demands that it would be physically as well as politically impossible to meet, such as removing South Korea from the US nuclear umbrella or extended deterrent.

The Obama administration’s shift from prospective engagement to the embrace of sanctions and a return to the “two track” approach came as early as February, as intelligence foresaw the launch of a three-stage “space launch vehicle” that ultimately took place on April 5. North Korea protested vigorously that it had a right to the peaceful use of outer space and was in any case not a state party to the Missile Technology Control Regime. These legal protests notwithstanding, the launch was seen as adequately cognate to an intercontinental missile test to constitute a violation of UNSC 1718, not only by the United States, South Korea and Japan but ultimately by China and Russia as well.<sup>7</sup> After efforts by Japan to secure support for a Security Council resolution failed, a compromise was reached on a Presidential Statement. Viewed as a weaker signal, the statement nonetheless condemned the launch as a violation of UNSC 1718, closing the “missile-satellite” distinction that North Korea had sought to exploit. The Presidential Statement called for an early resumption of the Six Party Talks but also called on parties to fully implement their sanctions obligations under 1718 and to further “adjust” those measures through the designation of more entities and goods.

A classic escalatory cycle followed. But North Korean capabilities were now well advanced from what they had been, with a corresponding indifference to the resumption of talks or to quid-pro-quo involving security guarantees. Within hours of the Presidential statement, North Korea “permanently” withdrew from the Six Party Talks, declared all commitments under the talks as null and void, and threatened to resume the reprocessing of spent fuel rods, pursue construction of a light-water reactor and boost its nuclear

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<sup>6</sup> . “DPRK Foreign Ministry’s Spokesman Dismisses U.S. Wrong Assertion,” January 13, 2009 and as amended following Hillary Clinton’s nomination hearings on January 17,2009 at <http://www.kcna.co.jp/index-e.htm>. North Korea’s commitment to denuclearization was signaled only very indirectly through Chinese sources following the visit of Wang Jiarui, Chief of the International Liaison Department of the Chinese Communist Party (CCP) to Pyongyang in January 2009. Xinhua, “Top DPRK Leader Kim Jong Il Meets with Visiting CPA Official, January 23, 2008, [http://news.xinhuanet.com/english/2009-01/23/content\\_10707546.htm](http://news.xinhuanet.com/english/2009-01/23/content_10707546.htm)

<sup>7</sup> . Paragraph 2 “Demands that the DPRK not conduct any further nuclear test or launch of a ballistic missile.” In UNSC 1874 and 2094, the ambiguity was removed by prohibiting launches using “ballistic missile technologies.”

deterrent.<sup>8</sup> IAEA and US inspectors who had been on the ground at Yongbyon were ejected. On April 24, the UN Sanctions Committee issued the “adjustments” to sanctions under UNSC Resolution 1718 requested by the Presidential Statement; three additional North Korean firms were designated. The North Korean foreign ministry quickly affirmed that reprocessing had begun, suggested that the imposition of sanctions would constitute a nullification of the armistice, and threatened both further missile tests and a second nuclear test.

That second test came on May 25. Following a prolonged and difficult diplomatic process, the UN Security Council passed Resolution 1874 on June 12, calling on North Korea to cease and desist development of its nuclear and missile programs and to return to the Six Party Talks, the Nonproliferation Treaty, and the International Atomic Energy Agency (IAEA) safeguards. It is worth outlining the corresponding sanctions in some detail. Even though American policymakers did not believe that they would induce a change in course (Bader 2012, 39), they were important both for their economic effects and for the nature of the political signal they sent, including from China.<sup>9</sup>

UNSCR 1874 went beyond UNSCR 1718 in both the scope of products covered and in the means of enforcing the sanctions.<sup>10</sup> The new resolution did not constitute a trade embargo on North Korea; humanitarian assistance was explicitly excluded and the design of the sanctions excluded the vast majority of commercial trade as we saw in Chapter Three. Nonetheless, it extended UNSCR 1718 to include all arms-related trade as well as training or assistance related to such sales. The significance of these sanctions would appear small given the likely decline in weapons trade (Chapter Three), but they had bite through their effect on so-called “dual-use” technologies with both civilian and potential military uses (Abt 2014, 77-93). Moreover, the resolution called on both international institutions and member states not to undertake new grants, financial assistance, or concessional loans to North Korea and asked that they maintain “vigilance” with respect to current aid programs.

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<sup>8</sup> . “DPRK Foreign Ministry Vigorously Refutes UNSC’s ‘Presidential Statement,’” April 14, 2009 at <http://www.kcna.co.jp/index-e.htm>.

<sup>9</sup> . For an overview of China’s bilateral response to the test, see Kenji Minemura, “N. Korea Squirms after China Raps Test,” Asahi Shinbun, February 24, 2010 at <http://www.asahi.com/english/TKY201002230434.html>

<sup>10</sup> . The resolution also established a new process for overseeing the sanctions effort by creating a Panel of Experts. The independent panel would oversee the implementation of both UNSCR 1718 and UNSCR 1874, monitor efforts on the part of member states, and provide more independent recommendations to the UN Security Council than could be provided by the inter-governmental sanctions committee. See UNSC 2010, 2012, 2013, 2014, 2015, 2016

The most interesting features of the resolution have to do with means of enforcement. The new Security Council resolution came close to making the American-led Proliferation Security Initiative (PSI) a formal multilateral effort. The resolution “calls upon” member states to inspect all cargo on their territory, including at both seaports and airports, if believed to contain prohibited items and contained a number of additional provisions that would affect shipping if rigorously enforced.<sup>11</sup> The resolution provided the basis for an increase in interdictions (Table 3.1), starting with the shadowing of a North Korean ship (the Kang Nam 1) in June of 2009, ultimately forcing its return to North Korea in June 2009. Significant shipments of weapons were also interdicted in 2009 and 2010 in France, the United Arab Emirates, Thailand and South Africa.<sup>12</sup>

In addition to interdiction, the UNSC resolution explicitly provided for the use of financial means for stopping the flow of WMD-related trade. These measures were potentially more sweeping than those related to trade sanctions since the resolution permitted the blocking of transfers and even the freezing of any assets that “could contribute” to North Korea’s weapons programs or activities.<sup>13</sup> As with the BDA sanctions, the US was willing to implement these measures aggressively on its own, for example by designating new entities and individuals under existing statute and issuing an additional bank advisory with respect to North Korea (Financial Crimes Enforcement Network 2009).<sup>14</sup> Nor was it alone; between them, the United States, the European Union, Japan and Australia had made 29 “autonomous designations” of North Korean firms: sanctions that were undertaken outside of the UN sanctions designation process. The US also engaged in an active sanctions enforcement diplomacy in the Asia-Pacific to encourage others to do so as well. Following the passage of UNSC Resolution 1874, the United States appointed an Ambassador for sanctions enforcement who traveled to the region and engaged in

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<sup>11</sup> . The resolution authorized members to inspect vessels on the high seas or to escort them to port if there are reasonable grounds to believe that they are carrying prohibited cargo. It also precluded the provision of bunkering services to any ship suspected of prohibited trade, placing an additional constraint on any suspect ship.

<sup>12</sup> . An important loophole is that interdiction must have the consent of the country under which the vessel is flagged; acting under Article 41 (as opposed to Article 42) of Chapter VII, UNSCR 1874 does not authorize the use of force.

<sup>13</sup> . The ability to attach financial transactions was also a more flexible instrument than the designation of particular firms because of the ability of North Korea to proliferate shell companies that were not technically designated by the UN Sanctions committee.

<sup>14</sup> . Financial Crimes Enforcement Network Advisory, “North Korean Government Agencies’ and Front Companies Involvement in Illicit Financial Activities” (FIN-2009-A002), June 18, 2009.

consultations with officials in China, Malaysia, Thailand, Singapore, and Russia on sanctions enforcement.

As the Obama administration pursued its multilateral approach to sanctions, it also made clear that no further inducements-- including in the form of a relaxation of sanctions-- would be offered to North Korea in advance of returning to the talks. In a widely-cited comment at the ASEAN Regional Forum in Singapore in May 2009, Secretary Gates said the US was “tired of buying the same horse twice” and expressed opposition to “the notion that we buy our way back to the status quo ante....”<sup>15</sup> The US also argued (and rightly from a legal point of view) that it was in any case not in a position to relax multilateral sanctions; any such change would be contingent on North Korea taking the actions called for under UN Security Council resolutions that were multilateral in nature.

Yet if the US was unwilling to offer inducements for the purpose of getting North Korea back to the talks, the question remained of what *prospective* benefits the United States and the other five parties might offer. The U.S. administration was unwilling to commit to finalizing the process of normalization prior to complete denuclearization, and for good political reasons; it seemed implausible that such a process could even begin let alone reach a conclusion while North Korea remained a de facto nuclear power. However, the United States also recognized clearly, in the words of a senior official, that “if North Korea is to take major steps to dismantle its nuclear capabilities that there must be a corresponding set of initiatives on the part of not only the United States but South Korea, China, and Japan.”<sup>16</sup> Given the difficulties of implementing all components of the agenda outlined in the September 2005 statement of principles at one time, it seemed inevitable that the talks would have to focus on the phasing of inducements and reciprocal actions.

The issue of inducements was initially made moot, however, because the passage of UNSCR 1874 in June was met almost immediately by North Korean escalation. In June, the Foreign Ministry announced that the country would weaponize all newly-extracted plutonium, commence a uranium enrichment program, and provide a “decisive military response” to any “blockade” against the country. According to the statement, it had “become an absolutely impossible option for the DPRK to even think about giving up its nuclear weapons.”

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<sup>15</sup> . “North Korea is Warned by Gates on Testing,” New York Times, May 29, 2009.

<sup>16</sup> . Assistant Secretary of State Kurt M. Campbell, Press Availability in Beijing, China, October 14, 2009.

Yet at the same time that North Korea was escalating, it too began to signal a willingness to re-engage and bilateral talks were held between an American delegation and their North Korean counterparts in December 2009. It is possible that sanctions and deteriorating economic circumstances had some effect in this regard. Indirect evidence could be gleaned from an extraordinary proposal to South Korea that it pay for a third bilateral summit.<sup>17</sup>

North Korean counterproposals with respect to the Six Party Talks cast doubt on Pyongyang's seriousness. The diplomatic to-and-fro centered on the format under which negotiations would take place, but the proposals only served to disguise much more fundamental disagreements about the agenda. The United States repeatedly stated its willingness to engage with North Korea, including bilaterally, as long as those talks were held "within the framework" of the Six Party Talks. Not only did the Six Party Talks provide a multilateral venue for coordinating with Japan, South Korea, China and Russia; holding negotiations under the aegis of the Six Party Talks also assured that diplomacy would focus on denuclearization. The United States repeated its opposition to "talks for talks' sake," and sought to reconfirm Pyongyang's commitment to agreements made in prior rounds of the talks. These included most notably in the September 2005 statement of principles and the implementation accords of February and October 2007.

Over the course of late 2009, a new North Korean strategy emerged that was deeply at odds not only with US and South Korean views, but with the view of the other five parties as well. North Korea appeared to support a return to multilateral talks through initial bilateral talks, and promised the high-level access that would permit indirect contact to the leadership; this constraint had plagued the late 2008 negotiations. However, multilateral talks among the armistice parties and bilateral talks with the US were now advanced as a precondition for even resuming—let alone completing—the agenda spelled out through the Six Party Talks process.<sup>18</sup> Moreover, the objectives of the talks would not be limited to a

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<sup>17</sup> According to Lee Myung Bak's memoir, the North Koreans asked for 100,000 tons of corn, 400,000 tons of rice, 300,000 tons of fertilizer, \$100 million USD worth of asphalt, and \$10 billion to capitalize a development bank for North Korea. See Choe, Sang-Hun. 2015. "North Korea Sought Talks and Attached a Hefty Price Tag, South's Ex-Leader Says." *New York Times*. January 29. At <http://www.nytimes.com/2015/01/30/world/asia/north-korea-sought-talks-and-attached-a-hefty-price-tag-souths-ex-leader-says.html>

<sup>18</sup> In an early formulation of the proposal by the Foreign Ministry, for example, North Korea allows that talks on a peace regime may be held "either at a separate forum as laid down in the September 19 Joint Statement or in the framework of the six-party talks for the denuclearization of the Korean Peninsula like the DPRK-US talks now under way..." "DPRK Proposes to Start of Peace Talks," KCNA January 11, 2010 at <http://www.kcna.co.jp/index-e.htm>. After a meeting with the Chinese leadership

bargain over North Korean denuclearization, but the “denuclearization of the entire peninsula.” Given that the US had withdrawn all tactical nuclear weapons from the peninsula under the George H.W. Bush administration and South Korea had no nuclear weapons program, this formulation implied a reconsideration of the extended deterrent and even US possession of nuclear weapons.

China sought to bridge the divide through intense diplomatic activity in February and March 2010. However, these efforts were preceded by an even more crucial high-level visit that brought a rich array of incentives to bear. Rightly seen as an inflection point in Beijing’s approach to North Korea (see Appendix One, Figure A.1), the visit effectively ratified Beijing’s “deep engagement” approach outlined in Chapter Six and extended a host of new direct and indirect supports.

In October 2009, Premier Wen Jiabao became the first Chinese premier in nearly two decades to visit Pyongyang, bringing with him a high level delegation of economic officials. This diplomatic effort set the stage for a succession of visits by Kim Jong Il to China in May and August 2010 and May 2011. Although taking place against the backdrop of ongoing North Korean reluctance to engage in the Six Party talks and the clashes with South Korea we describe below, each visit was scripted by China with a strong economic agenda, suggesting the benefits of reform. But as Reilly (2014a, c) summarizes, the most consequential effects of these meetings was increased Chinese engagement (see also Li 2016). On his trip, Wen promised to build a new bridge across the Yalu River (at an estimated cost of US\$150 million), signed a number of diplomatic accords, including a new aid agreement (Reilly 2014c), designated 2010 as the “Year of Sino-Korean Friendship,” and agreed to establish two new joint economic development zones on islands in the Yalu river. A host of Chinese initiatives followed these diplomatic exchanges, including use of the Chinese ambassador in Pyongyang to mobilize foreign investment in the country, announced support for Chinese firms, the creation of a Fund for Investment in North Korea through the Chinese Overseas Investment Federation, and commitments to the provision of infrastructure.

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in October 2009, Kim Jong Il stated that “We expressed our readiness to hold multilateral talks, depending on the outcome of the DPRK-U.S. talks. The six-party talks are also included in the multilateral talks.” This suggests both the importance of bilateral talks and the fact that multilateral talks must not be limited to the Six Party talks (“Kim Jong Il Visits Wen Jiabao at State Guest House,” KCNA October 5, 2009).

But what really mattered was the signal these measures sent to Chinese firms in sectors such as mining, including national-level SOEs (China Minmetals Corporation), provincial-level SOEs (Tonghua Iron and Steel) and large private groups (Wanxiang). Firms from the Northeast showed a particular interest in the opening, an outcome that fit with the 2002 national campaign to “revitalize the north-east” (*zhenxing dongbei*). Provincial and even municipal officials in cities such as Dandong and Jilin jumped on the bandwagon set loose by the Wen and Kim Jong Il visits, a phenomenon Reilly dubs “local liberalism” (2014b, 7). The rapid exploitation of the signals sent by the central government not only generated deeper cross-border ties but an effective lobby for closer North Korean relations and the provision of supporting infrastructure on the Chinese side of the border (Reilly 2014a, b).

We have no smoking gun to prove that these efforts at “deep engagement” on the part of China had the direct effect of undermining the prospects for talks. But whatever the intent of the Chinese initiatives, they clearly did not have the effect of restarting the talks; indeed as we will see in the next section they unfolded against a backdrop of North Korean provocations vis-à-vis the South. A procedural proposal by the Chinese would have granted North Korea another round of bilateral meetings with the United States, but was to be followed by a preparatory six party meeting in anticipation of a full resumption of the Six Party Talks. Accepting the Chinese proposal, the US saw the steps as linked, with the bilateral meetings tied to a commitment to resume the talks. Despite early Chinese optimism about the proposal, North Korea remained silent on it. Before a North Korean envoy could come to New York to explore the diplomatic options, the *Cheonan* incident occurred, turning policy in both the US and South Korea in a harder direction.

### **From the Sinking of the Cheonan to the Leap Year Deal**

In contrast to the Obama administration’s initial willingness to engage, Lee Myung Bak had explicitly run on a platform that rejected the approach to the North of the Kim Dae Jung-Roh Moo Hyun era. These differences initially put Seoul and Washington at odds, even at the end of the Bush administration (Sigal 2009). With the events of 2009, the sinking of the *Cheonan* and shelling of Yeongpyeong Island in 2010, however, the two governments converged around a steadily-tightening sanctions regime.

In March 2008, the Lee administration outlined a quite comprehensive set of economic inducements for North Korea under the rubric of the “Mutual Benefits and Common Prosperity” policy or “Vision 3000 through Denuclearization and Opening,” the latter because of its stated objective of lifting North Korea’s per capita income to \$3000 (Suh 2009). Three features of the Lee Myung Bak policy constituted a departure from that of his predecessors; all centered on demands that North Korea reciprocate. The first was its insistence that progress on denuclearization be made a condition for progress on North-South relations. The economic incentives on offer were initially linked to a return to the 2007 roadmap agreements that came out of the Six Party Talks, a linkage that North Korea had always rejected.

The second departure was the implicit assumption that the aid on offer from the South would be conditional on reform and opening in the North, an assumption that was increasingly divergent with North Korean realities (Chapter Two). On completion of the second phase of the 2007 roadmap, the South Korean government would initiate five wide-ranging economic development programs with the North, all premised however on sweeping reforms. The program included creating new free trade zones and building up export-oriented firms; major investment in infrastructure, including a North-South highway; education and vocational training aimed at increasing productivity and international competitiveness; and both government and NGO involvement in improvement of social infrastructure. These were to be backed by the fifth initiative: the orchestration of a massive \$40 billion fund to be disbursed over ten years and financed by the Inter-Korean Cooperation Fund, the international financial institutions (which North Korea would enter), foreign investment, and the aid package that was expected from normalization of diplomatic relations with Japan.

Third, and implicit in these two other components of the program, was a shift away from providing relatively unconditional aid. Even humanitarian support was made conditional on much tighter monitoring of actual conditions, transparency in distribution and North Korean conformity with international standards governing humanitarian assistance. As we have seen, the effect of these new standards was a rapid decline in South Korean assistance.

North Korea’s response to Lee’s initiative was particularly vitriolic, rejecting both the demands for denuclearization and opening and arguing for a return to the principles articulated in the two North-South summit declarations (June 15 2000 and October 4 2007);

reference to these two documents from the engagement era were to be a leitmotif of North Korean diplomacy toward the South through the entire period considered here. The Lee administration's approach was softened marginally in an important National Assembly speech July 11 2008 delivered in the immediate aftermath of the murder of a tourist by the North Korean military at the Mt. Kumgang resort. President Lee acknowledged the progress being made through the Six Party Talks and called for dialogue in order to implement the joint declarations. North Korea quickly rejected that initiative as well.<sup>19</sup> Even prior to the events of 2010 discussed below, virtually all aspects of the North-South relations went into abeyance, including the elaborate structure of North-South meetings built up over the previous decade (see Table 6.2).

But the North Korean response was not simply rhetorical; it extended to a significant restructuring of the military units responsible for the South<sup>20</sup> and a series of military encounters along the de facto maritime border in the West Sea (Roehrig 2009).<sup>21</sup> In early 2009, the North began a sustained escalation around the Northern Limit Line (NLL). In January 2009 Pyongyang declared its intention to protect its own alternative version of the maritime border and suggested it would not be bound by the armistice. Tensions around the issue escalated further when Korea joined the Proliferation Security Initiative in the wake of the second nuclear test in May 2009. The North Korean military responded by declaring that it could not guarantee the "legal status" of five South Korean islands that the NLL had been drawn to incorporate. Throughout the remainder of the year and into early 2010, North Korea repeatedly conducted short-range missile and artillery tests off both coasts. Particularly important in this pattern of escalation was a skirmish in November that resulted in the damage of a North Korean vessel and loss of life; this event was almost certainly the precursor to the subsequent sinking of the *Cheonan* the following March.

The question of how the Lee Myung-bak government handled the investigation of the *Cheonan*, whether it was used for political purposes, and whether the North Koreans

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<sup>19</sup> KCNA, "Lee Myung Bak's 'Policy Speech' under Fire," July 13, 2008.

<sup>20</sup> . The General Reconnaissance Bureau integrated a number of intelligence agencies and operational units under the Workers Party (the Operations Department and Overseas Intelligence Investigation Department [Office 35] and the Reconnaissance Bureau of the Ministry of the People's Armed Services. It is assumed that the General Reconnaissance Bureau had responsibility for the sinking of the *Cheonan*, and Kim Jong-il visited the unit shortly after the incident.

<sup>21</sup> The Northern Limit Line was drawn unilaterally by the UNC following a failure to agree on a maritime border during the armistice negotiations. The NLL had effectively served as the de facto maritime boundary in the West Sea for decades, but North Korea began to contest it in the 1970s for a combination of strategic and economic reasons. Armed clashes occurred around the NLL in 1999, 2002 and 2004.

were culpable as charged became contested political questions in South Korea (Civilian-Military Joint Investigation Group 2010, Suh and Lee 2010, Lee and Yang 2010, You 2014). From our perspective, however, the most important consequence was the effect of the incident on the strategies of both South Korea and the U.S. toward the North. In a nationally televised address from the Korean War Memorial on May 24, President Lee announced a sweeping new sanctions regime against the North, subsequently known as the “May 24 measures.”<sup>22</sup> The sanctions included the prohibition of both general and processing-on-commission trade, effectively limiting North-South trade to the Kaesong Industrial Complex.<sup>23</sup> Humanitarian aid was suspended except for aid targeting vulnerable groups such as children, and effectively that assistance fell of as well.

US policy followed suit. Even before the full report of the incident had been made public, Secretary of State Clinton endorsed the Lee administration’s approach, including its intention to bring the issue before the Security Council, and hinted at a full review of all US policies toward North Korea. The Joint Communique of the 42<sup>nd</sup> U.S.-ROK Security Consultative Meeting in October contained a particularly explicit commitment to extended deterrence, including reference to the nuclear umbrella, and the creation of an Extended Deterrence Policy Committee.

In a highly symbolic press conference at the DMZ in July, Secretary of State Clinton—accompanied by Secretary of Defense Gates—announced the administration’s intention to levy new sanctions on North Korea as well. Less than a month later, President Barack Obama signed a new executive order (EO 13551) targeting any entity that facilitated North Korean arms trafficking, import of luxury goods or other illicit activity on behalf of Pyongyang. These included money laundering, counterfeiting of goods and currency and cash smuggling associated with the notorious “Office 39” of the Korean Workers’ Party, long believed to provide slush funds to the top leadership, including through receipts from illicit activities (UNSC 2010; Gause 2015, 175-218).

The North Koreans again responded to sanctions by escalating. After American scientist Siegfried Hecker visited Yongbyon at North Korea’s invitation in November 2010, he reported that he had witnessed an estimated 1,000 centrifuges at the nuclear complex

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<sup>22</sup> . The sanctions regime is contained in Ministry of Unification, “Announcement of Measures Against North Korea,” at <http://nautilus.org/wp-content/uploads/2011/12/2010MOU.pdf>.

<sup>23</sup> . New investments into the country, including into Kaesong were also proscribed and the number of South Korean personnel in the zone reduced. The sanctions also prohibited North Korean ships from entering South Korean waters and banned all South Korean visits to the North outside of the Kaesong and Kumgang projects.

(Hecker 2010). Hecker's visit was clearly a pointed North Korean signal, and raised questions about the extent of North Korean cooperation with third parties such as Iran and Pakistan. It also revealed effective North Korean circumvention of UNSC Resolutions 1718 and 1874.

Only a few days following the release of Hecker's report, on 23 November 2010, North Korea shelled Yeonpyeong Island near the disputed Northern Limit Line killing two South Korean military personnel, two South Korean civilians, injuring an additional score, and damaging the island's infrastructure. The stated justification was the ongoing North Korean rejection of the legitimacy of the NLL and threats posed by joint US-South Korean military exercises in its vicinity.

Even more clearly than in the past, China's actions suggested an extreme unwillingness to take sides against North Korea let alone impose material costs. After issuing bland calls for calm "on both sides," and blocking UN Security Council action on the matter, China called for an "emergency session" of the Six Party Talks. The Chinese proposal was quickly rejected by South Korea, the United States, and Japan. Rather, the U.S. outlined in more detail that the talks could only restart on the basis of prior North Korean actions that signaled seriousness of intent. These preconditions included: an announced freeze on nuclear tests; a freeze on missile tests; a verifiable freeze on the enrichment program, to be monitored by the readmission of IAEA inspectors; a commitment to the 2005 joint statement; and a commitment to abide by the armistice.

On the military front, the US and South Korea went forward with planned joint naval exercises in the Yellow (West) Sea involving the US aircraft carrier the *George Washington*, despite earlier Chinese objections (Bader 2012, 90-91). President Lee Myung-bak replaced the defense minister and both he and the new defense minister made public comments about more forceful military responses to future North Korean provocations. South Korea undertook the largest civil defense drill in decades. US Chairman of the Joint Chiefs of Staff Adm. Mike Mullen re-enforced this message by visiting Seoul and signaling support for a marked relaxation of South Korean rules of engagement.

In both the US and South Korea, a minority argued that the two allies were caught in the same dynamic as the Bush Administration, with sanctions only serving to escalate rather than mitigate tensions and some form of engagement providing the only way out.<sup>24</sup>

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<sup>24</sup> . Interestingly, Siegfried Hecker held this view. See Hecker 2010.

However, in neither country was the political configuration favorable for re-engagement. Public opinion in South Korea swung strongly behind the Lee administration's strategy of further sanctions and demands for strict reciprocity. In the US, the November 2010 Congressional elections resulted in a Republican majority in the US House of Representatives and a narrowed Democratic majority in the Senate. This political configuration was strongly reminiscent of the that facing President Clinton when Republicans took control of Congress in 1994 and proceeded to use North Korea policy as a cudgel to beat the administration (Noland 2000, Hathaway and Tama 2004). Nonetheless, a deepening food crisis in 2011 (Chapter Four) and a Chinese diplomatic initiative set the stage for the final effort in the period covered here to deploy inducements vis-à-vis North Korea.

### **The Rise, Fall and Aftermath of the Leap Year Deal**

As we showed in Figure 4.1, the re-emergence of food problems can be seen in the secular decline in aggregate food supply starting in late 2005. Partly a result of reversals of reform such as the ban on private trading in grain and efforts to revive the PDS (Haggard and Noland 2009), high politics also played an important role in the shortages. Following the missile and nuclear tests in 2006, South Korea suspended fertilizer shipments and multilateral food aid dried up as a result of general donor fatigue. With global food prices rising sharply from late 2007, the regime's capacity to import grain on commercial terms was also seriously impaired. The aid deal of 2008 promised help, but by March of 2009 less than a third of the aid had been shipped because of ongoing conflicts over access. Following the tensions of early 2009, North Korea decided to walk away from the aid program altogether. Later in the year, the disastrous currency reform of November 2009 set in train an inertial inflation that was to persist for over three years, exacerbating the challenges facing households.

Over the first half of 2011, signs mounted of increasing distress including a number of exogenous shocks: adverse weather during both the 2010 planting season (extreme cold) and prior to the harvest (floods in August and September; FAO 2010) and the continuing rise in world food prices. An NGO assessment found food rations at near-famine era levels

(Weingartner 2011).<sup>25</sup> North Korean behavior also showed rising concern, for example in aggressive requests for bilateral aid and ultimately in approaches to both the South and the United States.

This sequence of events posed all of the humanitarian dilemmas outlined in the Introduction and Chapter Four. Should humanitarian assistance be separated from politics? Or could aid providing an opening wedge to dialogue? These dilemmas were on ample display in 2011-12 in the negotiation of the Leap Year Deal. Yet no sooner had a deal been reached that effectively offered food in exchange for a freeze than the regime signaled its priorities by attempting a satellite launch. The launch not only scuttled the initiative but set in train an escalatory cycle from which the parties did not emerge until mid-2013.

In parallel to these developments, China engaged in a diplomatic initiative designed to offer an exit from the stalemate generated by the sinking of the *Cheonan* and the shelling of Yeonpyeong Island. China's three-step formula consisted of a reopening of North-South channels, followed by bilateral talks with the US, and then a full resumption of the Six Party Talks. Following a breakthrough meeting between South Korean chief nuclear negotiator and his North Korean counterpart on the sidelines of the ASEAN Regional Forum in July, North Korea expressed willingness to implement the September 2005 Joint Statement and to make joint efforts to resume the Six Party Talks. This initiative was followed by two more rounds of North-South talks—although bilateral relations soured badly after the death of Kim Jong Il (Foster-Carter 2012)—bilateral discussions with the US in July, October and February, supplemented by separate talks on humanitarian assistance (Clinton 2011). An important meeting between Chinese Vice Premier Li Keqiang and Kim Jong Il in Pyongyang in October appeared to bless these efforts at rapprochement at the highest level (Zhang 2011).

The central product of these diplomatic efforts came in the so-called “Leap Year deal,” codified in subtly-different but largely congruent statements by the U.S. (Department of State 2012) and the North Korean Ministry of Foreign Affairs on February 29, 2012. The core quid pro quo—and a controversial one—was that the US would provide 240,000

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<sup>25</sup> See Marcus Noland, “Slave to the Blog: Updates Galore!” North Korea: Witness to Transformation blog, February 24, 2011 at <http://blogs.piie.com/nk/?p=463>; Stephan Haggard, “Food Backgrounder,” North Korea: Witness to Transformation blog, March 15, 2011 at <http://blogs.piie.com/nk/?p=657>; Haggard and Noland, “Blog post on 38North: ‘Logic and Illogic of Food Aid,’” North Korea: Witness to Transformation blog April 13, 2011, at <http://blogs.piie.com/nk/?p=870>; Noland and Haggard, “Parsing the WFP/FAO Report,” North Korea: Witness to Transformation blog, April 5, 2011 at <http://blogs.piie.com/nk/?p=826>

metric tons of nutritional assistance based on an appropriate monitoring protocol but “with the prospect of additional assistance based on continued need.”<sup>26</sup> The United States also included a statement of non-hostile intent and a willingness to allow people-to-people exchanges. For its part, the North would implement a series of steps that conformed broadly to the U.S. preconditions approach to restarting the Six Party Talks: a moratorium on long-range missile launches, nuclear tests and nuclear activities at Yongbyon, including uranium enrichment activities; and an agreement to allow IAEA inspectors to verify and monitor the moratorium and confirm the disablement of the 5-MW reactor and associated facilities. Despite subtle differences in the two statements,<sup>27</sup> they clearly reflected an agreement rooted ultimately in a “food for freeze” quid pro quo, administration claims to the contrary notwithstanding.

On March 16—with the regime now firmly under the leadership of Kim Jong Un—North Korea announced its intention to launch a satellite to commemorate Kim Il Sung’s 100th birthday. The announcement came barely two weeks after the Leap Year deal was rolled out, the attempted launch on April 13 about six weeks after it. Theories quickly proliferated about why the new leadership chose to test, including the symbolic value of the launch in Kim Il Sung’s centenary, the need to carry out a legacy project inherited from Kim Jong Il, and the need for the new leadership under Kim Jong Un to show resolve to both foreign and domestic audiences, particularly in the military. The leadership may also have simply miscalculated, believing that they could diminish opposition to the launch by proceeding with the terms of the nuclear component of the deal; only three days after the satellite launch announcement, the IAEA confirmed that they had in fact been invited back into North Korea to inspect facilities.

Whatever the domestic circumstances that generated the launch, and the legalistic justification North Korea offered,<sup>28</sup> three conclusions are germane here. The first is that

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<sup>26</sup> . DPRK Foreign Ministry Spokesman on Result of DPRK-U.S. Talks. 2012. KCNA. February 29. <http://www.kcna.co.jp/index-e.htm> and Nuland, Victoria. 2012. U.S.-DPRK Bilateral Discussions. Press Statement. February 29. <http://www.state.gov/r/pa/prs/ps/2012/02/184869.htm>

<sup>27</sup> . The North Korean statement made explicit mention of the fact that this interim step was a prelude to a resumption of the multilateral talks in which the lifting of sanctions, a peace regime and even the provision of light water reactors would be on the table. The American statement was silent on the resumption of talks and only noted that sanctions were not targeted at the welfare of the North Korean people.

<sup>28</sup> . Pyongyang claimed that Leap Year agreement made no explicit mention of satellite launches and that North Korea had the right to peaceful use of outer space as a signatory to the Outer Space Treaty. However, UNSC Resolution 1874 had been quite explicit in “deciding”—thus with the force of international law—“that the DPRK shall suspend all activities related to its ballistic missile

inducements were unable to secure even a freeze of North Korea's nuclear and missile programs nor offset whatever domestic political dynamics were at work to generate the launch.

Second, the announcement of the launch not only led to the collapse of the Leap Year deal but to further sanctions and the onset of another escalatory cycle. The US immediately withdrew its offer of food aid; North Korea responded by rescinding its invitation to IAEA inspectors. The launch not only scuttled the prospects of reconvening negotiations but raised the bar on them and generated pressure for more sanctions. Condemnation was not limited to the US, South Korea and Japan. Both Russia and China denounced the launch as well and quickly agreed to an April 16 UNSC President's Statement that outlined stronger actions than the tepid compromise Presidential Statement of April 13, 2009. For example, the 2012 Statement subjected new companies to the asset freeze, banned new technologies for transfer to North Korea, and promised more intensive monitoring of enforcement through an updated work program for the sanctions committee.<sup>29</sup>

The third conclusion centers on the complex coordination and moral hazard problems surrounding China's relationship with its North Korean client. A collection of Chinese documents on the late Kim Jong Il period (Cathcart and Madden 2012) shows that he sought assiduously in his last months to solidify economic, political and security ties with China: presiding over additional economic initiatives, meeting with and introducing his son to the incoming PRC Premier, and holding discussions with a top People's Liberation Army general. With the death of Kim Jong Il, China maintained its declaratory policy vis-à-vis North Korea's nuclear and long-range missile programs, but was simultaneously forced to define its position with respect to the succession.

Thanks to a second dossier assembled by Adam Cathcart (2012a), we have a near complete record of all official Chinese pronouncements surrounding the succession, as well as press and expert commentary. The immediate political reaction was unambiguous: the Chinese leadership—and at the very highest levels—both blessed the succession<sup>30</sup> and

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programme” and “that the DPRK not conduct any further nuclear test or any launch using ballistic missile technology.” U.S. negotiators—concerned about intelligence regarding a possible launch—claimed that they made it clear to their North Korean counterparts that the test of a satellite would be seen as a violation of the agreement.

<sup>29</sup> . Statement by the President of the Security Council, April 16, 2012, S/PRST/2012/13.

<sup>30</sup> . In its condolence message, China stated its expectation that North Korea “will remain united as one with the leadership of the Workers' Party of Korea (WPK) and comrade Kim Jong Un.” When condolences were expressed at the DPRK embassy, virtually the entire top Chinese leadership was present: President Hu Jintao, Vice President Xi Jinping, Wu Bangguo, propaganda chief Li Changchun,

summoned ambassadors from the five parties to assure them that the succession was going smoothly and warn against external meddling. Editorials reflecting the official position—and in some cases differing between their Chinese and English-language versions—emphasized that China must signal that it would protect North Korea’s independence, not meddle in its internal affairs, and take a strong stance against instability or “upheaval” (Cathcart 2012, 23-26). Moreover, while the magnitude of support remains debated, the Chinese stance was backed by a substantial injection of financial and material support, including food aid through the World Food Program at the peak of the lean season, support for the 100<sup>th</sup> anniversary celebration of the birth of Kim Il Sung (Cathcart and Madden 2012, He 2013; Reilly 2014b, c)<sup>31</sup> and later in the year by a virtual restatement of the “deep engagement” approach during a visit by Jang Song Thaek to Beijing. The Wen Jiabao-Jang Song Thaek joint communiqué and other statements emanating from the trip contained ample evidence of Chinese pique at North Korean reticence to undertake more wide-ranging reform and opening (Cathcart 2012b). Nonetheless, the statements also reaffirmed the “deep engagement” approach.

### **“Déjà vu All Over Again”: The December 2012 and February 2013 Missile and Nuclear Tests**

The failed satellite launch of April had brought the new North Korean leadership the worst of all possible worlds: a spectacular technological failure—and on full international and domestic media view—as well as the loss of a non-trivial aid package. It was thus a virtual certainty that the regime would try again, which it did with the second satellite on December 12. The 2012 satellite test set in train another cycle of sanctions, escalation in the form of the third nuclear test of February 12, 2013, and still further efforts to constrain North Korean behavior. These efforts included not only incremental changes in the sanctions regime but some of the most overt military posturing on the peninsula since the onset of the second nuclear crisis in late 2002. As we saw in Chapter Two, North Korea

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Vice Chairman of the Central Military Commission Guo Boxiong, Foreign Minister Yang Jiechi, and head of the CPC International Department Wang Jiarui. Wen Jiabao, Jia Qinglin, Li Keqiang, He Guoqiang, and Zhou Yongkang visited the embassy the next day.

<sup>31</sup>. In an important essay on China’s aid relationship with the DPRK by a leading expert with high-level access, Fang He (2013) claimed that China gave unconditional aid to the new regime in 2012 and the first half of 2013 totaling 600 million renmenbi (approximately \$100 million), in He’s view an unprecedented amount.

became even more explicit than ever in its commitment to retain its nuclear capability and develop a variety of delivery systems for it.

The second 2012 satellite test generated more than a month of contentious negotiations at the Security Council. Beijing and Washington finally struck a deal on UN Security Council Resolution 2087 (January 22, 2013), a step up from the President's Statement following the April launch. The resolution made marginal adjustments to the sanctions regime.<sup>32</sup> But US negotiators extracted a stated commitment to additional actions in the case of subsequent tests, a commitment it sought to cash following the fourth nuclear test in January 2016. Beijing also engaged in quite visible bilateral diplomacy as well, summoning North Korea's Ambassador several times in late January and publicly warning against the risks of a third nuclear test.

The North Korean response was almost immediate, and the statement—issued in the name of the National Defense Commission—constituted a clear indication of the shift in political direction that would be codified following the nuclear test in the *byungjin* line.<sup>33</sup> The statement effectively said that North Korea would never denuclearize; the only condition under which it would do so was global denuclearization. In the interim, not only were the Six Party Talks again declared dead, this time permanently (“...there will no longer exist the six-party talks...”). The statement also disavowed North Korean commitment to the September 19 joint statement that had been the single most significant achievement of the Six Party Talks process. The statement openly declared that the country would undertake a third nuclear test and would undertake satellite launches “one after another.” Moreover, while the statement noted that the UN Security Council resolution was “worked out through backstage dealing with the U.S. as a main player” it was adopted by the UNSC with “blind hand-raising by its member nations,” a particularly defiant statement vis-à-vis China. The next day, a similar statement followed vis-à-vis the South,<sup>34</sup> aimed at the incoming Park government--elected in December—which had articulated a more forthcoming posture toward the North (Park 2011, 2012). The statement formally disavowed the North-South

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<sup>32</sup>. The resolution expanded travel bans and asset freezes to four additional individuals and six additional entities, urged vigilance vis-à-vis the activities of North Korean officials abroad, including bulk cash transactions, and promised clarification of protocols for inspecting ships if the flag country or the DPRK refuses permission.

<sup>33</sup> . “DPRK NDC Issues Statement Refuting UNSC Resolution,” KCNA January 24, 2013, which simply cites the NDC statement in full.

<sup>34</sup> . “S. Korean Authorities Accused of Fabricating UN “Resolution” with Foreign Forces,” KCNA, January 25, 2013, reproducing a statement from the Committee for the Peaceful Reunification of Korea.

denuclearization agreement of 1991 and threatened attacks on the south if sanctions were implemented.

The nuclear test of February 12 once again set in train negotiations at the UN Security Council that effectively codified the multilateral sanctions regime that would remain in place through the fourth test in January 2016. The new sanctions contained in UN Security Council Resolution 2094 (March 7, 2013) can be divided between “punitive” sanctions aimed at changing the regime’s behavior—mainly a codification of sanctions on luxury goods<sup>35</sup>--and “defensive” sanctions aimed at impeding the North Korean nuclear weapons program and its proliferation activities. In addition to designation of new individuals and entities subject to travel bans and asset seizures, China agreed for the first time to language urging member states to prohibit any financial flows that might be associated with these programs. For example, states could block the establishment of correspondent relationships with banks in their jurisdictions. Although the language effectively excluded a range of North Korean accounts in China they did set the stage for US sanctions against North Korea’s Foreign Trade Bank, an effort to send a warning to Chinese commercial banks.<sup>36</sup> The new resolution also called on member states to deny ports or over-flight rights to ships and airplanes believed to be involved in the military programs or evasion of sanctions, and even calls for “enhanced vigilance over DPRK diplomatic personnel” to prevent them from engaging in proliferation activities.

Because of the opacity of the underlying connections to the weapons programs, these measures were bounded by a “credible information” clause: that governments can refuse to implement them if they claim lack of “reasonable grounds” to do so, granting substantial discretion in enforcement. Yet the test had clearly come as a surprise to China, unleashing a domestic debate on the issue (Beauchamp-Mustafaga 2013) and highly visible signals with respect to enforcement. These included the decision to join US sanctions against the Foreign Trade Bank and publication of a detailed dual-use technologies list in September (Cavazos, Hayes and van Hippel 2013).

What followed the new sanctions resolution—before they could even have material effect—was a succession of particularly escalatory moves; these are outlined in Table 7.2.

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<sup>35</sup> . Although it established for the first time a common definition of the term, the list was shortened at Chinese insistence and had in any case proven leaky as we saw in Chapter Three. The common list consisted only of jewelry, yachts, luxury autos, and racing cars, far shorter than individual lists that had been produced by Australia, the European Union, Japan, or even Russia.

<sup>36</sup> . See Stephan Haggard, “Financial Sanctions: The Devil in the Details,” North Korea: Witness to Transformation blog, March 12, 2013 at <http://blogs.piie.com/nk/?p=9679>

To be sure, many of North Korean “actions” were rhetorical, of dubious credibility and broadly in line with past responses to regularly-scheduled joint US-ROK military exercises.<sup>37</sup> Moreover, careful reading suggests most of these actions were defensive and designed to deter. However, threats to pre-empt and to launch attacks on the U.S. were novel and met with sharper responses than in the past. The United States initially augmented deployed forces in a way designed to signal resolve, including through mock bombing runs by nuclear-capable 5-52 and B-2 bombers.<sup>38</sup> In the midst of the exercises, Secretary of Defense Hagel announced a major ballistic missile defense initiative, including installation of 14 additional interceptors. The US and South Korea finalized a Combined Counter-Provocation Plan that defined new rules of engagement to assure a more rapid although response to North Korean military probes.

In addition to conventional military signaling, North Korea was quick to play the nuclear card. On April 2 the General Department of Atomic Energy announced concrete steps to restart both enrichment and reprocessing at Yongbyon, and explicitly for weapons purposes. Through the end of the period considered here, ongoing analysis of satellite imagery coupled with statements by the government itself suggested continual augmentation of the country’s nuclear capabilities: in evidence that the 5MW reactor had in fact been restarted; in completion of a light-water reactor; in expansion of the enrichment facility; in evidence of reprocessing; and in the stocks of fissile material already accumulated (International Atomic Energy Agency 2014; Albright 2015). In March 2014, the Foreign Ministry announced that the country was considering a “new form of nuclear test for bolstering up its nuclear deterrence,” with subsequent statements reiterating the right to conduct further nuclear tests.<sup>39</sup> The steps in the nuclear program were also matched by a sharp increase in missile testing (Lewis 2015) including evidence of an effort to develop a submarine-launched ballistic missile (SLBM) capability.

[INSERT TABLE 7.2 HERE]

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<sup>37</sup> . Key Resolve is a computer-assisted simulation exercise and ran from March 11 to 21 March 2013. Foal Eagle consists of combined field training-exercises involving approximately 10,000 US and 200,000 South Korean troops.

<sup>38</sup> . Adam Entous and Julian E. Barnes, “U.S. Dials Back on Korean Show of Force,” *Wall Street Journal*, April 3, 2013.

<sup>39</sup> . “DPRK FM Blasts UN for Taking Issue with DPRK over Its Justifiable Rocket Launching Drills”, KCNA, 30 March 2014; “WPK’s Line on Simultaneously Carrying On Economic Construction, Building of Nuclear Forces Is Justifiable”, KCNA, 3 April 2014.





Finally, as we showed in Chapter Two, these developments unfolded against broader political and doctrinal developments. Most significantly, the crisis overlapped with the roll-out of the *byungjin* line committing the regime to both economic reconstruction and continuing development of its nuclear program.

Subsequent diplomatic efforts to engage occurred along two axes: efforts by the five parties, and particularly China, to restart the Six Party Talks; and efforts to resume North-South talks as a prelude or complement to broader re-engagement. With respect to the reconvening of the Six Party Talks, North Korea moved toward a policy of holding talks “without preconditions,” effectively demanding that the United States drop its insistence on up-front actions. While such offers initially conceded denuclearization as an ultimate objective, they also asserted “the legitimate status of the DPRK as a nuclear weapons state” in the interim and suggested a range of prior actions the U.S. would have to take before denuclearization could proceed or talks could even start. Moreover North Korea continued to link denuclearization on the peninsula to wider global steps toward nuclear disarmament or an explicit rejection on the part of the United States of its long-standing policy of extended deterrence.<sup>40</sup> An offer made in January 2015 to trade a suspension of joint exercises for a moratorium on nuclear testing was a clear non-starter: the offer in fact required no action on North Korea’s part and provided no assurances on the further development of the program.<sup>41</sup> Over the course of 2015 and in the run-up to the fourth nuclear test in 2016, North Korea appeared to show less and less interest in the Six Party Talks, emphasizing the need to negotiate a peace regime first.<sup>42</sup>

For its part, the United States—as well as South Korea and Japan—continued to hew to “strategic patience”: that no up-front inducements were on offer and that North Korea had to signal intent by meeting existing obligations before talks good commence (for example, Davies 2013). Yet in intense diplomatic exchanges in September-November 2014, signals were sent that these preconditions could be moderated at least in part, for example

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<sup>40</sup>. The first of these offers—and one of the more complete in its justification—was made in statement issued by the NDC in June 2013. “DPRK Proposes Official Talks with U.S.,” KCNA, June 16. By early 2014, the stance of the regime had hardened significantly, with virtual rejection of denuclearization and threats to continue testing both nuclear weapons and missiles: “NDC of DPRK Clarifies Stand on U.S. Hostile Policy Towards It,” March 14, 2014.

<sup>41</sup>. Stephan Haggard, “More New Year’s Initiatives,” Witness to Transformation blog, January 13, 2015 at <http://blogs.piie.com/nk/?p=13772>.

<sup>42</sup>. See for example “Letter dated 19 October 2015 from the Permanent Representation of the DPRK to the United Nations address to the president of the Security Council,” S/201/799. Sigal 2016 dissects these proposals.

by undertaking some actions after talks had been reconvened.<sup>43</sup> In addition to several Track 2 exercises, these signals included two public offers of direct bilateral talks from the US and an invitation to a high-level Track 1.5 dialogue with all lead five party negotiators, effectively a meeting “without preconditions.” Yet despite these concessions—orchestrated in part by China’s persistence--North Korea continued to demur with respect to the Six Party Talks, even engaging in a massive and highly public hack of Sony Pictures Entertainment that brought forth additional US sanctions (Haggard and Lindsay 2015). Insistence on negotiation of a peace regime had become the centerpiece of North Korea’s strategy.

The tribulations of President Park Geun Hye’s *Trustpolitik* followed a similarly dispiriting path. Although complex and involving many discrete components (Ministry of Unification 2013), the conceptual underpinning of *Trustpolitik* was the effort to find a middle ground between the largely-unconditional engagement of the Kim-Roh years and the “prior expectations” approach of the Lee Myung Bak administration (Park 2011, 2012). The approach was embedded in a larger regional initiative (the Northeast Asia Peace and Cooperation Initiative; Lee 2014) that looked surprisingly similar to its Roh Moo Hyun predecessor. But descriptions of the process always focused first on small, incremental and easily reversible steps that would solve the bargaining problems described in the Introduction by building trust: resuming dialogue, humanitarian assistance, small-scale projects. Links to the nuclear program were not explicit, but only as trust was built—including through North Korean moderation with respect to its weapons program—could “Vision Korea” projects be launched. These included more capital-intensive efforts such as large-scale infrastructure projects and support for new investment zones as well as South Korean support for North Korean entry into the international financial institutions with its presumption of financial assistance.

The actual contours of *Trustpolitik*, however, were continually revised by the shifting landscape between North and South, and as a result of actions taken by both sides. As with the United States in 2009, the inauguration of a more forthcoming administration did not elicit cooperation. Even after the tensions of early 2013 subsided, early efforts to provide small-scale humanitarian assistance following the tensions of early 2013 quickly

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<sup>43</sup> . Yi Yong-in and Choi Hyun-june, “U.S. Six Party Talks Envoy Gives Strong Message on Dialogue with North Korea,” *Hankyoreh*, October 30, 2014; Anna Fifield, “U.S. and North Korea have been Secretly Having ‘Talks about Talks,’” *Washington Post*, February 2, 2015.

gave way to the standoff over the closure of Kaesong in April. Understanding the strategic mistake of walking away from the foreign exchange generated by the KIC—and with the May 24 sanctions still firmly in place--the North tacked back to negotiations in early June.<sup>44</sup> The status of the complex was only resolved, however, when the Park administration sent surprisingly strong signals of its willingness to close the zone altogether.<sup>45</sup> But subsequent offers on the part of the North were aimed, as they long had been, at getting the South to stop the exercises with the US and were quickly rejected.<sup>46</sup> A round of conciliatory signals in early 2014—including in the North Korean New Year’s speech, one-off resumption of family reunions and a modest aid initiative in February 2014—all failed to generate wider momentum for talks.

In an important speech in Dresden on March 28, President Park once again restated the logic of *Trustpolitik* with very similar proposals to those made in the past (Park 2014). But in an important turn, the speech addressed the issue of unification in a surprisingly frank way. The speech left little doubt that were reunification to occur, it would occur on Southern terms; the choice of the German venue could hardly be lost on Pyongyang. Prior to the Dresden speech, she had also formed a Presidential Commission to consider the issue of unification in greater detail. The North Korean response was swift and unequivocal.<sup>47</sup> A major negotiation in August 2015, triggered by a land mine that badly maimed two South Korean soldiers, resulted in a surprising agreement that--as so many in the past--failed to sustain forward momentum.<sup>48</sup> Following the nuclear and missile tests of 2016, Park gave a speech to the National Assembly that seemed to write her own obituary on the *Trustpolitik* experiment. She even explicitly raised the possibility of unification via of the collapse of the Kim regime and the absorption of the North by the South.

## **Conclusion: Hard Target Redux**

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<sup>44</sup> . “CPRK [Committee for the Peaceful Unification of Korea] Special Statement Proposes Talks between Authorities of North, South.” KCNA, June 6, 2013.

<sup>45</sup> . Talks had been on-off until August 7, when the Ministry of Unification (MOU) authorized payment of insurance compensation to 109 firms in the complex totaling over \$250 million. Within a week, the North had called for a resumption of talks and reached an agreement addressing Southern concerns about the zone.

<sup>46</sup> . “NDC of DPRK Advances Crucial Proposals to S. Korean Authorities,” KCNA January 16, 2014.

<sup>47</sup> . “NDC Spokesman Blast Park Geun Hye’s ‘Dresden Speech,’” April 12, 2014; “NDC of DPRK Sends Special Proposal to S. Korean Authorities,” June 30, 2014.

<sup>48</sup> . Stephan Haggard, “Tensions Update IV: The Agreement,” North Korea: Witness to Transformation blog, August 24, 2015 at <http://blogs.piie.com/nk/?p=14422>.

During the two administrations of Barak Obama, negotiations over North Korea's nuclear program moved from the loosely-structured format of the Six Party Talks to tacit bargaining among the major parties and episodic negotiations following the satellite launches and nuclear tests through the UN Security Council. The lessons we draw from the succession of bargaining "rounds" outlined in Table 7.1 are relatively easy to restate.

First, as in the Six Party Talks, the tacit negotiations were hampered by the sequencing and credibility problems outlined in the Introduction. The US—as well as Korea and Japan—were increasingly reluctant to return to negotiations in the absence of prior signals of intent on the part of North Korea. North Korea, too, repeatedly sought actions that would signal an end to the US "hostile policy" or a show of South Korean "sincerity." Yet all parties were generally loath to move first and the only significant agreement that was reached during the period, the Leap Year Deal, quickly collapsed.

Second, neither the imposition of sanctions nor the use of broader military signals had much effect on North Korean behavior. Three partial exceptions are worth noting. It is possible that the economic and food constraints that surfaced in 2010-11 had some bearing on the willingness of North Korea to re-engage following the *annus horribilis* of 2010. It is also possible that American and South Korean willingness to escalate and use pointed military signals in the spring of 2013 contributed to the de-escalation of the crisis. And finally, it appears that the Park administration's willingness to close Kaesong induced North Korea's return to the table at least on that narrow issue.

But none of these measures had effect on the core issue of resuming nuclear talks let alone making progress in them. In fairness, we have evidence that the principles were well aware of the fact that sanctions were unlikely to return North Korea to the table (for example, Bader 2012, 39). But a review of the period certainly confirms that North Korean responses to sanctions tended to be escalatory rather than conciliatory, a point raised repeatedly by the prominent "doves" cited in the introduction to this chapter (Asia Society 2009, Wit 2009, Lewis, Hayes and Bruce 2011, Sigal 2012 and 2016, Hayes and Tanter 2012, Halperin 2012, Moon 2012, Frank 2013, Gurtov 2014, Hippel and Hayes 2014).

However, we also noted that any effects that sanctions might have had were dampened by Chinese behavior and resulting coordination problems in both their design and implementation. Because of its concern about limiting downside risk from a North Korean collapse or outside intervention on the peninsula, Beijing repeatedly signaled limits on its willingness to bring pressure to bear. Signals of support were particularly strong

around the succession, despite evidence that policy preferences diverged sharply. In each subsequent round of conflict, Chinese showed repeated reticence to fully exercise its leverage.

Not only did China discount the effectiveness of sanctions, it also showed a revealed preference for a strategy we have called “deep engagement.” Although largely commercial, it involved positive signals to Chinese firms with respect to trade and investment, complementary investments, and ongoing provision of aid, particularly around the succession. Yet these strategies of engagement on the part of China did not work either.

Nor did other episodes of engagement. We considered several phases of the 2009-2016 cycle as reflecting signs of a willingness to engage on the part of the US: the early days of the Obama administration; the negotiations leading up to the Leap Year Deal; the political configuration that North Korea faced vis-à-vis the South with the election of President Park Geun Hye in December 2012; and the diplomatic initiatives of the first half of 2015. In each case it could be argued that engagement also suffered from coordination problems. Parties were reluctant to lift sanctions that had accumulated during the prior period and negotiations were complicated over the course of 2014 by a complex human rights politics associated with the UN Commission of Inquiry. As with those favoring more sanctions, critics can argue that the five parties were not forthcoming enough. But the Leap Year Deal is an important disconfirming case, suggesting the willingness to take risks with an agreement placing extraordinarily modest constraints on North Korea’s nuclear and missile program, not a single one of them irreversible.

We close with the central conclusion reached in Chapter Two: that the play of external sanctions and inducements vis-à-vis a hard target like North Korea appear to have much weaker effect than is thought. Are there either “smart engagement” or “smart sanctions” measures that were not tried but might nonetheless “work”? These issues were raised once again in the aftermath of the fourth nuclear test, satellite launch and missile tests of 2016, and we address them in the Conclusion.

Chapter 7 Figures and Tables

<b>Table 7.1</b>			
<b>Economic Statecraft 2009-2013:</b>			
<b>The Six Party Talks Phase</b>			
	<b>Economic and other inducements</b>	<b>Sanctions and constraints</b>	<b>North Korean response</b>
To the satellite launch (April 5, 2009) and second nuclear test (May 25, 2009)	Initial stated willingness on the part of the Obama administration to engage; maintenance of food aid program.	No change from status quo ante	Satellite launch and nuclear tests of April-May 2009.
From the 2009 satellite and nuclear tests to the sinking of the Cheonan and the shelling of Yeongpyeong Island	The onset of “strategic patience”: downplaying significance of Six Party Talks and holding out prospective benefits only	Active pursuit of multilateral sanctions following missile and nuclear tests (UNSC Presidential Statement April 13, 2009; UNSC Resolution 1874, June 12 2009).	Further missile tests (July 2009); withdrawal from Six Party talks.
The sinking of the Cheonan and shelling of Yeongpyeong Island (2010-11) through the death of Kim Jong Il	“Strategic patience” modified in 2011 through negotiations over a freeze agreement	Additional (“May 24”) sanctions from South Korea following sinking of Cheonan; negotiation of US-ROK Counter-Provocation Plan	
The collapse of the Leap Year Deal (March-April) through mid-2015	The Leap Year Deal (February 29, 2012), followed by return to strategic patience, prospective benefits only.	Additional multilateral and bilateral sanctions in wake of April and December 2012 satellite launches and third nuclear test (UNSC Presidential Statement of April 16, 2012, UNSC	North Korean satellite launches (April and December 2012); third nuclear test (February 2013), roll out of “byungjin line” (March-April 2013) committing to nuclear program, sustained increase in missile tests through 2014

		Resolutions 2087 [January 22, 2013] and 2094 [March 7, 2013]; military signaling during crisis of March-April 2013; sanctions following missile tests in 2015.	and first half of 2015.
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Table 7.2

North Korean Response to UN Security Council Resolution 2094

(March-April 2013)

Date	Statement/Action (Source)
March 5	Threatens nuclear retaliation for any US action; claims miniaturization of nuclear warhead; nullifies Armistice; discontinues Panmunjon mission of the KPA; severs US-DPRK hotline. (Supreme Command of the Korean People's Army)
March 7	Declares "right" to launch pre-emptive nuclear strike (Foreign Ministry)
March 8	Nullifies all agreements on non-aggression between North and South as well as the joint declaration on denuclearization (Committee for the Peaceful Unification of the Fatherland)
March 10	Declares right to launch pre-emptive nuclear strike if Key Resolve exercises proceed (Foreign Ministry)
March 11	Calls Key Resolve an effective declaration of war (Supreme Command of the Korean People's Army)
March 11-12	Kim Jong Un visits two military units opposite opposite the ROK's Baengnyeong Island, around which the Cheonan was sunk and declares the DPRK will turn the island into a "sea of fire."
March 14	Live fire drills near the Northern Limit Line
March 21	Statement that Anderson Air Force Base on Guam and Okinawa "are within striking range of our precision strike means." (Supreme Command of the KPA)
March 27	Severing of hotline used to coordinate movement of goods and people into and out of Kaesong Industrial Complex (Supreme Command of the KPA)
March 29	Kim Jong Un pictured in "operational meeting" of strategic rocket commanders, with maps showing strike plans against US targets. Rocket forces placed on "standby."
March 30	North-South relations put on a "state of war." ("The government, political parties and organizations of the DPRK")
March 31-April 2	Plenary of the WPK Central Committee introduces the <i>byungjin</i> line of simultaneous development of economy and nuclear weapons; ratified by 7 <sup>th</sup> Session of the 12 <sup>th</sup> Supreme People's Assembly
April 2	5MW reactor at Yongbyon and "enrichment plant" will be restarted with objective of further nuclear weapons program (General Department of Atomic Energy)
April 4	Musudan missiles moved to east coast launch site
April 8	All North Korean workers withdrawn from Kaesong Industrial Complex (statement by Kim Yang Gon, secretary of the Central Committee of the Workers' Party of Korea)
April 9	Foreigners warned to leave Seoul to avoid war (Korea Asia-Pacific Peace Committee).
April 15-26	Threat to attack the South "without notice" for insults to the leadership on Kim Il Sung's birthday ("Ultimatum" from Supreme Command of the KPA); repeated rejection of both US and South Korean offers of dialogue (including statements by Policy Department, National Defense Commission)

Sources: Cha and Kim 2013 and Stephan Haggard, "What Are the North Koreans Doing," Witness to Transformation Blog, April 1, 2013 at <http://blogs.piie.com/nk/?p=9889>, KCNA.

## Chapter Eight

### Conclusion:

#### Whither North Korea? Whither Economic Statecraft?

For a small, opaque country, North Korea has generated a surprisingly rich body of research. This literature ranges from strategic accounts of the nuclear weapons issue to the humanitarian and human rights challenges posed by its oppressive political system and the attendant refugee problem. Most of this work clutches for elusive straws of external influence, arguing for strategies to constrain North Korea's options through deterrence and sanctions, through diplomatic and economic engagement or for complex carrot-and-stick combinations of the two.

In this book, we have departed from these approaches by attempting to provide a unifying political economy lens on these issues. In effect, we follow "Deep Throat's" injunction to Watergate reporters Woodward and Bernstein to "follow the money." Without an understanding of the political economy of North Korea, including both its domestic coalitional foundations and its evolving external economic relations, it is hard to reach meaningful conclusions about the efficacy of sanctions and engagement. In sum, we need a theory of the case.

In this conclusion, we start by looking back at our core findings, measuring them against some of the analytic expectations established in the Introduction. We then turn in a more prospective direction by addressing two clusters of issues. First, what if North Korea were to change? How might that affect the conclusions drawn here? Second, what if the major parties undertook different strategies with respect to North Korea? Can we imagine policies that might be more effective? Although necessarily speculative, these questions permit us to engage in some comparisons with other relevant cases, most notably Iran. We also consider a new spate of diplomatic initiatives—including both sanctions and proposals for engagement—that were introduced in the wake of the fourth nuclear test in early 2016.

We argue that the prospects for fundamental political change are limited. However, there is evidence that a de facto if not de jure economic reform process is underway. We assess the prospects for reform, which rests not only on internal reforms of agriculture and industry but on

further opening of the external sector as well. Does such an opening make the country more vulnerable to sanctions and inducements? The answer is “yes,” but conditional on how key states—most notably China—respond to this process.

We then ask in what ways these partial reforms may be affected by more refined sanctions and inducement strategies. Our conclusions are pessimistic with respect to the promises of economic statecraft. Sanctions negotiated at the multilateral level and independent efforts on the part of other parties in early 2016 seemed quite sweeping in their intent, and if fully implemented would clearly have impact. Yet as of this writing, the question of how to coordinate across states with very different preferences persisted. The process and outcome of this last round of sanctions efforts raises quite fundamental questions about whether an increasingly divided world order—split between authoritarian and liberal governments—can find common ground in controlling “hard targets” like North Korea

Inducements faced similar constraints. We now have a long list of proposals for how economic integration might be used to underpin a new security architecture in Northeast Asia. But functionalist arguments that economic integration could facilitate political settlements have repeatedly failed in Northeast Asia. It appears, rather, that the path forward rests on reaching a political settlement. As we have seen, the bargaining problems for reaching such a settlement are great, requiring the five parties to essentially accept—and even recognize—a nuclear North Korea, a highly unlikely prospect. The default is a continuation of the status quo, with North Korea accumulating capabilities and its neighbors seeking to contain the attendant risks.

### **Findings: The Political Economy of Inducements and Constraints**

We cast our inquiry in a framework that considered two possible ways in which sanctions and inducements might work. In addition to the standard bargaining model, centered on quid-pro-quos and a cost-benefit calculus, we also considered the broader question of how sanctions and particularly engagement might have transformative effects. Following the work of Etel Solingen (1998, 2007), we began our analysis in Chapter Two with the underlying political structure and coalitional foundations of the North Korean regime. This exercise was important for providing a baseline with respect to political and economic change, but also for addressing the endogenous nature of countries’ foreign policies. Solingen argues that external economic relations are in the first instance a function of regime characteristics, social bases of support and

policy choices rather than the other way around. We argued that North Korea has to date been the paradigmatic “hard target”: a repressive one-party familial regime based on an inward-oriented political coalition with significant representation of the military, military-industrial complex and security apparatus. These factors not only make the regime relatively impervious to sanctions but shape how the regime engages with the world economy and thus its responsiveness to economic inducements as well.

In the next section, we consider in more detail whether and how Korea might be changing, both politically and economically. To date, however, the political system appears to have undergone only marginal changes despite the succession; as we might expect, power even appears to be more concentrated and in the context of a near-classic example of what Solingen calls a “backlash coalition.” On the economic front, the marketization that has occurred to date has been largely a bottom-up process born out of state failure rather than the product of proactive top-down reform. Commitment to reform—and commitments that would require a reassessment of the country’s broader foreign and military policy—has been limited at best. Indeed, the *byungjin* line openly rejects the very idea at the core of liberal models: that economic development and militarized foreign policies work at cross-purposes.

We argued that the narrowness of the regime’s key constituencies has affected the government’s responses to sanctions and inducements and the extent to which growing openness will have transformative effects. To date, the regime has managed to insulate itself from the effects of sanctions, imposing the costs of its autarkic policies on non-elite groups constituting the vast majority of the population. Inducements, by contrast, have been most attractive not when having wider effect—as a broader opening to trade and investment might—but when they could be captured and used by the state and politically-connected groups, including through illicit activities and weapons sales. This finding even pertains to food as well as other forms of external support as we showed in Chapter Four.

We also followed the existing sanctions literature in underlining how the efficacy of sanctions and inducements will depend on external coordination issues (Martin 1992; Hufbauer, Schott, Elliott and Oegg 2007). We also demonstrated how these coordination problems had a dynamic component (Caruso 2003; Kaempfer and Ross 2004). North Korea has been pulled into China’s orbit not only by that country’s extraordinary rapid growth, but also as a result of sanctions that pushed North Korea’s external trade toward its least punctilious partners. We

demonstrated this in detail with a closer consideration of North Korea's trade with both China and South Korea, a case study of trade in sanctioned luxury goods, and a detailed consideration of other sources of income ranging from illicit activities to aid and foreign investment.

An obvious point to emerge from this story is that not all forms of "engagement" are likely to have transformative effect. Not only does the state control the connections between the foreign and domestic economy, but it has been engaged in activities that have negative rather than positive externalities in the form of exports of drugs and weapons and counterfeiting.

In Chapter Five, we looked at these issues through a micro-lens, reporting the results of firm-level surveys of Chinese and South Korean firms doing business in North Korea. The objective was to gauge whether engagement—in the form of increased cross-border-exchange—was having transformative effects postulated by engagement models. Perhaps our most important finding is a descriptive one: at the time of the survey, trans-border transactions still remained to a significant extent under state control, although as we discuss below this could be changing. We found that the institutions of a market economy remained weak, with uncertainty over property rights and dispute settlement and weak indicators of the emergence of trust, such as the extension of credit. Chinese firms in particular report the necessity to bribe to do business, and we provide evidence that outside of larger state and private entities, firm size itself might be limited by the risks of predation.

The important exception that proves the rule is the import of South Korean institutions into the Kaesong Industrial Complex. We showed that these arrangements involved an effective set of subsidies or guarantees. Chinese firms operated in a relatively unsubsidized frontier-style capitalism while South Korean firms operated in an enclave that was ultimately the result of political negotiations between Seoul and Pyongyang. We outlined the skeptical case with respect to the transformative effects of these enclaves by considering in detail the tight controls exercised by the North Korean government over Kaesong and its workers and suppliers and the absence of backwards and forward linkages. Kaesong could "spread" only be replicating more such enclaves, but North Korean behavior limited the appeal of such efforts.

Chapters Six and Seven took up the diplomatic dimension of sanctions and engagement, focusing on the period since the onset of the second nuclear crisis; these chapters were designed to consider hypotheses about the effectiveness of sanctions and inducements in generating quid-pro-quo. First, we found that the coordination issues we highlight with respect to North Korea's

external economic relations are replicated in six-party diplomacy, surfacing first in the institutionalized mechanism of the Six Party Talks, and then outside it when those talks collapsed in 2008. We found strong evidence of the constraints on the five parties from their heterogeneous diplomatic strategies: both tough stances and more pro-engagement approaches continually ran into difficulties associated with divergent diplomatic approaches on the part of other parties.

We also found that while sanctions appeared to have surprisingly little effect on the course of negotiations, inducements fared little better. Even when coordinated, these inducements were caught up in the bargaining and sequencing problems we outlined in the introduction. Negotiations—and lack of negotiation after 2008--foundered repeatedly on mirror-image credible commitment problems. The United States and South Korea showed reticence to extend benefits given past history, a reticence neatly summed up by US Secretary of Defense Robert Gates' reluctance to "pay for the same horse twice." North Korea for its part saw little reason to abandon a cheap and effective deterrent for benefits that were highly uncertain, particularly given the political environment in the United States, Japan and Korea.

Finally, we sought to address the humanitarian dilemmas that surround economic statecraft, emphasizing once again that these problems arise not only with respect to sanctions but vis-à-vis inducements as well. Multilateral food assistance began in 1995 during the famine and the aid program subsequently grew into the area of most sustained interaction between North Korea and the international community. In trying to ameliorate this disaster, however, the humanitarian community faced a fundamentally hostile environment. The North Korean government would not permit independent distribution of food; rather, food aid was channelled through the Public Distribution System with severe constraints on assessment and monitoring activities. Yet even in the face of chronic shortages, the regime has been unwilling to reprioritize its external relations to put greater emphasis on human security, particularly by generating adequate foreign exchange to import food and medicine on commercial terms. This history has contributed to profound fatigue among the donors. The WFP programs of the 2010s were funded at only a fraction of their proposed levels and were at risk of being rolled up altogether despite ongoing evidence of malnutrition (UNICEF 2012).

In sum, we concluded from the evidence available over the course of the second nuclear crisis that the outside world should not overestimate the degree of influence it has on North

Korea. There are good theoretical reasons to believe that the pattern of North Korea's engagement with its key partners--South Korea, China, Japan, the United States, and Russia--could tilt its trajectory toward a more open market economy or reinforce existing tendencies toward state socialism or even the kind of kleptocratic resource-based economy sadly common in Central Asia or Sub-Saharan Africa. But these influences are themselves endogenous to North Korea's political economy, grounded ultimately in key features of the regime. While the rest of the world can influence incentives at the margin, our research is designed in large part as a cautionary tale: the way North Korea turns will depend on decisions made in Pyongyang.

That said, our account so far has necessarily been backward looking. It is at least possible that the North Korean political system could change and that the processes of cross-border marketization from below may simply not have had adequate time to generate their predicted effects; this sort of engagement may be a long game. What if North Korea were to change politically or economically, either more suddenly or through an evolutionary process?

### **Prospects for Political and Economic Change**

Chapter Two characterized core features of the political and economic system through mid-2016; here we want to assess the prospects for change as of mid-2016, a more dynamic but obviously more speculative undertaking. We look first at the prospects for political change—which we deem limited—and then at the prospects for incremental economic reforms, which are more likely and in fact are probably in train.

#### *Prospects for Political Change*

We argued that the transition from Kim Jong Il to Kim Jong Un did not mark a fundamental shift in the nature of the regime and indeed might have buttressed some of its core features, at least in the short-run. Successions in personalist systems can be expected to generate substantial churning as the incoming leadership expands its discretion and engages in coup-proofing by purging potential rivals, advancing the careers of followers and consolidating bases of support. However, the very uncertainty of the succession favored a complex of the same institutional forces that had been in place under the *ancien regime*. This remained true—and perhaps even more true--after the unveiling of the *byungjin* line in March 2013. Frank (2014)

argues that this new orientation marked a subtle shift from the *songun* or “military first” policy because of its suggestion that economic development would be elevated to a par with national security. But for our purposes here—which are to understand North Korea’s foreign policy behavior—the departures of *byungjin* seem to pale before the commitment to maintain and further develop the country’s nuclear capability.

Is the political system stable or is it vulnerable to change or even collapse? To answer this question, it is worthwhile to consider possible transition paths. Magaloni and Kricheli (2009) calculated a transition matrix for changes from different types of authoritarian rule over the 1950-2006 period. They find that single-party systems were the most stable authoritarian form, and would have shown up as more stable still had many not fallen in tight sequence following the collapse of the Soviet Union. The fact that the North Korea survived this external shock along with a handful of other communist systems is a reminder of authoritarian resilience, and the variety of tools—both repressive and accommodating—that such regimes can deploy to retain power (Dimitrov 2013).

When single-party regimes did transition, they were most likely to transit to military regimes (38.6 percent) or dominant party systems (33.3 percent), with democracy a distant third (19.3 percent, accounted for mostly by the anomalous Eastern European transitions, with the advantages of proximity to Europe). Transitions to “anarchy”—ie., the “collapse” scenario often discussed in the North Korea literature (for example, Bennett and Lind 2011)—were relatively rare (8.8 percent). Were it not for the ongoing legitimization challenge posed by North Korea’s junior status on a divided peninsula, it would be puzzling why collapse is deemed such a likely possibility for the North Korean system.

Given the leaderist and monolithic nature of the regime, a political opening from the top that would allow constrained competition—let alone democracy—seems highly unlikely. The risks would therefore appear to be greatest that the system would become more explicitly military, perhaps by an overt or subtle coup in which military actors became even more prominent than they currently are. We outlined in Chapter Two how the regime has met these risks, including through a legitimization strategy that has for decades identified the country with the Kim family; it is far from clear how a challenger would justify a departure from this ideological order. But the fundamental point to make is that the most likely regime transition

path “from above” is not one that would result in competitive authoritarianism or democracy but one in which the military would play an even more significant role.

What about the possibility of some kind of transition “from below”? In addition to the sheer repressiveness of the system and its spotty economic performance, two particular grievances are worth noting that could spark dissent: corruption and inequality. Rising corruption can be documented both in refugee surveys (Kim 2010, Haggard and Noland 2011a), the firm surveys discussed in Chapter 5, and most recently, case studies (Noland 2014a). The emergent market economy is characterized by pervasive rules and regulations that are subject to arbitrary and capricious change, effectively placing all economic agents out of compliance with some rule or regulation. Such a system invites shakedown and extortion and raises bribe prices.<sup>1</sup> There have been sporadic reports of confrontations between officials and market traders that could in theory spiral into more substantial challenges as they did, for example, in Tunisia.

Second, both anecdotal accounts and surveys suggest that inequality in North Korea is rising, with both spatial and class dimensions to the phenomenon (Kim and Kim 2012). There is also considerable complementary evidence derived from refugee surveys that depicts a collapse of the social welfare system, at least for non-elite households in the hinterlands (Kim et al. 2012). Growth could even be following the relatively unusual path of “the rich getting richer and the poor getting poorer,” in part because of the growing centrality of resource extraction associated rents in the economy. A combination of poor economic performance and rising inequality might also breed resentments that could manifest themselves in protest.

Given the extraordinary repressive apparatus of the state, the continued reach of the “organizational life” (Lankov, Kwak and Cho 2012) and the low level of societal trust revealed in refugee surveys, the likelihood of collective action from below appears limited. The prospects of mass mobilization that unseat authoritarian regimes usually reside in capital cities. Pyongyang has seen a flood of public and private investment, generating what might be called “the Pyongyang illusion.”<sup>2</sup> Those connected with the regime and in the protected private sector are

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<sup>1</sup> . These developments have a gender dimension as well. Women have been disproportionately shed from state-affiliated employment and thrust into a market environment characterized by weak institutions and corruption. Among the most recent cohort of refugees to leave North Korea surveyed by Haggard and Noland (2013), 95 percent of female traders report paying bribes to avoid the penal system. In short, the increasingly male-dominated state preys on the increasingly female-dominated market.

<sup>2</sup> . See Stephan Haggard, “The Pyongyang Illusion,” Witness to Transformation Blog, November 5, 2011 at <http://blogs.piie.com/nk/?p=463>. See also Collins 2016.

doing well, and some are in fact becoming rich. Given the neighborhood in which North Korea is located, the prospects of mass mobilization or insurgency moving in from the periphery are also limited. The greatest risk would therefore seem to arise from spontaneous, “prairie fire” protests that spiral beyond control. Yet the pervasiveness of the security apparatus and the willingness to use overwhelming force would seem to guarantee that such movements are effectively deterred and would be crushed if they did surface.

In sum, in looking at prospects for change, we need to think about a North Korean political system that is broadly structured as it currently is. If we preclude changes of the regime, or at least see them as unlikely, it does not rule out changes *in* the regime, as happened in China and Vietnam. Economic policy would clearly be a major way in which the system might change.

### *Prospects for Economic Reform*

The most likely change of this sort would be for the regime to initiate a gradual process of reform and opening that conforms—at least in broad outlines—with the Chinese approach. Reforms would unfold along three key axes, setting aside a complex set of macroeconomic questions: a continuation of the so-called June 28 [2012] agricultural reforms and the May 30 [2014] measures with regard to the state-owned enterprise sector and—most important for our purposes—an external opening to greater trade and investment.<sup>3</sup> To what extent are such changes feasible? And would such a reform path lead to a moderation of North Korea’s foreign policy behavior?

As of this writing, there is growing evidence that the North Korean pilot reforms in agriculture were in fact continuing (Ireson 2014). Although important for the livelihoods of cultivators, there are important reasons why North Korean reforms are unlikely to be led by rural reforms to the same extent as they were in China and Vietnam. In China, the productivity-increasing reforms in agriculture led to an increase in agricultural output and a movement of extremely low-productivity agricultural labor to the nascent light-manufacturing sector. From a political economy perspective, each of the three principal groups in the economy benefited: farmers saw rising incomes; the migrants to the emerging light manufacturing sector earned higher wages than on the farm; and even the urban proletariat in the state-owned manufacturing

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<sup>3</sup> . The following draws on Haggard and Noland 2007, Chapter Seven.

sector saw an improvement in real wages as the implicit terms of trade between food and industrial products fell. Reform under these circumstances constitutes a “happy equilibrium”: no large group comes out an obvious loser.

Not only is the share of the workforce in agriculture much less, roughly 70 percent in China and Vietnam at the time of their reforms compared to about half that when reforms were first contemplated in North Korea in the late 1990s (Noland 2000 Table 3.7). But agriculture in North Korea is more input-dependent. Agricultural reforms are most likely to have large effects if complemented by substantial increases in the availability of fertilizer and energy for irrigation, an allocation of resources on the part of the regime that has not been forthcoming. Such reforms would undoubtedly increase the welfare of farmers. But even with large increases in productivity and substantial gains for the farmers themselves, agriculture will not be the “leading sector” of a major transformation.

The flipside of the small agricultural sector is a large industrial sector. Despite its much lower level of income, reform in this sector on the surface more closely resembles the difficult processes of transition in a highly industrialized Eastern European country like Romania. Much of the capital stock in these countries was effectively worthless and largely had to be closed down altogether, with painful adjustments for displaced workers.

The process of marketization from below may make these processes easier in North Korea, both economically and politically; indeed, they could even be easier than on the cooperatives, where party and state functionaries could sabotage incentives favoring cultivators. The decline in the industrial sector in North Korea has been so substantial, and the social benefits provided by employment in the state sector already so eroded, that tremendous gains could arise from simply letting managers engage in business as they see fit, as is already occurring on a de facto if not de jure basis. We can even imagine quite fundamental sectoral changes as former managers of heavy industry shift into a variety of more profitable light manufacturing activities, exploiting their control over land and labor in league with the emerging private and even underground financial sector. As we showed in Chapter Three, there is some evidence that such shifts may already be spilling over into the external sector in the form of increasing exports of light labor-intensive manufactures (see also Li 2016).

North Korea is also no exception to the tendency of socialist economies to ignore the service sector. Under the current degree of marketization we already observe the growth of

small-scale activities such as restaurants, hauling and transportation services, and small shops. With deeper reforms—or simply a more *laissez-faire* approach to the state sector on the part of the government—one could imagine the growth of larger-scale commercial enterprises in such areas as construction, transportation, finance, and even telecommunications.

Given its small size and geographical position, however, it is clear that the foreign sector has to play an even larger role in the North Korean transition than it has played in China, with its continental size and huge domestic market. Interestingly, the renewed effort on the part of the regime to attract foreign direct investment is a tacit recognition of that fact. In addition to the extraordinary demand for investment given North Korea's poverty and lack of a functioning financial system, foreign firms also represent a kind of neural synapse between the latent productive potential of the North Korean economy and the world economy. Foreign firms have the blueprints for the products that the rest of the world wants to buy, as well as the global distribution and marketing networks to make it happen.

In the industrial sector, North Korea would be exporting minerals but also light and medium-tech labor-intensive manufactures. It would import capital goods, intermediates and food. The composition of employment would shift toward emerging export-oriented manufacturing sectors, and potentially millions of North Korean workers would change jobs as they did in the earlier East Asian miracles. Given the prevalence of sub-scale manufacturing establishments and the excessive geographic dispersion of existing facilities, this process of restructuring would have its own distributional consequences, to be sure. Some existing industrial towns could be depopulated, but others with more favorable geographic locations—near ports, near China or near the road and rail links with South Korea and Russia—would expand dramatically. Interactions with the outside world would increase exponentially, with the share of international trade in the economy multiples of what it is today.

Such an economic transformation is not without its own distinctive risks, particularly given the military ambitions of the *byungjin* line and the challenges such an opening could pose to the regime. As documented in Chapter Three, North Korea's external economic relations are characterized by an extraordinary dependence on China. But conventional gravity model results indicate that South Korea, not China is North Korea's natural primary trade partner (Noland 2015). If North Korea traded as though it were a "normal" country, South Korea would naturally account for most of North Korea's external commerce, followed by China, Japan, the US, and

Russia. There may well be legacy or hysteresis effects that boost China's prominence relative to what the models predict. Nevertheless, the implications are clear: a truly reformed North Korea would be pulled into South Korea's orbit, an outcome that the current regime would surely regard as unacceptable.

This observation suggests that any opening will take place through tentative steps that are amenable to political control, reversible and oriented largely to China and perhaps a handful of middle-income countries willing to take risks. A series of announcements since November 2013 has suggested an intention to do this through creating new special economic zones (SEZs).<sup>4</sup> The success of these efforts could be measured along two dimensions. The first is purely economic spillovers. Do the zones generate backwards and forward linkages? Do local firms become suppliers of inputs to foreign firms operating in the zone? Are the products produced in the zone used in the broader economy by local businesses or consumer? Does technology, broadly defined to include new management approaches or ways of doing business, diffuse beyond the confines of the SEZ?

Equally if not more importantly are the sorts of policy spillovers that are related to what we call the transformational model of engagement. Do SEZs come to drive broader economic policy as in China in the 1980s? Does the government effectively commit to strong property rights in these enclaves or are they subject to political manipulation, as occurred in Kaesong in 2013? Are the more liberal rules in the SEZs eventually broadened to the whole economy?

We do not need to look at past history in North Korea alone to be skeptical. The World Bank undertook a comprehensive review of SEZs around the world, and most SEZs fail to generate these policy spillovers (Farole 2011): they do not generate much investor interest nor—as a result—do they act as a catalyst for changes in the broader economy.<sup>5</sup> Put differently, an SEZ strategy generally cannot substitute for a broader reform effort.

Even if such a strategy were to take root it is at least worth noting several important sources of economic risk. The gradual improvement in the North Korean economy over the

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<sup>4</sup> . Most of these planned venues are quite small—on the order of 4 square kilometers or less—making them more like “bonded warehouses” than SEZs as commonly understood. But if successful they can be expanded, so size is not dispositive, at least in the beginning. See Stephan Haggard and Kent Boydston, “Slave to the Blog: Foreign Investment Edition,” Witness to Transformation blog, 10 June 2015, <http://blogs.piie.com/nk/?p=14178> accessed 16 June 2015

<sup>5</sup> . Indeed, if there were “leakage” of finished products intended for export out of the SEZs and into the local market, enterprises outside the SEZs operating under more onerous rules might rightly regard this development as a competitive threat and demand the SEZs be shuttered.

2010s appeared to rest in no small measure on expanding trade and investment with China rather than as a result of the pilot reforms introduced belatedly under Kim Jong Un. However, as discussed in Chapter Three, this trade expansion may be attributable in part to rising prices for North Korea's commodity exports, not rising volumes.<sup>6</sup> And what goes up can come down; some observers claim that we have seen the end of a "super-cycle" in commodities (Hendrix and Noland 2014). The Chinese economy is poised for a structural decline in growth rates (Laing 2013). Domestic reforms in North Korea might offset this trend, but should China experience an abrupt slowdown, we cannot rule out that a young and relatively inexperienced leader could find himself in a challenging external environment without a lot of policy levers at his disposal to cushion the fall. Ironically, sanctions could actually reinforce or accelerate a process of de facto marketization. As external conditions deteriorated the regime could respond by easing internal constraints on market activity as a kind of safety valve. In the long-run, such a process might contribute to the growth of the so-called *donju* class of local entrepreneurs, and even contribute to a more pluralistic domestic political economy.

### *Political and Economic Change: A Reprise*

In sum, the prospects for political and economic change in North Korea appear constrained. At the political level, the Kim family franchise seems surprisingly hard to dislodge, even if underperforming. The combination of strong institutions of repression and social control and a coalition of family, party and military-security-industrial complex makes authoritarian persistence a real possibility. Moreover, we can outline an adaptive, trial-and-error partial reform path that would generate not only economic but political benefits for the regime as was the case in other communist regimes that survived (Dimitrov 2013).

At the same time, we have traced a number of constraints on this gradual reform process. There are important gains from reforms in the agricultural and industrial sector. We can identify a strategy that focuses resources on Pyongyang and permits a gradual expansion of the service sector, spreading into real estate and development and from Pyongyang to provincial capitals.

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<sup>6</sup> . For more on the effect of commodity prices on North Korea-China trade see Kevin Stahler, "North Korea-China Trade Update: Coal Retreats, Textiles Surge," North Korea: Witness to Transformation blog, October 27, 2014 at <http://blogs.piie.com/nk/?p=13578>

The most substantial gains—and the ones most likely to have transformative effect—would be those of the external sector.

But North Korea's existential situation—the smaller, poorer member of a divided state surrounded by larger, richer countries—means that the political leadership is rightly hesitant to fully embrace reforms that would make it a distinctly second-class version of its southern neighbor. And while North Korea has mineral resources that confer some natural comparative advantage, the country does not exist in a commercial vacuum. Why would a foreign investor locate in one of these North Korean start-up SEZs rather than in Vietnam, or even Jordan, Myanmar, and Zambia where governments are making serious efforts to roll out the welcome mat to foreign investors without similar political risks?

But most importantly for our purposes, the regime's expressed intention of moving toward a cautious economic opening has—quite contrary to the transformative engagement model—had little or no effect on the conduct of its foreign policy. Indeed, if we take the *byungjin* line seriously it reflects the regime's belief, at least, that economic development and pursuit of nuclear weapons can go hand in hand. A key question is therefore how accommodating the rest of the world will be to North Korea's efforts; this question returns us to our interest in the role of sanctions and engagement.

### **The Role of Economic Statecraft I: Sanctions**

As we have emphasized throughout, North Korea's trade is heavily politicized. In considering the possible consequences of any North Korean reform effort, we also need to consider both the likely path of future sanctions and engagement strategies.

At the time of the fourth nuclear test in January 2016, North Korea was under multilateral economic sanctions via four United Nations Security Council resolutions (UNSCRs): 1695 (2006) adopted following North Korean missile tests; 1718 (2006) following North Korea's first nuclear test; 1874 (2009) following the second nuclear test; and 2094 (2013) following the third nuclear test. In addition to these multilateral sanctions, individual countries, including the US, South Korea, and Japan, maintained or instituted additional unilateral or so-called autonomous sanctions. In some cases these additional sanctions were also directly connected to North Korea's

nuclear efforts, for example, adding restrictions on particular products, entities or individuals.<sup>7</sup> In some cases, these sanctions were tied to altogether different issues, including human rights concerns.

Sanctions related to North Korea's weapons programs can be thought of as having two components. The first is essentially "defensive" in nature, seeking to disrupt the North Korean military program and protect against—and limit—North Korea's proliferation activities.<sup>8</sup> These measures include bans on the export of military hardware; bans on the importation of most kinds of military goods; bans on dual-use technologies that have both military and civilian uses; and the targeting of specific individuals engaged in the country's weapons program or proliferation. Each new UN Security Council resolution has expanded or tightened these measures at the margin.<sup>9</sup>

The metric for measuring the success of such sanctions is not altogether clear. On the one hand, critics deem them a failure because they have not prevented North Korea from continuing to make progress on its nuclear and missile programs: in part through the ongoing use of deception, for example through the use of shell companies (for example, United Nations Panel of Experts 2015, 2016; Mailey 2016)<sup>10</sup>; in part as a result of reverse engineering and relying on purely internal capacities; and in part through the coordination problems we have noted throughout the book. The success of such measures depends heavily on the exporting countries maintaining successful export control regimes. These measures are administratively difficult and require significant resources that a number of states may be unwilling to invest. Multilateral measures in support of interdiction also have "credible information" clauses; a government that

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<sup>7</sup> . In other cases, these sanctions addressed concerns ranging from human rights to particular North Korean actions such as the sinking of the *Cheonan* in the case of South Korea's May 24 sanctions.

<sup>8</sup> . These sanctions have also been aimed at the non-military illicit activities of various sorts described in Chapter Three, including counterfeiting, smuggling, drug trafficking, insurance fraud and so on. We argued that the share of North Korean trade accounted for by these activities is actually declining. The expansion of commercial trade in recent years has made North Korea less dependent on criminal activities and thus less vulnerable to their disruption.

<sup>9</sup> . For example, UNSCR 2094 increased the number of individuals and entities subject to travel bans and asset seizures, urged member states to prohibit financial flows that might be associated with the nuclear and missile programs, and urged denial of port or over-flight rights to ships and airplanes believed to be involved in the military programs or evasion of sanctions.

<sup>10</sup> .See also Juliette Garside and Luke Harding, "British banker set up firm 'used by North Korea to sell weapons'," The Guardian, 4 April 2016 <http://www.theguardian.com/news/2016/apr/04/panama-papers-briton-set-up-firm-allegedly-used-by-north-korea-weapons-sales> accessed 9 April 2016

does not want to enforce them can say that they lack credible information, or that the information that they were provided did not meet the standard of “reasonable grounds” for acting.

On the other hand, it is widely recognized that such measures are never going to plug all leaks and that the objective is ultimately to raise the costs and limit product choices associated with these programs rather than shutting them down altogether. Moreover, some of these measures—most notably those pertaining to dual-use technologies do have spillover effects into purely commercial trade and investment and perhaps even humanitarian programs as well (Abt 2014); as a result, they also have the effect of raising costs.

In addition to these “defensive” sanctions, both UN sanctions and particular bilateral sanctions, such as those imposed by the US, Japan and Korea, are designed to be punitive: to impose costs in the hope of changing North Korean behavior and in particular, bringing it back to talks and making concessions on its nuclear program. Our skepticism about these sanctions was twofold. First, we suggested that China appeared largely uninterested in supporting them or enforcing them when they did; we showed in our case study in Chapter Three that even nuisance restraints on luxury trade and at least until 2016 China resisted any effort to increase pressure on North Korea by going after its purely commercial trade with the rest of the world. Our second source of skepticism stemmed from our arguments about North Korea’s ability to both circumvent these restraints and absorb their costs; North Korea is a hard target.

Two innovations in the sanctions regime might change the prospects of influencing North Korea going forward. The first would be if China became sufficiently disaffected to use the vast economic leverage over the country that it so clearly possesses. Following the fourth nuclear test in January 2016, the relevant parties once again engaged in a contentious negotiation over a new Security Council resolution, finally passed on March 2 as UNSC Resolution 2270. For the first time since the onset of the nuclear crisis in 2002, China agreed to provisions that would affect North Korea’s commercial trade, including a conditional ban on coal imports—accounting for about a third of North Korea’s total exports--a ban on Chinese exports of aviation fuel, a variety of restraints that would affect its shipping and new financial sanctions.<sup>11</sup> Yet despite the willingness to use punitive measures, the resolution was written with caveats that granted China significant discretion in implementation. These included provisions that could be read to require

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<sup>11</sup>. For a full analysis of the sanctions, see Stephan Haggard, “The Sanctions Resolution,” North Korea: Witness to Transformation blog, March 3, 2016 at <http://blogs.piie.com/nk/?p=14880>.

a link between the sanctioned activity and the country's weapons program and a second, potentially larger reservation that referenced humanitarian concerns: that the sanctions not affect "transactions that are determined to be exclusively for livelihood purposes" (para. 29b).

As with all sanctions, much will depend on the capacity of North Korea to adjust to these new measures, assuming they are implemented. Such adjustments would include shifting toward unsanctioned activities (Li 2016), turning to more forgiving jurisdictions, exploiting sanctions leakage and black markets and simply imposing the costs on the population as necessary. Yet it is hard to escape the conclusion that a complete ban on coal exports—coming on top of the \$130 million a year in cash payments associated with the closure of Kaesong--would not only affect income accruing to the elite but would have wider implications as the country faced severe balance of payments constraints.

The parallels to Iran are worth noting, as they demonstrate the significance of the coordination problem and how it can even trump the domestic political economy factors we have highlighted. Iran was exposed to sanctions precisely because it was so dependent on oil exports. The P5+1 could not—nor did it seek to—shut down Iranian oil exports completely; agreements allowed a number of important importers, including China, to continue to purchase oil. But US sanctions against Iran's central bank and the European Union boycott on Iranian oil exports dramatically squeezed other purchasers and total oil exports declined from 2.8 million barrels per day in July 2011 to less than one million barrels a day by July 2012.

North Korea is less open, less dependent on any one commodity and less dependent on foreign investment, which was also affected by Iran sanctions; we would in any case need a more complete model of the North Korean economy to estimate the channels and magnitude of possible effects of wider sanctions. But as we noted in Chapter Three, its export profile increasingly resembles that of a rentier state, with coal and proscribed mineral exports topping 50 percent of the country's total trade. When multilateral sanctions against Iran coalesced around restricting the country's oil exports, the Iranian economy contracted sharply (2012-3). Moreover, the Iranian *rial* experienced a sharp depreciation that spread the effects of the sanctions broadly across the population (see World Bank 2015; Samore 2015; Katzman 2016).

It is not coincidental that the tightening of the sanctions regime against Iran appeared to be directly related to the decision of the country to come back to the bargaining table through the secret negotiations that began in March 2013, almost exactly when the effects of sanctions were

becoming evident. It is noteworthy that this channel was opened by Supreme Leader Ayatollah Ali Khamenei even before the change in government in August 2013 that brought a more moderate president to office in Hassan Rouhani.<sup>12</sup> In sum, it is entirely within the realm of possibility that a more exposed North Korea could in fact find itself politically vulnerable to sanctions were the Chinese weak link in the sanctions regime strengthened, even in the absence of any significant domestic political change in North Korea.

A second route through which external constraints might have effect, partly offsetting the coordination problem, would be more aggressive pursuit of secondary sanctions. Similar to measures used in the Banco Delta Asia (BDA) case, third parties could place greater restraints on North Korea's commercial trade, including with China. To implement such measures, the US and other parties would need to impose secondary sanctions against non-compliant Chinese financial institutions, which Beijing has vociferously opposed, and contend with the evasive adaptations North Korea has pursued in the past, such as shifting its banking and commercial operations deeper into the international gray market available to it in Russia, the Middle East and elsewhere (United Nations Security Council 2016). Nonetheless, proponents of such measures argued that they "worked" in the BDA case, citing both direct testimony from the North Koreans and their behavior to get back to talks following their imposition that we detailed in Chapter Six.

In the wake of the 4<sup>th</sup> nuclear test, the United States passed, and the president threatened to implement, precisely such secondary sanctions.<sup>13</sup> However, as we noted in Chapter Six, the "success" of the BDA sanctions involved the circuitous route of the suspension of the talks and North Korea's first nuclear test and ultimately required not simply a complex resolution of the BDA issue but further incentives from the five parties as well. Again, the comparison to the Iranian case is germane. Iran did not unilaterally undertake commitments to scale back its nuclear program; rather, the secret bilateral talks noted above led to reconvening so-called "P5+1" negotiations (the permanent members of the Security Council, plus Germany and EU representation) and it was those talks that generated both the interim agreement of November 2013 and the final conclusion of the framework agreement in July 2015. As these comparisons

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<sup>12</sup> . See Rozen, Laura. 2015. "Inside the Secret U.S-Iran Diplomacy that Sealed Nuke Deal," AI Monitor, August 11, 2015 at <http://www.al-monitor.com/pulse/originals/2015/08/iran-us-nuclear-khamenei-salehi-jcpoa-diplomacy.html#>

<sup>13</sup> For more detailed analysis of US sanctions legislation and Executive Order see National Committee on North Korea, "Summary of the North Korea Sanctions and Policy Enhancement Act of 2016" at <http://www.ncnk.org/> On the executive order, see Stephan Haggard, "Executive Order 13722," North Korea: Witness to Transformation Blog . March 21, 2016 at <http://blogs.piie.com/nk/?p=14915>

suggest, sanctions need to be considered in the broader framework on negotiations and the trade-offs and inducements such negotiations might ultimately generate.

### **The Role of Economic Statecraft II: Multilateral Strategies for Engagement**

In the early stages of the nuclear crisis, the question of inducements was often quite central to negotiations, apparent or example in the quid-pro-quo of 2007 that led to a brief period of progress in the Six Party Talks. Following the collapse of the talks, North Korea's economic interests have become simpler, and have been restated in virtually all of their pronouncements on the nuclear crisis. The sanctions regime is illegitimate, fails to take into account North Korea's security interests and is part and parcel of a "hostile policy" orchestrated against the country by the United States and its allies.<sup>14</sup> Sanctions should therefore be lifted.

But functional proposals for getting North Korea back to the talks have at times gone well beyond lifting sanctions, and have included a variety of proposals aimed at embedding North Korea in a larger Northeast Asian security and economic architecture or simply linking it to existing international institutions. These prospective inducements have not to date had any discernible effect in moving North Korea toward negotiations. Nonetheless, it is worth considering three clusters of options as a way of reviewing the pros and cons of engagement strategies with countries such as North Korea. First would be efforts to include North Korea in existing multilateral institutions, most notably the Asian Development Bank, World Bank, IMF, and nascent Asian Infrastructure Investment Bank (AIIB). A second cluster of proposals center on fostering economic integration through a regional free trade area. Finally, options for deeper integration might develop out of the Six Party Talks were they to resume.

We conclude that none of these options are particularly appealing to North Korea, and for reasons we have noted throughout: they would not only rest on a commitment to reform and opening but would involve substantial outside scrutiny of North Korea's economic system as well. In the following section, we invert the logic. Rather than considering how economic inducements might lead to a settlement of the nuclear question we conclude with a consideration

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<sup>14</sup> . See letter dated 4 March 2016 from the Permanent Representative of the Democratic People's Republic of Korea to the United Nations addressed to the Secretary-General  
At <http://docbox.un.org/DocBox/docbox.nsf/GetFile?OpenAgent&DS=A/70/776&Lang=E&Type=DOC>

of wider political proposals for the negotiation of a peace regime. As we will see, both economic and political forms of engagement are laced through with the moral hazard and bargaining problems that have been a focus of the book.

*Accession to Existing Institutions: The Asian Development Bank, World Bank Group, the IMF, and the AIIB*

Beyond the lifting of sanctions, the case for drawing on existing institutions is straightforward. North Korea is in need of depoliticized technical assistance on a panoply of issues running from the mundane but critical, such as developing meaningful national statistical capabilities, through basic agricultural and health technologies, to the social infrastructure of a modern economy: institutions for managing macroeconomic policy, including through a reform of the central bank; the specification of property rights and means for resolving commercial disputes; regulatory structures; international trade and investment policies and so on. This is what the World Bank, IMF, WTO and regional development banks—including the Asian Development Bank—do for a living. Why create new institutions when existing ones are perfectly well suited for the job? Moreover, these institutions have the additional political advantage of independence and standard operating procedures. As a result, they are less vulnerable to risks of moral hazard and politicization.

Were the underlying political issues surrounding North Korea's nuclear program resolved, the legal and procedural barriers to incorporating the country into international financial institutions are much less of a problem than is commonly thought.<sup>15</sup> One model of multilateral engagement of North Korea would be to allow the World Bank to play a coordinating role as the administrative arm of a consultative group. The Bank would engage in more detailed analysis of the North Korean economy and become the repository for a dedicated North Korea fund that would initially support technical assistance and the building of local institutional capacity. These early actions would eventually support entry into the IFIs, direct lending and investment guarantee activity through the International Finance Corporation.

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<sup>15</sup> . Joining the IMF is a pre-requisite for membership in the World Bank but both are universal institutions, have relatively limited—and vague—requirements for membership and do not require consensus or super-majority votes to take on new members (Feinberg 2011, 64-67). IMF membership is not a prerequisite for joining the Asian Development Bank (ADB), which as a result might be the appropriate starting point for North Korea.

Japanese post-colonial claims payments could be one source of financing for such a facility as the two countries normalized relations.<sup>16</sup> Additional funds might be available via the ADB and the newly-created Asian Infrastructure Investment Bank (AIIB).

The central difficulty is that North Korea has shown little interest in joining these multilateral financial institutions. In 1997, in the midst of economic collapse and famine, North Korea hosted an informational mission from the IMF and released to the Fund mission macroeconomic data that had been constructed with the assistance of the local United Nations Development Program (UNDP) office. However, members of the mission have indicated privately that when their North Korean interlocutors realized that additional data would have to be provided and immediate financial assistance would not be forthcoming, they lost interest. Rather than being seen as an inducement, the regime has to date treated these institutions as carriers of the same type of intrusive outside scrutiny that they have sought to evade with respect to their weapons programs.

*New Institutions: A Northeast Asian Free Trade Area*

An alternative to reliance on existing organizations would be to develop a new entity—either with or without North Korea initially—that might serve as a strong inducement for deeper integration with the regional economy by focusing on trade and investment. The most encompassing idea would be some form of a Northeast Asian free trade area. Grand initiatives of this sort have been proposed by a succession of South Korean presidents—albeit it with different titles—and not only during the engagement years of the Kim and Roh administrations; most recently Park Geun Hye has also proposed a Northeast Asia Peace and Cooperation Initiative (Republic of Korea Ministry of Foreign Affairs 2015). Such an initiative could emerge from efforts that are already well underway. South Korea has a free trade agreement with the US and one with China. China, Japan, and South Korea have announced their intention to negotiate a trilateral FTA that could become the nucleus of a wider agreement.

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<sup>16</sup> . Calibration on the basis of Vietnam’s experience in joining the World Bank suggests that the North Koreans might expect an eventual lending program on the order of \$150-\$250 million annually; given South Korea’s interest in revitalizing North Korea and the prospects of Japanese post-colonial payments, the actual lending from such a facility might be substantially larger. In the past, Japanese officials have signaled that normalization could include a multiyear package of grants, low interest rate loans, and trade credits of as much as \$10 billion, consistent with the value of Japan’s 1965 settlement with South Korea, appropriately adjusted for inflation and other factors.

Under current conditions, however, it is inconceivable that North Korea would accede to inclusion in a preferential trade agreement. In addition to the transparency issues outlined above, such a venture would require at least some commitment on the part of North Korea to quite fundamental liberalization of its external sector, which has been anathema as we have seen. Participation in such an arrangement would clearly rest on the willingness of the other parties to tolerate North Korean exceptionalism; an arrangement under which North Korea would enjoy some benefits of preferential trade—as it does with China and might with South Korea—without making substantial commitments of its own. We return to this possibility below, but note only that such an arrangement would substantially limit the transformative effect such arrangements are designed to have.

*“North Korea Plus”: The Economic Dimension of a Northeast Asia Peace and Security Mechanism*

If existing multilateral institutions or arrangements like a free trade are not likely to be of interest to North Korea, is their scope for an altogether new mechanism that would grow out of the Six Party Talks? Although the Six Party Talks are clearly in abeyance, the five parties all remain committed—at least as a matter of declaratory policy—to the multilateral cooperation contained in the Joint Statement of September 19, 2005 and the two 2007 “roadmap” agreements. These include a variety of possible cooperative arrangements on issues such as maritime and air transport, transborder environmental issues, and technical trade and investment facilitation measures, such as customs clearance and regional support for new export-oriented industrial parks in North Korea.

Two issues that deserve somewhat greater attention are ground transport and energy; both raise the crucial question of external financing of North Korean reforms. These sectors have repeatedly been vetted as opening wedges on wider cooperation between the North and its neighbors and are exemplary of the sort of functional integration that some have argued can be used to reach wider bargains. The continued economic growth of Northeast Asia will clearly depend in part on the ongoing development of the major transportation corridors in the region (Tsuji 2003, Na 2007). Two of these are directly related to the integration of the Korean peninsula: the western corridor or Gyungui line, which would not only link North and South but

provide a rail link for South Korea to China; and the eastern corridor, which could link both Koreas to each other and through Russia to Europe; the latter has become a focal point of Park Geun Hye's Eurasian initiative.<sup>17</sup> Rail transport might therefore constitute a useful early issue for discussion, particularly given the fact that it is relatively undemanding on North Korea but could nonetheless yield easy rents even if not linked to wider reforms. Similarly, multilateral support for an improvement of roads would get strong support from the DPRK, China, South Korea and Russia.

Energy shipments to the DPRK have played a crucial role as a short-run inducement in the Six Party Talks (Chapter Six).<sup>18</sup> Beyond the rehabilitation of the North Korean energy sector, broader energy cooperation is often highlighted as one area that could benefit from broader multilateral cooperation, particularly given the strategic jockeying over energy supplies in the region. The most significant ideas in this vein are for power grid interconnection and the development of oil or gas pipeline networks (Babson 2002, Gulidov and Kim 2007, Von Hippel and Hayes 2008).

These ideas face daunting technical constraints (for example, with respect to interconnection), but also extraordinarily high capital costs, and very long time frames for public and private investment to gel. As a result, both pipelines and grid interconnection remain vulnerable to the hold-up problem: that North Korea could easily disrupt and render worthless extraordinarily large investments as they did with the KEDO light-water reactor projects. As we noted in Chapter Three, ambitious Russian investment projects in North Korea have come to naught precisely over such concerns.

The common thread between all of these proposals—using existing institutions, developing altogether new ones, or embedding a settlement to the nuclear issue in complementary economic agreements—is the objective of integrating North Korea into the broader regional and global economies. We have argued that such an opening is a prerequisite to the country's economic renewal and resolution of its chronic humanitarian problems. We are perfectly cognizant that there is a critical role for the public sector in providing depoliticized

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<sup>17</sup> . For more details on the Park's Eurasia Initiative see the Ministry of Unification's "EurAsia Initiative policy proposal (2015) at [http://www.mofa.go.kr/ENG/image/common/title/res/0707\\_eurasia\\_bro.pdf](http://www.mofa.go.kr/ENG/image/common/title/res/0707_eurasia_bro.pdf)

<sup>18</sup> . The February 2007 Joint Statement promised an initial shipment of "emergency energy assistance" in the form of 50,000 tons of heavy fuel oil (HFO) but to be followed in the next phase by up to one million tons of HFO or their equivalent following denuclearization.

technical assistance and financing infrastructure. But earlier ventures such as the Tumen River project and Korean Peninsula Economic Development Organization (KEDO)—which was created in the wake of the Agreed Framework—are reminders of the costs of using a multilateral vehicle as a funnel for aid in the absence of complementary reforms. China and South Korea may extend support on a bilateral basis as a hedge against North Korea's collapse or as inducements in the talks. The development of more permanent multilateral structures is unlikely in the absence of a shift of course in North Korea. Institutions, in short, are not a solution to fundamental heterogeneity among the interests of the parties that seek to form them. Nor can these institutions solve the barriers posed by North Korea's grand strategy. Rather, these problems are a block to such institutions forming in the first place.

### **Conclusion: Negotiation as Engagement**

By the time of the fourth nuclear test, the prospect that any of the five parties would extend additional economic inducements to moderate North Korean behavior had become vanishingly small. South Korea's skepticism about engagement strategies can be dated to the election of conservative governments that first came to office in 2008. Japan began to wind down its North Korea trade at around the same time. The United States declared its unwillingness to "pay for the same horse twice" in 2009. Even China seemed to reach the limits of its patience following the third test in 2013, and while trade continued apace specific initiatives associated with its "deep engagement" period seemed to have gone into abeyance (Li 2016). By 2016, "inducements" had been reduced to the possibility that sanctions might be lifted in the context of a revived negotiation; all else was strictly prospective.

As a result, the debate about engagement has also narrowed substantially from the question of economic inducements to how negotiations might be restarted. As we saw in Chapter Seven, North Korea has shown decreasing interest in the Six Party Talks, floating peace regime proposals as a prior step required to build confidence. China has endorsed resumption of the Six Party Talks but as of this writing was also floating ideas that might permit a simultaneous launch of nuclear and peace regime talks. The United States for its part had no interest in peace regime talks unless progress could be made on denuclearization; even in a lame duck year and for legacy reasons, the Obama administration showed no interest in such an initiative. In the absence of

Chinese sanctions having the effect of pushing North Korea back to the bargaining table, these divergent approaches to negotiations were an obvious recipe for continued stalemate.

In closing, we can only ask the North Korean leadership “quo vadis?” In 2013, the young and untested leader of North Korea faced an interesting choice. When given the opportunity to meet Google chairman Eric Schmidt, leader of one of the world’s most dynamic and innovative companies, Kim Jong Un declined. Yet on multiple occasions—totaling six visits—he managed to find time to spend hours partying with former Chicago Bulls basketball player Dennis Rodman. This simple and revealing choice, as much as the complexities of the economic and diplomatic relations addressed in this book, is suggestive of how decision-making in authoritarian regimes is not only subject to the institutional and economic constraints but to the discretion and even whim of its leadership.

In dealing with such regimes—and North Korea is on many dimensions admittedly an extreme case—both sanctions and engagement have become favored instruments of different foreign policy constituencies. For those seeking to avoid the risks of military escalation, sanctions provide a relatively costless foreign policy tool, at least against smaller parties. If we set aside the political dimensions of engagement, it too is a relatively costless policy and particularly for a large country like the United States; this observation was at the heart of the so-called Obama doctrine. But perhaps the central lesson of our analysis is that the outside world should be modest in its expectations about outside influence. The restraints on economic statecraft hinge not only on well-known coordination problems and the bargaining issues we have emphasized but on internal features of “hard targets” such as North Korea. Without an understanding of the domestic political economy of such states and the quite distinctive external economic relations to which they give rise, the US and its allies will be operating in a policy world characterized by wishful thinking rather than effective influence.

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