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**The Political Economy of North  
Korea: Implications for  
Denuclearization and Proliferation**

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# **The Political Economy of North Korea: Implications for Denuclearization and Proliferation**

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## **Abstract**

Despite North Korea's turn away from economic reform and the constraints of the second nuclear crisis, the country has in fact become more economically open. But it has emphasized closer economic relations with China and other trading partners that show little interest in political quid-pro-quo, let alone sanctions. Yet the US can still exercise economic leverage by going aggressively after third-party financial intermediaries. This particular form of sanction does not require multilateral coordination, since foreign banking institutions that conduct significant business in the United States have a strong interest in avoiding institutions that the United States Treasury has identified as money-laundering or proliferation concerns.

There is some evidence that North Korea moderated its missile proliferation activities during periods when rapprochement with the United States, and to a lesser extent Japan, was a priority, but in the absence of such interest and as legitimate trade, investment, and aid dry up, the incentives to intensify proliferation activities increase.

The internal organization of the North Korean economy has important implications for any policy seeking transformation via engagement. The economy is structured in such a way that outside economic ties are still largely monopolized by state-owned enterprises and other gatekeepers, such as the military. Under such circumstances, the precise design of engagement policies requires very close scrutiny. Even nominally commercial relations can be exploited if the North Korean counterparties believe that they are ultimately political in nature, subsidized and thus vulnerable to blackmail. If economic ties are truly commercial in nature, those choosing to trade and invest with North Korea do so at their own risk. Under these circumstances, private actors will make economic decisions fully factoring in political risk, and North Korea will bear the costs if it chooses to renege on commitments or fails to provide a supportive policy environment.

Paper prepared for the conference on North Korean Nuclear Politics: Constructing a New Northeast Asian Order in the 21<sup>st</sup> Century," University of Washington, June 4-5, 2009. We would like to thank the Smith Richardson, MacArthur, and Korea Foundations for financial support and Jennifer Lee for research assistance.

Most analyses of North Korea's nuclear ambitions have viewed them through the lens of high politics. Recent statements suggest that North Korea may be trying to "break out": to secure a deterrent and to gain de facto recognition as a nuclear weapons state. Alternatively, North Korea may still be engaged in a protracted negotiation in which nuclear provocations are used to extract some military or diplomatic benefit, such as normalization of relations with the United States or a security guarantee.

However, North Korea's nuclear ambitions, and related proliferation activities, also have a political economy component. First, nuclear weapons development and proliferation activities can be "traded" not only for military or diplomatic gains, but for economic ones as well. This point has been made by both "hawks" and "doves." Hawks argue that North Korea is engaged in a blackmail game, in which provocations are used to extract material benefits. Making economic concessions therefore only encourages bad behavior, a classic example of a moral hazard problem. As a result, aid and other economic concessions should be tightly conditioned on North Korean actions. The Lee Myung Bak administration has adopted this position, offering very generous economic benefits to the North, but only *after* it sends decisive and irreversible signals of its intent to denuclearize.

Those in favor of engagement have also emphasized the role of expanded trade, investment and aid in dealing with North Korea, and using two quite different arguments. On the one hand, they believe that economic inducements can still serve as a useful instrument for convincing North Korea to abandon its nuclear ambitions. They point out that heavy fuel oil (HFO) shipments and the promise of the ill-fated light-water reactors (LWRs) were core components of the Agreed Framework. Economic "cooperation"—a euphemism for assistance—also figures in the September 2005 statement of principles and the February and October 2007 "roadmap" agreements as well.

Yet proponents of engagement also argue that expanded trade and investment will gradually moderate North Korean behavior. Engagement should be seen not simply as a quid-pro-quo strategy, but as a means of promoting economic reform, creating new economic interests and gradually loosening the reins of central control. This long-run

strategy was pivotal to the concept of engagement advanced by the both the Kim Dae Jung and Roh Moo Hyun administrations.<sup>1</sup>

Quite obviously, arguments in favor of engagement have been dealt a severe if not fatal blow by the missile and nuclear tests of 2009. However, the reasons are complicated and also have implications for those arguing for a more robust sanctions regime as well. In this paper, we summarize some recent research on the North Korean economy and speculate on its implications for denuclearization and proliferation.

First, there is strong evidence not only in 2009 but beginning as early as 2005 that the leadership has become increasingly wary of economic reform. The domestic origins of this shift are opaque but the behavioral evidence is unmistakable: the leadership has reverted to a more control-oriented—even Stalinist—approach to economic policy. General economic inducements, such as lifting of sanctions, entry into the IFIs or more formalized regional cooperation, have probably never been as significant economic carrots as outsiders believe. The regime has always favored very targeted transfers that can be controlled and used directly by the leadership to sustain control, such as food aid, HFO shipments or—even better—straight cash payments such as those secured from the 2000 North-South summit and the Kaesong and Mt. Kumgang projects. But if anything, the appeal of general economic inducements is even lower than it has historically been because of the shift away from reform.

A second, and apparently contradictory, observation is that despite the recent anti-reformist turn and the constraints of the second nuclear crisis, North Korea has in fact become more economically open. However the political geography of North Korea's trade has shifted quite fundamentally. Trade with Japan has virtually collapsed as Tokyo moved toward a virtual embargo. Trade with Europe stagnated following the onset of the nuclear crisis and trade, investment and particularly aid from South Korea fell sharply following the inauguration of Lee Myung Bak.

At the same time, the DPRK's dependence on China has grown dramatically in both absolute and relative terms. Overall trade with China has far outpaced GDP growth—implying greater openness to China—and the growth of China's trade and

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<sup>1</sup> For an important statement of the logic linking economic openness, development strategies and nuclear ambitions see Etel Solingen, *Nuclear Logics: Contrasting Paths in East Asia and the Middle East*. (Princeton: Princeton University Press, 2008).

investment has far outstripped trade with other partners, implying a rising trade share. In addition, North Korea has also sought out other partners which do not pose sanction risks, or with whom North Korea's nuclear and missile interests are aligned, most notably Iran, Syria, and potentially Egypt as well. These shifts in trade patterns make it much more difficult, although not impossible, to pursue an effective sanctions strategy. In the absence of robust cooperation from China, policy would have to shift from trade sanctions to more targeted efforts aimed at North Korea's international financial ties or even direct interdiction of seaborne trade, perhaps justified by proliferation concerns.

We proceed in four steps. In the first section, we provide a schematic overview of the development of the North Korean economy from the collapse of the Soviet Union to the onset of the second nuclear crisis. We emphasize the impact of the great famine of the mid-1990s on what we call "marketization from below" and the tentative economic reforms that culminated in the policy changes announced in July 2002. In the second section, we provide an overview of the evolution of the external sector, focusing particular attention on China and South Korea. We show the growing weight of China in North Korea's external economic relations, the increasingly commercial nature of these ties, and the minimal impact the missile and nuclear tests of 2006 had on the growth of China-DPRK trade and investment. These patterns contrast with North-South economic relations, which have been highly political under Kim Dae Jung and Roh Moo Hyun as well as Lee Myung Bak. In the third section, we trace briefly the process of "reform in reverse": the shift away from reform toward an increasingly control-oriented approach to economic policy. We conclude with some discussion of the policy implications of these developments.

### **The North Korean Economy: From the Collapse of the Soviet Union through the Onset of the Second Nuclear Crisis**

Following the collapse of the Soviet Union, the North Korean economy went into a steep decline, culminating in one of the most destructive famines of the 20<sup>th</sup> century.<sup>2</sup> As many as one million people—five percent of the entire population—perished in the

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<sup>2</sup> Stephan Haggard and Marcus Noland, *Famine in North Korea: Markets, Aid, and Reform* (New York: Columbia University Press, 2007).

mid-1990s. The causes of this collapse were multiple, including long-run distortions associated with the socialist growth model as well as the costs associated with the nuclear standoff of 1993-94. However, the failure to adjust to the collapse of Soviet support is the ultimate reason for the crisis. As the Soviet Union, then Russia, abandoned friendship prices and aid in favor of hard currency payments for exports, both the industrial and agricultural sectors went into a secular decline. The floods of 1995 were only a final shock. But they cannot be held solely or even primarily responsible for the economic collapse and famine, as the North Koreans argued at the time, as they had begun well before that time.

In response to the crisis, the North Korean economy began to undergo a profound transformation, what we call “marketization from below.” Households, work units, local party organs, government offices, and even military units all scrambled for food, initiating barter, trade and venturing into new, monetized, economic activities. On the cooperatives, these activities included the tending of private plots and the diversion of cooperative output into consumption and market sales. In the cities, markets began to play a more important role both in generating household income and as a source of retail purchases, including for food.<sup>3</sup>

A recent survey we conducted of 300 North Korean refugees living in South Korea provides insight into the extent of this process of informal marketization. We asked respondents whether, in addition to their regular work, they engaged in other economic activities. 70.9 percent said they had engaged in trading, 8.9 percent in private services, 18.9 in “other” business activities, and 14.9 in August 3 units, entrepreneurial businesses run out of the traditional state-owned enterprises. A surprising 69 percent of all respondents said that they secured over 50 percent of their income from private business activities, and 46 percent said they secured *all* of their income from private activities. In addition to working “outside the plan,” households were also forced to secure basic necessities outside of the Public Distribution System (PDS) as well: through market purchases, growing food themselves, or barter. Under 10 percent of the respondents in our survey said that the PDS or workplace was their primary source of

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<sup>3</sup> . The market for food was also fed by substantial diversion of the large inflow of food aid that began to arrive beginning in 1995.

food at the time they left North Korea. Moreover, there is little difference in this response across different dates of departure; if anything, reliance on the market appears to go up over time. By far the dominant responses to the question about the primary source of food were either that they bought food on the market (37.0 percent) or that they grew it themselves (27.9 percent)

At the peak of the famine, and its immediate aftermath, the regime had little choice but to allow this “marketization from below.” The crucial question was how they would respond to these new facts on the ground when the famine had passed. The answer is: “cautiously.” In 1999, the leadership introduced constitutional revisions that appeared to tentatively broaden the space for economic activity outside direct state control. External political developments provided some additional hints of an opening; these developments included not only the 2000 North-South summit, but also the resumption of high-level visits with China in 2000 and 2001 and the Koizumi summit of 2002. In July 2002, the regime undertook a major reform effort. We discuss the technical details of this reform in some detail elsewhere, and there are ample grounds for criticizing it as a limited and flawed effort.<sup>4</sup> Nonetheless, it did decriminalize some of the market activities that had sprung up during the famine (for example by allowing continued growth of controlled markets) and began or continued incremental reforms of the cooperatives (for example, by reducing the size of work teams) and of state-owned enterprises (for example, by granting greater managerial autonomy).

Yet the timing of the reform proved highly inauspicious. Within months of the launching the 2002 reforms, the second nuclear crisis had broken.

### **Developments in the External Sector**

Developments in North Korea’s external sector are not only important for the political reasons we focus on here, but for economic reasons as well. It is common to argue that North Korea should pursue a Chinese-style reform, but for a number of reasons agricultural reforms are unlikely to be as central to North Korea’s transformation as they were in leading system transformation in China and Vietnam. Not only is North Korea’s

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<sup>4</sup> . Haggard and Noland, *Famine in North Korea*, pp. 176-191.

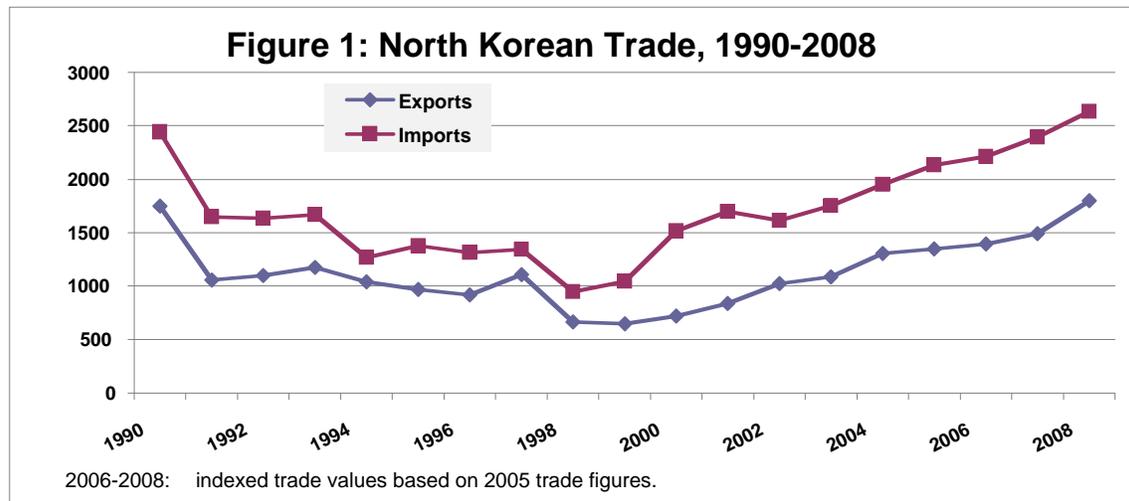
agricultural sector very much smaller than in those two socialist countries, but the relatively limited amount of arable land, Northern latitude, short growing seasons and vulnerability to both floods and drought all argue strongly against the prospect that the agricultural sector could lead the reform process.

Rather, the most auspicious path of transformation would be to follow a course similar, at least in broad outlines, to that of South Korea. This strategy would exploit proximity to larger, more advanced economies (including China as well as South Korea and Japan) and use both foreign investment and multilateral assistance to support increased trade, including through investment in trade-related infrastructure (ports, export-processing zones). Investment and exports would finance not only the imports needed to revive the North Korean economy, but also the food that has been in continuous short supply since the famine.

What has happened in fact? The broad development of North Korea's foreign economic relations since 1990 appears to follow developments in the economy more generally; Figure 1 provides an overview of North Korea's exports and imports from 1990 through 2008. Both exports and imports declined precipitously in the first half of the decade, bottoming out around 1998. Since that time, trade has shown a steady recovery, growing without interruption through the onset of the second nuclear crisis.

However, a closer examination of patterns of trade reveals quite fundamental changes in the nature of the DPRK's foreign economic relations. A first point to note from Figure 1 is that imports consistently outstrip exports: the country has run a current account deficit over the entire period, implying offsetting capital inflows. Prior to the political developments of the early 1990s, these deficits were effectively financed by aid from the DPRK's socialist patrons. In some cases, this "aid" took the form of the inability or unwillingness of DPRK firms to make required cash or barter payments; in effect, North Korea accumulated arrears. However, first the Soviet Union and Russia, and then China, largely abandoned trade at friendship prices. As a result, the DPRK's trade with Russia almost completely collapsed. Aid has continued to play some role in financing the DPRK's current account deficit, including ongoing assistance from China as well as multilateral and bilateral food aid. But there is ample anecdotal evidence that foreign direct investment has played an increasing role in financing North Korea's current

account deficit over time, both through Kaesong and through a variety of projects with Chinese and other investors.<sup>5</sup>



A second point to make is that the nature of North Korea's trade exhibits very interesting differences depending on trading partner, as can be seen by looking more closely at trade with the DPRK's two most significant partners, China and South Korea. North Korea's trade with China during and immediately after the great famine bore important similarities to the process of "marketization from below" described above. Not only did work units and households engage in domestic trade in order to secure food; those with access or proximity to the border also initiated new trading relationships with China.

Viewed from the North Korean side, these trade relations ranged from officially-sanctioned trade conducted through state-owned trading companies, to transactions that exploited family connections with the Korean Chinese community in the Chinese border provinces. In this latter category, some "trade" probably included unrequited transfers to relatives. In-between these two ideal types of official and private commercial interactions has been a very wide gray-area of trade that appears to have a strong commercial component, even if conducted by state-owned enterprises.

Viewed from the Chinese side, we have data from 2003 and 2007 on the share of trade accounted for by firms of different ownership: private, state-owned and

<sup>5</sup> Stephan Haggard and Marcus Noland, "North Korea's External Economic Relations," Peterson Institute for International Economics Working Paper 07-7, August 2007.

multinationals. In 2003, less than a quarter of China's trade with the DPRK passed through private companies, and none through multinationals. In 2007, more than half of the trade was through private Chinese companies, and multinationals accounted for roughly 10 percent. In short, trade across the Chinese border is increasingly commercial in form. Further indirect evidence of the "commercialization" of China-DPRK ties is the sharp increase in North Korea's exports to China. This increase in exports would be consistent with declining tolerance of private Chinese firms to tolerate arrears, and the corresponding pressure on North Korean firms to earn foreign exchange in order to finance imports.

Figure 2 provides monthly data on China's bilateral trade with North Korea. As can be seen, trade has expanded steadily since the onset of the nuclear crisis. Exports to North Korea have also outstripped imports from it, implying a bilateral trade deficit financed in part by growing foreign direct investment by Chinese enterprises. If our assumption of increasing commercialization is correct, then trade growth is no doubt explained in no small measure by China's booming economy. However, the growth in trade with China may also have been given an unintended boost by the onset of the nuclear crisis. Both push and pull factors were at work. On the one hand, the crisis resulted in an effective Japanese embargo, US financial sanctions (BDA) and multilateral sanctions following the missile and nuclear tests of 2006, all of which might have generated uncertainty in trade with other countries even if sanctions were not binding nor strongly enforced.

On the other hand, China's de facto strategy of engagement with North Korea persisted, providing an implicit framework for closer economic integration. In a more thorough study of trade during this period, including some simple econometric tests, we find that North Korea's 2006 nuclear test and the imposition of UN Security Council sanctions had no perceptible effect on North Korea's trade with China.<sup>6</sup>

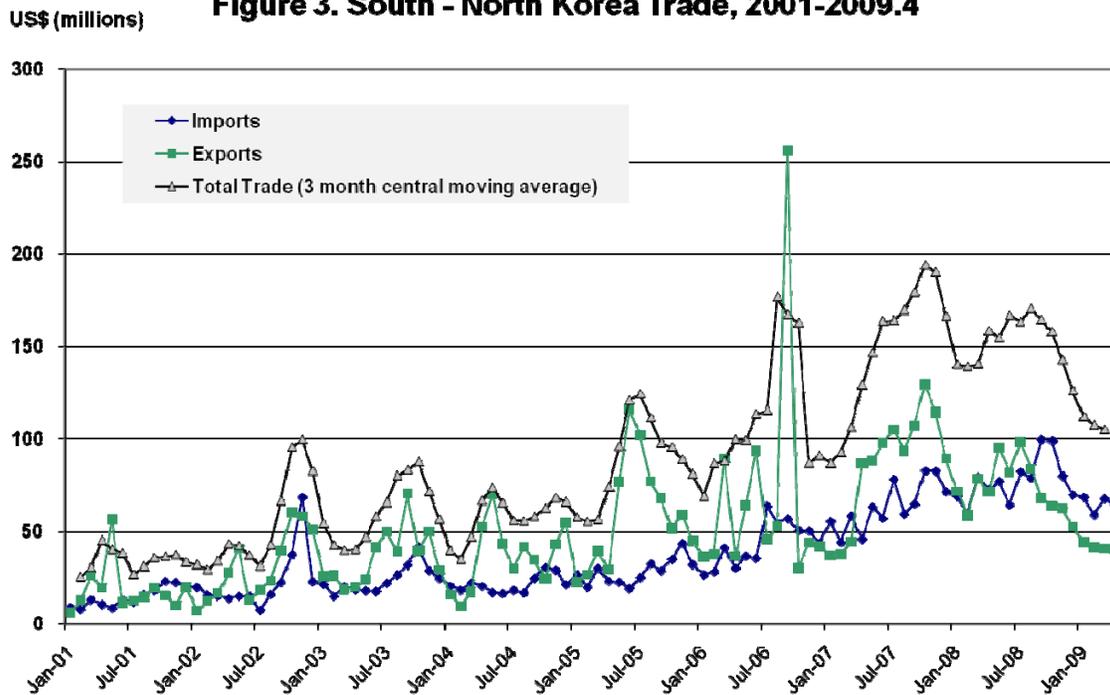
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<sup>6</sup> Marcus Noland, "The (Non) Impact of UN Sanctions on North Korea," *Asia Policy* 7 (January 2009): 61-88.



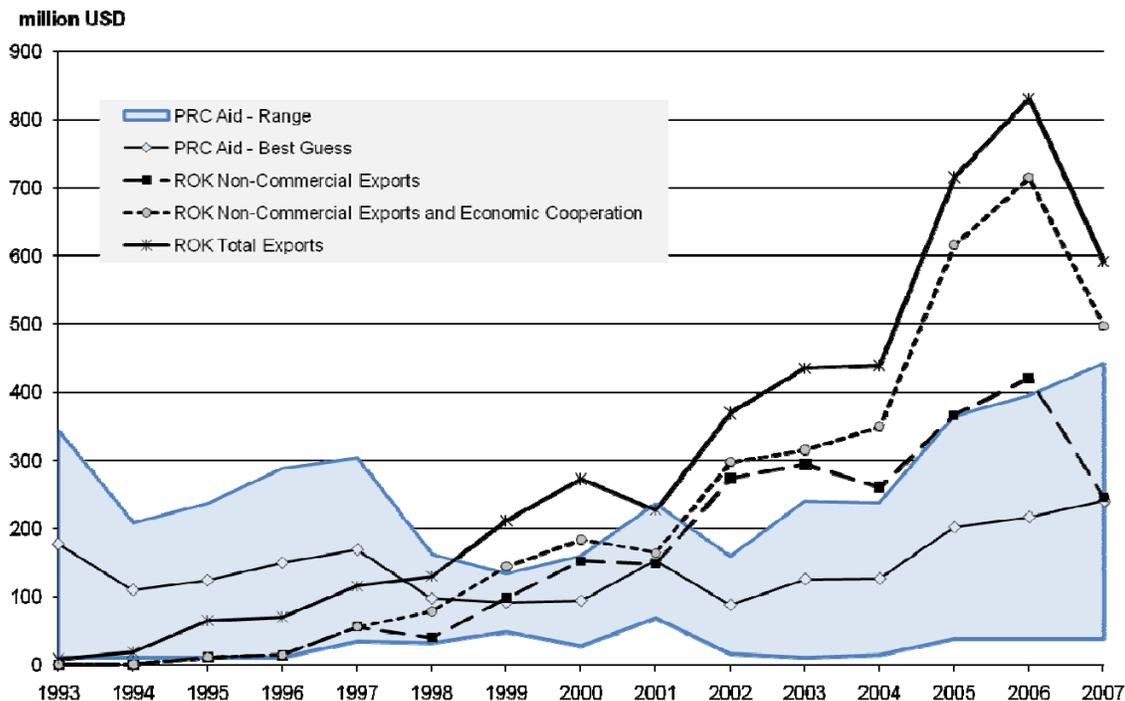
Figure 3 traces the development of South Korea's trade relations with the North. In contrast to the steady increase visible in bilateral DPRK-China trade, a close inspection of Figure 3 shows the substantial politicization of trade not only under Lee Myung Bak, but under Kim Dae Jung and Roh Moo Hyun as well. Trade did not begin in earnest until the initiation of the Sunshine Policy under Kim Dae Jung, but even following the summit of 2000 trade remained relatively flat through the end of the DJ administration before beginning a more erratic expansion under Roh Moo Hyun. However, despite the Roh administration's reputation as a relentless advocate of engagement, trade did suffer—if only briefly—from the missile and nuclear tests before appearing to take off over the course of 2007. But trade relations under the Lee Myung Bak administration proved more erratic well-before the disruptions associated with the events of 2009.

**Figure 3. South - North Korea Trade, 2001-2009.4**



Source: Ministry of Unification, Monthly North-South Trade

It is also important to note that from the beginning, North-South trade had a strong aid and noncommercial component. Even nominally commercial trade has a substantial strategic and noncommercial cast. The Mt. Kumgang tourist project and Kaesong Industrial Complex have involved private companies, but also substantial government subsidies. Figure 4 divides South Korea's exports to the North into three categories—commercial trade, cooperation projects (primarily Kumgang and Kaesong) and noncommercial trade or aid—and compares them with our estimates of Chinese aid. Between 1995 and 2007 South Korea's aid and economic cooperation activities together have at times accounted for almost 60 percent of total trade, and averaged more than 40 percent of trade over this period. Aid and other noncommercial exports from South Korea have increasingly outstripped even our highest estimates of Chinese aid. Under the government of newly elected President Lee Myung-bak, the relative magnitudes of these noncommercial transactions has decreased as South Korean policy emphasized a more conditional approach. Nonetheless, the irony is inescapable: up through the Lee Myung Bak administration, South Korea's trade with the North has been less commercial in nature than North Korea's trade with China.

**Figure 4. China and South Korea Aid and Exports to North Korea**

### Reform in Reverse: A Brief Review of the Evidence

The onset of succession concerns in the fall of 2008, the missile and nuclear tests of 2009, and the bellicose statements that have followed in their wake, have been interpreted as signaling a fundamental—if poorly understood—realignment in favor of “hardliners” and the military. However, a closer consideration of recent economic policy suggests that this shift has been apparent in the economic sphere since 2005 if not earlier. We consider five examples of “reform in reverse”:

- Developments in the food economy, including efforts to revive the PDS;
- The restrictive response of the government to the development of markets;
- The management of the border trade;
- Developments with respect to Kaesong;
- Government statements with respect to overall development strategy, most notably in the joint New Year’s editorial of 2009.

Possible explanations for these changes are as diverse as for North Korea's recent behavior with respect to the nuclear issue. The regime's emphasis on "military-first" politics limits the scope of the reform effort by continuing to tilt the overall allocation of resources in favor of the military, an important component of recent pronouncements on economic policy as we will see.<sup>7</sup> Arguably, the external environment has been partly to blame. The "hostile policy" of the Bush administration was certainly not conducive to the pursuit of reform, although this argument became somewhat more difficult to make as the second Bush administration belatedly embraced negotiations; it makes even less sense following the inauguration of Barack Obama. We are more inclined to the theory that the top leadership and conservative forces in it believe that "marketization from below" is eroding state power, and are not confident—as the Chinese Communist Party was—that they can maintain their political monopoly while simultaneously pursuing economic reform.

But whatever the reasons for this shift, it is important to emphasize the vicious cycle that erratic commitment to reform can set in motion. In a "virtuous cycle" model, reforms generate improved economic performance, new stakeholders and associated demands to push the process further, or at least tolerate increased private activity. In the absence of a general commitment to the reform process, it is difficult either for North Koreans or foreigners to invest with confidence. The result is that the reforms appear not to work. Moreover, the reversion to controls provides ample opportunities for corruption as "gatekeepers"—those responsible for enforcing controls—are handed new opportunities for rent-seeking. As a result, the reform process not only becomes corrupted but is associated with corruption as well.

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<sup>7</sup> For an analysis of the military's expanding role in the North Korean economy under the *songun* policy see [Georgy Toloraya](#), "North Korea Now: Will the Clock Be Turned Back?," The Brookings Institution, 11 February 2008, [http://www.brookings.edu/articles/2008/0211\\_north\\_korea\\_toloraya.aspx?p=1](http://www.brookings.edu/articles/2008/0211_north_korea_toloraya.aspx?p=1). Toloraya argues that the military opposes economic reform and marketization. Yet the existing military leadership could be a beneficiary of reform and opening. North Korea could experience a large "peace dividend" as part of its million man army was demobilized and put to work on civilian projects such as the rehabilitation of infrastructure. At least some of the military leadership could reinvent themselves as businessmen. See Marcus Noland, *Avoiding the Apocalypse: The Future of the Two Koreas* (Washington: Institute for International Economics, 2000), pp. 302-3 for a quantitative assessment.

*The Breakdown and Reconstitution of the Public Distribution System*

Prior to the great famine of the mid-1990s, the government set production quotas to the cooperatives, provided farmers' rations at the time of the harvest, and distributed food to urban residents through the PDS at nominal prices; markets played virtually no role in the allocation of food. During the famine, the PDS broke down and households relied on the market, barter, private farming activities and other private activities such as foraging. The influx of foreign aid in the late-1990s provided the basis for a partial revival of the PDS as donors had no independent channels for distributing food. But the process of marketization also continued apace driven by partial reforms, such as allowing some private plots and farmers markets, the diversion of food aid and cooperative output into the market and growing commercial trade in food across the Chinese border.

However, whenever the opportunity arose, the government has tried to reinstate the PDS and exercise control over the market for food. In August 2005, the government decided to reinstate the Public Distribution System (PDS) as of October 1 and to ban private trading in grain. These actions were taken in conjunction with the announcement that the World Food Program would be asked to leave the country as well. The ability of the government to implement this policy varied across the country, and eventually the government was forced to quietly shelve the policy as PDS sites were not able to meet targets and markets for grain began to re-emerge.

Historically, the North Korean government's supply-side response to urban food shortages has been confiscatory seizures in the rural areas. In late 2005 reports emerged of the government forcibly extracting food in contravention of the rules determining the disposition of cooperative farm output, though it is unclear just how widely this occurred. In the wake of the 2007 floods, it appears that such moves were intensified. First, the government increased production quotas for the next crop cycle, including through exactions earmarked for the military. Second, the government began to crack down on "embezzlement" and "corruption" on the part of cooperative managers and the growth of trade and barter of rice among the administrators charged with managing food distribution. Although rising prices in the wake of the floods no doubt created incentives

for corruption, some of these activities may simply have reflected an effort on the part of cooperative managers to protect their members. Third, the government began to express concern that cooperative farmers would divert effort from the current cooperative planting into the tending of private plots; as a result, new restrictions were placed on some of these activities as well. However, the more intense the levies on grain and the controls on private plots, the more clearly the government is signaling the likelihood of continuing distress in the future and the more likely farmers will respond rationally by seeking to protect themselves by seeking to hide and hoard grain.

Through a reconstruction of aggregate food balances, an analysis of prices, and direct observation by NGOs and WFP observers, we now know that the food situation in North Korea was more precarious in 2008 than at any time since the great famine.<sup>8</sup> These shortages help explain the willingness of the North Korean government to engage in negotiations over a large food aid package with the United States, concluded in May 2008. But in other respects, the 2007-8 crop cycle showed the continuing preference for controls and resistance to outside involvement in the food economy, most clearly visible in the decision to terminate the 500,000MT food program with the United States.

### *Responding to Markets and Traders*

The breakdown of the PDS and the emergence of markets poses important challenges for the government not only vis-à-vis the countryside but in the urban and industrial sectors as well. The first is the migration of labor out of the state sector and into market activities, and the corresponding weakening of the state-owned enterprise sector. The second is the breakdown of what is left of the social contract. Households dependent on the market have been forced to pay rapidly rising prices. North Korea's food problems have increasingly come to resemble those in market economies, in which prices rather than aggregate supplies per se are the determinants of hunger and malnutrition; this was particularly true in the spring and summer of 2008 as we show elsewhere in some detail.<sup>9</sup>

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<sup>8</sup> Stephan Haggard and Marcus Noland, "Famine in North Korea Redux?" *Journal of Asian Economics*, forthcoming.

<sup>9</sup> Haggard and Noland, "Famine in North Korea Redux?"

A final problem posed by the markets is an informational one. General markets have been fed by the burgeoning cross border trade with China in consumer goods. This trade has not only revealed the higher quality of Chinese and other foreign products but has included a wide array of cultural products that directly undermine ideological control and the government monopoly on information: from small televisions capable of receiving Chinese broadcasts in border areas to South Korean music videos and DVDs and even mobile phones. The campaign against the market is not just economic in nature but has a strong ideological component, emphasizing the anti-socialist nature of market activities.

As a result of these challenges, the recent effort to exercise control over the market has not been limited to food, but has included a wider assault on market activity. One step in this direction was the imposition of escalating age restrictions on market traders in the fall of 2007, ultimately banning women under 50 from trading in general markets. From mid-January 2008, the government also stepped up inspections on the general markets or *jangmadang* in an effort to control the range of goods on offer as well, with the apparent intention of reverting to the more limited farmers markets that were permitted to trade only in supplementary foodstuffs. In October 2008, DPRK authorities issued a decree through local commerce management offices around the country ordering all permanent markets to open only once every ten days. These control efforts recurred in early 2009, with announcements of bans on a variety of foreign products that have been increasingly important to the burgeoning retail trade.

These efforts at control are unlikely to be fully successful; age restrictions are circumvented by bringing grandparents into the market; regulated markets—and efforts to close them--have been supplemented by new “alley markets” that shift trading to new venues; and traders undoubtedly will seek to bribe inspectors. However, the restrictions have nonetheless sown uncertainty about alternative sources of livelihood for households, and in 2008 did so just as soaring food prices forced households to seek other sources of income and barter.

There is also some evidence that the efforts to exercise control over markets may influence the cross-border trade as well. Larger trading entities in the land ports along the border, particularly in Sinuiju, have also fallen under government scrutiny. In a

noteworthy development in April 2008, the central government dispatched a team of 200 investigators to Sinuiju in the name of an Anti-socialist Conscience Investigation to inspect the books of foreign trade organizations, necessarily affecting market activity as a result.

We are doubtful that the effort to impose controls is likely to generate an overt social or political backlash; the barriers to collective action in North Korea are well-known. But an interesting episode in March 2008 in Chongjin suggests complex political risks for the regime and that the markets themselves could become the locus of protest and everyday forms of resistance. In early March, city officials sought to enforce the age restriction on women traders. In what appeared like a coordinated action across several markets in the city, large groups of women staged protests against the ban on trading on March 4. Municipal authorities took the unusual step of re-opening the markets under the authority of the local ministry of labor on March 5 but were subsequently forced to reverse course and to enforce the ban at the insistence of the central government. The episode reveals the ongoing tensions that likely exist between the objectives of the center and local officials squeezed between the absence of resources, mounting political and social pressures and the risks of repression.

### *The Border Problem*

The dramatic increase in trade with China has resulted in the creation of dense business networks that include both major Chinese and North Korean enterprises, smaller Chinese-Korean businesses and North Koreans with relatives in China who are permitted to travel, albeit only with the greatest of difficulty. The major land ports on the North Korean side of the border, particularly Sinuiju, have become not only trading centers but major distribution hubs for the rest of the country.

But the border poses risks to both North Korea and China. When economic circumstances deteriorate, the incentives to move into China rise, either permanently or in search of business opportunities and food. Illicit border trade in drugs, particularly methamphetamines has also been widely reported as has smuggling of scrap metal and other products that reflect the looting of state-owned enterprises and public infrastructure.

Prior to changes in the North Korean penal code in 2004, a person who illegally crossed a “frontier of the Republic” faced a sentence of up to three years in a gwalliso (a political penal labor colony) but those who did not appear politically dangerous were sent to a village unit labor camp, where they would spend between three months and three years in forced labor. Those classified as ‘political offenders’ faced more severe penalties. In “serious” cases, defectors or asylum seekers are subjected to indefinite terms of imprisonment and forced labor, confiscation of property, or death. Regulations under the 2004 penal code appear to have codified the differential treatment between economic refugees and those cases deemed political, stipulating lighter sentences for those crossing for economic reasons. Yet not surprisingly, the legal revisions did not necessarily reflect reality: interviews with refugees suggest that judicial proceedings were often skipped, torture remained prevalent in detention facilities, and death rates in incarceration were high.

The recurrence of severe food shortages following the floods of 2007, however, was accompanied by a dramatic crackdown on border movements, a crackdown that accelerated as the Tumen River began to freeze in the early winter. From November 2007, reports from North Korea indicate the organization of Anti-Socialist Conscience Investigation Patrols (ASCIP) to control internal movements in North Hamkyung province and to confiscate “contraband.” The most dramatic signal sent by the regime was the public execution of 15 people, 13 of them women, in Onsung on February 20, 2008 on charges of trafficking. But sentences have also been increased; single border crossings not related to South Korea or having political overtones that were previously overlooked now carry sentences of three years, with those found guilty of multiple crossings—even if not political—receiving sentences up to ten years. In an interesting signal of the seriousness attached to this issue and concerns about the pervasiveness of corruption along the border, the police have even been granted new authority to incarcerate without going through prosecutors and to exercise some control over border security agents and even military personnel.

The economic implications of these new restrictions are impossible to estimate; the illicit border trade is relatively small and remittances passed through informal channels are unlikely to be very large either. However, the border has represented a

partial escape valve both through movement and trade. In conjunction, the observations about the PDS, the response to the growth of general markets, and the approach to the border all suggest that the regime has responded to adverse economic conditions with the imposition of controls, a number of which are likely to have perverse effects and directly limit the opportunities for households to cope with distress.

*Foreign Direct Investment: the Kaesong Saga*

The posture of the North Korean regime toward FDI has always been ambivalent. The early effort to experiment with an export-processing zone in Rajin-Sanbong faced a host of obstacles and failed to attract any significant investment.<sup>10</sup> Although proximate to both China and Russia its location on the Northeast coast did not exploit existing centers of economic activity on which it could build, as the early Chinese zones did. Weak infrastructure, both physical and legal, and an unwillingness to extend significant concessions all conspired against the project. The strange effort to establish a Sinuiju Special Administrative Region, modeled in detail on the Macao and Hong Kong SAR's and to be administered by Chinese entrepreneur Yang Bin, collapsed in 2002 when Yang was arrested by Chinese authorities. Despite recurrent rumors that the SAR or zone idea would be revived in Sinuiju, to date there has been no progress in constructing one despite the obvious economic complementarities with China.

Outside of discrete deals with particular companies, the Kaesong industrial complex thus constitutes the only other North Korean experiment with the export processing zone model. Despite pressures to respond to the 2006 missile and nuclear tests by re-examining Kaesong, the Roh administration chose to largely insulate this experiment from high politics.

North Korea has not shown similar restraint. As a result, the politics of Kaesong exhibits what might be called "reverse leverage": rather than Kaesong moderating North Korean behavior and encouraging the spread of reform, Pyongyang has sought to

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<sup>10</sup> . Marcus Noland and L. Gordon Flake, "Opening Attempt: North Korea and the Rajin-Sonbong Free Economic and Trade Zone," *Journal of Asian Business* 13, no 2 (Spring 1997): 99-116.

manipulate the high sunk costs in Kaesong to place pressure on the Lee Myung Bak administration.

The recent Kaesong saga began in July 2008, following the killing of a tourist at Mt. Kumgang, when North Korea delayed approval for South Koreans traveling to Kaesong and the industrial complex. The North said that this action was taken in response to delays in the delivery of equipment for a new military communications channel, which the South had withheld because of the Mount Kumgang incident. At this point, South Korean investors began to hedge their bets, running down inventories and postponing planned expansions of activity. The so-called “December 1 actions” of that year suspended train operations and tourism, closed an economic cooperation office and ordered the South to withdraw half the staff of the Kaesong Industrial Complex Management Committee. Again, specific political concerns were cited, including the Lee administration’s unwillingness to fulfill promises made at the 2000 and particularly 2007 North-South summits as well as concerns about anti-regime leaflets spread via balloon by South Korean activists. A particularly telling feature of the events of December 2008 was the visit to Kaesong by Lt. General Kim Yong-chol of the National Defense Commission and the thinly veiled effort to enlist Kaesong-invested enterprises as a domestic source of pressure on the administration’s policies. In March 2009, the DPRK took its first steps to rewrite rules—and extract rents—by enforcing environmental standards and levying fines for labor violations. The effective shutdown of the park in March was a side-effect—perhaps even unintended—of the suspension of an inter-Korean military communication channel in response to American military exercises. But by May, North Koreans were declaring existing contracts with respect to land rent, land use taxes, and wages “null and void” and even held a South Korean hostage at the complex on charges that he was engaged in politics.

Much of the discussion of the Kaesong saga has focused on whether the North Koreans really mean it, or whether these moves constitute efforts to renegotiate contracts on more favorable terms. This discussion misses a central point. The real costs are likely to take the form of lost future investment, deterred—at least in the absence of effective subsidies or guarantees—by the propensity of the current North Korean leadership to subordinate economic and reputational calculations to broader political objectives.

As we have seen from the aggregate data, weak property rights do not deter foreign direct investment altogether; Chinese and other firms have invested, in some cases large amounts of money as recent Orascom investments demonstrate. These firms have clearly found some way to secure their investments, in part through the formation of joint ventures with partners who provide not only complementary assets—typically land—but political protection as well.

To explore some of the constraints on foreign direct investment in North Korea, we conducted a survey in 2008 of 250 firms from the Chinese border provinces doing business in the country (as well as a control group of enterprises not doing business there). Although most of the companies were engaged only in trade, and what appear like spot-market transactions at that, 70 claimed to have some form of investment in North Korea. We asked them a series of questions about the constraints on their business. Not surprisingly, the quality of infrastructure figured prominently in their responses: 92 percent of investors agreed or strongly agreed that the quality of basic infrastructure was a problem for their business and 94 percent agreed that the ban on cell phones was a constraint. Yet property rights concerns also figured prominently. 65 percent agreed or strongly agreed that it is risky to invest in North Korea because assets may be expropriated outright. But 77 percent said that regulations in North Korea make it hard to do business and 81 percent said that it was risky to invest because the government can change the rules. 54 percent of all firms in the sample said that it was necessary to bribe officials to do business in the DPRK; however, among investors this share rose to 73 percent, underlining the vulnerability of investing as opposed to trading. Nor are the amounts trivial: 53 percent of investors claimed that they spent more than 10 percent of annual income on bribes.

In sum, North Korea has proven unwilling or unable to establish export processing zones that provide a stable investment climate, insulated from the vagaries of high politics and government predation. This does not rule out investment; the overwhelming number of respondents to our survey—although obviously self-selected—said that they were able to make money in North Korea. However, such investments were overwhelmingly with government entities and appeared to require particularistic connections and bribery to succeed.

*Economic Strategy: The January 2009 Joint Editorial and the Return to Chollima*

The concept of “military first politics” (*songun chongch'i*) is of obvious importance in understanding political developments in North Korea over the last decade. Introduced formally following Kim Jong Il’s re-election as chairman of the National Defense Commission in 1998, the concept has a number of distinct meanings and political uses. In the first instance, it is ideologically significant, highlighting the ongoing risk of external threats and the need for vigilance, a martial spirit and military-like social discipline. The concept also has obvious political significance, signaling Kim Jong Il’s favoring of—and arguably dependence on—the military as a core institution of his rule.

However, military first politics has also had an important political economy dimension as well. In an important contribution to our understanding of the reform process in North Korea, Robert Carlin and Joel Wit used North Korean economics journals and other sources to track the debate about economic reform in North Korea prior to and following the onset of the nuclear crisis.<sup>11</sup> The debate was cast largely in terms of the relative priority to be given to the military and heavy industry sectors as opposed to light industry, agriculture as well as Kim Jong Il’s particular preoccupation with high-technology projects. Conservative arguments not only warned about the risks to socialism and the significance of military strength in providing the context for growth; they also argued that the military and heavy industries could in effect be a “leading sector” in the effort to create a “strong and prosperous nation” (*kangsong taeguk*). Carlin and Wit were ultimately cautious in their conclusions, but noted that these open debates could constitute evidence—rather than anecdotal observation and assertion—of contending factions within the political leadership.

The “strong and prosperous nation” concept is plastic enough to accommodate a variety of means for achieving it; indeed “military-first” politics could be used as a political device to justify all sorts of top-down reforms and to jettison more problematic aspects of *juche* and past practices, even or perhaps particularly in the face of a severe external threats. Such an approach has historical antecedents that include the Meiji

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<sup>11</sup> . Robert L. Carlin and Joel S. Wit, *North Korean Reform: Politics, Economics, and Security*, Adelphi Paper No. 382. (London: International Institute for Security Studies, 2006).

Restoration (to whose slogans current North Korean formulations bear more than passing resemblance) as well as the founding of modern Turkey under Mustafa Kemal.

However, even a cursory reading of the 2009 New Year's joint editorial, a crucial document setting the general outlines of policy for the year, suggests that reformist forces are in retreat. The most general theme of the editorial is a return to the mobilizational development strategies of the Chollima movement, culminating in the announcement of a "150 day campaign" promulgated in May 2009. The editorial directly quotes Kim Jong Il on this point: "The whole country and all the people, as in those years of bringing about a great Chollima upsurge after the war, should launch a general offensive dynamically, sounding the advance for opening the gate to a great, prosperous and powerful nation, united closely around the Party with one mind and purpose."

With respect to sectoral priorities, the editorial leads with the metal industry as "the mainstay of our independent socialist economy," and gives pride of place to other heavy-industry sectors, including machine-building and chemicals. Recognition is given to the problems in the food sector, but the means of solving them revert to the mobilizational approach and technical fixes pushed during earlier periods of shortage: double-cropping, improved seeds, mobilization of work effort. Of particular interest is the role that the military is seen to play in this process, not only as defender but as a component of the growth effort: "great efforts should constantly be put to the development of the defence industry as required by the line of economic construction in the Songun era and everything necessary be provided for it on a preferential basis."

It is important to underscore a very important point about authoritarian regimes, and particularly personalist ones: they can quickly shift directions. There is nothing about this new course that could not, in principle, be reversed were the leadership choose to re-prioritize more reformist themes. However, policy choices have political economy as well as economic consequences; the shift in strategy in favor of a more Stalinist approach also empowers its beneficiaries and thus creates stakeholders in its persistence as well. There are also more immediate reasons for concern. Mobilizational campaigns are expensive; there are distinct limits to which they can tap work effort alone. As legitimate sources of revenue decline, aid dries up, and trade sanctions are tightened, the incentives

to proliferate and engage in illicit activities such as drug trafficking and counterfeiting obviously increases.

### **Conclusion: Implications for North Korea's Nuclear Program and Proliferation Activities**

What implications, if any, does this economic story have for the politics of North Korea's nuclear program and proliferation activities? The first, and most general point goes to the question of the regime's intentions. It is virtually impossible for outsiders to be confident that they understand the inner workings of North Korean decision-making. But it is important to ask whether military and diplomatic signals are aligned with other developments in the North Korean political economy. Had the North Korean leadership been pursuing a reformist path since the onset of the crisis--however gradually--it would have constituted an important signal that the country was open to economic inducements.

However, the evidence on this score is not comforting. The North Korean economy is indeed becoming more open, but the leadership remains highly ambivalent about this development and has shown little interest in economic carrots as a result. To the contrary, the willingness to terminate the US food aid program, the government's behavior with respect to Kaesong and the ongoing meddling in the border trade shows a regime that is either indifferent to, or actively hostile, towards economic engagement.

A second conclusion has to do with the political geography of North Korea's external economic relations. An unintended consequence of the crisis has been to push North Korea into a closer economic relationship with China and other trading partners that show little interest in political quid-pro-quo, let alone sanctions. Put differently, North Korea appears to have rearranged its external economic relations to reduce the risk that traditional sanctions would work.

As a result, however, China has become more rather than less central to any effective sanctions effort. The DPRK's very high level of dependence on China, even if on increasingly commercial terms, raises little doubt that Beijing could exercise influence on Pyongyang if it chose to do so. But as the North Korean leadership understands very well, the Chinese leadership faces its own risks in pushing North Korea to the edge,

including further escalatory moves on North Korea's part or a failed state on its Northeast border.

This does not mean that the US and its allies are without economic instruments. First, it is not beyond the realm of possibility that China has in fact reached the limits of its tolerance and that some coordinated or even unilateral action on its part might be forthcoming; as this is being written, it is still too soon to tell what China will do but preliminary signals suggest an increased willingness to impose sanctions.

In the absence of such coordination, the US can still exercise leverage if it can identify how and where North Korea finances its international trade, and goes aggressively after financial intermediaries as it did in the BDA case. This particular form of sanction does not require multilateral coordination, since foreign banking institutions that conduct significant business in the United States have a strong interest in avoiding institutions that the United States Treasury has identified as money-laundering or proliferation concerns.

A third conclusion has to do with incentives to proliferation activities.<sup>12</sup> There is some evidence that North Korea moderated its missile proliferation activities during periods when rapprochement with the United States, and to a lesser extent Japan, was a priority; the late Clinton period provides an example. However, in the absence of such an interest, the incentives to engage in arms transfers increases. Indeed, they arguably become greater because of the declining prospects for trade, investment and assistance from the US, Japan, South Korea and Western Europe. Given that the United States has even less leverage over customers such as Iran and Syria than it does over China, the only policy options for dealing with this particular form of trade expansion are much more direct, including sanctions on North Korea's Middle Eastern trading partners or a test of the direct interdiction model that is the untested core of the PSI.

A final conclusion concerns the more transformative conception of engagement that undergirded the Kim Dae Jung and Roh Moo Hyun approaches to North Korea. It is important to underscore that the engagement bet was not an irrational one. If North Korea had embarked on a more robust reformist path, the postulated mechanisms of long-run

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<sup>12</sup> See Bruce Bechtol, "Creating Instability in Dangerous Global Regions: North Korean Proliferation and Support to Terrorism in the Middle East and South Asia," *Comparative Strategy* 28 (2009): 99-115 for an overview.

transformation through engagement might have well taken place. Increased trade, investment and aid would have contributed not only to a deeper engagement in the world economy but been part and parcel of an internal transformation as well.

Yet as we have seen, the North Korean economy is structured in such a way that outside economic ties are still largely monopolized by state-owned enterprises and other gatekeepers, such as the military in the case of Kaesong. Under such circumstances, the precise design of engagement policies requires very close scrutiny. Direct transfers to the regime obviously will not have the same transformative effects as private investment and trade. Even nominally commercial relations can be exploited if the North Korean counterparties believe that they are ultimately political in nature, subsidized and thus vulnerable to blackmail; again, Kaesong is an important example. If economic ties are truly commercial in nature, those choosing to trade and invest with North Korea do so at their own risk. Under these circumstances, private actors will make economic decisions fully factoring in political risk, and North Korea will bear the costs if it chooses to renege on commitments or fails to provide a welcoming policy environment.

Finally, we conclude by underlining that the international community faces what might be called a “latent” humanitarian problem with respect to North Korea. These concerns were muted by a somewhat better-than-expected harvest in 2008, and probably by commercial purchases of food in the winter and early spring of 2008-9.<sup>13</sup> Even if North Korea does muddle through this crop cycle and the termination of the 500,000MT food aid program, there is little indication that the country is capable of feeding itself. As a result, the prospect of a recurrence of food shortages in the medium-term is high. As in the past, the peculiar difficulty of dealing with North Korea stems in part from the humanitarian dilemma the country poses to the international community: that it is difficult to turn away from the substantial suffering that the regime imposes on its own population, but increasingly unproductive to extend economic assistance in the face of entrenched resistance to broader reforms.

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<sup>13</sup> For a more detailed analysis of the 2008 harvest, see Stephan Haggard and Marcus Noland, “The North Korean Food Situation: Too Early to Break Out the Champagne,” East-West Center Asia Pacific Bulletin No. 27, February 5, 2009.