



ECONOMIC RELATIONS BETWEEN NORTH KOREA & ITS NEIGHBORS



INTRODUCTION

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. But the course of the crisis, and the prospects for reaching a durable settlement, have always rested in no small measure on economic issues. Could economic engagement and side payments moderate North Korean behavior, the central bet of the Kim Dae-jung and Roh Moo-hyun years? Or are sanctions a more effective route to getting North Korea's attention, as hawks have long argued?

These questions have taken on much greater significance in the wake of the fourth nuclear test (January 6), another satellite launch (February 7), and a succession of short- and intermediate-range missile tests, including most recently an apparent test of a submarine-launched ballistic missile. The reasons have to do with the passage of UN Security Council Resolution 2270 on March 2, 2016, which appeared to break ground with prior resolutions in seeking to constrict North Korea's commercial trade.

The willingness of Beijing to acquiesce to a more sweeping sanctions resolution is potentially an important development. However, China has stated repeatedly that its intention in signing on to a new sanctions resolution was not simply punitive; the purpose was to jump-start the Six Party Talks, which have been in abeyance since their collapse in 2008.

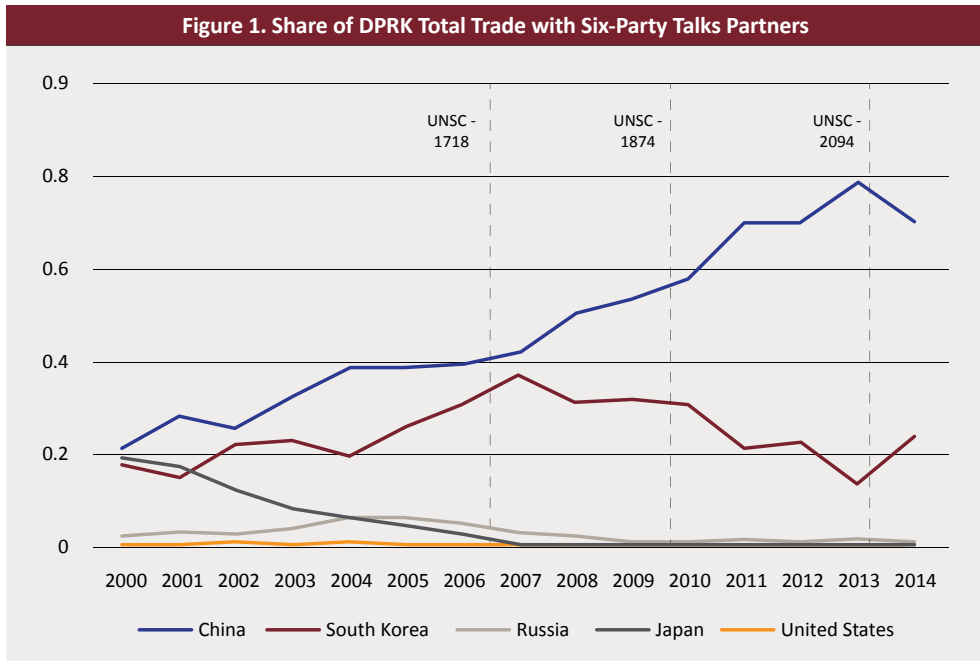
The chapters in Part 3 dissect the bilateral economic relations between the DPRK and four of the five parties engaged in those talks. The analysis of China by Li Tingting and of South Korea by Moon Chung-in and Lee Sang-kuhn cover the DPRK's two most important trading partners over the course of the crisis. The analysis of Russia by Liudmila Zakharova and Japan by William Brown consider two countries which have historically had highly significant economic relations with North Korea, but with which trade and investment relations have fallen off quite substantially. Nonetheless, both play potentially significant diplomatic roles in the crisis.

In this introduction, I provide a brief overview of the overall economic relationship between North Korea and the five parties, highlighting several perverse effects of sanctions, including the unusual concentration of North Korea's trade on China. I then turn to a brief analysis of recent sanctions and close with consideration of the complex strategic game between the United States, China, and North Korea over the possible resumption of talks. If China fully implements the sanctions and North Korea is forced to signal an interest in negotiations, the United States will come under pressure to re-engage. However, if China hesitates with respect to sanctions, or North Korea absorbs the cost of them and remains defiant, there will be little reason for the United States to reconsider its approach to the North, and the issue will effectively pass to the next administration. As of this writing, the latter course appears the more likely of the two.

THE POLITICAL ECONOMY OF THE SIX PARTY TALKS

Simply looking at the share of the five parties in North Korea's trade since 2000 reveals a tremendous amount about the broader strategic setting in which negotiations have taken place as well as the strategies of the different players. The first point to note is that over the course

of the crisis, North Korea’s trade with the rest of the world has shrunk quite dramatically. In 2000, the five parties accounted for roughly 60 percent of North Korea’s total trade, with the rest of the world accounting for the remaining 40 percent. By 2014, the five parties accounted for over 90 percent of the country’s total trade, with the rest of the world accounting for less than 10 percent. These estimates fail to capture trade with countries such as Iran, which also do not publish statistics, and may also miss trade passing through China to third parties. Nonetheless, the combination of increasing country risk and sanctions appear to have had some effect in limiting North Korea’s commercial possibilities.



Note: (1) 10 percent CIF/FOB conversion applied to values reported from from partner countries; (2) Includes inter-Korean trade designated as “non-commercial” by MOU.
 Source: Haggard and Noland (forthcoming).

The second point that is immediately apparent is the rapid growth of trade with China despite a succession of sanctions resolutions. Li offers somewhat different estimates of China’s trade. She also emphasizes not only the fall off in 2014 but a further slowdown in 2015, a result less of sanctions than of slowing growth and a fall in commodity prices. Nonetheless, it is clear that the nuclear crisis has been associated with growing North Korean dependence on China.

This pattern is, arguably, not surprising and might be explained largely by economic factors. China has grown rapidly over this period, and the broad pattern of greater trade focus on China—albeit not in such an extreme form—is visible in many countries in the region. As Li’s contribution points out, this trade growth is driven in part by a commodity boom, suggesting that North Korea’s political economy may be looking more like a rentier state. But as she also points out, trade growth has a political foundation. Kim Jong-il opened cautiously to China after 2000, and China reciprocated by pursuing a strategy of deep engagement with

the country. It did so even in the wake of the second nuclear test of 2009 and tensions with South Korea following the sinking of the *Cheonan* and shelling of Yeongpyeong Island in 2010. The open question is whether this strategy of deep engagement has come to an end with UNSC Resolution 2270.

The third point to note is the highly politicized nature of South Korea's trade with North Korea. By the onset of the nuclear crisis, South Korea already accounted for over twenty percent of North Korea's trade. Rather than falling off following the onset of the crisis, South Korea's trade share rose through the end of the Roh Moo-hyun administration before turning down under Lee Myung-bak and Park Geun-hye. Aid under the two conservative presidents fell to practically nothing, and commercial trade outside of Kaesong withered following the imposition of sanctions in the aftermath of the sinking of the *Cheonan*. The remainder of trade shown here emanated almost entirely from Kaesong, with South Korea's share falling after North Korea's brief closure of the industrial complex in 2013, rising again, before collapsing in 2016 with the shuttering of the complex in the aftermath of the fourth nuclear test.

The fourth point to note is the relative insignificance of trade at the current conjuncture with the United States, Japan, and Russia, but for altogether different reasons. In the case of the United States, North Korea was covered by a complex blanket of sanctions, some dating to the 1950 Trading with the Enemy Act and most imposed even before the onset of the nuclear crisis.

In 2000, Japan accounted for roughly the same share of North Korea's trade as China or South Korea. As William Brown shows in his contribution, policy gradually drifted toward a virtual embargo with the country in the aftermath of revelations about the Japanese abductees and, after 2006, in response to the first nuclear test. This occurred, in part, by gradually clamping down on remittances that had wound their way through the *Chosen Soren* (or *Chongryon* in Korean), the pro-North organization of Korean residents in Japan. At the moment, the only card that North Korea possibly holds with respect to Japan is entirely prospective, and, Brown argues, it has been misplayed. Prior to this last round of tests, a final settlement of the abduction issue might have opened the way for normalization of diplomatic relations that would come with an aid package similar in magnitude to that granted South Korea in 1965.

Russia's trade with North Korea, by contrast, is minimal but not for lack of trying. Liudmila Zakharova shows how during the Putin era, Russian interest in re-entering the Asian arena led to an uptick in activity with North Korea, including a final settlement of Soviet era debt, some investment in rail infrastructure, and promises of other large-scale investments. Unlike China and South Korea, however, economic complementarities are limited aside from advantages Russia could gain from transport or pipelines through North Korea. The collapse of oil prices and sanctions on Russia following the invasion of Crimea and intervention in Eastern Ukraine limited Russia's financial capacity to take a leading role in the country and despite stated plans, trade between the two countries has failed to take off except for the re-export activities through Rason—now under stress too.

Several more general points emerge from this overview. It is a virtual cliché in the literature on sanctions that they are unlikely to work in the absence of coordination among the sanctioning parties. As can be seen, North Korea has been able to maneuver between the sanctioning and non-sanctioning countries; note, for example, how the increase in China's trade share with

the DPRK almost exactly offsets the decline in Japan's share, and in a context of overall trade growth, not contraction. Similarly, multilateral sanctions were unlikely to have much effect as long as trade with the rest of the world was being replaced by trade with China. Will it be different this time?

Efforts to engage with North Korea on the part of China and South Korea have also been stymied by political resistance—although at different times—from South Korea and the United States, through which any political settlement on the peninsula must ultimately pass. Engagement strategies no less than sanctions face coordination dilemmas; Lee and Moon make this point quite forcefully in arguing that the hawkish posture of the U.S. under the Bush administration undercut the efforts of Kim Dae-jung and Roh Moo-hyun to engage.

SANCTIONS: THE LATEST PHASE

As I have provided a more detailed analysis of UNSC Resolution 2270 elsewhere,¹ I limit myself here to a few comments on features of the new multilateral sanctions that appear distinctive. In the past, all UNSC resolutions have targeted trade, investment, finance, and shipping that is directly related to the WMD programs, leaving commercial trade largely untouched; thus, the rapid increase in the commercial trade with China over the period. This time appears different. In terms of material value, by far the most significant component of the sanctions resolution is the potential restriction on coal exports (paragraph 29). If implemented, the rest of the resolution would be superfluous: coal accounts for about 40 percent of the DPRK's exports to China. In addition to coal, the resolution bans exports of gold, titanium, vanadium, and rare earths. These generate much more limited income, but as with coal the effects of these restrictions are twofold: not only do they interrupt trade, but they also deter potential investors in these activities, investors North Korea desperately needs to develop these resources. Another trade prohibition that is harder to gauge concerns small arms sales and service contracts related to conventional weapons, where purchasers are likely to be less cooperative with the sanctions effort. On the import side, the resolution bans aviation fuel, with potential effects on the ability of Air Koryo—let alone the air force—to even operate.

In addition to these trade measures, the resolution also places restraints on shipping and designates a number of specific entities, including Ocean Maritime Management; as a shipping company, its ships could be seized as assets of a designated entity, and one such ship was initially seized by the Philippines before being released. The resolution also authorizes restraints on financial transactions with the regime, although with the caveat that such restraints would be targeted at activities that could be linked to the country's weapons programs. Assessing the effects of any sanctions effort encompasses at least four elements:

- the statute itself, what is proscribed and with what precision or country-level discretion;
- the likelihood that any given provision will be implemented;
- the effect of the measure not only directly on the targeted party but on markets and particularly foreign exchange and commodity markets;
- the ability of the target to circumvent the restriction by substituting for the export or import in question and diversifying into new activities.

On the first two points, it appears that China has written the resolution with just enough bite to send a serious signal to North Korea, while including adequate caveats—including with respect to protecting people’s livelihood and links to the WMD program—that it can moderate implementation as it sees fit. It is a revealing sign of the current political economy of China that no sooner had it issued a quite visible and detailed order with guidelines on the implementation of the sanctions than it simultaneously shut down online customs statistics on trade with the country. As of this writing, we simply do not know how far and fast China is willing to move.

The material effects of the sanctions and capacity to circumvent them will depend on implementation, but, as Li’s contribution on China shows, North Korea has proven pretty adept in the past at adjusting to various sanctions measures. For example, it is widely believed that North Korea was a “Soprano state,” relying heavily on missile and weapons exports and a variety of illicit activities ranging from counterfeit \$100 bills to narcotics. However as this activity was squeezed by interdiction efforts, North Korea moved into the export of minerals and even some light-labor intensive manufacturing. We cannot rule out that it can continue to adjust.

That said, a plain reading of the resolution suggests that it should be extremely hard for North Korea to fully circumvent this round of sanctions if fully implemented. Trade with the rest of the world was already low, and the passage of the resolution has been accompanied by diplomacy urging strong vigilance on North Korean activities. Moreover, the effects of the sanctions do not only work on the sanctioned sectors. As we have seen from the Iranian sanctions, they can have an impact via the exchange rate and the drying up of capital flows as well as through trade. Moreover, such effects are felt widely through the economy and even in the non-traded goods sector. Again, as of this writing, the black market exchange rate appeared to be holding steady, perhaps because of hidden reserves, perhaps because the declining terms of trade with respect to exports are partly offset by lower oil prices. But if China fully implements the sanctions, we should see signs of material distress, manifest ultimately in efforts to get back to the nuclear negotiations.

THE DIPLOMATIC STATE OF PLAY

Although Japan and Russia may have future roles to play in the negotiations, the extent of their trade makes them diplomatic followers at this juncture. The one exception would be if Russia attempted to play a spoiler role by extending life-support to the North. But such a role is unlikely given that Russia has been consistent in its opposition to North Korea’s nuclear program and also signed on to Resolution 2270. Recently, Russia signaled its willingness to abide by the spirit and terms of Resolution 2270 by imposing financial sanctions on North Korea.

Surprisingly, South Korea’s role in the current diplomatic setting has also been compromised somewhat by Park Geun-hye’s decision to shutter Kaesong. By taking a very strong line and tying further progress in North-South relations to progress on the nuclear issue, South Korean diplomacy will hinge largely on what happens between China, the United States, and North Korea, and we focus on those three actors here.

U.S. policy toward North Korea is focused fairly narrowly on the question of denuclearization. Its strategy since the early Obama administration has been called “strategic patience,”

which can be defined as a stated willingness to negotiate, but only if North Korea makes a move to demonstrate the seriousness of its intent. Such a signal has involved a shifting set of prerequisites, such as a monitored freeze on the Yongbyon complex, although those conditions have been moderated in the past and could, in theory, be moderated further.

Given this stance, the two central questions driving U.S. diplomacy at the moment are: whether China actually implements Resolution 2270; and, if it does, whether the sanctions are adequate to get North Korea back to the negotiating table. In recent remarks at Hiroshima, Secretary Kerry recommitted quite publicly to the objectives of the 2005 Joint Statement and expressed a willingness to follow China's lead. However, the secretary also delivered an important caveat: that "[the resumption of talks] all depends on the North making the decision that they will negotiate denuclearization, which is the agreed-upon policy of China, the United States, Japan, Korea, Russia." In short, if Resolution 2270 is not implemented, or if it is implemented and China is unable to coax North Korea back to the negotiating table, the United States feels no obligation to move.

Certainly the current political conjuncture in the United States—during a presidential election year—provides few incentives for President Obama to take risks on a low-probability event that could have electoral costs.

The United States does retain one other option, however, in the form of quite broad secondary sanctions legislation. If that legislation is read closely, it reveals a clever structure, mirroring quite closely UNSC Resolution 2270. If 2270 is not implemented or fails to generate a North Korean response, then the president could come under pressure to take out this weapon and use it. Such action would require both financial intelligence on which firms to target and a more difficult political decision to employ this weapon against Chinese firms. Whether these sanctions would be effective is an open question, particularly given Chinese opposition to them. But, as of this writing, the choice to deploy them has not been forced on the United States.

From China's perspective, the coverage of UNSC Resolution 2270 has clearly been lopsided. All of the emphasis has been placed on sanctions, while ignoring the fact that the resolution also calls on the parties to return to the Six-Party Talks. From the perspective of the United States, these concessions may appear hortatory; from China's perspective they are decidedly not. China feels that it has made the commitments it was called on to make and that it now falls on the United States—and Japan and Korea—to come back to the negotiating table.

We do not have a public version of the Chinese proposal for such negotiations. But public comments by Chinese officials suggest they hinge on seeking a compromise under which negotiations on denuclearization would be coupled in some way with broader talks for a peace regime. North Korea has long sought such negotiations, and it is assumed they would imply normalization of diplomatic relations with the United States. Such negotiations might be handled through an omnibus Six-Party Talks with subcommittees on the nuclear and peace regime issues or some parallel process at—in the words of the 2005 Joint Statement—an appropriate forum.

The U.S. interpretation of the 2005 Joint Statement—shared by Korea and Japan—is that peace regime negotiations would only be launched, let alone completed, after there was significant progress on denuclearization and perhaps even a meaningful conclusion to this

process. As of this writing, however, the United States has been spared difficult decisions with respect to this sequencing issue by the fact that North Korea has shown little interest in returning to the Six-Party Talks.

Which brings us finally to the nub of the entire issue: North Korea's actual intentions. To date, North Korea has floated proposals which are complete non-starters from a political point of view. They include a proposal first made in January 2015 that North Korea would suspend or "freeze" nuclear tests in exchange for a suspension of U.S. exercises. In addition to the fact that such a proposal has a blackmail structure—"do not suspend your exercises and we will continue to test"—the proposal says nothing about the question of whether North Korea, in fact, has any willingness to come back to the Six-Party Talks. To date, evidence in this regard is scant. Through various back channels, North Korea has floated trial balloons with respect to the structure of peace regime negotiations, including a willingness to entertain Chinese and even South Korean participation. But at least in public, it has held firm to the position that negotiations on a peace regime would have to precede a return to nuclear talks; it has been some time since there was even a public commitment to the objectives of the 2005 Joint Statement.

What really is North Korea's intent? It is possible, if fully implemented, the current sanctions could force the country back to the Six-Party Talks. But Kim Jong-un has made it particularly difficult to take that off-ramp. The reasons for this difficulty started with the rollout of the *byungjin* line in early 2013, which publicly commits the regime to the simultaneous pursuit of nuclear weapons and economic development. The regime has also used the missile and nuclear programs quite publicly as pillars of domestic legitimation, and may be constrained by the military to remain committed to this path. Nothing that occurred at the 7th Party Congress, convened in May after a 36-year hiatus, gave any signal that Kim Jong-un is departing from the *byungjin* line; to the contrary, he appears to have doubled down on it. Given this domestic political configuration in North Korea, the question is not what the United States will do. The question is whether China has the nerve to fully press the material advantage over North Korea that it so clearly has and how the regime in Pyongyang will respond if it does.

ENDNOTES

1. <http://blogs.piie.com/nk/?p=14880>.