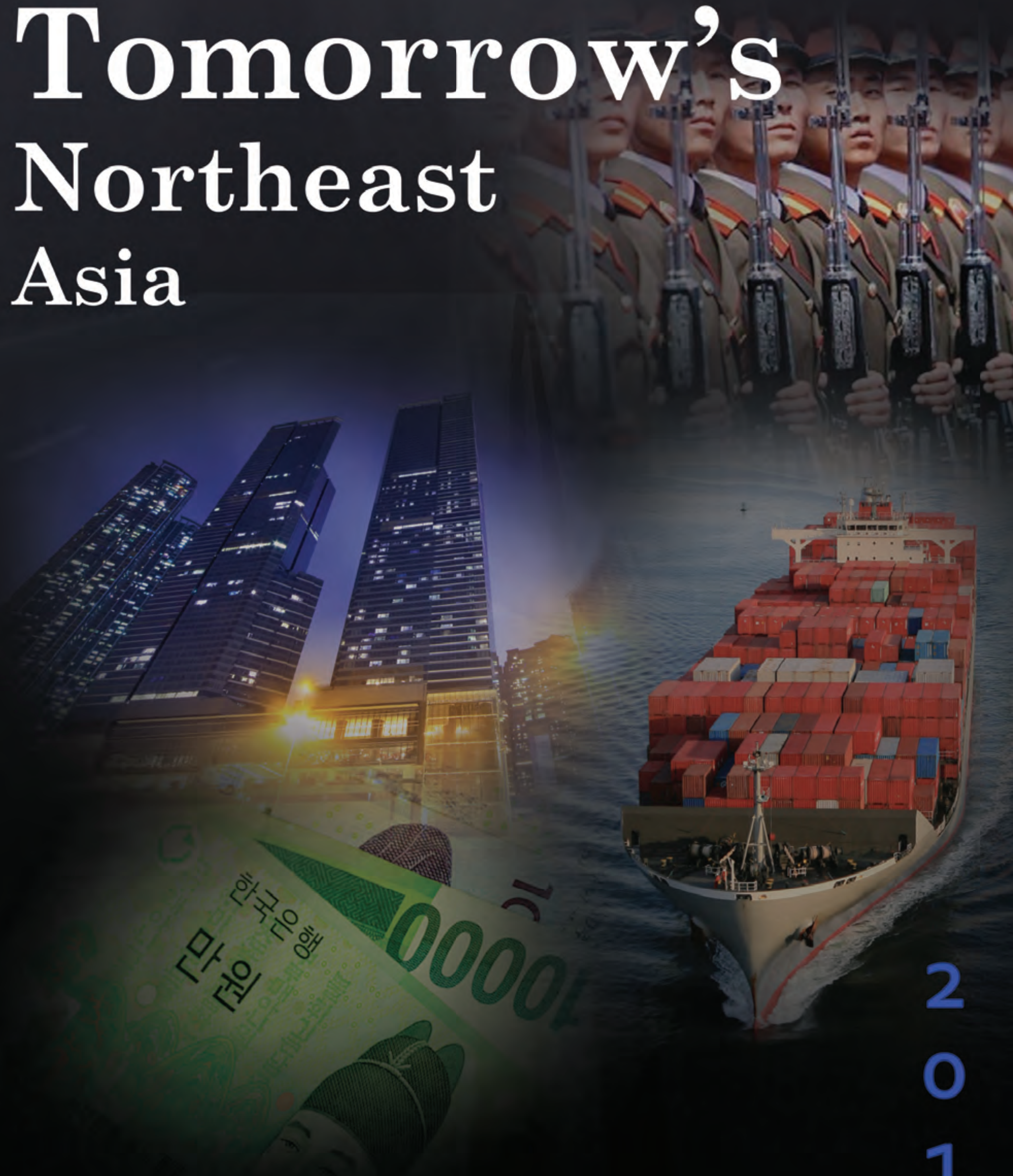
KEI

Tomorrow's Northeast Asia



2011

Joint U.S.-Korea Academic Studies
Volume 21

JOINT U.S.-KOREA ACADEMIC STUDIES

Volume 21, 2011

Prospects for Emerging East Asian Cooperation and Implications for the United States

Symposium Sponsored by

Korea Economic Institute,
Korea Institute for International Economic Policy, and
School of International Service at American University

20–22 October 2010

The views expressed in this publication are those of the authors. While this monograph is part of the overall program of the Korea Economic Institute endorsed by its Officers, Board of Directors, and Advisory Council, its contents do not necessarily reflect the views of individual members of the Board or of the Advisory Council.

Printed in the United States of America.
ISNN 1054-6944

CONTENTS

KEI ADVISORY COUNCIL

PREFACE

The Korea Economic Institute (KEI) in Washington, D.C., in cooperation with the School of International Service (SIS) at American University, also in Washington, D.C., cosponsored an academic symposium at SIS on 20–22 October 2010 on "Tomorrow's Northeast Asia." This volume contains the papers that were presented at the symposium and subsequently refined.

The 2010 symposium focused on emerging and future challenges facing Northeast Asia. Papers and discussions fell under five broad topics:

- Prospects for emerging East Asian cooperation and implications for the United States
- The emerging role of South Korea on a global stage
- The future of energy security in Northeast Asia
- Engaging and transforming North Korea's economy
- Finding room for a six-party solution to North Korea's nuclear crisis.

The sponsors and authors welcome comments on the material in this volume. This is the 21st in a series of annual academic symposia on Asia-Pacific economic and security issues that bring together leading academics and policy professionals from throughout the region.

Louis W. Goodman
Dean
School of International Service
American University

Charles L. (Jack) Pritchard
President
Korea Economic Institute

December 2010

HISTORY OF KOREA ECONOMIC INSTITUTE ACADEMIC SYMPOSIA

2010 American University, School of International Service, Washington, D.C.

2009 East-West Center, Honolulu
Additional partners: Hawaii Pacific University, Pacific Forum CSIS

2008 New York University,
Center for Japan-U.S. Business & Economic Studies,
Stern School of Business

2007 University of Southern California, Korean Studies Institute

2006 Harvard University,
Preventive Defense Project, John F. Kennedy School of Government

2005 University of Washington

2004 College of William & Mary

2003 Stanford University

2002 University of Pennsylvania

2001 University of California–Los Angeles

2000 Johns Hopkins School of Advanced International Studies

1999 George Washington University

1998 Georgetown University

1997 University of Southern California

1996 University of Michigan

1995 University of Chicago

1994 University of California–Berkeley

1993 Princeton University

1992 Columbia University

1991 Indiana University

1990 University of California–San Diego

ENGAGING AND TRANSFORMING NORTH KOREA'S ECONOMY

William B. Brown

ABSTRACT

North Korea badly needs change but whether that change can and should be induced or forced from the outside is open to question. This paper proceeds from the perspective that most outside engagement with North Korea to date has been detrimental to North Korean reform since it has aided the central state, which is adamantly opposed to decentralizing reforms. But a window for inducing change in North Korea may be opening as the socialist command economy continues to fail and as a likely lengthy political transition to a new leader begins. Several "rules" of engagement, or purposeful disengagement, are suggested that could help shove the country in a reform direction.

William B. Brown is a Professorial Lecturer of Economics at George Washington University and is retired from the U.S. Department of Commerce, Office of the Chief Economist, where he served as an economist working on East Asia.

Change, The Purpose of Engagement

Surely any country that makes as poor use of the hard work of its people as does North Korea needs to be transformed. The country is poor not because it lacks human and physical capital, natural resources, good geography, or even physical infrastructure but simply because it is not organized in a way that provides incentives for people to produce and distribute goods efficiently and save and invest for the future. It is not a natural system but a socialist system, built on a Soviet Marxist and Stalinist model that has been discarded everywhere else in the world. Cuba might come the closest to North Korea, but in September 2010 even Fidel Castro, when asked by a U.S. journalist (Goldberg 2010) about whether Cuba intends to export its ideology, quipped: "the Cuban model doesn't even work for Cuba." Castro may have been teasing, but in truth Cuba is a flourishing market economy compared with North Korea. As hard as the average, highly disciplined, and smart North Korean works, he or she is unable even to feed his or her family with anything but a bowl of barley soup. The children go hungry, diseases are uncontrolled, families use less electricity than they might have used 30 years earlier, and they use almost no fuel for heating in what is quite a cold climate. Foreign travel—even domestic travel—is nearly nonexistent.

A generation ago none of this was the case. Labor and capital productivity have plummeted to the point that the nation now lives off Chinese and South Korean handouts—the latter are drying up so the former are becoming more important. Some elites thrive as they work the arcane trading and money rules to their advantage, and Pyongyang city continues to try to build itself as a showcase of modernity, but everyone knows something is wrong. Even Kim Jong-il and his Korean Workers' Party know this but they have proven—except to perhaps some U.S. and South Korean academics—that they are incapable of reform. The currency swap of last December, when North Korea's money was stripped of its value, was for many the last straw.

We might agree that the country needs to be changed, but questions of course arise about whether such change should be brought in from the outside. Almost any discussion of economic development presupposes that at best this is an inside-out process and that imposed outside-in development is fraught with danger. In fact, my thesis is that North Korea has suffered and continues to suffer from too much of the wrong kinds of external engagement, driven first by the Soviet bloc building its carefully linked trade system and in more recent years by South Korea, Japan, Europe, and even the United States seeking to change it. China is North Korea's largest patron—Chinese at least admit that their main goal in providing aid to North Korea is to maintain just enough stability to thwart reforms that could prove destabilizing. Switzerland's government has decided to pull its aid office out of Pyongyang by the end of 2011, ending an assistance program that has lasted since 1995. Swiss journalist Jean-Michel Berthoud (2010) writes: "The basic question is whether it is better to isolate a totalitarian regime or work with it. In the case of North Korea, parliament and the Federal Council have made a clear-cut choice: development aid must cease." Swiss debate, of course, continues on this new policy.

Lessons from South Korea: Money and Banking, Not Food

It is this perspective—that economic change is needed but that change needs to be grasped by a nation's own authorities—that causes me to propose several "rules of engagement" as we deal, or choose not to deal, with Pyongyang. I am encouraged by the U.S. record many years ago of helping South Korea transform its economy during similarly dire circumstances. One fact may be representative. In 1960 North Korea produced for export more goods than did South Korea; in 2010 South Korea exports on a good day more than North Korea will for the entire year. Through the 1950s U.S. food aid prevented famine in the South, but, no doubt urged on by U.S. farm-state politics, the massive shipments continued for too long, thus nearly destroying South Korean farmers who could hardly compete with free grain dumped into their cities.[1]

By 1963 a decade of commodity assistance had created in the South an aid-dependent economy that saved and invested little; it had one of the world's smallest saving-to-GDP ratios. Fortunately, the nationalistic and self-reliant-minded Park Chung-hee came to power and quickly, with strong U.S. and Japanese financial support, put the country's fiscal house in order and constructed a new high-interest, high-return banking system that provided incentives to save and invest and disincentives to borrow and consume. With inflation subdued and a new currency with a competitive exchange rate, private savings poured into banks that lent or invested only in productive ventures—and stopped lending for expensive weddings and funerals. Ordinary people, President Lee Myung-bak among them, were thus able to plant a stake in the economy, work hard, take risks, and generally thrive in the record-breaking growth that followed.

There are many economic lessons to be taken from this history, and we need to pass them on to anyone in Pyongyang willing to listen. In a 1990s publication,

1 It is ironic that the South's farmers now want their government to buy up surplus rice and dump it into North Korean cities.

the World Bank (1993) calls South Korea a "miracle" economy. As the Bank goes on to show, it really is not a miracle; smart economic policies, not miracles, transformed South Korea, and these can be replicated in North Korea if given a chance.

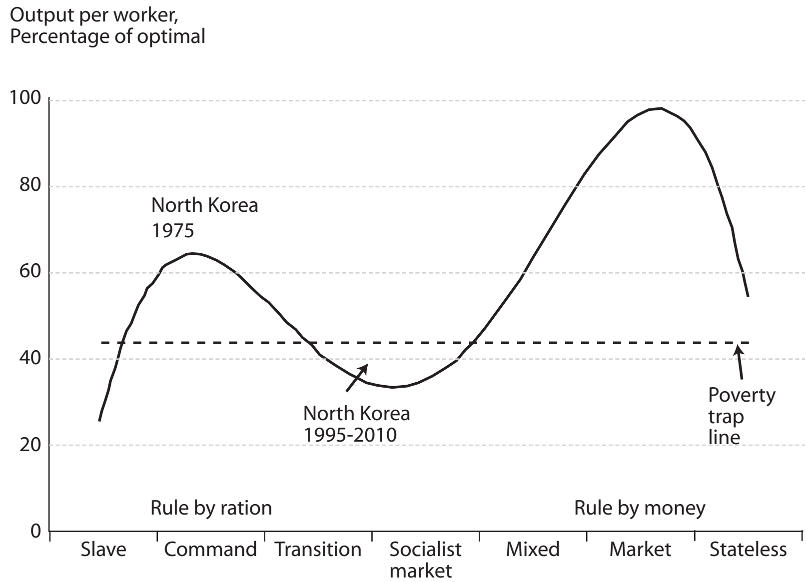
North Korea's Predicament: A Poverty Trap Overlaid by Broken Socialism

Now, with North Korea likely in an early phase of leadership transition, this may be a good time to begin discussions on how we can help influence back-room conversations in Pyongyang and the important decisions that will follow. In North Korean history, such windows of opportunity have been fleeting and rare. Before we talk to North Korea's leaders, however, we need to understand their predicament. I try to understand North Korea's economy by combining two simple economic development concepts, one a poverty trap and the other a socialist-to-capitalist transition trap (Haber, North, and Weingast 2002). These two concepts are illustrated in ***Figure 1***—a sketch really—which illustrates productivity (for example, of land, capital, and labor) on the vertical axis and a continuum between socialism and capitalism on the horizontal axis. Overlaid is a heavy dashed line indicating the poverty trap.

Casual observations place North Korea in a poverty trap since about the early 1990s; this trap is defined as a situation in which consumption demands, private and government, are higher than is the capacity of the country's factories and farms to supply, and borrowing capacity cannot fill the gap. There is thus no net savings or investment possible except for what can be procured as aid or direct investment from abroad. Thus, in Figure 1, the country's productivity is shown as somewhere at or below the dark dashed line. This means that an average North Korean worker does not produce enough goods and services to simultaneously sustain the high level of government spending and the low level of personal consumption. Nothing is left over to save and invest, and in fact some consumption seems to be made possible only by drawing down reserves and the capital stock itself. No data are available to prove this is the situation, but it can be observed in the numerous dilapidated factories strewn across the country, an electric power system that produces half its previous output, a run-down railroad system, the absence of new coal mine faces, and a large shuttered integrated steel mill. More frightening are the declining health standards of young people now entering the workforce and a likely parallel drawdown of human capital.

A development solution to a poverty trap is the introduction of foreign investment that allows a temporary buildup of capital stock and economic growth in

***Figure 1:* The Poverty Trap**



Source: Author's concept.

return for sending abroad some of the profits this investment brings. If a large share of the increased output can be saved and reinvested domestically, a positive growth cycle can begin. This avenue for climbing out of the poverty trap is not available to North Korea, however, because earlier defaults on foreign loans make foreign investment unlikely. In effect, like someone who has borrowed to his credit card's limit, North Korea already has eaten up the foreign credit available. In the summer of 2010 it was trying to sound open to foreign investment; the truth is that it always has wanted foreign investment but its business practices have never allowed investors to make money. Its reputation by now is solidly dark.

Fortunately, increasing capital stock is not the only way to grow. Standard economic growth theory (of Robert Solow, for example) maintains that sustained growth comes from two other sources as well: an increase in work time by a growing or more engaged workforce and an economywide increase in productivity brought on by systemic changes, gains from trade, changes in the composition of demand, and technological advancements that allow all factors of production to be used more effectively, a concept known as total factor productivity (TFP).[2]

2 For reference, in the United States, capital stock, labor increases, and TFP usually contribute about one percentage point each to the long-term average 3 percent annual GDP growth.

In North Korea an increase in work time may be nearly impossible given the appearance of an already hardworking society. A nationwide *chollima* work drive last fall put hundreds of thousands into overtime work, but this kind of effort cannot be sustained. TFP is the magic solution—the something for nothing often raved about by new-economy advocates everywhere—for North Korea's poverty trap, but it is hard to gauge for North Korea because the country is undergoing the negative systemic impact of a broken planning system along with the positive impact of a new private market system that is quietly developing.

Some proponents of economic engagement with North Korea may use the existence of a poverty trap to argue that the only feasible way out of this trap is external assistance that can jump-start the country onto a growth cycle. Energy, education, technology, and agricultural projects are the most common proposed activities that may add some TFP as well. The problem with this approach is that it fails to take into consideration the other dimension to North Korea's conundrum—the trap formed by the economy's position on the socialist-to-capitalist continuum.

The curved line in Figure 1 illustrates this situation by positing that North Korea's economy, in addition to being in a poverty trap, sits squarely between two very different and incompatible systems—the socialist command economy and free market capitalism. A socialist command system, for all its faults, can and did in North Korea's case provide a mechanism—a five-year plan—that channeled resources from consumption into investment and allowed the buildup of capital stock during the 1950s and 1960s and relatively strong growth. Even through the mid-1970s North Korea's GDP probably exceeded South Korea's on a per capita basis although per capita consumption and living standards were probably lower even then since so much of North Korea's output was distributed by the plan by the government and the military and for investment purposes.

Market-based economies, shown to the right in Figure 1, have proven to be far more efficient in the use of capital and labor, achieving much higher productivity levels. The problem in moving from one system to the other, however, is that a mix of the two systems creates such confused prices and decisions that productivity falls below that of either the socialist or the market system. If an economy could smoothly move from one system to the other, or if a middle way were more possible, North Korea would have many fewer problems.

If we think of the North Korean situation in these terms, foreign aid is no longer the only or even the best way out of the trap. A slight shift either to the right or the left can improve productivity and create an investable surplus that can put the economy on a growth cycle. What we have observed in Pyongyang during Kim Jong-il's tenure is a persistent effort to push the system to the left but without enough resources to push it far enough to get the planning mechanism working again. The last long-term plan was in the 1960s, and it failed. Simply put, the regime has not been able to requisition enough goods to fill the people's rations and provide material for industry and the military. So in place of rations, informal and often illegal markets have developed, and these markets have pulled the economy to the right on Figure 1. Without property rights and legal labor and capital markets this movement also has been incomplete, leaving the economy in a devastating standoff.

Only China tends to step in to keep the country afloat, mainly by giving North Korea 600,000 tons of crude oil a year, just enough to keep things running. Western countries, and South Korea and Japan, have from time to time tried to help but they give aid through the government, which uses it to bolster the ration system and resist the move to the right in the figure. This happened as recently as 2005, when, after relatively good harvests and a large inflow of food from the World Food Program, the United States, South Korea, and China, Pyongyang felt it had sufficient resources to restore the ration system and clamp down on the markets. This began a process that shifted the system to the left through the end of 2009, culminating in the disastrous currency swap of December 2009. In 2010, probably because of the public snapback against loss of money and because of reduced foreign aid, the economy shifted sharply to the right but probably not by enough to raise productivity above the poverty-trap level.

Foreign Economic Relations: An Exposed Hermit Kingdom

North Korea is sometimes called a "hermit kingdom" in need of opening up. Its trade relations are weak, especially considering its giant trading-country neighbors—China, Japan, and South Korea. But describing North Korea as a hermit is misleading. A better description may be that it is a remnant of what was once a large trading system, including the Soviet bloc and China, that was chained together to create a giant worldwide communist or command system. Opposite that system was what has become the World Trade Organization (WTO), a free-trade system that has grown to encompass nearly the entire world. North Korea is one of very few countries left that has yet to join or start a process of joining.

Command economies like North Korea's are not inherently antitrade, but with their fixed-price systems they cannot allow themselves to trade freely with market economies without huge distortions—as when subsidized medicine in a country is illegally exported to a nonsubsidized country and sold for big profits. I figured a few years ago that in North Korea a kilogram of rice was priced the same as about 700 kilowatt hours of electricity, if electricity were readily available. This meant the price of rice compared with the price of electricity was about a hundred times more than in the world marketplace, or that electricity was a hundred times cheaper. With electricity so cheap relative to rice, it made sense for a North Korean cooperative farm to use large amounts of power irrigating a rice paddy rather than letting the power be used to produce copper or zinc that could have been traded for perhaps a thousand times more rice than the irrigation allowed. This disparity would not have mattered so much in a command economy because the planners would dictate how much copper to export and how much electricity to use. The mixed economy, with these perverse price relationship, causes bad economic decisions that a country as poor as North Korea cannot afford.

The trouble works both ways. Free-trade economies cannot tolerate unregulated trade with fixed-price economies because market competition requires that prices be determined by marginal cost considerations—prices much below or above marginal production costs are either unsustainable or illegal as they suggest monopoly, the enemy of markets. In a market economy, the most efficient producer charges the least and gets the sale. A North Korean seller, as noted above, has no idea of the real costs of production because inputs, including wages, capital, and energy costs are, as shown in our example above, priced by the planners independent of their costs; if called upon to export, a firm will simply sell far enough below the market price to get the sale. The efficient market firm can never win in this situation, so it naturally, and correctly from an efficiency perspective, will demand trade protection from its government.

In the United States protection is provided in the form of often prohibitive “column 2” tariffs that once were applied to all communist countries and now are applied only to those countries not in the WTO or in the often prolonged process of joining. This means North Korea is in very select company—Cuba may be the only other column 2 country. North Koreans and some Americans describe this as a U.S. “sanction,” but in my view that is incorrect. If Pyongyang were to take the steps taken by other countries to join the WTO—steps that make their domestic economies competitive—I’m sure the United States would graduate it to most-favored-nation or “normal” tariff status. By not taking these steps, Pyongyang chooses not to enter the U.S. market in a competitive way.

Other countries have similar rules although the United States probably is among the most intolerant of noncompetitive pricing just as it is among the most open

Table 1: **North Korea's Trade with the World and with Selected Countries, 2009, in billions of U.S. dollars**

	Exports	Imports	Balance
World	2.000	3.100	–1.100
China	0.793	1.888	–1.095
South Korea	0.934	0.745	0.189
Germany	.027	.043	–0.016
Russia	0.021	0.041	–0.020

Source: KOTRA.

to countries with competitive pricing. One goes hand in hand with the other. By taking North Korea off the U.S. State Sponsors of Terrorism list in 2008, the George W. Bush administration in effect welcomed North Korea to apply to enter the WTO—U.S. law requires that any U.S. administration veto membership in international institutions of any country on this list of state sponsors of terrorism—but North Korea has not yet taken advantage. Any discussion of trade with North Korea by an American should start with these basic facts.

Foreign Trade: China and South Korea Dominate Trade

North Korea does not publish trade statistics, but a pretty good picture can be obtained from data published by its trade partners—the partners' exports are North Korea's imports and vice versa. These are tabulated by the Korea Trade-Investment Promotion Agency (KOTRA) and by Global Trade Atlas (***Table1***).

- North Korea exported only about $2 billion in goods in 2009, with China purchasing $793 million—anthracite coal, iron, and other ores; and fish products—and South Korea importing $934 million, mostly finished goods from the Kaesong industrial zone. Through July 2010 exports to China rose 11 percent, in part owing to price increases. This was partly offset by *Cheonan*-related sanctions by South Korea that have stopped trade other than through Kaesong. This level of exports is very small, probably less than 10 percent of GDP, for a country with as many natural resources as North Korea has and geography that virtually touches three of the world's largest economies and traders (China, Russia, and South Korea). For anyone seeking to engage North Korea, its lack of foreign exchange is thus a large problem.

- North Korea imported goods in the amount of approximately $3.1 billion in 2009, with China by far the largest supplier of $1.888 billion worth of crude oil, coking coal, grain (including grain purchased by nongovernmental organizations in China and given to North Korea), and various machinery and consumer products. Imports from China were up a strong 32 percent through July of 2010 compared with year-earlier figures although in part because of a jump in crude oil prices. Imports from South Korea were $745 million in 2009, largely equipment for the Kaesong factories and parts that are assembled to be re-exported. In 2010 imports from South Korea are likely to be down sharply because of the *Cheonan* sinking.

- Notably absent from North Korea's trade is Japan and the United States, two of the world's largest trading countries. Japan until a few years ago was perennially one of North Korea's top partners. Japanese sanctions linked to the unresolved abductions issue, nuclear and missile tests, and unpaid debts have cut North Korea off from a major potential market and supplier of modern technology.

- Pyongyang's $1.1 billion trade deficit last year was largely funded by aid and remittances and service earnings from ethnic Koreans living abroad. Virtually no commercial or other government credit is available to Pyongyang, so its imports are constrained to what it can earn in exports and to what it can garner from donors.

- North Korea's foreign debt runs in the tens of billions of dollars, but it appears to be entirely nonperforming, and much of it has been written off by European and Japanese private and government lenders. No interest or principal payments are made public by either the regime or its creditors. This default status is a huge deterrent to development and one that is not entirely the fault of North Korea. I argue that foreign governments are largely to blame because they have lent money to North Korea even when they have known there was very little chance of repayment. These include the U.S. government in the Korean Peninsula Energy Development Organization (KEDO) project and the South Korean government in its periodic shipments of grain to North Korea. Surprisingly few attempts are made to force Pyongyang to repay its loans by, for example, legally attaching the few North Korean assets abroad. It is interesting that the Russian Duma is the most vocal foreign entity demanding at least token payments on billions of dollars in Soviet-era debt. As a result of North Korean unwillingness or inability to pay, trade between Russia and North Korea is minor.

Money Problems: Opportunities for Change

Closely related to the country's external financial problems is the problem of money in North Korea. This is relatively new because up through the 1980s North Korea operated on a ration system with essentially no money in circulation. Monetization has spread since the ration system broke down, and now money appears to dominate consumer transactions even though it continues to meet strong resistance from the government, which is loath to give up the socialist rationing system. Without an ability to procure enough food or other goods to supply the daily rations, Pyongyang has had no choice but to let monetization proceed; thus, individuals increasingly produce or buy goods and services on their own and trade them in markets. A confusing policy change occurred in mid-2002 when these local markets were legalized and when the state raised its ration prices and wages on average close to 100 times to match the market price of goods. Whether this was a move to accept something of a market economy—there were no moves to allow other important markets such as labor or capital markets to develop, and ownership of capital and land was still mostly in the hands of the state—or whether it was an attempt to close markets by changing state prices to make the markets unprofitable is not clear. At any rate the measures failed, and the country was soon enveloped in hyperinflation, a curious phenomenon in a system geared to fixed prices.

As the gap between market and rationed prices again widened, opportunities for arbitrage became so great that by December 2009 the regime again felt the need to unify the state and market prices and take away the gain from wealthy merchants who ultimately might pose a risk to the regime. This time, rather than close the gap by raising state prices, the central bank tried to close it the other way: forcing market prices lower by withdrawing money in circulation.[3] If this had worked there would have been a large drop in the money supply and lower market prices, but Pyongyang badly miscalculated. It hadn't realized that the act of dishonoring its own bank notes in this way would drive everyone to try to exchange the cash for hard currency or hard goods as quickly as possible. An instant increase in the velocity of money offset the reduction in money supply, and prices again soared. Public anger exploded, forcing the regime to apologize, backtrack on market closures, and probably execute the party's leading finance official.

Inflation has since slowed, but the disruption to markets and households was acute. Confidence in the regime and in its economic policy seems now at an

---

3 The bank exchanged only the equivalent of about $35 per person, nullifying the value of all other *won*-denominated savings.

all-time low, and foreign currency is reportedly being used widely in unregulated and volatile markets. Harmful to the state, the use of foreign money, especially Chinese yuan and U.S. dollars, raises all kinds of opportunities for foreign activities and engagement at a highly decentralized level with North Koreans. And if this dollarization continues to its logical end, the regime itself will need its own U.S. dollar earnings to procure goods and services even inside North Korea. Some of this already may be happening.

Suggested Rules of Engagement

The snapshot above provides a sense of North Korea's economy today and the complexity, dangers, and opportunities that lie in engaging with it. Out of this complexity, I offer the following guidelines for U.S. engagement or purposeful nonengagement with North Korea.

Trade is good; aid, unless people are starving, is bad. Even trade between market and socialist systems is complicated and is in need of regulation. We should impress upon North Korea the need for it to join the WTO so that it can receive normal tariff treatment. Otherwise we should not bend our rules; they are there for a purpose. We should thus not allow Kaesong products to enter the United States under normal tariffs until North Korea joins, or at least starts the process, of joining the WTO.

North Korea continues to receive more aid than is healthy for its economy. Aid delays the development of exports and distorts internal production incentives—that is, food aid hurts farmers, helps city dwellers. Any country, and especially North Korea, has plenty of human and physical resources it can use. Guided by the universal principles of comparative advantage, North Korea could create meaningful jobs that would turn its resources into viable exports that it could use to buy food and other necessities.

If a situation is so bleak that it requires aid, the aid givers must make this aid as market friendly as possible. This might mean that, for example, grains are given to farmers who grow grains, allowing them to sell their additional surplus in urban markets. The increased supply would bring down prices and help city dwellers yet not hurt the farmers since they would get to sell larger quantities. Foreign food aid given to cities may have been one of the most harmful aspects of outside engagement with North Korea to date, as it has protected a woefully inefficient, socialized farming system.

Equity is good, loans are bad—at least when the borrower is bankrupt. North Korea's creditors, including Europeans, Japanese, South Koreans, and Americans, are at fault for lending North Korea money when they knew North Korea could not or would not repay. For North Korea to have a realistic chance of following China's path of economic reform—which depends on substantial foreign investment—it needs a bankruptcy workout to restore creditworthiness. For this, membership in the International Monetary Fund and World Bank would be helpful. North Korea may well have a liquidity problem, not a solvency problem because the state owns the productive assets of the country. A workout would allow Pyongyang to sell off assets to private, mostly North Korean buyers who could make much more productive use of them and earn foreign exchange needed to repay loans.

Foreigners seeking to engage North Korea should press for equity ventures, for example, sharing the ownership of nonferrous mines that can be developed for export purposes. Equity sharing, as well as a careful step-by-step process that requires little initial trust by either side and that then builds trust with every transaction, is a good way to proceed. Chinese firms may be starting to do this. U.S. firms might have an advantage, however, as North Koreans are likely to be suspicious that Chinese, South Korean, or Japanese firms are trying to buy up too much of their territory.

Direct pay is good; indirect pay is close to slavery. This continues to be my main complaint with Kaesong and Mt. Kumgang and with the United Nations Development Program and other foreign offices in Pyongyang. International labor laws require direct payment for good reasons. If workers receive reasonable wages directly from the firms employing them, the workers will spend that money (converted to domestic currency at a market rate), and as that money circulates it spawns new shops and businesses in an unending positive staircase of development. This is the "multiplier" economic developers love to talk about.

In contrast, when pay is given to a North Korean state agency, the agency gives the worker a ration coupon, not money. The coupon cannot be transferred or stored and therefore is not money, and the North Korean agency thus retains total control over the individual. If direct payment seems impossible in North Korea, a foreign engager should be innovative and find ways to get around the rules by providing, for example, exaggerated overtime pay, large monetary bonuses, or payments to supervisors.

Sanctions (prohibitions or taxes) against bad behavior should be narrowly defined and targeted, and clear workouts should be identified. Current U.S. and UN sanctions on North Korea do closely follow these guidelines; they are not aimed at the larger economy, and they don't really impact it. We should push back when Pyongyang calls any kind of regulation a "sanction" or when it says such regulations are hurting North Korea's economy. High U.S. tariffs on North Korean products, for example, are not sanctions. They simply are U.S. (and WTO) rules for dealing with nonmarket economies. If North Korea wants to engage the U.S. market, it is free to do so, but it needs to join the rules-based WTO, as China did in a decade-long but highly constructive process. Similarly, our unwillingness to lend money to North Korea is not a sanction; instead, it is our natural response to a borrower that does not or cannot repay its debts. North Korea can overcome this barrier, but it will require some kind of bankruptcy workout that addresses its liquidity problem.

The *Cheonan* sinking must be dealt with. It is apparent that North Korea sank the South Korean warship. Does anyone really believe that (a) the ship blew up a few kilometers south of the Northern Limit Line after happening to run over an old mine, (b) the embarrassed South Korean officers then planted a torpedo so as to put the blame on North Korea, and (c) no smart person, Korean or American, has uncovered this plot and become a hero or made millions of dollars?

Letting the issue fester will be a long deterrent to positive engagement with North Korea, and whitewashing it will lead to more years of distrustful negotiations that lead nowhere. We and Seoul should discuss with Pyongyang whether this incident was an act of war, an act of terrorism, or an accident or rogue action. Each has different consequences—if North Korea meant war, we should preempt further such attacks; if terrorism, we should sanction and go after the likely perpetrators; if an accident or rogue action, we should expect Pyongyang to fix the internal problems and compensate the sailors' families and the South Korean navy. If money is a problem, China can foot the bill and the matter be settled. We might presume on the basis of Pyongyang's subsequent actions that this was not meant to be an act of war or terrorism but a rogue or accidental act that needs to be compensated. It is interesting that a separate recent incident may form the template for solving this issue. Pyongyang, according to Chinese media, recently and quietly paid Chinese families $3,000 each for several Chinese men killed by North Korean border guards on the Yalu River at about the same time as the sinking. The amount of this compensation is far too small, but it does suggest a solution to what otherwise could turn out to be a long-term, festering issue.

The nuclear issue vis-à-vis North Korea must be handled partly though economics. If nothing more we should try raising the costs and lowering the benefits of North Korea having nuclear weapons, and lowering the costs and raising the benefits of it getting rid of them. One example of raising the costs: with China watching closely, encourage Japan and South Korea to obtain non-nuclear preemption capabilities of their own (for example, thousands—maybe tens of thousands—of short-range high-performance missiles). One example of raising the benefits to North Korea of getting rid of the presumed weapons: dissuade Japan and South Korea from acquiring non-nuclear prevention capabilities and repeat our statement that we will never use nuclear weapons against a non-nuclear state. Also, we can make it clear that a nuclear North Korea will not have access to the civilian electric nuclear technology that currently powers about half of South Korean and Japanese industry and that is slated to be a rapidly growing component of Chinese electric power. If North Korea gives up the weapons and rejoins the International Atomic Energy Agency as a non-nuclear state, civilian electric power is easily within their reach, and this can thus play a big role in revitalizing the country's economy.

Treat North Korea, as much as possible, as a normal country. This is the most difficult challenge because North Korea, of course, is not a normal country. The *Cheonan* sinking is pretty clear evidence that North Korea is one of the oddest countries in the world, willing to accept the risk of starting a war with a powerful and rightfully angry rival backed by a superpower for apparently minimal gain. It is as different from the United States as possible in many respects, and its differences from South Korea are growing rapidly. But the country is odd in large part because it has been treated oddly ever since it was created by Joseph Stalin. Each of its big neighbors—Japan, China, Russia, and of course its rival government in the South—has been fearful lest Kim Il-sung or his son does something that provokes a new war in a tense neighborhood. North Korea's government has learned to trade on these fears, using the proceeds to keep itself in power even as it fails its citizens. Economic engagement that avoids these fears and treats every transaction with North Korea as a business activity in which both sides must gain may be the only way to change North Korea into a normal country.

List of References

Berthoud, Jean-Michel. 2010. "Switzerland and North Korea: The End of an Era?" swissinfo.ch (Switzerland Broadcasting Corporation), 9 January. (Translated by Open Source Center, 28 May 2010).

Goldberg, Jeffrey. 2010. "Fidel: 'Cuban Model Doesn't Even Work for Us Anymore.'" TheAtlantic.com, 8 September. www.theatlantic.com/international/archive/2010/09/fidel-cuban-model-doesnt-even-work-for-us-anymore/62602/.

Haber, Stephen, Douglass C. North, and Barry R. Weingast. 2002. "The Poverty Trap." Hoover Digest, no. 4. www.hoover.org/publications/hoover-digest/article/6212.

World Bank. 1993. *East Asian Miracle: Economic Growth and Public Policy.* New York: Oxford University Press.

2011 Academic Symposium

Prospects for Emerging East Asian Cooperation and Implications for the United States
Andrew L. Oros, Doug Joong Kim, David Arase

The Emerging Role of South Korea on a Global Stage
Balbina Hwang, Youngji Jo

The Future of Energy Security in Northeast Asia
Chen Kane, Stephanie C. Lieggi, Miles Pomper, George Hutchinson

Engaging and Transforming North Korea's Economy
Doowon Lee, William Brown

Finding Room for a Six Party Solution to North Korea's Nuclear Crisis
Charles Armstrong (on South Korea), Drew Thompson, Natalie Mathews (on China), Michael Auslin (on Japan), Stephen Blank (on Russia)

October 20-22, 2010

Sponsored by:

The Korea Economic Institute
The Korea Institute for International Economic Policy
American University School of International Service