



A Security and Peace Mechanism for Northeast Asia: The Economic Dimension

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A continuing leitmotif of the six-party talks is the prospect that a resolution of the nuclear question could set the stage for more institutionalized and enduring multilateral cooperation in Northeast Asia. The Joint Statement of September 19, 2005, which outlined the principles governing subsequent negotiations, referenced new “ways and means for promoting security cooperation in northeast Asia,” and the February 13, 2007 Joint Statement created a Working Group on a Northeast Asia Peace and Security Mechanism (NAPSM).

From the beginning, these aspirations have included a strong economic component. The September 2005 Joint Statement invokes “economic cooperation in the fields of energy, trade and investment, bilaterally and/or multilaterally.” The February 2007 Joint Statement explicitly references humanitarian assistance to North Korea (or more formally, the Democratic People’s Republic of Korea or DPRK) as well, and created an Economy and Energy Cooperation Working Group (EEC/WG). Although initially focused on the delivery of heavy fuel oil and its equivalents to the DPRK, this working group could become the locus for wider economic cooperation and thus complement the security agenda.

The benefits to be derived from integrating North Korea into the regional economy do not necessarily point to a central role for the NAPSM, however. These objectives might also be achieved through other multilateral institutions, including the international financial institutions, or through regional or bilateral aid, trade, and investment agreements. Moreover, it is not clear that the economic agenda of any new multilateral institution should focus solely or even primarily on North Korea; to the contrary, we argue that for such a body to be robust it should engage the interests of all six of the parties.

Stephan Haggard and Marcus Noland

Stephan M. Haggard is the Lawrence and Sallye Krause Professor of Korea-Pacific Studies and Director of the Korea-Pacific Program (KPP) at the University of California, San Diego School of International Relations and Pacific Studies (IR/PS). He has written extensively on the political economy of East Asia and is the coauthor with Marcus Noland of Famine in North Korea: Markets, Aid, and Reform (Columbia University Press, 2007).

Marcus Noland is a senior fellow at the Peterson Institute for International Economics, with which he has been associated since 1985. He has written extensively on the economies of Japan, Korea, and China, as well as the problems of North Korea and the prospects for Korean unification. He was a Senior Economist at the Council of Economic Advisers in the Executive Office of the President of the United States and has held research or teaching positions at Yale University, the Johns Hopkins University, the University of Southern California, Tokyo University, Saitama University (now the National Graduate Institute for Policy Studies), the University of Ghana, the Korea Development Institute, and the East-West Center. He won the 2000–01 Ohira Memorial Award for his book Avoiding the Apocalypse: The Future of the Two Koreas.

In this brief, we explore the economic dimension of multilateral security cooperation in Northeast Asia. We begin with a discussion of the purported security benefits of economic engagement with North Korea. We then outline recent economic developments in North Korea, which provide a crucial background to any discussion of the issue. We raise some cautionary questions about the scope for multilateral economic cooperation in Northeast Asia before outlining how economic cooperation can complement longer-run security and economic objectives on the peninsula, including economic reform in North Korea.

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The Benefits of Engagement

A central objective of any security and peace mechanism for Northeast Asia should be to integrate North Korea into the regional economy. The advantages of economic integration—which undergirds the “sunshine” policy and the concept of “engagement”—are worth elaborating as they entail several trade-offs.

First, regional economic integration creates valued economic assets, physical infrastructure, and trade in a potential war zone. Deeper economic integration would therefore bring crosscutting pressures to bear on a North Korean military strategy that has emphasized forward-deployed conventional forces. The location of the Kaesong Industrial Complex (KIC), the rail and road crossings, and the proposed joint economic zone surrounding the Northern Limit Line and economic cooperation project at Haeju all reflect such a calculus, as can be seen by military reticence about them on both sides of the border.

Second, increased economic integration could prove useful in coaxing the North Koreans to engage in the security dialogue and over the longer run might increase economic stakes in ongoing political cooperation. However, these effects should not be exaggerated. To date, the use of economic carrots appears to have had surprisingly little effect on North Korea’s bargaining behavior; if anything, the evidence suggests that North Korea is more forthcoming when facing economic constraints.¹

The longer-run effects of economic integration will also depend on the nature of the economic ties that develop and can by no means be taken for granted. Experience throughout the world demonstrates that aid can leverage reform or support temporizing behavior, depending on the way transfers are designed and the attitude of the recipient government. In a country such as North Korea, even nominally private economic exchanges can be monopolized by the state and military sector and provide fungible resources that support the regime. Private investment confined to zones (Kaesong) or particular projects (Kumgang) may or may not have broader political implications.

Third, increased economic integration is likely to be the sine qua non of a successful economic transformation of North Korea. It is often argued that North Korea should adopt a Chinese or Vietnamese model, but this analogy is subtly misleading. Although agricultural price and land tenure reforms are certainly worth undertaking, they are unlikely to provide the same impetus to the broader reform effort that they did in China. Even more than in China, North Korea’s trans-

formation will depend on foreign investment, trade, and remittances—in effect, a strategy similar to that pursued by South Korea from the mid-1960s or Vietnam from the 1990s.

Moreover, it is important to point out that, to the extent such reforms are successful, they have highly ambiguous consequences for the political transformation of the country. Successful economic reforms may have long-run political consequences but could well stabilize the regime in the short run. Indeed, among some strategic thinkers in both South Korea and China, a central objective of engagement is precisely to avoid regime or even state collapse.

Economic engagement is further complicated, finally, by purely humanitarian concerns. North Korea is desperately poor and has recently experienced a slowdown in growth, a decline in food assistance, and ongoing food shortages. Sadly, North Korea will continue to need humanitarian assistance for some time to come regardless of what happens in the six-party talks. No matter how well designed, such assistance will inevitably have ambiguous effects on regime change as well.

The North Korean Economy: A Brief Economic History

Further insight into the prospects for deeper economic integration can be gained by considering North Korea’s recent economic history. 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 twentieth century.² As many as one million people—5 percent of the entire population—perished in the mid-1990s. As this occurred, however, 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 scrambled for food, initiating barter trade and venturing into new, monetized, economic activities.

The North Korean regime’s response to this “marketization from below” has been both slow and ambivalent. It was not until July 2002 that reforms decriminalized some of the market activities that had sprung up during the famine, for example by permitting the growth of controlled markets. However, in 2005, in the wake of increased aid and improved harvests, the government imposed a ban on private trade in grain, which had emerged as the principal source of food for most households, and attempted to resuscitate the failed public distribution system. It has tried to force workers back into the collapsing, state-

owned enterprise sector, for example by prohibiting women from working as traders. Most recently it has apparently cracked down on unregulated activities of North Korean trading firms in China.

The positive interpretation of these moves is that they represent an attempt to create regularized institutions and practices out of the chaotic environment that emerged in the wake of the famine and the 2002 reforms. However, a disturbing aspect of recent history has been the government's tendency to liberalize under duress and to reassert control when times are good. It is fair to say that the government has not fundamentally embraced the reform process and that as a result economic policy suffers from debilitating credibility problems; it is difficult either for North Koreans or foreigners to invest with confidence—at least at any significant scale—if the policy environment remains highly uncertain.³ The North Korean emphasis on “military-first” politics further limits the scope of the reforms by continuing to tilt the overall allocation of resources in favor of the military.⁴

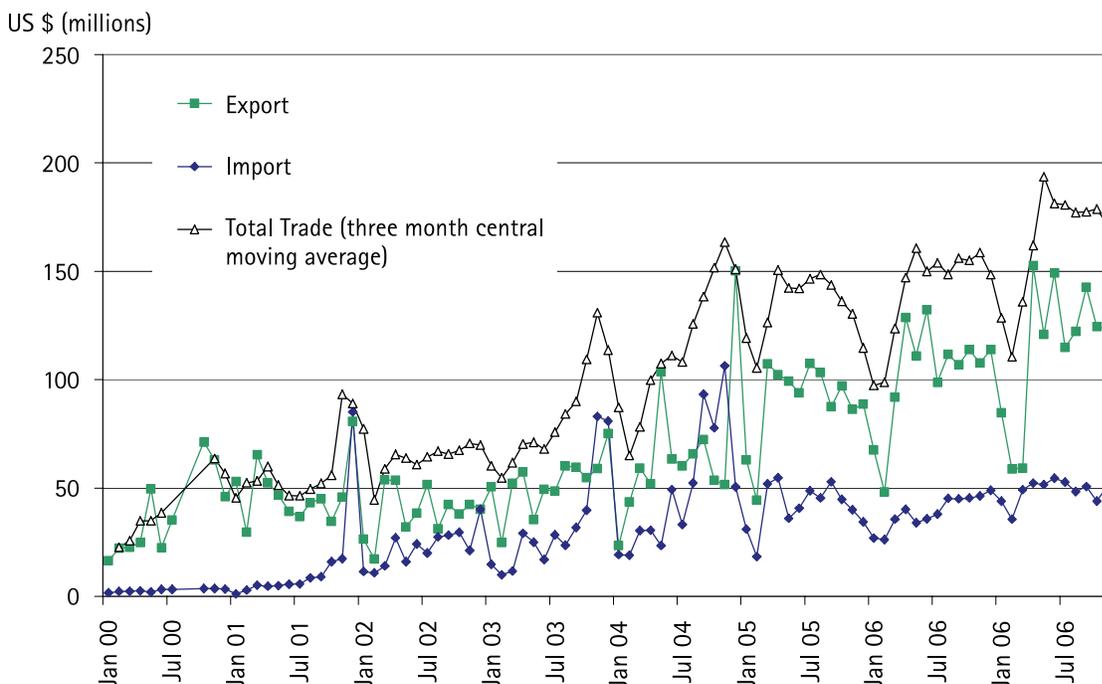
The extent of economic liberalization has also been disappointing. As we have argued, agricultural reforms are unlikely to be as central to North Korea's transformation as they were in China and Vietnam. Instead, given the relatively smaller size of North Korea's agricultural sector and its proximity to larger, more advanced economies, foreign investment and multilateral assistance in support of increased trade are the sine qua non of genuine

economic transformation. Investment and exports will finance not only the imports needed to revive the North Korean economy, but also the food that has been in short supply since the famine.

However, the relatively limited scope of policy reform does not imply the absence of foreign trade and investment ties; to the contrary, North Korea's external economic relations have been increasing steadily with two countries—China and South Korea—playing central roles.⁵

North Korea's ties with China's booming economy may have been given an unintended boost by the onset of the nuclear crisis. The crisis generated uncertainty, multilateral sanctions, an effective Japanese embargo, and US financial sanctions. Sanctions may have forced North Korea back to the bargaining table, but in combination they also had the unintended effect of linking North Korea even more closely with China. This deepening integration has not primarily taken the form of aid, which we estimate has remained constant since the late 1990s. Rather, growing interdependence rested on expanding trade and investment, driven by small traders and state-owned and private enterprises particularly from Northeast China, reflecting that country's voracious appetite for raw materials.⁶ As Figure 1 shows, China's trade with North Korea has expanded steadily since the onset of the nuclear crisis. Exports to North Korea have also outstripped its imports, implying a bilateral trade deficit financed in part by growing foreign direct investment by Chinese enterprises.

Figure 1. China DPRK Trade 2000–2007



South Korea's trade and investment relations with the North have been driven more directly by politics. Trade did not begin in earnest until the initiation of the "sunshine" policy under Kim Dae Jung, and from the beginning had a strong aid and noncommercial component. Yet even nominally commercial trade has a substantial strategic and noncommercial cast. The Mt. Kungang tourist project and KIC have involved private companies, but also substantial government subsidies. Moreover, both have been confined to enclosed zones with uncertain spillover effects.

Figure 2 divides South Korea's exports to the North into three categories—commercial trade, cooperation projects (primarily Kungang 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 could decrease as South Korean policy begins to emphasize "trade not aid" in its dealings with the North.⁷ Ironically, to date, socialist China appears more commercial in its dealings with the DPRK than with South Korea.

How might North Korea's incipient opening be further advanced through a multilateral framework? How should such a mechanism be designed, and what should its agenda be?

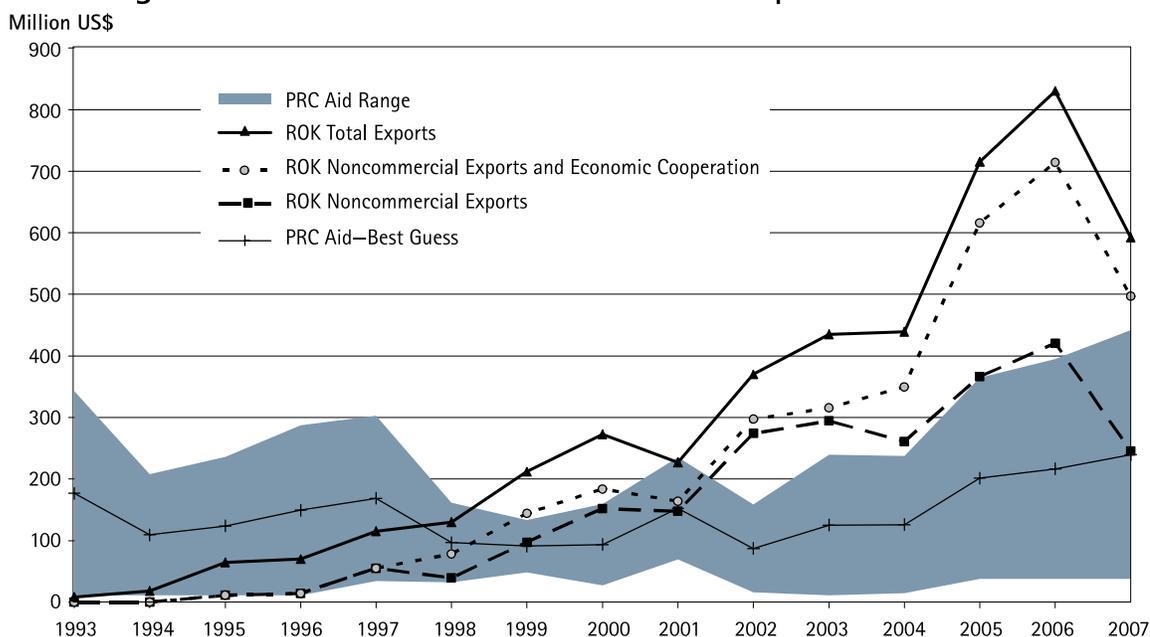
Multilateralism: Four Caveats

Multilateral institutions are well-suited to circumstances in which there are inefficiencies in traditional, bilateral diplomacy or coordination problems that require cooperation among multiple parties. Such multilateral institutions have proven their merit in a range of settings, from the global to the regional. In the Northeast Asian context, the six-party talks have proven remarkably resilient. Despite the slow pace of the negotiations, none of the parties appears willing to abandon them altogether, and all have signaled a willingness to discuss a more enduring multilateral mechanism. Moreover, the economic weight of the six parties and the spate of bilateral and regional trade agreements in the Asia-Pacific raise the question of whether Northeast Asia may be ripe for deeper economic cooperation and integration.

However, it is important to begin with some reservations. Some caution is warranted about what a multilateral mechanism might be able to achieve on the economic front, and there are serious questions about the appropriate focus for such an entity.

First, the advance of multilateral cooperation hinges on the resolution of the nuclear question; multilateral economic diplomacy cannot move

Figure 2. China and South Korea Aid and Exports to North Korea



Sources: KEIP 2005, MOU 2007, UN COMTRADE 2008, KITA 2008

Note: High Chinese aid estimate is the sum of all food and fuel exports to North Korea, low is officially reported data (2005 number used for 2006 and 2007 as well), best guess is the simple average of the two.

ahead of the more difficult discussions of security as they have in other regions. The reasons are not simply tactical: that the other five parties should withhold carrots until North Korea shows its willingness to cooperate. The reasons have to do with the fact that closer economic integration, including foreign investment, is unlikely to take off if the nuclear question and broader security issues are not moving toward resolution.

Second, it is important to avoid a top-down, planning approach to multilateral economic cooperation and to emphasize the significance of reform and the private sector. A number of think tanks and academics in the region have advanced vision documents with respect to Northeast Asian economic integration, and the recent summit brought several specific “cooperation projects” to the bargaining table. Even President Lee Myung-bak has advanced a proposal for ambitious infrastructure investment in the North. The Tumen River project, however, provides a case study of how well-intentioned multilateral schemes can go nowhere in the absence of complementary domestic policies and underlying economic feasibility. Similarly, the efforts by the Korean Peninsula Energy Development Organization (KEDO) to provide North Korea with light water reactors (LWRs)—whatever their political merits—proved a complete white elephant from an economic perspective. Although multilateral cooperation on expensive infrastructure, such as pipelines and the energy grid, might be warranted over the long run, beginning with such initiatives may skew the discussion away from much needed reforms and send misleading signals to North Korea given the vast resources such projects would demand.

A first corollary of the injunction to avoid top-down approaches is that any collective development assistance must be extended in support of economic reform. Experience throughout the developing world demonstrates that assistance will have only marginal effects, and may even have negative consequences, if not coupled with policy changes. It is not simply that aid sustains the regime; since aid is fungible, even purely humanitarian aid will have that effect. The problem is that too much aid can delay or even undermine the reform process. Whatever the multilateral mechanism that ultimately emerges, it should serve to encourage the cause of reform and economic opening in the North.

A second corollary of the injunction against top-down approaches is the importance of engaging the private sector: through trade, foreign direct investment, private capital flows (including remittances), and sheer expertise. Economic rehabilitation will require investment in social overhead

capital, which will be led primarily by the public sector. If North Korea is to evolve toward a self-sustaining market-oriented economy, private sector involvement will be crucial. The participation of foreign firms means that projects are subject to the market test of profitability and encourages North Korean authorities to think of economic engagement in terms of joint gain, rather than as political tribute.

There are a variety of ways in which public sector initiatives, and even subsidies, could support private investment. Examples include offering multilateral assistance for the development of export processing zones and engaging South Korean institutions such as the Korea Trade-Investment Promotion Agency (KOTRA) and the Korea Eximbank in North Korea.

Many discussions of the rehabilitation of the North Korean economy have overemphasized public investment and have failed to consider the crucial complementarities among public sector investment, economic reform, and the engagement of the private sector. At least some of the massive costs of modernizing the North Korean economy can be borne by the private sector through foreign direct investment if North Korea makes it attractive to do business. This is even true with respect to infrastructure, where a number of developing countries have benefited from private investment in projects ranging from telecommunications to highways and even the provision of power and water. The involvement of the private sector both contributes to the revitalization of the country and constitutes a natural hedge with respect to the costs of unification.

Over the medium run, there is also a role for commercial lending. The North Korean government will eventually seek to resolve the overhang from its past international defaults (probably with South Korean government assistance) and reenter international capital markets as a borrower. Such borrowing has been important in financing infrastructural development in Vietnam once reform makes such investments viable. Put most simply, aid is not enough; public support needs to be supplemented by foreign direct investment and commercial lending.

A third reservation about a regional multilateral mechanism is that it should not duplicate at the regional level what might be more effectively managed through existing multilateral institutions. North Korea is in need of depoliticized technical assistance about a whole panoply of issues running from the mundane but critical, such as developing meaningful national statistical capabilities, through basic agricultural and

health technologies, to the social infrastructure of a modern economy. This infrastructure includes policy mechanisms to do the following: manage macroeconomic policy, including through a reform of the central bank; specify property rights and resolve commercial disputes; regulate markets, including financial markets as they emerge; establish and implement international trade and investment policies, and so on.⁸

The possibility of a Northeast Asian Development Bank has been floated as a vehicle for undertaking these tasks. However, it would be a mistake to try to construct a new institution at the subregional level that would duplicate the activities of existing global and regional institutions in which the five other countries are well-represented. Moreover, such an institution could be interpreted by the North Koreans as little more than a dedicated channel for assistance. To the extent that the five governments have particular expertise that they wish to contribute to North Korean economic rehabilitation, staff can be seconded to existing institutions, as was done in the case of KEDO, or bilaterally to the extent that the North Koreans allow it.

Rather, such advice will be facilitated by North Korea's entry into the World Bank, the International Monetary Fund (IMF), the Asian Development Bank (ADB),⁹ and the World Trade Organization (WTO) and an expansion of the activities of those agencies that are currently engaged there, such as the United Nations Development Fund (UNDP), World Health Organization (WHO) and United Nations Children's Fund (UNICEF). In our view, the sooner this happens, the better.¹⁰

We can imagine a model in which the World Bank would play a coordinating but not exclusive role. The Bank would engage in more detailed analysis of the North Korean economy and lead a consultative group on the country to facilitate the coordination of multilateral assistance. The Bank could also become the repository for a dedicated North Korea fund that would initially support technical assistance and the building of local institutional capacity. These early actions would eventually support direct lending and investment guarantee activity. Japanese post-colonial claims payments could be one source of financing for such a facility as the two countries normalize relations.¹¹ Calibration on the basis of Vietnam's experience in joining the World Bank suggests that the North Koreans might expect an eventual lending program on the order of \$150 million to \$250 million annually; given South Korea's interest in revitalizing North Korea and the prospects of Japanese post-colonial payments, the actual lending from such a facility might be substantially larger.¹²

A fourth and final caveat with respect to multilateralism is that the five parties are going to pursue their own foreign economic policies with respect to North Korea. Although a multilateral setting can be useful in demonstrating common interests among the parties—such as the significance of denuclearization—the five clearly diverge on a range of questions from the merely tactical to the strategic; multilateralism will not resolve these differences but will rather have to accommodate them.

Japan is not currently in the mood to play the financial role it did with respect to KEDO; further economic engagement will clearly rest on the outcome of negotiations over normalization and especially on the abductee question.

Once the issue of North Korea's nuclear declaration has been resolved, the US role with respect to economic questions will focus on removing North Korea from the terrorist list, terminating the application of the International Emergency Economic Powers Act (the successor to the Trading with the Enemy Act), removing remaining sanctions, and normalizing political relations. At some later stage, and depending on the course of North Korea's political and economic reforms, the United States might contemplate rules of origin that would permit imports from South Korea that were processed in Kaesong or even granting North Korea normal trade relations (*née* most-favored-nation status). These steps clearly lie in the future, however, and except for humanitarian assistance US aid is likely to be modest.

Russia has a stake in the North Korean economy and has been given leadership of the working group on the new security and peace mechanism. Russia, however, is not likely to be a major donor either.

The two central players on the economic front are China and South Korea. As we have already noted, China has a growing economic stake in North Korea. This stake is largely commercial but supplemented by aid that acts as both a lever to and a hedge against the refugee problems that would emerge were North Korea to undergo political upheaval or a recurrence of economic collapse.

The missile and nuclear tests resulted in a suspension of South Korea's humanitarian assistance to North Korea (see Figure 2). South Korea's election of a conservative candidate is also likely to change the tone of engagement with the North at the margin. But support for humanitarian assistance, the road and rail links, Kaesong, energy assistance, and other economic cooperation projects is widespread and likely to continue. Indeed, the Lee Myung-bak

transition team has outlined an extraordinarily ambitious economic program, contingent on full denuclearization, which includes mobilization of a \$40 billion international fund for North Korea, support for road links and other infrastructure, and training.¹³ A centerpiece of President Lee's strategy is to expand export-oriented investment in North Korea, an approach very much in line with the strategy we have articulated here.

The Economic Component of the Northeast Asia Peace and Security Mechanism

The Agenda

In turning to what might be done, we should first ask whether the North Korean tail should be wagging the Northeast Asian dog. The potential gains from closer economic integration among the six parties, and particularly in the areas immediately surrounding the Korean peninsula, are by no means limited to the gains from securing greater North Korean cooperation. Arguably, economic cooperation should not be tied to North Korea at all but should move directly toward discussions of a more wide-ranging Northeast Asian economic community.

We also see several drawbacks to focusing solely on the Korean peninsula, including the difficulty of maintaining common interests once the nuclear issue is resolved and the political drawbacks vis-à-vis North Korea of an entity that could be construed primarily as an aid vehicle. Moreover, it is far from clear that the North Koreans see a multilateral mechanism as a substantial inducement; although open to the idea, Korean negotiators have placed much more substantial weight on key bilateral relationships, including normalization of relations with the United States.

Rather, discussions of the mechanism should focus on issues that are of both longer-run and short-run interest and provide benefits to all six of the parties. These would be addressed with the understanding that North Korea can avail itself of these discussions as it takes the necessary decisions to do so.

The most encompassing idea, and one vetted widely in South Korea, would be a Northeast Asian Free Trade Area (NEAFTA). Given the weight of the five parties in the Asia-Pacific economy, such a grouping would be a major step toward wider regional integration. Although this is a laudable long-term objective, it overreaches. Both Japan and the United States have had problems reaching or

ratifying bilateral agreements with South Korea. Russia has had difficulty even with the less demanding task of joining the WTO. China and Japan would have to achieve a breakthrough in political as well as economic relations, and Japan has consistently run into domestic political resistance from agriculture (among other sectors) to WTO-consistent free trade agreements. Here as with other issues, North Korea has to date shown little interest in a reform of this magnitude. At this stage, a frontal effort to move toward a NEAFTA is less likely to yield fruit than is a more incremental and less legalistic approach that builds on the six-party talk mechanism.

A range of issues fits the idea of a "variable speed geometry" and is likely to garner early support as topics worthy of discussion. These include maritime and air transport (and its externalities), the spectrum of transborder environmental issues (acid rain, dust, and haze), and technical trade facilitation issues among the parties, such as customs clearance and regional support for new export-oriented industrial parks in North Korea.

Two issues that deserve somewhat greater attention are ground transport and energy. The continued economic growth of Northeast Asia will clearly depend in part on the ongoing development of the major transportation corridors in the region.¹⁴ Two of these are directly related to the integration of the Korean peninsula: the western corridor or Gyungui line, which would not only link North and South but provide a rail link for South Korea to China; and the eastern corridor, which is of importance not only to the impoverished east coast of North Korea but could link both Koreas through Russia to Europe. The investment required to rehabilitate North Korean rail infrastructure and to manage issues such as differences in track gauge cannot be dismissed. Yet all of the continental countries stand to benefit directly from such investments, and so would Japan. Rail transport might therefore constitute a useful early issue for discussion, particularly given the fact that it is relatively undemanding on North Korea but could nonetheless yield easy returns. Similarly, multilateral support for an improvement of roads would win strong support from the DPRK, China, South Korea, and Russia.

Energy shipments to the DPRK have played a crucial role as a short-run inducement in the six-party talks.¹⁵ Energy cooperation is often highlighted as one that could benefit from broader multilateral cooperation, particularly given the strategic jockeying over energy supplies in the region and the resulting potential for political or even military conflict.

Yet the energy agenda for both North Korea and the region is littered with potential pitfalls. North Korea has repeatedly asserted its Article IV right under the Non-Proliferation Treaty to a peaceful nuclear program and has continually revisited the issue of the LWRs that were promised under the Agreed Framework. These reactors faced difficulties and delays in construction and now stand—unfinished—as a testament to the risks of large-scale, politically motivated projects. The most thorough analyses of the LWR project concludes that they are a costly and inappropriate way for meeting North Korea’s vast energy needs; given the poor state of North Korea’s electricity grid, the energy generated by LWRs might even have to be exported!¹⁶

Nonetheless, Pyongyang is likely to return to this issue either as a possible security hedge or as a bargaining tactic for extracting resources, for example through tabling an “LWR equivalent” package. These discussions should not simply be deferred to a later date, as the United States did at the time of the September 2005 Statement of Principles; this strategy sends a misleading signal. Rather, these demands should be rechanneled altogether into the variety of other well-considered proposals that are both more cost-effective and more directly complement the reform process: encouraging the development of energy markets and appropriate pricing, reducing waste, rehabilitating coal supply and transport, opening to foreign investment in the energy sector, and developing small-scale renewable energy sources.¹⁷ In all of these efforts, the engagement of the private sector should be a consideration, not simply to defray the economic costs but to encourage the North Korean reform process.

Beyond the rehabilitation of North Korea’s energy sector, attention has been given to more wide-ranging ventures that might engage all of the parties in the region, including regional power grid interconnection and the development of oil or gas pipeline networks.¹⁸ Yet these ideas face daunting technical constraints (for example, with respect to interconnection), extraordinarily high capital costs, and very long time frames for public and private investment to gel. Moreover, both pipelines and grid interconnection remain vulnerable to the holdup problem: that North Korea could easily disrupt and render worthless large investments. As a result, these larger infrastructure ideas seem to be longer-range prospects rather than plausible starting points.

Institutions, Format, Procedures

There are a variety of ways that the proposed NAPSM could emerge.¹⁹ Given the advantages of moving quickly on economic questions if North

Korea takes the crucial decision to abandon its nuclear program, the EEC/WG seems the most logical nucleus for economic discussions, even if it is later superseded or subsumed into a new entity. The EEC/WG would transit from its present focus on provision of heavy fuel oil and equivalents to the DPRK to select items on the broader agenda just outlined.

We have already emphasized that any new entity not be seen as a forum simply for discussing aid commitments to North Korea, particularly if it is desirable to do much of the heavy lifting in that regard through existing global and regional institutions and bilateral aid efforts. Crafting an agenda that combines issues related to North Korea more directly, such as energy, with issues of broader regional import, such as transportation, seems crucial.

To do this, the new mechanism should configure itself as a venue for a particular kind of technology transfer and socialization: a forum to engage North Korea as well as the other parties in a discussion of the regional economy; the benefits that come from a more open trade and investment regime; and the physical, legal, and financial infrastructure that would support the regional economy. In this regard, three extremely modest procedural proposals might repay the multilateral effort in a more handsome way than more elaborate schemes.

First, the NAPSM presents the participating governments with a bureaucratic balancing act. Because of the dominance of foreign policy and security issues, it will inevitably be led by foreign ministries. Yet the issues that we have discussed are usually managed by economics, finance, trade, energy, environment, and transportation ministries. While these other bureaucratic actors have periodically been represented in the five powers’ delegations, North Korea’s participation has been monopolized by its foreign ministry. At present this representation has precluded substantive discussions in the EEC/WG, and will severely impede meaningful economic discussions in the future if allowed to continue. The five parties should make sustained efforts to engage portions of the North Korean bureaucracy that are not typically exposed to such discussions, such as ministries involved in economic management, the environment, and transport.

A second and related challenge is how to maintain high-level interest across multiple ministries. Periodic ministerials will be needed to maintain commitment and momentum, but senior officials already face a proliferation of international meetings. All five of the Northeast Asia powers are members of Asia-Pacific Economic Cooperation

(APEC), whose finance ministers meet annually in the run-up to the heads of governments meetings. It might be possible to organize economic ministerials related to the NAPSM around the APEC calendar in order to secure high-level involvement. As North Korea commits to a course of reform, it would profit from being a member of APEC as well and, as with other multilateral institutions, might initially gain observer status.

Third, it is important to think about how the private sector may be engaged as a resource. Inviting representatives of major firms to discuss their operations, capabilities, and policy interests could have important educational effect, particularly for the North Koreans. Again, piggybacking on the APEC calendar may be valuable in this regard, since the business sectors of the five powers are already integrated into APEC-related groups and activities.

The most logical way to meet these objectives would be to begin with agenda-setting discussions in the context of the initial ministerial meeting. These discussions would set the stage for the evolution of the EEC/WG and the widening of both public and private sector participation through functional working groups on the topics we have outlined.

Conclusion

A primary, though not exclusive, objective of the NAPSM should be the integration of North Korea into the Asian and global economies. Such an opening is a prerequisite to the country's economic renewal and resolution of its chronic humanitarian problems. Deepened economic interdependence would also embed North Korea in relations that could reduce the likelihood of disruptive behavior. Yet attainment of these hoped-for outcomes depends crucially on the nature of the economic ties that develop and are by no means assured. The modalities of engagement are important not only in direct economic terms, but also in their effect on the trajectory of North Korea's political and economic development.

For such engagement to be fruitful and politically sustainable, it must emphasize reform in North Korea and the international private sector's involvement in the country's economic revival. The multilateral project otherwise risks becoming yet another costly and failed initiative that will neither deliver the expected economic benefits nor encourage constructive internal change in North Korea; as we have argued, such a mechanism could even have perverse effects on the reform process.

Yet at the same time there is clearly a critical role for the public sector in providing depoliticized technical assistance and financing for infrastructural rehabilitation and encouraging the reform process itself. We are skeptical about the advisability of reproducing on the subregional level the capacities of existing global and regional institutions such as the World Bank or the ADB. The existing institutional framework is sufficiently flexible to accommodate major subregional initiatives without reconstituting institutions from scratch. Grandiose proposals such as a free trade area for Northeast Asia will likely be a distraction from more incremental projects that could serve as the building blocks for more expansive initiatives further down the road.

However, functional working groups on some of the topics we have outlined—the environment, maritime transport, technical barriers to trade, road and rail links, and in the future perhaps energy—could provide the locus for integrating multilateral and bilateral assistance with increased private involvement. Moreover, these issues engage not only North Korea but also the other five parties.

Apart from its intrinsic difficulty, this agenda poses some specific bureaucratic challenges. Foreign ministries will inevitably take the lead in developing the NAPSM; indeed, leadership at the ministerial level or even higher will be essential if the process is to gain ground. However, the implementation of the economic agenda will require high-level coordination across a variety of ministries. North Korea has thus far proved problematic in this regard. Moreover, given the importance in private sector involvement in achieving sustainable economic development in North Korea, modalities will have to be developed to integrate the private sector fully.

It bears underlining by way of conclusion that the entire Northeast Asian economic agenda depends on the resolution of the nuclear issue. The governments of the region will not move beyond temporizing support in an effort to avoid a North Korean collapse until North Korea denuclearizes. Nor will the private sector engage in any major way until the nuclear issue is resolved. In the absence of a supportive diplomatic environment, the North Korean aspects of the broader economic agenda will not come to fruition.

Endnotes

- ¹ The financial constraints on North Korea associated with the designation of Banco Delta Asia (BDA) as a money laundering concern to the United States in September 2005 were a major preoccupation of the North Korean government and may have even triggered the missile and nuclear tests of 2006. The resolution of the BDA “sanctions” in January 2007 was central for restarting the six-party talks.
- ² Stephan Haggard and Marcus Noland, *Famine in North Korea: Markets, Aid, and Reform* (New York: Columbia University Press, 2007).
- ³ The economic situation is not uniformly negative, however. For example, although remaining high, the rate of inflation, which had been running well over 100 percent annually, has attenuated over the past year or so.
- ⁴ 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, February 11, 2008, 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. 302-303 for a quantitative assessment.
- ⁵ Stephan Haggard and Marcus Noland, “North Korea’s External Economic Relations,” Peterson Institute for International Economics Working Paper 07-7, August 2007.
- ⁶ More recently, an unknown share of this activity may reflect transactions with South Korean firms operating in the border region with Chinese partners.
- ⁷ The humanitarian share may actually increase in the short run if North Korean recalcitrance on the nuclear issue is met with a slowdown in all but humanitarian aid flows. Similarly the cooperation projects involve sunk costs and will likely decline in importance—unless the nuclear issue is resolved. If this were to occur, ambitious infrastructure investment from the South could “lead” private investment into the North, with noncommercial transactions also seeing an increase in share over the short run.
- ⁸ We have made the same argument about duplicating multilateral efforts with respect to humanitarian assistance as well. For better or worse, humanitarian assistance to North Korea is highly politicized and reflects strong domestic political commitments in China and particularly in South Korea. From the standpoint of efficiency, however, the overall aid mission would be better served by channeling more Chinese and South Korean assistance through multilateral institutions such as the World Food Program. See Stephan Haggard and Marcus Noland, *Famine in North Korea: Markets, Aid, and Reform*, Chap. 6 for further elaboration.
- ⁹ It is sometimes suggested that North Korea join the ADB before joining the World Bank, since Bank membership is contingent on joining the IMF, and ADB membership is not. Again, the specifics of membership accession could take many forms, but the important point is that ADB membership not be used to duck the more rigorous accession process of the larger Bretton Woods Institutions. In any event, North Korea’s potential membership at the ADB would depend on reaching a political accommodation with the United States and Japan, its two largest shareholders, whatever the formal technicalities; this is likewise true with respect to observer status at the WTO.
- ¹⁰ Normally members are granted observer status as a transitional status during accession negotiations. In some unusual circumstances typically involving post-conflict or new states (the Palestinian Authority, post-Khmer Rouge Cambodia, East Timor), direct lending activities began before full membership, and this is sometimes floated for North Korea. Whatever the specific arrangements, it is important that observer status not be exploited as a permanent mechanism to sidestep membership obligations. Rather, it should be a genuinely temporary state en route to full membership driven by the North Korean government’s embrace of reform and opening.
- ¹¹ Japanese officials have not denied formulas reported in the press that would put the total value of a multiyear package of grants, low-interest-rate loans, and trade credits at approximately \$10 billion, consistent with the value of Japan’s 1965 settlement with South Korea, appropriately adjusted for inflation and other factors. Japan will certainly argue that its \$1 billion contribution to KEDO should be credited against this bill, and it has been speculated that Japan might even claim credit for the costs of recapitalizing failed Chochongryun-affiliated financial institutions. See Marcus Noland, *Korea After Kim Jong-il* (Washington: Institute for International Economics, 2004) for further details and references.
- ¹² See Marcus Noland, *Avoiding the Apocalypse: The Future of the Two Koreas* (Washington: Institute for

International Economics, 2000), pp. 340-342 for discussion.

- ¹³ Foreign Affairs Unit, Office of the President Elect, "President-Elect Lee Myung-Bak's Foreign Policy," mimeo.
- ¹⁴ A useful introduction to these issues is Hisako Tsuji, "An International Logistics Infrastructure for Northeast Asia," Economic Research Institute for Northeast Asia Discussion Paper No. 0307e, November 2003.
- ¹⁵ The February 2007 Joint Statement promised an initial shipment of "emergency energy assistance" in the form of 50,000 tons of Heavy Fuel Oil (HFO) to be followed in the next phase by up to one million tons of HFO or their equivalent following denuclearization.
- ¹⁶ Peter Hayes, David Von Hippel, and Nautilus Team, "Modernizing the US-DPRK Agreed Framework: The Energy Imperative," *Asian Perspective*, Vol. 26, No. 1, 2002, pp. 9-28.
- ¹⁷ Peter Hayes, "DPRK Energy Security Without Rewarding Bad Behavior," Nautilus Institute PFO 03-2A, January 13, 2003, <http://www.nautilus.org/DPRKBriefingBook/energy/issue.html>.
- ¹⁸ See in particular Bradley O. Babson, "Searching for the Right Side of History in Northeast Asia: Potential Role of Energy Cooperation with North Korea," Economic Research Institute for Northeast Asia Report, Vol. 46, June 2002, pp. 20-23.
- ¹⁹ The most likely route is that a resolution of the nuclear question is followed by a ceremonial ministerial meeting at the foreign minister level that endorses further multilateral steps. The six-party talks could become the new institution, with the established working groups as the nucleus of new forms of multilateral cooperation; in this instance, the EEC/WG would expand to consider other issues. Alternatively, the Working Group on the NAPSM may be the locus for the negotiation of a new entity that would encompass both a new security agenda, such as confidence-building measures, as well as the economic issues highlighted here. Finally, the Northeast Asian Cooperation Dialogue, currently a track two effort that has considered economic issues in its own working groups, could be transformed into an intergovernmental entity.

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The Stanley Foundation
209 Iowa Avenue
Muscatine, IA 52761 USA
563-264-1500
563-264-0864 fax
info@stanleyfoundation.org

Production: Amy Bakke, Lonnie Buchanan, and
Kathy Sunderbruch

The Stanley Foundation
209 Iowa Avenue
Muscatine, IA 52761 USA

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