

## The Summit and the Economic Future of the Peninsula

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North Korea has experienced a decade of economic decline. A famine has claimed the lives of perhaps ten percent of the pre-crisis population. Despite its *juche* (self-reliance) ideology, the country is increasingly reliant on the beneficence of others. The regime has undertaken a series of hesitant changes in economic policy that appear designed to maximize foreign exchange earnings while minimizing systemic change. These policy innovations include the Rajin-Sonbong special economic zone, the Mt. Kungang tourism project, the possible establishment of mining concessions, and the possible establishment of new special economic zones and bonded warehouses in the vicinity of Haeju, Nampo, and Wonsan.

South Korea is coming out of its worst economic crisis in a generation. The old state-led economic paradigm has been discredited, but South Korean businessmen and policymakers have yet to construct a real alternative model, and despite the economy's recent buoyancy, the future remains uncertain.

The April 2000 announcement that the leaders of North and South Korea would meet in the first ever North-South summit stunned the world. The question immediately arises as to whether this signals a change in strategic direction on the part of a newly confident Kim Jong-il in response to the engagement policy of Kim Dae-jung? Or was this simply a tactical move to extract maximum concessions from an electorally weak Kim Dae-jung, in search of an "April surprise," and to buy insurance against the possibility that a harder line US administration might be elected in November?

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The key is North Korean intentions. It is easy to dismiss the meeting as a cynical ploy of the North Koreans, timed to extract maximum concessions from an electorally weak Kim Dae-jung. On the demand side, the North has a history of demanding tribute as the quid pro quo for participation in various diplomatic fora. On multiple occasions it has extracted payments from the US to secure its participation in diplomatic negotiations. Indeed, North Korea is now the largest US aid recipient in Asia. Last year, a visit to Beijing by Supreme People's Assembly Chairman, Kim Yong-nam, netted 150,000 tons of grain and 40,000 tons of coal, and the North Koreans were reputedly demanding from the Chinese a package worth \$800 million for a visit by the Dear Leader Kim Jong-il.

On the supply side, the South has a history of "checkbook diplomacy" as well, for example in its provision of \$3 billion in concessional loans to the Soviet Union at the time diplomatic relations were normalized between Moscow and Seoul. It has already announced a gift of 200,000 tons of fertilizer and there is talk of encouraging a "gold rush" of South Korean firms to the North. Given these proclivities, the mind reels at the thought of what price caused this diplomatic market to clear three days before the South Korean elections in which the party of incumbent South Korean President Kim Dae-jung trailed at the polls. Yet even if resource extraction is a primary motivation on the part of the North Koreans, it may not be the only motivation.

Extortion has its limits as an economic development model. It may well be that Kim Jong-il, having consolidated power, feels sufficiently confident to break out of North Korea's strategic straight-jacket, and knows that he is unlikely to ever have a counterpart as amenable to engagement as Kim Dae-jung. Importantly, the meeting with the South Korean leader can be justified internally as the fulfillment of the Great Leader Kim Il-sung's plan. After all, at the time of his death in 1994, plans were underway for a summit between the elder Kim and his counterpart, then South Korean President Kim Young Sam.

Ultimately, the intentions of the Kim Jong-il regime are central, and one can only speculate as to what they may be. It may well be that the summit represents an important step in the strategic reorientation of North Korea. South Korea is not the only country with whom the North Koreans have begun talking. In recent months the North Koreans have re-established diplomatic relations with

Australia, engaged the Philippines, Italy, and most importantly, Japan, in discussions aimed at the normalization of diplomatic relations. They have expressed interest in joining the ASEAN Regional Forum (ARF), the only multilateral security organization in the region, and once again have begun showing interest in the international economic institutions. Rapprochement with Seoul would be central to any such strategy of opening.

### **Wants and Needs**

Whether these actions will be enough to pull North Korea out of its economic decline is another matter, however. The North Korean economy desperately needs two things to meet the minimum survival requirements of its population: food and energy. It may well be that the country generates enough through production or aid to attain the minimum survival basket, but chooses not to do so (i.e. the regime has a strong preference for guns over butter). Taking these preferences as given, how much additional income would the country need to hit the minimum survival basket? Under current conditions North Korea runs a structural food deficit of around two million tons. For the last five years, this gap has mainly been closed through the provision of international assistance.

In addition to food, North Korea needs energy. It is reliant on imported oil to generate fuels and fertilizer for use in transportation and agriculture. Electricity is mainly generated using coal and hydropower. Generation has been hampered by difficulties in extracting increasingly inaccessible and low quality domestic coal reserves. Beyond this problem, the power grid (largely underground for security purposes) is said to suffer from extraordinarily large transmission losses. The 1994 Agreed Framework between North Korea and the United States provides for the construction of two light water reactors and the provision of oil in the interim. The problem is that this is essentially a diplomatic agreement over North Korea's nuclear program, and does not really address the true needs of the North Korean economy. From an economics standpoint, it would be better to renegotiate the Agreed Framework, scrapping the costly light water reactors, and instead building more cost-effective electrical generating systems, refurbishing the existing electrical grid, and building the necessary

infrastructure that would allow North Korea to export electricity to South Korea and China, and thereby earn foreign exchange.

Anthony R. Michell has estimated that if the Framework Agreement as negotiated is fully implemented, the actual cost of purchasing the estimated shortfalls in grain and energy inputs, as well as desperately needed supplies of fertilizers, pharmaceuticals, etc. would not be very large, less than \$1 billion dollars. Assuming no more interruptions in service, the Hyundai Mt. Kumgang tourism deal guarantees North Korean nearly \$150 million annually over the relevant time period. This is a minimum. North Korea receives a payment per visitor. If Hyundai were to meet its target of 1.5 million visitors annually by 2005, North Korea would stand to net approximately \$450 million per year — or enough to cover its grain deficit on commercial terms. Moreover, other South Korean firms have expressed interest in similar tourist ventures. If the North Koreans went through with the other projects in the Hyundai agreement, including the establishment of a new SEZ at Haeju, this could generate additional revenues.

For \$2 billion annually, one could sufficiently fix the North Korean economy that it would generate rising living standards and presumably reduce discontent. Around half of this would be for recurrent flow consumption expenditures, and around half would be for industrial and infrastructural investments that could be self-financed through export revenues. Most of this trade would be with South Korea and Japan, with China and the US playing smaller roles — even after the US lifts its embargo against North Korea. Thus the necessary recurrent external financing needs would be around \$1 billion annually.

## Financing Basic Needs

Where could this money come from? There are many possibilities, but the single biggest potential source of additional financing would be the resolution of North Korea's post-colonial claims against Japan. This issue was raised by former US Secretary of Defense William Perry during his visit to Pyongyang last year. The Japanese government paid the South Korean government \$800 million in compensation for colonial and wartime activities at the time of normalization of diplomatic relations in 1965, with \$300 million in the form of grants, \$200 million in development assistance loans,

and \$300 million in commercial credits. The North Korean government expects similar compensation. Adjusting the South Korean payment for differences in population, accrued interest, inflation and appreciation of the yen since 1965, one obtains a figure in excess of \$20 billion. An additional issue raised by the North Koreans that was not included in the South Korean package is compensation for "comfort women" who were pressed into sexual slavery during the Second World War. Reputedly settlement figures on the order of \$5-8 billion have been discussed within the Japanese government. In comparison, Yi Chong-hyok, Vice Chairman of the Korea Asia-Pacific Peace Committee, a KWP organization, in remarks before a Washington audience in 1996 indicated that \$10 billion would be the minimum bound for compensation. Japan will certainly argue that its billion dollar contribution to the Korean Peninsula Energy Development Organization (KEDO) should be counted against this charge. Some have speculated that Japan will even try to claim credit for the costs of recapitalizing bankrupt Chochongryun-controlled financial institutions in Japan. In any event, such sums, properly deployed, could go a long way in restoring North Korea creditworthiness and financing economic modernization.

If North Korea were to accept the Perry review's terms of engagement, another carrot that the US, Japan, and South Korea could hold out would be membership in the international financial organizations and the prospect of multilateral economic assistance. Pyongyang has periodically expressed interest in joining the International Monetary Fund (IMF), World Bank, and Asian Development Bank (ADB). Membership talks have never made much progress, however, for they have snagged on North Korea's unwillingness to permit the kind of access to economic data and information required for membership in these organizations and Japanese opposition relating to unresolved political issues, most notably the alleged kidnapping of Japanese citizens. Under normal circumstances, if North Korea were to join these organizations, in the absence of considerable reorientation in domestic economic policies, it would be unlikely that the multilateral development banks would make significant loans. However, given the political importance of North Korea to the US and Japan (influential shareholders in the World Bank, and the dominant shareholders in the ADB), one would expect that North Korea might receive favorable treatment.

Technical advice and assistance would really be more important than direct lending activities, which would ultimately only complement the activities of private investors. Such an observation was recently made by IMF resident representative in Seoul, David T. Coe, though it was immediately denounced by a US Congressman.

Working from the case of Vietnam (another Asian transitional economy where the government undertook rapid economic reforms) and scaling down the multilateral development banks' lending program for the smaller size of the North Korean population, one obtains lending on a scale of \$150-250 billion annually. Not trivial, but not enough to finance even a bare-bones recovery program. More money might be available if the US, Japan, South Korea and others set up a special fund for North Korea at the World Bank or ADB. Such a fund might be a particularly useful way of politically laundering Japanese reparations. It is possible that under some circumstances North Korea could access multilateral development bank loans even if it were not a member. For example the World Bank maintains a special program for peace and sustainable development in the Middle East through which it makes loans in the areas controlled by the Palestinian Authority. It also has adopted a policy that allows it to assist countries which are emerging from crises even though they are not members in good standing of the Bank. This policy was adopted after the Bank was precluded from lending to Cambodia because of a debt arrearage problem. The key attributes in these cases appear to be a cooperative recipient government and strong support from major Bank shareholders. Bank staff have also expressed the view privately that an independent, poor North Korea would probably be able to access more lending than a unified middle-income Korea. Either way, the settlement of post-colonial claims with Japan would dwarf anything North Korea could expect from the multilateral development banks.

## The South Korean Role

South Korea has an enormously important role in this. Setting aside the issue of post-colonial claims against Japan, South Korea would be the leading source of trade and investment for North Korea. Moreover, it is unlikely that either Japan or the US would get too far ahead of South Korea in the diplomatic game. South

Korea will inevitably lead engagement with the North, despite what one hears in some quarters of Washington.

At the same time, engagement with the North presents some risks for the South (as well as its allies). In his March "Berlin Declaration," President Kim Dae-jung indicated the willingness of the South Korean government to directly underwrite the economic rehabilitation of the North. Although the South Korean government has gone to great lengths to try and distinguish unconditional "humanitarian aid" from other sorts of economic engagement which would be undertaken on the basis of reciprocity, this distinction (maintained by other governments as well) is fictional. Indeed, the use of private South Korean firms as tools of South Korean foreign policy simply complicates business-government relations in South Korea and makes the creation of a more liberal transparent economic system in the South all the more difficult. Some in the United States, fear that Kim Dae-jung will "sell out" the US on issues such as the proliferation of weapons of mass destruction and their missile delivery systems.

So what can we expect? At the summit, the best for which one can reasonably hope are three things. The first would be a pleasant photo of the two leaders together. The second would be that in their personal discussions that they find something in the other that could serve as the basis of some ongoing constructive relationship. And third, that Kim Dae-jung gets something tangible out of the meeting, most likely in the area of reuniting families divided by the war. It is far less likely that the two sides will make progress on security issues. Economic engagement issues would fall into a middle ground between the politically easy (divided families) and the politically difficult (military security). These three modest accomplishments should be sufficient for each of the leaders to sell this initial meeting to their respective domestic audiences. Greater progress can await subsequent meetings.

One should never refuse to talk to an adversary, even if doing so carries risks. The announcement of the upcoming summit is consistent with a variety of hypotheses about North Korean motivation and behavior, and there is no guarantee that it will not end in tears. Only time will tell whether the planned summit will open a new, more cooperative era in North-South relations, and by extension a reduction in tensions throughout Northeast Asia, or will simply mark another dreary iteration in the North Korean extortion game. ■

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