

Hold Your Dollars! The Right, and Wrong, Ways to Engage North Korea

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By William Brown

South Korea is abuzz with talk of big economic projects in North Korea, like railroads, electric transmission lines, and gas and oil pipelines, a remarkable change just since September when a huge nuclear blast shook the peninsula, forcing everyone to take notice of Kim Jong-un's growing arsenal. Even some Americans are joining the big business optimism. Not much talk though from the Europeans, Japanese and Chinese; their businessmen and politicians were badly burned years ago by failed North Korea investments. And Korean companies seem wary that Seoul will weigh in on them to push unrealistic and ultimately unprofitable investments. It's easy to forget the communist country's "Opening before Reform" in the 1970s that turned into a disastrous bankruptcy of Pyongyang's financial institutions, even the central bank. And tough economic sanctions, a virtual prohibition of trade, remain in force as attention turns to how engagement might proceed should Kim do what he says and end his nuclear weapons program.

This is a tricky proposition, one that requires a kind of thinking rarely applied to North Korea—a combination of muscular security policy and developmental economics. We can't force the outcome, but we need to provide encouragement to both denuclearization and economic reform, and penalties if Pyongyang reneges. A tough combination but, in my view, possible and well worth the chance.

The tempting, and likely wrong approach would be to again try to buy away the nuclear program, giving Pyongyang what we think it wants in return for dismantlement. Big projects, such as the 1990s KEDO nuclear power deal, or large sums of money, as in several South Korean ventures and U.S. offers, always seem to be the preferred way to do this, even though it is not clear to me why North Koreans should be enamored with South Korean chaebols, and trains, crisscrossing the country on the way to China. These have failed in the past because such gifts don't meet the test of sustainable commercial viability in the target economy, creating distortions and disappointments when they inevitably fail. Moreover, the "buy it" approach is to pretend the nuclear weapons are the source of the problem, not the symptom. As Kim wrote Donald Trump in his invitation to meet, the real problem is American, and world-wide, hostility to North Korea's system. Trump might have answered that the hostility is real and that it is embedded in our view of Marxist-Leninism, which still controls and impoverishes the North Korean people. More gifts to the state will strengthen the system, creating more disappointments and more reasons for Kim to hold nuclear weapons. To break this cycle, our reengagement needs to work the two issues simultaneously; end the weapons program and end the failed economic system.

No doubt this will be difficult, but if it seems impossible it may be due to lack of understanding of the enormous pressure now being applied to Kim and the miserable condition of his command economy, pulled apart by market forces and foreign currencies that have invaded North Korea. Kim

took his first ever trip to Beijing in March just as North Korean trade with China was plummeting, with exports down about 90 percent from year-earlier levels and vital imports plunging more than half. And upon returning, just in April, Kim gave a speech to his Party leadership that indicates he wants to put full priority on the economy, letting nothing get in the way. Kim's verbiage might be dismissed by many, but it, together with highly positive statements about the Moon and Trump summits, two more quick trips to China, and a sharp decline in anti-U.S. propaganda, have given North Koreans a big boost in optimism that economic life will soon turn for the better. It seems Kim has staked his future to this promise and will be desperate to succeed, even as sanctions remain in place. Reform policies, aided but not controlled by outside forces, may be the only way this can happen, and Kim probably knows it.

Given this opportunity, what should we do and what should we not do? Here is a short list, just for starters. The actual process will take years but several key decisions, made by Pyongyang within a few months, could set them off in a very good direction.

1. We need to engage North Korean policymakers and technocrats on economic development, not just nuclear disarmament. Conversations might include big foreign investment projects, but these should not drive the conversation. Instead North Korea needs to learn to begin macroeconomic reforms—creation of a viable money and banking system that induces the buildup of domestic savings—and microeconomic reforms, creation of property rights and a single price system that bridges the enormous gap between state dictated and market prices, wages, interest rates, and exchange rates. Success will depend on Pyongyang's willingness to reform; there is little we can make them do but there is a lot we can do, both the U.S. and South Korea, should they begin to make the right decisions. Backing a new won currency, for instance. But without these reforms, big projects are bound to fail as they have before. And if Pyongyang resolutely fails to make progress, there is plenty more maximum pressure that can be applied to get them to the right place.
2. An early "give" to Pyongyang could be U.S. actions to again remove Trading With the Enemy Act penalties that force a veto of any North Korean attempt to join the WTO, the IMF, and the World Bank. Washington could even offer to mentor Pyongyang through the long reform process it would take to join the WTO, and thus gain normal trade access to the whole world.
3. An early "ask" should be advancement of Kim's earlier pilot projects to shrink and then end the collective farm system and return the country to family based farms, as in China and as in North Korea before the Korean War. Family farms everywhere are enormously more productive, releasing labor for industry and with more production, ending the malnutrition that still pervades the country. Studies show that land reform, forced by the U.S. occupation army in Japan, Taiwan, and South Korea following World War II, may have been the single most important factor behind those countries' huge economic successes.
4. Several "rules of engagement" could be employed that guide all economic and financial engagements with North Korea. For instance, as required by the ILO, any pay for North Korean work must go directly to the workers themselves, not through the government or state enterprises' ration, or payment in-kind, systems. Probably about half North Koreans work for pay but the other half, including all government workers, most professionals, workers in state enterprises, and most party officials, work for rations, supplementing those meager offerings with secondary work in markets, a most in-efficient system.

5. Another rule should be to only use the market exchange rate for won, stable in recent years at about 8,000 won per dollar, and not the 130 won per dollar official rate. And more generally, employ all possible efforts to use markets instead of official state procurements.
6. Reopening the Kaesong Industrial Zone might be considered if the above rules are employed, most importantly that workers are paid directly. This was promised at the original opening fifteen years ago but never implemented. Instead, a cruel and demeaning “Choco Pie” economy developed. Significant funds should be allocated to a check system so that workers could be sure of obtaining their full earnings. If successful, the U.S. might offer to bring Kaesong made products into the KORUS, a huge inducement to further success. Wages would circulate in the Kaesong local economy affecting hundreds of thousands of people, generating a significant source of market oriented economic growth.

The rules of engagement should also include negative policies, things that should not occur. Most importantly, this should include no commodity aid, except in a famine. Commodity aid, in the tens of billions of dollars, has distorted North Korea’s economy over past decades, eliminating its capacity to export. (If imports are free, exports are not needed, and thus are not produced.) Commodity aid, moreover, disadvantages domestic producers, most importantly, farmers. The temptation to offload excess South Korean rice, or American corn, on the North Korean market should, most emphatically be resisted. Even special needs products provided by World Food Program and other donor organizations should be questioned, since local farmers and merchants should be able to provide the same.

Likewise, foreign investment, except when an equity stake can be ensured, should be minimized until North Korea can get a new money and banking system in order. Otherwise, foreign money will either drive out domestic investment (a “carpet bagger” effect) or, more likely, domestic investors will drive out the foreign investors. But true equity deals, where ownership rights are allowed not just for foreigners, but to North Koreans as well, should be promoted as the legal system evolves. The latter, the North Korean people, in this new system will be the owners, not the Worker’s Party and not foreign carpetbaggers or international banks. For Kim, this might be a hard sell but, given the alternatives, maybe not impossible.

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