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## A SURVEY OF ASIA IN 2007

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# NORTH KOREA IN 2007

## *Shuffling in from the Cold*

Stephan Haggard and Marcus Noland

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### Abstract

The year 2007 witnessed a gradual rapprochement between North Korea and the world, reflecting changes both in the country's external environment and domestic political economy. Key markers were the resumption of the Six-Party Talks and the second North-South summit. Whether these developments will endure depends largely on North Korean intentions.

Keywords: North Korea, Six-Party Talks, North-South summit, famine, reform

If 2006 was a year of confrontation, culminating in North Korea's missile and nuclear tests and the tightening of both multilateral and bilateral sanctions, 2007 was characterized by a gradual rapprochement. The key markers in this process were the resumption of the Six-Party Talks and the second North-South summit. This thaw appears to be a product of changes both in North Korea's external environment and in the country's domestic political economy. Whether these developments will prove enduring depends both on the intentions of the North Korean leadership—always difficult to read—and on longer-range political and economic dynamics inside and outside the country.

### The Nuclear Issue and the Six-Party Talks

The unraveling of the 1994 Agreed Framework that froze North Korea's nuclear program can be dated to October 2002, when the United States accused

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North Korea of seeking to enrich uranium. The North Koreans responded by unsealing the Yongbyon reactor, expelling International Atomic Energy Agency (IAEA) monitors, and reprocessing the spent reactor fuel to extract weapons grade fissile material.

During the second George W. Bush administration, American strategy toward North Korea shifted, and the United States increased diplomatic efforts to put the genie back in the bottle. The Six-Party process (comprising North Korea, South Korea, the United States, China, Japan, and Russia) yielded a Statement of Principles in September 2005 under which North Korea agreed to “abandoning all nuclear weapons and existing nuclear programs and returning, at an early date, to the Treaty on the Non-Proliferation of Nuclear Weapons and to IAEA safeguards.”<sup>1</sup>

Further progress was almost immediately derailed as the implications became clear of the U.S. Treasury’s designation of a small Macao bank, Banco Delta Asia (BDA), as a primary money-laundering concern. The bank held North Korean accounts valued at roughly \$24 million, which were effectively frozen after the bank collapsed and went into receivership. But the more important consequence was the message the U.S. Treasury action sent to other financial institutions: do business with North Korea at your own risk. North Korea’s fragile links to the international financial system were dealt a blow, and it demanded not only the return of the frozen funds but also the reestablishment of bank accounts as a precondition for implementation of its side of the bargain.

With diplomatic progress stalled, the North Koreans raised the ante, testing missiles in July 2006 and a nuclear device that October. Even China displayed its displeasure by signing on to U.N. Security Council sanctions, and Japan drifted toward an almost complete embargo.

Bilateral negotiations between the United States and North Korea on the BDA issue permitted the resumption of the Six-Party Talks and a breakthrough agreement on February 13, 2007. In the short run—60 days—North Korea promised to shut down the Yongbyon facilities and permit the IAEA to return, implicitly in exchange for resolution of the BDA issue. In a second phase, North Korea agreed to “disablement of all existing nuclear facilities” and provision of a complete declaration of all nuclear programs. In this second phase, the other parties agreed to provide energy assistance, including heavy fuel oil. Both the United States and Japan agreed to move toward normalization, with important economic implications in both cases.<sup>2</sup>

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1. U.S. Department of State, *Joint Statement of the Fourth Round of the Six-Party Talks*, Beijing, September 19, 2005, available at <<http://www.state.gov/r/pa/prs/ps/2005/53490.htm>>, accessed November 3, 2007.

2. *Ibid.*, *Initial Actions for the Implementation of the Joint Statement*, February 13, 2007, available at <<http://www.state.gov/r/pa/prs/ps/2007/february/80479.htm>>, accessed November 3, 2007.

Implementation of the first phase actions initially foundered on the inability of the United States to deliver the frozen BDA funds. The agreement reopened fissures over North Korea policy within the U.S. government; foreign banks proved wary of accepting accounts that might be vulnerable to subsequent Treasury actions. But Treasury zeal was ultimately trumped by the administration's decision to pursue a negotiated settlement,<sup>3</sup> and in mid-June the frozen funds were transferred to North Korean-controlled accounts in a Russian bank. In relatively short order in June and July, an IAEA delegation visited Yongbyon, South Korea announced the resumption of aid, the first shipment of oil under the February agreement landed in the North, and the North Koreans announced the closure of the Yongbyon reactor. The barn door had been closed successfully after the horses had escaped.

With the BDA issue resolved and North Korea showing an apparent willingness to comply with its "first phase" obligations, diplomacy moved toward the thorny issues of implementing a more complete denuclearization. In October a second agreement was struck. North Korea agreed to disable its Yongbyon facilities, provide a complete nuclear declaration by December 31, and "reaffirmed its commitment not to transfer nuclear materials, technology, and know-how."<sup>4</sup> In return, and much more vaguely, the United States agreed to begin the process of delisting North Korea as a state sponsor of terror, removing economic sanctions, and moving toward normalization. In two quiet signals of its changed course, the Bush administration hinted at its willingness to provide bilateral humanitarian assistance and asked Congress to authorize support for the larger tranche of fuel oil shipments.

Looking forward, each component of the second phase actions could prove contentious. Some observers parsed the meaning of "disablement," but the more troublesome issue is likely to be the credibility, and verifiability, of North Korea's nuclear declaration. The regime has promised to address the disputed existence of a second nuclear program based on highly enriched uranium, after denying it had any such program. But the October agreement makes no explicit reference to North Korea's nuclear arsenal nor to existing stocks of plutonium. It is hard to read any of the core documents—the September 2005 Statement of Principles and the February and October 2007 agreements—as allowing such stocks, and the Chinese have stood surprisingly firm on the principle that denuclearization means denuclearization. Nonetheless, there will be

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3. U.S. Department of Treasury, *Statement by DAS Glaser on the Disposition of DPRK-Related Funds Frozen at Banco Delta Asia*, available at <<http://www.treasury.gov/press/releases/hp322.htm>>, accessed November 3, 2007.

4. U.S. Department of State, *Six-Party Talks—Second-Phase Actions for the Implementation of the September 2005 Joint Statement*, available at <<http://www.state.gov/r/pa/prs/ps/2007/oct/93217.htm>>, accessed on November 2, 2007.

some irreducible uncertainty about North Korea's nuclear history and assets; judging the tolerable degree of uncertainty will be controversial politically.

Potential land mines also lie buried in North Korea's seemingly innocuous commitment "not to transfer nuclear materials, technology, and know-how." It had been rumored that North Korea had been secretly exporting equipment and expertise. The salience of this possibility increased dramatically in September as press reports began to emerge of an Israeli attack on a suspected reactor site in Syria; subsequent leaks from Israeli intelligence suggested a North Korean link. Although neither the nature of the facility nor any North Korean involvement has been substantiated, Syrian actions were far from reassuring as the bombed site was quickly bulldozed under. If a North Korean–Syrian connection were established, it would raise serious political obstacles not only to U.S. commitments under the February and October agreements but also to the entire Six-Party process.

### Economic Developments

The North Korean economy experienced a steep decline following the collapse of the Soviet Union, culminating in the devastating mid-1990s famine. The state's failure to fulfill the most basic component of the socialist social contract—the public distribution of food—forced households, enterprises, local party organs, and military units to engage in market-like behavior. North Korea's economic transition over the past decade can best be understood not as a top-down state-led reform but rather as a bottom-up process of marketization in response to state failure. After bottoming out in 1998, the economy began a slow recovery in 1999. In the summer of 2002 the government initiated a reform program that in effect ratified these changes while at the same time trying to control and, in some instances, even reverse them. But the onset of the nuclear crisis had two important economic effects: It pushed security calculations to the fore and shifted the policy focus away from reforms, and it substantially altered the external economic landscape. Sanctions, the financial shock associated with the BDA affair, and heightened efforts to arrest illicit activities such as counterfeiting and drug trafficking appear to have had consequences. The (South Korean) Bank of Korea estimated that North Korean growth turned negative in 2006 for the first time since 1999.

In March 2007, the World Food Program announced that North Korea was one million metric tons short of grain and faced calamity unless additional aid was forthcoming. Yet, multilateral assistance, which had fallen as North Korea's diplomatic relations deteriorated in 2006, did not revive immediately with the resumption of talks in 2007. South Korea also took a surprisingly tough posture with respect to humanitarian assistance following the missile and nuclear tests.

Although such food balance calculations are subject to large error, there is evidence of distress. Fragmentary data exhibited a steady rise in grain prices through the year, increasing more rapidly than in the previous year, more rapidly than prices of other goods in the economy, and more rapidly than world grain prices, suggesting that conditions were indeed deteriorating. In August North Korea was hit with severe flooding and grain prices spiked before attenuating somewhat. In October the Korea Rural Economic Institute, a South Korean government-affiliated think tank, estimated that North Korea faced a 1.4 million metric ton grain deficit and a return to 1990s-style famine conditions.

A recurrence of famine is unlikely, because of the economy's increased flexibility as well as a more supportive donor environment. But the government's response to these economic developments continues to be ambivalent at best. Stories abound of the growth of the informal economy in North Korea. Yet, so do recurrent efforts on the part of the government to limit the extent of the process, from a 2005 ban on private trade in grain to more recent limits on the ability of workers to exit the collapsing state-owned enterprise sector for alternative employment. Our assessment is that this marketization process is irreversible, fed in particular by rapidly deepening economic integration with China. But policy has not fully embraced these changes from below, and the limited evidence we have suggests ongoing debate over the allocation of resources to military and alternative civilian uses.

### The South Korean Dimension

The most profound change in North Korea's external environment over the past decade has been the shift in South Korean foreign policy toward a strategy of engagement. Kim Dae-jung's "sunshine policy" derived its name from Aesop's fable of the North Wind and the Sun, in which the Sun and Wind compete to see which can strip the coat off a traveler. While the Wind fruitlessly attempts to blow the coat off, the Sun uses its warmth to induce the traveler to disrobe. Analogously, engagement was originally conceived as an instrument: The point was to encourage sufficient systemic evolution within North Korea to establish a meaningful basis for reconciliation and, ultimately, national unification.

Under President Roh Moo-hyun, the sunshine policy has taken on additional and sometimes conflicting rationales including open-ended humanitarian commitments, avoiding a costly collapse, and balancing North Korea's deepening economic integration with (some would claim effective economic colonization by) China.

These conflicting concerns were evident in the laundry list of aspirations contained in the October 2007 North-South summit communiqué. On the security side of the ledger, the communiqué committed the parties to negotiate a peace

agreement that would replace the armistice. One phrase raised eyebrows, however: that “the leaders of the three or four parties directly concerned” convene these peace negotiations.<sup>5</sup> Was this a return to the North Korean effort to hold talks with the United States and China—the other signatories of the armistice—over the head of the South Koreans? Or were the Chinese or even the Americans to be the omitted party?

The question of the linkage between the Six-Party and the North-South processes also proved controversial. The nuclear controversy received only a single passing mention in the middle of the North-South communiqué. In a hurry to leave his legacy, Roh expressed an interest in starting the peace negotiations in parallel with the denuclearization process.

Statements from both Beijing and Washington soon made clear that any peace negotiations would take a four-party shape and depend on Pyongyang implementing the 2007 agreements. But the communiqué did suggest some intriguing North-South confidence-building measures, including an ambitious and highly controversial joint fishing area in the West Sea and the development of the port of Haeju.

The central issue of the summit, however, was couched in the euphemistic language of “economic cooperation.” Humanitarian assistance from South Korea has been large and only weakly monitored. The central inter-Korean cooperation projects, the Mt. Kumgang tourism project and the Kaesong Industrial Complex, are both enclaves, fenced off literally and figuratively from the rest of North Korea. Moreover, both operate with a mix of public and private financing that is far from transparent. Ironically, North Korea’s economic integration with China is occurring on more market-conforming terms than are North-South economic relations, which contain a large noncommercial component.

South Korean politicians of all stripes have outlined various approaches to the provision of aid, mostly focusing on the very substantial infrastructure investments required to integrate North Korea not only with the South but also with the world economy more generally. Yet, the political logic of such aid is by no means straightforward. Aid from Seoul could act as an inducement to resolve the nuclear issue and leverage economic reform efforts. But aid from

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5. The language of the document was subsequently altered on most South Korean government websites—as was other controversial language referring to things such as the North and South having agreed “to resolve the issue of unification on their own initiative and according to the spirit of ‘by-the-Korean-people-themselves’” and the resolution of the nuclear issue. For example, compare the *Declaration on the Advancement of South-North Relations, Peace, and Prosperity* text as originally released, Korean Consulate General in Los Angeles, at <[http://www.koreanconsulatela.org/english/sub\\_index03.htm?pg=030201&newsid=000069](http://www.koreanconsulatela.org/english/sub_index03.htm?pg=030201&newsid=000069)>, with Korean Overseas Information Service, at <[http://www.korea.net/News/Issues/issueDetailView.asp?board\\_no=18214&menu\\_code=A](http://www.korea.net/News/Issues/issueDetailView.asp?board_no=18214&menu_code=A)>, both accessed November 3, 2007.

the South could also reduce economic incentives to cooperate, undercutting the nuclear negotiations. North Korea's celebration of the first anniversary of its nuclear test—in contrast to the muted internal discussion on diplomatic progress on the denuclearization front—underscores that achieving denuclearization could prove an arduous march of its own.

Moreover, large-scale aid—particularly in fungible form—could actually reduce incentives to economic reform, a term that the North Koreans clearly did not want to see included in the summit document. Representatives of the large South Korean groups who accompanied the president to the summit were blunter in this regard than the administration, emphasizing that if North Korea wanted more investment, it needed to make the country more attractive to foreign investors. The balance between aid and commercial engagement will be a central issue for the next South Korean president.

### Whither North Korea?

The last year has undoubtedly seen important changes on the Korean Peninsula. Pyongyang has been more cooperative with respect to the denuclearization process than many had anticipated. Yet, implementing these agreements leaves ample room for misunderstanding on both sides. The North Korean declaration will be an important test, raising the issue about how much ambiguity is politically tolerable. Verification and inspections are another potential flashpoint in the negotiations.

It is also highly likely that North Korea will try to extract additional payments for compliance where it can. These could include the extension of “normal trade relations,” support for North Korea's membership in international trade and financial organizations, and even eligibility for participation in such U.S. public-sector programs as the Export-Import Bank or the Overseas Private Investment Corporation. While alteration of some U.S. policies (such as removal from the terrorism list) can be done through administrative fiat, others, such as the granting of “normal trade status,” require congressional action. In addition to the immediate electoral constraints, the normalization process will raise a broader agenda relating to other issues of concern, including human rights, that could complicate negotiations.

South Korean policy, or more precisely, the congruence between Washington and Seoul, will play a crucial role in how these negotiations unfold. It is by no means clear that the incoming South Korean president will remain committed to the ideas outlined in the communiqué. The October 2007 summit announcement may end up like the 1991 North-South Denuclearization Accord, amounting to little more than a statement of good intentions rather than a road map for subsequent policy.

The biggest riddle, however, remains the political dynamics of the Kim Jong-il regime and ultimately its durability. Much speculation surrounds the

issue of the identities and policy leanings of potential factions within the government and society. The April 2007 replacement of the prime minister and other internal personnel changes do not appear to signal a decisive break in either the direction of reaction or of deepening reform.

Larger issues loom. Succession is the weak point in any authoritarian regime and it is not at all evident that a dynastic heir is being groomed; none of the three sons who have been mooted as possible candidates appears today to be a credible successor. The Korean Workers Party has atrophied; unlike in China, the party does not have the coherence or command to manage the succession on its own.

The military appears to be the key institution, indicated most clearly by the fact that Kim Jong-il continues to lead North Korea from his position as chairman of the National Defense Commission and continues to emphasize “military-first” politics. The military remains an important lobbyist for itself but is also engaged in a variety of commercial ventures. We can at least imagine a scenario in which the military is coopted more squarely into a state-led modernizing project for the country, either before or after Kim Jong-il’s demise. But it is certain that with each passing year, the succession issue becomes a more central question for the future of North Korea.

### Epilogue

Two events at year’s end were likely to influence developments on the peninsula: Lee Myung-bak’s victory in South Korea’s presidential election and North Korea’s failure to meet the December 31 deadline to “disable” the nuclear-related facilities at Yangbyon and declare its nuclear programs.

Lee’s election is unlikely to fundamentally change South Korea’s strategy. Support for engagement is strong; at issue are the terms on which it proceeds. Lee has indicated that he is likely to condition aid on both the nuclear issue and other questions of interest to the South.

Curiously, the United States appears almost to be moving in the opposite direction. President Bush revealed in December that he had sent a letter to Kim Jong-Il; American diplomats talked of reaching out to the North Korean military; and cultural exchanges, including a possible visit to North Korea by the New York Philharmonic, are being planned.

Pyongyang’s failure to meet the deadline with respect to the disablement of Yongbyon is not surprising, given the task’s complexity and the contested nature of the term “disablement.”<sup>6</sup> The failure to meet the deadline to “provide a complete and correct declaration of all its nuclear programs”—while also

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6. David Albright and Paul Brannan, *Disabling DPRK Nuclear Facilities*, United States Institute of Peace Working Paper, October 23, 2007.

unsurprising—is potentially more serious. This requirement has been read expansively—but quite literally—by the United States and the other parties to include weapons, stocks of fissile material, and equipment used to produce both, including the alleged uranium enrichment program. North Korea has dragged its feet, perhaps calibrating how much it has to concede in order to keep wider negotiations going. In the short run, it will argue that the United States had not kept its commitments with respect to promised oil shipments or the North's removal from the terrorism list. The negotiations generated by the October Agreement will extend well into 2008, if not beyond.