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Engagement: Brief for an Incoming Korean President

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Forthcoming in *Freedom Review*, January 2008
December 14, 2007

Recent developments on the Korean peninsula present the incoming South Korean president with substantial opportunities. The Six Party Talks have established a road map for North Korean disarmament. The inter-Korean summit outlined an ambitious array of North-South economic initiatives and advanced the goal of replacing the existing armistice with a permanent peace treaty.

Subsequent progress has not been uniform and reversals will undoubtedly occur. But do these recent developments vindicate the strategy of engagement with North Korea pursued by the last two administrations? Our answer is "yes," but with important qualifications. The rationale for engagement is straightforward—to encourage sufficient evolution in North Korea's internal practices and external behavior to provide a meaningful basis for national reconciliation and eventual unification. The question at this juncture is no longer whether to engage North Korea but rather how to do so most effectively.

In Aesop's fable that gave the Sunshine Policy its name, the Sun and the Wind bet over which could disrobe a traveler. While the Wind fruitlessly tried to blow off the traveler's cloak, the Sun succeeded by providing warmth. Similarly, attempts to strangle the North Korean regime have failed. Pressure and isolation have not only imposed costs on a captive population but have provided the regime with an excuse for its failed practices. In the short run, positive economic inducements can signal cooperative intent and tilt internal decisionmaking in favor of "doves." Over the longer run, the expansion of economic interdependence bolsters new economic interests more amenable to cooperation. Increased trade, investment, and aid also serve as a hedge against a sudden collapse of the North Korean system.

However, past efforts at engagement have created problems as well. Open-ended economic assistance to the North runs the risk of the so-called Samaritan's dilemma. Knowing that the donor wants to provide support, there is little reason for the recipient to change its behavior, including in ways that will reduce the need for support over the longer run. Far from transforming North Korea, increased access to foreign resources not only directly sustains the regime but can reduce incentives for reform. Given this dilemma, how can the incoming administration cooperate with its allies and friends to craft a more effective engagement strategy?

The North Korean Economy

Answering that question requires an understanding of the North Korean economy and what recent developments imply for state capacity, intentions, and vulnerabilities. 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 20th century. As many as one million people—five 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.

An unplanned yet important result of this grassroots transformation was a rapid growth in economic ties 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 commercial relations, in significant part driven by small traders and enterprises from China's Northeast and reflecting China's voracious appetite for raw materials.

Recent developments have had the unintended consequence of further deepening Sino-North Korean ties. The nuclear crisis generated multilateral sanctions, an effective Japanese embargo, and surprisingly effective US financial sanctions. All of these factors pushed North Korea into closer ties with China.

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 and tolerating a gradual increase in foreign participation in the economy.

But the government has never been completely comfortable with the emergence of a market economy. In 2005, it imposed a ban on private trade in grain which had emerged as the principal source of food for most households. It has tried to force workers back into the collapsing state-owned enterprise sector, most recently by restricting the ability of women to work as traders. The North Korean emphasis on "military-first" politics further limits the reform process.

The extent of genuine opening has been particularly disappointing. Given its economic characteristics, agricultural reforms—even if forthcoming—are unlikely to be as central to North Korea's transformation as they were in China's. Rather increased international trade and investment are the sine qua non of genuine economic transformation.

Moreover, the partial reforms have contributed to growing inequality between those lucky or connected enough to operate successfully in the market economy and those confined to the state sector or economically depressed regions. Precisely because they have been partial, reforms have been less successful than they might have been.

Principles for a New Engagement Strategy

Given this context of growing "marketization from below," increasing integration with China but limited reform, how can South Korea's engagement strategy be most effective? We stress four considerations: reciprocity and sequencing; the importance of reform; the involvement of the private sector; and the building of a multilateral framework.

The first desiderata concerns reciprocity and sequencing in the extension of economic benefits. Economic concessions and aid—particularly humanitarian aid—can create a climate of good will and suggest the larger range of possibilities for cooperation. We appreciate the underlying impulse of South Koreans to assist North Koreans in distress; family ties run deep, and the Koreans are, in the end, one people.

But extending aid in advance of promised actions, or simply for the purpose of holding talks, has not proven an effective strategy. Rather, aid should be calibrated and expanded in line with progress on issues of interest to South Korea.

Second, aid must be extended in support of reform. Experience throughout the 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.

The summit revealed the sensitivity of the North Korean leadership to this issue. Nonetheless, South Korea needs to be a soft-spoken but firm advocate of reform. Drawing on its own historical experience as well as other models, South Korea can assist the regime not only with money but with technical assistance and policy proposals as well.

A third principle is the importance of the involvement of the private sector: through trade, foreign direct investment, and private capital flows. Nongovernmental organizations (NGOs) are an effective dimension of this private involvement and have on occasion managed sustained and direct contact with North Korean communities. An effective engagement strategy will certainly involve public sector support, including in infrastructure investment. But private sector participation has important advantages for both sides.

North Korea will ultimately evolve toward a more market-oriented economy. The participation of South Korean 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.

For private sector involvement to have maximum impact, however, requires transparency. Any large-scale economic involvement with North Korea is intrinsically political and subject to corruption—in both South and North Korea. Subsidies to private sector involvement with the North should be clear, transparent, and limited. Cooperation projects should minimize discretionary state involvement either directly or indirectly through public sector financial institutions or other state-owned enterprises.

Although aid will play a role in reunification, many of the costs of unification can be born by the private sector—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 North Korean economy and constitutes a natural hedge with respect to the costs of unification.

Finally, a successful engagement strategy should have a strong multilateral dimension. The Roh administration's initial thinking about Northeast Asia placed a strong emphasis on regional cooperation, with a vision of a zone of peace and prosperity that would encompass all of the major players in the region. Yet tensions with the United States over how to deal with North Korea, as well as fears about Chinese involvement, have given greater urgency to the bilateral track.

Multilateral cooperation reduces the chances that North Korea will play the interests of the other five parties of the Six Party Talks against one another, but will also provide additional resources for the tremendous investment ultimately required for North Korea to effectively join the international and regional economies. International financial institutions such as the World Bank and Asian Development Bank have a role to play in this process as providers of nonpoliticized technical assistance and policy advice, as well as capital.

Assessing Recent Initiatives

The scale of South Korea's official assistance to the North has been rising steadily since 1999. A significant component has been humanitarian relief, primarily in the form of food and fertilizer delivered directly by the government or indirectly via South Korean NGOs. Even with the diversion of some of this assistance, aid has probably alleviated suffering in the North.

Nonetheless, bilateral aid is less efficient than aid channeled through the multilateral channel, centered on the World Food Program (WFP). Moreover, bilateral assistance has weakened the WFP's negotiating leverage vis-à-vis the North Korean government. To be clear, such problems are not distinctive to South Korea: China's aid also moves through bilateral channels, and the United States is now discussing an initiative that would channel renewed assistance through rival NGOs risking a race to the bottom. First principles suggest that there is value in shifting a portion of Korean and proposed American assistance back through the WFP.

But in the future straight humanitarian relief is likely to be dwarfed by economic cooperation projects. The October summit document and subsequent follow-on announcements have laid out an ambitious menu of projects that could be potentially beneficial to both North and South Korea: reestablishment of trans-Korean transportation links; expansion of the Kaesong Industrial Complex and its replication in other locations; and cooperation in specific industries such as shipbuilding where complementarities would seem to exist between North and South Korean capabilities. All of these are potential positives.

Their impact will be limited, however, as long as North Korea avoids the challenge of broader opening and reform. If President Roh's post-summit comments about avoiding discussion of "reform" and "opening" are tactical, we are sympathetic. But North-South discussions to date have steered clear of substantive engagement on the basic building blocks of a market economy—operation of markets, enterprise management, and agricultural reform—which would allow the North Koreans to make the most of the aid that they will receive. Infrastructure construction is not an end in itself; infrastructural investments should be a complement to a more thoroughgoing rehabilitation and opening of the North Korean economy.

The existing centerpieces of economic cooperation, the Mt. Kumgang tourism project, and the Kaesong Industrial Complex, share a number of characteristics: They are both enclaves near the border, fenced off, literally and figuratively, from the rest of North Korea, operating on a mix of public and private financing. Given

the decades of enmity and distrust between the two Koreas, such projects are probably a historical necessity.

North Korea is sufficiently comfortable with these arrangements to replicate them elsewhere, for example in the form of a Mt. Paekdu tourism venture (on the Chinese border) and Kaesong-like industrial enclaves in Haeju and elsewhere. The industrial parks are justifiable insofar as the most natural South Korean investors in the North are small- and medium-sized industrial enterprises which are increasingly uncompetitive in South Korea, but could remain viable given access to lower wage North Korean labor. Extending the provision of physical infrastructure and effective political guarantees for these small enterprises makes a certain sense, particularly if the alternative is for these firms to move their operations to China or Vietnam.

But if not handled carefully, the availability of direct and indirect subsidies could simply invite participation of failing firms. Anecdotal evidence suggests that many participants in Kaesong have not been financially successful, and some are operating with high debt-equity ratios reminiscent of the financial crisis of 1997–98. By contrast the larger Korean firms, those with the most substantial capabilities, have largely shied away from investment in North Korea. Looking forward, “cooperation projects” would not be managed or underwritten by the government; rather, the government would play the role of broker, encouraging the North Korean government to create the policy conditions that would induce entry by South Korean enterprises and thus maximize joint gains.

The new Korean administration will reflect the strong desire of the South Korean people to assist North Korea and hedge against the risks of instability and collapse. Yet in defining a course of engagement, the objective of positive change and development should not be lost. Reciprocity, an emphasis on reform, the involvement of the private sector, and the building of a multilateral framework are some simple principles that can help guide such assistance. Such a strategy will promote win-win economic interactions in the short run and ultimate convergence and unification over the long run.