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North Korea Inside Out:  
**The Case for Economic Engagement**

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December 2009

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The Case for Economic Engagement**

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**Report of an Independent Task Force convened by**

**Asia Society  
Center on U.S.-China Relations**

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*The views expressed in this report are those of the primary authors only and do not necessarily represent those of the above advisors and reviewers, or institutional positions of Asia Society or the University of California.*

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## I. Executive Summary

**The United States should adopt a long-term strategy** of economic engagement with North Korea. North Korea's attitude toward the world is closely related to the underlying structure of its domestic political-economy: a closed, command economy that favors the military and heavy industry and is isolated from the sweeping economic and political changes that have transformed the Asian landscape in recent decades. Encouraging a more open and market-friendly economic growth strategy would benefit the North Korean people as a whole and would generate vested interests in continued reform and opening, and a less confrontational foreign policy. In other words, economic engagement could change North Korea's perception of its own self-interest. China's economic transformation stands as an important precedent, showing how a greater emphasis on reform and opening can have positive effects on foreign policy as well. Economic change has the potential to induce and reinforce the D.P.R.K.'s peaceful transition into a country that can better provide for its people's welfare and engage with other countries in a non-hostile manner.

Economic engagement should be a central part of U.S. strategy in dealing with Pyongyang, and is complementary to the current focus on solving the nuclear issue. Sanctions have a role in defending the U.S. against risks of proliferation, but they have not and cannot provide a long-run solution to the North Korean problem. Combining targeted sanctions with robust engagement, as the Obama administration is attempting to do with Iran and Burma, offers the best hope of changing the motivations and the actions of states that presently take a hostile stance toward the U.S. and the international community.

The first section of the report, "Case for Engagement," identifies a number of potential benefits to the U.S. and its allies of economic engagement with the D.P.R.K. The most fundamental is that it would encourage the gradual transformation of the D.P.R.K.'s political economy and foreign policy, with direct benefits to international peace. Economic engagement opens space for the Korean people to have greater contact with outsiders, and vice versa; it also reinforces changes that are already taking place from the ground up. An active economic engagement policy would bring the long-term strategic approach of the U.S. into alignment with those of its allies and partners, who maintain much more extensive economic ties to North Korea than does the U.S.

Our report is focused on the economic side of engagement, and particularly on forms of economic engagement that can and should proceed now as first steps in a process of phased engagement. While some engagement should continue to be conditioned on progress on the nuclear and other fronts, many forms of engagement should proceed with no conditions attached. We do not claim that economic engagement will resolve the nuclear issue, particularly in the near term. But, in the long run, the mechanisms of engagement we recommend would have a positive influence on the environment in which Pyongyang makes its nuclear security calculations—including its weighing of the costs and benefits of its nuclear weapons and missile programs.

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The report's second section, "Prospects for Engagement," describes the continuing internal barriers to North Korea's reform and opening. We highlight previous tentative efforts at reform and opening, including legal and policy changes, ideological shifts, and experiments with special economic zones and joint ventures. North Korea's history of experiments with reform is limited, and domestic resistance to transition is formidable. But these efforts, particularly those led by Kim Jong-il in the late 1990s and early 2000s, suggest at least some impulse toward reform and opening. Moreover, a growing body of evidence suggests that a substantial process of transformation from below is already underway in Korea, and should be actively encouraged.

The final section, "Channels of Engagement," provides recommendations for how to initiate the new policy approach. The report identifies official contacts, Track Two dialogues, academic exchanges, and non-governmental organizations' (NGOs) development programs as the first steps in economic engagement. We also recommend that the U.S. government adopt a new visa policy to increase contacts significantly. We further suggest how the U.S. could help enable international financial institutions (IFIs) like the World Bank, International Monetary Fund, and Asian Development Bank to begin to interact with North Korea.

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## II. The Case for Engagement

**United States-North Korea relations** since the end of the Cold War have been dominated by the effort to dissuade North Korea from gaining the capability to produce, deliver, and spread nuclear weapons. After fifteen years of on-again, off-again bilateral and multilateral negotiations, preventing the D.P.R.K. from producing and proliferating nuclear weapons remains today the all-consuming focus of U.S. policy toward Pyongyang.

Our task force recommends taking a broader and more ambitious approach to U.S.-D.P.R.K. relations than the United States has pursued to date. The United States, working with its allies and friends in the region, should aim its policies toward the goal of influencing North Korea's long-term intentions and behavior, as well as its capabilities. We recommend a sustained and determined process of economic engagement with the D.P.R.K. by means of activities that do not jeopardize U.S. security concerns, and could catalyze a process with positive long-term effects.

The Obama Administration has determined that sanctions are appropriate in the near term to demonstrate the will of the international community to stem the spread of nuclear weapons and to bring the D.P.R.K. back to the negotiating table. But sanctions will not over the long run bring about a positive change in North Korea's behavior toward other countries or its own citizens. Furthermore, while the current sanctions may impede North Korea's transfers of nuclear and missile technology to other countries or groups, they are unlikely to block them entirely. Sanctions alone cannot provide protection from the threat posed now or in the future by North Korea.

Combining sanctions with robust engagement, as the Obama administration is attempting to do with Iran and Burma, offers the best hope of changing the motivations and the actions of states that presently take a hostile stance toward the U.S. and the international community.<sup>1</sup>

This report makes the case for economic engagement with North Korea, describes North Korea's unfulfilled potential to support such efforts, and offers concrete proposals for how to undertake economic engagement through academic exchange, NGO cooperation, and participation in the IFIs. Unlike foreign aid, on which the D.P.R.K. has become dependent, these types of economic engagement will enable the D.P.R.K. to provide for its own people. And unlike foreign aid, which can be diverted to the North Korean military or internal security apparatus, these actions will not strengthen the coercive power of the North Korean regime. Instead, economic engagement starts a process that may lead to significant benefits without enhancing the D.P.R.K.'s military capabilities or making the U.S. or its allies more vulnerable.

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<sup>1</sup> As Secretary of State Clinton remarked in announcing talks with the Burmese leadership, "Engagement versus sanctions is a false choice...going forward, we will be employing both those tools, pursuing our same goals." Hillary Rodham Clinton, "Remarks At United Nations After P-5 +1 Meeting," (available at U.S. Department of State website: <http://www.state.gov/secretary/rm/2009a/09/129539.htm>).

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## Benefits of Engagement

Economic cooperation and interaction between the D.P.R.K., the U.S., and other countries would encourage the gradual transformation of the D.P.R.K.'s political economy and foreign policy, with direct benefits to international peace. Integrating North Korea into the dynamic Asia-Pacific region would improve the welfare of the long-isolated North Korean people and create conditions conducive to a lasting peace in Northeast Asia.

By bringing economic engagement to the forefront, this report suggests a different lens through which to view U.S. policy toward the D.P.R.K. Domestic economic circumstances and the political interests linked to them shape the possibilities for and constraints on decision makers in Pyongyang. Thus, North Korea's attitude toward international relations is closely related to the underlying structure, long-term trends, and current conditions of its domestic political economy. By encouraging North Korea in the process of economic growth in a way that substantially benefits its people as a whole, engagement would generate vested interests in continued reform and opening, and in less hostile foreign relations.

U.S. support for economic development in North Korea also would help advance the process of gradual economic integration of North and South Korea, with the potential for significant long-term economic benefits to Koreans on both sides of the demilitarized zone (DMZ).<sup>2</sup> More interactions between the U.S. and D.P.R.K. would contribute positively to whatever path the two Koreas find for reconciliation.

In other words, cooperation on economic development should not be viewed simply as a "carrot" to reward North Korea for denuclearization. Rather, it is a powerful mechanism to change North Korea's internal and external behavior. Economic change has the potential to induce and reinforce the D.P.R.K.'s peaceful transition into a country that can better provide for its people's welfare and engage with other countries in a non-hostile manner.

## Contact with the Outside World

Economic engagement opens space for the Korean people to have greater contact with outsiders, and vice versa. As the past experiences of Eastern Europe, the Soviet Union, and China suggest, standoff policies of sanctions and isolation freeze domestic policies in place; international engagement expands the opening for gradual change. The international financial institutions (IFIs), for example, played a catalytic role in China's economic transition since the early 1980s. Countries like China, Vietnam, and Mongolia that embraced international assistance in the transition process are prospering and contributing to regional peace. Countries that have been isolated remain mired in economic stagnation and are sources of regional instability. We strongly advocate that the U.S. encourage efforts by the IFIs to engage the D.P.R.K. in a long-term process of institutional participation.

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<sup>2</sup> See Gooheon Kwon, "A United Korea? Reassessing North Korea Risks (Part 1)," *Global Economics Paper* 188, Goldman Sachs Global Economics, Commodities and Strategy Research, Sept. 21, 2009.

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## The China Precedent

Post-1978 China provides the most dramatic example of how domestic economic reform can reshape the foreign policy of a Communist country. The Chinese experience proved that economic reform need not be political suicide for Communist leaders. Reforms were designed as ad hoc arrangements to be negotiated for each unit or set of units, a form of patronage that the leaders could disburse to build support from key groups such as provincial officials. Access to the market, foreign trade, and foreign investment translated into larger gains than were possible within the planned economy. As the reform bandwagon gathered momentum, growth accelerated, and living standards improved, China's leaders came to believe that their political survival depended on preventing any international clashes that could derail the country's economic growth.

To reassure other countries that it was not a threat and maintain a peaceful international environment for its development, China remade itself from a revolutionary anti-Western power to a responsible power that embraces international norms. There are profound differences between North Korea today and China three decades ago, and the vested interests opposed to change in the D.P.R.K. are formidable. Nonetheless, China's transformation in domestic motivations and foreign policy stands as a precedent for the kind of shift that may eventually occur in the D.P.R.K.

## Coordinated Engagement

Economic engagement has another overlooked benefit: U.S. policy would complement the efforts of allies and partners in the region who already maintain much more extensive economic ties to North Korea than does the United States. To take the most important example, South Korea maintains a major economic cooperation project with the North, the Kaesong Industrial Complex, and a large volume of processing-on-commission trade—this continues despite President Lee Myung-bak's shift to a tougher political line toward the North. China is pursuing an even more extensive long-term strategy of economic engagement with North Korea, an approach reaffirmed by Premier Wen Jiabao during his October 2009 visit to Pyongyang. Beijing manages a robust commercial relationship with North Korea, ranging from small-scale cross-border trade to strategic investments in North Korean natural resources and infrastructure. At a lower level, Russia has also expanded its economic ties with the D.P.R.K. since their nadir in the years after the collapse of the Soviet Union. During the past few years the Japanese government has frozen what used to be extensive economic linkages to North Korea, but the new government in Tokyo may revisit that policy.

An economic engagement agenda is therefore in line with the long-term approach of U.S. partners in the region. It also affords the U.S. opportunities to work proactively with the IFIs, UN agencies, and NGOs to advance their development work with the D.P.R.K. The notion that the U.S. faces a zero-sum choice between engagement with North Korea and fidelity to its traditional allies and the international community is illusory. Bilateral economic engagement will reinforce, not undermine, these other ongoing efforts.

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## Domestic Politics

There are a number of possible objections to our case for economic engagement. One is that the timing of such a strategy is wrong. Beginning in the summer of 2008, there was a good deal of speculation about the health of North Korean leader Kim Jong-il and prospects for political succession in the D.P.R.K. Based on developments during the first half of 2009, many analysts concluded that hardliners, especially from the Korean People's Army, were growing in political influence. The widespread theory that hardliners stand to benefit from Kim Jong-il's illness, the approaching leadership succession, and the possible inheritance of paramount leader status by Kim Jong-il's son, has caused observers to take the pessimistic view that engagement is futile, if not foolhardy.

It is precisely in times of internal transition, however, that the U.S. needs to open channels to as many groups as possible, to gain more accurate information about the political dynamics inside North Korea and to look for opportunities to bolster the influence of voices favoring reform and opening. The U.S. should recognize that there will be substantial resistance—political and economic, central and local—to greater engagement. Pyongyang is apt to rebuff some U.S. overtures, and the U.S. needs to be both patient and determined. But it is critical that the pressure for engagement be sustained. Military and civilian hardliners in Pyongyang flourish in an international atmosphere of hostility, distrust, and isolation; pragmatists will be unable to advance their agenda without contact with the world outside. If hawks are gaining the upper hand in policy decisions in Pyongyang, all the more reason for the U.S. to redouble its efforts for dialogue that might reduce tension and enable pragmatic elements to reemerge.

Even when the current situation looks bleak, the U.S. should prepare for openings for engagement. North Korea has a history of surprising observers by abrupt diplomatic and policy shifts. In August 2009, the D.P.R.K. suddenly signaled its desire for dialogue and cooperation with South Korea, the United States, and Japan. These positive gestures are reminiscent of the 2000-2002 period when Kim Jong-il stunned observers by holding high-level summits and seeking reconciliation with the same three nations. In the summer of 2002, the D.P.R.K. held a summit with Japan, launched cooperative projects with South Korea (including putting its military to work demining the DMZ), and attempted some modest economic reforms. This window of opportunity was closed, however, as the Agreed Framework collapsed following the mission to Pyongyang by Assistant Secretary of State James Kelly in October 2002. Nor were foreign governments or international agencies prepared to reinforce the reform impetus by guiding North Korean economic policy-makers along the difficult road from command to market economy.

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## Bargaining Strategies

A second objection is that engagement should be conditioned on North Korean behavior. In the past, Washington has conditioned engagement with North Korea on progress in denuclearization. This strategy puts the cart before the horse, and has been unsuccessful. It has the perverse result of strengthening arguments inside North Korea that the country needs a strong deterrent to protect itself from outside threats. The U.S. can better advance its aims by opening the space for change to take place from the ground up.

While some engagement should continue to be conditioned on progress on the nuclear and other fronts, many forms of engagement should proceed with no conditions attached. Our report is focused on the economic side of engagement, and particularly on forms of economic engagement that can and should proceed now, without any conditionality, as first steps in a process of phased engagement.

## Denuclearization

A final objection is that engagement rewards bad behavior and will not solve the nuclear issue. We do not claim that economic engagement will resolve the nuclear issue, particularly in the near term.<sup>3</sup> But engagement can complement our bargaining with North Korea in the short run, and in the long run have a positive influence on the environment in which Pyongyang makes calculations about the costs and benefits of its nuclear weapons and missile programs.

The following section, "Prospects for Economic Engagement," presents reasons why North Korea, despite current appearances, might be more receptive to this process than is commonly thought. We highlight previous tentative efforts at reform and opening, including legal and policy changes, ideological shifts, and experiments with special economic zones and joint ventures.

The third section, "Channels of Engagement," suggests ways to engage the D.P.R.K. through official contacts, Track Two dialogues, academic exchanges, training programs, and NGO development programs. We further suggest how the U.S. could open the way for the IFIs to begin to interact with North Korea.

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<sup>3</sup> For a new negotiating strategy, see Joel Wit, "U.S. Strategy toward North Korea: Rebuilding Dialogue and Engagement," *U.S.-Korea Institute at SAIS Report*, Oct. 2009. Also see the Nautilus Institute website (<http://www.nautilus.org/DPRKPolicy.html>).



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### III. Prospects for Engagement

Perhaps the most fundamental objection to the case for engagement is simply that the D.P.R.K. appears not to want it. What evidence is there of an impulse toward reform and opening on the part of the North Korean leadership? And, insofar as there is an impulse, why has it never been pursued? Are there ministers, generals, and managers who recognize the merits of China and Vietnam's experiments with reform and opening and the impressive economic progress of South Korea? Or is the D.P.R.K. elite united in a stubborn commitment to a centrally-planned, military- and heavy-industry dominated, self-sufficient economic model for achieving its stated goal of becoming a "strong and prosperous great nation" by the year 2012?

#### Resisting the Market

At first glance, North Korea would appear to show no sign of a reform impetus. Despite the economic progress of its socialist neighbors, the D.P.R.K. resists China and Vietnam's models of economic reform and opening. D.P.R.K. founder Kim Il-sung's philosophy of "self-reliance" (*juche*), the ideological bedrock of North Korean foreign and economic policy statements since the 1960s, prizes autarky over opening.<sup>4</sup> His son and successor, Kim Jong-il, built up the military as his power base in the wake of his father's death in 1994. He decided to rule through his position as chairman of the National Defense Commission and established a "military-first politics" (*son'gun chongch'i*), which gives greater weight to military might than to raising civilian standards of living.

Efforts at reform initiated in the late 1990s and early 2000s appeared to go into reverse around 2005, in part as a result of the onset of the nuclear crisis. The current campaign to achieve ambitious economic targets in military and defense industries by 2012 relies on central planning and mass mobilization. This year, the D.P.R.K. carried out a "150 Day Battle" to kickstart the drive to achieve 2012 goals.<sup>5</sup> Foreign visitors this summer observed red "150 Day Battle" banners and posters flying throughout Pyongyang, and a foreign delegation in February observed a rally of college students in Kim Il-sung Square with trucks and carts filled with scrap metal, a scene reminiscent of China's Great Leap Forward.

Even prior to this most recent campaign, the authorities had sought to restore dependence on the state distribution system. There have been reports of efforts to close or restrict market activity in various parts of the country: limiting markets to three days a month and restricting market hours to 2-6 p.m.; banning select items and setting price

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<sup>4</sup> For a new negotiating strategy, see Joel Wit, "U.S. Strategy toward North Korea: Rebuilding Dialogue and Engagement," *U.S.-Korea Institute at SAIS Report*, Oct. 2009. Also see the Nautilus Institute website (<http://www.nautilus.org/DPRKPolicy.html>).

<sup>5</sup> Recently North Korea announced another 100 Day Battle launched by Kim Jong-il's third son, Kim Jong-un. See "North Korea to launch the new 100 Day Battle," *NK Brief*, no. 09-15-1, The Institute for Far Eastern Studies, 2009.

controls on certain goods; and barring women under the age of 40 (later increased to 49) from markets.<sup>6</sup>

#### Marketization from Below

Beneath the surface of North Korea's anti-market policies and ideology, however, one finds a more complex situation. The famine of the 1990s unleashed marketization from below after the public distribution system broke down.<sup>7</sup> Economic desperation drove individuals to engage in private economic activity to supplement inadequate state distributions of food. Market forces also started to seep across the porous border from China, especially in the northern part of the country.<sup>8</sup> Since the famine, the state distribution system has only been partially restored, and the flow of goods and people across the Yalu and Tumen rivers from China and Russia has steadily increased. In 2008, D.P.R.K.-P.R.C. trade increased by 48%, with China exporting USD 2 billion to and importing around 750 million from North Korea.<sup>9</sup> China commands over 40% of all D.P.R.K. trade, and its investment in the D.P.R.K. grew from USD 3.5 million in 2003 to 130 million in 2006.<sup>10</sup>

Some of the government's attempts at restricting markets may be motivated by the desire to control the flood of Chinese goods, either to protect markets for products made in the D.P.R.K. or to extract bribes for "illicit" trade. State entities are also now in some cases making profits at state-run stores, or receiving lucrative fees from one particular "free" market over another. Reports of closing markets may reflect bureaucratic attempts to increase officials' share of profit from market activities, as opposed to eradicating the market itself.<sup>11</sup> North Korean government directives restricting the market are frequently ignored or impossible to implement, providing an oblique measure of the increasing role of markets in North Korean life.<sup>12</sup>

Whatever the complex mix of state and market that is emerging in North Korea, there are strong reasons to encourage the broad trend toward greater reliance on market forces. Not only does such a change augur well for the North Korean people over the longer run, but vested interests in a more open economy should gradually moderate North Korea's international behavior.

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<sup>6</sup> "North Koreans Subject to Harsher Market Controls," *NK Brief*, no. 09-5-6-1, Institute for Far Eastern Studies, 2009; Kim Kwang-Tae, "Crackdown on Markets to Stem Imports," *ABCNews.com*, Jan. 14, 2009 (available at <http://abcnews.go.com/International/wireStory?id=6643496>); Bradley K. Martin & Hideko Takayama, "Kim Jong-il Cracks Down on Markets, Seeing Threat to Control," *Bloomberg*, Apr. 15, 2008 (available at <http://www.bloombergnews.net/apps/news?pid=20601109&refer=home&sid=aY8sulwUHccU#>).

<sup>7</sup> Stephan Haggard and Marcus Noland, *Famine in North Korea* (New York: Columbia University Press, 2007).

<sup>8</sup> Andrei Lankov, *North of the DMZ: Essays on Daily Life in North Korea* (Jefferson, N.C.: McFarland & Company, Inc., 2007), 315-319.

<sup>9</sup> "N. Korea's 2008 Trade Hits Record U.S.\$3.8 Bln: Report," *Yonhap News Agency*, May 18, 2009 (based on Korea Trade-Investment Promotion Agency report).

<sup>10</sup> Park Byung-kwang, "China-North Korea Economic Relations during the Hu Jintao Era," *Study of International Issues*, Spring 2009.

<sup>11</sup> See Choe Sang-hun, "North Korea Said to Shut Market in Bid for Control," *The New York Times*, Sept. 19, 2009.

<sup>12</sup> Stephan Haggard and Marcus Noland, "Sanctioning North Korea: The Political Economy of Denuclearization and Proliferation," *Peterson Institute for International Economics Working Paper*, July 2009, 8-9; "D.P.R.K. market closure reports deemed rumor," *NK Brief*, no. 09-7-8-1, The Institute for Far Eastern Studies, 2009; "DPRK market restrictions vs market realities," *NK Brief*, no. 09-4-3-1, 2009.



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## Experiments with “Economic Improvement”

At the central policy level, the state’s response to grassroots marketization has varied over time. The D.P.R.K. leadership has made sporadic efforts to overcome the resistance from vested interests of heavy industry and the military to initiate domestic economic reform and international opening. Both Kim Il-sung and Kim Jong-il tinkered with economic reforms that included revisions to investment laws and the D.P.R.K. Constitution, as well as changes in agricultural and industrial management and work incentives.<sup>13</sup>

A contrast is often drawn between North Korea and China, which first sought political normalization with the United States under Mao in the early 1970s, and only later began economic liberalization under Deng Xiaoping in the late ‘70s and ‘80s. Although it is less well known, Kim Il-sung tried something similar to Mao by reaching out to the U.S., South Korea, and Japan. In the early 1990s, Kim opened discussions with Tokyo on normalizing D.P.R.K.-Japan relations, and by the time of his sudden death in 1994, Kim had signed off on a historic agreement with President Clinton and was close to holding a summit with the South Korean president.<sup>14</sup>

The most recent reform endeavor was undertaken by Kim Jong-il in the late 1990s and early 2000s. The strongest evidence that Kim Jong-il intended to reform North Korea’s economic system is that during this period he visited China three times and exhibited a clear interest in China’s economic model.<sup>15</sup> He even brought his top generals along to visit Shanghai in January of 2001, and standing on the floor of the Shanghai Stock Exchange, explained to them how a stock market works. Starting in the late 1990s, North Koreans were sent overseas to participate in an increasing number of economic training programs. During the early 2000s, Kim Jong-il, in an apparent effort to create an international environment conducive to economic reform, hosted a series of historic summits in Pyongyang with South Korean President Kim Daejung, U.S. Secretary of State Madeleine Albright, and Japanese Prime Minister Junichiro Koizumi, as well as the leaders of Russia, China, and the E.U.

In July 2002, North Korea introduced the “Economic Management Improvement Measures.” The measures were significant steps by North Korean standards towards a market transition: increases in food prices and wages; devaluation of the North Korean currency; and performance-based profit sharing with managers and employees of enterprises.<sup>16</sup> But these measures sowed economic uncertainty rather than reaping foreign investment or producing domestic growth. Price rises far exceeded wage increases, and triple-digit inflation wreaked havoc on household budgets. Industry struggled in the absence of access to foreign capital, infrastructure upgrades, affordable energy, or economic policy guidance in the complexities of transitioning out of central planning. Due to the high rate of inflation, a one-time devaluation of the North Korean won from 2:1 USD to 150:1 USD

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<sup>13</sup> Haggard and Noland, *Famine*, 171-180.

<sup>14</sup> On Kim Il-sung’s overtures to North Korea’s antagonists, see Don Oberdorfer, *The Two Koreas* (New York: Basic Books, 2001).

<sup>15</sup> See Mika Marumoto, “North Korea and the China Model: The Switch from Hostility to Acquiescence,” *Korea Economic Institute’s ‘On Korea’ Academic Paper Series 1*, 2008, 98-117.

<sup>16</sup> Kim Young-yoon and Choi Soo-young, *Understanding North Korea’s Economic Reforms* (Seoul: Center for the North Korea Economy, Korea Institute for National Unification, 2005).

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was insufficient to bring the exchange rate into equilibrium, and the black market value of the won fell to 3,700:1 by the end of 2006. The reforms failed to take and gave way to a backlash of ideological orthodoxy, much like abortive reform drives experienced by the Soviet Union and Eastern European countries.

Despite the limited success of these particular economic reforms, we should not overlook the fact that North Korean authorities have been willing to experiment with the market. Rather than seeing the current reversal of reform as a permanent shift in orientation, the U.S. should be encouraging a return to reformist policies.

## Special Economic Zones

In the early 2000s, the North Korean leadership also experimented with special economic zones (SEZs) and foreign joint ventures. SEZs played a spectacular role in sparking China’s economic growth in the 1980s and ‘90s, and many countries in Asia and beyond have tried to replicate the success of boomtowns like Shenzhen.

North Korea has paid attention to Beijing’s success with special zones for attracting foreign investment and know-how. In 2002, the D.P.R.K. announced the creation of a joint venture SEZ with China at the border city of Sinuiju. The location of the special zone appeared to be inspired by the success of Shenzhen and the other zones located in Guangdong province, right next door to the advanced economy in Hong Kong. The North Korean government promised to create a semi-autonomous free trade zone in Sinuiju, operating according to its own by-laws and capitalist economic principles. They sought to build the confidence of international investors by announcing the appointment of Dutch-Chinese businessman Yang Bin, then the second wealthiest man in China, to run the new trade zone. But in a sudden political reversal, Beijing arrested Sinuiju’s newly appointed head on corruption charges.

Yang Bin’s imprisonment effectively buried the Sinuiju project, which was officially shelved in 2004. That year, North Korea made another push at creating a trade zone in Rason, on the Russia-China border (plans for a SEZ in the area, formerly known as Rajin-Sonbong, date back to 1989). Less dramatically than Sinuiju, the Rason SEZ has also failed to take, although the PRC is now negotiating a lease on the Rajin port, and plans to build a 67km highway and 5-10 square kilometer industrial zone.<sup>17</sup>

The D.P.R.K.’s experiments in creating special economic zones with the Republic of Korea have been more successful. Two North-South SEZs lie just north of the DMZ: Kaesong Industrial Complex, near the west coast, and Mount Kumgang Tourist Park, on the eastern seacoast. Kumgang, the older of the two, came out of a 1989 agreement between Hyundai founder Chung Ju-yung and Kim Il-sung’s government to create a tourist resort for South Koreans north of the DMZ. Opening in 1998, Kumgang brought the D.P.R.K. USD 72 million in rent, and tourists from the South spent some 10 million there annually.<sup>18</sup>

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<sup>17</sup> See Marcus Noland, *Avoiding the Apocalypse: The Future of Two Koreas* (Washington, D.C.: Institute for International Economics, 2000), 133-139.

<sup>18</sup> Stephan Haggard and Marcus Noland, “North Korea External Economic Relations,” *The Peterson Institute for International Economics Working Papers*, July 2007 (available at <http://www.petersoninstitute.org/publications/wp/wp07-7.pdf>).

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Kumgang recorded its millionth visitor in the summer of 2005. The resort has been closed since July 2008, after a tragic shooting incident, but looks likely to reopen.

The special administrative industrial region of Kaesong was created in 2002, and opened for business at the end of 2004. Focusing on light industry and manufacturing, Kaesong was designed to take advantage of the North's low labor costs and the South's advanced production capacity. Kaesong has grown from just a handful to over 100 companies employing 40,000 workers (the ultimate goal is to employ over 500,000 North Koreans).<sup>19</sup> Kaesong is often criticized for its failure to conform to market principles, in light of the significant political and financial backing of the South Korean government. Yet South Korean companies invested in Kaesong do not show signs of wanting to opt out, and may be starting to turn profits. The government in Pyongyang also appears committed to Kaesong. After threatening to limit Kaesong trade, it recently retracted demands for exponential increases in wages and rent and settled for a modest five percent rise. As a Congressional Research Service report noted, Kaesong "potentially could play a significant role as a demonstration project to educate North Koreans on the workings of a market-based economy."<sup>20</sup>

Sanctions, tariffs, and export controls shut Kaesong products out of the U.S. market, restricting its capacity to expand. One of the most direct ways in which the U.S. government could provide incentives for further improvement and expansion of Kaesong—and through Kaesong for liberalization of the North Korean economy—is to open the U.S. market to Kaesong goods. The Korea-U.S. Free Trade Agreement, awaiting Congressional approval, provides a mechanism (the Committee on Outward Processing Zones) to consider future classification of Kaesong goods as South Korean, thereby avoiding the prohibitive tariffs on D.P.R.K. goods.<sup>21</sup>

## Joint Ventures

Despite their limitations, the zones at Kaesong, Kumgang, Rason, and Sinuiju reflect Pyongyang's tentative effort at opening and altering the nature of the North Korean economy. Joint ventures provide another example of this intent. Access to foreign capital, technology, and expertise via the establishment of joint ventures has been a critical ingredient in Asia's post-war economic boom. But as with special economic zones, so too joint ventures have failed to take root deeply in North Korea's rugged economic soil, though not entirely for a lack of trying. A handful of investment funds and joint venture companies have been attempted in recent years in mining, textiles, and information technology. Intrepid

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<sup>19</sup> Seon Yoon, "An Economic Perspective of Kaesong Industrial Complex in North Korea," *American Journal of Applied Sciences*, November 2007.

<sup>20</sup> Dick K. Nanto and Mark E. Manyin, "The Kaesong North-South Korean Industrial Complex," *Congressional Research Service Report*, Feb. 14, 2008, 20-21. Labor conditions are an important concern vis-à-vis Kaesong. Acknowledging concerns about labor practices, the CRS report goes on to point out, "The KIC provides an opportunity for businesses to operate in North Korea according to what may be higher labor and environmental standards than exist in the rest of the country and to educate North Korean middle managers on how such standards work."

<sup>21</sup> See Nanto and Manyin, "Kaesong," 2.

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investors and entrepreneurs, from northern Europe and the Middle East to Southeast Asia, are testing the waters.<sup>22</sup>

A legal framework exists for foreign companies to do business in the North. The D.P.R.K. followed China's lead early on by revising its law on joint ventures with the help of a U.S. law firm. The Equity Joint Venture Act was enacted in 1984 and constitutionally ratified in 1992. Amendments in 1999 and 2004 created more legal space for foreign investors operating in the D.P.R.K.<sup>23</sup> Recently, Pyongyang has expressed interest in attracting more foreign business.<sup>24</sup> On the ground, the D.P.R.K.'s promises of capital protection are unproven, and most investors worldwide remain wary.

The vast majority of companies that form joint ventures or have business operations in the D.P.R.K. are Chinese.<sup>25</sup> Very few other foreign firms are active in the D.P.R.K. A noteworthy exception is the Egyptian company Orascom, which may have the widest array of ventures under development. Orascom Construction Industries (now owned by the French company Lafarge) announced a deal in 2007 to purchase a 50% stake in a North Korean cement plant, and to bring North Korean workers to parts of the Middle East. This was followed up by Orascom Telecom's announcement in 2008 that it was paying USD 400 million for a 25-year lease to develop a cell-phone network. As of August, 2009, nearly 50,000 new subscribers had purchased phones and opened accounts through the joint venture between Orascom and the state-owned Korea Post and Telecommunications.<sup>26</sup>

North Korea's recent history of abortive experiments with reform does not constitute an impressive record of economic innovation. It does suggest, however, that some people inside the country, including perhaps leader Kim Jong-il himself, recognize the shortcomings of the existing system and are open to change.

North Korea's previous experiments have not received much notice or encouragement from the outside world. Over the past decades, as the countries all around it have transformed their political economy, the domestic interests and forces opposed to change in North Korea have maintained the upper hand. Engagement threatens their political power and financial interests. Sanctions will strengthen, rather than undercut, their ability to resist opening. A sanctions regime must, therefore, be complemented by a sustained, proactive engagement that supports more moderate voices within the D.P.R.K.

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<sup>22</sup> See Bradley K. Martin, "North Korea Fund Seeks \$50 Million after Terror Label Removed," *Bloomberg*, Feb. 23, 2009; Johan Huizinga, "Business with North Korea Carries on Quietly," *Radio Netherlands Worldwide*, May 27, 2009.

<sup>23</sup> Dae Kyu Yoon, "North Korea's Transformation: A Legal Perspective," IFES Forum, Feb. 12, 2009 (available at <http://ifes.kyungnam.ac.kr/eng/m05/s20/content.asp?ifesforumNO=243&GoP=1>).

<sup>24</sup> "N. Korea Vows to Expand Trade," *Yonhap News Agency*, Sept. 21, 2009; "N. Korea Boosts Incentives for Investors," *Yonhap News Agency*, Sept. 4, 2009; "DPRK Banks' Role Strengthened to Increase Security of Personal Holdings," *NK Brief*, no. 09-9-4-1, 2009.

<sup>25</sup> For more on the significance of Sino-D.P.R.K. commercial interactions in the Jilin-Hamgyong border region, see John S. Park, "North Korea, Inc.: Gaining Insights into Regime Stability from Recent Commercial Activity," *United States Institute of Peace Working Paper*, Apr. 22, 2009 (available at <http://www.usip.org/files/resources/North%20Korea,%20Inc.PDF>).

<sup>26</sup> See Marcus Noland, "Telecommunications in North Korea: Has Orascom Made the Connection?," *North Korean Review* 5, no. 1, Spring 2009.

## IV. Channels of Engagement

**In the past**, Washington has held economic and political engagement hostage to progress in denuclearization. In our view, however, not all forms of engagement with North Korea should be deferred until the D.P.R.K. undertakes denuclearization. There are a number of steps in the economic sphere that the United States should take immediately, regardless of the status of negotiations on security matters. South Korea, China, Russia and European countries (almost all of which have normalized relations with Pyongyang) interact with North Korea in the economic sphere, even when security negotiations are stalled. The United States is the outlier.

### Official Contacts

The most basic form of engagement is official contacts and face-to-face meetings with North Korean officials. In the past, restrictions placed upon U.S. diplomats limiting their contact with D.P.R.K. counterparts hamstrung American diplomacy. Treating dialogue as a “reward” for “good behavior” runs counter to U.S. interests. U.S. interests are enhanced by broadening its contacts with North Korean stakeholders, even when Pyongyang appears hostile and formal talks are stalled. Our task force’s first, overarching recommendation is that U.S. diplomats be instructed to initiate and maintain channels as widely as possible with North Korea. In doing so, the U.S. must carefully coordinate with its allies and partners, most importantly South Korea and Japan. Coordinated bilateral channels provide information and can be used to reinforce crucial messages at all levels of government.

### Track Two Dialogues

Alongside government-to-government contacts, Track Two dialogues hold the potential for positive, long-term impact on North Korea’s willingness and capacity to move from its hostile crouch into a neutral stance toward the world.<sup>27</sup> In 1986, John Lewis, director of Stanford University’s Center for International Security and Cooperation (CISAC), pioneered one of the first Track Two programs with the D.P.R.K. in the United States. Lewis was joined by William Perry in 1998, when he returned to Stanford after serving as Secretary of Defense. Their ongoing Project on Peace and Cooperation in the Asian-Pacific Region focuses on security issues in Northeast Asia, fostering dialogue between scholars and officials.

In 1993, Susan Shirk founded the University of California’s Northeast Asia Cooperation Dialogue (NEACD), which anticipated the Six Party Talks framework by a decade, and continues to bring together officials, military officers, and academics from the U.S., North and South Korea, Japan, China, and Russia. The Council for Security Cooperation in the

<sup>27</sup> For a brief survey of these efforts, see Karin Lee, “The DPRK and Track II Exchanges,” *NCNK Newsletter* 1, no. 6 (available at <http://www.ncnk.org/resources/newsletter-content-items/ncnk-newsletter-vol-1-no-6-the-dprk-and-track-ii-exchanges>).

Asia-Pacific (CSCAP) was established in 1993 to serve as the ASEAN Regional Forum’s Track Two mechanism. The National Committee on American Foreign Policy and Korea Society launched a joint Track Two in 2003, focusing on U.S.-D.P.R.K. issues, with attendance from U.S. and D.P.R.K. officials over the last six years.

These Track Two Dialogues have often focused on political and security issues. But all have the capacity to advance the discussion on economic development and reform issues, and have done so effectively in the past. U.S. policy should encourage these programs as a mechanism for introducing North Koreans to life beyond the D.P.R.K. and reducing their suspicions of the outside world. They are also a good means of deepening understanding of the D.P.R.K.’s structure and policy-making process, and can also further the message of the benefits to be gained from economic openness and reform.

### Academic Cooperation

Beyond Track Two and official contacts, phased engagement with North Korea should be pursued through U.S. encouragement of activities by universities, research centers, NGOs, and IFIs. Development training and assistance led by universities and NGOs are perhaps easier to initiate in the short term. Integrating the D.P.R.K. into IFIs is a more difficult, long-term process but should begin now.

Universities, research institutes, and NGOs from other countries already play a significant role in improving North Koreans’ knowledge of economic ideas and managerial methods. American institutions also have much to offer in such knowledge building. Educational and NGO interactions, in addition to their training objectives, create valuable opportunities for North Koreans to be exposed to life outside the D.P.R.K., and for Americans to learn about the domestic situation from a broader range of stakeholders inside North Korea.

European governments, with logistical support from their embassies in Pyongyang, support a wide array of academic endeavors. Examples include the British Council’s English teacher program in Pyongyang; the European Business Association’s Pyongyang Business School (supported by the Swiss Agency for Development and Co-operation); and the International Council of Swedish Industry/ KTH Royal Institute of Technology’s Centre for Banking & Finance’s Sweden-D.P.R.K. Program (supported by the Swedish International Development Cooperation Agency).<sup>28</sup> Australia is also active in providing training opportunities—the University of Sydney, for example, has carried out training programs in development assistance management and statistics software with North Korean government officers.<sup>29</sup> One of the most ambitious efforts at academic cooperation

<sup>28</sup> For an assessment of economics-based exchanges with the D.P.R.K., highlighting the experiences of Europeans, see Jin Park and Seung-Ho Jung, “Ten Years of Knowledge Partnership with North Korea,” *Asian Perspective* 31, no. 2, 2007, 75-93. For more on the Pyongyang Business School and other programs, see the Swiss Agency for Development and Co-operation’s website ([http://www.swiss-cooperation.admin.ch/northkorea/en/Home/Newsletter/May\\_August/SDC\\_programme](http://www.swiss-cooperation.admin.ch/northkorea/en/Home/Newsletter/May_August/SDC_programme)). On the Sweden-D.P.R.K. Program, see the International Council of Swedish Industry website ([http://www.nir.se/sweden\\_-\\_dprk.asp](http://www.nir.se/sweden_-_dprk.asp)).

<sup>29</sup> See the University of Sydney website for a brief description ([http://www.usyd.edu.au/riap/training/int\\_dev\\_projects.shtml#nk](http://www.usyd.edu.au/riap/training/int_dev_projects.shtml#nk)).

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is the Pyongyang University of Science and Technology, spearheaded by James Kim, which plans to open its doors within the year.<sup>30</sup>

By contrast, there is just a single academic exchange program between American and North Korean universities: the computer science program between Syracuse University in New York and Kim Chaek University of Technology in Pyongyang. Though modest in scope, it has developed over many years, and is viewed as successful by the two partners.<sup>31</sup> North Korean experts also have participated in a few study tours to U.S. academic institutions on agricultural and medical topics.<sup>32</sup> In almost all of these cases, the primary motivation comes from an international NGO active in the D.P.R.K. that seeks U.S. university partners to provide key training needs.

The United States should facilitate academic exchange programs, especially those with an economic, management, or legal focus. The U.S. should change its current visa policy, which uses visa approvals as a reward to the D.P.R.K., or denials to signal U.S. displeasure. While U.S. safety and security must be of primary concern, and North Koreans should not be allowed to enter the U.S. without thorough vetting by the relevant U.S. agencies, the general policy should be to encourage North Koreans to visit the United States for cultural, academic, and technical exchanges in all fields. The U.S. should also look for ways to provide funding for academic exchanges. Finally, the United States should explore establishing a liaison office in the D.P.R.K., staffed with a representative who can facilitate exchanges.

## NGO Projects

Washington should assist the efforts of the NGO community to create and expand cooperative projects with the D.P.R.K. in community development and economic improvement. Aid-based NGOs found it challenging to implement their programs according to international standards when they first began working in the D.P.R.K. during the years of flood and famine in the 1990s. But a handful of U.S. NGOs have persisted and have had success working in various sectors of North Korean life, such as public health and agriculture.<sup>33</sup> The Asia Foundation for many years has run a series of small-scale but

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<sup>30</sup> See the recent profile of PUST founder James Kim by Bill Power, "The Capitalist Who Loves North Korea," *CNN Money*, Sept. 15, 2009 (available at [http://money.cnn.com/2009/09/14/magazines/fortune/pyongyang\\_university\\_north\\_korea.fortune/?postversion=2009091509](http://money.cnn.com/2009/09/14/magazines/fortune/pyongyang_university_north_korea.fortune/?postversion=2009091509)).

<sup>31</sup> For information on this program, see Hyunjin Seo and Stuart Thorson, "Academic Science Engagement with North Korea," *KEI Academic Paper Series* 4, no. 4, Apr. 2009. Also see Fred Carriere and Stuart Thorson, "Dark Horse," *NCNK Newsletter* 1, no. 2 (available at <http://www.ncnk.org/resources/newsletter-content-items/ncnk-newsletter-vol-1-2-dark-horse>).

<sup>32</sup> See Randall Ireson, "The Knowledge Sharing Experience in Agriculture," *Ten Prospects for International Cooperation in Knowledge Sharing in the Service of Economic Development in the DPRK*, Nov. 2007 (available at [http://www.ncnk.org/resources/publications/Ireson\\_KS\\_paper\\_Nov\\_07.doc/file\\_view](http://www.ncnk.org/resources/publications/Ireson_KS_paper_Nov_07.doc/file_view)).

<sup>33</sup> Mercy Corps, Global Resource Services, The Eugene Bell Foundation, and Samaritan's Purse were the lead organizations in administering a USD 4M project for provisioning electrical supplies and hospital equipment and providing hospital training (see "U.S. Spends \$4 Million on Medical Aid for N. Korea in 2008," *Korea Herald*, Dec. 21, 2008). MercyCorps, Global Resource Services and Samaritan's Purse were also part of the consortium, along with World Vision and Christian Friends of Korea, that provided a portion of U.S. food aid, until the program was suspended in March 2009.

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successful programs relating to economic issues, including legal training sessions in Beijing, book donations to the D.P.R.K., and agricultural exchange with experts from the D.P.R.K. and Cornell University.

A number of U.S. NGOs have been engaged in community development projects that address a range of topics, including energy, drinking water, health, and food production.<sup>34</sup> Community development programs typically involve multiple site visits a year, resulting in better program partnership, project implementation, and maintenance of capital investments. NGOs have also reported that capital improvements in one community can inspire its neighbors to work to upgrade their own facilities.

The most tangible way for the U.S. government to support such efforts is to allocate seed funding for economic development assistance programs. Although proposals should be carefully vetted, program design requirements should be flexible: NGOs have deep-seated expertise drawn from their long-term working relationships with North Korea, and will be in the best position to evaluate the different needs of individual communities. When program sustainability depends on reinvesting a portion of proceeds into factories, selling products in the market, or trading goods with nearby communities, D.P.R.K. commitments to these components of program success should be confirmed by the NGOs. This will reinforce positive economic changes at the ground floor in North Korea.

The D.P.R.K. government has stated an interest in development assistance, but freedom of movement, data collection, program monitoring, and resource control issues have presented obstacles to collaboration. NGOs and their governments should encourage the D.P.R.K. to simplify regulations for NGOs operating in-country, liberalize its visa and foreign residency policies, and allow NGOs to select and train staff. If some of these restrictions are relaxed, the NGOs in turn will be able to significantly ramp up their work with the D.P.R.K.<sup>35</sup> Until its abrupt cancellation in March 2009, USAID was able to carry out its food assistance program in the D.P.R.K. with unprecedented levels of openness and cooperation. Hopefully it can serve as a model for future development assistance programs.

It may prove fruitful, especially in the short run, to locate cooperative U.S.-D.P.R.K. projects in third countries. China and Mongolia offer logical bases for pilot projects of this kind because they are close to the D.P.R.K., cost-efficient, and don't require American visas. Vietnam has played host to training projects in economic planning for North Korean participants, supported by European governments. There are many well-trained American and Asian experts already working in Asia's transition economies or who travel there frequently with extensive knowledge and experience to contribute. U.S. policy should encourage involving North Koreans in workshops on various aspects of economic transition led by American and Asian experts.

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<sup>34</sup> See Victor Hsu, "A DPRK Shangri-La," *NCNK Newsletter* 2, no. 1 (available at <http://www.ncnk.org/resources/newsletter-content-items/ncnk-newsletter-vol-2-no-1-a-dprk-shangrila>).

<sup>35</sup> These suggestions for basic adjustments in D.P.R.K. policy toward NGOs come from Edward P. Reed, "The Role of International Aid Organizations in the Development of North Korea: Experiences and Prospects," *Asian Perspective* 29, no. 3, 2005, 51-72.



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## International Financial Institutions

The Asian Development Bank (ADB), International Monetary Fund (IMF) and World Bank played critical roles in assisting Asia's command economies, notably China, Vietnam and Mongolia, with their economic transitions. Although the IFIs have international governing boards, Washington's political opposition has been a main obstacle preventing these organizations from initiating and further developing contacts with Pyongyang. Once the U.S. government gives the green light, IFI economists could begin informal discussions with North Korean economic officials in order to familiarize themselves with the workings of the economy, in preparation for designing a program of technical assistance that would precede any consideration of actual membership and loans for North Korea. In the case of other transition economies, the IFIs worked with country officials for years to get their economic statistics in decent shape and to provide other technical advice well before the economies were ready to advance to membership.

At this preliminary stage, the U.S. should support granting the D.P.R.K. "observer status" in the IMF and ADB. This classification would free up resources in those institutions to fund studies of the North Korean economy in order to design a process of technical assistance to prepare the D.P.R.K. for possible eventual membership. The U.S. government should encourage IFI expert participation in workshops and training activities developed by those organizations already engaged with the D.P.R.K., such as the European Commission, NGOs and UN agencies.

The D.P.R.K. can also be invited to participate in the annual meetings of the IFIs as a "special guest" to learn how these organizations function, develop contacts in the financial community, and hold informal discussions with IFI management about prospects for developing future relations. The U.S. government should support IFI fact-finding missions to the D.P.R.K. and discussions of priorities for training and technical assistance cooperation, as well as technical level visits of D.P.R.K. experts to IFI headquarters and offices in other countries to learn about IFI operations in practice.

If North Korean officials show themselves willing to continue with the process of IFI engagement based on this first set of interactions, the U.S. should support moving to the next, more substantive phase of pre-membership engagement. The primary goal of this phase would be to deepen North Koreans' knowledge of the process necessary for membership and outline the basic elements of what a development assistance program might look like, including expected actions on the part of the North Korean government itself. The U.S. should support a range of activities in this phase, including IFI-sponsored workshops, training programs, and study tours on a widening range of topics related to economic management, transition to market economic mechanisms, and financial and legal system development; and joint research and sector studies looking at strategies, policy options, technical issues and institution building in priority areas of the D.P.R.K. economy.

At the appropriate time, consideration could be given to the establishment of a D.P.R.K. trust fund administered by one or more IFIs to support both IFI-led and country-led policy research, capacity building, pre-investment technical studies and pilot projects. Donor coordination would facilitate roundtables with IFI participation and provide technical assistance geared to meeting requirements for IFI membership.

At the final stage of IFI engagement the D.P.R.K. would be welcomed as a formal member and receive access to loans. In order for the U.S. and other countries to support D.P.R.K. membership, considerable progress will need to have occurred on the security and nuclear issues, but the groundwork for membership will have already been laid. As a member, North Korea would become eligible for IFI-led donor coordination activities, such as establishing a Consultative Group for the D.P.R.K., and receiving IFI support for external debt restructuring through the Paris Club and London Club. Full integration of the D.P.R.K. in the international financial system would of course also make it incumbent on the D.P.R.K. to accept all obligations of membership, including IFI safeguard policies and practices in social and environmental impacts as well as financial due diligence and anti-corruption mechanisms.

Membership and loans from IFIs could help North Korea make the transition to an integrated modern economy. But the main gains are not financial, and there are many preliminary and intermediate steps along the way. Prior to membership, the IFIs can provide knowledge sharing opportunities, policy advice, technical assistance for meeting requirements for membership, and carefully prescribed investment funding for critical needs. The application process itself would help guide North Korea in the direction of structural economic reforms.

Rather than dangle IFI membership as a "carrot" to lure North Korea to undertake denuclearization, the U.S. should initiate the long-term process of IFI engagement with the D.P.R.K. as a means of encouraging a transition in the North Korean political economy. The sooner the process starts, the better. Bradley Babson, former official at the World Bank, details specific steps in IFI participation in fuller detail in the Appendix.

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## V. Conclusion

**There are no easy solutions** to the North Korean problem. Sanctions have been tried for decades, and at times have been useful in moving Pyongyang back to negotiations. But their long-term effect has been to harden the D.P.R.K.'s resistance to international cooperation and reinforce its isolation from the liberalizing influence of global economic integration. Sanctions alone will not create a lasting solution to the North Korean conundrum, and must be complemented by other long-term strategic approaches.

The United States needs a long-term strategy aimed at transforming North Korea's intentions and behavior to complement the short-term focus on the D.P.R.K.'s nuclear capabilities. A central piece of that strategy is to engage North Korea in the process of economic integration with the world economy. As discussed in "Prospects for Engagement," there is reason to believe that the leadership in Pyongyang could be open to such overtures. Each step along the way is bound to be arduous. Even the preliminary activities proposed in "Channels of Engagement," such as academic exchanges, cooperation with NGOs, and engagement with the IFIs, are fraught with complications. Suspicious of American motives and nervous about the political fall-out of economic change, North Korean decision-makers may rebuff initial proposals for cooperation. There are no guarantees that even if they welcome economic engagement they will be able to win over those who enjoy special protection and status under the command economy.

Yet despite its current policy orientation, North Korea has economic assets that can contribute to a new growth path: an educated labor force, a rich supply of minerals, a long history as an industrial country, and neighbors like the R.O.K. and China who are eager to do business. The very process of economic engagement with the U.S. has the potential to catalyze fundamental changes in North Korean political economy and foreign relations, while at the same time allowing the U.S. to learn more about its internal dynamics and refine its policies accordingly. The United States has taken the economic engagement approach with many other countries, but never with North Korea. Now is the time to begin developing a new, long-term policy approach that engages North Korea from the inside out.

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# Appendix

## Rationale and Phasing of IFI Engagement with the DPRK

By Bradley O. Babson

<p><b>Rationale for Phased IFI Engagement</b></p> <ul style="list-style-type: none"> <li>• Supporting expansion of opportunities for knowledge sharing for economic modernization, which can also promote mutual learning and trust building, and influence the quality of internal economic policy debates.</li> <li>• Supporting younger generation gaining access to knowledge and relationships that reinforce their confidence in building a better future.</li> <li>• Promoting transparency, openness, accountability and systemic integration with the international economy, while reducing secrecy that protects inefficient and unacceptable practices.</li> <li>• Encouraging expansion of markets and decentralized decision-making by enterprises, collective farms, households and local governments, while helping the central government to build capacity for macroeconomic management and institution building to support the growth of a market economy.</li> <li>• Supporting adoption of appropriate regulation and social safety nets, while resisting regressive efforts to stifle markets.</li> <li>• Supporting development of a rules-based financial system and credible legal enforcement system, while pursuing anti-money laundering and illicit transactions concerns.</li> <li>• Encouraging development of a business culture based on internationally accepted commercial norms, such as honoring contracts, while resisting corruption and cash-for-concessions dealings.</li> <li>• Providing mechanisms for mobilization and coordination of ODA to support economic development as and when the security issues are resolved.</li> </ul>		
<p><b>Phase 1: Objectives and Methods for Immediate Engagement</b></p> <p><b>Objectives</b></p> <ul style="list-style-type: none"> <li>• Create opportunities for IFI involvement in knowledge sharing and confidence building in managing economic modernization.</li> <li>• Demonstrate commitment of the US and international community to supporting DPRK’s moving towards integration in the international financial system.</li> </ul> <p><b>Methods</b></p> <ul style="list-style-type: none"> <li>• IFI participation in workshops and training activities organized by others, such as the European Commission, NGOs and UN agencies already engaged with the DPRK.</li> <li>• Invitation to DPRK to participate in the Annual Meetings of the IFIs as a “special guest” to learn how these organizations function, develop contacts in the financial community, and hold informal discussions with IFI management about prospects for developing future relations.</li> <li>• IFI fact-finding missions to the DPRK and discussions of priorities for training and technical assistance cooperation</li> <li>• Technical level visits of experts to IFI headquarters and IFI offices in other countries to learn about IFI operations in practice</li> </ul>	<p><b>Phase 2: Objectives and Methods - Pre-IFI Membership (linked to positive progress in economic cooperation)</b></p> <p><b>Objectives</b></p> <ul style="list-style-type: none"> <li>• Expand knowledge opportunities for North Koreans, linked to a deepening collaborative economic development and modernization process.</li> <li>• Put in place the main elements of a development assistance program based on best practice principles at a modest scale, including policy dialogue, technical assistance for capacity building, joint research, pre-investment studies, and demonstration projects.</li> <li>• Expand the environment for trade and FDI in line with international norms.</li> </ul> <p><b>Methods</b></p> <ul style="list-style-type: none"> <li>• IFI-sponsored workshops, training programs and study tours on a widening range of topics related to economic management, transition to market economic mechanisms, financial and legal system development, etc.</li> <li>• Joint research and sector studies looking at strategies, policy options, technical issues and institution building in priority areas such as agriculture, energy, transport, housing, state enterprises etc.</li> <li>• Establish a DPRK trust fund administered by one or more IFIs to support both IFI-led and country-led policy research, capacity building, pre-investment technical studies and pilot projects.</li> <li>• Donor coordination roundtables with IFI participation.</li> <li>• Technical assistance geared to meeting requirements for IFI membership.</li> </ul>	<p><b>Phase 3: Objectives and Methods - Normal IFI Relations/Membership (linked to a significant agreement in the security discussions)</b></p> <p><b>Objectives</b></p> <ul style="list-style-type: none"> <li>• Full integration of the DPRK in the international financial system, including DPRK accepting all obligations of membership.</li> <li>• Development assistance calibrated to absorptive capacity and North Korean economic institution building progress, supported by IFI programs and financing.</li> <li>• Expansion of trade and foreign investment through an outward-oriented economic development policy endorsed by IFIs.</li> <li>• Acceptance of IFI safeguard policies and practices in social and environmental impacts as well as financial due diligence and anti-corruption mechanisms.</li> </ul> <p><b>Methods</b></p> <ul style="list-style-type: none"> <li>• Support for DPRK membership applications to IFIs by existing members.</li> <li>• IFI policy dialogue, technical support and financing based on normal policies and practices that apply to members.</li> <li>• DPRK participation in the governance of the IFIs through voting share and representation in the boards of executive directors.</li> <li>• IFI-led donor coordination activities, e.g. establishing a DPRK Consultative Group.</li> <li>• IFI support for external debt restructuring through the Paris Club and London Club.</li> </ul>



