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the Korean Peninsula**

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THE NORTH KOREAN ECONOMY AND THE NEW ASIAN ECONOMIC ORDER

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I. Introduction

It is inevitable that the economy of the Democratic People's Republic of Korea (DPRK) will undergo dramatic transformations in the coming years. Internal and external pressures for change are too great to harbor any expectation that the North Korean economic system can be both isolated and stable. But the path of change, the consequences for the welfare of the North Korean people, and relations between the DPRK and its neighbors remain in late 2004 highly uncertain. This path of change will be influenced in part by decisions of the DPRK leadership and in part by the environment in which this process takes place. This environment itself is evolving, both as the political process for resolving the security issues facing the Korean peninsula unfolds and as a result of developments of political and economic relations among the countries of Asia more broadly.

The underlying premise of the analysis that follows is that the DPRK wants a future that will lead to improved economic welfare for the North Korean people, gradual reunification with the Republic of Korea (ROK), and supportive relations with other Asian countries and the international community as a whole. One implication of this premise is that the six-party-talks process of negotiating a realistic and long-term framework to resolve issues of the DPRK's nuclear program is a critically important starting point for any discussion of the DPRK economy and a new Asian economic order. Another implication is that inter-Korean reconciliation is an equally important process that will exert major influence on both the trajectory for the North Korean economy and the eventual shape of the new Asian economic order itself. A third implication is that institution building for future economic regionalism in Northeast Asia will be shaped significantly by the challenge of integrating the DPRK in the regional economy.

II. Assessment of the Current State of the DPRK Economy

The present economic situation in the DPRK can be characterized as fragile but showing signs of adjustment to the new economic management policies put in place in 2002 and 2003 that are creating incentives for more profit-motivated decision making at the firm level and expansion of now legal markets. Also, the DPRK's trade relations are evolving in ways that demonstrate the leadership's commitment to expanding the outward orientation of the economy, but that also reflect political as well as economic factors in relations with major trading partners. Nevertheless, the DPRK economy remains vulnerable to inflation and growing inequality and needs more far-reaching reforms, the development of legal and financial institutions to support the expanding market mechanisms, and an infusion of capital and knowledge to fuel growth.

Production

The Bank of Korea (BOK 2004) estimates that real gross domestic product (GDP) in the DPRK increased 1.8 percent in 2003, continuing a five-year trend of small but positive growth since the DPRK's nadir of economic performance in 1998.¹ This growth is mainly attributable to increased production in mining, manufacturing, and the electricity, gas, and water sectors. Agricultural production is estimated to have increased by 1.7 percent owing to favorable weather and donated fertilizer. Also, increased hydropower production because of good rainfall and increased coal production stemming in part from improved worker motivation following large wage increases seem to be alleviating some of the severe energy shortages that have been a major constraint to the economy. As a result, manufacturing output increased 2.6 percent in 2003 compared with a 2 percent decrease in 2002. Consumer demand and improved electricity supply were important determinants of this turnaround. Similarly, a growth of 0.7 percent in services in 2003, after a 0.2 percent decline in 2002, is attributed to increased transport and trade stemming from growing commercial transactions stimulated by the new economic management policies. If the BOK is correctly reporting the dynamics and trends of economic activity in the DPRK, it is fair to conclude that the new system of incentives is beginning to take effect but that the scale of response is still very small because of capital shortages, lack of technology, continuing infrastructure bottlenecks, and institutional impediments.

Prices

Since the price reforms of July 2002, inflation has become a major factor in the DPRK economy. Official reporting of price data is not available. Yonhap News reported on 16 June 2004 that while the official price of rice has remained at 46 *won*/kg, market prices increased to 150 *won*/kg in 2003 and to 240 in early 2004. On 27 July 2004, the *Daily Chosun* reported that pork prices had stabilized at 500–700 *won*/kg. The black market exchange rate fell from 150 *won*/dollar in August 2002 to 1,600 *won*/dollar in mid-2004.

In view of the fact that average wages are 2,000–3,000 *won*/month, the inflation information available indicates that basic commodities are out of reach for those unable to earn income in the emerging market economy in the DPRK. Although the ROK Ministry of Unification reported on 30 June (Digital KOTRA 2004) that the number of markets in the DPRK had grown significantly—by more than 300—since they

1. Statistics on the DPRK economy are not reported by the DPRK government; thus, this assessment is based on secondary sources, principally from the ROK. The BOK routinely updates its estimates of DPRK economic statistics, as does the ROK Ministry of Unification (MOU). Although the accuracy of secondary data on the DPRK economy has its limitations, ROK reporting does permit a reasonable assessment of general trends.

were legalized in 2003 and that the reforms in recent years have made the DPRK more market friendly and spurred a business mind-set, other reports show a growing inequality in DPRK society.² It is difficult to assess the relative impact of greater participation in the market versus growing poverty caused by inflation exceeding wage increases. Nevertheless, it is clear that, within the DPRK economy, internal forces have been unleashed that are changing the political economy of the system with uncertain future implications for internal political dynamics. Without a supply-side response to boost output significantly, it can be expected that inflation and currency depreciation will continue, which will further stress the dynamics of inequality that are developing inside the DPRK.

Trade

Among significant recent developments in the DPRK's trade have been a decline in humanitarian assistance provided through the United Nations (UN) annual appeal,³ cessation of heavy oil shipments provided by the Korea Energy Development Organization (KEDO), and a sharp drop in trade with Japan. These reflect the impact of the nuclear crisis, aid fatigue and increased claims of other countries on international humanitarian assistance, and issues in bilateral relations with Japan. Nevertheless, the DPRK has more than offset these losses through increased trade with China and the ROK.

An evaluation of recent trade trends by the Korea Trade-Investment Promotion Agency (KOTRA 2004) reports that in 2003 DPRK foreign trade (excluding trade with the ROK) increased by 5.8 percent from 2002, with exports growing at 5.5 percent and imports by 5.9 percent. The trade deficit amounted to \$837 million.⁴ The total trade volume of nearly \$2.4 billion was the highest since 1994 and reflects a general policy

2. FAO/WFP (2003) and informal reports suggest that some firms have not been able to meet new wage requirements or have displaced workers and, as a result, income disparities are growing among urban households.

3. On 28 July 2004, *UN News* reported that it had received commitments for just 23.4 percent of the UN Consolidated Appeal for DPRK for 2004. On 1 August 2004, Reuters reported that the World Food Programme (WFP) had received contributions for only 16.3 percent of its appeal for emergency feeding programs, which represents a major shortfall compared with earlier years. On 6 August 2004, *Asahi Shimbun* reported that Russia announced that it would provide 35,000 tons of food aid to the DPRK, and Japan announced that it would provide \$47 million for the WFP to purchase 125,000 tons of food and for the United Nations Children's Fund (UNICEF) and the World Health Organization to deliver medical assistance.

4. There are no coherent statistics on the financing of the DPRK's external trade gap. While subsidized trade with some countries and humanitarian aid account for part of the financing, unreported military sales and illicit drugs are generally believed to account for a significant portion of the gap. For a discussion of illegal or questionable sources of funds, see Nanto and Chanlett-Avery (2004, 17–18)

of the leadership of expanding international trade as a central component of strategy to improve the DPRK economy. Although this is a welcome sign of intent that is showing modest results, the scale of trade is still very small. For perspective, the BOK reports that, excluding inter-Korean trade, the value of exports from the ROK in 2003 was 248.5 times as large as the value of exports from the DPRK. Similarly, the value of imports arriving in the ROK was 111.1 times the value of imports to the DPRK.

An important development is a surge in trade between the DPRK and China. KOTRA estimates that total trade volume exceeded \$1 billion in 2003, a 38.6 percent increase over 2002. Trade with China accounted for 42.8 percent of the DPRK's total foreign trade (excluding the ROK), up from 32.6 percent in 2002. By contrast, trade with Japan dropped from 16.3 percent in 2002 to 11.1 percent in 2003. Other major trading partners in 2003 were Thailand (10.6 percent), India (6.2 percent), and Russia (4.9 percent).

DPRK exports to China in 2003 grew by 46.1 percent over 2002, reflecting an increased ability to sell seafood, metal products, and textiles. Imports from China grew by 34.3 percent, reflecting increases in energy and food supplied by China as offsets to the drop in oil shipments from KEDO and food assistance provided through the UN. Imports from China amounted to \$627.583 million, and exports to China were \$395.344 million. The resulting 2003 trade deficit of \$232.239 million represents an 18 percent increase over the 2002 deficit of \$196.624 million. Yonhap News on 28 July 2004 reported that, for the first six months of 2004, this trend continued, with total trade growing by 37 percent over the same period in 2003 and the trade gap reaching \$174 million for the half year. This combination of expanding volume of trade and increasing deficit signals China's willingness to deepen its support of and economic engagement with the DPRK as an encouragement for continuing a policy of economic reform and participating constructively in the six-party talks. It also signals China's willingness to offset U.S. and Japanese efforts to tighten economic pressures on the DPRK and its desire to seek a soft landing for the nuclear crisis.

Similarly, Russia has also signaled its willingness to offset the loss of KEDO oil shipments to the DPRK through the increased export of refined petroleum products to the DPRK in 2003. While DPRK exports to Russia declined by 23.3 percent, its imports from Russia grew by 50 percent in 2003 compared with 2002. Thus Russia, like China, expanded its trade deficit with the DPRK as a way to lessen the impact of the KEDO decision and encourage the DPRK to seek a sustainable solution to its energy needs through the six-party talks.

Inter-Korean trade, reflecting the proengagement policy of the Roh Moo-hyun administration, has also been growing. The BOK reports that bilateral trade amounted

to \$724.2 million in 2003, an increase of 12.8 percent over 2002. This compares with estimates of DPRK trade with China of \$1.02 billion and with Japan of \$265.3 million, indicating that the ROK is the number-two trading partner with the DPRK and that ROK and China trade together account for about 58 percent of total DPRK cross-border trade.

The parallels of the ROK's and China's economic policies toward the DPRK are also reflected in the trend of the DPRK's trade deficit. ROK exports to the DPRK grew 17.5 percent in 2003, while imports from the DPRK grew by 6.5 percent. As a result, the trade deficit increased from \$98.6 million to \$145.7 million—48 percent. Food and humanitarian assistance and increased commercial trade more than offset the loss of KEDO-related trade in 2003. The growth in DPRK exports to the ROK was due to both the expanding processing-on-commission trade and expanded commercial transactions in agriculture, forestry, and fisheries products.

On 15 July 2004, the Associated Press reported that the ROK Ministry of Unification (MOU) found that these trends accelerated in the first half of 2004, with total trade value growing by 21 percent in the first half of the year, compared with the same period in 2003. This is attributed to both expanding commercial transactions and aid shipments. While ROK exports to the DPRK grew by 33.5 percent, imports from the DPRK grew by only 3.5 percent, thus continuing the trend of a widening trade deficit. Aid shipments valued at \$152 million accounted for 73 percent of ROK exports to the DPRK during this period, reflecting the commitment of the Roh administration to implementing its Peace and Prosperity policy toward the DPRK while continuing to press for resolution of the nuclear crisis through the six-party talks.

Inter-Korean Economic Cooperation

More generally, inter-Korean economic relations have been accelerating in 2004 with the agreement to proceed with opening a pilot phase of the Kaesong industrial complex project before the end of the year and progress in implementing road and rail connections. It is noteworthy that demand among ROK small and medium-sized firms to participate in the Kaesong initiative is high, reflecting competitive pressures in the ROK market and suggesting that the economic logic of combining low-wage DPRK labor with ROK technology, management skill, and marketing ability has a good chance of working if the two Korean governments succeed in creating a commercially friendly business environment. It is also noteworthy that, in July 2004, ROK rice aid to the DPRK was transported by truck across the border for the first time and that the DPRK has agreed to more stringent monitoring by the ROK of distribution of this aid. To meet its objective of provision of systematic aid to the DPRK, on 7 April 2004 the MOU announced that it will form a consultative committee on provision of aid to North Korea and divide the roles of central agencies, local governments, and civic

groups as well as improve coordination of regions, schedules, and beneficiaries of ROK aid. This combination of seeking commercial viability in inter-Korean investment and trade while rationalizing and improving transparency of ROK aid is an important development that distinguishes policies of the Roh Moo-hyun administration from policies pursued by the Kim Dae-jung administration.

Implications for Future Strategy

An important conclusion of the assessment of recent developments in the DPRK economy is that economic performance and system change are intimately related to political developments both within the DPRK and among its major foreign interlocutors. The future path for the DPRK economy will be influenced by both domestic and international forces. The strategy for the DPRK's economic rehabilitation thus will require a political dimension linked to the interests of all of the major countries that have a stake in this process. An important element of these countries' interest is the desire to support a transformation of the DPRK economic system that corresponds with a more general transformation of the regime from one vested in isolation to one vested in transparent international partnerships. This will require a disciplined, two-pronged approach of both curtailment of illicit and questionable income-earning activities and constructive economic engagement.

While a political framework that provides the DPRK access to capital and technology will be critical, external assistance can best be provided in the context of a strategy for comprehensive economic reconstruction that is guided by a long-term vision. A good summary of the major tasks for economic reconstruction of the DPRK is provided by Ro and Ahn (2003). The authors stress that access to capital and technology will be critical requirements, and, just as important, economic incentives need to be put in place to overcome the endemic lethargy of the DPRK economic system. The shift toward capitalism will require major changes in ownership and privatized production, genuine price liberalization, trade reform, removal of infrastructure bottlenecks, financial mechanisms to support markets, the introduction of a knowledge-based economy and the development of information technologies, a restructured industrial system emphasizing light rather than heavy industry, and a reformed legal system.

Such a comprehensive strategy poses huge challenges of design and implementation. Major questions exist about the sequencing of reform, priorities for investment, and roles of the international community. Although a full treatment of these issues is beyond the scope of this paper, the following sections explore a number of aspects of these challenges from the perspective of the emerging dynamics of a new Asian economic order and especially the interplay of political and economic factors that will shape the course of future developments.

III. The Emerging New Asian Economic Order and the Future DPRK Economy

The emerging new Asian economic order and implications for the DPRK will be shaped by developments in several critical areas. These include the six-party talks, inter-Korean economic cooperation, regional organizations, and subregional initiatives.

Six-Party Talks: The Economic Side of the Equation

The six-party talks have come to a critical stage. Now that concrete proposals have been tabled by both the DPRK and the United States, serious negotiations can proceed. Two results of the talks so far are agreement that a staged approach is acceptable and the creation of a working group to iron out details in advance of the formal meetings. Together these provide the essential ingredients for designing and agreeing on a road map that will address both the complex security issues involved and a sequenced economic support program. The objective should be a soft landing for the nuclear crisis and a platform for managing the transformation of the DPRK economy and its opening up for expanded foreign investment and trade. The way the deal is shaped and the institutional arrangements that are set in place to support its implementation will be important components of a new order in Northeast Asia, with consequences for both the future of multilateral security cooperation and economic engagement by the international community with the DPRK. It is thus crucial at this critical stage of the negotiation process that careful thought be given to the details of the economic side of the road map, the linkages of progress on the security agenda with progress on the economic-support agenda, the roles of various players in the economic support framework, and the mechanisms to supervise the implementation of the agreements.

Several criteria can be used to evaluate the quality of the decisions negotiated on the economic side of the equation:

- Do incentives exist for the DPRK to take responsibility for deciding and implementing economic reforms that will expand the role of market mechanisms and promote sustainable growth?
- Are economic assistance projects and activities selected and designed to provide a genuine economic benefit to the DPRK that will not have to be undone later?⁵

5. The KEDO light water reactor project in its current form does not meet this test.

- Is economic assistance logically sequenced with regard to coordination of investment with policy reforms and institutional capacity building, especially in the financial and legal systems?
- Do early activities provide learning opportunities for the DPRK to develop knowledge and skills to undertake tasks of economic reform and reconstruction?
- Are projects avoided that lead to economically inefficient investment or that distort incentives for development of markets and private initiative?
- Are roles and coordination mechanisms defined for major players—the UN, international financial institutions, the ROK, China, Japan, Russia, the United States, the European Union (EU), bilateral aid agencies of countries not participating in the six-party talks, and nongovernmental organizations—that are expected to provide economic assistance?
- Does the sequence of economic assistance lead to irreversible change in the DPRK economic system; can it be halted if there is backsliding on the security side of the equation?
- Is there significant impact on vulnerable social groups and poverty alleviation broadly in North Korean society?
- Is economic assistance designed and implemented to reinforce principles of good governance, including transparency, participation of beneficiaries, and cost-effectiveness?
- Are protections against corruption built into mechanisms for provision of economic assistance?

In addition to the issue of the quality of the economic agreements to be reached in the six-party-talks process, effective mechanisms will need to be put in place to monitor progress in implementation and make corrections where needed. The chairmanship, membership, and processes of such mechanisms will set important precedents for the longer-term management of policy dialogue and coordination of economic engagement with the DPRK as well as define leadership and multilateral-conduct models that will have significant consequence. An important contribution to the future new economic order in Northeast Asia would be to embed in these arrangements and practices the principles of transparency, open multilateral policy dialogue, partnerships based on mutual interests and comparative advantages, and orderly management of conflicts and disputes.

Korean Reconciliation: Implications of Inter-Korean Economic Cooperation

The underlying strategy of eventual peaceful reunification that the two Koreas are pursuing is premised on reducing the enormous gap between the two economies and promoting gradual integration of two very different economic systems. This requires both an economic growth formula for the DPRK that will be sustained for many years and a willingness on the part of the two countries to coordinate policies and work collaboratively on a joint agenda to harmonize legal, financial, and social institutions to permit expanding trade and investment, development of domestic and export markets for goods and services, and management of labor markets in the two countries. The idea of managed gradual economic integration is complex and hugely challenging. A process that proceeds along this path during the coming years would be an important component of the emerging Asian economic order, with significant implications for both Koreas and their economic relations with other countries as well as each other.

Rule of law. The shift from military deterrence to a new security architecture that relies significantly on economic cooperation mechanisms for maintaining peace and managing conflict is a fundamental change for the two Koreas and for Northeast Asia as a whole. Promotion of broadly accepted standards of conduct in business relationships and encouragement for broadening the rule of law in resolving conflicts will be a critical factor in the emergence of a new economic order in Asia that supports development of market mechanisms in all of the countries and embraces the DPRK economy.

Coordination of economic development strategies and management. The extent to which inter-Korean economic cooperation will demand adroit management of economic policy and development strategy as the economies become increasingly integrated is not yet generally appreciated. The major issues of concern for South Korea are not the same as for North Korea. For the ROK, major issues will be:

- How to sustain its drive for increasing competitiveness in the global market economy while it keeps fiscal control over pressures to spend heavily on the inter-Korean relationship; and
- How to avoid risks of reinforcing distortions in the DPRK economy while supporting development of market mechanisms and increasing liberalization of the DPRK economic system. This applies to all factor markets, but especially labor.

For the DPRK, major issues include:

- How to achieve stable, robust economic growth and maximize foreign aid and investment while it manages domestic adjustments and keeps its balance in its relations with its neighbors; and
- How to manage a transformation of its economic system and integration in the regional and global economy while it pursues the goal of long-term unification through gradual integration with the ROK economy. This is the DPRK's underlying challenge.

The international community and especially the International Monetary Fund (IMF) have a potentially important role in monitoring closely the developments in the two Koreas and using opportunities such as regular Article IV consultations to assess issues emerging in the inter-Korea economic management agenda. Establishing the discipline of such routine monitoring and policy dialogue would help avoid future crises for both countries and maintain confidence of foreign investors in economic management of both Koreas during a period of unusual vulnerabilities to policy laxity or miscalculation.

Two-client model. Normally, economic policy dialogue, technical assistance, and financial aid are provided in a development assistance model that is based on a single client supported by other countries and international organizations. Typical IMF Article IV consultations and structural adjustment programs and World Bank or Asian Development Bank country assistance strategies and programs are based on this framework. The same is true for aid coordination mechanisms such as consultative groups. The DPRK will require structured assistance from the international community along these lines to support the economic reform and reconstruction process. But the situation on the Korean peninsula is very different from the normal context for development assistance. Inter-Korean economic cooperation poses a new challenge of a two-client model for all the multilateral economic organizations as well as the international community more generally.

To make a two-client model operationally feasible, it is essential that the two Koreas have a well-defined joint decision-making and policy dialogue capability. The organizational arrangements for economic coordination that have been put in place since the signing in 2000 of the June 15 North-South Joint Declaration are an essential part of setting up a workable framework for international support to a two-client system, but further elaboration of these mechanisms will be needed.

For a two-client model to be effective, international support must also be accountable to both countries and not perceived to be serving the interests of one country at the

expense of the other. Achieving even-handedness given the enormous differences in economic power and social expectations between the two Koreas at present will require exceptional diplomatic as well as technical competencies among the international support group as well as development of new modalities for ensuring appropriate information sharing on a timely basis and consultations on processes as well as substantive issues.

Linkages of inter-Korean economic cooperation and regional economic cooperation in Northeast Asia. The inter-Korean economic cooperation agenda also will not be solely a peninsula matter. Intersecting this agenda are a number of regional issues involving one or both Koreas. The most prominent of these issues relate to energy trade in Northeast Asia and prospects for expanded transport links to stimulate private investment and regional economic development and integration. Integrating the DPRK more fully in the regional economy will require improving policies and procedures for cross-border trade facilitation and removing infrastructure bottlenecks with other countries in addition to the ROK, which will impact economic development strategy, public investment planning, incentives for private investment, and priorities for use of external financial aid. This will place important demands on aid and investment coordination between the inter-Korean economic cooperation agenda and other regional economic initiatives.

In general, it will be important to establish new institutional arrangements for information sharing, policy dialogue, and coordinated decision making for moving forward with a future regional economic cooperation process that goes beyond the partial frameworks now in place: the Tumen River Area Development Program, which does not include Japan; and the ASEAN + 3 (Association of Southeast Asian Nations) coordination activities, which do not include the DPRK or Russia. New regional frameworks will also need to intersect with the mechanism for planning inter-Korean economic cooperation, and appropriate modalities for ensuring effective coordination will need to be established. By definition, such frameworks will need to be multilateral in nature, but participation need not be limited to the countries of Northeast Asia. Other countries from outside the region and international organizations should also participate to ensure full coordination of support for both the regional economic agenda and the inter-Korea economic agenda.

The East Asia Region as a Whole: APEC, ASEAN + 3, and the FTA Agenda

The two most important institutions of the economic order for the East Asia region as a whole are the Asia-Pacific Economic Cooperation (APEC) and the ASEAN + 3 mechanisms. Presently, the DPRK is not a member of either of these bodies, although it does attend meetings of the ASEAN Regional Forum (ARF) for discussions of regional security issues under ASEAN auspices.

It is hard to imagine, even under the most optimistic scenario, that the DPRK would ever be an economically important participant in these Asia-wide organizations. It will not be a capital supplier, nor a major market, nor a source of new knowledge or technology for the foreseeable future. For existing members, the benefits of DPRK participation would be mainly political, but for the DPRK—for securing legitimacy and for its economy—the benefits could be substantial. If participation leads to development of relationships, educational opportunities for officials and businesspeople, and motivation to pursue economic reforms that would permit expanded trade and investment from other Asian countries outside the Northeast Asia neighborhood, the DPRK economy could reap significant tangible benefits. Thailand is already one of the DPRK's leading trading partners, and good relations with other ASEAN members such as Vietnam and Indonesia could help build and diversify economic relations that would be supportive of the overall objective of integrating the DPRK in the international community. In this respect, given the interest of Europe in supporting achievement of security goals in Northeast Asia, providing positive incentives for DPRK trade with Europe, and extending humanitarian and development assistance, DPRK participation in the Asia-Europe Meeting (ASEM) would also be fruitful for relations between Europe and Asia.

It is difficult, however, to see ASEAN + 3 extending full membership to the DPRK in the sense of redefining its identity as ASEAN + 4. One major reason is that this precedent would open the door to sensitive issues, such as participation of Australia, New Zealand, and also possibly Russia. Thus, relations between the DPRK and ASEAN can be expected to grow primarily through informal means and selective participation in meetings where this would be seen as enhancing the larger process of integrating the DPRK into the Asian community.

APEC, on the other hand, is a different situation, and a good case could be made for formal membership of the DPRK in APEC in the future. Membership in APEC has already been extended widely to countries of the Pacific Rim, and the inclusion of the DPRK would not raise the same kinds of issues that would be raised for ASEAN + 3. APEC also has an infrastructure of subgroups addressing a variety of issues in the region, and some of these would be suitable for active DPRK participation. Because APEC includes the active involvement of both the United States and Russia, which are not involved in ASEAN + 3 activities, admission of the DPRK would also permit more direct engagement and working relations with these countries as well as with other member countries and provide the potential for better coordination with the political and security frameworks for regional cooperation that could evolve from the six-party-talks process if the negotiations are successful.

The future of Asian economic regionalism. In some sense, ASEAN + 3 and APEC represent competing ideas of the future guiding hand of economic regionalism

in East Asia.⁶ The tensions between these two frameworks hinge on perceptions of Asian identity, questions about how competition for influence between Japan and China will play out in the coming years, and concerns within the region of the future U.S. role and pursuit of its interests, reinforced by lingering sentiments about how the Asian financial crisis of the late 1990s was managed. Plans for various subregional free trade areas (including AFTA, China + 10, and Japan + 10), development of Asian monetary arrangements initiated through the Chiang Mai Initiative of 1999, and proposals for creation of new financial instruments such as an Asian bond market all signal that the East Asian economic order is evolving, but without a full consensus on the shape and distribution of roles among the existing regional economic organizations or future economic relations among the major powers.

Both APEC and ASEAN are seeking to expand their visions of economic cooperation in Asia as a whole. Maintaining dynamism by adapting to changes in the global and regional economy and building a deepening feeling of regional community and shared interests while respecting diversity within Asia are the over-riding goals for both institutions.

APEC adopted the Shanghai Accord in October 2001. This accord affirms a vision of a region with continued economic growth prospects that can share in the benefits of globalization and expansion of the information economy and contribute to the shaping of the global economic order, particularly through the Doha Round of World Trade Organization (WTO) negotiations. The vision recognizes the need for ongoing structural reforms among the economies of the region, capacity building to manage new challenges, development of appropriate trade policies for the information economy, deepening trade facilitation, and increasing transparency. Priority is also given to improving implementation mechanisms.

ASEAN + 3 established an East Asian Vision Group to shape a consensus statement on the future of the region. The report of this group was issued in late 2001 and aims to “create a vision that would inspire East Asian peoples and governments to work toward building an East Asian Community that will address the region’s future challenges and advance mutual understanding and trust.” The main concept is to move from “a region of nations to a bona fide regional community where collective efforts are made for peace, prosperity and progress.” Economic relations would be the catalyst for the community-building process.

The recommendations of the group include establishment of an East Asian free trade area, expansion of the framework agreement on an ASEAN investment area to all of

6. For a good discussion of these issues from a U.S. perspective, see Lincoln (2004).

East Asia, promotion of technical cooperation and assistance to less-developed members of the region, development of a future-oriented economic structure integrating the knowledge economy, establishment of a self-help financing facility, improvements in the exchange-rate coordination mechanism, and the strengthening of regional economic monitoring and reporting to supplement the global surveillance provided through the IMF. The report also makes specific recommendations in the areas of political and security cooperation, environmental cooperation, social cooperation, and institutional cooperation. The institutional recommendations provide for moving from annual summit meetings of ASEAN + 3 to an East Asian summit and establishment of an East Asian forum that would include representatives from both governmental and nongovernmental organizations.

The implication for the DPRK is that the debates in APEC and ASEAN + 3 about the future shape of Asian economic regionalism are being driven by much larger and more fundamental political and economic dynamics than the issues facing the absorption of the DPRK economy into the system. The DPRK will be a bystander to these debates and will need to set its own economic reform and development strategy in relation to the standards and processes being worked out for the region more broadly.

A growing focus on free trade agreements (FTAs) in the East Asia region does not clarify whether any country will be seeking to negotiate an FTA anytime soon with the DPRK; neither is it clear that any countries will choose to include the DPRK in a subregional FTA. DPRK policies, institutions, and transparent reporting will need to become much closer to international norms. This raises some important issues for the ROK and the future inter-Korean economic relationship. As inter-Korean trade is not considered foreign trade by the ROK, an expanding economic relationship—with the DPRK producing goods intended for export to other countries—could become an issue in FTAs that the ROK attempts to negotiate in the future. The Kaesong industrial complex will bring these issues to the surface quickly, and the way they are resolved will have significant implications for future ROK investment in the DPRK and the process of economic integration between the two Koreas.

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DPRK economic relations with its neighbors. An outward-oriented economic growth strategy is inevitable for the DPRK. Increasing trade and investment links with other countries is the only path to sustained growth. The most important trade and investment partners for the DPRK will be its regional neighbors. Thus, the challenge for both the DPRK and its neighbors will be how to expand trade and investment in ways that over time reduce DPRK aid dependence and increase economic relations that are based on mutual economic benefits and reliance on commercial principles.

The foundations for this transition are already being put in place. The Kaesong industrial complex will be a critically important test of the ability of the ROK and the DPRK to succeed in establishing profitable business relations that can grow and extend to other locations. The Chinese economic relationship is also evolving. The MOU on 19 July 2004 reported that the DPRK is making active efforts to attract investments from Chinese corporations and individuals and is promoting Chinese tourism, while the Chinese government is providing a glass factory as part of its economic assistance and is expanding technical cooperation in science and technology, moving beyond agricultural and energy support.

Chinese policy toward the DPRK can be expected to evolve toward hardening the terms of its economic support and promoting mutually profitable commercial ventures as the political and security context develops as a result of the six-party-talks process. Improved relations with Japan that lead to normalization will result in not only a large economic development assistance package but also access to Japanese markets for DPRK exports. It is the integration of the DPRK economy with the large markets of the ROK, China, and Japan that will be the source of long-term growth for the DPRK. Although economic relations with Russia will also be important for the DPRK, especially in the context of regional energy and transport agreements, the DPRK's economic future depends on its ability to produce goods and services for export to the three large markets on its doorstep.

Economic regionalism in Northeast Asia. Economic relations among the neighboring countries of Northeast Asia will exert a major influence on the strategy for DPRK economic development and, in turn, will be influenced in important ways by political agreements that change the security equation on the Korean peninsula.

Because of Cold War divides, lingering historical animosities, and economic systems that evolved in very different ways during the past 100 years, economic development in Northeast Asia until very recently has been notable for its lack of regionalism. However, since the collapse of the Soviet Union, economic systems of all the former socialist states are now moving toward expanded market mechanisms, even though great differences still exist in the cultures of economic governance and the sophistication of markets and institutions to support them. China's success in economic transformation, together with its rapidly expanded foreign investment and trade, is also exerting significant influence. The private sector in both the ROK and Japan has greatly increased its penetration of China, which is causing governments to overcome their historical reluctance to seek creative new intergovernmental agreements on economic relations. Energy security considerations are also making an impact on the relations among Japan, the ROK, China, and Russia such that the prospects for regional competition and cooperation in oil, gas, and power trade are all improving.

At present no formal intergovernmental economic cooperation mechanisms include all the countries of the Northeast Asia region. The Commission for the Tumen River Area Development and Northeast Asia (Tumen Commission) was established in 1995 and is the closest organization to meeting this objective. It includes both Koreas, China, Russia, and Mongolia. However, Japan is not a member. China, Japan, and the ROK, motivated by their participation in ASEAN + 3, have undertaken a number of initiatives in joint economic research and environmental action planning. The establishment of intergovernmental cooperation through studies and workshops coordinated by designated institutes in each country is an important development that has good potential for expansion to include a wider range of topics and potentially to involve other countries as well.

A successful agreement in the six-party talks that includes significant economic engagement with the DPRK will inevitably lead to adjustments in the larger subregional economic cooperation mechanisms as well as to pressures to expand coordination of aid and trade with the DPRK. Although the six-party-talks mechanism may evolve into a longer-term security dialogue forum, it is not the appropriate mechanism for coordinating economic cooperation, partly because economic agencies are not currently directly involved in the six-party-talks framework (even though half the deal involves economic commitments) and partly because other potential significant donors and investors, such as the EU and countries like Australia and Canada, are not integrated in the six-party-talks framework.

Future evolution of subregional economic institution building. One potential path of regional economic institutional development could be the elaboration and formalization of cooperative activities that have already emerged among China, Japan, and the ROK. Tripartite informal mechanisms that have been evolving under the intergovernmental coordination for ASEAN + 3 could lead to formal economic agendas and decision making (as have already been adopted for environmental cooperation). At present, for example, studies are being undertaken of the eventual feasibility of a tripartite FTA. The dilemma that will be posed by the issue of inclusion of the DPRK is whether the needs of the larger and more sophisticated economies would run the risk of subordination to the needs of the DPRK and management of economic relations with the DPRK. Conversely, the DPRK issues could be sidelined by the larger dynamics of trade and investment relations among China, the ROK, and Japan. It will be impossible to ignore the disparity of the two agendas.

One strategy would be to follow the model adopted by Europe in dealing with transition economies of Eastern Europe and the former Soviet Union. In the European case, admission to the economic institutions of the EU was not automatic. Countries that wanted to join the club were required to undertake economic reform and institution building to meet the baseline standards set by the EU as a precondition of membership.

Technical assistance and aid were provided to help aspirants make the reforms and build the capacities to meet these tests. In the Northeast Asia situation, this would mean telling the DPRK that it could become a formal member of a Northeast Asia economic cooperation framework and process that evolves from ASEAN + 3 mechanisms only after it has reached defined thresholds of transition to a market economy and economic policy performance. Incentives could be designed to encourage and support DPRK efforts to meet these threshold tests. The ROK would need to play a pivotal role in facilitating the DPRK transition in a way that is managed in parallel with deepening economic integration of the two Korean economies under the long-term unification process.

A variant of this approach would be to selectively include Russia and the DPRK in issue-specific frameworks for regional cooperation and multilateral decision making. This would be logical for specific subregional economic development programs such as energy trade, transport, and tourism. Formal and transparent multilateral agreements and processes for decision making would provide a context for development assistance from the multilateral development banks and bilateral agencies such as the Japan Bank for International Cooperation. It would also reduce risks to private sector investors in cross-border projects such as in energy and transport.

Energy is a particularly important area for regional cooperation. The Korean Peninsula Energy Development Organization (KEDO) potentially could be given a broader mandate and expanded membership to implement energy-related commitments agreed during the six-party-talks process. Both China and Russia would need to join KEDO for it to take on a regional role beyond its current mandate for providing limited support to the DPRK energy sector. In any case, any future role for KEDO will need to be coordinated with economic engagement frameworks that are supporting DPRK economic reform, reconstruction, and integration with the regional economy.

Another path to regional economic cooperation is the evolution of the Tumen Commission and its Tumen River Area Development Program (TRADP) that has been supported by the United Nations Development Programme and a number of donors since 1995. While the TRADP has been criticized for not fulfilling its early expectations, especially in attracting investment to the DPRK, it has in fact accomplished more than generally appreciated.⁷ At a recent meeting of the commission, it was decided to extend the Tumen Agreement beyond its planned expiration in 2005 and to strengthen the program in the coming years. With China's new policy thrust for the economic development of the provinces of northeastern China, and with positive developments in Japan-DPRK relations, it is possible that the Tumen Commission

7. For a full discussion, see Tsuji (2004).

could be expanded to include Japan and receive higher-level political attention from the participating central governments as well as local governments than it was able to achieve in the first nine years of its existence. If so, it could evolve into an important mechanism for economic cooperation in the provinces directly abutting the DPRK and be an important mechanism for addressing many of the practical issues involved with expanding trade and investment in this subregion. In this case, the DPRK would continue to be a central, not peripheral, figure in the workings of this subregional organization, thereby gaining experience and confidence in multilateral cooperation that can have spillover benefits in other areas as well.

These paths for development of Northeast Asia economic cooperation institutional mechanisms are not mutually exclusive. It is quite conceivable that, for engaging the DPRK, a two-track approach with several institutional contexts might be the most effective organization of a future economic order in the region. For issue-specific regional frameworks and for the Tumen Commission, the DPRK would be treated as an equal partner, and decisions about economic cooperation would be based on immediate and practical considerations. For the larger issues facing economic relations among China, the ROK, and Japan, the DPRK would not be a equal participant but would be engaged in ways that would help motivate and shape its longer-term economic-system reforms and its deepening integration with the regional and global economies.

IV. Conclusion

Because the future of the DPRK economy is intimately tied up with the future economic order of Asia, the way that political and security issues are resolved on the Korean peninsula will have major consequences for economic relations in Northeast Asia and the development of regional institutions. Many challenges lie ahead, for both the DPRK and the international community, as they shape a path and process of economic engagement with the DPRK that also invigorates economic regionalism in Northeast Asia. Beyond the immediate focus of the six-party talks, this is the agenda that will promote long-term peace and prosperity for all the countries of the region.

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