

# CRS Report for Congress

## The North Korean Economy: Overview and Policy Analysis

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## Summary

This report provides an overview of the economy of the Democratic People's Republic of Korea (DPRK) or North Korea, its external economic relations, attempts at reform, and U.S. policy options. Along with the United States, North Korea's major trading partners — China, Japan, South Korea, and Russia — form the so-called “six parties,” who are engaged in talks, currently restarted, to resolve issues raised by the DPRK's development of nuclear weapons.

The economy of North Korea is of interest to Congress because it provides the financial and industrial resources for Pyongyang to develop its military, can be used as leverage in negotiations, constitutes an important “push factor” for potential refugees seeking to flee the country, creates pressures for the country to trade in arms and illegal drugs, is a rationale for humanitarian assistance, is tied to Pyongyang's nuclear program, and creates instability that affects South Korea and China. The North Korean threat to sell nuclear weapons material could be driven in part by Pyongyang's need to generate export earnings. The dismal economic conditions also foster forces of discontent that potentially could turn against the Kim regime — especially if knowledge of the luxurious lifestyle of communist party leaders becomes better known or as the poor economic performance hurts even Pyongyang's elite.

Economic conditions in North Korea currently seem to be improving but have been dismal for those out of the center of power. Mass starvation — eased only by international food aid and other humanitarian assistance — has stalked the countryside. Over the past 15 years, industrial production in North Korea has shrunk considerably. The country has embarked on a program of economic reforms that include raising wages, allowing prices to better reflect market values, reducing dependence on rationing of essential commodities, trimming back centralized control over factory operations, and opening foreign trade zones for international investment.

North Korea has extensive trading relationships with China and South Korea and more limited trade with Japan and Russia. Because of U.S. economic sanctions and lack of normal trade relations status, U.S. imports from North Korea in 2006 were nil, while U.S. exports consisted of \$3,000 worth of books and newspapers. The DPRK has been running an estimated \$1.8 billion deficit per year in its international trade accounts that it funds primarily through receipts of foreign assistance and foreign investment as well as through various questionable activities, such as sales of weapons, transporting and producing illegal drugs, and counterfeiting brand name products and currency.

U.S.-led financial sanctions on North Korea have disrupted that country's trade. In the six-party talks, economic assistance (including fuel oil) is a major bargaining chip. Economic policy options include increasing or easing economic sanctions, preventing shipments of illicit cargo, normalizing relations with Pyongyang, negotiating a trade agreement, allowing the DPRK to join international financial institutions, and removing the country from the terrorism list. This report will be updated as conditions warrant.

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# The North Korean Economy: Background and Policy Analysis

## Most Recent Developments

- March 12, 2007. Treasury announced that through an agreement with Macau and China, the \$25 million held by Banco Delta Asia would be released to be used by the DPRK for humanitarian purposes.
- March 19, 2007. The Six-Party Talks resumed in Beijing, but North Korea refused to proceed with the talks until the \$25 million frozen in the Banco Delta Asia bank was released.
- March 14, 2007. Treasury finalized its rule against Banco Delta Asia in Macau, barring the bank from accessing the U.S. financial system.
- February 13, 2007. The countries in the Six-Party Talks announce an agreement in which North Korea halts its nuclear program in exchange for energy assistance and diplomatic recognition.
- October 14, 2006. The UN Security Council adopted Resolution 1718 calling for all UN members to take wide-ranging economic and diplomatic sanctions against North Korea.

## Introduction

The Stalinist state of North Korea (Democratic People's Republic of Korea or DPRK) faces a dilemma as its economy stagnates, goods are unequally distributed, and much of the population undergoes severe privation. The end of the Cold War negated its value as a surrogate fighter for the former Soviet Union and China and as a standard bearer for the international proletarian revolution. The country's leaders in Pyongyang have very limited options remaining because (1) they perceive themselves to be a possible target of U.S. military action; (2) they have pushed ahead with developing nuclear weapons despite warnings not to do so from both friends and foes, (e.g., China and the United States); and (3) they have committed themselves to a nuclear free Korean peninsula.

On October 9, 2006, Pyongyang announced that it had completed an underground nuclear test. Although the test was characterized as a "fizzle" at best, the focus of the Six-Party Talks has turned from prevention of nuclear weapons to either rollback of the nuclear program or containment and non-proliferation.

In negotiating with the DPRK, the United States has five major policy levers: economic assistance, economic sanctions, non-proliferation enforcement, diplomatic isolation, and the threat of preemptive military action. This report examines the economic side of U.S. leverage with North Korea. The security side is addressed in other CRS reports.<sup>1</sup> Here we provide an overview of the North Korean economy, survey its economic relationships with major trading partners, and conclude with a discussion of U.S. policy options.

Information on the DPRK's economy is scanty and suspect. The closed nature of the country and the lack both of a comprehensive data-gathering structure using modern economic concepts and a systematic reporting mechanism make quantitative assessments difficult. Still, sufficient information is available to provide a sketch of the North Korean economy that has enough details to address different policy paths.

U.S. interest in the moribund North Korea economy goes beyond the leverage that economic assistance provides in negotiations over Pyongyang's nuclear weapons. The economy is tied to Pyongyang's push to develop nuclear energy and bombs; provides the financial and industrial resources for Pyongyang to support its military; constitutes an important "push factor" for refugees seeking to flee the country; creates pressures for the country to trade in arms and illegal drugs; when performing poorly, provides the rationale for international humanitarian assistance; and creates instability that affects South Korea and China. The North Korean threat to sell nuclear weapons material seems to be driven in part by its need to generate export earnings to pay for imports. Dismal economic conditions for many in North Korea foster forces of discontent that potentially could turn against the ruling regime of Kim Jong-il — especially if knowledge of the luxurious lifestyle of regime leaders spreads or if the poor economic performance hurts even Pyongyang's elite. The North Korean economy also is a target of U.S. economic sanctions. For the United States, the confrontation with the DPRK centers on security issues, but economic and diplomatic levers are more pliable, manageable, and can be applied in discrete segments.

### North Korea at a Glance

**Land Area:** 120,540 sq km, slightly smaller than Mississippi

**Population:** 23.1 million (2006 est.)

**Head of State:** Kim Jong-il

**Capital:** Pyongyang

**Life expectancy:** 63.6 years

**GDP:** estimated \$40-\$68 billion at purchasing power parity in 2006

**GDP Per Capita:** \$1,800-\$2,700 at PPP in 2006

**GDP Composition:** agriculture: 30% industry: 39%, services: 31%

**Exports:** \$1.8 billion (2005)

**Export Commodities:** minerals, metallurgical products, manufactures (including armaments), textiles, and fishery products

**Imports:** \$3.6 billion c.i.f. (2005)

**Import Commodities:** petroleum, coking coal, machinery and equipment; textiles, grain

Sources: CIA, *World Factbook*; Global Insight

<sup>1</sup> See CRS Report RL33590, *North Korea's Nuclear Weapons Program*, and CRS Report RL33567, *Korea-U.S. Relations: Issues for Congress*, both by Larry A. Niksch.

This report notes that the worst of North Korea's economic crisis seems to have passed, but the economy is still heavily dependent on foreign assistance to stave off starvation among a sizable proportion of its people. About 40% of the population reportedly still suffers from malnutrition. Currently, Pyongyang's reforms along with better weather, some food aid, and increasing trade with South Korea and China are enabling the country to bridge its shortfall between food production and basic human needs. However, donor fatigue and competing humanitarian needs in Africa and elsewhere are depressing current donation levels. UN trade sanctions along with U.S. financial sanctions appear to have had some effect, judging by the complaints coming out of Pyongyang. U.S. trade sanctions, however, have little impact because the United States already has virtually no trade with the DPRK and the country can turn to other nations for needed imports. The Six-Party Agreement of February 13, 2007, includes an economic incentive of heavy fuel oil as well as the prospect of the normalization of diplomatic relations between the DPRK and the United States and Japan in exchange for North Korea's freezing and allowing inspections of the activity at its Yongbyon nuclear reactor.

## Overviews of the DPRK Economy

The North Korean economy is one of the world's most isolated and bleak.<sup>2</sup> It was completely bypassed by the Asian "economic miracles" of the past three decades that brought modern economic growth and industrialization to South Korea, Taiwan, Singapore, and Hong Kong, as well as rapid growth and trade liberalization to China, Thailand, Malaysia and other Asian nations. The "Stalinist" North Korean economy can be characterized by state ownership of means of production, centralized economic planning and command, and an emphasis on military development. The economic system is designed to be self-reliant and closed. The irony of the situation is that the longer the economy tries to remain self-sufficient, the poorer its performance, and the more dependent the country becomes on the outside world just to survive.

During the 1990s, major portions of the North Korean population survived primarily through transfers of food and other economic assistance from abroad. The worst of the food crisis has now passed, but the country is dependent on staples from China, South Korea, and, when allowed, from the UN World Food Program (WFP).

During the 1990s, the inefficiencies of North Korea's centrally planned economy, especially its promotion of state-owned heavy industries, along with high military spending — about 15-25% of GDP — joined with drought and floods to push the economy into crisis. In addition, the collapse of the Soviet bloc meant the loss of Russian aid, export markets, and cheap oil. Trade with the former Soviet Union dropped from as much as \$3 billion \$58 million in 1999 and has recovered to only \$230 million (mostly petroleum) by 2005.<sup>3</sup> This added to disastrous domestic

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<sup>2</sup> For an in-depth study of the North Korean economy, see Marcus C. Noland, *Avoiding the Apocalypse: The Future of the Two Koreas*, Institute for International Economics, 2000.

<sup>3</sup> Data from Global Insight. Subscription database.

economic conditions in North Korea.<sup>4</sup> Food has been so scarce that North Korean youth are shorter than those in other East Asian nations.<sup>5</sup> Since 1998, the military reportedly has had to lower its minimum height requirement in order to garner sufficient new recruits. Life expectancy has been contracting. With the help of the WFP, which had been feeding more than a quarter of North Korea's 22 million people, chronic malnourishment among children reportedly fell from 62% in 1998 to about 37% in 2004. About one-third of mothers are considered to be both malnourished and anemic.<sup>6</sup> In January 2006, Pyongyang ordered the WFP to stop food deliveries to the DPRK, but limited food assistance (about 75,000 tons annually) was resumed after an agreement in May 2006.<sup>7</sup> Pyongyang recently has embarked on a series of reforms that may ease the economic pressures over the long term.

The DPRK's gross national product in 2006 in purchasing power parity prices (PPP) — prices adjusted to international levels — has been estimated at \$40 billion (CIA estimate) to \$68 billion (Global Insight estimate). This amounts to national income of about \$1,800 to \$2,700 per capita in PPP values or roughly in the range of that of Zimbabwe, Uzbekistan, Bangladesh, or the Sudan. This is considerably lower than that of China (\$6,572), Indonesia (\$3,842), or Japan (\$30,821). It is also dramatically lower than South Korea's \$21,868 in PPP values or \$16,200 at market prices.<sup>8</sup> According to Global Insight, in market prices, North Korea's GDP is an estimated \$12.2 billion. A remarkable fact is that in the post-Korean War and into the mid-1970s, living standards were higher in North Korea than in either South Korea or China. Now, North Korea is far behind its rapidly growing neighbors.

As shown in **Figure 1**, growth in estimated real gross domestic product (GDP) in the DPRK was dropped into the negative for most of the 1990s before beginning to recover in 1999. In 2004 to 2006, growth has been continuing at about 2%, up slightly from earlier years. In essence, the economy is expanding moderately but still is below its 1989 level. In 1989, real per capita gross domestic product on a purchasing power parity basis (using 1996 prices) was estimated at \$3,276. It dropped to \$2,055 in 1998 but had recovered moderately to an estimated \$2,420 by 2006.<sup>9</sup> Nominal per capita GDP (valued at current exchange rates and not adjusted for inflation), similarly dropped from \$1,097 in 1989 to \$706 in 1999 and recovered somewhat to \$909 by 2003, but following the devaluation of the North Korean won in conjunction with economic reforms, fell to a dollar value of \$535 in 2006.

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<sup>4</sup> Global Insight. Korea, North: Economic Trends: Economic Growth: Background. March 4, 2003.

<sup>5</sup> Chao, Julie. Economic Devastation Visible in Pyongyang. Korea Is like a Land Time Forgot, and Crisis with U.S. Isn't Helping. *The Austin American Statesman*, May 3, 2003. P. A17.

<sup>6</sup> Watts, Jonathan. Where Are You, Beloved General? In a Land Where Paranoia, Propaganda, and Poverty Are the Norm, an Albino Raccoon Reassures North Koreans That Good Times Are Ahead. *Mother Jones*, Vol. 28, No. 3, May 1, 2003. P. 52.

<sup>7</sup> UN World Food Programme. WFP Set to Resume Operations in North Korea, Press Release, May 10, 2006.

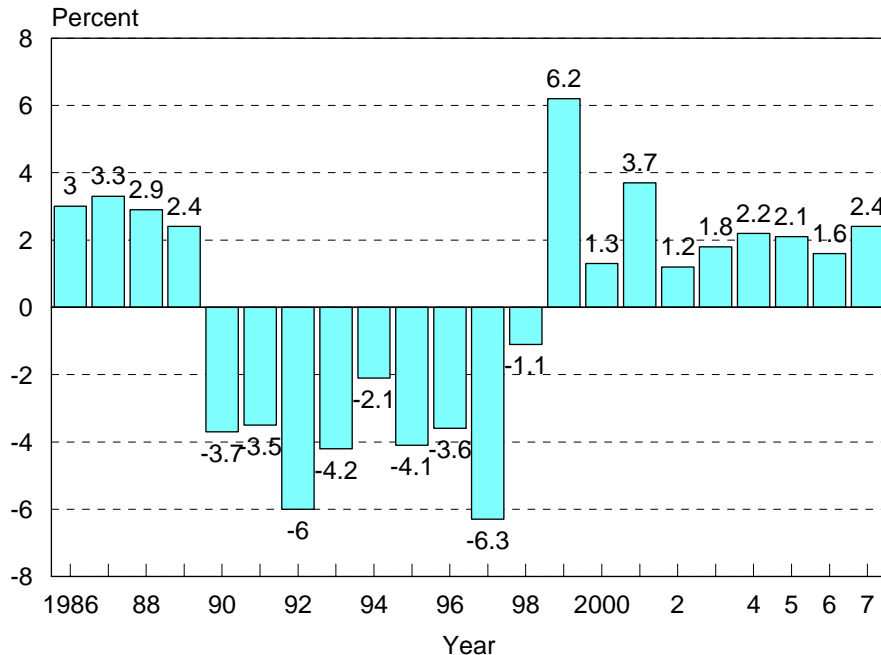
<sup>8</sup> PPI figures are from the World Bank. *World Development Indicators*.

<sup>9</sup> Global Insight. North Korea, Detailed Forecast, annual data. Updated October 2006.



Agricultural production appears to be back around the 1992 level primarily because of better weather and imports of fertilizer from South Korea.

**Figure 1. Real Annual Growth in North Korea's GDP  
1986-2006 with 2007 Estimate**



Sources: Bank of Korea and Global Insight

In this land of scarcity, consumer necessities have been rationed and used to reward party loyalists. Under Pyongyang's economic reforms, this system appears to be phasing out, but in the fall of 2005, North Korea backtracked on some of its economic reforms by forbidding private sales of grains and reinstating a centralized food rationing system. Pyongyang also reportedly closed its food markets but then opened consolidated markets that carried food and other items. According to South Korean observers, North Korea classifies its citizens into three ranks and fifty-one categories based on their ideological orientation. The categories are then used to allocate rations for daily necessities, jobs, and housing.<sup>10</sup> The elite in North Korean society (party cadres who are leaders in the military and bureaucracy) have enjoyed privileges far above the reach of the average citizen. While starvation haunts the provinces, many of the privileged class live in Pyongyang (where provincial North Koreans cannot enter without special permission); some drive foreign cars, acquire imported home appliances, reside in apartments on a lower floor (so they do not have to climb too many stairs when the electricity is out), and buy imported food, medicines, and toiletries at special hard currency stores.<sup>11</sup> The elite have a strong vested interest in maintaining the current economic system, despite its problems.

<sup>10</sup> South Korea. Ministry of Unification. *North Korea Today*, August 14, 2001 (Internet edition).

<sup>11</sup> UN World Food Programme. *World Hunger — Korea (DPR)*. Available at [[http://www.wfp.org/country\\_brief/indexcountry.asp?country=408](http://www.wfp.org/country_brief/indexcountry.asp?country=408)].

Their incomes originate from the treasury, from foreign investors (mostly South Korean), remittances from ethnic Koreans in Japan (although these have been curtailed), and the country's shadowy trade in everything from missile technology to fake banknotes and narcotics.<sup>12</sup>

## Economic Philosophy

The Pyongyang regime has pursued a policy of self-sufficiency and isolation from the world economy that they call *juche* or self-reliance. *Juche* goes beyond economics as it has been used since the 1950s to perpetuate power by the central government and to build an aura of the supernatural around their supreme leaders Kim — both father and son.<sup>13</sup> Although the regime does not emphasize the connection, the current system of dynastic succession with a paramount father figure also harkens back to Confucianism and the powerful dynastic tradition that united the Korean peninsula for hundreds of years.

The economic practice of *juche* has minimized international trade relations, discouraged foreign direct investment, and fostered what it considers to be core industries — mostly heavy manufacturing. While promoting such heavy industry, for most of the post-Korean War period, Pyongyang has emphasized the parallel development of military strength.

Current head of state, Kim Jong-il (often referred to as “Dear Leader”), has given highest priority to the military. This places the army ahead of the working class for the first time in the history of North Korea's so-called revolutionary movement.<sup>14</sup> Under Kim Il-sung (Kim Jong-il's father), the *juche* ideology placed equal emphasis on political independence, self-defense, and economic self-support capabilities. Kim Jong-il, however, insists that North Korea can be a “country strong in ideology and economy” only when its military is strong.<sup>15</sup> The country, therefore, has been developing its industries within the context of a military-industrial complex with strong links between heavy industry and munitions production. Some of North Korea's munitions industries (manufacturing dual use products) are virtually indistinguishable from those supplying civilians.<sup>16</sup>

In 2005, Pyongyang's defense budget was an estimated \$1.9 billion to maintain its 1.1 million member military. South Korea estimated the North's military expenditures at \$5 billion in 2003. In 2006, North Korea stated that the defense

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<sup>12</sup> Desperate Straits, Special Report (1). *The Economist*, May 3, 2003 (U.S. Edition).

<sup>13</sup> See, for example: Natural Wonders Prove Kim Jong-Il's Divinity: North Korean Media, Agence France Presse. May 3, 2003.

<sup>14</sup> British Broadcasting Corporation. N. Korea: Paper Supports Leader Kim Jong-il's Military-first Ideology, April 26, 2003. Reported by BBC from KNCA News Agency (Pyongyang).

<sup>15</sup> Toyama, Shigeki. Expert on Kim Chong-il's “Military-First Politics,” South-North Issues, Tokyo Gunji Kenkyu (in Japanese, translated by FBIS), August 1, 2002. P. 108-117.

<sup>16</sup> Nam, Woon-Suk. Guidelines of Economic Policies. KOTRA, January 9, 2001.

budget was 15.9% of its total annual budget, but others had put the figure at 27.2% in 2003.<sup>17</sup>

The heavy weight of the military in Pyongyang's decision making may help explain what to outsiders seem to be inexplicable actions by the North Korean government. For example, almost immediately after negotiators had issued the September 19, 2005, Six-party Statement in which North Korea ostensibly committed itself to abandoning all nuclear weapons and existing nuclear programs, Pyongyang began backtracking and within two months announced a boycott of future Six-Party Talks.<sup>18</sup> It also may help explain North Korea's carrying out its first nuclear test on October 9, 2006, despite being warned not to do so by the United States, China, and other nations.

When *juche* is combined with central planning, a command economy, and government ownership of the means of production, economic decisions that in a market economy would be made by private business and farmers have to go through a few elite in Pyongyang. These decision makers may or may not understand advances in agronomy or manufacturing and tend to be motivated by non-economic factors, such as maintaining political power or avoiding blame for initiatives gone awry. Farming methods based partly on crop rotation or new varieties of rice, for example, may be viewed as too risky.<sup>19</sup> Foreign investment also is hindered partly because the regime abhors being "exploited" by capitalists who seek to make profits on their business ventures in North Korea and partly because of their deep-seated mistrust of Westerners, Japanese, and South Koreans.

As with other isolationist economies in the contemporary world of globalization and interlinked societies, North Korea has been plagued with the negative effects of its attempts at self sufficiency: technological obsolescence, uncompetitive exports, economic privation, and lack of foreign exchange. These difficulties, together with advice from China and the demise of the Stalinist economy in Russia, have compelled the Pyongyang regime to introduce some economic reforms, or what they refer to as "adjustments." To a large extent, they are adopting the Chinese reform sequence with economic reforms preceding political reforms while eschewing the Russian model of political reform preceding and concurrent with economic reforms.

## Industrial Sectors

North Korea's industrial sectors are shifting rapidly. At the end of World War II, the DPRK represented the industrialized part of the Korean peninsula. Under Japanese colonialism, heavy industry, water power, and manufacturing were concentrated in the North, while agriculture flourished in the less mountainous

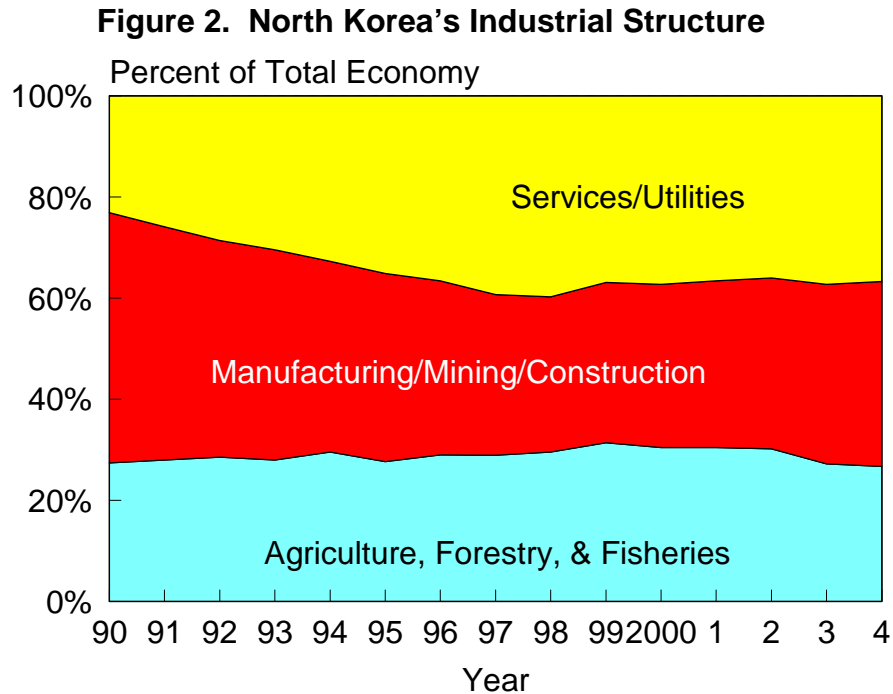
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<sup>17</sup> The International Institute for Strategic Studies. *The Military Balance, 2006*. London, Routledge, 2006. P. 276.

<sup>18</sup> Asia: The deal that wasn't; North Korea. *The Economist*. London: September 24, 2005. p. 81.

<sup>19</sup> Current experiments in agriculture are directed from Pyongyang with seven major tasks that include replacing chemical fertilizers with organic and microbial ones. See Yonhap News. N. Korea Eyes China as a Model for Development. May 11, 2004.

South. Even in 1990, 49% of the North Korean economy was in mining, manufacturing, and construction, while 23% was in services (including government and utilities) and 27% in agriculture. In recent years, however, the DPRK's non-military industries have almost collapsed. By 1997, mining, manufacturing, and construction had dropped from 49% to 32% of the economy but in 2003 had risen somewhat to 36%. In 2003, services had risen to 37% of the economy, while agriculture has remained fairly constant at 27%. (See **Figure 2.**) Some of the most advanced industries in North Korea are associated with its military.



Source: The Bank of Korea.

The drop in the share of manufacturing in GDP has come about largely because of the rapid decline in production from factories, not because of large absolute increases in services or agricultural production. Reports indicate that factories have been running at about 30% of their capacity. The economy lacks food for workers, raw materials, energy, and foreign currency to buy new equipment and imported inputs into the manufacturing process.<sup>20</sup> Much industrial capital stock is nearly beyond repair as a result of years of underinvestment and shortages of spare parts. Recently, the government has emphasized earning hard currency, developing information technology, addressing power shortages, and attracting foreign aid, but it appears unwilling to do so in any way that jeopardizes its control. It has initiated some market-oriented reforms and allowed some liberalization that might bring new capital and production methods into its factories, but it is a long way from the reforms that have occurred in other socialist countries.

<sup>20</sup> Former North Korean Professor Interviewed on Pyongyang's Economic Reform. *Choson Ilbo*, April 14, 2003. Translated and reported by BBC Worldwide Monitoring, April 18, 2003.

The agricultural sector also is in dire straits. The economy depends heavily on collective farms that have been devastated by drought or floods, lack of fertilizers and other inputs, antiquated farming methods, and a lack of incentives for private production. A report in 2003 from North Korea indicated that the situation along the border with China had deteriorated to the point that rates of starvation, disease, and even suicides were reaching a crisis point.<sup>21</sup> The situation arguably would be worse without international food and other humanitarian aid.

## Economic Reforms and Free Trade Zones

In July 2002, Pyongyang announced a series of economic reforms that some surmise may mark the beginning of the end of the Stalinist controls over the economy and the onset of more use of the market mechanism to make economic decisions, particularly production and consumer purchases. Although the government has dubbed the reforms an “economic adjustment policy,”<sup>22</sup> the actions appear to be a desperate attempt to revive the moribund economy, similar to what was done in China. The reforms also dovetail with North Korea’s “military first” policy. As Kim Jong-il has given first priority to the military, the rest of the population has suffered.<sup>23</sup> This, in turn, has raised pressures on Pyongyang to reform its economic system.

The adjustments featured an end to the rationing system for daily commodities (except for food), a huge increase in prices of essentials and in wages, a major devaluation of the currency (official exchange rate), abolishment of the foreign exchange coupon system, increased autonomy of enterprises, authorization of the establishment of markets and other trading centers, and a limited opening of the economy to foreign investment. Prices still remain under centralized control but at levels closer to those existing in peasant (free) markets. North Korea has not abandoned the socialist planned economy, but it has been compelled to reform certain aspects of it.

Under the reforms, overall prices were increased by 10 to 20 times. Government prices for many essential items, however, rose by much more. The price for rice rose by 550 times, for corn 471 times, for diesel oil 38 times, and for electricity 60 times. Wages also were raised but not enough to keep pace with skyrocketing consumer prices. Wages rose by 18 times for laborers and 20 times for managers.<sup>24</sup> Even though not all workers received the promised wage increases, the price and wage reforms caused households to face rampant consumer inflation, and many people ended up worse off financially than before the reforms.

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<sup>21</sup> Gifford, Rob. North Korea (audio report), NPR Morning Edition, April 30, 2003.

<sup>22</sup> Hong, Ihk-pyo. A Shift Toward Capitalism? Recent Economic Reforms in North Korea. *East Asia Review*, vol. 14, Winter 2002. Pp. 93-106.

<sup>23</sup> In January 2007, the communist party’s central committee reportedly asked families to “voluntarily” offer food to the army, since the food shortage in the people’s army was severe. Yang, Jung A. Citizens Exploited as the Nation Cannot Produce its Own Income. *The Daily NK* (Internet edition), January 24, 2007.

<sup>24</sup> Hong, Ihk-pyo, A Shift Toward Capitalism?, *East Asia Review*, Winter 2002. Pp. 96.

In North Korean factories, reforms include greater control over prices, procurement, wages, and some incentives to increase profits in order to distribute them based on individual performance. The regime also is looking to implement reforms in agriculture similar to those implemented in China (along the lines of the rural household contract system). In the mid-1990s, North Korea's agricultural work squads had already been reduced in size. Now they are moving toward family oriented operations with farmers allowed to retain more of any production exceeding official targets.

Although small farmers' markets have long existed in North Korea, Pyongyang did not legalize such farmers' markets until June 2003. This followed the formal recognition of commercial transactions between individuals and the 1998 revision to the constitution that allowed individuals to keep profits earned through legitimate economic activities.<sup>25</sup> Now free markets and shopping centers that use currency, not ration coupons, are spreading. The Pyongyang Central Market, for example, became so crowded that a new, three-story supermarket had to be built. Pyongyang's Tongil market with its lines of covered stalls stocked with items such as fruit, watches, foreign liquor, clothes, Chinese-made television sets, and beer from Singapore also is bustling with sellers and consumers reminiscent of those in other Asian countries.<sup>26</sup> Visitors to Pyongyang in late 2006 indicated that the market was thriving with all types of products and shoppers driving European cars.<sup>27</sup>

## Foreign Investment

North Korean economic reforms also include opening certain areas to foreign investment. Under the Joint-Operation Act of 1984 to 1994, there were 148 cases of foreign investment worth about \$200 million into North Korea. Of these 148 cases, 131 were from pro-North Korean residents of Japan. In 1991, Pyongyang opened the Rajin-Sonbong free trade zone and established the Foreigner Investment Act. To 1997, some 80 investments totaled \$1.4 million. Other areas receiving foreign investment include Nampo, Pyongyang, Kosung-gun, Shimpo, Wonsan, and Mt. Kumkang. Foreign companies in North Korea include 50 South Korean companies (e.g., Hyundai, Daewoo, Taechang, LG, Haeju, and G-Hanshin), DHL, ING Bearing Bank; Japan's Hohwa, Saga, and New Future Ltd. companies; Taiwan's JIAGE Ltd., and the China Shimyang National Machinery Facility Sales Agency Corporation.<sup>28</sup> The U.N. Development Programme is promoting the Tumen River Valley Development Project which aims to develop business based on transit

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<sup>25</sup> Jeong, Chang-hyun. Capitalist Experiments Seen Expanding into DPRK. *Joong Ang Ilbo*, October 19, 2003. Translated in CanKor #160 by Cananda-DPR Korea e-clipping Service, April 13, 2004.

<sup>26</sup> Lintner, Bertil. North Korea, Shop Till You Drop, *Far Eastern Economic Review*, May 13, 2004. P. 14-19.

<sup>27</sup> Pritchard, Charles L. Siegfried S. Hecker, and Robert Carlin. News Conference: Update from Pyongyang, sponsored by the Korea Economic Institute, held at the National Press Club, Washington, DC, November 15, 2006.

<sup>28</sup> KOTRA, North Korea, Status of Induced Foreign Capital.

transportation, tourism, and commissioned processing trade.<sup>29</sup> Mt. Kumkang has been developed with the cooperation of South Korea's Hyundai corporation into a tourist destination for South Koreans and a venue for reunions of families separated by the DMZ.

Since 2000, the DPRK has attempted to emulate China's highly successful free trade zones (FTZ) by establishing the Sinuiju Special Administrative Region (SAR) on the northwestern border with China and Kaesong (Gaesong) Industrial Complex along the border with South Korea. Since being established in 2002, the development of the Sinuiju SAR has been stymied because of the arrest by Beijing of Chinese businessman Yang Bin, a Chinese-Dutch entrepreneur who was named as its governor, on charges of illegal land use, bribery and fraud. After Kim Jong-il's visit to China in 2006, Sinuiju appears to be receiving new attention. Foreign currency management groups reportedly are moving in, and ordinary citizens are being replaced by residents of Pyongyang and other areas.<sup>30</sup>

## **Kaesong Industrial Complex**

Currently, the most significant effort at creating free-trade zones is the Kaesong Industrial Complex (KIC). This joint effort between the North and South is developing rapidly, despite tensions over North Korea's testing of ballistic missiles and a nuclear weapon. The KIC is managed by South Korea's Hyundai Asan and Korea Land Corporation. Located just over the border 43 miles north of Seoul on the route to Pyongyang, this 810-acre complex aims to attract South Korean companies, particularly small and medium sized enterprises, seeking lower labor and other costs for their manufactured products and who may not be able to establish subsidiaries in China or other countries. In January 2006, 15 companies had begun operations in Kaesong. By January 2007, they were employing 8,746 North Korean personnel (another 2,206 North Koreans were working in construction in the complex). To be completed in three stages, the first stage (2002-2007) had 3.3 million square meters of a total of 66 million square meters being constructed or under construction in 2006. Hyundai Asan and the Korea Land Corporation plan to eventually attract 300 businesses in the first stage, 700 in the second, and 1,000 businesses in the third stage with an estimated total of 300,000 workers. Of the \$374 million initial cost for the first stage, \$223 million was to be provided by the South Korean government. In December 2006, the Korea Electric Power Corporation connected North and South Korea by a 100,000 kilowatt power-transmission line for use by the companies in the KIC.

The 15 companies operating in Kaesong in 2006 and their products include Living Art (kitchenware), Shinwon (apparel), SJ Tech (semiconductor component containers), Samduk Trading (footwear), Hosan Ace (fan coils), Magic Micro (lamp assemblies for LCD monitors), Daewha Fuel Pump (automobile parts), Taesung Industrial (cosmetics containers), Bucheon Industrial (wire harness), Munchang Co. (apparel), Romanson (watches, jewelry), JY Solutec (automobile components and molds), TS Precision Machinery (semiconductor mold components), JCCOM

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<sup>29</sup> K. Park. A Report on Visit to Rajin-Seonbong Region, January 4, 2001. KOTRA,

<sup>30</sup> Institute For Far Eastern Studies. Interest Revived in the Sinuiju Special Administrative Region. Reported by Nautilus Institute, Policy Forum Online 06-25A, March 30, 2006.

(communication components), and Yongin Electronics (transformers, coils).<sup>31</sup> In 2006, the KIC produced some \$7.5 million worth of goods each month.<sup>32</sup>

Kaesong developed partly from South Korea's sunshine policy of economic engagement with the North. The KIC serves both geopolitical and economic purposes. Geopolitically, it provides a channel for rapprochement between North and South Korea, a bridge for communication, a method of defusing tensions, and a way to expose North Koreans to outside ideas and ways of doing business. Economically, the KIC provides small- and medium-sized South Korean firms with a low-cost supply of labor for manufacturing products, provides jobs for North Korean workers, and provides needed hard currency for Pyongyang. Even after the North Korean nuclear test in 2006, KIC operations continued.

A controversial issue has arisen with respect to the KIC and the proposed South Korea-U.S. Free-trade Agreement. South Korea has requested that products exported from the complex be considered to have originated in South Korea in order to qualify for duty free status under the proposed FTA. Such a provision has been included in other South Korean FTAs. The U.S. negotiating position, however, has been that only products made in South Korea would be included.<sup>33</sup> At a House International Relations Committee hearing on July 20, 2006, Assistant U.S. Trade Representative Karan Bhatia indicated that the proposed FTA would not cover goods made in a free-trade zone in North Korea.<sup>34</sup>

Other issues raised by the K.C. have been the conditions for North Korean workers, whether they are being exploited,<sup>35</sup> as well as the hard currency funds the industrial complex provides for the ruling regime in Pyongyang. South Korean officials, as well as other analysts, point out that average wages and working conditions at Kaesong are far better than those in the rest of North Korea. The monthly minimum wage is \$50 (\$57.50 including the cost of social insurance). General workers receive \$50, team leaders receive \$52-\$55, and heads of companies receive \$75 per month. After the government, takes its share of the wages, the workers receive about \$37 per month. Workers also receive overtime pay.<sup>36</sup>

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<sup>31</sup> Republic of Korea. Ministry of Unification. Gaeseong Industrial Complex Project — Status and Tasks, June 2005.

<sup>32</sup> South Korea to Continue “Utmost Efforts” for Inter-Korean complex — Minister. Yonhap News Agency. Reported by BBC Monitoring Asia Pacific. London, December 8, 2006.

<sup>33</sup> For details, see CRS Report RL33435, *The Proposed South Korea-U.S. Free Trade Agreement (KORUS FTA)*, by William H. Cooper and Mark E. Manyin.

<sup>34</sup> Hyde Warns USTR to Keep Kaesong, Visas out of Korea FTA. *Inside US Trade*, July 21, 2006.

<sup>35</sup> Rights Body Criticizes South Korea Over Refugee Protection, Inter-Korean Complex. Yonhap News Agency, Seoul. Reported by BBC Monitoring Asia Pacific. London, January 12, 2007.

<sup>36</sup> South Korea Considers Expanding Joint Industrial Complex in North. Yonhap News Agency, Seoul. Reported by BBC Monitoring Asia Pacific. London, July 26, 2006. Ministry of Unification (South Korea). The Gaesong Industrial Complex. Status of North Korean Workers. November 14, 2006. On Internet at [<http://www.unikorea.go.kr/english/EUP/>



The North Korean government derives hard currency from several sources in the KIC project, including leasing fees and its cut from the wages of North Korean workers. The wages are first paid in hard currency to a North Korean government agency that takes a certain percentage before paying the North Korean workers in won. If the government collects about \$20 per month (in social insurance taxes plus its cut of wages) for each of the 10,000 workers now at Kaesong, its monthly take from wages would amount to approximately \$200,000 per month or \$2,440,000 over a year. One estimate is that Pyongyang has earned a total of about \$20 million from the Kaesong Industrial Complex.<sup>37</sup>

## International Trade

Despite North Korea's isolation and emphasis on *juche*, it does trade with other countries. The foreign economic sector plays an important role for Pyongyang in that it allows the country to import food, technology, and other merchandise that it is unable to produce in sufficient quantities at home. Since North Korea does not export enough to pay for its imports, it generates a deficit in reported merchandise trade that must be financed by other means. Pyongyang has to find sources of foreign exchange — other than from its overtly traded exports — to pay for the imports. Experts surmise that North Korea's involvement in illicit or questionable economic activities, particularly illegal drug trade and sales of military equipment, may be an attempt to generate the foreign exchange necessary to fill this trade gap.<sup>38</sup>

Detailed data on the country's external economic relations suffer from reliability problems similar to those associated with the domestic economy. The foreign economic data on actual commercial transactions, however, tend to be the most accurate since they also are reported by trading partner countries and are compiled by the International Monetary Fund and United Nations. Individual countries, for example, report on their imports from and exports to North Korea. These data, however, differ from North Korea's actual annual numbers because of the time lag in shipping (a product shipped from a country in late December of a year might not be recorded as arriving in North Korea until the following year), costs of freight and insurance (North Korean import data may be on a c.i.f. basis that includes insurance and freight charges that are not included in a country's export data), and differences in data gathering methods, coverage, and reporting. Detailed and reliable data on trade in military equipment and illegal drugs are notoriously difficult to obtain and to verify.

South Korea also compiles statistics on trade with North Korea that differ from its data reported to the United Nations. South Korea considers trade with the North

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<sup>36</sup> (...continued)  
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<sup>37</sup> CRS Report RL33435, *The Proposed South Korea-U.S. Free Trade Agreement (KORUS FTA)*, by William H. Cooper and Mark E. Manyin.

<sup>38</sup> Eberstadt, Nicholas Statement. Hearing on Drugs, Counterfeiting, and Weapons Proliferation: The North Korean Connection, Subcommittee on Financial Management, the Budget, and International Security, U.S. Senate Committee on Governmental Affairs, May 20, 2003.

as inter-Korean trade, not foreign trade. The trade figures that South Korea report to the IMF for its commercial transactions with the North are considerably lower than the figures that it reports as inter-Korean trade [available from the Korean Trade-Investment Agency (KOTRA)]. The South Korean data also include more detail on non-transactional trade (mostly foreign aid) with North Korea. IMF data also differ somewhat from those reported by data vending companies (such as World Trade Atlas). This report uses a combination of trade totals from the IMF, partner country data from the World Trade Atlas, and intra-Korean trade from South Korea's KOTRA.

**Table 1. North Korean Trade by Selected Trading Partner  
Selected Years, 1994-2006**  
(\$ in millions)

North Korean Exports to:										
	1994	1998	1999	2000	2001	2002	2003	2004	2005	2006
World	1,039	965	892	995	1,047	1,274	1,206	1,462	1,760	n.a.
China	181	51	42	37	167	271	395	582	497	468
Japan	328	219	203	257	226	234	174	164	132	76
S. Korea	176	92	122	152	176	272	289	258	340	520
Russia	44	8	7	8	15	10	3	5	7	20
Germany	57	24	20	20	19	25	17	93	15	17
North Korean Imports from:										
	1994	1998	1999	2000	2001	2002	2003	2004	2005	2006
World	1,286	1,300	1,436	2,376	3,520	2,436	2,698	3,258	3,556	n.a.
China	467	357	329	451	571	467	628	794	1,085	1,232
Japan	171	175	148	207	1,065	133	91	89	63	44
S. Korea	18	130	212	273	227	370	435	439	715	830
Russia	70	56	48	36	56	47	112	205	198	191
Germany	59	24	32	53	82	141	71	67	62	59
Balance of Trade	-247	-335	-544	-1,381	-2,473	-1,162	-1,492	-1,796	-1,796	n.a.

**Source:** S. Korean data from S. Korea, Unification Ministry. World trade data from International Monetary Fund, *Direction of Trade Statistics*. Country data from World Trade Atlas. World sum is the estimated total North Korean trade plus trade with South Korea.

**Note:** Global Insight estimates North Korea's balance of trade to be -\$1.581 billion in 2004, -\$1.303 billion in 2005, and -\$1.414 billion in 2006, but these figures do not include trade with South Korea. n.a. = not yet available.

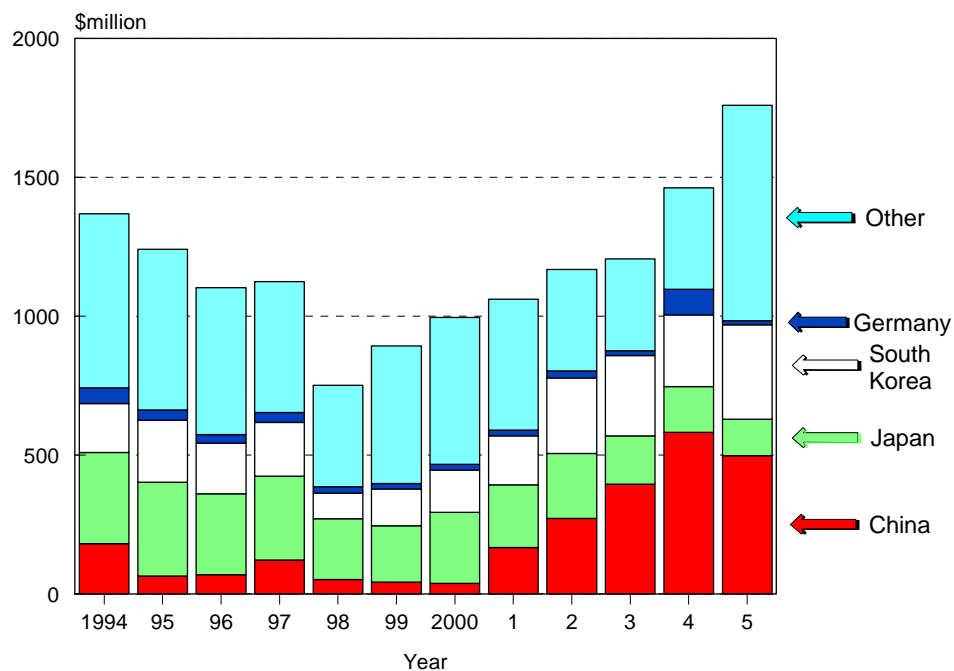
The DPRK's policy of *juche*, its suspicion of foreign countries, and the collapse of its industrial production, has resulted in a minimal level of commercial relations with other nations in the world. As shown in **Table 1**, in 2002 it exported \$1,274 million in merchandise exports (up from \$1,047 million in 2001) while importing

\$2,436 million (down from 2001 but up slightly from recent years) for a merchandise trade deficit of \$1,162 million. Total exports in 2003 appear to have declined slightly. After exports dropped in 1998, they have recovered considerably in recent years, although they are still quite a bit under their 1990 levels.<sup>39</sup>

North Korea's major trading partners have been China, Japan, South Korea, Russia, Germany, Brazil, India, Thailand, Singapore, and Hong Kong. As shown in **Figure 3**, North Korea's major import sources have been China, Japan, South Korea, Russia, and Germany. Thailand and India also are becoming major suppliers. Major imports by North Korea include machinery, minerals, plant products, and chemical products.<sup>40</sup> In particular, imports of energy materials and foods reflect Pyongyang's attempts to remedy these fundamental shortages.

Despite current tensions over Pyongyang's nuclear program, imports appear to be growing and may have exceeded their peak in 2001. Fuel imports from China, and food imports from various countries account for most of the increases. Trade with Japan has been decreasing, while trade with South Korea has increased considerably.

**Figure 3. North Korean Exports of Merchandise by Major Country of Destination, 1994-2005**



Source: IMF, *Direction of Trade Statistics*, (South) Korean Trade and Investment Agency (KOTRA), and World Trade Atlas.

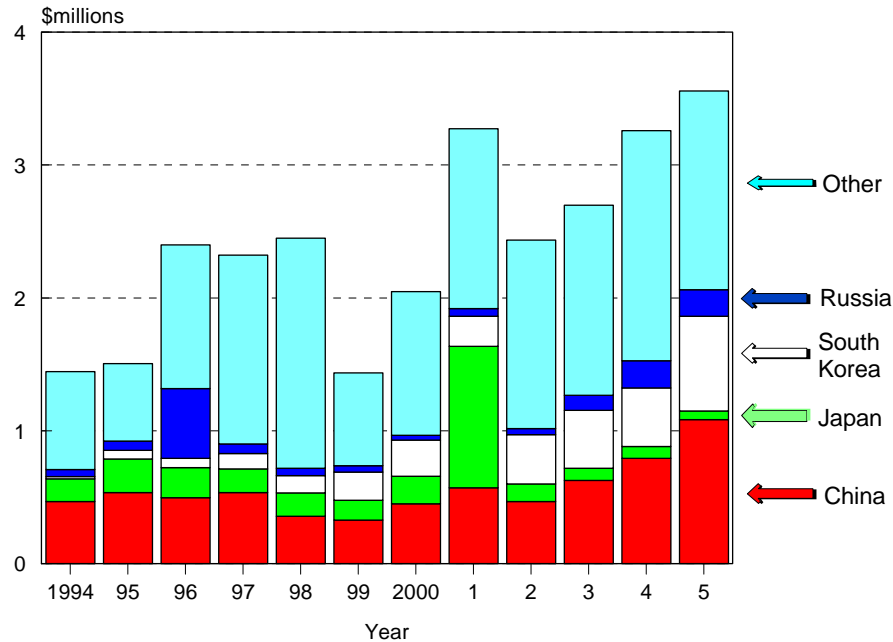
Major export markets for the DPRK have been Japan and China with South Korea developing as a major market following the easing of relations. (See **Figure**

<sup>39</sup> (South) Korea Trade-Investment Agency (KOTRA).

<sup>40</sup> (South) Korea Trade-Investment Agency (KOTRA).

4.) In Europe, Germany has been North Korea's major trading partner, and in Latin America, Brazil is developing as a market for North Korea's exports. In 2003, exports to Japan declined — due in part to friction over the DPRK's admitted kidnappings of Japanese citizens. North Korea's major exports include animal products, textiles, machinery, electronic products, and base metals.

**Figure 4. North Korean Imports of Merchandise by Major Country Source, 1994-2005**



Source: Data from IMF, Direction of Trade Statistics, World Trade Atlas, & (South) Korean Trade-Investment Agency (KOTRA).

A recent remarkable development has been North Korea's increase in exports of primary products (such as fish, shellfish and agro-forest products) as well as mineral products (such as base metallic minerals). Pyongyang reportedly has imported aquaculture technology to increase production of cultivated fish and agricultural equipment to increase output of grains and livestock. It also has imported equipment for its coal and mineral mines. Some of this increased output is being sold abroad to generate foreign exchange to fund imports.<sup>41</sup>

Meanwhile, traditional exports of textiles and electrical appliances have been declining. This reflects North Korea's unstable power supply, lack of raw materials and components imported from abroad, and the need to ship finished goods to China or another third country for final inspection. This diminishing ability of North Korea to provide a reliable manufacturing platform for the least complicated assembly operations does not bode well for the country's future ability to generate the exports necessary to balance its trade accounts.

<sup>41</sup> KOTRA. North Korea's Foreign Trade in 2001. Available at [<http://crm.kotra.or.kr>].

## Other Sources of Foreign Exchange

North Korea's annual merchandise trade deficit of \$1 billion or more implies that Pyongyang must be generating that amount in foreign exchange through some means — either legal or illegal. Legal means include borrowing, foreign investments, foreign aid, remittances from overseas North Korean workers, selling military equipment not reflected in trade data, and by selling services abroad. Illegal methods include the counterfeiting of hard currency, illegal sales of military equipment or technology, sales of illegal drugs, or by shipping illegal cargo between third countries. The country also can dip into their foreign exchange reserves.

### Legal Sources of Funds

North Korea is able to borrow on international capital markets. As of the fourth quarter of 2006, the country had loans from foreign located banks of \$197 million (up from \$121 million at the end of 2005, \$81 million in 2004, and \$190 million in 2003). The figure for 2006 is a relatively small amount, only \$8.50 per capita. If loans from foreign controlled banks are added to those from foreign located banks, the total comes to \$306 million for the fourth quarter of 2006. Total consolidated liabilities to foreign banks (including debt securities held by foreign banks) declined to \$133 million by the fourth quarter of 2005 from \$289 million the year previous. By June 2006, however, the total had risen to \$351 million.<sup>42</sup>

International bond issues are not a major source of funds for North Korea. In May 2003, the country issued ten-year bonds — the first since 1950 — but since its sovereign securities are not rated by major Western credit rating agencies, the issue has generated little interest on international financial markets and is aimed at domestic investors. Pyongyang claims that a million people had signed up to receive the bonds, but many speculate that the deductions from the salaries of North Korean purchasers in amounts equivalent to four months' wages to buy the bonds is not voluntary.<sup>43</sup>

Although North Korea is not a major recipient of foreign direct investment (FDI), in 1997 FDI inflows totaled \$307.4 million. Inflows declined to \$30.7 million in 1998, -\$14.9 million in 1999, \$5 million in 2000, -\$4 million in 2001, -\$15 million in 2002, -\$158 million in 2003, \$197 million in 2005, and \$113 million in 2005. In 2005, the stock of FDI in North Korea totaled \$1,495 million.<sup>44</sup> North Korea's free trade zones, however, are attracting more foreign direct investment, but so far the actual inflows appear to have been fairly modest. South Korea's Hyundai Corporation, however, secretly paid North Korea nearly \$500 million, partly in money borrowed from the South Korean government just a week before the two nations held a historic summit in June 2000. This was part of an estimated billion

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<sup>42</sup> Data are from: Joint BIS-IMF-OECD-WB External Debt Hub at [[http://devdata.worldbank.org/sdmx/jedh/jedh\\_home.html](http://devdata.worldbank.org/sdmx/jedh/jedh_home.html)].

<sup>43</sup> Gittings, Danny. Kim Can't Kill the Free Market. *The Wall Street Journal (Brussels)*, May 30, 2003. P. A11.

<sup>44</sup> United Nations Conference on Trade and Development. *World Investment Report, 2006*. New York, United Nations, Foreign Direct Investment Database.

dollars or more Hyundai was to pay for exclusive rights to engage in seven major economic projects there.<sup>45</sup>

A major source of funding for imports into the DPRK has been foreign aid or direct government transfers. Both developmental and humanitarian aid and past assistance under KEDO (Korean Peninsula Energy Development Organization, created under the 1994 Agreed Framework, but construction was terminated in 2003) to build two light water nuclear reactors and provide heavy fuel oil have enabled imports into North Korea without financing from Pyongyang.

**Table 2. North Korea: Total Receipts by Major Source/Donor, 1999-2005**  
(\$ in millions)

	Total Receipts Net						
	1999	2000	2001	2002	2003	2004	2005
U.S.	146.3	1.6	0.3	131.2	42.9	56.5	7.9
Germany	-0.3	-2.4	34.1	35.0	11.8	54.2	6.6
France	0.7	28.4	12.8	-656.4	447.7	1,151.1	6.2
Australia	4.7	7.9	4.8	5.4	2.1	3.9	5.3
Norway	3.9	4.6	7.9	5.5	9.5	5.6	5.3
Sweden	4.4	3.5	3.4	4.3	4.9	46.2	59.4
Switz.	-5.9	1.0	6.1	2.1	4.0	3.9	4.2
UK	-11.9	-7.4	1.1	-15.9	44.8	142.3	0.2
EC	16.9	25.0	40.3	61.2	30.9	31.4	19.4
Multilateral	35.6	46.4	65.0	40.1	51.7	47.5	41.5
World Food Program	0.4	0.6	0.6	0.1	3.2	7.5	8.4
Arab Countries	..	..	.4	1.8	1.3	10.8	..
<b>Total</b>	<b>156.6</b>	<b>76.07</b>	<b>188.6</b>	<b>-440.2</b>	<b>630.2</b>	<b>1,564.7</b>	<b>144.1</b>

**Source:** Organisation for Economic Cooperation and Development. *Source OECD, International Development Statistics*, on-line database. [<http://stats.oecd.org>]

**Note:** Data are from OECD members, multilateral agencies, and 12 other reporting nations excluding South Korea, China, and Russia. Multilateral Agencies include the UN, International Fund for Agricultural Development, Arab Agencies, and European Community. EC = European Community. Total Receipts include Official Development Assistance + Other Official Flows + Private Flows.

<sup>45</sup> Seo, Soo-min. Questions Linger Despite President's Statement. *Korea Times*, February 14, 2003. Dorgan, Michael. Secret Payment to North Korea Disclosed, *Knight Ridder Newspapers*, January 30, 2003.

North Korea also receives funds in the form of official development assistance (ODA) from aid donor nations, multilateral development banks, and other organizations; other official flows; and private flows. The Organisation for Economic Co-operation and Development (OECD) compiles these data from its member nations plus 12 others and from multilateral agencies. The OECD data, however, do not include reporting from South Korea (Seoul considers transactions with the North as intra-country, not as foreign), China, or Russia (not members of the OECD). As shown in **Table 2**, in 2004, net total receipts for North Korea came to \$1,564.7 million from donors, primarily because of a \$1,151.1 million receipt from France, \$142.3 million from the United Kingdom, and \$56.5 million from the United States. In 2005, however, the net total dropped to \$144.1 million as the dispute over North Korea's nuclear program escalated.

As shown in **Table 3**, much of the total receipts by North Korea came in the form of official development assistance. In recent years, the country has received between \$73 and \$201 billion in net official development assistance (ODA) from the countries and agencies that report such data to the OECD. In 2004, total net ODA was \$195.9 million and in 2005 was \$81.1 million. The major donors have been the multilateral agencies, European Community, the United States, Sweden, Norway, and Germany. South Korean, Chinese, and Russian aid to North Korea is not included in the ODA data.

**Table 3. North Korea: Net Official Development Assistance by Major Source/Donor, 1999-2005**  
(\$ in millions)

	Total Net Official Development Assistance						
	1999	2000	2001	2002	2003	2004	2005
U.S.	146.3	1.6	0.3	131.2	42.9	55.7	7.9
Germany	2.9	1.5	27.0	33.2	7.2	7.5	5.2
France	0.1	1.7	0.3	0.5	-0.4	-0.5	-0.4
Australia	4.0	7.1	4.6	2.0	2.1	3.3	4.6
Norway	3.9	3.3	3.5	3.6	4.4	5.6	5.3
Sweden	4.4	3.5	3.4	4.3	4.9	5.4	5.5
Switzerland	2.0	2.6	4.5	3.4	4.0	3.9	4.2
European Community	16.9	25.0	40.3	61.2	30.9	31.4	19.4
Multilateral Agencies	35.6	46.4	65.0	75.5	51.7	47.5	41.5
<b>Total</b>	<b>200.8</b>	<b>73.3</b>	<b>117.6</b>	<b>265.2</b>	<b>167.8</b>	<b>195.9</b>	<b>81.1</b>

**Source:** Organisation for Economic Cooperation and Development, Development Statistics database.

The United States also has paid North Korea to search for remains of American servicemen missing from the Korean War. In 2003, it paid \$2.1 million to conduct four searches.<sup>46</sup>

**Table 4. Economic Aid and Other Official Flows From South Korea to North Korea, 2000-2004 and Total 1995 to 2004**

(\$ in millions)

Year/ Type	2000	2001	2002	2003	2004	Total 1995-2004
<b>Total</b>	<b>706.5</b>	<b>453.2</b>	<b>584.9</b>	<b>650.4</b>	<b>543.3</b>	<b>3,279.7</b>
KEDO <sup>a</sup>	308.9	271.1	288.7	333.0	137.1	1,365.2
Food Aid Pledges	93.4	17.3	120.4	122.2	164.6	794.9
Fertilizer Pledges	83.4	49.5	66.6	70.1	89.8	387.9
Road & Rail Links	12.9	69.6	53.5	94.1	92.6	322.7
Payment for 2000 Summit	200.0					
Mt. Kumgang Tours <sup>b</sup>	—	34.8	43.9	5.1	6.8	90.6
Aid to ROK Business	0.4	0.8	2.2	10.7	11.9	26.1
Kaesong Industrial Complex <sup>b</sup>					21.8	21.8
Family Reunions	2.4	1.0	1.6	2.5	2.8	10.7
Other <sup>c</sup>	5.0	9.1	7.9	12.8	15.9	50.7

**Source:** CRS Report RL31785, *Foreign Assistance to North Korea*, by Mark E. Manyin, Appendix A. See report for data sources and analysis.

a. Korean Peninsula Energy Development Organization

b. Republic of Korea Export-Import Bank's "DPRK Support Fund"

c. Includes Cultural Exchanges and Aid to non-governmental organizations

Since 2000, South Korean government assistance to North Korea has been running at around \$500 million per year (\$543 million in 2004 and \$419 million in 2006). South Korean civilian organizations also provide assistance to North Korea (\$71 million in 2003).<sup>47</sup> The KEDO item is for energy and funds provided to the

<sup>46</sup> U.S. to Pay N. Korea for MIA Search. Associated Press. July 15, 2003. For details on U.S. assistance to North Korea, see CRS Report RS21834, *U.S. Assistance to North Korea: Fact Sheet*, by Mark E. Manyin.

<sup>47</sup> Republic of Korea, Ministry of Unification. Inter-Korean Relations on the Occasion of the 4<sup>th</sup> Anniversary of the June 15 Joint Declaration. June 18, 2004. p. 9.



Korean Peninsula Energy Development Organization in exchange for North Korea's pledge to dismantle its existing nuclear program. This program has been halted.<sup>48</sup>

Another major source of income for certain North Korean families has been in remittances from overseas Koreans, particularly those who live in Japan.<sup>49</sup> Most of the North Koreans in Japan either remained there after World War II or are descendants of those people. Some had been forcibly brought there to work in coal mines or factories during the 50-year Japanese occupation of Korea. Currently, of the approximately 650,000 ethnic Koreans who live in Japan, an estimated 56,000 to 90,000 are from the North Korean area, and many are reported to be actively involved in supporting the Pyongyang regime. Ethnic Koreans in Japan work in a variety of businesses and occupations, but they face discrimination in Japanese society and are known for operating pachinko (pinball) parlors and other enterprises providing entertainment and night life as well as being involved with Japan's *yakuza* or gangsters. Many of these, as well as managers of North Korean-related credit unions, regularly send remittances to relatives or associates in North Korea. One unusual method of smuggling money to North Korea has been to hide 10,000 yen bills (worth roughly \$90 each) under expensive melons being shipped to Kim Jong-il as gifts.<sup>50</sup>

Given the decade of stagnation of the Japanese economy and rising tensions between Japan and North Korea, these remittances have reportedly been declining. A 2003 Japanese newspaper report placed the amount at between \$200 million and \$600 million per year, but that figure could be exaggerated.<sup>51</sup> In testimony before parliament, Japan's Finance Minister stated that in Japan's FY2002, \$34 million had been sent from Japan to North Korea through financial channels that required reports to the Japanese government.<sup>52</sup> A working estimate would be approximately \$100 million per year in such remittances. Anecdotal evidence indicates that considerable amounts of currency from Japan are simply carried by individuals on ships and not reported. More than 1,000 North Korean freight vessels had been traveling between North Korea and Japan each year. Japan, however, has tightened inspections of North Korean ships and curtailed operations of ferry boats traveling between the two countries.<sup>53</sup>

In summary, the DPRK's net total receipts plus remittances, aid and investments from South Korea, and special food and fuel assistance in connection with negotiations over Pyongyang's nuclear program, constitute most of the overt

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<sup>48</sup> CRS Report RS21834, *U.S. Assistance to North Korea: Fact Sheet*, by Mark E. Manyin.

<sup>49</sup> For details, see CRS Report RL32137, *North Korean Supporters in Japan: Issues for U.S. Policy*, by Emma Chanlett-Avery.

<sup>50</sup> Melons Used to Smuggle Cash to N Korea. Japan Today News (Online), January 1, 2003.

<sup>51</sup> Remittance Law Reinterpreted Cash Transfers to Pyongyang May Be Suspended as Deterrent. *The Daily Yomiuri* (Tokyo), May 19, 2003. p. 1.

<sup>52</sup> Japanese Finance Minister Says "At Least" 34m US Dollars Sent to North Korea. Financial Times Information, Global News Wire — Asia Africa Intelligence Wire. June 6, 2003.

<sup>53</sup> See, for example, Masaki, Hisane. N Korea's Missiles Met by Japanese Sanctions, *Asia Times Online*, July 6, 2006.

resource inflows that North Korea receives each year over and above its export earnings. These amount to perhaps a half billion dollars per year but can be offset by loan repayments. North Korea must finance the remainder of its trade deficit — which is about \$1.7 billion — by other means. It appears that these other means include exports of military equipment, counterfeiting currency, and trade in illegal substances.

### **Illegal or Questionable Sources of Funds<sup>54</sup>**

Data on North Korean sales of military equipment abroad is understandably murky, but the country is thought to have sold hundreds of ballistic missiles to Iran, Iraq, Syria, Pakistan, and other nations in the past decade to earn foreign currency.<sup>55</sup> The interdiction by Spain of an unmarked vessel in December 2002 containing parts for 12 to 15 Scud missiles (valued at about \$4 million each) bound for Yemen from North Korea is one example of such arms sales.<sup>56</sup> In testimony before the House Committee on International Relations, the Undersecretary of State for Arms Control and International Security pointed out that North Korea possesses Scud and No-Dong missiles and is developing the Taepo-Dong 2. He stated that the country is by far the most aggressive proliferator of missiles and related technologies to countries of concern. These sales are one of the North's major sources of hard currency.<sup>57</sup> According to a U.S. military officer quoted in the Japanese press, North Korea exported \$580 million worth of ballistic missiles to the Middle East in 2001.<sup>58</sup> Between 1998 and 2001, North Korea is estimated to have exported some \$1 billion in conventional arms to developing nations.<sup>59</sup>

With respect to illegal drug trade, officials from the U.S. military command in Seoul reportedly said that North Korea is earning between \$500 million and \$1 billion annually from the narcotics trade.<sup>60</sup> North Korea is thought to produce more than 40 tons of opium per year which would make it the world's third-largest opium exporter and sixth-largest heroin exporter. The regime also is accused of trafficking in methamphetamine stimulants. U.S. counter-narcotics officials are reported to have said that since 1976, there have been at least 50 arrests or drug seizures involving

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<sup>54</sup> See CRS Report RL33885, *North Korean Crime-for-Profit Activities*, by Raphael F. Perl and Dick K. Nanto.

<sup>55</sup> Asano, Yoshiharu. N. Korea Missile Exports Earned 580 Mil. Dollars in '01. *Daily Yomiuri*, May 13, 2003.

<sup>56</sup> Solomon, Jay. U.S. Debates North Korean Exports, *Asian Wall Street Journal*, May 5, 2003. p. A1.

<sup>57</sup> Testimony of John R. Bolton, Under Secretary for Arms Control and International Security, U.S. Department of State. U.S. House Committee on International Relations, June 4, 2003.

<sup>58</sup> Asano, Yoshiharu. N. Korea Missile Exports Earned 580 Mil. Dollars in '01. *Daily Yomiuri*, May 13, 2003. Pearson, Brendan. Illicit Boost for N Korea Economy. *Australian Financial Review*, May 14, 2003. p. 12.

<sup>59</sup> CRS Report RL33696, *Conventional Arms Transfers to Developing Nations, 1998-2005*, by Richard F. Grimmett. p. 53. This figure is rounded to the nearest \$100 million.

<sup>60</sup> Paddock, Richard C. and Barbara Demick. N. Korea's Growing Drug Trade Seen in Botched Heroin Delivery, *Washington Post*, May 21, 2003.

North Koreans in more than 20 countries. Japanese authorities say that nearly 50% of illegal drug imports into Japan come from North Korea.<sup>61</sup> According to the U.S. State Department, although such reports have not been conclusively verified by independent sources, defector statements have been consistent over years and occur in the context of regular narcotics seizures linked to North Korea. The State Department's *International Narcotics Control Strategy Report* for 2003 states that quantity of information and quality of many reports "give credence to allegations of state sponsorship of drug production and trafficking that can not be ignored. It appears doubtful that large quantities of illicit narcotics could be produced in and/or trafficked through North Korea without high-level party and/or government involvement, if not state support."<sup>62</sup>

In a blatant incident in May 2003, the Australian navy and special forces commandeered a North Korean ship (Pong Su) off the country's southern coast that allegedly was moving 110 pounds of almost pure heroin valued at \$50 million. The ship apparently picked up the heroin elsewhere in Asia and took a circuitous route to Australia.<sup>63</sup>

Allegations also have been made that North Korea engages in counterfeiting operations, particularly of U.S. \$100 notes. It is believed that the country earns \$15 million to \$20 million per year in counterfeiting.<sup>64</sup>

In the opinion of a North Korean expert at Seoul's Sejong Institute, "North Korea's economy had received a death sentence long ago, but it keeps afloat thanks to international aid and the country's trading in weapons and illicit goods."<sup>65</sup>

Since late 2005, the United States has taken several measures to reduce illicit financial activities by North Korea. On June 28, 2006, President Bush issued Executive Order 13382 (Blocking Property of Weapons of Mass Destruction Proliferators and Their Supporters).<sup>66</sup> On October 21, 2005, pursuant to Executive Order 13382, the U.S. Treasury designated eight North Korean entities as proliferators of weapons of mass destruction and their delivery vehicles. The action prohibits all transactions between the designated entities and any U.S. person and freezes any assets the entities may have under U.S. jurisdiction.<sup>67</sup>

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<sup>61</sup> Kim, Ah-young, Halt North Korea's Drug Habit; a Narcotic State, *International Herald Tribune*, June 18, 2003. p. 8.

<sup>62</sup> U.S. Department of State. *International Narcotics Control Strategy Report*, 2003. May 2004.

<sup>63</sup> Struck, Doug. Heroin Trail Leads to North Korea. *Washington Post Foreign Service*, May 12, 2003. p. A01.

<sup>64</sup> For details, see CRS Report RL33324, *North Korean Counterfeiting of U.S. Currency*, by Raphael F. Perl and Dick K. Nanto.

<sup>65</sup> Choe, Sang-Hun. N. Korea Sees Sanctions Amid Tough Times. Associated Press Online, June 12, 2003.

<sup>66</sup> Available at [<http://www.whitehouse.gov/news/releases/2005/06/20050629.html>].

<sup>67</sup> U.S. Department of the Treasury. Treasury Targets North Korean Entities for Supporting WMD Proliferation. Press Release JS-2984, October 21, 2005.

On September 15, 2005, the U.S. Treasury designated Banco Delta Asia SARL as a “primary money laundering concern” under Section 311 of the Patriot Act because it represents an unacceptable risk of money laundering and other financial crimes. Treasury stated that “Banco Delta Asia has been a willing pawn for the North Korean government to engage in corrupt financial activities through Macau ....”<sup>68</sup> On March 14, 2007, the Treasury finalized its rule against Banco Delta Asia, barring the bank from accessing the U.S. financial system, but allowing for the \$25 million in North Korean funds held to be released.

## U.S.-DPRK Trade Relations

U.S. trade with the DPRK is quite limited. The United States does not maintain any diplomatic, consular, or trade relations with North Korea, and the country does not have normal trade relations (most favored nation) status. This means that North Korean exports are subject to the relatively high tariffs existing before World War II in the United States. For example, women’s blouses of wool or cotton carry a 90% import duty if from North Korea but are duty free if from Canada, Israel, or Mexico or are subject to 9 to 10% duty if from most other nations. As a communist nation, North Korea also does not qualify for duty-free treatment of certain products that are imported from designated developing countries under the generalized system of preferences program.<sup>69</sup>

The United States, moreover, maintains various economic sanctions on North Korea because it is on the U.S. State Department list of state supporters of international terrorism, is considered a threat to national security, is a communist state, and it proliferates weapons of mass destruction.<sup>70</sup> Travel to and trade with North Korea in other than dual-use goods are allowed if overarching requirements are met, and there are no restrictions on the amount of money Americans may spend in the DPRK. The sanctions related to the proliferation of weapons of mass destruction generally target the offending entities. North Korean assets in the United States frozen prior to June 19, 2000, remain frozen. North Korea is on the most restricted list of countries for U.S. exports (Country Group E list) of items such as computers, software, national security-controlled items, items on the Commerce Control List,<sup>71</sup> and service or repair of such items. Economic sanctions on North Korea, however, are essentially unilateral by the United States. Most other nations allow relatively free trade in non-sensitive goods with the DPRK.

The issue of trade with the DPRK has arisen during negotiations between the United States and South Korea on the proposed Korea-U.S. Free Trade Agreement. South Korea has proposed that products from the Kaesong Industrial Complex in North Korea be included in the FTA. In essence, this would require that the rules of

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<sup>68</sup> U.S. Department of the Treasury. Treasury Designates Banco Delta Asia as Primary Money Laundering Concern under USA PATRIOT Act. Press Release JS-2720, September 15, 2005.

<sup>69</sup> See CRS Report 97-389, *Generalized System of Preferences*, by William H. Cooper.

<sup>70</sup> See CRS Report RL31696, *North Korea: Economic Sanctions*, by Dianne E. Rennack.

<sup>71</sup> [[http://w3.access.gpo.gov/bis/ear/ear\\_data.html](http://w3.access.gpo.gov/bis/ear/ear_data.html)]

origin in the FTA allow products made in Kaesong by South Korean firms to enter the United States duty free or under the duty stipulated in the FTA. Reportedly, the United States has not agreed to this provision thus far.<sup>72</sup>

The United States uses trade with North Korea as leverage and to send a message of disapproval for various activities by Pyongyang. Unless the political situation between North Korea and the United States is resolved, prospects for increased bilateral trade are dim. In addition to high tariffs and trade sanctions, the United States has blocked North Korea's admission to membership in international financial institutions (such as the World Bank, International Monetary Fund, and Asian Development Bank) which also would allow the DPRK to receive development assistance that would help finance additional imports from countries such as the United States.

**Table 5. U.S. Trade by Commodity With the Democratic People's Republic of Korea (North Korea) in 2004-2006**  
(\$ in thousands)

SITC Category	U.S. Exports			U.S. Imports		
	2004	2005	2006	2004	2005	2006
Cereals and Cereal Preparations	10,285	2,277	0	0	0	0
Fixed Vegetable Fats and Oils	4,259	0	0	0	0	0
Vegetables	3,461	1,806	0	0	0	0
Preparations of Cereal, Flour, starch or Milk; Bakers Wares	2,459	0	0	0	0	0
Misc. Grain, Seed, Fruit		1,573	0		0	0
Dairy Products and Birds' Eggs	1,157	0	0	0	0	0
Misc. Textile Articles	191	0	0	0	0	0
Organic Chemicals	0	0	0	1,418	0	0
Woven Apparel	0	0	0	77	0	0
Tools, Cutlery	0	0	0	0	3	0
Books, Newspapers	0	0	3		0	0
<b>Total</b>	<b>23,750</b>	<b>5,757</b>	<b>3</b>	<b>1,495</b>	<b>3</b>	<b>0</b>

**Source:** U.S. Department of Commerce accessed through World Trade Atlas.

<sup>72</sup> See CRS Report RL33435, *The Proposed South Korea-U.S. Free Trade Agreement (KORUS FTA)*, by William H. Cooper and Mark E. Manyin.

**Table 5** shows U.S. trade with North Korea for 2004-2006. In 2004, U.S. exports to the DPRK of \$23.8 million were mostly for food provided as humanitarian aid. In 2005, food aid was down to \$5.8 million, and in 2006 had ceased. In 2006, the only U.S. exports were books and newspapers worth \$3,000. As for imports, in 2004, the United States imported \$1.5 million in organic chemicals plus \$77,000 in woven apparel from North Korea. In 2005, imports had dropped to \$3,000 worth of tools and cutlery, and were nil in 2006.

**Table 6** shows U.S. merchandise exports, imports, and trade balances with North Korea since 1990. Imports have been zero or relatively low with a peak of \$1,495,000 in 2004. Almost all of these imports from North Korea were organic chemicals and woven apparel. A possible concern is that imports of books, newspapers, and manuscripts have dropped to zero. For a country with great strategic importance to the United States, information on North Korea is not flowing directly into the U.S. market. U.S. exports at \$23,750,000 in 2004 rose from \$32,000 in 1990 to \$25,012,000 in 2002. Another peak occurred in 1995 when U.S. exports totaled \$11,607,000. Of this amount, \$10,810,000 was in cereals. The United States has been running a small annual surplus in its trade with North Korea, but the food aid has been provided without cost to North Korea.

According to the U.S. Department of Commerce, the United States has no direct investment in North Korea.<sup>73</sup> An American company interested in doing business in North Korea, particularly establishing a company, likely would work through an overseas subsidiary. Some American business executives with the U.S. Chamber of Commerce in South Korea, for example, reportedly travel to North Korea for business purposes,<sup>74</sup> and some U.S. enterprises reportedly are working as subcontractors in the development of North Korea's Kaesong industrial complex.<sup>75</sup>

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<sup>73</sup> U.S. Bureau of Economic Analysis. U.S. Direct Investment Abroad Detail for Historical-Cost Position and Related Capital and Income Flows, 2001. *Survey of Current Business*, September 2002, p. 94.

<sup>74</sup> Meeting with President of the American Chamber of Commerce and CRS analysts, April 7, 2003, Washington, DC.

<sup>75</sup> Koo, Kyung-hee. U.S. Enterprises Participate in Developing the Gaeseong Industrial Complex. KOTRA-North Korea Team. January 30, 2004. Reprinted in *KOTRA Bulletin*, February 11, 2004.

**Table 6. U.S. Merchandise Exports, Imports, and Trade Balances with North Korea, 1990-2006**  
(\$ in thousands)

Year	U.S. Exports	U.S. Imports	Balance
1990	32	0	32
1991	484	10	474
1992	83	0	83
1993	1,979	0	1,979
1994	180	0	180
1995	11,607	0	11,607
1996	541	0	541
1997	2,409	0	2,409
1998	4,454	0	4,454
1999	11,265	29	11,236
2000	2,737	154	2,583
2001	650	26	624
2002	25,012	15	24,997
2003	7,977	0	7,977
2004	23,750	1,495	22,255
2005	5,757	3	5,754
2006	3	0	3

**Source:** U.S. Department of Commerce through World Trade Atlas.

## North-South Korean Economic Relations

Economic relations have been a major route for opening relations between North and South Korea. Seoul has a major stake in relations with the DPRK and the outcome of the current Six-Party Talks.<sup>76</sup> It seeks a “soft landing” for the current standoff over the North’s nuclear program — one that will lead to a lessening of tensions and steady integration of North Korea’s economy into the global economic and financial system. As with other countries divided by ideology and a history of hostilities as “pawns” on the chess board of the Cold War, the two halves of the peninsula face numerous issues to be resolved before they can normalize relations — let alone contemplate reunification.

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<sup>76</sup> The Six-Party Talks are made up of representatives from the United States, Japan, North Korea, South Korea, Russia, and China.

South Korea has much to gain from rapprochement with the North. Its strategy has been to use its economic leverage and family reunions (families separated by the division of the Korean Peninsula) to open channels with the North Korean people while maintaining a credible military deterrent to overt hostile action by Pyongyang. South Korea recognizes that essentially it has won the Cold War on the Korean peninsula, but it recoils at the prospect of funding economic rehabilitation in the DPRK as West Germany did with East Germany. Seoul also recognizes that its economic ties are gradually shifting from reliance on the American market to greater integration with China, Japan, and other countries of Asia. Its labor costs are rising, and many of its companies are remaining competitive only by manufacturing in China and other low-wage markets. For them, the prospect of abundant cheap labor just a short distance to the north is appealing and perhaps an alternative to cheap labor in China.

In 2006, total merchandise trade between the two Koreas reached \$1,349.7 million, more than triple the \$403.0 million just five years earlier. The largest increases have been in South Korean exports (\$830.2 million in 2006), although imports also have risen (\$519.6 million in 2006). Much of the increase in exports has been in the form of food and industrial goods. In 2006, \$419.3 million in South Korean exports to the North were actually South Korean aid shipments.

The major items purchased by South Korea from the North include food/aquatic/forestry products, textiles, steel/metal products, and electronics. The major South Korean exports to North Korea include chemicals, textiles, machinery, steel/metal products, and food/forestry products.

Since 1992, particularly under the Sunshine Policy of former South Korean President Kim Dae Jung and under the Policy for Peace and Prosperity of current President Roh Moo-hyun, Seoul has permitted its corporations to pursue business interests in North Korea. In 2003, the government allowed activities by 89 companies including 35 involved in contract processing (assembly, sewing, or other processing done under contract) by North Koreans.<sup>77</sup> The companies included Daewoo (jackets, bags), Samsung Electronics (communications center, switchboard), Samcholi Bicycle, Green Cross (medicine), International Corn Foundation (corn seeds), Hyundai (Mt. Kumkang tourism, development), and Hanshin Co. (glass). The Korea Electronic Power Corporation's work on the construction of a light water nuclear power plant under the U.S.-North Korean 1994 Agreed Framework has been halted.<sup>78</sup> One global strategy of South Korean businesses is to develop processing sites in North Korea to take advantage of low labor costs there; in some cases, labor costs are competitive with those in China. The two countries also have taken some halting steps toward linking their economic systems. In addition to the business

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<sup>77</sup> Speech by Minister Jeong Se-hyun on the 34<sup>th</sup> Anniversary of the Ministry of Unification. *Korean Unification Bulletin*, No. 53, March 2003.

<sup>78</sup> In March 1996, KEPCO was designated the prime contractor for the construction of two 1,000MW light water nuclear reactors in North Korea for KEDO (Korean Peninsula Energy Development Organization). It broke ground near Sinpo in August 1997. By the end of 2001, the project was 16% completed with some 1,200 workers employed. For details on the Agreed Framework, see CRS Report RL33590, *North Korea's Nuclear Weapons Development and Diplomacy*, by Larry Nicksch. For the approval list, see KOTRA, *Companies Approved for South-North Korean Economic Cooperation*.



relationships, since September 2002, the two countries have been reconnecting the Gyeongui (Seoul-Sinuiju) and Donghae (East Sea) railway lines and adjacent highways.

As discussed in the section above on Economic Reforms and Free Trade Zones, the focus of North-South economic cooperation now is the Kaesong Industrial Complex (KIC). Managed by South Korea's Hyundai Asan and Korea Land Corporation and located just over the border in North Korea, this 810 acre complex already has attracted small and medium sized enterprises from South Korea. The KIC accounts for much of the increased commercial trade between the North and the South. In 2006, the KIC produced some \$7.5 million worth of goods each month.<sup>79</sup> It provides small- and medium-sized South Korean firms with a low-cost supply of labor for manufacturing products, provides jobs for North Korean workers, and provides needed hard currency for Pyongyang.

North Korea depends more on South Korea in international trade than South Korea does on the North. North Korea accounts for less than 1% of total South Korean exports, while North Korean exports to South Korea account for more than a third of total North Korean exports. South Korea has access to global markets for many of its world class industries (automobiles, semiconductors, consumer electronics, etc.), while North Korea faces restricted markets for its limited array of exports.

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<sup>79</sup> South Korea to Continue "Utmost Efforts" for Inter-Korean complex — Minister. Yonhap News Agency. Reported by BBC Monitoring Asia Pacific. London, December 8, 2006.

**Table 7. South Korean Merchandise Trade with North Korea, 1990-2006**  
(\$ in thousands)

Year	South Korean Imports	South Korean Exports	Total Trade	Balance
1990	12,278	1,188	13,466	-11,090
1991	105,719	5,547	111,266	-100,172
1992	162,863	10,563	173,426	-152,3
1993	178,167	8,425	186,592	-169,742
1994	176,298	18,249	194,547	-158,049
1995	222,855	64,436	287,291	-158,419
1996	182,400	69,639	252,039	-112,761
1997	193,069	115,270	308,339	-77,799
1998	92,264	129,679	221,943	37,415
1999	121,604	211,832	333,436	90,228
2000	152,373	272,775	425,148	120,402
2001	176,170	226,787	402,957	50,617
2002	271,575	370,155	641,730	98,580
2003	289,252	434,965	724,217	145,713
2004	258,000	439,000	697,000	181,000
2005	340,300	715,500	1,055,800	375,200
2006	519,563	830,198	1,349,761	310,635

**Sources:** South Korea Ministry of Unification, KOTRA.

## China-DPRK Economic Relations

China remains North Korea's chief ally. In addition to sharing its status as one of the last communist regimes in the world, China views the Korean peninsula as vital to its strategic interests. Beijing values North Korea as a buffer between the democratic South Korea and the U.S. forces stationed there, as a rationale to divert U.S. and Japanese resources in the Asia Pacific toward dealing with Pyongyang and less focused on the growing military might of China, and as a destination for Chinese foreign investment and trade. Beijing arguably has more influence in Pyongyang than any other nation.

Cooperation between the two countries is extensive but often strained. In 1961, China and the DPRK signed a mutual defense pact, but recently a Chinese official reportedly said that they are not "well informed of the internal situation of the North

Korean military” and that the DPRK “does not listen to what China has to say.”<sup>80</sup> (This presumably referred to Pyongyang’s missile and nuclear tests.) Also with respect to North Korean refugees, their first destination is usually northeastern China. According to Human Rights Watch, China labels North Korean border-crossers as illegal economic migrants, rather than refugees or asylum seekers, and usually sends them back to North Korea.<sup>81</sup>

China also is hosting and facilitating the ongoing Six-Party Talks that seek a resolution to the North Korean nuclear problem.

In August 2001, Chinese President Jiang Zemin visited Pyongyang and promised increased humanitarian and economic assistance. In April 2004, Kim Jong-il visited Beijing to discuss food aid and nuclear issues.

According to Jane’s Information Group, several issues have arisen to cause friction in the Sino-North Korean relationship. These include

- Chinese exasperation at the DPRK’s failure to reform its economy;
- Pyongyang’s prevarication over the nuclear and peace treaty issues and the consequent dangerous stimulus this provides to proliferation in the region;
- The nuclear standoff with the United States and Pyongyang’s possession of nuclear weapons;
- Growing economic and political rapport between Pyongyang and Taipei;
- The North Korean refugee problem on the China-DPRK border;
- Pyongyang’s missile testing, prompting Japan to acquire a Theater Missile Defense system, with Taiwan wishing to be included;
- North Korea’s construction of underground missile sites close to the Chinese border; and
- North Korea’s cavalier attitude towards business. (China occasionally suspends shipments of humanitarian aid to the DPRK because Pyongyang regularly ‘forgets’ to return Chinese railroad rolling stock.)<sup>82</sup>

In 2006, Pyongyang’s missile and nuclear tests severely strained relations between China and the DPRK. Beijing had warned the DPRK not to conduct either of the tests and “lost face” when Pyongyang went ahead with them anyway. As a result, for the first time China agreed to UN resolutions imposing sanctions on the DPRK<sup>83</sup> and also took measures to halt banking transactions with North Korean entities and to curtail shipments of petroleum. China, however, did not agree to

<sup>80</sup> Chu, Wan-chung. These Days, North Korea Does not Even Listen to China. *Chosun Ilbo*, August 7, 2006. Reprinted by BBC Monitoring Asia Pacific, August 10, 2006.

<sup>81</sup> Human Rights Watch. China: Protect North Korean Refugees, March 9, 2004. James D. Seymour. China: Background Paper on the Situation of North Koreans in China, A Writenet Report by commissioned by United Nations High Commissioner for Refugees, Protection Information Section, January 2005.

<sup>82</sup> Jane’s Information Group, *op. cit.*

<sup>83</sup> See UN Security Council Resolution 1718, October 14, 2006.

conduct inspections of shipments along its borders with North Korea. Some analysts indicate that Pyongyang may be growing weary of its lop-sided relations with Beijing and may be attempting to become more independent. Pyongyang may view nuclear weapons as a “trump card to intimidate China as much as the United States.”<sup>84</sup>

Since the collapse of the Soviet Union, China has been the DPRK’s largest trading partner and supplier of concessional assistance (through subsidized trade and direct transfers). As an export market and source of imports, however, North Korea plays a relatively minor role for China. In 2006, the DPRK ranked 65<sup>th</sup> among China’s export markets — smaller than Bulgaria, Egypt, or Hungary. As a source of imports, North Korea ranked 64<sup>th</sup> — below Gabon, Peru, or Belgium.

**Table 8. China’s Merchandise Trade with the DPRK, 1995-2006**  
(\$ in millions)

Year	China’s Imports	China’s Exports	Total Trade	China’s Balance
1995	63.609	486.037	549.646	422.428
1996	68.638	497.014	565.652	428.376
1997	121.610	534.411	656.021	412.801
1998	51.089	356.661	407.750	305.572
1999	41.722	328.634	370.356	286.912
2000	37.214	450.839	488.053	413.625
2001	166.797	570.660	737.457	403.863
2002	270.863	467.309	738.172	196.446
2003	395.546	627.995	1,023.541	232.449
2004	582.193	794.525	1,376.718	212.332
2005	496.511	1,084.723	1,581.234	588.212
2006	467.718	1,231.886	1,699.604	764.168

**Sources:** Chinese (PRC excluding Hong Kong) data as supplied by World Trade Atlas.

China also provides aid directly to Pyongyang. By bypassing the United Nations, China is able to use its assistance to pursue its own political goals independently of the goals of other countries. It is widely believed that Chinese food aid is channeled to the military. This allows the World Food Program’s food aid to

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<sup>84</sup> Kahn, Joseph. China May Press North Koreans. *The New York Times*, October 20, 2006. P. A1.

be targeted at the general population without risk that the military-first policy or regime stability would be undermined by foreign aid policies of other countries.<sup>85</sup>

In November 2003, China reportedly transferred responsibility for securing its border with North Korea from the police to its army.<sup>86</sup> Many of China's two million ethnic Koreans live along this border, and it is a favorite crossing point for refugees from North Korea. In 2006, China built a 20-kilometer long fence along its border with North Korea. It is located primarily along areas where the Yalu River dividing the two countries is narrow and the river banks low.<sup>87</sup> Much of China's trade with the DPRK goes through the port of Dandong on the Yalu River. In 2002, 40% of Chinese exports to and 11% of its imports from North Korea passed through Dandong.<sup>88</sup>

China's major imports from North Korea include mineral ores, mineral fuels and oil, woven apparel, fish and seafood, iron and steel, and wood. China's major exports to North Korea include mineral fuels and oil, meat, electrical machinery, machinery, plastic, man-made filament, vehicles, and iron and steel.

## Japan-DPRK Economic Relations

Japan's economic relations with North Korea have declined sharply as tension over Pyongyang's nuclear and missile programs has spiked. After North Korea test launched several missiles in July 2006 and then detonated a nuclear device in October 2006, Japan imposed strict unilateral sanctions, causing bilateral trade to plummet. Japan banned imports and most North Korean nationals from entering Japan, prohibited all North Korean ships from entering Japanese ports, and outlawed the export of "luxury goods" to North Korea, including caviar, jewelry, liquor, and any food known to be favored by North Korean leader Kim Jong-il.

This pattern is a reversal of earlier economic relations. Although Japan and North Korea have never established official diplomatic relations, the two nations maintained significant economic ties for well over a decade. From the end of the Cold War, Japan was second only to China among North Korea's top trading partners. Bilateral trade declined considerably in the 1980s, but the drop was attributed primarily to the steep overall downturn of the North Korean economy as much as the state of bilateral relations. Before relations deteriorated, Japanese

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<sup>85</sup> Babson, Bradley O. *Towards a Peaceful Resolution with North Korea: Crafting a New International Engagement Framework* Paper presented at a conference sponsored by the American Enterprise Institute, Korea Economic Institute, and Korea Institute for International Economic Policy, Washington, DC, February 12-13, 2004.

<sup>86</sup> Foley, James. China Steps Up Security on North Korean Border. *Jane's Intelligence Review*, November 1, 2003.

<sup>87</sup> China Erects Massive Fence on N. Korean Border After Test. *World Tribune.com*, October 25, 2006. Schafer, Sarah. Threatening the Whole World, on China's Border with North Korea, Local Villagers Fear the Fallout from Pyongyang's Nuclear Aspirations, *Newsweek*, October 12, 2006. (Internet edition).

<sup>88</sup> Lee, Chang-hak. China's Trade with N.K. Via Dandong Exceeds US \$200 million. KOTRA, February 21, 2003.

leaders made several efforts to normalize relations with North Korea, promising considerable economic assistance to the country. Since 2002, however, North Korea's provocative missile and nuclear device tests, along with the issue of Japanese citizens kidnapped by North Korean agents in the 1970s and 1980s, has stalled any further diplomatic progress and retarded economic relations. From 2001-2005, Japan's share of North Korean trade declined as China, South Korea, and Russia expanded trade with Pyongyang. By 2006, total trade between Japan and the DPRK fell to \$120 million from \$1,290 million in 2001.

**Table 9. Japan's Merchandise Trade with the DPRK, 1994-2006**  
(\$ in millions)

Year	Japan's Imports	Japan's Exports	Total Trade	Japan's Balance
1994	328.313	171.092	499.405	-157.221
1995	338.073	253.798	591.871	-84.275
1996	290.745	226.480	517.225	-64.265
1997	301.796	178.942	480.738	-122.854
1998	219.489	175.137	394.626	-44.352
1999	202.564	147.839	350.403	-54.725
2000	256.891	206.760	463.651	-50.131
2001	225.618	1,064.519	1,290.14	838.901
2002	235.840	132.645	368.485	-103.195
2003	174.390	91.445	265.835	-82.945
2004	164.299	88.743	253.042	-75.556
2005	132.277	62.505	194.782	-69.772
2006	76.418	43.860	120.278	-32.558

**Source:** Japanese data as supplied by World Trade Atlas.

Seafood makes up almost half of the North's exports to Japan, followed by electrical machinery, aluminum and articles thereof, mineral fuels, and apparel. North Korean clams and matsutake mushrooms are particularly prized in the Japanese market. Japan sends items such as vehicles, electrical machinery, boilers/reactors, manmade filaments, wool, and articles of iron or steel to North Korea. Some Japanese lawmakers have argued that Japan should expand the ban on imports from North Korea to cover exports as well.

Japan's food aid to North Korea has also dwindled as relations soured. The pattern of Japanese aid reflects developments in the political relationship between Tokyo and Pyongyang: shipments began in 1995 and 1996 when relations warmed, were temporarily suspended periodically as tensions mounted, and eventually ceased altogether in late 2004 because of disagreement over the abduction issue. Between

1995 and 2004, Japan provided 1.2 million metric tons of humanitarian food aid to North Korea, mostly through the United Nations World Food Program.<sup>89</sup>

A group of pro-Pyongyang ethnic Koreans living in Japan known as the Chosen Soren (Chongryun in Korean) in the past provided North Korea with additional funds in the form of cash remittances and, possibly, facilitated illicit trade such as drug trafficking and counterfeiting. Although the exact amount of remittances is unknown, the total appeared to be in the neighborhood of \$100 million per year but declined sharply since the early 1990s. A series of scandals involving ethnic Korean banks in Japan revealed that money was illegally channeled to North Korea through the network of Chosen Soren-affiliated credit unions. Following the missile tests in 2006, Japan froze fund transfers and overseas remittances by 15 groups and one individual suspected of links to North Korean weapons programs, and established rules that require financial institutions to report to the Japanese government remittances overseas of more than 300 million yen.

A thorn in the relations between Japan and the DPRK has been the issue of Japanese citizens abducted by North Korea, ostensibly to be used by their government to teach Japanese language and culture. The bilateral talks in 2007 on normalizing relations between the two countries broke down over the issue of the abductees.

## Russia-DPRK Economic Relations

Russian reforms and the end of the Cold War greatly reduced the priority of the DPRK in the strategy of Russian foreign policy. Following Soviet support of North Korea in the Korean War, the USSR provided assistance to Pyongyang that helped equip its military and create its heavy industrial sector. In 1998, at the peak of the bilateral relationship, about 60% of North Korea's trade was with the Soviet Union. Much of the trade was in raw materials and petroleum that Moscow provided to Pyongyang at concessional prices. Relations between the two cooled in the 1990s as Russia recognized South Korea, announced that trade with North Korea was to be conducted in hard currencies, and opted out of its bilateral defense agreement.<sup>90</sup>

Recently, overall relations between Russia and North Korea have been improving. Russia is upgrading its railway connections with North Korea and has been participating in an ambitious plan to build a trans-Korean railway. As is the case with China and South Korea, Russia is critical to North Korean security, since Russia shares a border with the DPRK, and Russian cooperation would be necessary to enforce any security guarantee. As fuel aid from abroad has decreased, moreover, North Korea has turned again toward Russia as a source of supply.

Still, the DPRK's trade with Russia lags behind what it has been in the past. In 2006, North Korea ranked 98<sup>th</sup> among Russia's sources of imports (below Jamaica and El Salvador) and 64<sup>th</sup> in terms of markets for Russian exports (below the Virgin

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<sup>89</sup> CRS Report RL31785, *Foreign Assistance to North Korea*, by Mark Manyin.

<sup>90</sup> Lunev, Stanislav. New Era in Russian-North Korean Relations. Newsmax.com, August 23, 2000.

Islands and Armenia). The increasing volume of Russian mineral fuel exports to the DPRK has moved Russia past Japan, Germany, and Thailand to become North Korea's third largest trading partner.

Major Russian exports to the DPRK include mineral fuels, wood and pulp, fertilizers, machinery, iron/steel, and wood. The large increase in Russian exports have come mostly in mineral fuel oil which increased from \$20 million in 2002 to \$170 million in 2006 (down from \$198 million in 2005). Pyongyang had to turn to Russia for petroleum, as supplies of fuel oil from the United States, Japan, and South Korea were curtailed as the Six-Party Talks bogged down. Major Russian imports from North Korea include machinery, electrical machinery, and manmade staple fibers.

**Table 10. Russia's Merchandise Trade with the DPRK,  
1994-2006**  
(\$ in millions)

Year	Russia's Imports	Russia's Exports	Total Trade	Balance
1994	44.00*	52.00*	96.00*	8.00*
1995	15.00*	70.00*	85.00*	55.00*
1996	347.00*	525.00*	872.00*	178.00*
1997	16.790	72.449	89.239	55.659
1998	8.463	56.497	64.960	48.034
1999	7.208	48.507	55.715	41.299
2000	7.633	35.631	43.264	27.998
2001	14.664	56.099	70.763	41.435
2002	10.317	47.404	57.721	37.087
2003	2.903	112.343	115.246	109.440
2004	4.575	204.665	209.240	200.090
2005	6.862	224.402	231.264	217.540
2006	20.076	190.563	210.639	170.487

**Sources:** Russian data as supplied by World Trade Atlas.

\*1994-96 data from International Monetary Fund. *Direction of Trade Statistics*.

In December 2006, Russia reportedly agreed to write off some 80% of the \$8 billion in debt owed it by the DPRK. North Korea had borrowed the funds in the 1960s to build power plants. This opens the way for Russia to engage in more



economic cooperation with the DPRK and to facilitate progress in the Six-Party Talks.<sup>91</sup>

## **U.S. Interests, Strategy, and Policy**

The three legs of any grand strategy toward the DPRK include economic, diplomatic, and military means to accomplish U.S. goals and protect U.S. national interests. This report examines the economic side of this triad of strategic policy instruments but also reviews the diplomatic and military aspects of U.S. policy in order to provide a policy context.

### **U.S. Interests, Goals, and Strategy**

The DPRK threatens several U.S. national interests. It threatens U.S. security through its development and potential proliferation of nuclear weapons as well as other weapons of mass destruction. North Korea's missile delivery systems currently can reach South Korea and Japan, and it is reportedly developing a missile (Taep' o-dong 2) that can reach the continental United States.<sup>92</sup> Its conventional forces are concentrated along the demilitarized zone within striking distance of South Korean population centers and U.S. forces. North Korea's dictatorial, communist, and oppressive regime headed by Kim Jong-il runs counter to U.S. values of freedom, liberty, human rights, democracy, and economic choice.

The national security strategy of the United States touches on North Korea mainly through the following broadly stated goals: (1) to prevent enemies from threatening the United States, allies, and friends with weapons of mass destruction; (2) to strengthen alliances to defeat global terrorism and to work to prevent attacks against the United States or friendly countries; (3) to work with others to defuse regional conflicts; (4) to ignite a new era of global economic growth through free markets and trade; and (5) to champion aspirations for human dignity.<sup>93</sup>

As applied to the DPRK, the immediate U.S. goals include (1) to halt or eliminate North Korea's development of nuclear or other weapons of mass destruction; (2) to curtail illegal and questionable activities by North Korea to include illicit sales of missiles,<sup>94</sup> dealing in illegal drugs, counterfeiting of currency, and proliferation of weapons of mass destruction, particularly to terrorist groups; (3) to reduce the threat of war on the Korean peninsula; (4) to ensure that North Korea does not participate in international terrorist activity; (5) to induce economic, political, and societal change in the country that could bring about favorable changes

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<sup>91</sup> Russa to Forgive Most of N. Korea's Debt. *The Chosun Ilbo* (digital version), January 5, 2007.

<sup>92</sup> See CRS Report RS21473, *North Korean Ballistic Missile Threat to the United States*, by Andrew Feickert.

<sup>93</sup> The White House. *The National Security Strategy of the United States of America*. September 2002.

<sup>94</sup> See CRS Report RS21473, *North Korean Ballistic Missile Threat to the United States*, by Steven A. Hildreth.

in the Kim regime, in governance, in the standard of living of its people, and in attitudes toward the United States, and (6) to enhance the security of South Korea and Japan with respect to the DPRK.

Conventional wisdom with respect to North Korea includes the following assumptions: (1) without stringent monitoring mechanisms, Pyongyang probably will cheat on any agreement; (2) North Korea regularly breaks international laws or treaties dealing with activities such as the non-proliferation of weapons of mass destruction, illicit drug trade, or counterfeiting of currency; (3) economic privation in North Korea mainly affects the population outside of Pyongyang and only indirectly affects the military and party leaders; (4) popular sentiment opposing the current regime is weak or suppressed sufficiently for Kim Jong-il to remain in power for an indefinite period of time; (5) a U.S. military attack on North Korea would result in an immediate counter-attack on Seoul and other targets in South Korea using existing conventional weaponry that would cause extensive damage; and (6) any North Korean use of nuclear bombs on the United States or its allies would trigger retaliation that likely would destroy Pyongyang, its military installations, and other targets.

Other factors to be considered include the following: (1) South Korea currently is pursuing a policy of rapprochement and eventual normalization of relations with North Korea, although it maintains considerable distrust and hostility toward the country; (2) among the countries with interest in North Korea, China appears to have the most influence and economic and political interaction, although ties with Russia still are strong, and South Korea is a major source of economic assistance and trade; (3) Japan would likely provide a large monetary settlement to Pyongyang in return for its years of occupation should a peace settlement be reached; (4) the border between China and North Korea is porous, particularly in the winter when the rivers are frozen and electricity so scarce that few lights operate at night; (5) centrally planned, communist economies, that have been operating for several decades create distortions and consumer dissatisfaction that enable rapid transition to a market economy once those economies are liberalized; (6) economic reform and the opening of trade and investment in North Korea would likely induce large increases in production and economic well-being, but most DPRK production facilities are so lacking in new machinery and equipment that major investments would be needed raise them to world standards; and (7) the level of distrust between the United States and the DPRK is deep and long-standing.

Given U.S. interests and goals, it appears that U.S. strategy may include the following: (1) convincing the Pyongyang regime that developing nuclear weapons decreases, not increases, its security; (2) creating tension within the regime over the allocation of resources between nuclear and conventional weapons and between the military and civilian economies; (3) weakening the hold by Pyongyang on the daily lives of its citizens and support of Kim Jong-il by fostering alternative centers of power, facilitating the transition to a market economy, and increasing information flows into the country; (4) depriving the central government of revenues derived from illicit activities; and (5) eliciting greater cooperation from China and Russia to induce them to apply more pressure on Pyongyang to make suitable concessions and carry through on commitments deriving from the Six-Party Talks.

An economic strategy would be to generate interests in and dependency on international trade, investment, and greater interaction with the outside world that could weaken the hold by Pyongyang on the daily lives of citizens and bring the country more into the globalized world. Such economic liberalization also could reduce pressures on North Korea to engage in illicit trade in order to cover its trade deficit and diminish the need for Pyongyang to saber rattle in order to divert attention from its domestic problems.

Major U.S. policy options, given the above interests, goals, assumptions, and strategies with respect to the DPRK, include the following.

- Continue current policies of negotiations plus sanctions (continue Six-Party Talks, maintain sanctions, and continue or intensify the Proliferation Security Initiative with its interdiction of illicit trade in weapons, drugs, counterfeit currency).
- Intensify negative pressures on the DPRK (tighten economic and financial sanctions, restrict trade between North Korea and countries such as China, Japan, South Korea, and Europe, and discourage foreign investment in the DPRK).
- Increase engagement to include positive incentives for reform over the long term (loosen sanctions, encourage reforms, facilitate foreign investment, promote trade, and allow North Korea to join the International Monetary Fund and Asian Development Bank).
- Combine policy options into a package of incentives.

## **Current U.S. Policy**

Current U.S. policy with respect to the DPRK includes (1) diplomatic engagement through the Six-Party Talks; (2) non-proliferation efforts, including the Proliferation Security Initiative; (3) international efforts to counter trafficking by North Korea in illegal drugs, counterfeit currency, or other contraband; (4) maintenance of U.S. military forces in South Korea, Japan, and elsewhere in the Pacific as a credible deterrent against North Korean aggression; (5) economic sanctions and diplomatic isolation; (6) keeping North Korea on the U.S. list of terrorist states; and (7) keeping North Korea from joining international financial institutions.

In September 2005, the United States used new authority under the Patriot Act to name the Banco Delta Asia (BDA) bank in Macau (a territory of China) as a primary money laundering concern.<sup>95</sup> This resulted in special measures being

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<sup>95</sup> The Department of the Treasury. Treasury Designates Banco Delta Asia as Primary Money Laundering Concern under USA Patriot Act. Press Release JS-2720. September 15, 2005. See *Federal Register*, Vol. 70 No. 181, Sept. 20, 2005 (Notices), p. 55214. The finding asserts that at least one regular North-Korean-front client of BDA was widely reported to be conducting “numerous illegal activities, including distributing counterfeit currency and smuggling counterfeit tobacco products” for over a decade. See also

(continued...)

proposed that would have excluded the bank from any dealings with the U.S. financial system.<sup>96</sup> The immediate result was a freezing of \$25 million in North Korean accounts at BDA and the triggering of a chain reaction that caused such a run on the bank that the Macau government had to take over its operations. International banks, from not only from the United States but from other nations, refused to deal with even some legitimate North Korea traders. North Koreans tried moving their international bank accounts to countries such as China and to use bank in Austria and Switzerland,<sup>97</sup> but eventually even China joined in the financial sanctions (after North Korea conducted ballistic missile and nuclear weapons tests in 2006).

The BDA action seemed to have caused considerable damage to Pyongyang's interests. Not only did it stymie international trade, but the frozen accounts apparently were used by the inner circle of cadre in Pyongyang to buy luxury goods and other imports. Observers postulate that it was the BDA action and subsequent similar actions by other nations combined with pressure from China that ultimately brought the DPRK back to the Six-Party Talks and led to the Six-Party Agreement of February 13, 2007. As part of this agreement, the United States stated that it would resolve the Banco Delta issue within 30 days.<sup>98</sup>

The February 13, 2007, Six-Party Agreement includes a provision that North Korea is to freeze its nuclear installations at Yongbyon and invite back the International Atomic Energy Agency to monitor the freeze. In exchange, South Korea is to provide financing for 50,000 tons of heavy oil to be shipped to the North. In addition, North Korea is to discuss with the other six parties "a list of all its nuclear programs, including plutonium extracted from used fuel rods" from the five megawatt reactor (which North Korea claims to have reprocessed into nuclear weapons-grade plutonium). The DPRK and the United States also are to start talks "aimed at resolving bilateral issues and moving toward full diplomatic relations." Under the Agreement, North Korea and Japan also were to "start bilateral talks" toward normalization of relations on the basis of settlement of "outstanding issues

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<sup>95</sup> (...continued)

Department of the Treasury Press Release of September 15, 2005, (JS-2720) on Treasury Designation of Banco Delta Asia as a Primary Money Laundering Concern and Treasury Dept. FINCEN Advisory of December 13, 2005, on Guidelines to Financial Institutions on the Provision of Banking Services to North Korean Government Agencies and Associated Front Companies Engaged in Illicit Activities which encourages financial institutions worldwide to take precautions that they are not used as a conduit for the laundering of proceeds of DPRK illicit activities.

<sup>96</sup> See *Federal Register*, Vol. 70 No. 181, Sept. 20, 2005 (Notice of Proposed Rulemaking) p. 55217ff.

<sup>97</sup> Major Chinese Banks Refrain From Dealing with N. Korean Firms. *Kyodo News*, March 13, 2006.

<sup>98</sup> King, Neil Jr. And Evan Ramstad. Politics & Economics: What Drove the North Korea Deal; U.S. Hungered for Diplomatic Victory, Pyongyang for Financial Relief. *Wall Street Journal*, February 14, 2007, p. A.4. The Banco Delta action was taken partly under the Bush Administration's Illicit Activities Initiative. See David L. Asher, Statement Before the Subcommittee on Federal Financial Management, Government Information, and International Security, Senate Homeland Security and Government Affairs Committee, April 25, 2006. David Lague and Donald Greenlees. Squeeze on Banco Delta Asia hit North Korea where it hurt. *International Herald Tribune*. January 18, 2007.

of concern” (which Japan interprets as requiring a settlement of the issue of North Korea’s kidnapping of Japanese citizens).

The February 13 Agreement represented a clear change in strategy by the United States and other parties to the talks. For the first time, the Banco Delta Asia action was linked by the United States to the Six-Party Talks and nuclear issues. In essence, the United States agreed to see that the Banco Delta issue was to be settled before Pyongyang would have to take action to invite International Atomic Energy Agency inspectors back into the country and to shut down its nuclear plant. For the DPRK, this meant that the \$25 million in frozen funds from Banco Delta accounts would be released first. The Agreement also implied that a strategy of regime change appeared to be off the table. The question now is whether the DPRK will live up to its commitments under the Agreement and what leverage the United States, China, and other participants have to ensure Pyongyang’s compliance.

What is clear from the experience of the past four years is that Pyongyang’s stalling and the United States’ refusing to negotiate bilaterally (even under the umbrella of the Six-Party Talks) provided time for Pyongyang to continue to pursue its nuclear program. It is now evident that North Korea actually had created a nuclear bomb.

North Korea claims that the reasons for its nuclear program are to deter an attack by the United States and to use them if South Korea starts a war or to devastate Japan to prevent the United States from participating in such a war.<sup>99</sup> The nuclear program also enables it to gain international prestige, to exercise a degree of hegemony over South Korea, and to extract economic assistance from other countries. Pyongyang is unlikely to abandon this nuclear program without significant changes to the underlying reasons for its existence. Its fear of being attacked has been exacerbated by its inclusion in the “axis of evil,” the Bush doctrine of preemptive strikes, and the U.S.-led invasion of Iraq.<sup>100</sup> Some also consider Pyongyang’s nuclear program to be a bargaining chip to be traded for economic assistance and to gain international recognition.

What also can be said about U.S. policy is that except for the Banco Delta Asia action, economic sanctions have brought few concrete results. The sanctions have primarily been American. North Korea continues to trade with other countries as well as to receive humanitarian food aid and limited foreign investment. Even the United States attempts to keep humanitarian aid separate from political considerations. The policy questions with respect to sanctions are whether economic sanctions have actually worsened economic conditions in North Korea and whether the poor economic conditions have changed policies in Pyongyang.

It appears that despite deep privation and negative growth during the mid-1990s, the sanctions had little effect on Pyongyang’s behavior in ways that would achieve U.S. ends. The ruling elite and military have first priority on scarce food and

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<sup>99</sup> Jane’s Information Group. Armed Forces, Korea, North. Jane’s Sentinel Security Assessment, March 4, 2003.

<sup>100</sup> Laney, James T. and Jason T. Shaplen. “How to Deal With North Korea,” *Foreign Affairs*, March/April 2003. p. 20-21.

other supplies. The Kim regime allots economic privileges to its insiders. Peasants may starve, but ranking communist party members live in a separate world of relative luxury.<sup>101</sup> The poor economic conditions also do not appear to have materially undermined the Kim regime. Experts consider internal dissident forces too weak and Kim's control over his military too strong for a domestic *coup* to occur.<sup>102</sup> Pyongyang has taken halting steps toward opening its economy to international investment and has allowed more private markets, but these are similar to policies nearly all centrally planned economies are taking, and China and Russia have been recommending that North Korea adopt them also.

Irrespective of whether the U.S. economic sanctions worsened North Korea's economy, the poor state of the North Korea's agriculture and industries has indirectly affected U.S. national interests. It has necessitated humanitarian aid and has generated a deficit in trade that Pyongyang has attempted to fill by dealing in illegal drugs and missiles. Food scarcity also has pushed numerous refugees into China and South Korea.

Following the DPRK's nuclear test in 2006, the United States took the issue to the United Nations. The resulting UN Security Council Resolution 1718 (October 14, 2006), called on North Korea to abandon its nuclear and missile programs and imposed several sanctions. The resolution imposes an arms embargo on North Korea, bans trade in materials related to ballistic missiles or weapons of mass destruction, and bars exports of luxury goods to the DPRK. It also freezes funds and other financial assets owned by people connected with North Korea's unconventional weapons program and bans travel by such people. China and Russia supported this resolution. Japan has curtailed imports from and travel to North Korea, has banned North Korean ships from entering its ports, and has prohibited exports of 24 luxury products to the DPRK.

In terms of non-proliferation, the Proliferation Security Initiative now has more than 60 governments participating. Although aimed at stopping trade in weapons of mass destruction and their components, the prospect of ships being inspected complicates North Korean efforts to smuggle illicit weapons, drugs, and counterfeit currency.<sup>103</sup>

With respect to North Korea and terrorism, the United States has kept North Korea on its list of terrorist states primarily because of past terrorist activity. The blowing up of an airliner with South Korean government officials on board and the harboring of Japanese Red Army members from the 1960s are the two primary

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<sup>101</sup> BBC Monitoring, Asia Pacific. Former Bodyguard of North Korean Leader Interviewed, October 13, 2003, p. 1.

<sup>102</sup> The only significant power base that might challenge the regime is the military. Since Kim Jong-il became Chairman of the National Defence Commission, however, he has promoted 230 generals. Most of the army's 1,200-strong general officer corps owe their allegiance to him. Jane's Information Group, "Internal Affairs, Korea, North," *Jane's Sentinel Security Assessment*. June 10, 2003.

<sup>103</sup> The White House. Proliferation Security Initiative, Fact Sheet. September 4, 2003. U.S. Department of State. U.S. Notes First Anniversary of Proliferation Security Initiative. Press Release, June 1, 2004.

reasons for keeping the DPRK on the terrorist list. The United States apparently has assured Japan that North Korea will remain on the terrorist list until it completely resolves the kidnapping issue with Japan. Being on this list requires the United States to impose certain trade restrictions.

## The Six-Party Talks

Current engagement with North Korea is being conducted under the Six-Party Talks plus bilateral discussions between Pyongyang and other nations. The Talks include the United States, DPRK, China, Japan, South Korea, and Russia. This brings all major players to the table, exposes China and Russia to North Korean obstinacy, enables China and Russia to exert pressure on Pyongyang, and includes Japan and South Korea who have direct interests in a peaceful resolution of the problem and are likely to be the major providers of aid to the DPRK. (For discussion of the talks, see CRS Report RL33590, *North Korea's Nuclear Weapons Development and Diplomacy*, and CRS Report RL33567, *Korea-U.S. Relations: Issues for Congress*, both by Larry Niksch.)

**Table 11** summarizes the major negotiating priorities and bargaining chips for each side in the Six-Party Talks. Any policy package would have to address at least some of the priorities of each nation.

The highest priority for the United States, Japan, and Russia reportedly is for North Korea to scrap its nuclear weapons program in a manner that is verifiable. Japan also is concerned about North Korean missiles (which have been fired over Japan) and a full accounting for the abduction of its citizens. In addition, the United States, China, and Japan seek a stop to weapons proliferation, while Japan also seeks normalization of relations with the DPRK, and South Korea seeks a framework for rapprochement, possible reunification with the North, less military tension along the demilitarized zone (DMZ), and access to cheap labor and markets in the North.

Pyongyang's primary goals appear to include (1) preservation of communist rule under Kim Jong-il, (2) obtaining a security guarantee that would preclude a possible preemptive attack by the United States or its allies, (3) maintaining key elements of its nuclear weapons programs, (4) establishing diplomatic relations with the United States and Japan, (5) reunification with the South on its own terms, and (6) obtaining economic assistance for its ailing economy while maintaining its *juche* philosophy. The Kim regime appears to be operating under the assumption that because of its designation as a member of the "axis of evil" by the Bush Administration, it has a high probability of being targeted for military action based on the Iraq precedent.

A risk of any policy package, such as the February 13, 2007 Agreement, is that North Korea might not scrap its nuclear program once it receives the Banco Delta funds and energy aid starts to flow again. Some surmise that Kim Jong-il is still smarting at being characterized as "evil" and is unlikely to allow the Bush Administration to claim "victory" in shutting down the DPRK's nuclear program. If Pyongyang does not follow through on the Agreement, tensions could escalate,

and punitive measures, including military action, could be considered.<sup>104</sup> Absent those extreme measures, the world may have to learn to live with a nuclear-armed North Korea much as it has learned to live with a nuclear-armed Pakistan and India, and Japan and South Korea would have to consider whether to develop nuclear capability themselves. Another risk of providing a policy package that includes real incentives could be that the United States would be perceived as being blackmailed and giving away too much to a dictator who regularly violates the human rights of his people.

**Table 11. Major Priorities and Bargaining Chips by Country in the Six-Party Talks with North Korea**

Country	Priority	Bargaining Chips
United States	Complete, verifiable, and irrevocable scrapping of nuclear weapons; non-proliferation	Guarantee security and regime, economic aid, normalized diplomatic and trade relations
North Korea	Guarantee security and regime; establish diplomatic relations with the U.S. and Japan; reunification with South Korea on own terms	Scrap nuclear weapons and missiles, reduce tensions along DMZ
South Korea	Set framework for peaceful resolution and prosperity on the peninsula; reunification; access to North Korean labor and markets, non-nuclear Korean peninsula	Economic support, energy, business investment
Japan	Scrap nuclear weapons program and missiles; resolve abductions of Japanese citizens issue	Normalized diplomatic relations, economic support
China	Non-nuclear Korean peninsula, non-proliferation; continued influence on peninsula, weakening U.S. alliance with Japan and with South Korea	Economic support, alliance support
Russia	Scrap N. Korean nuclear weapons; promote stability in N.E. Asia	Buffer diplomacy, energy

**Source:** Adapted from: *The Seoul Economic Daily*, 22 August 2003, cited in Hong Soon-Jick, "North Korean Nuclear Crisis: Prospects and Policy Directions," *East Asian Review*, Vol. 15, No. 3, Autumn 2003, p. 31.

The costs of a diplomatic solution to tensions with North Korea would be relatively small compared with a nuclear arms race in Northeast Asia or a preemptive strike on North Korea by the United States. Opening trade and diplomatic relations would be of relatively low cost for the United States, but this would require resolution of certain issues.

<sup>104</sup> See OPLAN 5026 - Air Strikes. [<http://www.globalsecurity.org/military/ops/oplan-5026.htm>]



## Possible Economic Incentives

The February 13 Six-Party Agreement includes various economic incentives for the DPRK. The short-term incentives include providing fuel and releasing the Banco Delta funds, while long-term incentives include normalization of economic relations, removing the DPRK from the U.S. terrorist list, and allowing North Korea to join multilateral financial institutions, such as the Asian Development Bank and International Monetary Fund. The list of potential economic incentives, include the following:

**Normalizing Diplomatic Relations.** Normalization of diplomatic relations with the DPRK would apply to the United States, Japan, and South Korea. North Korea already has diplomatic relations with China, Russia, and the European Union (including an embassy in London). For Japan, the DPRK would have to resolve certain issues, including a full accounting of the status of kidnapped Japanese citizens, North Korea's missile firings over Japan, and incursions by suspected DPRK espionage and drug-running ships into Japanese waters. Upon conclusion of these normalization talks, Japan is likely to offer \$5 billion to \$10 billion to North Korea in compensation for its occupation.<sup>105</sup>

Normalizing diplomatic relations allows countries to communicate with each other in a more direct fashion, enables diplomats to gather information directly, and provides more interaction on a personal level. Normalized relations can help to overcome the Pyongyang propaganda machine both within the DPRK and on the world stage. Normalization, however, can imply that the United States is willing to tolerate conditions in North Korea. This may be unacceptable to some. Absent normalized relations, Washington could seek a relationship similar to that with Cuba. Even without diplomatic ties, the U.S. mission in Havana is attached to that of Switzerland and maintains a staff similar in size to a regular embassy. (North Korea has been a member of the United Nations since 1991 and has representatives in New York.) Japan has initiated talks with Pyongyang that could lead to normalized relations, and South Korea has been seeking diplomatic ties and possibly some form of reunification in the future. In 2007, bilateral talks between Japan and the DPRK on normalization were stymied by the abduction issue.

**Negotiating a Trade Agreement.** The United States could begin talks with the DPRK on a trade agreement which would cover goods, services, and investments and could be modeled after the 2001 bilateral trade agreement concluded between the United States and the Socialist Republic of Vietnam.<sup>106</sup> Upon implementation of the trade agreement, each country would accord the other normal trade relations (most favored nation) status. The immediate effect would be to allow North Korean exports to the United States to enter at the lower rates of duty accorded to nearly all other nations of the world. The trade agreement also could cover investment and other U.S. interests.

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<sup>105</sup> See CRS Report RL32161, *Japan-North Korea Relations: Selected Issues*, by Mark Manyin.

<sup>106</sup> The White House, George W. Bush. "Presidential Proclamation: To Implement the Agreement Between the U.S. and Socialist Republic of Vietnam on Trade Relations," June 1, 2001.

While the DPRK's market currently is small, eventually it could re-industrialize and become a larger economic player in the region. Liberalization of North Korean trade and investment relations, moreover, can work through the economy in the same way that it did in China and Russia by exposing the public to the benefits of increased wealth. The major negative to establishing trade with North Korea is that, unless it is part of a larger package that includes other concessions, the United States could be viewed as exchanging an important bargaining chip for minimal gain.

**Easing U.S. Sanctions.** The United States could ease economic sanctions on North Korea if the country resolves the issues that caused the sanctions to be imposed initially. Since North Korea's other trading partners have more liberal trade with North Korea, it is mainly American companies and traders that are impacted by the sanctions. Pyongyang can spend its available foreign exchange in any of a number of world markets — in China, Japan (to an extent), South Korea, Europe, or elsewhere. Moreover, as North Korea opens its economy, U.S. businesses would be able to decide whether or not to invest there based on their own economic interests and not because they are precluded from doing so by U.S. law.

**Allowing the DPRK to Join International Financial Institutions (IFIs).** The United States could stop blocking the DPRK from joining the major IFIs, particularly the Asian Development Bank, World Bank, and International Monetary Fund. Pyongyang is particularly interested in joining the Asian Development Bank, but IFI procedures require membership first in the International Monetary Fund. The IMF requires certain economic data which the World Bank or Asia Development Bank needs to evaluate projects and loan requests. Membership in IFIs requires that a country establish data gathering and reporting mechanisms as well as open their country to visits, surveys, or assessments by the IFI. As an incentive, a special fund could be set up in the World Bank or Asian Development Bank to assist North Korea in its economic transition. This fund could be financed by Japan or South Korea in conjunction with their normalization of relations with the DPRK.

**Removing the DPRK from the Terrorism List.** The United States, Japan, and the DPRK could commence negotiations to remove the DPRK from the U.S. State Department's list of nations that support or sponsor international terrorism. Removal from the list would require Congressional concurrence. Once off this list, North Korea would become eligible for U.S. foreign aid, loans from the U.S. Export-Import Bank, loans from international financial organizations in which it has membership, and an easing of U.S. export control requirements. In order to be removed from this list, it appears that the DPRK would have to do the following: (1) issue a written guarantee that it no longer is engaged in terrorism; (2) provide evidence that it has not engaged in any terrorist act in the past year; (3) join international anti-terrorism agreements; and (4) address issues of past support of terrorism (particularly the harboring of Japanese Red Army terrorists and kidnapping of Japanese citizens).<sup>107</sup>

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<sup>107</sup> See CRS Report RL33567, *Korea-U.S. Relations: Issues for Congress*, by Larry A. Niksch.

## Fuel and Food Aid

In the Six-Party Talks, since the DPRK appears to be most concerned with obtaining fuel and food aid in exchange for concessions on its nuclear program, the United States could provide assistance in any of a variety of forms. The February 13, 2007 Agreement provides for some fuel oil to be sent to North Korea and to be financed by South Korea.

## Legislative Action

Major congressional action with respect to security aspects of U.S.-DPRK relations is included in CRS Report RL33567, *Korea-U.S. Relations: Issues for Congress*, and in CRS Report RL33590, *North Korea's Nuclear Weapons Development and Diplomacy*, both by Larry A. Niksch.

## Brief Chronology

- March 19, 2007. The Six-Party Talks resumed in Beijing with the DPRK insisting that the \$25 million frozen in BDA accounts in Macau be transferred to DPRK accounts in China before the talks could proceed.
- March 14, 2007. Treasury finalized its rule against Banco Delta Asia in Macau, barring the bank from accessing the U.S. financial system.
- October 13, 2007. The countries in the Six-Party Talks announced an agreement in which North Korea halts its nuclear program in exchange for energy assistance and diplomatic recognition.
- October 14, 2006. The UN Security Council adopted Resolution 1718 calling for all UN members to take wide-ranging economic and diplomatic sanctions against North Korea.
- October 10, 2006. Japan announced a ban on imports from North Korea, on their ships entering Japanese ports, and on entry into Japan in principle by North Koreans.
- October 9, 2006. Pyongyang announced that it had conducted an underground nuclear test.
- January 20, 2006. North Korea stated that it would not return to the Six-Party Talks until the United States lifted its financial sanctions on Banco Delta Asia and on eight North Korean entities for allegedly proliferating weapons of mass destruction.
- January 10-18, 2006. Kim Jong-il visited southern China and Beijing ostensibly to learn how China can help North Korea

improve its economy. In Beijing, the two countries discussed the Six-Party Talks dealing with North Korea's nuclear program.

- January 1, 2006. The U.N. World Food Program, which was helping to feed one-third of North Korea's 22 million people as recently as August 2005, ended all feeding programs at the request of the North Korea's government.
- Fall 2005. North Korea reportedly revived rationing and rolled back market reforms (closed some private food markets).
- October 21, 2005. Pursuant to Executive Order 13382, the U.S. Treasury designated eight North Korean entities as proliferators of weapons of mass destruction and their delivery vehicles. The action prohibits all transactions between the designated entities and any U.S. person and freezes any assets the entities may have under U.S. jurisdiction.
- September 15, 2005. The U.S. Treasury designated Banco Delta Asia SARL as a "primary money laundering concern" under Section 311 of the Patriot Act because it represents an unacceptable risk of money laundering and other financial crimes. Treasury stated that "Banco Delta Asia has been a willing pawn for the North Korean government to engage in corrupt financial activities through Macau...."<sup>108</sup>

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<sup>108</sup> U.S. Department of the Treasury. Treasury Designates Banco Delta Asia as Primary Money Laundering Concern under USA PATRIOT Act. Press Release JS-2720, September 15, 2005.