Policy Forum 03-26A: The Role of Economic Leverage in Negotiations with North Korea

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The Role of Economic Leverage in Negotiations with North Korea

By Kimberly Ann Elliott

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I. Introduction

In this essay, Kimberly Ann Elliott, Research Fellow at the Institute for International Economics in Washington, D.C. outlines the strategy and potential efficacy of economic sanctions on North Korea. Consequently, Elliott concludes, multilateral cooperation and negotiation are critical to peacefully resolving the current nuclear crisis on the Korean peninsula. While North Korea's closest neighbors are again resisting the sanctions option, if economic sanctions were part of a carrots and stick strategy to negotiate a resolution to the crisis, they might choose to cooperate-especially if the principal alternatives are continued instability or a military strike.

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II. Essay by Kimberly Ann Elliott

"The Role of Economic Leverage in Negotiations with North Korea"
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Not quite a decade ago, as the last nuclear crisis with North Korea was reaching a peak, I wrote a paper on economic sanctions for the Nautilus Institute that began with the following:

The debate over US policy toward North Korea boils down to one deceptively simple question: what does Kim Il-sung want? No one can be sure of the answer and different interpretations have quite different policy implications. If the Great Leader views a nuclear weapons option as important to the survival of his regime, economic sanctions are unlikely to force him to give it up. But if he views the threat of developing nuclear weapons as a bargaining chip, some combination of carrots and sticks may induce him to trade it away.

Change the name to Kim Jong-il, and Great Leader to Dear Leader, and essentially the same could be said of the situation facing policymakers today on the Korean peninsula.

What differs most notably from a decade ago is the American position of refusing to negotiate directly with the North Korean regime. Governments and attitudes have also changed in other key countries, most notably President Kim Dae-jung's introduction of the sunshine policy. But President George W. Bush's hard-line position is the key factor driving events at the moment. There have been many theories attempting to explain this stance, but the important question is whether it reflects disagreement with key allies over just the means to resolve the situation or over the desired end as well. As they were a decade ago, Japan, China, and South Korea, are concerned about either provoking a military response from North Korea or causing a sudden and destabilizing collapse of the regime. There have been reports that at least parts of the Bush administration have concluded that engagement and gradual reintegration of the peninsula are no longer options and that Kim Jong-il's government should be squeezed until it does collapse.

Economic sanctions contribute to the achievement of foreign policy goals when the economic and political costs of the sanctions to the target outweigh the costs it expects to incur from complying. When the goal is regime destabilization, this means that some group in the country must have the ability and the incentive to overthrow the targeted leadership. In this case, public negotiations play little or no role, though behind-the-scenes discussion may occur with key players. But for sanctions to play a role in a negotiated resolution, North Korea must be willing to give up its nuclear programs at some price and the United States must be willing to negotiate and able to put together a coalition of key countries with enough leverage to make both threats and promises credible. Just as it did a decade ago, this means cooperating with China, Japan, and South Korea.

Whether or not the Bush administration stance of no direct negotiations changes-that is whether the goal is to use economic leverage to induce changes in North Korean behavior or to squeeze the regime until it collapses-much of the analysis from a decade ago of how economic sanctions might work against North Korea remains relevant today. This essay is an abbreviated update of that analysis as it applies to the current situation.

THE NORTH KOREAN ECONOMY

North Korea presents unusually difficult challenges for countries contemplating the use of economic sanctions. Although the government has implemented some tentative economic reforms, the legacy of the Great Leader's economic philosophy of "juche," emphasizing self-reliance, and fears of losing political control keep North Korea's the most closed economy in the world. In addition to ideology, North Korea's limited economic integration is also a consequence of the US decision during the Korean war to try and isolate the North economically. Although the ban on bilateral trade and financial relations was eased under the 1994 Framework Agreement, extensive restrictions remain and little trade between the United States and North Korea has resulted. North Korea's external trade is also limited for commercial reasons relating to its inability to generate foreign exchange buy imports and its unwillingness to reliably service external debts. Under the combined effects of isolation, economic mismanagement, high military spending, and the lingering effects of the mid-1990s famine, the North Korean economy barely functions. For several years now, it has been incapable even of feeding people without international assistance.

Because North Korea's trade and financial relations with the rest of the world are already limited, the scope and volume of potential leverage is less than in many other cases, which, in turn, limits the range of sanctions options available. But juche also means that North Korea imports only products that it must have to keep the economy functioning and that it cannot produce domestically; it must then export to earn hard currency to pay for the imports or to provide products for barter. This creates more leverage than the aggregate trade numbers might suggest, but it also deepens the dilemma for the international community since sanctions would affect key sectors, including the military, and might then reverberate quickly throughout the economy. Substantial economic disruption could increase the risk of either a military response by North Korea or economic collapse, both of which North Korea's neighbors want to avoid.

According to the data that is available, North Korea's major trading partners are China, Japan, and South Korea, in that order. Russia, a major trading partner before the collapse of the Soviet Union, was of declining importance a decade ago and now accounts for barely 3 percent of North Korea's total merchandise trade, about the same as Germany. Food and petroleum products account for more than a quarter of total North Korean imports with China as the most source. North Korea exports mainly natural resource products and light manufactures, in addition to less open exports of arms (including missiles) and illegal drugs. Other sources of foreign exchange include remittances and investment from North Koreans living in Japan, though these are reported to have declined along with the health of the Japanese economy, and China's willingness to finance a large bilateral trade deficit. South Korean trade and investment with the North is a potentially large source of foreign exchange and capital. All of these countries, plus the United States, have also been important in providing foreign food and energy assistance, as well as constructing two light-water reactors, under the Framework Agreement. Since the revelation last Fall of North Korea's nuclear enrichment program, however, oil shipments have been cut off and food assistance has been reduced, though the US government denies that it is for political reasons.

A FRAMEWORK FOR ANALYZING ECONOMIC SANCTIONS

In Economic Sanctions Reconsidered, Gary Hufbauer, Jeffrey Schott, and I examined 115 cases of economic sanctions beginning with World War I and ending with Iraq's invasion of Kuwait in 1990. Most episodes occurred after the Second World War, and most were unilaterally imposed by the United States (77 of the 115) with only minor or no cooperation from its allies. The goals of sanctions ranged from the relatively modest, such as settling transnational expropriation disputes, to the highly ambitious, such as ending apartheid in South Africa.

v My colleagues and I made judgments about the outcome in each case--the extent to which stated foreign policy goals were achieved--and the contribution made to that outcome by sanctions. We then developed a set of six political and five economic variables that might be expected to affect the effectiveness of sanctions. By comparing outcomes across cases with the values for the economic and political variables, we were able to draw conclusions about some of the factors that appear to influence the effectiveness of economic sanctions in achieving foreign policy goals.

Overall, we found that economic sanctions had contributed to at least partially successful outcomes in 34 percent of the 115 cases studied. The success rate for cases involving what were defined as "major" goals--such as impairing the military potential of an adversary or forcing the surrender of territory--was lower, just 23 percent. We also found that the probability of a successful outcome with US-imposed sanctions had declined sharply, from just over 50 percent in the early post-World War II period to less than 20 percent since the early 1970s. In general, we concluded that sanctions are most likely to be effective when:

(1) the goal is relatively modest, thus lessening the importance of multilateral cooperation, which often is difficult to obtain, and reducing the chances a rival power will bother to step in with offsetting assistance;

(2) the target is economically weak and politically unstable even before sanctions are imposed;

(3) the sanctioner and its target are friendly toward one another and conduct substantial trade (the sanctioner accounted for 28 percent of the average target's trade in success cases but only 19 percent in failures; in cases involving relatively more difficult goals, the ratios were 36 percent and 16 percent, respectively);

(4) the sanctions are imposed quickly and decisively to maximize impact (the average cost to the target as a percentage of GNP in all success cases was 2.4 percent and 1 percent in failures, in cases involving "major" goals, the figures were 4.5 percent and 0.5 percent, respectively);

(5) the sanctioner avoids high costs to itself.

Our biggest surprise was that international cooperation was negatively correlated with the probability of success. As noted, however, the data set is dominated by unilateral US sanction cases in which international cooperation played no role because the United States did not seek it. When it was sought, it was usually in cases involving more difficult goals, though the data suggests that it was a necessary but not sufficient condition for success in such cases. Finally, the results suggest that international cooperation has become more important over time as US economic and political hegemony has declined and the global economy has become more interdependent.

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THE FRAMEWORK APPLIED TO NORTH KOREA

This section takes each of the five major conclusions outlined above in turn and applies them to the North Korean case. It takes as a starting premise that the goal is a negotiated solution of the nuclear crisis and not the destabilization of the Kim Jong-il regime.

(1) Goals, cooperation, and offsetting assistance. Inducing North Korea to abandon its nuclear weapons program is a high profile, ambitious objective. A secondary, but important, goal is preserving the integrity of the international nonproliferation regime. Thus, international cooperation is essential in this case. From the US perspective, cooperation is essential because the United States already has banned virtually all trade and financial relations with North Korea since 1950 and, thus, has very little negative economic leverage available to it.

Fears of unintended consequences, however, complicate the decision to impose economic sanctions for North Korea's immediate neighbors. South Korea and Japan do not want to provoke Kim Jong-il into a rash military response, and South Korea and China do not want to risk an economic collapse of the regime that could create many thousands of refugees and cost billions of dollars to clean up. Although my colleague Marcus Noland argued in this forum that South Korea is probably exaggerating the likely costs of collapse and absorption of the North, most South Koreans remain unconvinced. If the United States wants the multilateral backing of a UN Security Resolution for economic sanctions, it will also have to convince China not to use its veto.

(2) Economic health and political stability. North Korea's economy is clearly under severe stress, but that has not yet translated into clear signs of political instability, in part because of China, South Korea, and others to provide at least enough food and other assistance to keep it afloat.

(3) Diplomatic and trade relations prior to sanctions. The volume of potential economic leverage is limited because of North Korea's self-imposed isolation. Still, if China, Japan, and South Korea cooperate, the sanctions would cover more than 50 percent of North Korea's reported trade flows, well above the average in past successful cases (36 percent in difficult cases).

(4) Potential economic costs of sanctions for the target. If North Korea's foreign trade accounts for 10 to 15 percent of GDP, comprehensive UN sanctions could easily impose an economic cost on North Korea at least equal to the average for past successful cases with ambitious objectives (4.5 percent of GNP), even allowing for extensive evasion and smuggling. If the role of trade plus foreign assistance is larger than suggested by these figures, the impact could be even larger.

(5) Economic costs to the sanctioner. The obverse of North Korea's relative autarky is that its trade is not large enough to be of much economic importance to its partners. But the potential costs could be quite high if sanctions provoke a military response from North Korea or an economic and political collapse. Concerns about these potential costs were major factors dictating a cautious strategy in the earlier crisis and remain an impediment to gaining the cooperation of key partners.

SANCTIONS ALTERNATIVES WITH RESPECT TO NORTH KOREA

As it did previously, North Korea is threatening to treat the imposition of sanctions as an act of war. Its economy hovers even closer to the brink of total collapse and, despite the seriousness of the nuclear threat on the peninsula, its neighbors appear even more reluctant to impose sanctions to coerce North Korean compliance than a decade ago. In addition, whatever the resolution of the situation in Iraq, it will be more difficult than before for the United States to turn to the United Nations to provide multilateral cover for the imposition of economic sanctions. Thus the challenges to using this tool are even greater today than before.

In 1993-94, the administration of President William Clinton responded to similar diplomatic pressures by proposing a strategy of gradual escalation of sanctions, contrary to the advice in Hufbauer, Schott, and Elliott to impose sanctions quickly and decisively. The first phase of the proposed Clinton sanctions involved boycotting North Korean arms exports, which would cost the regime an estimated $50 million to $100 million a year. The second phase would have banned all financial transactions, including the remittances from Koreans in Japan, estimated at several hundred million then but now of unknown, probably smaller, magnitude. Unless China decides to extend additional assistance, a ban on financial transactions would inhibit the regime's ability to import oil, food, and other products even without imposing sanctions directly on exports to North Korea. This plan did not explicitly mention moving to a full trade embargo in a stage three. While China then might have abstained on a Security Council vote and acquiesced in the phase one and two sanctions, a trade embargo would involve it in enforcement.

This time around, the administration of President George W. Bush, although it has rejected all other elements of the Clinton approach to North Korea, seems to be contemplating a similar approach to sanctions. According to press reports, the contemplated strategy involves cutting off important sources of North Korean foreign exchange without having to rely on the North's key trading partners. The administration succeeded in getting South Korea and Japan to agree to cut off fuel oil shipments under the Agreed Framework and it continues to press China to exert more leverage over North Korea. But South Korea and China, in particular, remain reluctant to push North Korea to the wall because of the potential military, political and economic consequences. Thus, the administration is reportedly concentrating on how it could cut off North Korea's export of illegal drugs, arms, and, if it comes to that, fissile material.

These sanctions obviously pose significant enforcement challenges, however. The major markets for North Korea's lucrative missile exports are Iran and Syria, which would seem to have little incentive to cooperate in a sanctions effort. The Clinton administration called for a cargo flight ban to enforce the arms boycott, but rejected naval interdiction as too provocative. The Bush administration seems more willing to use naval interdiction, but the decision to allow the ship carrying North Korean missiles to Yemen to complete its journey underscores the legal and diplomatic obstacles involved. Moreover, even with physical interdiction, trade across the Chinese and Russian borders of drugs and smaller arms could open a major loophole without their cooperation. Thus, these sanctions alone would likely be insufficient either to coerce changes in North Korean behavior or to cause the collapse of the regime, if that is the goal.

In sum, multilateral cooperation and negotiation are critical to peacefully resolving the current nuclear crisis on the Korean peninsula. While North Korea's closest neighbors are again resisting the sanctions option, if economic sanctions were part of a carrots and stick strategy to negotiate a resolution to the crisis, they might choose to cooperate-especially if the principal alternatives are continued instability or a military strike. In this scenario, a UN Security Council resolution condemning North Korea's violations of international norms and commitments and authorizing physical interdiction of illicit North Korean exports would be valuable. Given the anger over the abductions of its citizens and the missile test over Tokyo a few years ago, Japan also might be more willing than previously to cut off remittances and limit other transactions with North Korea. China and South Korea might not need to do more than state that they would not bail out North Korea and perhaps send a signal by slowing or suspending some current transactions. And, for this scenario to have any chance of working, the United States would have to be willing to negotiate the terms of North Korea's surrender of its nuclear weapons capability-and so would Kim Jong-il.

III. Nautilus Invites Your Responses

The Northeast Asia Peace and Security Network invites your responses to this essay. Please send responses to: napsnet-reply@nautilus.org . Responses will be considered for redistribution to the network only if they include the author's name, affiliation, and explicit consent.

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