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Challenges in Expanding External Economic Relations with North Korea

North Korean System at the Dawn of the 21st Century

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North Korea is starting off the 21st Century with a major shift in its relations with the international community. Politically, the process of expanding relations began with Italy, the first G7 country to extend diplomatic recognition to North Korea. This has been followed by of visits and meetings with a number of other European countries, including Sweden, France, the UK, and a number of countries from the Pacific rim, including Australia, Canada, and the Philippines. At the center of the process are the positive developments in discussions with the US and Japan that are leading to significant steps forward towards normalization of relations with both countries, and the overtures recently made by South Korean President Kim Dae Jung in Berlin to make similar advances in inter-Korean relations. The remarkable feature of all these developments is that they are intentional and managed, suggesting that the North Korean leadership is determined to set the country on a major new course aimed at integrating North Korea in the international community after decades of isolation.

In the shadow of this hopeful prospect of a new era of international political relations is the perception of a failed economy and a society that is experiencing a high degree of social distress. North Korea has earned a reputation of using crises to gain concessions of resources from foreign countries to offset these domestic failings. An important question is whether the leadership is using a new tactic of pursuing friendly relations to achieve the same objective while maintaining the main elements of the economic and social system that was developed over the years, or whether there is an intention of drawing on new external relations to help make changes in the economic and social system that will enable prosperity at home and genuine integration in the global economy and international society.

To help put some perspectives on this question, this paper will explore the evidence that North Korea has been making internal changes to prepare the way for a significant increase in the scale and a shift in composition of foreign economic relations. The paper then will assess the implications expanded external economic relations on the domestic economic and social system. And finally the paper will discuss the challenges that expanding external economic relations will pose both for the North Korean leadership and for the international community.

Motivation for Change

The three years following Kim Il Sung's death in 1994 will be seen in retrospect as the nadir of North Korea's experiment with history. The combination of having to follow through on a high stakes confrontation with the U.S. over North Korea's nuclear program, managing the first ever father-t--son transfer of power in a Communist regime, coping with a free fall in the economy triggered by the loss of Soviet aid and trade and reinforced by a series of natural calamities, and adapting to a deepening of political isolation following China's decision to extend diplomatic recognition to the Republic of Korea in 1993, all contributed to a period of high risk for the North Korean State. Many would have bet that North Korea would not be able to overcome this cocktail of bad news.

From this perspective, it is not surprising that the North Korean leadership, now firmly under the control of Kim Jong Il, would be motivated to seek an alternative future than the all too real prospects of collapse and demise. Given the fact that the changes in North Korea's external relations that we are now observing are only at the very beginning stage, it is reasonable to ask whether the North Korean authorities have been working in recent years towards building the underpinnings for a shift of policy.

Legal Foundations for External Economic Policy Changes

The Supreme People's Assembly adopted a number of Constitutional Amendments at its session in September 1998. These were not so much driven by a desire to shape a new policy as a desire to recognize, adopt and legalize changes that had already began to take place in North Korea. Specifically, the new Constitution:

- Added economic prosperity as a national objective and diminished the isolationist stance of the previous Constitution. Article 26 states: "The self-reliant national economy in the Democratic People's Republic of Korea is a solid foundation for the people's happy socialist lives and for the growth and prosperity of the fatherland...". The previous Constitutional formulation was for "the country's independent development."

- Added a new Article 37 which encourages establishment and management of foreign investment enterprises in special economic zones: "The State shall encourage institutions, enterprises and organizations in our country to joint ventures and cooperation of enterprises and cooperation of enterprise with foreign corporations and individuals. The State shall encourage the establishment of various companies in the special economic zones." This includes but is not limited to the Rajin-Sonbong area.

- Expanded eligibility for new forms of trade relationships. Article 36 states: "In the Democratic People's Republic of Korea foreign trade shall be conducted by the State or cooperative organizations." This permits recognition of the right to trade for companies that have cooperative or joint venture agreements with foreign companies. The previous Constitution provided that trade be conducted by the State or under its supervision.

- Changed the Administration Council into a Cabinet and enhanced its role and in a similar vein abolished a number of committees and integrated them into Ministries. The policy and decision making apparatus of the government is now much closer to the organization of the responsibilities and authorities in other countries. The Committee for Promotion of External Economic Cooperation, for example, has now been integrated into the Ministry of Trade and headed by a Vice Minister.

- Expanded the scope for private economic ownership and activity. Article 24 defines private property as property owned and consumed by individual citizens. It permits citizens to derive private property from both socialist distributions from the State and also from individual sideline activities, including those from kitchen gardens and "those from other legal economic activities."

- Included a new emphasis on "modernization." Article 28 states: The State shall accelerate the rural technical revolution and industrialize, modernize agriculture, increase the role of the county..." This suggests that the government may be more open than commonly believed to systemic changes in the organization of economic activity and policy, but under the rubric of "modernization," not "reform."

- Introduced a system of independent cost accounting and concepts of cost, price and profit. Article 33 states: The State in accordance with the demands of the Taean work system, shall apply a cost accounting system in managing the economy and guide the people to use such economic levers as cost, price and profit."

In addition to these Constitutional changes, the government has introduced a number of changes in the foreign investment laws. By late 1999, amendments had been made to the: (1) Law on Free Economic trade Zone; (2) Foreign Investment Law; (3) Foreign Enterprise Law; (4) Joint Production Law; (5) Law on Foreign Investment Enterprises and Foreigners Tax; (6) Foreign Currency Control Law; (7) Land Lease Law; (8) Law on Foreign Investment Bank; (9) Joint Venture Law, (10) External Economic Arbitration Law, and (11) Foreign Invested Company Labor Regulations. The scale of this legal activity alone signals that the North Korean government has been following a policy of preparing for expanded economic relations with foreign commercial enterprises. Several notable features of the changes introduced are:

- Recognition the possibility of joint venture and joint production projects, not only in the Rajin-Sonbong region, but in other regions.

- A new term "foreign enterprise" was introduced in the Foreign Investment Law. Foreign enterprise is defined to mean a joint venture, joint production enterprise, foreign organ, or an enterprise, individual or economic organization which derives income in the territory of DPRK.

- New dispute mechanisms have been designed and adopted, where by disputes that cannot be resolved by negotiations will be settled by arbitration or court procedure under DPRK law.

- Local governments have been given more responsibility and authority in managing foreign investment relationships.

- The Cabinet is empowered to decide rates for individual income tax, property tax, inheritance tax, business tax, and car utilization tax.

- Favorable tax treatment and land access are accorded for State-encouraged projects, joint production with overseas North Koreans, and joint production projects promoted in specified areas.

- Hiring and firing policies and compensation rules for labor employed by foreign invested companies have been specified.

Taken together, the Constitutional changes and the revisions to foreign investment laws suggest that North Korea is willing to introduce new concepts of economic management and to seek ways to make foreign investment a more important part of North Korea's economic future. Even so, the adoption by the Supreme People's Assembly in April 1999 of the "Law of the DPRK on the People's Economic Plans" also indicates that a high priority is still given to protecting the socialist character of the North Korean economy. This law re-asserts the primacy of the control of the state over the economy and the importance placed on central planning, and was seen by some observers as an effort by conservative factors in the Kim Jong Il regime to limit the flow of capitalist ideas into the country. Thus the desire to retain strong control over the economy while removing legal impediments to foreign investment seems to be the present course of North Korean legal thinking. While apparently contradictory, this policy of seeking growth through expansion of external resource flows, while adhering to the failed socialist system of the planned economy, seems to reflect a desire of the leadership to have their cake and eat it too.

Overseas Travel and Training

One of the biggest obstacles to expanded external economic relations for North Korea is the very low level of knowledge of the market economies and how they work. This knowledge gap can only be filled through increased human contacts and educational and training opportunities, both inside and outside the country. The Tumen Region Area Development Program coordinated by UNDP has played an important role in giving North Korean officials experiences with investment promotion and economic coordination with its neighbors. In recent years, North Korea has started sending more of its people abroad on short and long term training and official visits. According to a report of the South Korean National Intelligence Service, in 1994 North Korea made 80 overseas official visits. This had risen to only 99 in 1997, but then increased dramatically to 134 visits in 1998 and 222 in 1999. Also, in 1999 North Korea actively participated in 15 International Export Exhibitions, which featured items such as clothes, pottery, handicrafts, ginseng, herbs and liquor. Thirteen of the Exhibitions were in foreign countries, mainly in Asia and Europe, while two were held in Pyongyang. This increase in overseas activity is clearly a precursor to the intensive diplomacy that now seems to be underway.

Training abroad has also been sponsored by UN agencies, primarily the UNDP, some countries with diplomatic relations, and NGOs arranging study tours mainly in technical areas. Beginning in 1997, North Korean students were enrolled in the economic program at Australia National University and recent talks have signaled a desire by North Korea to expand its bilateral training relationships with Australia and also a number of European countries. While initial overtures to the IMF and World Bank to help arrange training in international economics and finance have not yet led to concrete results, they do indicate that the North Korean authorities are aware of their need for technical training and are reaching out in new ways to help overcome the knowledge gap.

Trends in Foreign Investment and Trade

Rajin-Sonbong Free Economic and Trade Zone

North Korea has given priority since 1993 to attracting foreign investment to the Rajin-Sonbong Free Economic and Trade Zone (Rajin-Sonbong FETZ). The total amount of contracts committed from 1993-97 amounted to $750 million, of which only $58 million was actually been disbursed during this 5 year period. This low level of success may have stimulated some re-thinking of external economic strategy among the North Korean authorities that has led to the acceptance of much broader geographic potential for investments in the last two years. Even so, the Rajin-Sonbong FETZ experience contains some valuable insights.

The first is that it is fact possible to attract foreign investment to North Korea. Through 1997, 111 contracts had been signed following an intensive promotion campaign assisted by the UNDP. Also, 10 countries invested in the Rajin-Sonbong FETZ during this period, with Hong Kong and China dominating the scene about equally -- amounting to 80% of commitments and 55% of disbursements. Japan (including four companies sponsored by the Chosensoren) was the third largest investor, with 10% of commitments and 9% of disbursements. No South Korean firms invested in this zone during this period.

The second notable feature is that foreign investment has taken three major forms: equity joint venture (60%), independent foreign enterprise (24%), and contract joint venture (16%). This demonstrates that it is possible to organize different kinds of economic relationships in North Korea.

The third feature worth highlighting is that investments have taken place in a rather broad range of economic activities, covering 18 areas. The largest number of projects is in distribution and retail, followed by marine products, transportation, hotels, tourism, finance, food processing and manufacturing.

In 1997, extensive reforms were implemented in the Rajin-Sonbong FETZ to encourage and facilitate greater foreign investment. The foreign exchange rate was readjusted to USD 1: Chosun Won 220 from the previous rate of USD 1: Chosun Won 2.16. Private corporations were permitted to set up offices in the Rajin-Sonbong region. When the Wonjong Bridge Free Trade Market opened in June 1997 this provided an avenue for trade between North Korean and Chinese merchants across the border. However since 1998, the DPRK has imposed severe restrictions on private cross border markets, and now the Wonjong Bridge Free Trade Market is virtually non-existent due to the severe government crack down.

On September 24, 1998, the Rajin Business Institute was established to train students, government officials, and state managers on the workings of financial management and taxation, promotion of foreign investment, and international trade. This encouraged numerous foreign corporations such as the Emperor Group, Loxley Pacific Corporation, and the Standtern Group to invest in North Korea. However, since 1998, there has been no public report of the progress of foreign investment in the

Rajin-Sonbong Free Economic and Trade Zone.

Types of Foreign Investment

The degree of foreign business permitted in North Korea varies depending on the nature of the investment. For example, a Foreign Enterprise is a wholly foreign owned company, which means its management is free from North Korean government control. However, current DPRK law prohibits Foreign Enterprise business in the following areas: electronics, automation, machine building, food-processing, garment, daily necessities, pharmaceuticals, chemicals, transportation, and service industries. A foreign company does not have direct access to the North Korean market, and therefore has no control

over the distribution or marketing of its goods. Instead, all goods manufactured by foreign firms must be sold to the DPRK trade agency. It is even more difficult to obtain permission to establish Foreign Enterprises(FEs) than Equity Joint Ventures(EJVs) and Contractual Joint Ventures(CJVs).

A Equity Joint Venture is an alternative method for foreign companies to invest in North Korea. However, EJVs are only allowed in explicitly sanctioned areas of science and high technology, construction, and transportation. The organizational structure of EJVs is similar to that of firms in market capitalist countries which consists of a board of directors, executive management, and auditors. Both North Korean and foreign investors are responsible for the management and liable to the actions and performance of the joint venture proportionately. EJVs export and import goods based on international market prices. All domestic transactions are channeled through government designated public agencies or domestic enterprises under the "annual plan of purchasing and selling."

The third form of foreign investment is Contractual Joint Ventures (CJV). This is the preferred method of foreign investment by the North Korean government for basic manufacturing, tourism, and service sectors. Only North Korean partners can participate in the management of the joint venture. The participation of foreign investors is limited to the financing of the business and retaining the contracted portion of the profits. A CJV is the functional equivalent of a partnership with no limitation of liability.

Trade Trends

Total trade volumes have declined steadily throughout the 1990's paralleling the collapse of the official economy. Estimates by KOTRA, Ministry of Unification in ROK are that total trade volume declined from $4.2 billion in 1990 to $1.4 billion in 1998, and that the trade/GNP ratio declined from 20.4% to 11.3% over the same period.

There has also been a trend towards diversification of trade partners, with an increasing share of trade with non-communist countries. The share of imports from non-communist countries has grown from less than 40% in the early 1990's to over 50% by 1997; and the trend in exports has been even more dramatic, with exports to non-communist countries growing from less than 50% in the early 1990's to over 80% by 1997. Even so, North Korea in the late 1990's continues to rely heavily on China and Japan for its external trade, together accounting for nearly 60% of the total value of trade in about equal shares. This does not take into account the growth of the increasingly important informal border trade between North Korea and China, which is fueling the beginnings of a bottom-up market economy inside North Korea. The share of Russia declined dramatically in official trade from over 50% in the early 1990's to less than 5% by the end of the decade. While the South Korean

share of trade has risen significantly from a very low level in the early 1990's of about 5% to about 15% by 1998, the economic crisis in South Korea also has been a factor limiting growth in inter-Korean trade.

China

Trade with China is a special case. In 1998, China supplied 500,000 tons of crude oil, equivalent to the KEDO commitment. China also supplied about 25% of food imports to the country that year. General trade accounted for over half of North Korean imports from China, with border trade contributing another 25%. On the other hand, border trade with China accounted for 66% of North Korea's exports to China, and general trade only 15%. The Chinese trade relationship with North Korea is thus notable in three respects. First, Chinese food and oil are helping to sustain the North Korean economy and regime in a significant way. Second, the border trade represents an important new dynamic that is affecting the internal changes within the North Korean economy. Third, China remains a supplier of conventional military supplies to North Korea. These reflect an underlying policy of both protecting regime survival and encouraging economic change.

Recent Developments in Inter-Korean Trade and Investment

1998 and 1999 have seen important developments in inter-Korean economic relations. In April 1998, the South Korean government adopted measures to encourage the private sector to promote economic cooperation with the North. These measures included lifting restrictions on travel, raising ceilings on investment by South Korean companies in North Korea and simplifying authorization rules and procedures, introducing a negative list system for investment, allowing transfer of "idle industrial facilities" to the North, and allowing South Korean companies to hire North Korean employees for third country projects. As a result there has been an expansion in the number and types of South Korean investment in the North and significantly expanded interactions between the South Korean private sector and North Korean officials. The most well known of these initiatives have been taken by the Hyundai ASAN Corporation, notably the Mt. Kumgang tour project, which is now operating smoothly and sending over 1,000 people a day on the tour. This is also generating significant foreign exchange earnings of about $8 million a month for the North Korean government. About 10 other projects have been agreed in the past two years and more are under discussion.

Inter-Korean trade is also expanding after a drop in 1998 triggered by the financial crisis in South Korea. North Korean exports to South Korea rose from $92 million in 1998 to $121 million in 1999, while imports increased from $130 million to $212 million. The composition of trade is changing rapidly. Imports to North Korea increased in chemicals, non-metallic minerals, and metal and steel, while exports to South Korea expanded in agriculture and fisheries products, While textiles remains an important part of overall trade, its share is declining as relations diversify. The ratio of Processing on Commission (POC) in inter-Korean trade also recovered from a drop to 16% in 1997 to pre-crisis levels of about 30% in 1998 and 1999. Almost $4 billion in raw materials were imported by North Korea in 1999 for processing. The increase in POC activity is an important means for human resource development and technology transfer to North Korea. Inter-Korean trade in 1999 also included disbursements for the KEDO light water reactor project and heavy oil accounting for about 15% of total trade and humanitarian aid for about 13%.

As international economic trends are moving towards areas related to high technology, the South Korean Ministry of Unification recently announced its plans to revise the current Inter-Korean Economic Cooperation law. South Korean legislation is expected to be amended to ease control on the trade of high technology products while also accommodating the possibilities of investing internet businesses in North Korea. Following the Hyundai initiatives, Samsung recently opened the Samsung-Chosun Computer Software Joint Development Center in Beijing. Also, Pyonghwa Motors

obtained the necessary approvals from the MOU to build automobile manufacturing factories under the license of Piaat in North Korea.

A recent survey conducted by the Federation of Korean Industries in 1999 indicates that nearly 60% of the 394 companies responding expressed interest in doing business with North Korea, and that the preferred sectors in the medium term are agriculture, fisheries and textiles. Of firms that are presently doing business with North Korea, it seems that political rather than purely commercial motivations are dominant. Rather than seeking short term profit, these firms are motivated to seek favorable market position for the longer term, enhance their corporate image, or help meet humanitarian needs in North Korea. Expectations of early profits are low.

Clearly inter-Korean economic relations are both expanding and diversifying and these trends are likely to continue. However, the survey of South Korean Companies doing business in North Korea also contains important insights into perceived obstacles to expansion of investment and trade. The main concerns are:

- *High distribution costs*, caused in part by the high cost of transportation and in part by high fees for handling of goods.

- *Political uncertainty,* due to the lack of an official mechanism between the two Koreas for discussing and resolving issues relating to intra-Korean trade.

- *Lack of information*, especially the absence of a business information center for inter-Korean trade and general lack of transparency.

- *Lack of infrastructure*, with the largest concerns relating to telecommunications, internal transport, port facilities, and power.

- *Lack of institutions*, with the greatest concerns expressed about need for a dispute resolution system, frustration that technicians are not allowed to stay in North Korea, and the lack of insurance for possible economic losses.

Shifting Aid: From Humanitarian to Development Assistance

Since 1996, North Korea has received a significant amount of humanitarian assistance, mainly in the form of food aid in response to appeals of the World Food Program, but also increasingly in health and nutrition. It is estimated that total aid has grown from $90 million in 1996 to $380 million in 1999, with the US contributing about half of the total last year, followed by China, South Korea and the European Union. The scale of this assistance has made an important contribution to both sustaining North Korean society in the face of severe food deprivation and also to expansion of direct contacts between North Koreans and the international community. Not as visible, but perhaps

just as important, is the contribution of external aid to the formation of the nascent informal market economy. Leakage of aid to the market and sale of farmers' surpluses to the market have been two of the most important mechanisms for resources to enter these markets.

It is unrealistic to expect that the international community will extend high amounts of humanitarian assistance indefinitely. Improvements in agricultural productivity and general economic performance will be needed for North Korea to regain food self sufficiency. The government's willingness to work closely with UNDP to prepare an Agricultural Recovery and Environmental Protection Program(AREP), reveals both an understanding of the need to make internal changes to achieve these goals and recognition that new forms of assistance and relations with the international community will be needed as well. A donor meeting convened by UNDP in May 1998 was the first time that the international community gathered to discuss with the North Korean government a diagnosis of the problems and proposed approaches for solutions. It was a remarkable event in that it demonstrated the possibility of dialogue and coordinated efforts to work with North Koreans to help them solve their problems. Even so, the meeting did not result in the hoped for pledges of financial support, which donors were not yet ready to endorse in the absence of progress on the political and security issues of primary concern to the international community. The key requirement for helping North Korea solve its economic and social problems is a shift from humanitarian assistance to development assistance, from providing resources to maintain human consumption to providing resources to build assets and increase productivity. There is evidence that this shift is now underway, with an increasing proportion of aid being given in the form of agricultural inputs such as seeds and fertilizers, food-for-work agreements, and small scale development projects funded by UN agencies and some NGOs.

Recent Policy Statements on External Economic Relations

North Korean policy statements are signaling a desire for expanded economic relations, but with an important caveat that there should be respect for differences in the economic systems of trade and investment partners. At the Northeast Asian Economic Form in October 1999, the North Korean representative Kim Si Jin, Vice Chairman of the Committee for Promotion of External Economic Cooperation made the following statements:

"It is our external policy to develop economic and trade relations with the different countries of the world under principles of independence, friendship, equality and mutual benefit. Being one of the region's countries, we pay particular attention to Northeast Asia regional cooperation....Regional cooperation in Northeast Asia is clearly distinguished from other parts of the world in that it is happening among countries with many differences in many aspects. Whether it is successful or not is largely dependent whether opportunities with the rest of the region's countries increase mutual and reciprocal advantages that are fully accounted and provide region-wide benefits. We will in the future continue regional economic cooperation including cooperation in Tumen river area development in conformity with our own needs and peculiarities and on the principle of promoting the joint interests of the region's countries."

On January 28, North Korean Central Broadcasting indicated that a major push to develop export markets was underway: "The officials and workers engaged in foreign trade are exerting all-out efforts to expand overseas markets to meet the needs of a changed situation...They will strive to keep shipment schedules and improve the quality of exports."

State Enterprise Reform

Along with these external policies, the government has taken a recent initiative to revitalize the management of the State enterprise system. This has taken the form of reorganization of industrial

enterprises, revamping the management model, and decentralization. As a result of these reforms, comprehensive production units such as the Combined Enterprises, General Enterprises and General Management Bureaus, have been streamlined into general "factories," "enterprises," and "management bureaus." The restructuring has given smaller production units more responsibility and incentives to seek greater profits. In addition, individual firms scattered among various government ministries, have been merged or integrated into three large government enterprises: Daesung Company of the Workers' Party, Meabong Company of the military, and Kwanmyung Company of the Cabinet. Unprofitable firms have also been closed, for example reducing trading companies from about 300 to about 120. Finally, the Minister of Finance has called for "senior officials serving in central or local government organizations, plants and corporations to be familiar with economic calculations and do their production or management activities very fastidiously, just as if running their households." While these responses may be partial in relations to the reforms needed to place the enterprise system in North Korea on a sustainable growth path, they do indicate a willingness to make systemic changes to improve economic efficiency. Altogether they are much more far reaching than earlier attempts at restructuring state enterprises, such as the effort made in 1994 which only affected about 20 firms.

Changing Dynamics of the North Korean Economy and Social System

North Korea's economy is already deeply in transition. Faced by the collapse of the official economy, the government has responded in five ways. First, it has sought grants from governments, NGOS and UN agencies to buttress food production and consumption, health services and fuel shortages. Second, it has permitted new forms of foreign investment and trade as described above, to obtain the benefits of expanding economic relations with the foreign private sector. Third, it has made partial efforts to revitalize the organization and management of the State enterprise sector, introducing more principles of efficiency. Fourth, it has accepted the expansion of farmers markets throughout the country as an unofficially recognized mechanism to satisfy basic needs of the people that are not being met through the State distribution system. Finally, it is clear that the North Korean government has husbanded scarce foreign exchange and domestic resources under the control of the State to shore up the military sector. This is reflected in the surge of military supplies imported from China in 1999, as well as continuing efforts to strengthen the missile program.

These responses give clear indications of the forces that are driving the North Korean leadership. Putting the North Korean economy onto a new path that can succeed in regaining growth and rebuilding consumption for the population to at least levels that will permit a strengthening not weakening of social capital requires facing up to several imperatives.

First, North Korea can only in the future have trade and investment relations with market economies. It cannot revert to the counter-trade framework that existed before the collapse of the Soviet Union. Adjusting to this trade shock and the need to establish new forms of economic relations with the globalizing market economy is the fundamental challenge facing the leadership. From this perspective it seems clear that the leadership has gotten the message, even though parts of the government may continue to resist and deny the reality, and even through the efforts to date are partial and not guided by a clear understanding of all the dynamics involved in the shift in strategy that North Korea needs to take.

Second, North Korea is only going to have sustainable economic relations with the market economies if these are formed on the basis of sound economic principles and normal commercial practices. Investment and trade that is motivated by political considerations and which does not embody economic fundamentals will not provide the foundation for long term economic security that North Korea needs if it is remain a viable State. Also, it is imperative that domestic enterprises and foreign invested firms also adopt sound economic management principles. Proper cost accounting

and modern management will be necessary, as will macroeconomic policies that send the right price and incentive signals.

Third, the gap that has been created between the economic reality in North Korea and the formal social policies, poses a huge challenge. Not only can the State not provide basic human services to the population, but its ability even to feed and clothe the large urban population has been eroded by the breakdown of the State distribution system. This failure of the State to be able to deliver basic social services and consumption needs of the people has led to the emergence of an unofficial market economy that is fulfilling a social function of enabling the population to satisfy some of their basic needs through the market rather than the State. It is estimated that presently 70-80% of the consumption of the urban population is now met through these markets that sell not only food but many basic commodities. The State has accepted a proliferation of these markets around the country -- now estimate to have reached over 300, but their existence and growth is evidence of a new parallel economy emerging in North Korea that is guided by very different behavior and principles than the official economy. This also has major significance for social control and the relationship of the State to the people of North Korea.

Fourth, the power structure of North Korea has long been dominated by a small elite and the military. The economic dynamics threaten the old forms of resource allocation between different groups within North Korean Society and especially the privileges accorded the military economy.

The essential challenge facing the country in the future is how to manage these changing relationships between the different components of the North Korean economy and social system: the elite, the military, the official state enterprise and agricultural cooperative system, and the emerging unofficial new market economy. This is also the major challenge facing the international community as it contemplates the consequences of expanding economic relations with North Korea, not just for political stability in Northeast Asia but also for the dynamics of internal social and political change.

Implications of Expanding External Economic Relations on Internal Economic and Social Dynamics

If more money is going to flow into North Korea in the future through foreign investment, trade and development assistance, it will have a major impact on these internal economic and social dynamics. A first question is whether the government's strategy will be to use these new resources to rebuild the capacity of the State to protect its security through a stronger military, even if firm agreements are reached with the State on curtailing its missile and nuclear programs. It is hard to imagine a scenario where North Korea does not try to strengthen its conventional and strategic military capabilities, and it is equally hard to imagine how effectively the international community could constrain this, apart from strict monitoring of political agreements made in advance of any significant expansion of economic relations. The only logical hope is that North Korea determines that it is not in its own interest to seek a major rebuilding of its military capabilities and that its future security lies in good relations with the international community rather than confrontational capability.

A second question is whether the State will use an increase in resources available to the country to rejuvenate its socialist system. If so, the emerging unofficial market economy may be a temporary phenomenon, if the markets are closed as the State regains the ability to distribute most goods and services for public consumption through the State distribution system. If, on the other hand, these markets are accepted as part of the new economic order, then the question is how external resources will influence the growth and functioning of the markets and how the official state economy adapts to a parallel growth model. It is impossible to imagine how North Korea could adopt a parallel growth model without major reforms of the state enterprise system and without a major price reform to bring state prices in line with prices in the market segment of the economy. The

current gap between state and market prices is one of the primary factors fueling the growth of the market economy.

A third question is how expanded external economic relations will affect the perception of the North Korean people of the outside world and their place in it. There is no question that the presence of foreigners inside North Korea since the mid-190's has led to some relaxation of restraints and a great deal more contact and collaborative activities. However, the fact that a number of NGOs have left the country out of frustration also signals that control over the activities of foreigners and their access to information is a major source of friction that can undermine the objective of expanding economic relationships. This reflects a major issue for the North Korean leadership, which is how to manage the wide gap between the self perception of most North Koreans and the realities of the outside world. The dilemma they face is how to get the money and resources without giving up control or risking "cultural pollution" that could lead to internal political dissent. This issue and how the government handles it is likely to affect the dynamics of North Korea's relations with foreigners for some time to come, especially investors and development assistance agencies.

It is hard to forecast where the path that North Korea's efforts to expand external relations will lead. What we do know is that the policies that are adopted by the government and the policies that are adopted by the international community relating to how new external resources are made available to North Korea, will play a critical role in determining the outcomes. Thus there are important challenges in the period ahead both for North Korea and for the international community.

Challenges for the North Korean Government

The challenges for the North Korean government can be grouped into three areas: removing obstacles to attracting foreign investors and trading partners, learning to work with development assistance donors, and managing the domestic consequences of expanded external economic activities.

Removing Obstacles for Foreign Investment and Trade

Macroeconomic Framework. The major requirement for long term investors and trading partners will be to get a macroeconomic framework in place that provides the right incentives for profitable and economically sustainable commercial transactions. The most important issue will be price reform, both in the official exchange rate and for domestic prices. At present the official exchange rate is 2.2 won to the US dollar. The black market rate is 200. Official wage rates are 100-150 won per month, while it is estimated that it costs 4000 won per month in the farmers markets to feed a family of four for a month. While North Korea introduced some currency reforms in 1997 limited to the Rajin-Sonbong area, these will need to be broadened and also address the issue of non-convertibility of the won. A related issue is making available to investors and trading partners reliable information about economic conditions. This means that improving economic statistics and reporting these in international conventional formats will be necessary. Essentially, the implication is the North Korea will need to join the International Monetary Fund and comply with its standards and reporting requirements.

Public Infrastructure. Transport, power, water supply, and telecommunications are essential public infrastructure to attract private investment. At present, infrastructure in North Korea is in broken down condition. Major investments in rehabilitation and upgrading will be needed. Since the State does not have the resources or technology to do this on its own, official development assistance will be needed to remove the infrastructure bottlenecks. President Kim Dae Jung announced in Berlin in March that South Korea was prepared to finance infrastructure rehabilitation in North Korea on a State to State basis. This represents the first time that any member of the international community

has signaled its willingness to help North Korea address its infrastructure problems. A major advantage for North Korea in eventually joining and gaining access to the resources of the World Bank and Asian Development Bank will be for their assistance in rebuilding transport, power, irrigation, and urban infrastructure.

Financial System. North Korea's banking system is not designed to support normal international commercial transactions, and the Central Bank is not equipped to provide either the policy guidance or supervision of the financial sector that will be required if North Korea is going to expand its international economic relations. A major and long term agenda will be in modernizing the banking system and building prudential regulation and supervision capacity of the Central Bank.

External Debt Another major impediment for investors and especially their bankers, is the fact that North Korea has about $12 billion in arrears to external creditors and no credible external debt management capabilities in place. Most of the debt to OECD countries was incurred during the 1970's. Because of the large drop in GNP in the 1900's, the external debt to GNP ratio has risen sharply from an estimated 34% in 1990 to 96% in 1998. This implies that an early priority after joining the IMF will be planning a Paris Club rescheduling of official external debt, as was the case when Vietnam opened up in the early 1990's. Also, technical assistance to help the North Korean government establish modern debt management and supervision capabilities will be an early priority for development assistance.

Legal System While North Korea has clearly made a significant effort since 1997 to improve the legal foundation for expanded foreign investment and trade, further refinements will be needed to satisfy investors and trading partners that the risks they face in doing business with North Korea are adequately covered. This is likely to require significant additional efforts to provide clarifications of policy and details of rules and procedures to attract investors on a commercial basis. Mechanisms will be needed to educate North Korean officials about these risks and to provide technical assistance to help sharpen laws and regulations. Another major area of concern is enforcement. The willingness of North Korean partners to honor the value of sanctity of contracts and the capabilities of the North Korean court system to settle disputes with foreign interests are highly questionable.

Businesslike Behaviors The lack of knowledge of international commercial practices and finance is a major impediment to forming businesslike relationships. Training will be needed for all actors involved in the government, financial institutions, and enterprises. In addition, foreign language capabilities are likely to be highly taxed as the number of investor and trading relationships expands. Thus language training will also need to be given a high priority. This includes both expanded foreign language training, and introducing into the North Korean language standardized terms for technical economic, financial and commercial concepts that are not in common use.

Management Control and Labor Practices. Joint ventures with foreign companies are very likely to encounter major problems in the intersection of foreign and North Korean expectations for control over management decisions and especially labor. This will require finding ways to work cooperatively, communicate well, and resolve operational and management disputes at the firm level.

Official Development Assistance

Membership in the International Financial Institutions (IFIs) The best way for North Korea to obtain ODA on the scale needed to rehabilitate the economy is to join the World Bank and Asian Development Bank. To join, however, means that North Korea will have to obtain the support of the major shareholders of these institutions, most importantly from the U.S. and Japan, and also be willing to abide by the conditions of membership. Both of these are big hurdles. To join the

international financial institutions, a country not only has to apply, but it has to be voted into membership by the existing shareholders. This requires a positive action by the shareholders. As a practical matter, North Korea will have to overcome both the political and the legal reasons why the U.S. and Japan cannot at present support their bid, even if they do decide to make a formal application. This can only be done through advances in North Korea's bilateral relationships. The diplomatic and political processes now underway will have to yield concrete results and precede any realistic expectation of obtaining IFI resources.

ODA Policies and Procedures An equally difficult challenge for the North Korean government will be accepting the fact that donors such as the IFIs and many bilateral aid agencies will require policy dialogue, institution building and transparency as essential ingredients of the ODA relationship. What the experience of the past 40 years of ODA has taught the international community is that good policies and sound institutions are more important than aid flows to achieve good economic and social development. If the North Korean objective is to get the money without discussion of the policies and institutional issues, they will soon discover disappointment and frustration in their relations with ODA donors. Also, development assistance is inherently different than humanitarian assistance. It involves different kinds of information, different methods of appraisal, implementation and evaluation, and different types of working relationships.

Aid Coordination At present there exists a humanitarian coordinating capability in Pyongyang for UN agencies and NGOs providing support to North Korea. This plays an extremely important role in sharing of experiences and shaping of common policies and practices to try to achieve effective delivery of these services to North Korea. As the shift takes place from humanitarian to development assistance, it will be necessary to change the donor coordination mechanism as well and the government will need to be fully integrated into this mechanism. This will require the government to engage in policy dialogue with the donor community as a whole and not only one on one with various donors, and will make it very difficult for the government to segment its external ODA relationships and treat them independently.

Managing Domestic Consequences

Organizational Issues As external economic relations grow and diversify, it will be necessary for the North Korean government to establish decision-making and administrative mechanisms to manage the many issues that will require attention and action. A major issue is likely to be internal turf battles for control over these relationships. Internal struggles and poor decision making can lead to investor and donor dissatisfaction and departure.

Distribution of Rents and Corruption Another major issue will be the risk of corruption and rent seeking among the State organizations and officials involved with foreign investment and ODA. Experience with other former communists countries in transition suggests this will be a large and difficult problem to overcome. In North Korea, the issue is especially important as there is likely to be significant pressure to siphon resources for the consumption of the inner elite and to satisfy the military. Another critical aspect is whether resources will flow to the unofficial market economy and help it grow and contribute to a broadening of welfare gains within North Korean society, or whether the resources that accrue to the State will permit a policy of reasserting the primacy of the State in meeting the consumption needs of the population and lead to a weakening or disappearance of the parallel market economy. How the government handles these issues will affect the attitudes of the international community in supporting expanding investment and development assistance.

Contacts with Foreigners Concerns about domestic political dissent and "cultural pollution" are likely also to rise as foreign investment and ODA activities expand and require interactions with many North Koreans. To manage these issues will require foresighted and progressive leadership,

which many observers would doubt exists in the North Korean regime at present.

Challenges for the International Community

The patience of the international community is likely to be sorely tried as investors and donors seek to build new relationships that meet their requirements for commercial and developmental viability.

Linkage of Political and Economic Relations The most important issue facing the international community will be how to coordinate political dialogue and process with the expansion of economic relations. There is already a well functioning policy coordination process between the U.S., Japan and South Korea and good coordination with China, the European Union and other interested countries such as Australia. These efforts will need to be expanded beyond security and humanitarian issues to achieve a fully coordinated orchestration of policy. This will be increasingly difficult as the number of countries engaged grows and as there are a larger variety of actors involved, especially in the private sector. The addition of human rights concerns to the list of areas of engagement by the international community is also inevitable once the security issues of first priority are resolved. It will be necessary to organize this coordination both outside of North Korea and in Pyongyang. The United Nations, especially the UNDP, should be given a stronger mandate and resources to play a central role as the focus shifts towards the economic and wider social agenda.

Education and Training On virtually every front, education and training of North Koreans will be a top priority for successful building of new external economic relationships. This will also involve both expanded external training through formal programs in universities, study tours, and short term specialized courses, and also expanded training in-county through building local educational and training capacities, short term courses for targeted groups, on-the-job learning, and technical assistance. The variety of topics and mechanisms to convey new knowledge and skills will present large challenges to the providers as well as the receivers. Some coordination mechanism will be most useful in this area as well.

Maintaining Discipline to Promote "Good Habits" North Korea does not have a good reputation for businesslike behavior. It is important that foreign investors, trading partners, aid agencies and NGOs conduct their business relations with strict regard to normal commercial and economic practices. It will not help North Korea's integration with the international community for agreements to be based on political expediency or efforts to purchase long term advantage at the sacrifice of these norms.

Policy Dialogue and Institution Building While some elements within the international community are likely to push for radical economic and institutional changes, it is important that strategies for influencing change be based on a mixture of economic rationality and sensitivity to political, cultural and historical factors that will affect North Korean behaviors. This is an art not a science and there are likely to be differences of opinion of the speed and pace of desirable change. Thus mechanisms to debate these issues and try to advance consensus thinking will be important for the international community. Similarly it will be useful to develop mechanisms for ongoing dialogue with the government on policies and management of change.

Conclusions

North Korea is on a path that could lead to significantly expanded external economic relations. While the future direction that these relations will take is uncertain, it is clear that there are many challenges to be faced, both by North Korea and the international community. Overcoming these challenges will require determination, patience and good will for all concerned. The policies of the

North Korean authorities and the policies of the international community will have a major impact on the political, economic and social outcomes of a strategy to help North Korea to become less isolated and a more normal member of the international community.

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