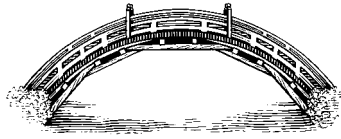


SPECIAL ROUNDTABLE

What If?
Economic Implications of a Fundamental
Shift in North Korean Security Policy



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Visualizing a North Korean “Bold Switchover”: International Financial Institutions and Economic Development in the DPRK

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NOTE ≈ *The views expressed in this paper are those of the author and do not necessarily reflect those of the World Bank, International Monetary Fund, and Asian Development Bank, or their Executive Directors and the countries they represent. An earlier version of this essay appeared under the title “Implications of a ‘Bold Switchover’ in Security Policy for Involving the International Financial Institutions in Financing North Korean Economic Development.”*

EXECUTIVE SUMMARY

This essay examines the issues involved in the mobilization of international aid to support any future “bold switchover” in North Korea’s security policy, and assesses possible roles for international financial institutions (IFI) such as the World Bank.

MAIN ARGUMENT

Due to the unique conditions of the North Korean context, any IFI role in that country would require major shifts in the way that the Democratic People’s Republic of Korea (DPRK) currently shares information, develops economic policies and institutional capacities, and works with foreign partners.

POLICY IMPLICATIONS

- If the IFIs are to play an effective role in providing the necessary aid coordination to help the DPRK, then both Pyongyang and the major IFI shareholders will need to exhibit strong political will and shift their present thinking regarding the desirability of IFI engagement.
- DPRK membership in the IFIs would require that Pyongyang adhere to international norms regarding information sharing, conduct in economic relations, and access to IFI resources.
- As an interim step, special trust funds administered by the World Bank—often useful in post-conflict situations—should be considered for North Korea.
- In order to ensure the necessary discipline in setting priorities and coordinating political and developmental aid as steps to reach agreed outcomes, the DPRK should consider the adoption of mechanisms such as the “transition results matrix.”
- The development of a relationship between the World Bank and the DPRK, along with the incumbent coordination of development aid, will need to proceed through a phased process.
- Given the particularities of the North Korean context, political and development aid must be coordinated appropriately to ensure economic rationality and the sustainability of political achievements.

If North Korea (Democratic People's Republic of Korea, DPRK) were to relax its "military-first" policy and transform relations with its neighbors and the international community at large, such a "bold switchover" in security policy would provide both the DPRK leadership and the international community with strong incentives to anchor a new security environment by working to provide significant economic benefits for the North Korean people. The challenges would be enormous, however, and would include managing domestic political economy implications of the policy shift, developing a realistic economic development strategy that would be linked to a military demobilization and redeployment strategy, establishing new working relationships with foreign partners who would provide foreign aid and private investment, and effectively absorbing external finance and technical assistance. Among the first questions to be addressed under such a scenario is whether or not the DPRK would choose to finally become a regular member of the international financial institutions (IFI). Such a move would allow IFIs to play the same central role in policy dialogue, development finance, and donor coordination that they perform in other developing countries.

This essay examines the issues that both the DPRK government and the international community would need to address in their efforts both to mobilize international aid to support transition in the DPRK and to build a future role for IFIs such as the World Bank.¹ The main argument is that, although a potential role for IFIs in North Korea does exist, the unique conditions of the DPRK context would require that any such role be preceded by major shifts in the way that Pyongyang currently shares information, develops economic policies and institutional capacities, and works with foreign partners. The development of a relationship between the World Bank and the DPRK, along with the incumbent coordination of development aid, will need to proceed through a phased process.

This essay is divided into six sections:

- ≈ pp. 14–16 offers a review of the potential role for the IFIs
- ≈ pp. 16–18 discusses three initial steps that the IFIs could take even before gaining access to the DPRK's finances
- ≈ pp. 18–19 sets out the general requirements for the DPRK's membership in IFIs

¹ For a general overview of the needs and challenges for international involvement, see Stanley Foundation, "Future Multilateral Economic Cooperation with the Democratic People's Republic of Korea" (a report on a conference in Berlin, June 15–17, 2005) ≈ <http://www.stanleyfoundation.org/reports/EENK05.pdf>.

- ≈ pp. 20–22 highlights the need for the World Bank to adopt a phased-in approach to building a relationship with the DPRK
- ≈ pp. 22–24 examines the larger issue of coordinating political and development aid in the DPRK context
- ≈ p. 24 draws implications for developing an appropriate support strategy for the World Bank and other donors

POTENTIAL ROLE FOR INTERNATIONAL FINANCIAL INSTITUTIONS IN NORTH KOREA

A bold switchover policy would potentially trigger a dramatic re-allocation of resources in the DPRK economy that would stimulate economic growth through improved efficiency of resource use. Depending on the strategies and policies adopted, however, the costs of transition could be large and the equity outcomes highly uncertain. In order to accomplish a transformation that would put the DPRK economy on a sustainable growth path, North Korea would require both an infusion of capital investment as well as resources for managing the social costs of transition. Because the DPRK's public finance and banking institutions are incapable of mobilizing domestic savings to finance these needs in the short and medium term, Pyongyang will require large-scale external financing through both Official Development Assistance (ODA) and foreign private investment. The DPRK will also need advice and technical assistance to design economic development strategies and policies that will convince donors and private investors that the DPRK is capable of utilizing external assistance and investment appropriately. The resolution of the DPRK's long-standing external debt arrears and improvement of debt management capacity will constitute essential parts of this agenda. In addition to designing future economic development strategies and policies, mobilizing foreign capital and knowledge resources, and building investor confidence, the DPRK will also need help in establishing management capacity and coordinating not only dialogue with donors and investors but also the implementation of projects and programs that are supported by these donors.

The IFIs have the capacity and experience to support the DPRK in addressing these challenges.² The International Monetary Fund (IMF) is particularly important for the future of the DPRK due to the role this

² For a full discussion of the potential roles for the IFIs, see Bradley Babson, "The International Financial Institutions and the DPRK: Prospects and Constraints," University of British Columbia, Institute of Asian Research, North Pacific Policy Papers, no. 9 (2002).

organization can play in helping the DPRK to compile statistical information regarding North Korea's financial condition and economic performance that would be essential in building the confidence of donors and investors. If Pyongyang does not meet the basic requirements of routine and transparent reporting on the macro economy and financial sector, the DPRK will not be able to expand from receiving humanitarian and political aid to being the recipient of development aid and private investment from the international community. The approval of bilateral commitments of ODA for most donors will require a credible macroeconomic framework, and the IMF endorsement of this framework will be one of the major determinants of the willingness of donors to commit large-scale ODA to the DPRK. Similarly, the IMF will play a critical role in the resolution of the DPRK's external debt overhang already owed to the Paris Club. This resolution will be important not only for the DPRK's ability to mobilize future ODA but also in order to improve the country's creditworthiness ratings and investment climate for foreign investors.

The World Bank is also a potentially important partner for the DPRK. The World Bank has global experience both in supporting economic transition from planned to market economies as well as in post-conflict reconstruction and transition from humanitarian to development assistance. Moreover, the World Bank has a history of close relations with South Korea, China, and Russia as borrowers, and with the United States and Japan as the organization's two largest shareholders. Thus the World Bank is well-positioned to work closely with the countries involved in the Six-Party Talks to develop a program of support for the future DPRK under a bold switchover policy. Through the Consultative Group mechanism, the World Bank can not only provide the overarching coordination necessary for a coherent transition and development program from the broader international community, but can also ensure effective coordination both in policy dialogue with the DPRK and in aid mobilization and implementation.

The Asian Development Bank (ADB) will likewise have an important potential future role in the DPRK. Much like the World Bank, the ADB can help mobilize capital for investment and provide technical assistance that will supplement the resources being mobilized both bilaterally and through the World Bank. The ADB has also developed competent sub-regional development expertise, most notably through its successful sponsorship of the Greater Mekong Sub-Region (GMS) initiative. The ADB has already supported regional development activities in Northeast Asia through studies conducted in collaboration with the Tumen River Area Development Program

(TRADP), of which the DPRK is a participating member. The fact that Russia is not a member of the ADB, however, would require that special arrangements be made for the ADB to work together with Russia in a coordinated regional program for the economic integration of the DPRK into Northeast Asia.

INITIAL STEPS

In order for the DPRK to benefit from potential IFI involvement in North Korea, Pyongyang must understand how IFIs would approach the development of a relationship and the types of initial activities that would need to be undertaken before gaining access to IFI financial resources. Initially, the non-financial aspects of the relationship would be much more important, and would focus on the following three areas: training and capacity-building, development strategy and policy dialogue, and pre-investment activities.

Training and Capacity-Building

The DPRK will need to institute a comprehensive program of training and capacity-building. Presumably, the IFIs would contribute to such a program in a number of ways. For instance, the World Bank Institute (WBI) provides a variety of learning services, including designing and delivering courses and seminars, promoting knowledge networks and communities of practice, and providing technical and policy advice. The IMF Institute similarly provides programs for macroeconomic and financial system policy, monitoring, and management, while the ADB Institute promotes research on development models and organizes policy discussions and learning opportunities. Taking advantage of these learning resources would require that the DPRK develop the large-scale capacity to mobilize the participants for both in-country and overseas learning programs, work with the training agencies to design programs tailored to high-priority needs, and utilize the knowledge gained. Coordination with other suppliers of training and knowledge services would also be important.

The innovative programming of the World Bank's Global Development Learning Network (GDLN) provides access to knowledge and experience in the practical aspects of development. If the DPRK government adopts a policy of allowing connections to the international information networks, the GDLN (and the Internet in general) can be a highly effective tool to promote learning for government officials, university students, and business managers. The DPRK government would, however, first need to accept the implications

of exposing a broad spectrum of North Korean society to detailed knowledge of development and business practices in the outside world.

Equally significant would be the transfer of knowledge and experience that comes informally through such cooperative activities as studies and pre-investment preparations by teams of IFI staff working with counterparts from various ministries. These on-the-job learning opportunities at the technical level are extremely important for building working relations, successfully implementing large-scale development projects, and meeting the various requirements of the funding agencies. To be effective, IFI staff would need to have ready access to their counterparts, be permitted to work together in teams to accomplish tasks, and be able to rely upon professional and open relations when problems arise even at the lowest levels of bureaucracy.

Development Strategy and the Importance of Policy Dialogue

Any relationship that the DPRK develops with the IFIs will be greatly strengthened early on by mutual understanding of the DPRK's particular economic and social conditions. This understanding will help to decide which policies would best promote economic recovery and which development strategies would best help the DPRK achieve its goals and objectives in a manner that the IFIs can, in light of their mandates and general policies, wholeheartedly support. Policy dialogue plays a vital role in any IFI action undertaken in support of a country's development. One way this dialogue is accomplished is through joint studies of relevant topics. Such topics typically include needs assessments, public investment and expenditure reviews, sector studies, and seminars related to development planning and management. The breadth of relevant topics implies that the DPRK would need to be able to accommodate groups of experts who would interact with government officials at various levels on policy-related issues. In order to stimulate meaningful and effective policy dialogue, it is essential that a clear framework for decisionmaking across major stakeholder groups within the DPRK is established.

Pre-Investment Activities

IFI lending requires more than just a mutual agreement on development strategies and policies. Pre-investment activities also require assessments of a government's legal system, internal financial management capabilities (including controls over budget planning, budget administration, and audit standards), technical preparation of projects, environmental and social impacts

of proposed investments, preparation of mitigation plans, and the adoption of policies and procedures relating to procurement of goods and services that meet IFI requirements. Because these pre-investment activities span across many different government agencies, managing internal coordination within the government is an essential part of a working relationship with the IFIs (which also need access to all the concerned agencies in the conduct of their work).

GENERAL REQUIREMENTS FOR RELATIONS WITH THE IFIS

The DPRK is not a member of any of the IFIs, and relations between North Korea and such organizations are essentially non-existent. Ever since the food crisis of the mid-1990s, however, the DPRK and IFIs have had sporadic contact with each other. In 1997 the DPRK unexpectedly sent a letter to the ADB seeking to explore the possibility of membership—a possibility that was rejected by the major shareholders. In September 1997 the IMF sent a fact-finding mission to the DPRK and submitted a report of mission findings to the IMF's Board of Executive Directors. In February 1998 the World Bank sent an exploratory mission to the DPRK with the intent of building an understanding of the benefits and requirements of a relationship with the DPRK. Following the inter-Korean summit of 2000, informal contacts led to a formal invitation being issued to the DPRK to participate as a “special guest” in the IMF/World Bank Annual Meetings in 2000. North Korea declined this invitation, however, and direct contacts ceased following the events of October 2002 and the ensuing nuclear crisis.

Two essential requirements would have to be met for a bold switchover policy to benefit relations between the DPRK and the IFIs. First, the DPRK would need to actively participate in the relationship and accept the international norms that would accompany the development of such relations. Second, the shareholders would need to support the free flow of IFI resources, both knowledge and financial, to the DPRK.

An early issue to be addressed in any new relationship is the establishment of communications and counterparts. Both sides need to designate responsibility for managing the development of the relationship and coordinating communications. Individuals also need to be assigned to carry out these responsibilities—a task they cannot fulfill without the allocation of proper resources with which to conduct their activities. There are no fixed rules for the assignment of lead counterpart relationships for countries other than that they be financial agencies. The Central Bank is typically given the

lead role for developing relations with the IMF, and the Ministry of Finance assumes responsibility for multilateral development banks. In order to avoid miscommunication and misunderstandings during the early phases of relationship building, internal communication within both the DPRK government and the IFIs themselves is essential. Education of policymakers, mid-level officials, and technical staff is very important at this early stage. Equally important is control over official communications and approvals by senior officials for actions between the two sides.

To obtain membership in an IFI, a country initially needs to make a formal application, meet the legal requirements for membership, and receive a vote of approval from the boards of governors. In the case of the IMF, this requires at least 85% support from the shareholders. Furthermore, membership in the World Bank must precede membership in the IMF (although processing both applications simultaneously has become common practice). One of the requirements of the World Bank is that a country must first join the International Bank for Reconstruction and Development (IBRD) before becoming eligible for membership in other IBRD organs—such as the International Development Association (IDA), the International Finance Corporation (IFC), and the Multilateral Investment Guarantee Agency (MIGA). In the case of the DPRK, becoming a member of any of these World Bank organs would carry potential benefits. Though joining the IMF before joining the ADB is not a formal legal requirement, in reality the board of governors is unlikely to approve membership for an applicant that has not already been accepted as a member of the IMF. Rules similar to those governing membership applications for the IBRD and IDA of the World Bank also govern access to the ADB Official Capital Resources (OCR) and Asian Development Fund (ADF).

Merely receiving assistance from an IFI, however, does not require membership. If the Boards of Executive Directors were to adopt a resolution stating that the provision of assistance to the DPRK is in the interests of existing members, such assistance could certainly be proffered. In practice assistance of this sort falls into three categories. The first is technical assistance and training designed primarily to help potential members both prepare themselves for the application process and meet the legal and technical requirements for membership. The second is analytical work and technical assistance related to post-conflict recovery and economic reconstruction planning. The third is assistance provided through special trust funds established by donors and the World Bank that require the World Bank to administer the funds and provide other services such as aid coordination.

NEED FOR A PHASED-IN ROLE FOR THE WORLD BANK IN THE DPRK

Even if the DPRK adopted a major shift in security policy and political relations with the international community, it is by no means self-evident that North Korea would be ready to meet the requirements of a full-scale relationship with the World Bank.³ Given the absence of any historical relationship, a process of mutual education would likely constitute the first step. The most logical strategy would be a phased approach in which each stage provides the foundation for an expanded relationship and scale of assistance in the next. A possible sequence might resemble the following model:

- *Phase 1:* Education, training activities, cooperation in a comprehensive economic assessment, and development strategy dialogue.
- *Phase 2:* Establishment of a “special trust fund” to finance a program of high priority training, technical assistance, sector and institutional assessments, and pre-investment studies. An initial donor coordination mechanism should accompany the establishment of the trust fund.
- *Phase 3:* Membership in the IMF, IBRD, and IDA; initiation of an IDA assistance program; and establishment of a consultative group for the DPRK. Membership in the IFC and MIGA would also be appropriate in this phase.
- *Phase 4:* Graduation to IBRD borrowing and support for accession to the World Trade Organization.


The first phase might last one year in duration, whereas the second phase could span three to four years. Phase three could overlap with phase two and last as long as is deemed necessary, with the eventual goal of moving to phase four as soon as performance permits. Given space constraints, this essay will analyze the creation of the special trust fund as noted in phase two.

³ For an in-depth examination of the requirements of any new relationship between the DPRK and IFIs—such as the IMF, IBRD, and IDA—please see the full version of this essay, Bradley O. Babson, “Implications of a ‘Bold Switchover’ in Security Policy for Involving the International Financial Institutions in Financing North Korean Economic Development” (report prepared for a conference sponsored by The National Bureau of Asian Research, March 2006) ≈ <http://www.nbr.org/programs/northeast/nkbs.pdf>.

Special Trust Funds

In recent years a number of situations have arisen in which the World Bank has been asked to establish and manage special trust funds for countries that are emerging from conflict. Special trust funds have been established for such non-member states as the West Bank and Gaza, Bosnia-Herzegovina, Kosovo, and Timor-Leste. More recently, the World Bank has also set up special trust funds for existing members who are facing special circumstances, such as in the Sudan, Afghanistan, and Iraq. These special trust funds are typically established based upon a resolution of the Board of Executive Directors at the World Bank, and operate under rules and procedures formulated for each country on a case-by-case basis. These trust funds pool finances from participating donors and disburse funds in accordance with operational rules, normally on a grant basis. In such cases the World Bank has been appointed trustee of the fund, and a donor council of contributors approves programs for use of the funds. In the case of the Timor-Leste fund, the ADB, working in tandem with the World Bank, has been given an implementing agency role.⁴

The advantage of special trust funds in a post-conflict situation is that they can help bridge the transition from humanitarian aid to development assistance. Through start-up aid for economic reconstruction and development, those funds can help bridge political aid given to improve the security environment and the transition to peacetime. The idea of establishing a special trust fund for the DPRK at an appropriate political moment to facilitate both of these transitions is very appealing. Certainly, any decision by Pyongyang to adopt a bold switchover security policy would be sufficient to trigger a willingness in the donor community to establish such a fund for the DPRK. Though the specific roles and procedures governing the fund would need to be negotiated to fit the special circumstances on the Korean peninsula, such an undertaking would not be particularly difficult. The administration of the fund could likewise be assigned to either an entity created specifically for this purpose or to an existing multilateral organization—such as the UN, UNDP, or World Bank—that could call on experience in delivery special assistance in post-conflict environments. The fact that the World Bank has established special trust funds for other post-conflict situations would seem to indicate that such an arrangement could work for the DPRK as well, especially since the mechanisms for administration, monitoring, and reporting are all well

⁴ For a detailed description of the operations of “special trust funds,” see Chuong N. Phung and Jean François Bauer, “Interim Evaluation of the Trust Fund for Timor-Leste (TFET)” (a report prepared for the European Commission, October 2004)  <http://siteresources.worldbank.org/INTTIMORLESTE/Resources/EuopenComission-EvaluationReport.pdf>.

established. Establishing such a fund would, however, require that the Board of Executive Directors adopt a resolution authorizing the World Bank both to undertake such a responsibility and to develop a working relationship with the DPRK (even if the membership process was still at an early stage).

LINKING POLITICAL AND DEVELOPMENT AID IN THE DPRK CONTEXT

Unless clear and transparent agreements and accountabilities govern the use of all resources available to a government, the fungible nature of money can result in foreign aid of any sort being allocated to other priorities. Moreover, though external aid given to a country may be earmarked for humanitarian, political, or economic development objectives, decisions to extend aid for any of these reasons have consequences both for the economy and the incentives for the major economic stakeholders in determining their priorities and actions. For these reasons, it is important not to focus solely on the motivational frameworks for supplying aid to the DPRK; the goal should instead be to effectively manage an external economic engagement strategy that will accomplish the objectives underlying these motivational equations. Assistance provided to the DPRK during the past decade has tended not to be utilized in a manner consistent with the donor's wishes. Thus any future assistance programs for the DPRK need to be governed by transparent international norms and be based upon coherent policy coordination among the donors.⁵

Any bold switchover in DPRK security policy would likely pave the way for the normalization of DPRK-Japan relations; as a result, a significant amount of politically motivated aid would likely flow into North Korea. Though the chief suppliers of this aid would be those countries involved in the Six-Party Talks, the European Union and other countries (such as Australia and Canada) would likely choose to participate as well. These countries would also be likely to become important future suppliers of development assistance


⁵ For a good analysis of aid and international norms in the DPRK case, see Carol Lancaster, "Foreign Aid and International Norms: The Case of North Korea," in *A New International Engagement Framework for North Korea? Contending Perspectives*, ed. Ahn Choong-yong, Nicholas Eberstadt, and Lee Young-sun (Washington D.C.: Korea Economic Institute of America, 2004), 159–74. For lessons from experience, see Bradley Babson, "Designing Public Sector Capital Mobilization Strategies for the DPRK" (paper prepared for a conference sponsored by the American Enterprise Institute, Korea Economic Institute, and Korea Institute for International Economic Policy, Washington, D.C., February 12–13, 2004), 231–56 ≈ http://www.nautilus.org/archives/pub/ftp/napsnet/special_reports/Babson.pdf.

to the DPRK, both bilaterally and through multilateral organizations such as the World Bank and the ADB.

A scenario in which both political and development aid would flow to the DPRK presents implications worth considering. First, political aid must not undermine incentives for the DPRK to pursue economic reforms and carry out development policies that are in North Korea's own long-term interest. Second, neither political aid nor development aid should undermine the political will that led to a bold switchover in security policy in the first place. The ways in which aid is provided and managed should serve to reinforce the DPRK's political and economic security. Third is that synergies should be exploited between aid that is provided for political reasons and aid that is provided through development assistance based on international norms. This step is particularly critical in the coordination of military manpower redeployment with job creation and new skills training opportunities, the transfer of military assets to civilian economic use, the priorities and policies needed to make best economic use of infrastructure construction that is funded through political aid, and the integration of investments and activities funded by political aid with formulation of a comprehensive economic development strategy. Finally, it is important that bilateral and multilateral aid are well coordinated and that an overall coherence underlies the transfer and absorption of external resources into the DPRK.

A tool that has been developed for other post-conflict situations may be appropriate for the DPRK context. The "results transition matrix" (TRM) is a mechanism for coordinating the planning of activities and assistance provided by donors in a phased manner. TRM, which was developed by the World Bank and United Nations Development Group in collaboration with other donors, is now in use in Haiti, Timor-Leste, Liberia, the Sudan, and Central African Republic.⁶ The TRM aims to accomplish the following four objectives:

- provide a management tool for national authorities to use as a calendar for focusing on key actions
- identify explicitly the links between political-security and economic-social issues
- articulate a compact between the national authorities and the general populace and provide a framework for demonstrating benefits and gains achieved during the transition

⁶ For a detailed description and assessment of lessons of experience, see United Nations Development Group and World Bank, "An Operational Note on Transition Results Matrices: Using Results-Based Frameworks in Fragile States" January 2005  <http://siteresources.worldbank.org/INTLICUS/PoliciesandGuidance/20330632/Operational%20Note%20on%20TRMs.pdf>.

- serve as a catalyst for harmonization among donors, allow for improved donor coordination, and articulate a compact between the national government and international donors

Experience has shown that, by identifying key priorities and balancing comprehensiveness with selectivity, a results-based TRM can help governments manage, discipline, and foster coordination among donors.

CONCLUSION

By combining a phased approach to building a role for the World Bank in North Korea with a TRM supported by donors who provide both political aid and development assistance, it is possible to imagine a viable roadmap for moving forward with a complex and challenging agenda. Such a possibility could only be realized, however, if the DPRK were to adopt a bold switchover policy. Fostering realistic expectations within specific timeframes is critical toward building trust and confidence in new working relationships between the DPRK and foreign partners. To achieve this understanding, high-level discussions concerning the future involvement of IFIs in the DPRK need to take place. Though the World Bank can play a pivotal role in the planning and implementation of such a process, the DPRK must be willing to engage in such discussions, and those holding a major stake in the future of the DPRK and Northeast Asia must support a bold approach to economic and social development as well as to security realignment.