
Conclusions

In Korean there is a saying, “two enemies will meet on a one log bridge.” On the Korean peninsula today, two rivals tied together by history, geography, and nationality face off along the world’s most militarized border. South Korea has been described as the first developing country to achieve developed country status. It has made the transition from military authoritarianism to a fragile and still maturing democracy. Yet even as policymakers in developing countries look to the “Korean model” for insights, the crisis that rocked South Korea at the end of 1997 is forcing a reassessment of this approach.

In stark contrast, North Korea is arguably the strangest political regime in existence today. It is perennially ranked last in *Euromoney’s* annual assessment of country risk. The world’s first example of dynastic Stalinism has endured a decade of economic decline and has experienced famine, yet it has continued to pour resources into the development of weapons of mass destruction and their delivery systems. This crisis is fundamentally systemic, not a period of aberrant performance due to bad weather or unfavorable external shocks, though both have contributed to the North’s current predicament. Yet, to paraphrase Mark Twain, reports of the regime’s collapse have been exaggerated, and its durability has confounded numerous observers.

This confrontation is terribly important, not only to the Koreans themselves, but to the rest of the world. North Korea has a history of external violence, and during the past century the Korean peninsula has been contested by the United States, Russia, China, and Japan. The outcome on the Korean peninsula will have enormous implications for the long-

run economic, political, and military development of Asia and the US role in that part of the world.

North Korea

North Korea has a dysfunctional economy and a political regime that appears to place an extremely high value on military expenditure relative to the well-being of its populace. Unwilling or incapable of resolving its internal problems, it has pursued a policy of international brinkmanship to extract resources from the international community. However, the two principal creations of this policy, the Korean Peninsula Energy Development Organization (KEDO) and the multinational famine relief effort, do not address the country's essential economic problems and indeed may be politically unsustainable in the outside world. KEDO is a creature of diplomacy masquerading as an energy development program that is unlikely to make much real contribution to resolving North Korea's acute energy problems. In a somewhat similar fashion, the multinational famine relief effort is driven largely by diplomatic considerations. At best, it only ameliorates the manifestation of the North's economic collapse. It neither addresses its underlying causes nor promotes the needed solutions. Thus, in the case of North Korea, the world confronts an ongoing foreign policy problem driven by an apparent refusal of the Kim regime to deal with its own internal difficulties.

There are solutions to North Korea's economic problems. As demonstrated in chapter 7, economic reform could have enormous payoffs, increasing domestic food availability and, more generally, addressing the pressing material needs of the people. The real issue is not whether reform would be beneficial—it would, though the technical difficulties of reforming the North Korean economy should not be minimized. The real issue is whether reform would be compatible with the continued existence of the Kim Jong-il regime and, if not, what the world should expect. The key questions relate to the intentions of the regime. How much internal transformation can it tolerate? And how will the regime use its newly obtained wealth?

With respect to the first question, the signals are mixed. Over an extended period of years the regime has engaged in an extremely cautious opening to the outside world. It has emphasized forms of interaction (special economic zones and tourist projects in isolated parts of the country) that appear to be designed to maximize foreign exchange earnings while minimizing contact with foreigners and the transformative possibilities of these interactions. Marginally broader forms of opening have been discussed as well. This is a kind of "quarantined" opening, consistent with official propaganda, which has likened market relations to a "germ" that is to be warded off.

Yet even this hesitant opening has a “two steps forward, one step back” character. At times, North Korea has engaged foreigners in cooperation while simultaneously denouncing such cooperation internally or engaging in provocative actions that undercut the possibility of such cooperation. This behavior could reflect genuine ideological divisions within the regime or simply bureaucratic politics in which different organs pursue their own missions without regard to any broader coherency. Presumably, the resolution of such problems is made more difficult by the extraordinarily repressive nature of internal politics. Ultimately, the rest of the world has little influence on the pace and content of economic change within North Korea. However, the world does have a very large stake in how the regime spends its money.

One can imagine at least two North Korean strategies for this endgame. The first is for the North Korean elite to accept that they are on the wrong side of history. The South Koreans are bigger and richer and have the Americans in their corner. The peninsula is not going to be unified forcibly on North Korean terms. The North’s proposal for a Confederal Republic of Koryo is a dead letter. Its preconditions for North-South dialogue: discontinue the South’s military association and exercises with foreign powers; abolish the South Korean National Security Law; and eliminate restrictions on private movements for national unification will not be met.¹ Even a “one country, two systems” model along the lines of China and Hong Kong may be unworkable. After throwing in the towel politically, the goal of the regime could become self-enrichment. The elite’s one real card is their control over the levers of power in a sovereign state. From this derives their ability to channel to themselves the lion’s share of economic gains generated by reform. The most efficient way to improve their own material condition (as well as that of the broader North Korean society) would be to engage with foreigners and begin acting cooperatively. Such maneuvers must be done carefully however, so as not to jeopardize the elite’s hold on power.

From this perspective, a certain investment in weapons of mass destruction and, more importantly, delivery systems capable of hitting targets beyond the Korean peninsula, is probably warranted to keep the South Koreans and Americans in check. Investments would be made in relatively inexpensive defensive systems to confound any external threats. For example, tunneling has been used to decrease the effectiveness of US and South Korean munitions, deter accurate targeting, and create diversionary or decoy targets. Other possibilities would include electronic countermeasures, such as jamming equipment (to interfere with US and South Korean weapon guidance systems, mobile surface to air missiles, and advanced naval mines), and the rebasing of air assets near the Chinese border to

1. See the *People’s Korea*, 15 December 1999, and H. W. Lee 2000.

deter US and South Korean attacks. (Remember: without sovereignty, they are nothing.) Massive forward-deployed conventional forces are an unnecessary burden, however, and represent a real drag on the economy. In this characterization, North Korea is a porcupine in the forest, repelling aggression, not a tiger rapaciously hunting in the jungle.

This vision has real operational implications for both North Korea and the rest of the world. Externally, North Korea should maintain deterrence, which implies continued production, testing, and deployment of missiles capable of striking Japan and South Korea at a minimum, though not necessarily their export. Internally, reform should be pursued to the fullest extent consistent with social stability and the generation of rents for the ruling class. Conventional forces could be significantly demobilized to capture the “peace dividend,” as demonstrated in chapter 7. While unilateral partial demobilization would make sense in purely self-interested terms, it would be worthwhile to engage South Korea and the United States to see what they would be willing to pay. This initiative might be undertaken in the context of a renegotiation of the Agreed Framework. The light water reactor project does not address North Korea’s real energy problems. In this “golden parachutes” scenario, North Korea would be willing to forego the construction of the LWRs (and all the problems they would entail) in return for genuine economic assistance. Together, South Korea and Japan already have pledged \$4 billion to KEDO, and more funds could be obtained from the multilateral development banks. These funds, invested efficiently rather than squandered on LWRs, could go a long way toward restoring stability, if not prosperity, to the North Korean economy. Thus, a “golden parachutes” strategy would have concrete implications for the operation of the North Korean economy, including its expenditure patterns, its military deployments, and its diplomatic engagements.

An alternative scenario would be “playing for time.” In this case, internal reforms would be kept minimal, since regime preservation, not material improvement, would be the fundamental goal. Economic openings and diplomatic engagements would be expedient means to an end, not ends in themselves. Economic gains would be plowed back into a broad program of military modernization.²

While the jury is still out, the preponderance of recent evidence supports the “playing for time” interpretation of North Korean behavior. Despite the fact that the Hyundai deal is bringing in hundreds of millions of dollars in hard currency revenues, making it possible for North Korea to import food on commercial terms, North Korea has increased its dependence on external assistance for food and has used the Hyundai revenues for other purposes. According to the South Korean National Defense

2. See Bennett (1999) on North Korean military capabilities and unification strategies.

White Paper (1999), North Korea has increased its reserves of chemical weapons, boosted army manpower by 10,000 troops, created a missile division, and added 10 submarines to its fleet. In August 1999, it was revealed that North Korea had purchased roughly 40 aging MiG-21 fighters and eight military helicopters from Kazakhstan. It was subsequently reported that North Korea was trying to obtain more advanced MiG-29 and SU-30 fighters as well.³ In September 1999, a classified US Air Force report allegedly describing continued North Korean work on its Taepo-dong missile was leaked to the press. In March 2000, in testimony before the Senate Armed Forces Committee, General Thomas Schwartz, Commander, US Forces Korea, stated that North Korea had accelerated its arms buildup and was forward-deploying artillery and rocket-launchers in hardened sites.⁴ In a public briefing the following day, Admiral Dennis Blair, Commander-in-Chief, US Pacific Forces, indicated that North Korean military exercises during the winter of 1999-2000 had been the most extensive in recent years.⁵ Russian observers claim that North Korea is emphasizing “high impact” arms over conventional weapons.

Of course, this evidence does not prove that the North Koreans are playing for time. It is possible that the appeals for food assistance are purely opportunistic—after all, why pay for something if others are willing to provide it for free? It is surely easier politically for the United States to provide food aid than other kinds of assistance. In this respect, food assistance may be the manifestation of a kind of diplomatic mutual dependency syndrome between the Kim Jong-il regime and the Clinton Administration. Likewise, the fighter purchases could be rationalized as simply the North Korean military spending revenues it obtains through its own arms sales rather than the product of considered strategic planning. Even statements from the US military could be interpreted in a similarly self-interested light, though it is harder to rationalize away the Russian report. The announcement of the North-South summit, just days before a South Korean election in which the incumbent government was trailing in the polls, could be interpreted as either signalling a strategic shift, or simply a tactical move to maximize concessional assistance. If “golden parachutes” for the Northern elite means “unification by acquisition” by the South, it certainly does not appear that the North Koreans are positioning themselves as a friendly takeover target.

3. The MiG-21 sale eventually resulted in the sacking of the Kazakh defense minister and the imposition on Kazakhstan of some minor economic sanctions by the United States. North Korea has reportedly undertaken other buying missions as well.

4. “Statement of General Thomas A. Schwartz, Commander-in-Chief United Nations Command/Combined Forces Command and Commander, US Forces Korea,” Senate Armed Services Committee, 7 March 2000.

5. Department of Defense news briefing, 8 March 2000.

South Korea

The internal problems that South Korea faces are of a fundamentally different nature. In the South, heavy government intervention in, and coordination, of private sector economic activity has largely outlived its usefulness, even though this has been a significant aspect of South Korean economic policy since the inception of the Republic. The challenge now is to develop political and economic policies for constructive disengagement between government and the private sector. Through such an undertaking, the state would retreat from some of its more dirigiste policies, while at the same time strengthening its capacities as a guarantor of property rights, a prudential regulator, and, ultimately, a disinterested facilitator or referee of economic life.

The modifiers political *and* economic are used intentionally in this regard. There are very clear economic problems facing South Korea in areas such as financial market regulation, competition policy, labor relations, and trade policy. These policies cannot be viewed in isolation either from each other or from the historical and political context in which they have arisen. Put crudely, government interventions in the economy have generated rents that have been allocated politically, establishing a symbiotic relationship between the political and business worlds much more pronounced than observed in most other countries. As a result, economic policy decisions not only have economic ramifications, but they also have major political consequences that go to the heart of South Korea's young, and still not entirely mature, democracy.

Successfully implementing a policy of constructive disengagement would be a daunting task under any circumstances. The existence of North Korea adds an extra dimension of complexity to the challenge facing South Korea. Fortunately, the reforms that would be desirable from a purely internal perspective also are reforms that will better position South Korea to deal with contingencies involving the North.

However, the ability of South Korea to implement such a policy of constructive disengagement successfully is by no means assured. The rapidity of the country's recovery from the financial crisis may actually reduce the likelihood of it making this transition. In this regard, the recent policies of the South Korean government have been uneven. Through preference or lack of other means, the government has resorted to relatively illiberal means in its attempt to achieve a more liberal, efficient, and equitable South Korean economy. At least compared to its Asian neighbors, relatively good progress has been made in cleaning up the banking system. Less headway has been achieved on the interrelated issues of structural reform, corporate governance, and product market competition. The government has displayed an ambivalent attitude toward inward foreign direct investment (FDI), on the one hand liberalizing laws and permitting greatly increased FDI flows, while on the other

discouraging foreign investment in a number of high-profile privatizations. Current concern is growing over *chaebol* domination of non-bank financial institutions.

In the short run, South Korea's relatively relaxed approach to continued cleanup of the financial sector and corporate restructuring will probably not greatly imperil its recovery. The single biggest component of demand has been household consumption, which has been financed largely by dissaving and a reduction in the household saving rate from an abnormally high level in 1998. As long as there are no major disruptions in the financial sector (which could cause panic and a jump in precautionary saving), households will be able to self-finance consumption. Likewise, firms should be able to continue to operate successfully, barring a major mishap in the domestic financial system. They have been financing much of their current investment in plant and equipment out of retained earnings, which are, to a certain extent, immune from impairment of the financial sector. Furthermore, throughout the crisis, exporters had relatively good access to finance through their ties to less affected foreign financial institutions. Thus they escaped the brunt of the credit crunch in 1998. In the short run, the risks to the South Korean economy may stem more from renewed inflation and labor unrest than from impairment of the financial sector.

The real financial and corporate problems are long-run in nature. They relate to how the South Korean government will extricate itself from the financial sector and what impact this disengagement will have on the decision making of the financial sector and corporate managements. Without behavioral changes, South Korea faces the possibility of another costly financial crisis in the not-too-distant future.

The *chaebol* are at the center of the reform agenda. These huge conglomerates are in many respects creatures of government policies. Successive Korean governments have had extreme difficulty in balancing sometimes conflicting goals of equity, efficiency, and political expediency regarding the *chaebol* and competition policy generally. The government now faces the very difficult challenge of devising a set of policies that will reduce the degree of government intervention in the economy without either destroying these firms or allowing them to completely dominate South Korean economic and political life.

This can be seen most acutely in the financial sector, where the symbiotic relationships between the *chaebol* and the state have contributed to the weakening and corruption of the South Korean financial system, fostering a higher likelihood of systemic crisis than is either necessary or advisable. The recent financial crisis has provided the country and its political leadership an opportunity to develop a more flexible banking system and more robust money, bond, and stock markets. Considerable progress has been made, though far more remains to be done.

To recover successfully from the crisis and prevent another recurrence, the major systemic reform goal is relatively easy to identify: Subject firms to real capital market discipline and a real market for corporate control. Similarly, the means to attain this goal are not hard to identify. They include: adoption of improved accounting standards; installation of outside directors; reduction of state involvement in bank lending decisions (together with increased emphasis on direct finance); and promotion of independent institutional investors capable of monitoring management. This set of measures is not controversial—they have been identified by the South Korean government in one form or another. The problem is how to get from here to there given South Korea's economic and political institutions, particularly the overwhelming presence of the *chaebol*.

Upon reviewing South Korean economic history, two lessons stand out. First, progress in policy reform has been the greatest where international involvement has been the highest. Over the course of the last 50 years, international trade policy has stood out as the arena of most successful policy reform. It also has been the area in which there has been the greatest consensus about and articulation of international norms (such as free trade in goods). Moreover, this has been the area in which international institutions, such as the World Trade Organization, have been the most developed.⁶ In the financial arena, there has been less consensus about best practices with regard either to domestic institutions or external relations, and the international institutions (the Bank of International Settlements and the International Monetary Fund) have been relatively less successful in promoting an international consensus about desirable norms. In areas such as labor policy, there has been little consensus beyond some minimal standards (i.e., prohibitions on forced labor or child labor), and the international institution (the International Labor Organization) is weak. Similarly, in the area of competition policy, there has been little consensus about desirable practices, and no international organization (except perhaps the OECD) has really addressed these issues.

Perhaps it is not surprising, then, that South Korea has made the greatest progress in international trade liberalization, arguably has performed next best in financial reform, and probably has achieved the least in the largely "domestic" arenas of labor and competition policy. The reasons are straightforward: The existence of international norms gives policymakers a goal at which to aim, and the existence of the international institutions (and other avenues of international diplomatic pressure) help in overcoming the historical weakness and parochialism of South Korean political institutions.

A second lesson is that rules are better than discretion. Economists typically regard simple and transparent rules as preferable to discretion,

6. Bilateral and regional pressures have contributed to liberalization as well. See Noland (1993b, 1998b) and J. Yang (1999) for discussions of US-South Korean bilateral trade relations.

in that rules tend to reduce uncertainties about future policies. The stabilization of expectations then enables decision making on the part of private agents, thereby contributing to more efficient economic outcomes.

Such rules-based systems are difficult to develop in countries with weak democratic political institutions, yet the payoffs can be considerable. In the aftermath of the crisis, the relatively liberal government of President Kim Dae-jung has, at times, undertaken relatively illiberal policies to promote economic restructuring and recovery. This is perhaps best exemplified in the ongoing to-ing and fro-ing over the so-called “big deals”—the government’s attempt to engineer a restructuring of the *chaebol* by pressuring them to swap business assets and consolidate production in particular industries.

In this environment, it is desirable to promote rules-based changes that involve foreigners and foreign institutions whenever possible. The emphasis on rules and the inclusion of non-Korean actors should help overcome the weaknesses of South Korean political institutions and push change in a constructive direction.

Internal Reforms

South Korea needs to continue its process of internal reform, both because of the beneficial direct impact on the well-being of South Koreans, and because it will improve South Korea’s preparation for contingencies involving North Korea. In the financial sector, the continuing rehabilitation of banking is central. The costs of cleaning up the financial sector may ultimately reach 30 to 35 percent of GDP. This amount can be financed. The real question is whether, at the end of the day, the standard operating procedures of the South Korean corporate and financial sectors will have changed. If not, a recurrence of the crisis is possible.

In this regard, a lot is at stake in the resolution of the Daewoo collapse. There are at least two channels through which the Daewoo case will influence the future development of the South Korean financial sector. The first is that the unresolved nature of the Daewoo situation discourages the denationalization of the banks, thereby impeding foreign involvement in the South Korean banking system and extending government influence over the sector. The reason is straightforward: South Korean banks hold Daewoo debt. Until the Daewoo situation is resolved, foreign investment in a South Korean bank will amount to buying “a pig in a poke.” Under such circumstances, power remains in the hands of politicized bureaucrats rather than in the hands of efficient foreign bankers. This arrangement may be good for patronage, but it is not good for economic rationality.⁷

7. To cite but one example, in August 1999, as bond prices fell in the wake of the Daewoo collapse, the government forced South Korean banks to contribute 20 trillion won to a fund to buy bonds. The government was aided in this undertaking by the fact that at the time

The other channel through which the Daewoo case will influence future developments is its effect on other *chaebol* managements and their lenders. If, at the end of the day, the Daewoo management remains largely intact, then the lesson that will be learned by the other *chaebol* managements is that the financial risks that Daewoo took and the illegal behavior in which it allegedly engaged may well have been worth it. This would be the domestic moral hazard problem discussed in box 6.1, in spades.

One solution to this conundrum would be to de-emphasize indirect finance channels prone to political intervention. Personal and corporate tax changes are needed to reduce favorable treatment of debt and thereby encourage equity finance. In debt markets, greater differentiation of risk should be encouraged through the creation of benchmark issues to encourage a secondary market, and rating activities by both South Korean and foreign ratings agencies should be promoted. A high-yield bond market should be fostered for firms that traditionally have not been among the government's preferred borrowers and that suffered disproportionately in the 1998 credit crunch.

With a greater emphasis on direct finance, there is a parallel need to promote the activities of independent institutional investors who are capable of monitoring corporate management decisions and exerting capital market discipline on incumbent managements. A source of current concern is *chaebol* domination of the nascent mutual fund industry. Three reinforcing means of addressing this issue come to mind. One method would be to create fire walls and separate the financial and non-financial *chaebol*. While this approach goes against trends elsewhere, given the predominant role of the largest *chaebol* in the South Korean economy, the exclusion of industrial *chaebol* from participation in the financial sector is warranted. As it now stands, the *chaebol* own significant stakes in merchant banks, securities companies, investment trusts, and insurance companies.⁸

Another strategy would be to encourage foreign financial firms in fund management. They have expertise currently lacking in South Korean firms and are unencumbered by the web of connections and obligations characteristic of the South Korean financial sector.

A third approach would be along the lines of proposals by Graham (1999b) and Leipziger (1999) for a swap of suitably written-down non-performing loans for government bonds, followed by a mandatory corporate debt-for-equity swap, and then sale of government-held shares to the public. This approach would in effect democratize the ownership of the *chaebol*. It also could be used to foster the development of independent

it owned the three biggest commercial banks (Hanvit, Chohung, and Seoul) and had a majority stake in three others (Housing and Commercial, Kookmin, and Korea Exchange Bank). As pointed out in chapter 6, a similar undertaking in 1989 to prop up share prices contributed to financial sector weakness in the 1990s.

8. See Leipziger 1999, table 5.

institutional investors. Last, but not least, there is a need to improve the transparency of accounting and the functioning of South Korea's bankruptcy procedures.

A final question involves the optimal policies for the capital account. The South Korean financial crisis had its origins in fundamentally flawed financial market policies that socialized risk on a massive scale for an extended period of time. One flaw in the system was poorly designed liberalization of the capital account, which created perverse incentives for short-term borrowing. This mistake was but one of a series of mistakes, and a crisis eventually would have occurred under any set of capital account rules. The particular policies in place in 1997 accentuated the importance of foreign debt during the crisis and contributed to its timing. However, external considerations were not the primary cause of the crisis.

Given that more complete markets are presumptively superior to less complete markets, one could argue that the crisis would have been less severe if South Korean markets had been more open to long-term investment. The liberalization program adopted since the crisis has tended to increase the openness of South Korean financial markets and to ameliorate some of the perverse incentives embodied in precrisis policies. The real issue is whether greater openness is enough. Some (e.g., Stiglitz 1999) have called for "surge suppressors," such as Chilean-style taxes, to dampen excessive capital inflows. These are no panacea, as they appear mainly to affect the composition, not the volume, of capital inflows, though their imposition would probably do little harm and might do some good.⁹

What is known for sure is that South Korea needs better regulation and supervision of its financial institutions. The 1990s liberalization amounted to putting regulators with automobile drivers' licenses into the cockpits of jumbo jets. Relative to other countries in the region, considerable improvements in the regulatory framework have been achieved, but more needs to be done. This area is one in which the United States, South Korea, and international institutions such as the World Bank can continue fruitful collaboration.

The final issue that South Korea faces in this regard is the organization of the international financial system. Unlike the national-level reforms noted above, South Korea cannot resolve this issue on its own. It will require cooperation with the United States, Japan, and others to advance its interests in the redesign of the international financial architecture.

In product markets, there is a real threat of anti-competitive behavior due to increased concentration coming out of the crisis—a development actually encouraged by the government's policy of promoting "big deals" and industrial consolidation. For example, Hyundai-Kia now holds

9. See Edwards 1999.

72 percent of the passenger automobile market, 77 percent of the bus market, and 95 percent of the truck market.

The standard remedy in this case is a hortatory call to strengthen the Korea Fair Trade Commission (KFTC) and to engage in cooperative international competition policies either bilaterally or multilaterally. In fact, the KFTC has increased its level of activity in the wake of the crisis. Yet “strengthening the KFTC” cannot be accomplished overnight. As a consequence, it is imperative that South Korea aggressively liberalize international trade to “import” competition, especially in sectors such as motor vehicle products, in which the potential for abuse of market position appears the greatest. The idea would be to use the threat of imports to maintain the contestability of markets, while strengthening domestic pro-competitive forces. In this respect, liberalizing international trade does not mean just cutting tariffs, which in the case of South Korea are often reasonably low. It also includes undertaking a variety of ancillary actions that would facilitate the presence of foreign firms in the market through trade or investment.¹⁰

South Korea’s labor markets have a reputation for rigidity, despite the fact that, by standard indices such as job turnover or real wage variability, economy-wide they are the most flexible in the OECD. The segment in which rigidity is a valid concern is employment in the largest *chaebol*. For them, current employment regulations make labor a quasi-fixed factor of production, discouraging hiring while encouraging the adoption of inappropriately capital-intensive techniques of production, and stigmatizing the unfortunates who do lose their jobs. The appropriate response is a two-track strategy of reducing labor market regulation (making it easier to dismiss employees) and strengthening the unemployment insurance system and social safety net. This set of issues is complex, as currently a whole basket of benefits (including pensions and housing) are not entirely portable and are contingent on employment.

These reforms would generate changes in the South Korean economy—the democratization of finance, increased competition in product markets, and more flexible labor markets—that would create a more dynamic entrepreneurial economy. Beyond the present crisis, the government should err on the side of a tight fiscal policy in anticipation of future liabilities associated with unification.

Policies with Respect to North Korea

From a South Korean standpoint, North Korea can be regarded as a huge contingent liability. Fortunately for South Korea, the actions that address

10. For an example of this, see the analysis of the automobile sector by the American Chamber of Commerce (1999).

its own internal problems in the wake of the financial crisis are some of the same actions that are advisable in preparation for future eventualities involving the North. Some of these actions are contingent on particular outcomes in the North, some are not.

Setting aside the possibility of war, the worst case would be an abrupt collapse of North Korea that could require hundreds of billions of dollars in expenditures to resolve. There are two obvious responses. One would be to prepare for this contingency by strengthening public finances and building up reserves for such a rainy day. The operational implication is that, as the immediate financial crisis in South Korea is surmounted, the government should return to its historical policy of fiscal rectitude and build up its government surpluses. Such an approach would contribute to funding the costs of unification by providing reserves and facilitating additional borrowing.

The other obvious response would be to try and head off collapse. The Kim Dae-jung administration has broken from past history by explicitly announcing that it will not undertake measures to subvert North Korea. Instead, its stated preference is for peaceful coexistence. Not all modes of peaceful coexistence are equally attractive, however. Rather than simply accepting North Korea as is, Seoul should structure its economic engagement with Pyongyang in ways that promote systemic transformation of the North and strengthen the relatively progressive forces within North Korea. If one were to rank South Korean economic interaction with North Korea by the possibility for promoting systemic change, projects like the Mt. Kumgang tourist project would rank at the bottom—contact between North and South Koreans is highly restricted, and the project can be fenced off from the rest of the North Korean economy and society, literally as well as figuratively. This sort of project largely serves to generate foreign exchange earnings for the North Korean central government (if not for Kim Jong-il personally) without posing any significant challenges to how the regime operates. The Mt. Kumgang project was probably a necessary confidence-building measure for broader forms of economic interaction. That said, it appears to involve implicit subsidies on the part of the South Korean government. Additional ventures along these lines should be assessed with a skeptical eye.

Marginally more desirable are the proposals for foreign mining concessions. These projects are classic enclave economies that again would be fenced off from the rest of the economy, literally and figuratively. Interaction would largely involve the central government's mining ministry. Special economic zones, while also geographically limited (especially in the case of the isolated Rajin-Sonbong zone), at least involve interactions between foreign firms and a broader range of North Korean institutions and enterprises. Special economic zones, export processing zones, or bonded warehouses in more desirable urban locations could potentially

involve higher degrees of contact and, for this reason alone, would be better still.

The most desirable form of engagement would be foreign direct investment outside of specified zones. This type of interaction would involve the most extensive contact between North Koreans and outsiders, and competition among North Korean institutions and enterprises to attract FDI could have enormous learning and demonstration effects. This would be the form of engagement most likely to generate systemic change. The North Koreans have described economic opening “as a Trojan horse tasked with destabilizing socialism.” They are right, of course.

Lastly, the South Korean government should support North Korean entry into international financial institutions. Contact with these institutions might promote learning about the modern global economy, its institutions, and its practices, and generally serve to socialize North Korean policymakers in desirable directions. Involvement with the international financial institutions might also have the added benefit of being less prone to the vagaries of bilateral relations than other modes of engagement.

Unification

Although South Korea proclaims that it is not interested in absorbing the North, and although its own official unification scheme is gradual in the extreme, ultimately its vision of a protracted consensual unification may not come to pass. Instead, events in the North may necessitate a much more precipitous process than Seoul may prefer. Thus it is worthwhile thinking about what such a scenario might entail.

The specific form of the North’s breakdown would have enormous implications for the undertakings required. The commonalities across scenarios would be that close coordination among South Korea, the United States, and China would be essential, and that their respective militaries would play critical roles due to their rapid response and logistical capabilities. Once the situation on the ground was stabilized, broader economic and political policy decisions would be required.

At the time of unification, the South Korean government will have multiple (and potentially conflicting) policy objectives. On the one hand, maintenance of economic activity in the North on market-consistent terms will be a top priority. At the same time, the government should seek to effect a one-time-only wealth transfer to the current North Korean population, since they will have to adjust to market institutions with virtually no household wealth. One can imagine a multi-pronged approach:

- Adopt dual rate monetary conversion. Aim for slight undervaluation of the North Korean won to maintain competitiveness, thereby making

North Korea an attractive location for investment. Convert personal savings at an overvalued rate (effecting a wealth transfer).

- Deed land to the tiller and the housing stock to its occupants, contingent on maintaining use for some specified period of time.
- Maintain some kind of temporary, emergency, non-market social safety net in the North.

Having given the land to the tiller, one must confront the issue of property rights claims by past owners or their descendants and the more general issue of assignment of property rights to commercial or industrial assets. Lessons learned from the experience of Germany and other former centrally planned economies are instructive in this regard:

- Avoid the policy of restitution for seized assets. Monetary compensation for seized assets might be considered, though even some South Korean analysts have argued that this would be a mistake.
- Privatize quickly and avoid the cash-on-the-barrelhead model. Abolish inter-enterprise debts.
- Emphasize investment, not consumption, transfers.
- Accept assistance from foreigners, including the Japanese.

With respect to privatization, the experience of East Germany and other centrally planned economies suggests that it would be best to move quickly and avoid the cash-in-advance model, since it would severely restrict potential buyers. Attempts to restructure these enterprises before privatization should also be avoided. That is better left to the market. Inter-firm debts, which are a legacy of irrational policies under the centrally planned regime, should be written off. Debt-equity swaps could be used to pay off external debt and simultaneously create a stake in the viability of North Korean enterprises for South Korean or foreign firms.

Given these considerations, there appears to be one institution in South Korea ideally suited for the task of making North Korea competitive: the *chaebol*. Unfortunately, one policy goal (to get the North Korean economy functioning as rapidly as possible) and another policy goal (to clean up business-government relations in South Korea) would conflict. It goes without saying which one will receive the greater weight. The *chaebol* are probably ideally suited for refurbishing the North Korean economy. However, saddling them with unproductive North Korean enterprises would have an economic price in terms of reducing *chaebol* competitiveness internationally and possibly encouraging anti-competitive behavior domestically. There would also be a political price in the form of the *quid pro quos* that the *chaebol* could be expected to extract. This complication

in business-government relations is probably an unavoidable by-product of increased economic integration between North and South Korea in any scenario.

The other important actors whose roles would have to be defined are the North Koreans themselves. Presumably, a unified Korean government would want to avoid the German-style monetary and privatization policies that effectively froze East Germans out of privatization. If not addressed, then the same problem could arise in an even more severe way in the Korean case, especially given the greater divergence in income levels and the probably even smaller outstanding claims on productive assets that North Korean residents would have at the time of unification.

It would be desirable to create new businesses in North Korea, as start-ups rather than restructured existing enterprises have generated most of the revival of industrial output in other transitional economies. There could be a role for fiscal incentives here. As Cheong and Lee (1996) point out, South Korean firms already have been relocating labor-intensive activities abroad. However, investment in the North may be associated with a positive externality, since it would presumably reduce unification costs. Hence there is a divergence between the private and social rate of return on South Korean foreign direct investment and scope for government intervention.¹¹ Wage subsidies in the North would be another obvious alternative.¹² Given the South Korean government's interventionist bent, it would be surprising if policies like this were *not* undertaken.¹³

The use of fiscal incentives raises the broader issue of financing. There are a couple of obvious points to be made. Since South Koreans fear the impact of absorption on their own economy, minimizing the burden on South Korean taxpayers has to be an imperative of South Korean govern-

11. A similar argument for tax breaks prior to unification could be made, though the advisability of investment insurance prior to unification is less clear. Tax incentives would apply only if a South Korean firm were to own and operate a facility in the North, and if it did not expose the government to expropriation risk (borne by the firm). Insurance guarantees could create South Korean government exposure to North Korean expropriation and generate some serious moral hazard problems.

Agreements between the North and South governments on such things as avoidance of double taxation, dispute settlement, and standards harmonization would be appropriate, however.

12. See Koo (1998) for a wage subsidy proposal.

13. Yeon (1994), for example, writes, "The government could use a number of policy tools in order to encourage private sector decision making in directions it considers desirable, including special tax treatment, low-interest loans, channeling public funds towards certain investment, and providing information and advice. Government intervention would also be needed in order to influence the rate of industrial and rural development, as well as to control speculative and rent-seeking behavior on the part of both the public and private sectors" (p.394).

ment policy.¹⁴ This means that attracting private capital, especially foreign private investment, will be of the highest priority.

South Korea's need to prepare for the contingencies of unification with North Korea coincides with its need to strengthen its financial system in the wake of its own financial crisis. In the event of unification, there is absolutely no reason to finance the construction of infrastructure out of current tax receipts. Instead, the government will want to use both taxes and bonds to finance unification expenditures. Hence the development of a robust government bond market prior to unification should be a priority. A second priority would be the rejuvenation of South Korea's flagging privatization program: There is no reason why the privatization agenda in the North should be more aggressive than the one in the South.¹⁵

With respect to trade, the unified Korea would presumably operate under South Korean trade policies, including tariffs, quotas, etc. This would result in substantial de-protection for North Korean enterprises (though prior to unification one could imagine a variety of halfway houses that would permit North Korean producers to operate under greater protection). Treatment of agriculture could be particularly problematic relative to the German case: Agriculture is more important to North Korea than it was to East Germany, and, unlike South Korea, the Germans had little autonomy in agricultural policy since it was determined within the context of Germany's membership in the European Union. Moreover, South Korea's agricultural policies are even more distortionary internally than those of the European Union.¹⁶ Extending costly South Korean agricultural policies to farmers in the North would be so expensive that, rather than doing so, the unified Korea might be pushed into reform.

As shown in table 7.2, a liberalized North Korea would trade most intensively with South Korea (accounting for 35 percent of its trade) and Japan (an additional 30 percent). With unification, the single biggest share of trade (the 35 percent with South Korea) would be internal and not subject to WTO rules. Some observers have advocated the internal application of dumping rules to protect South Korean producers. This approach would be a mistake, since the priority would undoubtedly be on maintaining production in the North.

14. Yeon (1994), for example, writes: "The financial cost of Korean reconstruction and restructuring could amount to \$230-250 billion over a ten year period. . . . North Korea is in no position to finance any portion of the costs of rapid unification. This means that the financial burden associated with Korean economic, monetary, and social integration would have to fall almost entirely on South Korea" (p.395).

15. Bae (1996) makes recommendations to improve tax collection. He raises the possibility of privatizing South Korean government assets as a means to finance unification as well.

16. Von Cramon-Taubadel (1998) discusses prospective issues relating to agriculture in the context of unification.

The second largest share of trade would be with Japan, and this trade would be subject to WTO rules, which constrain the use of safeguards. It would not be surprising, given the prevalence of discriminatory arrangements within Asia and the unresolved issue of Japanese post-colonial claims, if some bilateral understanding was reached between the unified Korea and Japan on this issue.

Lastly, and perhaps most importantly, is the issue of labor market adjustment. Unification would create big incentives to migrate, especially if unification was accompanied, as expected, by demobilization of the huge North Korean army. Some advocate maintaining the DMZ as a form of influx control, but it is questionable as to how politically sustainable such a plan would be. (North Koreans will make up about a third of the electorate.) If the German case holds any lessons for Korea, it is that the decision to migrate is strongly influenced by employment security. This lesson simply underscores the need to implement privatization and restructuring as quickly as possible. A structured program for temporary commuting might be a politically feasible halfway house between unfettered migration and the maintenance of the DMZ.

Migration also could be discouraged by policies that would award property rights to housing and productive assets to users (conditional on their continued residence in the North), or by policies to distribute aid only to households at their original place of residence. More generally, social policies will affect the incidence of migration. Retraining is certainly an area for government involvement (optimally in conjunction with prospective private employers). These programs can be located in the North.

A more difficult issue involves the social safety net. Koo (1998) argues that a wage subsidy policy could be a substitute for the non-existent unemployment insurance program. However, this policy could be only a partial remedy. The government will have to face issues such as whether health care should be on the North Korean socialized basis or on the South Korean private insurance model. There are good arguments for the private insurance model, but one must recognize that, under this system, the quality of health care is strongly related to income level. Adoption of the private approach, in the context of low North Korean incomes and the wrenching dislocation that would accompany unification, could mean that demographic shocks in North Korea could be even more severe than those observed in post-unification East Germany.

All of this suggests that the political rights afforded to the residents of North Korea are the key determinants of economic outcomes. Per capita income differences are large, the North Korean population is young, and Seoul, glowing like a beacon, lies just south of the DMZ. Unless they are forcibly restrained, one must assume that large numbers of North Koreans will head south. Even if they were temporarily restrained, pressures for cross-border migration would persist until the income gap was substan-

tially reduced. This could require considerable capital investment and technological transfer.

Ultimately, Korea will have to deal with issues relating to political integration. How this integration occurs will in part be a function of how unification occurs—whether through a negotiated process by two functioning sovereign states, an explosion, or an implosion. Nevertheless, some fundamental issues will arise in virtually any context.

At the most basic level are the issues of accountability, retribution, and justice. Three issues stand out: human rights abuses, the initiation and conduct of the Korean War, and state-sponsored terrorism.¹⁷ In each case, international, as well as national, tribunals could claim jurisdiction. The relevant authorities will have to decide how far up (or down) the chain of command responsibility lies. Likewise, victims of crime and abuse of power are entitled to rehabilitation and compensation under UN Declarations of which both North and South Korea are signatories.

The real problem that will confront Korea, as has been encountered by other societies undergoing similar political transformations, is how to balance claims of justice against broader societal interests in facilitating and smoothing a desired political transition.

These issues are likely to be particularly acute in the Korean case. As bad as East Germany was, it did not compare to North Korea. Having fought a horrific civil war, the Koreans will have to confront a legacy far more poisoned than the one faced by the Germans in 1989. For both substantive and cultural reasons, retribution will be a far more important issue in Korea than it was in Germany. Truth and reconciliation commissions such as those used in Argentina and South Africa may be able to play some role.

It will be imperative for Northerners to be incorporated into the political life of the unified Korea.¹⁸ The legal basis of their claim to full participation appears to be strong: Article 4 of the present South Korean constitution implies that even current residents of the North are citizens of the Republic of Korea. Political inclusion in a democratic Korea will require a “de-Nazification”-like process for the elites, together with proactive policies for the masses. The South will have to accept that long-run maintenance of the DMZ as a method of population control is not sustainable and that the perpetuation of significant differences between the North and South is not in the long-run interests of the current population of the South.

The issue then becomes: What will be the form and character of the polity of a united Korea?¹⁹ While trends are positive, it is not clear that

17. See C. B. Park (1997). This discussion will proceed as if only North Korea was in the dock. In some contexts, North Korea could plausibly raise similar issues concerning South Korea.

18. Moon (1999) raises for consideration an extensive set of tasks and issues along these lines.

19. See N.Y. Lee (1998) for a detailed discussion of prospective political institutions of a unified Korea.

today South Korea is a *Rechtsstaat* (a state governed by law) in the same way that Germany is. The government of a unified Korea will have to confront troublesome issues of respect for law, the role of the judiciary, and local government autonomy. The latter issue is particularly salient given the history of regionalism in Korean politics and the centralization of both the North and South Korean states today.²⁰ More broadly, a unified Korea will have to deal with the questions of who sets the rules? To give a prosaic example, who will set school curricula? Will it be set centrally (as is done today in both North and South Korea), or will it be done locally? How will Korean history, including the history of the past five decades, be treated in that curriculum?

A unified Korea will be riven by regional and class cleavages. In the case of Germany, strong political parties have acted as a mechanism for trans-partition political integration. In contrast, political parties in South Korea are weak, and, given the isolation of North Korea (again worse than the East German case), there is no evidence that any mainstream South Korean politician has any significant mass following in the North. It is within the realm of reason that the (North) Korean Workers' Party could emerge as the largest (or at least the most disciplined and coherent) political party in a unified Korea. The point is that the country will face an enormous task, both in revitalizing the North Korean economy and in extending the emerging liberal political culture of South Korea.

Lastly, something will have to be done with the gigantic North Korean military, its missile program, and its weapons of mass destruction. Even accepting the "shrimp among whales" metaphor, one would have to expect a significant demobilization of forces in a unified Korea, and the modeling work presented in chapter 8 suggests that the "peace dividend" could be considerable. Nonetheless, decisions about the military will be enormously sensitive both within Korea and vis-à-vis its neighbors. Ultimately, this issue will call into question the presence of US forces on the peninsula. The range of possibilities runs from reconfiguration and redeployment (most likely as a regionally-oriented force based in the far southern part of the peninsula or off the peninsula altogether) to withdrawal and demobilization.

What happens on the Korean peninsula will largely be determined by Koreans. Although the United States, Japan, China, other countries, and international institutions have important roles to play, Korean history will ultimately be written by Koreans. The appropriate role of the outside world will be to support the Koreans in their attempt to strengthen liberal

20. See Steinberg (1998), N.Y. Lee (1998), and Moon (1999) for contrasting views on the desirability of greater decentralization of the government of a unified Korea. As noted in chapter 6, the present South Korean government has undertaken a limited process of decentralization of authority.

democratic institutions in the face of what could be an enormous political and economic shock.

Other Actors

The United States

The United States has a broad set of interests on the Korean peninsula. The Korean War cost more than 33,000 US lives, and the United States continues to maintain a military presence in South Korea and Japan as a legacy of that involvement. Today, South Korea is America's ninth largest trade partner, accounting for roughly \$50 billion in two-way trade annually. South Korea is an important US ally, and the United States has a large stake in its national security as well as in its economic and political development. In the economic sphere, the main US task is to support South Korea's ongoing economic recovery from the financial crisis. In this regard, there are two principal arenas in which the two countries interact: international trade and international financial policy.

With respect to the former, the biggest contribution that the United States can make in the short run is to keep its market open. Access to the US market will continue to be an important part of South Korea's economic recovery for the foreseeable future. The ability to export to the United States could become even more important if South Korea's recovery was to falter or if recession in the United States were to be accompanied by demands for protection. In the longer run, South Korea's growth and its increasing integration with the rest of Asia mean that its dependence on the US market is likely to decline in relative terms. Although South Korea remains significantly dependent on the US market (especially in this immediate post-crisis period), and although it will certainly seek to maintain a good relationship with the United States for the foreseeable future, the degree of asymmetry in terms of dependence is lessening. Past trade conflict between South Korea and the United States has been played out in excessively bilateral and politicized forums. In the future, with democratization and growth, South Korea should begin to play a more prominent role in international organizations. What have been largely bilateral issues may be submerged in more multilateral forums. The traditional US approach—unilateral demands backed by the implicit threat of market closure—will probably become increasingly ineffective in the future due both to this fundamental shift in the relationship and to the formation of the World Trade Organization. The WTO can be expected to play a greater role in intermediating conflict in the future. In this regard, the failure of the WTO to launch a new round of trade negotiations at its biennial ministerial in Seattle in 1999 was a setback.

The second economic policy area in which South Korea and the United States interact involves international financial policy and what has come to be known as the international financial architecture. Both countries are in the "Group of 20," a group of large industrial economies and systemically significant developing countries that has come together to discuss reforms of the current system. The United States would be well advised to consider South Korean views on these issues carefully. After all, South Korea was the recipient of the largest bailout package in history, which nonetheless was neither widely popular nor necessarily regarded as appropriate either by South Korean economists and officials or by some outside observers. The United States, in particular, is regarded in many quarters as having used the conditionality embodied in the IMF program for its own mercantilist purposes without ever actually spending a dime of its own commitment to the "second line of defense." The most recent US proposal for architectural reform (Summers 1999) appears to advocate both a toughening of the terms on which the IMF lends and a broadening of the terms of conditionality. The terms of conditionality were regarded as politically controversial and politically intrusive in the South Korean case.

Beyond these issues, the United States has an important role in questions relating to North Korea. The US political system has two goals with regard to North Korea. The first is to reduce the threat it poses to US security interests in Northeast Asia and elsewhere around the world. The second is to alleviate the humanitarian tragedy of the famine. Different groups and individuals within the political system place different emphases and priorities on these two goals, but it is safe to say that, in the long run, actions to address the famine will be politically unsustainable without progress in addressing the security threat.

Washington's relations with Pyongyang have been marked by an almost Pavlovian pattern, in which the North Koreans create a crisis and the United States responds by essentially trying to bribe North Korea into acceptable behavior. This pattern was arguably established in 1994 with the signing of the Agreed Framework, which committed the United States to a costly and questionable scheme to build light water reactors (LWRs) in North Korea in return for North Korean compliance with the Non-proliferation Treaty. In the case of the Agreed Framework, at least the United States could claim that it was getting something demonstrable in return—the freezing of North Korean nuclear activities at Yongbyon. More generally, the *modus operandi* has been that North Korea provokes a confrontation and then invites in the World Food Program (WFP), which has a humanitarian and bureaucratic interest in erring on the side of generosity in dealing with the North Korean famine. The WFP then issues an appeal for international humanitarian assistance, and the United States uses it as multilateral cover for what can only be described as diplomatic bribery. In the case of the inspection of Kumchangri, the United States

did not even go through the motions of contributing via the UN, but simply paid off the North Koreans directly.²¹

The result has been a string of North Korean tactical victories—it has successfully used extortionary tactics to extract resources from a timid and compliant United States which, at the end of the day, would prefer to temporize and appease the North Koreans rather than confront them. From a US perspective, this result presents two problems. First, there is no real evidence that these US responses to North Korean brinkmanship have furthered US strategic interests on the peninsula. Second, rather than transforming North Korea in ways that the United States would find more desirable, they actually reward bad behavior.

The goal of US policy in this regard should be to play to our strength—our lucrative market—and avoid our weakness—our comparative disadvantage in negotiating with opaque totalitarian states.²² The United States should therefore attempt to shift the locus of its relations with North Korea away from the State Department and toward the market—or, in the language of US politics, get North Korea off welfare and onto workfare. The Perry report and the “package deal” could be interpreted as moving partly in this direction, at least by attempting to avoid North Korean “salami tactics.” Operationally, this “tough love” approach would have two components. First would be sanctions removal, which the United States has announced but not actually implemented. (This would not include the COCOM sanctions under the Wassenaar Agreement.) Conditional on North Korea refraining from terrorist acts—it has been more than a decade now since any significant North Korean terrorist incident—removal from the State Department’s list of countries supporting terrorism would open eligibility for North Korean participation in US economic programs such as Export-Import Bank trade loans and OPIC investment guarantees. The United States also would want to provide North Korea with textile and apparel import quotas, inasmuch as textiles and apparel are among North Korea’s most promising sectors. The idea would be to encourage North Korea to participate in legitimate international commerce.

At the same time, the United States would scale back its participation in WFP appeals. Food is fungible, and food aid amounts to unconditional balance of payments support. There is no reason that the United States should provide this to North Korea in perpetuity, especially if the US is opening its doors to legitimate commercial exchange. The amount of foreign exchange necessary to close the North Korean food gap is rela-

21. US officials reputedly have expressed frustration with the WFP’s apparent inability to issue appeals quickly enough to satisfy US desires to provide food assistance linked to political negotiations.

22. See Snyder (1999b) for a comprehensive analysis of US-North Korean negotiations.

tively small—on the order of hundreds of millions of dollars. Current US policy embodies the bizarre contradiction that the United States discourages commercial activity by which Pyongyang could earn the dollars to buy food from American farmers, but instead taxes US citizens to provide the same food *gratis*. US policy should aim to get North Korea off international welfare and into the global marketplace.

Furthermore, to the extent that the United States wants to deliver humanitarian aid to North Koreans, there is no reason that it must be done in North Korea. Under the status quo, China, the poorest of North Korea's neighbors, bears the brunt of North Korea's refugee exodus. In addition to the direct costs of absorbing refugees, China prefers not to see an increase in the ethnic Korean population of its border provinces of Jilin and Liaoning. The obvious solution would be a multinational effort to bear the costs of refugee resettlement. At a minimum, this effort could amount to defraying the costs of housing and feeding refugees in China. More equitably, South Korea, Japan, and other countries (including the United States) could take in refugees for resettlement.

The final aspect of a more constructive US policy toward North Korea would be a willingness on the part of the United States to reopen the Agreed Framework. The Agreed Framework in essence trades some ambiguity over North Korea's nuclear history for the ending of its ongoing nuclear weapons program. The problem with this bargain (setting aside the verifiability of North Korean compliance—itself a significant issue) is that it sets up a likely confrontation among the United States and its partners (principally South Korea and Japan) with North Korea around 2002-03. The nub of the problem is that the agreement commits the United States to completing the LWRs in 2003, though the United States will assuredly argue that this is merely a target. Under current circumstances, completion is unlikely to occur by that date, leading to the United States arguably being out of compliance with the agreement. Moreover, before sensitive reactor components are installed, the International Atomic Energy Agency (IAEA) must verify North Korea's past nuclear history. There is likely to be ambiguity in that determination, which can open up disagreement between South Korea and Japan on the one hand and the United States on the other (since the United States puts a greater priority on proliferation concerns). Heavy fuel oil donor fatigue on the part of Congress is another potential source of friction with Pyongyang, Seoul, and Tokyo. The planned North-South summit, a dramatic fulfillment of North Korea's pledge to resume talks with the South, will strengthen North Korea's hand and put additional pressure on the United States and its allies. Implementation of the Agreed Framework is a train wreck in the offing.

The United States ought to recognize this likely sequence of events, get ahead of the curve, and indicate a willingness to reopen the agreement.

The idea is that the United States and its partners would scrap the commitment to build the light water reactors and instead use the funds committed to KEDO to address the real economic and energy problems that North Korea faces. This shift could involve replacing the LWRs with more sensible coal-fired plants, rehabilitating the North Korean electrical grid, building transformers (which would permit North Korea to export electricity to South Korea and China), and financing other kinds of infrastructural investment.²³ If the North Koreans are truly interested in rejuvenating their economy, then these measures will be far more useful than a couple of light water reactors. There is no guarantee that the North Koreans would respond positively to such an offer—after all, they were the originators of the basic deal underlying the Agreed Framework. Nevertheless, it is surely worth raising this possibility. If their true interests lie in building nuclear weapons, then they will hold the United States to its 1994 commitment. Such a response by the North Koreans would presumably increase the attractiveness of missile defense systems to the United States, Japan, and South Korea.²⁴

Japan

Like the United States, Japan's policy toward the Korean peninsula can be thought of as having two aspects: promotion of continued economic recovery in South Korea and support for a process of domesticating North Korea. In both instances, Japan has a key role to play. Japan's own economic trouble helped precipitate the financial crisis in South Korea, when weak Japanese banks began to call in lines of credit in 1997 and refused to roll over loans. Prior to its own crisis, Japan was South Korea's largest trade partner, and its economic weakness of late has adversely affected South Korea. Modeling work by Noland et al. (1999) has demonstrated that developments in Japan have a considerable impact on economic activity in South Korea, both through direct trade linkages between the two countries and through competition in third country export markets such as the United States and the European Union. Either renewed recession in Japan or a weak yen strategy of export-led recovery would have a detrimental impact on South Korea. From this standpoint, the best thing that Japan could do for South Korea would be to strengthen its own financial system to enable it to play a more constructive role as a source

23. Oddly enough, the Pyongyang-affiliated journalist M.C. Kim (1998) comes to some similar conclusions with regard to how the US failure to implement its Agreed Framework commitments might play out.

24. See Garwin (1999), O'Hanlon (1999), Lewis, Gronlund, and Wright (1999-2000), and Payne (2000) for differing assessments of missile defense schemes. The North Koreans have indicated that, if the United States proceeded toward installing a missile defense system, then they would reconsider their moratorium on flight testing missiles.

and intermediary of international capital flows and to promote domestic demand-led recovery within Japan.

For want of robust military capability, Japan's policy toward North Korea has a similar economic focus. The big money issue outstanding between North Korea and the rest of the world is the settlement of post-colonial claims with Japan. Taking the 1965 accord between South Korea and Japan as a base, and adjusting for changes in price levels, differences in population, accrued interest, etc., one can obtain a figure on the order of \$20 billion in today's dollars. Given relative negotiating positions and the current state of Japanese public finances, it is unlikely that the North Koreans will be able to extract anything approaching this sum from Japan. Internal Japanese discussions revolve around figures that are less than half as large. Nevertheless, Japanese reparations are the one large monetary claim that North Korea has on the rest of the world. Moreover, settlement of this issue would be less reversible than removal of the US embargo.

Japan will certainly argue that its billion-dollar contribution to KEDO should be counted against this charge. Some have speculated that Japan will even try to claim credit for the costs of recapitalizing bankrupt *Chochongryun*-controlled financial institutions in Japan. Contributions to a "North Korea Fund" administered by the World Bank or the Asian Development Bank would be another way of handling reparations. In any event, the sum that North Korea could ultimately call upon is likely to be bigger than anything that it can expect to receive from other countries or the international financial institutions. As a consequence, settlement of this claim is a sensitive political issue. It is of utmost importance that Tokyo coordinate very closely with Washington and Seoul on this matter. This settlement was reputedly put on the table during the May 1999 Perry mission to Pyongyang as a consequence of close consultation between Washington, Tokyo, and Seoul. Presumably, it will be raised again in bilateral talks between Tokyo and Pyongyang.

The December 1999 visit of former Prime Minister Murayama to Pyongyang has led to renewed Japanese food assistance. As mentioned earlier, it is not necessary that food assistance to needy North Koreans be provided in North Korea. Japan bears a significant historical responsibility for the situation on the Korean peninsula. Although it might cause some political discomfort in Japan, acceptance of refugees for resettlement could take some pressure off China and would make a significant contribution to alleviating the suffering of the North Korean population.

China

China occupies the most ambiguous position of any of the major powers in the region. The conventional thinking in China is that it benefits from

the maintenance of a divided peninsula and a fraternally allied socialist state on its border. The senior Chinese leadership includes a significant number of Korean War veterans who have a personal bond to North Korea. In 1999, China apparently stepped up military cooperation with North Korea, and US Secretary of State Madeleine Albright has publicly questioned Chinese assistance to North Korea's missile development program. China has steadfastly avoided participation in KEDO or the WFP food program, preferring to act alone and with little transparency, yet Clinton Administration officials from the President on down praise China's cooperation on Korea-related issues.

That said, China has been the major loser in developments on the peninsula over the last several years. The August 1998 North Korean missile test spurred an unprecedented degree of military cooperation between Tokyo and Seoul, encouraged increases in military expenditures and a more assertive national security posture in Japan, and undercut Chinese diplomatic efforts in opposition to the development and deployment of Theater Missile Defenses (TMD) in Northeast Asia.²⁵ The development of longer-range North Korean missiles and the deployment of North Korean missile batteries in areas near the Chinese border have dismayed the Chinese. Lastly, and perhaps most importantly, from the Chinese perspective North Korea's reluctance to adopt Chinese-style economic reforms perpetuates a potentially unstable situation in which China could be inundated with unwanted refugee flows as it was in the mid-1990s, or, worse yet, be drawn into a second confrontation with the United States on the Korean peninsula.

In some respects, China's interests with regard to North Korea are similar to those of South Korea and Japan: It would like to see a stable, non-threatening North Korea that could act as a buffer state, without continually upsetting strategic calculations in Northeast Asia. Its role is distinct, in that the domestic political basis for underwriting the Pyongyang regime is more robust in Beijing than in Tokyo or Seoul. As a consequence, Beijing is Pyongyang's most reliable ally and prospectively an important tutor in economic reform, despite differences in the two countries' situations.

The absence of significant constructive change in North Korea may put these ties at risk, however. Although the older generation of Chinese leaders may feel ideological and historical bonds with North Korea, the younger generation, many of whom were victimized in the Cultural Revolution, regard the personality cult around the Kims with a mixture of revulsion and derision. As many of them have observed, Beijing maintains

25. For an interesting analysis of the TMD issue, see Cha (1999).

a cordial and prosperous relationship with Seoul.²⁶ The sticking point, of course, is the presence of US troops on the Korean peninsula.

Although supporting the North Koreans may be China's first-best option, at some point China may conclude that North Korea is irredeemable and that the maintenance of a divided peninsula is unsustainable. At this point, China may switch strategies, seeking to achieve a second-best alternative of a unified Korea strategically removed from the US orbit. China could play a role similar to the one played by Gorbachev and the Hungarians in the case of East Germany. It could, in essence, pull the plug on the Kim Jong-il regime by cutting off assistance, opening the border, and taking up a multinational coalition's offer to fund refugee resettlement. The issue is what price they could extract from Seoul. Presumably, the Chinese would request removal of US troops from the Korean peninsula and the nullification of the US-South Korea mutual defense treaty, although intermediate solutions might be possible (no US troops in the northern part of the peninsula). In the extreme case, South Korean policymakers could face a choice between national unification on the one hand or continued military alliance with the United States on the other. In this circumstance, it is not at all clear how South Korea would choose.

Others

In addition to the United States, Japan, and China, other actors may play significant roles on the Korean peninsula. The European Union has considerable diplomatic and financial resources and participates in the KEDO consortium. However, it is far away, and the Korean peninsula is relatively peripheral to its strategic interests.

In contrast, Russia, which borders North Korea, has expressed interest in raising its diplomatic profile in Northeast Asia but has few financial resources. This limits Russia's capacity for playing a significant role in Korean affairs. Were Moscow to have a major impact on events on the Korean peninsula, it most likely would be as a spoiler, providing North Korea diplomatic support and frustrating the plans of the United States and others in order to obtain diplomatic concessions on other issues of more direct Russian interest, such as its economic interactions with the West. However, others argue that, by giving the Russians enough "face," they could be persuaded to play a constructive role vis-à-vis North Korea.

Either way, there are two obvious areas of concern for the rest of the world. Russia is likely to continue to downsize its military, thereby generating redundant personnel and equipment. Given the Soviet mili-

26. Bazhanov and Moltz (2000) provide vivid examples of such Chinese attitudes toward North Korea.

tary's historical ties to Pyongyang, Russia could become an ongoing source of specialist personnel and hardware for North Korea's military modernization, whether officially sanctioned by Moscow or not.

A second area of concern has to do with illicit activities, specifically cooperation between North Korean state-sponsored criminal enterprises and Russian transnational criminal groups. North Korea has exploited the breakdown of law and order in Russia to conduct criminal activities, including drug trafficking, arms smuggling, and counterfeit dispensing on Russian soil. Continued weakness in Russia and penetration of the state by Russian criminal groups could foster a supportive environment for North Korean transnational criminal activities.

Finally, international organizations could have a significant impact on the Korean peninsula. Technically, the current division of the peninsula reflects the UN-supervised armistice agreement, which ended fighting during the Korean War, and the presence of US troops on the peninsula is a legacy of the US participation in the United Nations police action in Korea. One gets the impression that New York is unenthusiastic about the continued UN role in Korea, however titular. In the end, any peace treaty or other significant political changes on the peninsula is likely to reflect the diplomacy of key national players, not the United Nations.

Of potentially greater importance could be the activities of the International Monetary Fund, the World Bank, and the Asian Development Bank. Of course, they do not act completely autonomously, and their activities to a significant extent will reflect the diplomatic consensus among the United States, Japan, and South Korea. Also, their direct lending activities in North Korea (or in a united Korea) are likely to be relatively modest. Nevertheless, these institutions could play a constructive role by offering relatively non-politicized technical advice and support and complementing the activities of private investors. They could play an even bigger role if interested parties were to pool their resources and establish a "North Korea Fund" within one or both of the development banks.

Final Thoughts

Koreans sometimes describe themselves as a "shrimp among whales," and during the past century Koreans and foreigners have clashed violently over control of the Korean peninsula. The result of these struggles is a peninsula divided between an increasingly prosperous and democratic South Korea and an increasingly destitute and totalitarian North Korea. Even if the North did not exist, the South would face great economic and political challenges in its own process of economic development and political maturation. The existence of the North creates an additional layer of complexity to the challenges that South Korea confronts, posing both a threat to its economic prosperity and to its political democratization,

while at the same time creating an opportunity to extend those same achievements to 20 million more Koreans.

Foreign powers have been a significant force in these developments, acting constructively at times and malevolently at others. Although Koreans will ultimately write their own history, foreigners will continue to exercise significant influence on events on the peninsula. One can only hope that they play a more unambiguously positive role in this new century than they did in the last.