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# Economic Leverage and the North Korean Nuclear Crisis

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Almost a decade ago, as the last nuclear crisis with North Korea was reaching a peak, I concluded the following about the potential utility of economic sanctions:

> The debate over US policy toward North Korea boils down to one deceptively simple question: what does Kim Il-sung want? No one can be sure of the answer and different interpretations have quite different policy implications. If the Great Leader views a nuclear weapons option as important to the survival of his regime, economic sanctions are unlikely to force him to give it up. But if he views the threat of developing nuclear weapons as a bargaining chip, some combination of carrots and sticks may induce him to trade it away.[1]

Change the name to Kim Jong-il and Great Leader to Dear Leader, and essentially the same could be said of the situation facing policymakers today on the Korean peninsula. What differs most from a decade ago is the American position. Since coming to office in 2001, the administration of President George W. Bush has refused to negotiate directly with the North Korean regime.

> ***The important new question is whether the Bush administration's stance reflects disagreement with key countries only over the means to resolve the situation or over the desired end as well.***

Governments and attitudes have changed in other key countries also, most notably in South Korea, where President Kim Dae-jung has introduced the sunshine policy. But the Bush administration's insistence that it will not negotiate until North Korea has taken steps to dismantle its nuclear programs has put it at odds with key countries in the region. As they were a decade ago, China, Japan, and South Korea are still concerned about provok-

[1] Elliott (1997). This policy brief draws heavily on that earlier paper.

ing a military response from North Korea or causing a sudden collapse of the regime, which could have substantial spillovers on them. The important new question is whether the Bush administration's stance reflects disagreement with key countries only over the *means* to resolve the situation or over the desired *end* as well. More hawkish elements of the Bush administration reportedly have concluded that engagement and gradual reintegration of the peninsula are no longer options and that Kim Jong-il's government should be squeezed until it does collapse.

Under these circumstances, what role might economic leverage play today? Economic sanctions contribute to the achievement of coercive foreign policy goals when the costs of the sanctions imposed on a country outweigh the costs it expects to incur from complying with the imposing country's demands. If the goal is containing or rolling back the nuclear threat on the peninsula, then North Korea must be willing to give up its nuclear programs at some price, and the United States must be willing to negotiate the terms. US policymakers must also be able to put together a coalition of key countries with enough leverage to make both threats and promises credible. Just as it did a decade ago, the United States must cooperate with China, Japan, and South Korea. If the goal is deposing Kim Jong-il, then some group within the country must have the ability and the incentive to overthrow the targeted leadership. But North Korea's neighbors oppose stiff economic sanctions because they fear a destabilizing regime change, and it is not clear how the United States could bring sufficient leverage to bear to achieve this goal unilaterally.

**The North Korean Economy**

North Korea presents unusual challenges for countries contemplating the use of economic sanctions.[2] Although the government has undertaken tentative economic reforms, the legacy of the Great Leader's economic philosophy of "juche," emphasizing self-reliance, has made North Korea the most closed economy in the world. In addition to ideology, North Korea's limited economic integration is also a consequence of the US decision during the Korean War to isolate the North economically. Although the ban on bilateral trade and financial relations was eased under the Agreed Framework that resolved the 1994 crisis, extensive restrictions remain, and little trade between the United States and North Korea has resulted. North Korea's external trade is also limited by its inability to generate foreign exchange to buy imports or to reliably service external debts. Under the combined effects of isolation, economic mismanagement, high military spending, and the lingering effects of the mid-1990s famine, the North Korean economy barely functions. For several years, it has been incapable even of feeding its people without international assistance.

Because North Korea's trade and financial relations with the rest of the world are limited, the scope and volume of potential leverage are also limited, which, in turn, restricts the range of sanctions options available. But juche also means that North Korea imports only those products that it needs to keep the economy functioning and cannot produce domestically; it must then either export to earn hard currency to pay for the imports or provide products for barter. This creates more leverage than the aggregate trade numbers might suggest, but it also deepens the dilemma for the international community since sanctions would affect key sectors, including the military, and might then reverberate quickly throughout the economy. Substantial economic disruption could increase the risk of either a military response by North Korea or economic collapse, both of which North Korea's neighbors want to avoid. Because of the proximity of Seoul to the demilitarized zone, the North Korean military effectively holds it, and 50,000 American soldiers on the border, hostage. An implosion of the regime in the North and absorption by the South would also be economically costly and China fears that it might unleash hundreds of thousands of refugees.

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According to available data (mostly from the late 1990s), North Korea's major trading partners are China, Japan, and South Korea, in that order. Russia, a major trading partner before the collapse of the Soviet Union, was of declining importance a decade ago and now accounts for less than 3 percent of North Korea's total merchandise trade, about the same as Germany. China is by far North Korea's most important economic partner, allowing it to run large trade deficits and accounting for nearly

[2] This section draws heavily on Noland (2002). See also Noland (2000).

a third of its imports, including most oil and food imports not provided under the Agreed Framework or as international food aid. Overall, food and petroleum products account for more than a quarter of reported North Korean imports. It also receives hundreds of millions of dollars annually in international humanitarian assistance, much of it in-kind food aid. North Korea exports mainly natural-resource products and light manufactures, in addition to less-open exports of arms (including missiles) and illegal drugs.

Other sources of foreign exchange include remittances and investment from North Koreans in Japan, though these are estimated to have declined along with the Japanese economy, and China's financing of the large bilateral trade deficit. South Korean trade and investment is a potential source of foreign exchange and capital. These countries and the United States have also been important in providing food and energy assistance, as well as constructing two light-water reactors under the Agreed Framework. Since the revelation last fall of North Korea's uranium enrichment program, however, oil shipments have been cut off and food assistance has been reduced, though US policymakers deny that the latter is for political reasons.

**A Framework for Analyzing Economic Sanctions**

In *Economic Sanctions Reconsidered* (second edition, 1990), Gary Hufbauer, Jeffrey Schott, and I examined 115 cases of economic sanctions beginning with World War I and ending with Iraq's invasion of Kuwait in 1990. Most episodes occurred after World War II, and most were unilaterally imposed by the United States (77 of the 115) with only minor or no cooperation from its allies. The goals of sanctions ranged from the relatively modest, such as settling transnational expropriation disputes, to the highly ambitious, such as ending apartheid in South Africa. Over the past decade, sanctions have been used in efforts to end conflicts in the Balkans and to promote democracy in Latin America, sub-Saharan Africa, and elsewhere. Preliminary results from the third edition of *Economic Sanctions Reconsidered* suggest that the United States was still the most frequent user of sanctions, but the European Union and the United Nations became much more active in the 1990s as well. In general, we do not expect the new data to change our conclusions significantly, and most of what follows is from the second edition because results for the new one are still being compiled.

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

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

- the *goal* is relatively modest, thus lessening the importance of *multilateral cooperation*, which often is difficult to obtain, and reducing the chances a rival power will provide *offsetting assistance*;
- the target is *economically weak and politically unstable* even before sanctions are imposed;
- the sanctioner and its target are *friendly* toward one another and *conduct substantial trade* (the sanctioner accounted for 28 percent of the average target's trade in success cases but only 19 percent in failures; in cases involving relatively more difficult goals, the ratios were 36 percent and 16 percent, respectively);
- the sanctions are imposed quickly and decisively to *maximize impact* (the average cost to the target as a percentage of GNP in all success cases was 2.4 percent and 1 percent in failures, in cases involving "major" goals, the figures were 4.5 percent and 0.5 percent, respectively); and
- the sanctioner *avoids high costs to itself*.

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

## The Framework Applied to North Korea

If Kim Jong-il feels a nuclear option is essential to his survival then sanctions will not induce him to give it up. But if a deal is possible, then economic sanctions have a role. This section takes each of the five major conclusions outlined above and applies them to the North Korean case.

*Goals, cooperation, and offsetting assistance.* Inducing North Korea to abandon its nuclear weapons program is a high-profile, ambitious objective. A second important goal is preserving the integrity of the international nonproliferation regime. Thus, history suggests that international cooperation is a necessary if not sufficient condition for success. Moreover, from the US perspective, cooperation is essential because the United States already has banned virtually all trade and financial relations with North Korea since 1950 and, thus, has very little negative economic leverage available to it.

Fears of unintended consequences for North Korea's immediate neighbors, however, complicate the decision to impose economic sanctions. South Korea and Japan, in particular, do not want to provoke Kim Jong-il into a rash military response, and South Korea and China do not want to risk an economic collapse of the regime, which could create many thousands of refugees and cost billions of dollars to clean up. Although my colleague Marcus Noland argues that South Korea is exaggerating the likely economic costs of collapse and absorption of the North, they are still substantial and most South Koreans have yet to be convinced (Noland 2003).

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These concerns and the lack of unilateral US leverage, in turn, limit the goals that are likely to be in reach with economic sanctions. However much President Bush "loathes" the North Korean leader, and however desirable regime change might be, it is not a goal that is going to garner the cooperation needed to squeeze the country hard.

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

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

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

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

## Sanctions Alternatives With Respect to North Korea

The above analysis produces few definitive answers about the potential utility of economic sanctions in this case. Multilateral sanctions could be economically quite costly to North Korea, but the goal is also quite difficult. Moreover, the degree of international cooperation that the United States can expect is questionable because the costs to the sanctioning coalition could be quite high as well. And US unilateral leverage remains limited, which

[3] The sources of North Korean trade are from Noland (2000, 91); on the increasingly important role of China, see the *Washington Post*, February 4, 2003, A20.

constrains the goal of regime change.[4] In the end, both the sanctions that could feasibly be marshaled and the response to them by Kim Jong-il depend on what each of the key partners wants or fears most.

As it did previously, North Korea is threatening to treat the imposition of sanctions as an act of war. Its economy hovers even closer to the brink of total collapse, and its neighbors are as concerned about the effects of sanctions on North Korean stability as they were a decade ago. In addition, whatever the resolution of the situation in Iraq, it may be more difficult than before for the United States to credibly use the United Nations to provide multilateral cover for the imposition of economic sanctions. Thus the challenges to using this tool are even greater today than before.

In 1993–94, the administration of President Bill Clinton responded to similar diplomatic pressures by proposing a strategy of gradual escalation of sanctions, contrary to the advice in Hufbauer, Schott, and Elliott (1990) to impose sanctions quickly and decisively. The first phase of the proposed Clinton sanctions involved boycotting North Korean arms exports, which would have cost the regime an estimated $50 million to $100 million a year. The second phase would have banned all financial transactions, including the remittances from Koreans in Japan, estimated at several hundred million dollars then but now of uncertain and much smaller magnitude. Even in the absence of direct sanctions on exports to North Korea, such restrictions on financial transactions would inhibit the regime's ability to import oil, food, and other products. And the Clinton plan did not explicitly mention moving to a full trade embargo, even in stage three. The plan was designed to elicit at least informal Chinese cooperation, by giving them the opportunity to abstain on a Security Council vote and acquiesce in phase one and two sanctions, without taking action or being directly involved in enforcement themselves.

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Ultimately, however, the stick of sanctions and the carrots of energy and other economic assistance resulted in the negotiation of the Agreed Framework between North and South Korea, Japan, and the United States.[5] Under the Framework, North Korea agreed to shut down and eventually dismantle its small nuclear reactor and reprocessing plant, under international supervision, in exchange for two more proliferation-resistant light-water reactors (LWRs) and supplies of fuel oil while the reactors were being built. In addition, negotiators agreed that North Korea and the United States would take steps toward normalizing economic and political relations, including the lifting of the US embargo.

From the beginning, there were concerns, particularly in Congress, that US negotiators had given up too much. Nonproliferation experts and others argued that providing North Korea with LWRs made no economic or energy sense and, for a variety of reasons, construction lagged badly. Many congressional critics opposed making any concessions at all and repeatedly threatened to cut off funding for the fuel oil shipments. In the face of congressional resistance, the Clinton administration also delayed lifting US sanctions. Whether in response to these events or because it never really intended to comply, North Korea secretly resumed efforts in the 1990s to build a nuclear weapons program, this time using uranium enrichment rather than reprocessing technology.

The Bush administration came into office openly distrustful of Kim Jong-il and leery of the Clinton policy of engagement. In his January 2002 state of the union address following the terrorist attacks on the World Trade Center, President Bush included North Korea, along with Iraq and Iran, in an "axis of evil" that he said was seeking weapons of mass destruction and aiding terrorists. Then, in fall 2002, the Bush administration declared the Agreed Framework null and void when North Korea, confronted with evidence of the enrichment program, confirmed its existence and offered to negotiate a new deal. The administration refused to negotiate bilaterally until North Korea took steps to dismantle its nuclear programs. It also convinced South Korea and Japan to end fuel oil shipments under the

[4] One possible unilateral option is to reduce the foreign exchange available to North Korea by interdicting shipments of arms, missiles, illicit drugs, and, eventually, nuclear material (*New York Times*, February 17, 2003). But the diplomatic costs of that strategy were highlighted when the United States decided to allow a ship carrying North Korean missiles to Yemen to complete its journey after it was stopped by Spanish naval forces. The higher risk, of course, is that interdiction would trigger a military reaction by North Korea with the potential to spiral out of control.

[5] Discussion of the events since 1994 is based on the case study prepared for the forthcoming third edition of *Economic Sanctions Reconsidered.*

Agreed Framework and pressed China to exert more leverage over North Korea. In this case, in contrast to Iraq, American policymakers insist they will move forward *only* under a multilateral framework.

Policymakers in South Korea and China remain reluctant to push North Korea to the wall and believe that the core security issues must be settled between North Korea and the United States. But, like the regime in the North, they appear to be increasingly concerned that, after Saddam Hussein, Kim Jong-il may be the next member of the "axis of evil" to be targeted by the United States. Fears that continued escalation by North Korea might lead the United States to consider a last-resort strike against the Yongbyon nuclear complex have spurred new diplomatic activity in the region. China is also concerned about the potential for an arms race in the region if North Korea announces itself as a nuclear power. While North Korea's closest neighbors are still publicly resisting the sanctions option, there are some signs that they are trying to engage the United States and North Korea in a carrot-and-stick strategy that could lead to a negotiated resolution to the crisis.

*As part of a carefully calibrated, verifiable, and reciprocal agreement, the United States should also be willing to lift remaining, non-security-related economic sanctions.*

At the end of March, South Korean National Security Adviser Ra Jong-yil proposed replacing the Framework plans for LWRs with a gas pipeline from Russia through North Korea to the South (*Financial Times*, March 31, 2003, p. 1). The pipeline would still cost billions of dollars to build, and there are many details to work out. But this proposal offers at least the possibility of a solution that is more economically and politically viable, and therefore more sustainable, than the Agreed Framework. The evident economic absurdity of building LWRs in North Korea, the resulting need for large public subsidies to do it, and American ambivalence about the deal from the beginning, undermined the Framework's implementation. If extending the pipeline to South Korea would make it attractive enough for the private sector to get more involved, it could generate a momentum that the LWR contract never had.

Just before South Korea suggested this carrot, China reportedly waved the sanctions stick, albeit quietly, claiming that technical problems shut down an oil pipeline to North Korea for three days in late winter. In a meeting in February, Chinese Vice Foreign Minister Wang Yi reportedly told North Korean Foreign Minister Paek Nam Sun that continued provocations could lead China to drop its opposition to sanctions (*Baltimore Sun*, March 28, 2003, 12A). South Korea is also pushing China to cooperate in building a compromise framework for negotiations that could bridge the US demand for multilateral talks and the North Korean demand for direct bilateral talks. Although, China and Russia blocked a resolution in the UN Security Council condemning North Korea's announced withdrawal from the Nuclear Non-Proliferation Treaty, they are continuing to pressure North Korea to come to the table. On April 11, Russian Deputy Foreign Minister Aleksandr Losyukov said Russia might reconsider its opposition to sanctions if North Korea begins producing nuclear weapons (*New York Times*, April 12, 2003, A5). Shortly after, North Korea announced that it would consider a multilateral framework for talks, though issues relating to who should be at the table and what preconditions the United States would demand remain to be worked out (*Washington Post*, April 13, 2002, A22).

Thus, the outlines of a potential compromise may be emerging. South Korea and Japan, with Russia's cooperation, can put the carrots of increased trade and investment as well as energy assistance on the table if North Korea agrees to put *all* its nuclear programs on the table and verifiably commits to forego any nuclear option in the future. China needs to continue to pressure North Korea behind the scenes to keep it from escalating further and to be sure it comes to the table on terms the Bush administration can accept. If North Korea does not respond and continues to escalate, China will need to follow through on its threat to support some sanctions.

The most important thing that the United States brings to the table in the short run is a willingness to address North Korean security concerns raised by the "axis of evil" terminology and the use of preventive war to disarm Iraq. Down the road, as part of a carefully calibrated, verifiable, and reciprocal agreement, the United States should also be willing to lift remaining, non-security-related economic sanctions. Elsewhere (except for Cuba), President Bush promotes increased trade as a mechanism for promoting democracy as well as prosperity. Why not in North Korea?

For this sort of a deal to work, specific terms and verification measures obviously have to be far more carefully negotiated than they were in 1994. Ultimately, though, the key question remains: what do Kim Jong-il *and* George Bush want?

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