


Growth despite Sanctions?

Revisiting the Effect of North Korea Sanctions



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Recently the central bank of Korea, the Bank of Korea, announced that North Korea's GDP in 2016 increased by 3.9%p compared with the previous year. In 2016, the UN passed two resolutions for strong economic sanctions on North Korea, UNSCR 2270 and 2321. This economic performance, therefore, seems to support and even prove the popular hypothesis among North Korean experts that sanctions against North Korea are useless. This article deals with this recent phenomenon of "growth despite sanction" in North Korea.

This short article consists of two parts, the first part of which analyzes the internal driving forces of recent economic growth, which has not drawn much attention yet. And then we will provide an explanation for why previous sanctions on North Korea have failed to generate sufficient effect, why the United Nations Security Council Resolutions 2321 and 2371 are different from previous ones, what the potential effect of recent sanctions will be, and when this will materialize.

Internal Elements of North Korean Growth

The North Korean economy consists of two sectors. The first is the strategic

sector (e.g. military industry and related heavy industries), which is operated through a planning mechanism. The second is the non-strategic sector (mainly light industries and local industries), which is operated by market mechanisms.

The North Korean government's investment strategy has been focused on strategic sectors, and it has allowed marketization in non-strategic sectors since the early 2000's. This is referred to as the "Military First Economic Policy" (MFEP), which is the developmental strategy of the Kim Jong-Il era. Under MFEP, instead of allowing marketization in non-strategic sectors, the government extracted surplus values in the form of tax from non-strategic sectors, and poured this into strategic sectors. Meanwhile no surplus values from strategic sectors were transferred into non-strategic sectors. This unilateral flow of surplus values is the most distinct characteristic of MFEP.

According to Pyongyang's official propaganda, this strategy will make possible the rapid economic development of strategic sectors, and then by a trickle-down effect, non-strategic sectors will follow the path soon. But this pseudotheory was never proved during the Kim Jong-Il era. It has been the military sector only which has continued to grow.

There have been speculations as to whether Kim Jong-un would continue his father's developmental strategy. As soon as he seized power, Kim Jong-un declared the so-called "economic development and nuclear force building in parallel policy" (hereafter the "Parallel Policy"), leading experts to wonder whether this is just a continuation of MFEP or reflects some real changes from it.

According to the official explanation by the North Korean government and Kim Jong-un himself, the Parallel Policy is different from MFEP. While MFEP signifies growth and unilateral investment in military industries and defense affairs, Parallel Policy means to freeze or even cut some of those investments and instead invest more in civilian economic sectors.

Most experts have pronounced the vision of Parallel Policy as unrealistic as long as the Pyongyang regime does not abandon its nuclear weapon program, and that Parallel Policy will eventually adopt the same developmental strategy as MFEP. However, as time goes on, circumstantial evidence shows that North Korea's official explanation is more than just propaganda; circumstantial evidence indicates that North Korea is implementing an increasing number of real economic reforms.

First, it appears that North Korea has succeeded in substituting its imports in the military industries, especially in WMD-related industries. This has made it much cheaper to realize progress in its WMD capability, which is why the Kim Jong-un regime has been able to conduct missile and nuclear tests so frequently.

Second, it seems that the North Korean government is investing more resources in civilian economies than earlier periods, and some technologies developed in military industries are spilling over into civilian economies. Even military industry factories have begun to produce consumer goods and machines for civilian economies.

Third, additionally the Kim Jong-un regime has carried out a consistent reformist policy in economic management measures (i.e. marketization). While only this third aspect is often mentioned by experts when they talk about North Korean economic reform, a scope of reform limited to economy management measures cannot succeed. Reforms in management measures can succeed and continue only when they are supported by reform of investment strategies. This is precisely why Chinese economic reform succeeded in the 1980's.

These three elements are the domestic driving forces for the recent growth of the North Korean economy. And it goes without saying that the rapid growth of DPRK-China trade since the mid-2000's is the external driving force. But for further economic development, there are two closely related obstacles which must be overcome.

First, to continue economic growth, North Korea must attract foreign investment and developed technology into its civilian economic sectors. But in the current international situation surrounding the nuclear issue, this looks like to be difficult.

Second, international sanctions, especially sanctions under UN Security Council Resolutions 2321 and 2371, will cause North Korean trade and foreign currency earnings to shrink rapidly. And this may cause economic chaos in the dollarized economy.

Why International Sanctions Did Not Work before UNSCR 2321

How is this economic growth possible with all the international sanctions imposed on North Korea? The answer is simple. International sanctions did not and could not work before UNSCR 2321. Since North Korea's first nuclear test in 2006, there have been many bilateral and multilateral sanctions imposed on North Korea. But these failed to have a meaningful impact on the North Korean economy until the adoption of UNSCR 2321.

First, Japan, which had accounted for one-third of all North Korean trade, banned all trade with North Korea following the first nuclear test, but growth in North Korea's trade with South Korea and China offset the Japanese sanction in the mid- and late 2000's.

Second, South Korea banned all trade with North Korea except through the Kaesong Industrial Complex from mid-2010 (following which even the Kaesong Complex was shut down in early 2016), but the rapid growth of North Korean trade with China made sanctions imposed by South Korea and Japan meaningless in the early and mid-2010's.

Third, before UNSCR 2270, which was adopted in early 2016 following North Korea's 4th nuclear test in 2016, UN sanctions focused on blocking trade directly related with WMD development, which resulted in the North Korean civilian economy remaining relatively untouched from UN sanctions.

Fourth, with the adoption of UNSCR 2270, the international society tried to restrict North Korea's "normal" (i.e. civilian) trade under the implicit and explicit interpretation that even foreign currency earned from "normal trade" contributes to WMD development. This can be true. As explained above, under the MFEP, surplus values from non-strategic sectors could and even should be transferred to strategic sectors. Because of previous sanctions, North Korean arms trades shrank rapidly, including WMD-related trade, making it reasonable to suspect that the Pyongyang regime began to extract more surplus values (in this case, foreign currency) from "normal" trade.

Under this interpretation, the international society decided to restrict North Korea's export of minerals, which has been its No. 1 export item. China agreed to the sanction, and restrictions on mineral imports from North Korea commenced in April 2016. But when South Korea decided to deploy the THAAD system on the Korean Peninsula in July 2016, China began to rapidly increase its mineral imports from North Korea in August 2016. This watering down of sanctions by China was possible because there was a salvo clause in UNSCR 2270 that the mineral sanctions would not apply to trade relevant to the "livelihood of people."

Finally, UNSCR 2321 adopted in November 2016 introduced import quotas of North Korean coal (400 million dollars or 7.5 million tons per year) with full agreement from the Chinese, and deleted the salvo clause. There is no way for the Chinese government to deceive or not implement the coal quota sanction because most of North Korean coal is imported by ship and can be easily detected. Under UNSCR 2321 coal quota sanction, North Korea's loss in

foreign currency earning will amount to 700 million dollars a year, which is a significant amount for North Korea.

Because of the characteristics of coal trade between China and North Korea, the effect of a coal quota sanction can be somewhat delayed. Much of the coal trade between China and North Korea is done in the form of investment. The Chinese counterpart pays first and then North Korea pays back with coals accordingly. So although coal trades stopped since March 2017, it remains highly probable that Chinese companies already invested (meaning prepaid) their balances for 2017 and maybe the next few years as well. This is why the North Korean economy still remains calm despite the UNSCR 2321 sanctions. It will take several months for the sanction effect to materialize. But what is sure is that the UNSCR 2321 sanction will have a definite impact, and this will greatly affect the North Korean economy.

The Economic Impact of UNSCR 2371

In August 2017, the international society adopted UNSCR 2371, which literally bans imports of North Korea's top export items – including coal, iron and iron ore, fishery – and freezes imports of North Korean labor. This is a truly powerful and harsh sanction. As mentioned above, UNSCR 2321 will cut North Korean foreign currency earnings by 700 million dollars. UNSCR 2371 will cut at least an additional 700 million dollars more (400 million dollars from coal exports, 200 million dollars from iron and iron ore exports, 1 million from fishery earnings). In sum, North Korean foreign currency earnings will be cut by at least 1.4 billion dollars from 2015 levels. This amounts to almost half of North Korean exports.

Facing this abrupt decrease in its foreign currency inflows, Pyongyang will try to find additional channels to earn foreign currency, which is almost impossible – monitoring on arms trade and illegal trade has been strengthened significantly, a freeze was put on foreign labor export and foreign investment in North Korea under UNSCR 2371, and tourism and international donations are keenly affected by international sanctions, and so on. This means the only option for the regime will be to absorb domestic foreign currency in the market.

If realized, however, this would deal a major blow to the North Korean economy on both the consumption and production sides.

First, the markets in North Korea are grounded in foreign currency. A heavy fall in coal exports will lead to a significant reduction in foreign currency inflows to North Korean markets. In addition, if the North Korean regime seeks to absorb foreign currency from markets, for-

foreign currency-based transactions in the markets will come to a halt, triggering a sharp inflation.

Second, active production and distribution in some parts of the North Korean economy is supported by investments from donju, North Korean capitalists. Donju make capital investments to buy products (raw materials, facilities, consumer goods and others) for production and sale, and operate factories and state-run retail stores by paying the employees on their own. Then they earn profits from these activities. North Korea's property development is also being led by investments from donju to a significant degree.

If the North Korean regime pushes to absorb foreign currency from markets, donju will stop making new investments and try to recover their investments earlier than scheduled. This in turn would suspend production activities in the North Korean economy, which have been maintained at the minimal level. **KIEP**