

Mansfield Corporate Affiliates Program Luncheon:

Dr. Marcus Noland

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“Economic Repercussions of the DPRK Nuclear Test”

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Summary by Aaron Siirila



Dr. Noland opened his remarks with a brief outline of North Korea’s economy and then provided his views on whether UN sanctions in the wake of Pyongyang’s recent nuclear test will be effective. He noted that “the financial market reaction [to the test] was milder than expected,” and therefore would only briefly touch on that issue.

According to Dr. Noland, North Korea has been in a steady “decline since the mid 1980s,” and that decline “accelerated after 1990 with the breakup of the USSR” and the end of “highly subsidized oil” from the Soviets. At the same time, “North Korea has pursued a system of self-sufficiency, which, as an economist, I feel is unwise,” Noland said.

In the early 1990s, North Korea was hit particularly hard by food shortages and widespread famine. Although the famine officially started in 1994, Noland pointed out that signs of the famine were already showing a year earlier. The famine eventually killed 600,000 to one million people, or three to five percent of North Korea’s total population. With the central plan fraying at the same time, North Koreans took to technically illegal free-market survival mechanisms, such as private trade in food.

Beginning in 1999, North Korea enacted several economic reforms, the most dramatic in July 2002. However, these reforms “were not forward-looking, top-down reforms,” but rather “they were defensive” and “primarily reactive in nature.” Because of their inept implementation, the results of these reforms were widened inequality. “Reckless policies” undertaken in 2005-06 banned private trade in grain, which had kept the North Korean people alive during the famine, and also severely limited international food assistance to North Korea, which Noland estimated had been feeding one-third of North Korea’s population.

Pyongyang’s threat to expel the World Food Program (WFP) and international humanitarian NGOs was devastating to many North Koreans. In addition, these groups have been a crucial channel of on-the-ground information about the regime. The WFP previously had 50 people working in North Korea, and they were doing excellent, comprehensive survey work, such as household surveys on nutrition that provided valuable insight into North Korea. The WFP and other NGOs were simply the best sources of data the outside world had on North Korea. However, “all that was lost in the last year.” The WFP now has just 10 people in North Korea, confined to Pyongyang and only allowed to leave once every three months.

These actions “have set the stage for a renewed humanitarian crisis” in North Korea. This is despite the fact that there has been some speculation “that North Korea was hunkering down and

stockpiling oil and food” in preparation for possible sanctions after their nuclear test, Dr. Noland said.

In terms of North Korea’s trade, despite the hype, Pyongyang does have some legitimate merchandise exports with the world. Dr. Noland mentioned that, curiously, North Korea at one time had a substantial share of the Japanese men’s suit market.

Foreign economic and humanitarian assistance brings in as much to the North Korean economy as legitimate trade. Economically speaking, when North Korea was receiving food aid it literally stopped buying or importing food from abroad. Thus, Dr. Noland argued, in humanitarian assistance “there is clearly a balance of payments issue. In giving them food aid we allow them to reallocate money for other uses.” Needless to say, those other uses are not always desirable to the international community.

The third source of income for North Korea is what Dr. Noland describes as “undesirable trade,” which also brings in as much money as merchandise exports. The undesirables include missile sales, drug production, drug couriership for other countries or organizations, currency counterfeiting and smuggling.

With such diverse sources of income, will UN sanctions be effective? Dr. Noland’s short answer is no. Dr. Noland gave three reasons for his pessimistic answer. The first reason is that, generally speaking, “economic sanctions are not usually effective in changing core political aims of the state targeted” by sanctions. That is to say, “countries don’t change their fundamental aims in the face of sanctions,” and if North Korea’s aim is to possess nuclear weapons then sanctions will not stop it.

Sanctions are also unlikely to be effective because there is no centralized agency to carry out enforcement. With each country establishing its own enforcement regulations and procedures, any perceived failure “will lead to finger-pointing and recrimination” by the sanctioning countries.

Finally, in the face of sanctions, North Korean politicians will inevitably continue to push the envelope, primarily to test whether the US threat is credible. With this continual pushing of limits, the DPRK may eventually overstep – accidentally or otherwise – a real threshold in the minds of what US leaders are prepared to allow North Korea to do. At that point, failed sanctions may hinder US flexibility when the US and its allies may have few non-military options left.

Sanctions, however, may be useful in some aspects. The first is by bringing China on board international norms. The second is that “inflicting pain” on North Korea may serve as a deterrent to other countries who may be tempted to think that a country can develop nuclear weapons without fear of international condemnation. In the end, however, Dr. Noland felt that sanctions would probably fail because the world could not provide “either enough pressure or enough incentives” to denuclearize North Korea.

In the question and answer session, a question was posed about what the immediate goals of the US are concerning the current crisis. Dr. Noland responded by saying that the US was hoping for

a return to the negotiating table. On a longer view, however, he said “we’re starting to get signals from Beijing that China is looking beyond just getting North Korea back to the Six Party Talks,” which Dr. Noland took as a good sign of Chinese strategic foresight.

Mansfield Foundation Executive Director Gordon Flake posed a question to Dr. Noland: what kind of development in the crisis would lead to capital flight in South Korea and China, and would such an economic threat motivate Seoul and Beijing to intensify negotiations with Pyongyang? Dr. Noland responded by first reiterating the tiny effect the nuclear tests had on the financial markets in the region. He pointed to a paper he had written for the National Bureau of Asia Research (NBR) in January 2006 in which he correctly predicted the relatively small size of the financial shock after the nuclear test. Dr. Noland also clarified a common misconception about capital flight, where it is argued that panicky international companies are the first to remove funds. In fact, it is usually the better-informed local investors who first withdraw their assets. International investors are usually reactive and the last the leave.

Nevertheless, Dr. Noland argued “in Seoul, you have the real possibility of capital flight.” For comparison’s sake, the reaction in Seoul to Pyongyang’s 1994 aborted attempt to withdraw from the NPT was actually a small *increase* in the financial markets. Since then, however, four developments have made capital instability much more likely. First, capital controls have been reduced, whereas in 1994 government regulations made capital flight impossible. Second, the government no longer manages and directs the financial markets and economy to the extent it did in 1994, again making investor panic more likely to lead to market downturns. Third, derivatives, known for being particularly volatile, have taken a large role in the market. In fact, South Korean financial markets are the most dependent on derivatives in the world. Finally, Dr. Noland remarked, “liquid assets in South Korea are owned disproportionately by older investors . . . who are also more likely to have skeptical views of North Korea.” They are risk-averse, especially when it comes to their northern neighbor.

The South Korean central bank still “has the capacity to issue capital controls in the wake of a crisis, but I think the political decision-making would be too slow,” Dr. Noland said. He argued that in such a crisis, the bank would probably seek explicit permission from the executive branch of the government but that the Blue House, fearing alienation, would probably reject a proposal to firmly clamp down on the markets. Thus, if the bank did take any action, it is likely to be too little, too late.

Responding to a question about the Banco Delta Asia (BDA), Dr. Noland said, “the hit on BDA” by the US Treasury “had a non-trivial effect on North Korea’s economy” and ability to conduct trade. However, the secondary effects in the wake of the BDA crackdown have been more pronounced, as private banks around the world have begun to reconsider business ties with any North Korean entity, legal or otherwise.