



Korea: Long-term Decline in the North Korea Premium

Asian Rates and Credit Research

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Overview

An expected lack of progress at the nuclear talks is unlikely to lead to the collapse of the North Korean economy, but rather to slow growth due to limited aid and foreign investment. In the North Korean context, slow income growth could be supportive of political stability. By mid-2005, the market could get used to political and economic stability in North Korea, together with an uneasy coexistence with the US. This in turn could lead to a reduction in the North Korea premium followed by a North Korea-based sovereign upgrade for the South.

- *The North Korean economy does not seem about to collapse: the mid-2002 reforms have not resulted in loss of monetary control, most likely as a result of the lack of monetary accommodation and the removal of bottlenecks to domestic and international trade.*
- *Some supply response to the mid-2002 reforms seems to have taken place, but will remain limited in the absence of large-scale international aid and foreign investment, which would require a successful conclusion to the nuclear talks.*
- *A successful conclusion to the talks is unlikely in view of North Korea's reliance on its nuclear weapons programme as a means to ensuring regime survival and of the divisions within the US administration.*
- *A lack of a successful conclusion to the talks does not mean war but rather the development of an uneasy coexistence with the US, since neither side has an incentive to let the confrontation escalate into military conflict.*
- *A slow income growth could be supportive of political stability because it would make it easier for the regime to control popular expectations.*
- *Political and economic stability would, over the longer term, see the completion of the transition from a planned to a market economy and greater integration of North Korea into the global economy. This in turn, could support a long-term normalisation of North Korea's diplomatic relations with the external world.*
- *While this provides grounds for a North Korea-based ratings upgrade in H2 05, we still see good prospects for a South Korea ratings upgrade this year, based on strong relations with the US; political stabilisation in South Korea; a final resolution of the credit card crisis as well as further progress in corporate and financial sector reform.*

Economic Reforms: Pushed by Necessity, Driven by Chairman Kim

Economy hit by collapse of Soviet trading bloc; death of Kim Il-sung; mid-90s floods

North Korea's communist economy suffered from the breakdown of the Soviet trading bloc in the late 1980s, just as its former peers in Eastern Europe and the former Soviet Union did. In 1994, the economic system was further disrupted by the death of Paramount Leader Kim Il-sung, who had run the country for nearly half a century. In addition, floods in 1995-96 destroyed an agricultural sector already weakened by collectivist farming methods.

Economic collapse did not precipitate economic or political systemic change

Unlike countries in Europe and the former Soviet Union, North Korea's economic debacle was not accompanied by systemic political and economic change. Instead, the economy developed survival mechanisms under the existing political system. To a large extent, past reform efforts seem to represent the institutionalisation of these coping mechanisms. For instance, in the aftermath of the 1995-96 floods, which saw mass starvation, illegal transactions in foodstuff through farmers markets had to be tolerated, as the public distribution system could no longer meet the basic needs of the population.

First-step reforms in late 1990s built around coping mechanisms

At the same time, attempts to improve the economy were implemented. For instance, a constitutional amendment in September 1998 freed technocrats in charge of economic management from oversight of the Central People's Committee, dominated by cadres of North Korea's communist party.¹ In addition, in 1998, local governments were given the responsibility of managing light industries and cooperative farms in local areas, while cabinet ministries retained oversight of heavy industries. These changes were further confirmed in a document entitled "Directives for Economic Management" delivered by Kim Jong-il in late 2001.²

Bolder measures taken July 2002

Despite the reforms, by 2001, North Korea's GDP was still more than 20% below its 1989 level.³ The reforms had to pick up pace. In mid-2002, Pyongyang announced (to somewhat baffled external observers) a series of, by local standards, drastic changes that had taken place on 1 July 2002:

- Multi-fold increases in the price of food grains, fuel, electricity, transportation, rents and wages, with, for instance, the price of rice raised 550 times and basic wages 18 times.
- Devaluation of USD/KPW⁴ to 150 from 2.15, close to the black market rate of 200.
- Farmers markets were officially legalised.
- Some price-setting autonomy was given to consumption goods factories,
- State enterprises were to become profitable or be closed, with "a cost accounting system to be applied more thoroughly", and subsidies abolished.
- Creation of a special economic zone at Sinuiji, on the border with Dandong in China.

¹ Chong Bong-uk, "A Year after radical economic reforms", *Vantage Point*, July 2003. Due to the limited availability of primary sources of information, we have had to rely heavily on secondary sources that are referenced in the text.

² See, Oh Seung-yul, "Changes in the North Korean economy: new policies and limitations", *Korea's economy 2003 Vol. 19*, Korea Economic Institute of America, Washington DC

³ "Gross Domestic Product of North Korea in 2002", Bank of Korea, April 2002.

⁴ Korean People's Won, the currency of North Korea.

Reform touted as Kim Jong-il's initiative; technocrats appointed over ideologues

North Korean officials have repeatedly emphasised that the reforms were the results of Kim Jong-il's personal initiative. Indeed, the 1998 reforms coincided with the appointment of Kim Jong-il as chairman of the omnipotent National Defence Commission (NDC), four years after the death of his father, Kim Il-sung. This appointment in effect marked the official inauguration of the Kim Jong-il era. Kim Jong-il seems to have promoted younger, less ideological technocrats to manage the economy. For instance, 2003 saw the appointment of a new premier, Pak Pong Ju, who used to be the chemical industry minister, while appointments at the NDC saw members in their 80s replaced by members in their late 50s or early 60s. In addition, members of the State Planning Commission and ministers of heavy industries were replaced by technocrats with a proven track record in economic management.⁵

International experience studied to garner lessons

The North Korean authorities have also made it clear that they have looked at the experience of a number of economies, including Hungary, Vietnam, China, the UK, Italy and Sweden. In 2002, now Prime Minister Pak Pong Ju, then serving as chemical industries minister, led a North Korean delegation on a tour of semiconductor plants in South Korea. He commented that, "it is too bad I have but two eyes to see."⁶ Recent economic appointments of technocrats rather than ideologues together with renewed interest in foreign economies suggest the reforms could be driven by a group working directly with Kim Jong-il, involving technocrats with some experience of the reform process in Eastern Europe in the 1980s and younger North Koreans who have been sent on study tours in market economies. Kim Jong-il himself is reported to be a workaholic, with a high degree of sophistication and is likely to be personally involved in a number of key economic decisions.⁷

Neither Runaway Inflation Nor Chinese Growth

Monetary control maintained despite huge rise in prices, wages

We were expecting the stratospheric price and wage increases of July 2002 to have resulted in a loss of monetary control – high and accelerating inflation – but this does not seem to have been the case. According to a Bank of Korea study,⁸ the "free market" price of 1kg of rice went from KPW47 before the 1 July reforms (compared with a pre-reform official price of KPW0.08) to KPW230 in May 2003, while "basic" nominal wages went from KPW100 a month to KPW2,000. As a result, 10 months after reforms, real wages in terms of rice purchasing power were actually higher by a factor of 4.3,⁹ an increase that does not suggest loss of monetary control.

Stabilisation of free market rice prices suggest inflation has slowed

The price reforms are likely to have pushed inflation above 100%, which is the formal definition of hyperinflation. However, the apparent stabilisation of the price of free market rice suggests inflation came down in 2003. This is further supported by the evolution of USD/KPW on the black market, from about 200 in July 2002 to about 900 in October 2003, a 4.5x increase over five quarters. This depreciation is consistent with the dramatic adjustment in relative prices taking place over the period and the

⁵ Nam Sung-Wook, "Moves towards economic reforms", *Vantage Point*, October 2003.

⁶ George Wehrfritz, "The first signs of life", *Newsweek*, 2 February 2004

⁷ Peter Maas, "The Last Emperor", *The New York Times Magazine*, 19 October 2004

⁸ Suhk Sam Park, "Banking and Price System of North Korea", Bank of Korea, January 2004.

⁹ This example highlights the difficulty of measuring inflation in the transition from plan to market: nominally low prices set by the planning authority do not represent actual cost because of lack of availability of goods at these prices. Due to the difficulty of obtaining rice at the official price of KPW0.08 before July 2002, it is fair to assume that free market prices were more representative of the real cost.

liberalisation of domestic and international trade. In December 2003 however the black market rate of USD/KPW had stabilised at 1,000, a markedly slower depreciation compared with the previous five quarters.

Likely central bank did not accommodate price, wage spike

The surprising absence of loss of monetary control is the result of a number of factors. First, it is likely that the central bank of the DPRK did not accommodate the higher prices and wages. Restrained money growth at this stage of the reform process in centrally planned economies typically results in lower credit to state enterprises and inter-enterprise arrears¹⁰. We do not know if there were inter-enterprise arrears, but a decision by the authorities in 2003 to allow state enterprises to use cash to settle inter-state enterprise trade could signal this was indeed the case. In addition, tight monetary policy at the time of price reform usually results in a marked output contraction, which further contributes to inflation. North Korean factories were known to produce at very low levels of capacity *before* the mid-2002 price reforms, which suggest that further downside to output, and upside to inflation, was limited. Lastly, in May 2003 the authorities started selling bonds with a 10-year maturity; the third government bond issue in the history of the DPRK, the last dating back to the 1950s.¹¹ Initially the bond issue was to last only a few months, although the sale is still ongoing, which suggests the government could be struggling to meet its sales targets.¹² This, in turn, could be an additional indicator of tight monetary conditions. Finally, the decision to finance the budget with long-term bonds rather than through printing money could signal a decision to limit money growth in order to retain monetary control¹³.

Domestic moves: Farmers markets legalised; new cash bills positive signals

Second, the legal and de facto liberalisation of domestic and international trade is likely to have reduced wastage and increased actual goods availability. The liberalisation of domestic trade has taken place through the progressive legalisation of private trading. As mentioned earlier, until the July 2002 reforms farmers markets were officially illegal but tolerated; after July 2002 they were legalised. Also, a new KPW1,000 bill was issued when previously the highest denomination was KPW500, which could signal a willingness to allow for more cash-based, free market transactions. Since then, according to international media reports, the variety of goods found in these markets has expanded to include consumer goods, including imports and even industrial inputs. In June 2003, the North officially allowed the trading of non-farm goods in farmers markets. The authorities have now built infrastructure for these markets in the main cities and foreigners are allowed to visit them.

External moves: exhibitions, trade fairs; tourism opened further

The liberalisation of external trade seems to be mainly de facto, allowing private, small-scale importers to sell their wares on the legalised domestic markets. At the same time, in July 2002 the FX and external trade regimes were rationalised: the devaluation of the KPW was accompanied by the unification of convertible won (or foreigners' won) and non-convertible won while import tariffs on consumer goods were raised from 20% to 40%. In addition, in 2003 the North Korean authorities launched a series of overseas exhibitions and domestic international fairs to promote external trade. At the same time, tourism has also been liberalised: the DPRK has started to actively seek tourists beyond members of DPRK support groups abroad. Applications for tourist visas can now be made over the Internet. In November '03, the tourist resort of Mount Kumgang was designated as a tax free special tourism zone, open to foreign investment. Finally, state enterprises have been given greater control over the use of FX earnings. The Bank

¹⁰ "From Plan to Market", *1996 World Development Report*, World Bank

¹¹ *People's Korea*, May 2003

¹² Nam Sung-Wook, "Moves towards economic reforms", *Vantage Point*, October 2003.

¹³ Suhk Sam Park, op. cit.

	of Korea estimates that North Korean exports, excluding services, increased by 13% in 2002, while imports contracted by 6% due to a decline in external aid.
2002 GDP growth 1.2% – growth in agriculture, light industry offset by primary industry	Third, limited available evidence suggests the supply response to the July 2002 reforms has been modest, but positive. Recent visitors report a limited increase in electricity supply in Pyongyang as well as some specific part of the country. ¹⁴ This is consistent with a Bank of Korea study reporting that the main impact of the July 2002 measures was to raise the relative prices of food and electricity, while the relative price of coal was greatly reduced, presumably to support electricity production ¹⁵ . In addition, the Bank of Korea estimates that the reforms have increased production in agriculture, light industries and retail services. However, due to a contraction of mining and heavy industries, as well as in the government sector, overall North Korean GDP in 2002 increased by only 1.2%. ¹⁶
Some foreign parties assembling goods in North Korea	This limited supply response is likely to reflect the adjustment of prices as well as the emergence of a grassroots market economy as reported by international media. Farm managers have been increasingly allowed to choose their crops while small private services such as bicycle repair shops or apartment repairs are growing. In addition, about 500 South Korean corporates and a few European and Japanese names are now assembling goods in North Korea ranging from consumer electronics and shoes to pianos and cars. Finally, there have been a few instances of technology transfers, mainly through NGOs. For instance, a goat farm outside Pyongyang was provided with the equipment needed to raise cattle and distribute dairy products by a South Korean NGO, which has provided income and employment for 600 households. ¹⁷ A pioneer project to grow high yield potatoes is currently under implementation. ¹⁸
Infrastructure needs rebuilding...	While North Korea seems for now to have avoided a loss of monetary control, a growth rate of 1.2% in 2002 is a far cry from Chinese and Vietnamese post-reform growth rates. But moving to a Chinese growth path would require large-scale foreign private investment and foreign aid. The dilapidated state of North Korean infrastructure is a clear stumbling block for economic take off. Rebuilding the infrastructure will, however, require large investment from private sources or multilateral development institutions. Furthermore, in a country that has never seen significant trade or investment flows from OECD countries, technology is likely to be obsolete. Upgrading technology and industrial capacity would again require large foreign investment, rather than the simple assembly work currently underway. However, large-scale public or private flows are unlikely to reach North Korea until the nuclear issue is resolved. Without progress on the nuclear front, the opening of the Kaesong industrial zone at the border with South Korea could increase the scale, but not the nature (assembly work with limited impact on capital and technology) of investment in the DPRK.
... technology needs upgrading...	
... which needs massive aid and foreign investment	

¹⁴ *The Economist*, “Progress at a snail pace”, 9 October 2003; James Brooke, “Cautiously, North Korea Opens Toward the South”, *New York Times* 24 November 2003; Brookings/ Asian Society Briefing, “The North Korea Deadlock: a report from the regions”, 15 January 2004; George Wehrfritz, op. cit.

¹⁵ Suhk Sam Park, op. cit.

¹⁶ Bank of Korea, op. cit.

¹⁷ Lee Song Sop, “Changing North Korean Lifestyles”, *Vantage Point*, September 2003.

¹⁸ “Pacesetters in potato farming meet”, KCNA, 29 January 2003

Nuclear Talks Unlikely to Bring Results in 2004

While there is some talk of extending this week's round of six-party talks from the scheduled three days, we believe tangible results this year are unlikely for the following reasons.

Other parties have little sway over main protagonists

First, although the talks involve six countries, the two main parties are clearly the US and the DPRK. The reason for involving China, Russia, Japan and South Korea is the refusal by the US to accede to North Korea's demands for bilateral negotiations, which, in the eyes of the US, would have rewarded North Korea's violation of the 1994 Framework agreement. While Japan, China, Russia and South Korea are coming to the table with a different agenda – Japan wants to resolve the abductees issue, Russia wants to expand its influence in Northeast Asia – we do not expect them to have much influence on either the US or North Korea.

Chinese leverage over North Korea exaggerated

We believe in particular that the influence of China over North Korea has been overstated. The current Chinese leadership, too young to have fought in the Korean War, is believed not to be enthralled with North Korea. However, China needs a stable North Korea to stem the flow of North Korean refugees and act as a buffer against the US military presence in Northeast Asia. In economist-speak, North Korea is "too big to fail" for China, which reduces Chinese leverage over the North Korean leadership.¹⁹

North sees nuclear programme as guarantee of regime survival

Second, North Korea sees its nuclear weapons programme as a guarantee of regime survival and is unlikely to give it up for anything less important. Furthermore, given the dire economic circumstances of North Korea, nuclear weapons constitute a much cheaper military deterrent than a conventional army. Lastly, the possession of nuclear weapons is likely to be a source of considerable domestic prestige, especially vis-à-vis the army and party, the leadership's key constituencies. Hence, North Korea has demanded security guarantees and aid from the US in exchange for freezing its nuclear weapons programme.

In addition, the freeze offered by North Korea concerns only the plutonium-based programme. Recent revelations by A Q Khan, one of Pakistan's nuclear proliferators, suggest that in addition to a plutonium enrichment programme, North Korea is also running a uranium enrichment programme. North Korea has denied running a uranium enrichment programme, which the US said it had acknowledged in October 2002, when it was first presented with evidence it had breached the 1994 framework agreement. This shows how far North Korea is from making concessions.

Aid is unlikely to constitute a significant enticement for North Korea to give up its nuclear weapons programme. As we have previously highlighted, nuclear weapons are much more important for the survival of the North Korean regime than aid: the mass starvation in the mid-1990s did not lead to regime change.²⁰ In addition, current economic conditions are a marked improvement over the mid-1990s.

But US is unlikely to back down on nuclear demands

Third, the US is unlikely to accede to North Korean demands. The US position remains that North Korea has to dismantle its nuclear programme in a verifiable, irreversible way before it agrees to provide security guarantees and open the possibility of large-scale economic assistance. A step-by-step process could bring both sides together but it appears unlikely in the current US context. Within the US administration, doves that favour a diplomatic resolution and hawks that favour regime change have still not

¹⁹ See Richard Bush's comments in Brookings/Asian Society Briefing, op. cit.

²⁰ See Barclays' Asian Rates and Credit Research, *Korea Making Sense of the Dear Leader*, 3 March 2003

resolved their differences. For instance, the uranium enrichment programme allegedly run by North Korea has prompted two distinct reactions from the US Department of State. Assistant Secretary of State James Kelly has commented that North Korea's uranium programme "is of longer duration and more advanced than we had assessed" while Assistant Secretary of State John Bolton has warned that "North Korea's unwillingness to discuss the uranium enrichment programme could subvert President Bush's determination for a peaceful, diplomatic resolution of the North Korean issue." It is unlikely that these policy differences will be resolved ahead of the November 2004 US presidential elections, which leads us to expect little progress at talks this year.

Long-term Normalisation?

Slower reform may support political stability

While we do not see much prospect of a positive outcome to the talks this year we believe this does not preclude the long-term economic and diplomatic normalisation of North Korea. In fact, by slowing down the pace of reform, a lack of agreement on nuclear issues could actually support political stability in North Korea.

Kangsong Taeguk, a North Korean Meiji?

Economic change subordinated to political stability

As we stated earlier, the objective of the regime is survival: we believe North Korea is engaged in the perennial quest of totalitarian regimes for Western technology and economic efficiency untainted by Western liberal democratic values. The North Korean leadership translates this concept as *Kangsong Taeguk*, a great country which is strong ideologically and militarily, and prosperous economically. This implies that economic reforms will continue as long as they are not seen as threatening political stability or rather, the pace of economic reforms will be dictated by the overriding need to maintain the political status quo. In addition, North Korea is believed to be spending about one third of its GDP on military expenditure²¹ and is unlikely to abandon its policy of "army first" any time soon, since the army is one of the key constituencies of the current leadership. Indeed, it is likely that the attractiveness of the reforms to the regime largely comes from the increased resources that would be available to the army due to greater economic prosperity.

We are now more optimistic the government can maintain economic stability

Few totalitarian countries have managed to liberalise their economies without major political change. China and Vietnam have managed to do so, but from initial conditions that are very different from North Korea's current situation.²² Based on recent information that has come out of North Korea, we believe there is now a stronger chance of success than we at first thought when reforms were introduced in July 2002. Political and economic stability in the transition from plan to market appear feasible, albeit not without risk, for the following reasons.

Better than expected economic reform management

The North Korean authorities seem to have a much better understanding of the issues involved in the transition from plan to market than we had expected. Our earlier expectations of inability to manage the reform process were based on North Korean accounts of their reform intentions. Making sense of North Korea's communications with the external world is a challenge because they often fall plainly within the "bizarre" category. The Cold War era sloganeering and colourful personal insults used in official

²¹ *World Fact Book 2003*, CIA document

²² See Barclays' Asian Rates and Credit Research, *Korean Reunification: One Country, Two systems?* 19 February 2003

press releases could suggest the lack of a rational decision making process.²³ However, North Korean deeds tend to be stronger than North Korean words: as we had noted in previous research, we believe the North Koreans to be rational negotiators.²⁴ In addition, we feel that the recent implementation of major price and trade reform without economic dislocation is a major accomplishment. While growth in 2002 was modest, its quality seems to have improved with the expansion of light industries and the contraction of heavy industries, suggesting more responsiveness to demand.

It appears second-stage reforms have now begun

It seems that North Korea could have a well thought out plan for a gradual transition from plan to market. The lack of monetary accommodation of the price increases suggests a better understanding of monetary mechanisms than we had expected. The combination of unification of multiple exchange rate systems, devaluation and higher import duties could come out of a World Bank/IMF sponsored adjustment programme. In addition, it appears North Korea is now moving into second stage reforms with, for instance, financial sector reform.²⁵ With limited aid and foreign investment, and under the current political system, such a reform process is clearly not going to bring North Korean income close to OECD levels of prosperity. However, over a long period of time it is bound to produce a marked improvement from the currently estimated USD760 income per capita.

Co-opting the Elite to Maintain Political Stability

Managing the political consequences of the transition from plan to market could turn out to be even more challenging than the economic transition itself. Any reform process involving deep changes in relative prices produces losers as well as winners. For instance, an increase by 430% in the rice purchasing power of wages, together with GDP growth of only 1.2% and the imposition of a hard budget constraint on state enterprises suggest many workers must not be getting their full wages in cash. That many North Koreans are still suffering great hardship is evidenced by a World Food Program warning in February that, due to lack of funding, it had to cut food aid to 4mn North Koreans.

The government is co-opting the elites with access to hard currency

Maintaining the political sustainability of the reforms is however more likely to require co-opting the ruling elite rather than the people. As mentioned earlier, current economic hardship still represents an improvement over the mass starvation a decade ago that failed to lead to regime change. Giving the elite access to hard currency could be a way of ensuring they are sheltered from the economic consequences of reforms. Allowing them to capture rents that are bound to be a result of the gradual opening of the economy would be another way to do so. There is some evidence that this is already happening: in a seminar held by the Switzerland-Korea chamber of commerce, “highest-end consumer goods for North Korea’s privileged class” was identified as one of five promising areas of trade between the two countries. Indeed, according to the same seminar, in the first 10 months of 2003 imports of “Swiss high grade watches” represented nearly USD2mn.²⁶

²³ We will not give examples but refer readers to government websites such as www.kcna.co.jp or www.peoplekorea.com

²⁴ See Barclays’ Asian Rates and Credit Research, *Korea: Making Sense of the Dear Leader* 3 March 2003.

²⁵ Suhk Sam Park, op. cit.

²⁶ “Five promising business fields available with North Korea”, *KOTRA Bulletin*, 18 February 2004. <http://crm.kotra.or.kr/main/info/nk/eng/main.php3>

An Uneasy Coexistence with the US

We believe that political and economic stability could be accompanied by an uneasy coexistence with the US. As mentioned in earlier analysis, we view a military conflict as highly unlikely because the cost to both sides would be too high. The difficulty and cost of post-war reconstruction in Iraq suggest the US is unlikely to launch itself in another foreign policy adventure for a considerable period of time. In addition, a war with North Korea would entail a very high level of civilian and military casualties. Furthermore, a US military strike against North Korea is highly unlikely, as it would require the agreement of the South Korean government. Finally, US Secretary of State Powell indicated last year that for the US the “red line in the sand” was proliferation.

No conflict but continued efforts to clamp down on illicit exports like drugs

While the US is unlikely to launch a military attack on North Korea, it is very likely to continue with initiatives such as the Proliferation Security Initiative (PSI) that seeks to interdict illicit DPRK exports, for instance drugs and WMDs. North Korea is believed to have been exporting drugs for years and in 2003 the Australian authorities (who participate in the PSI) seized drugs onboard a North Korean ship in Australian waters. International law will however make it difficult for the US to enforce a full economic blockade of North Korea and its interdiction efforts will have to remain limited to illicit exports. This implies that the impact of the PSI will be to increase North Korea’s reliance on legitimate exports as a source of FX, and hence could support the normalisation of North Korea’s relations with the external world.

North Korean brinkmanship to stop short of provoking military conflict

Since the only possible outcome to a full military confrontation with the US would be defeat and loss of power for North Korea’s current leadership, it will remain very wary of not escalating the confrontation. This has been the experience with past North Korean brinkmanship that has carefully dosed increases in provocations so as to stop short of provoking a military conflict with the US or of jeopardising aid.²⁷ For instance, in January 2004, when an unofficial US delegation visited the Yongbyong reactor, where plutonium had been safeguarded under the 1994 Framework Agreement, it was shown an empty storage pond and a glass jar with some metal but no hard evidence that the spent fuel had been reprocessed.²⁸ Such ambiguity could serve two purposes: increasing the credibility of North Korea’s WMDs programme – there is a real possibility that the refusal to let in inspectors is because there are no WMDs, rather than because there are; and maintaining foreign aid inflows. Proof that North Korea has indeed reprocessed the plutonium stored at Yongbyong would make it more difficult for foreign donors, including South Korea, to continue to support the country.

A Long-term Decline to the North Korean Premium

Managing popular expectations easier under slow economic growth

While North Korea is an extraordinarily repressive regime that does not have to worry about social unrest, it still needs to manage the expectations of its population. A fast and very large opening of the economy would carry the danger of raising people’s expectations. Should such an opening result in an economic take-off, foreign investment and foreign aid would be associated with improvements in the standard of living. Despite the regime’s omnipresent propaganda, this could be a source of political instability. On the contrary, a favourite trick of totalitarian regimes is to use economic insecurity (and external threats!) to justify their hold on power. Very slow reforms, economic opening, and rise in income seem much more consistent with political

²⁷ See Asian rates and Credit Research *Korea: Making Sense of the Dear Leader* 3 March 2003

²⁸ Siegfried S. Hecker, “Visit to the Yongbyon Nuclear Scientific Research Center in North Korea”, Senate Committee on Foreign Relations Hearing, United State Senate, 21 January 2004

stability in North Korea. To that extent therefore, the current nuclear stalemate and its negative impact on foreign aid and investment could be seen as supporting the political status quo in North Korea.

North Korea actively seeking foreign trade and investment

The combination of a well controlled reform process, of political stability, and of an uneasy coexistence with the US could see over a very long period of time the completion of the transition from plan to market with a gradual increase in the standard of living. This transition however does not preclude a long-term normalisation of diplomatic and economic relations with the external world. North Korea is actively seeking to develop international trade and attract FDI. To that effect, it has created special economic zones at Sinuiji on the Chinese border and Keasong close to the DMZ.

Lack of infrastructure in North; normalisation of relations with South

As North Korea is unlikely to have the resources that would be necessary to rebuild its infrastructure at any time in the near future, most of the development of its manufacturing sector will have to take place close to the DMZ so as to plug into South Korea's electricity grids and transportation networks. This suggests North Korea could become increasingly reliant for its export earnings on production facilities that would be in the line of fire should conflict arise with the US. This, together with a greater reliance on legitimate exports as a source of FX, could support a long-term normalisation of relations with the external world.

Normalisation process remains fraught with risks

But this is likely to be an arduous process, fraught with risk. Miscalculation on either side could escalate the confrontation with the US. The transition from plan to market is an exceedingly complex process: the countries of the ex-Soviet Union went through a decade of output decline before they saw an increase in the standard of living.²⁹ Finally, under such a slow transition it will take a very long time before the North Korean people see an improvement in their standard of living and in the political options open to them.

North Korean premium in South Korea's rating to fade in H2 05

As the market gets used to an uneasy coexistence between North Korea and the US and to political and economic stability in North Korea, it is likely that the North Korean premium will fall, which could see a tightening of sovereign spreads, followed by sovereign ratings upgrades. We think the North Korean premium is most likely to decrease after mid-2005, once the next US president is inaugurated and uncertainty over the US policy on Korea dissipates.

Still expecting a sovereign upgrade this year

While this provides grounds for a North Korea-based ratings upgrade for South Korea in H2 05, we still see good prospects of a ratings upgrade this year, based on strong relations with the US; political stabilisation in South Korea; a final resolution of the credit card crisis, as well as further progress in corporate and financial sector reform.

²⁹ See Barclays' Asian Rates and Credit Research, *Korean Reunification: One Country, Two systems?* 19 February 2003

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