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Introduction

Estimates vary greatly of the financial requirements for reconstruction and future growth of the DPRK economy and meeting the educational, health and social security needs of DPRK society. Private investment will be critical in this process, but efforts to stimulate private capital both domestic and foreign will need to go hand in hand with mobilizing public investment to remove infrastructure bottlenecks and provide essential social services. An early priority will be to launch investigations to take stock of DPRK's needs and to improve the basis for estimating financial resource requirements for the short and medium-term. However, there is broad consensus that the needs are huge. Major challenges facing the DPRK leadership and international community in a New International Engagement Framework will be how to mobilize both domestic and foreign public savings to meet capital investment and recurrent expenditure requirements, how to link public resources mobilization with a comprehensive economic reform strategy and viable macroeconomic framework, how to get the most synergy from public and private investment, how best to support a new political economy in DPRK that will share the benefits of growth widely among the population and attend to the needs of most vulnerable groups, and how to develop absorptive capacity of DPRK to use funds efficiently and with transparent accountability to minimize what will be great temptations for corruption.

This paper explores issues that will need to be addressed in efforts to mobilize public capital for DPRK in ways that are congruent with an ongoing process of economic reform and institution building for good governance that will be required by the international community as the basis for their assistance. The underlying premise is that political developments will have created conditions under which the DPRK authorities are prepared to work with the international community in a spirit of partnership to help DPRK transform its economic system and integrate with the regional and global economy, while pursuing a long-term policy of gradual reunification with ROK in which economic integration will precede political integration. The paper first reviews lessons from past experience that will be important to bear in mind in planning for the future. It then discusses a number of factors that will need to be taken into account in designing future public resource mobilization strategies, covering both domestic and foreign perspectives. The paper then identifies and assesses a number of possible modalities and coordination mechanisms, pointing out their strengths and limitations.

Lessons from the Past

In general, the lessons of experience in mobilizing public resources for DPRK in the international community during the 1990's point to the critical tension between political interests of donors and the DPRK leadership on the one hand, and the humanitarian and economic development needs of DPRK society on the other. The tendency to politicize provision of foreign aid is very high, with the consequence of reducing impact on the lives of the DPRK population and distorting incentives for reforms by the authorities.

Subsidized Socialism. It is worth remembering that DPRK built a socialist economic system in which all domestic resources were public and subsidies from the Soviet Union and China were major sources of international assistance for many years. The misallocation of resources and dependency on foreign support that resulted from DPRK's economic management system and political relationships with its Communist backers, contributed greatly to the breakdown of the DPRK economy in the 1990's and the humanitarian crisis that emerged. While espousing the "*Juche*" philosophy of self-reliance, DPRK actually built a system that institutionalized economic dependence on foreign public financial assistance, even though this was largely disguised in the form of "friendship prices" and counter-trade practices that provided large subsidies, especially for energy. This dependence, plus the distorting effects of prices that did not reflect economic cost, led to energy-intensive investments in industry, transport, and agriculture that were inefficient and ultimately unsustainable. DPRK's military-first policies and favoritism of the elite amplified these failures, which were not challenged by the suppliers of DPRK's economic aid during this period. The important lessons from these experiences are that the economic policy context is critical for foreign aid to be effective in promoting economic development, and that aid provided primarily for political purposes -- in this case to ensure regime survival -- does not necessarily lead to economic viability and can foster aid dependence that acts as an inhibitor of needed economic reform. There is nothing surprising in this, and it reflects the consensus of international experience with economic development globally.

Korea Peninsula Energy Development Organization (KEDO). The international response to both DPRK's nuclear brinkmanship of the early 1990's and the food crisis of the mid-1990's, essentially resulted in mobilization of new forms of international public financial assistance for DPRK. The establishment of KEDO under the Agreed Framework negotiated in 1994 between the U.S. and DPRK, created a mechanism where public resources from KEDO members (primarily the U.S, Japan, ROK and the European Union) were mobilized to provide both 500,000 metric tons of heavy fuel oil annually to DPRK and construction of two Light Water Reactor (LWR) nuclear power plants. While this agreement broke down following disclosure of a secret uranium enrichment program in October 2002, with suspension of oil shipments in December 2002 and suspension of the LWR project in November 2003, the resources provided by KEDO to DPRK between 1995 and 2003 did accomplish some positive results. On the political side, the KEDO program did contain DPRK's plutonium nuclear program and allowed for direct contacts and negotiations between KEDO members and DPRK during a period of extreme difficulties for DPRK, both in leadership change following the death of Kim Il Sung and in coping with its economic and food crises. These stabilizing factors were important in maintaining peace and fostering an environment where DPRK could build trust with new foreign partners in cooperative activities. On the economic side, the fuel oil did help offset the trade shock that accompanied the collapse of the Soviet Union in 1992, and the LWR project did provide a means to develop practical working modalities for foreigners with DPRK authorities. The LWR project itself, however, was never seen by either side as a truly economic undertaking designed to overcome DPRK's shortages of electric power. Many issues were left unattended as the project developed, including such elementary questions as how to finance transmission lines needed to connect the plants to the national electricity grid and how to stabilize the grid itself to be able to absorb power from the LWRs. With the suspension and likely cancellation of the LWR project now a reality, there is a growing realization (especially in ROK) that significant resources have been deployed without any tangible economic benefit. An important lesson of the KEDO experience is that when public resources are mobilized primarily to achieve political goals -- in this case containing DPRK's nuclear program-- but are provided as economic assistance that does not meet a test of economic or commercial rationality, the political achievement may be unsustainable and the resources essentially wasted. While the demise of the KEDO LWR project may have been triggered by the discovery of the secret uranium enrichment program, it was destined in any case to face a crisis when the lack of economic justification and provision of needed complementary investments could no longer be ignored. A second lesson is that KEDO did succeed in demonstrating the value of multilateralism, both in mobilizing significant public resources from donors with very different interests and in coordinating policies relating to management of these resources and operational relations with DPRK authorities. For this reason, it may well be desirable to consider a future role for KEDO in mobilizing resources for DPRK under a New International Engagement Framework, if it is provided with a new mandate and is better able to integrate its economic and political functions.

Humanitarian Aid. The international response to the DPRK famine of the mid-1990's also holds valuable lessons for the future. The mobilization of significant humanitarian assistance was accomplished in a disciplined way under the leadership of the United Nations. The annual UN Appeal is based on detailed crop production and food availability assessments by the World Food Program (WFP) and Food and Agriculture Organization (FAO), with health and educational humanitarian needs defined by the World Health Organization (WHO) and UNICEF. These objectively defined appeals have been supported by donors through contributions to UN-managed delivery programs, bilateral transfers, and support for NGO's active in DPRK. The willingness of donors, particularly the U.S., ROK, Japan and European Union, to provide humanitarian assistance while at the same time challenging DPRK on its weapons programs, contributed importantly to a growing perception that it is possible to engage DPRK on multiple fronts at the same time, and that de-linking humanitarian assistance from other issues could create an atmosphere conducive for addressing other concerns of the international community. The fact that DPRK was willing to ask for international assistance and to set up administrative mechanisms to cooperate with foreign partners has contributed to the beginning of a more businesslike way of interacting. While there have been many issues of concern about monitoring delivery of food aid to intended beneficiaries, access to different areas of the country, and restrictions imposed by the government on foreigners working in DPRK, there has been steady improvement over the years, due in part to mutual trust building and in part to learning from experiences.

There are important limitations, however, on the humanitarian resource mobilization experience of recent years. First is aid fatigue. After seven years of appeals for food aid, the willingness of the international community to continue to meet the food deficit in DPRK is dwindling. This reflects both frustration that the more fundamental obstacles to improving food security in DPRK have not been overcome and emergence of new claimants on resources for humanitarian assistance that compete for attention with DPRK, notably in Africa, Afghanistan and Iraq. A second limitation is unwillingness of most donors to shift from humanitarian assistance to development assistance, pending resolution of major political security issues. An initiative by the United Nations Development Programme (UNDP) in 1998 to convene a Roundtable for donors and DPRK authorities to discuss an Agricultural Recovery and Environmental Protection program (AREP) failed to mobilize resources needed to address DPRK's underlying difficulties in expanding agricultural production. While the UN and NGOs have made limited progress on a small scale, most governments have not (with the exception of ROK). A third limitation is the recent willingness of some governments to link humanitarian assistance to other political objectives. Since the re-emergence of a nuclear crisis in late 2002, neither the U.S. nor Japan have made credible efforts to respond to the shortfall in the UN Appeal for 2003 and expected for 2004, although official policy is still to maintain a separation of humanitarian aid from other issues. The overall lesson from the humanitarian experience of recent years is that mobilization of significant public resources for DPRK depends critically on political will, and this will cannot be assumed to be stable, even for basic humanitarian needs.

Korean Reconciliation. Political will to mobilize resources for DPRK has been significantly affected by the appeal of inter-Korean reconciliation. The Sunshine policy adopted by President Kim Dae Jung in ROK, led to significant use of public funds to finance inter-Korean projects, including subsidies to private companies such as Hyundai Assan's Mount Kumgang tourism project. The Inter-Korean Economic Cooperation Fund administered by the Ministry of Unification grew from 40 billion Won in 1998 to 1037 billion won in 2002.[1] In the first 11 months of 2003, ROK provided $125 million in direct economic and humanitarian aid to DPRK, while at the same time continuing efforts to resolve DPRK's nuclear program peacefully through dialogue.[2]

However, allegations of under-the-table payments to secure agreement for the June 2000 Summit meeting between Kim Jong Il and Kim Dae Jung, also underscore the risk that public funds can be used in non-transparent ways that ultimately undermine the objectives of reconciliation and distort incentives for DPRK to adopt businesslike practices in its dealing with foreigners. The lesson is that corruption is an issue that can infect the donor as well as recipient and that the risk of corruption playing a major role in

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1 ROK Ministry of Unification.

2 Yonhap, December 10, 2003.

use of public resources mobilized for DPRK is high. Strong efforts will need to be made to introduce transparency and safeguards in the mechanisms for both decision-making about the granting of funds and in the use of funds.

Chinese Aid. The experience of Chinese economic support for DPRK in the 1990's also contains important lessons. Since the collapse of the Soviet Union, China has been DPRK's biggest trading partner and largest supplier of concessional assistance, both through subsidized trade and through direct transfers. Chinese agricultural and energy assistance have been vital to DPRK's ability to avoid internal instability that could threaten survival of the regime. China has not chosen to channel resources through the UN Appeal mechanism, and relied on bilateral channels. This permits China to use its assistance to pursue its own political goals independently of the goals of other countries which channel their funds through the UN Appeal. It is widely believed, for example, that Chinese food aid is channeled to the military, which allows the WFP food aid to be targeted at the general population without risk that the military-first policy or regime stability would be undermined by foreign aid policies of other countries.

Cash versus In-Kind. It is noteworthy that most publicly-provided humanitarian aid to DPRK, inter-Korean economic assistance (for example in connecting cross-border road and rail links), subsidized trade with China and the former Soviet Union, and KEDO provision of oil and LWR construction, have not been in cash, but in kind. Cash payments have been made openly by the private sector, but not openly by the public sector, except in the case of protocols negotiated by KEDO under the LWR project, for example for wage payments for North Korean labor. (As mentioned above, allegations of cash payments by the Kim Dae Jung government are considered a scandal.) This preference for in-kind over cash illustrates the lack of trust by external providers of publicly-funded assistance that the DPRK authorities would use funds for purposes intended, and would divert them either to the military or consumption of the elite. Any future effort to address DPRK's large scale infrastructure investment needs will need to involve very different modalities for channeling funds for contracts for civil works, equipments and technical services. The negotiation of protocols for procurement of goods and services as well as supervision of the use of funds will be needed for any future program of development assistance, and will be a major issue for both multilateral and bilateral donors. KEDO experience will be a valuable starting point in these discussions.

Transition to Market Economy. The failures of the DPRK economic system, combined with the limitations of foreign assistance in this environment, are the backdrop for the emergence of the informal market economy in DPRK, as people have sought new means to meet basic needs and responded to incentives to fend for themselves and not depend upon the state. Economic reforms introduced by the government since mid-2002 have accepted that market mechanisms are now playing an important role in the DPRK economy and social system and that market incentives are needed to increase both agricultural and industrial production. Lack of resources to finance needed infrastructure and intermediate inputs has constrained a supply response to those reforms. Thus mobilization of public resources, both domestically and internationally, is critically needed to reinforce the reform process and stimulate economic recovery. The dilemma faced by the international community and DPRK leadership if political developments permit a rationalization of the use of foreign aid for humanitarian and economic development purposes, is how to do this without undermining the positive features of the emerging market economy. Just when incentives are beginning to stimulate entrepreneurship and the taste of freedom in the DPRK population, there is a risk that foreign aid will be used to suit the political needs of donors and the DPRK authorities, and undercut the transformative processes now underway in DPRK. The challenge is to design policies and mechanisms that put publicly mobilized resources to best use in accelerating economic system change and putting the country on a path to prosperity for its citizens.

Major Considerations in Designing Public Capital Mobilization Strategy

Any future efforts to mobilize public capital under a New International Engagement Framework, will need to take into account a number of critical factors. These relate to the initial conditions of the DPRK economic situation, strategy for economic reform and institution building, requirements of macroeconomic stability, DPRK creditworthiness, multilateral assistance considerations (including membership in International Financial Institutions), bilateral interests and political constraints, and aid coordination and management mechanisms. All of these factors will influence the determinations of how much public capital will need to be mobilized, the purposes for which it will be applied, the balance of contributions from domestic, multilateral and bilateral sources, modalities that will be used, and conditionalities that will accompany commitments of funds.

Initial Conditions. The first questions to be asked by potential suppliers of public capital are what the funds will be used for and how much will be needed in specific timeframes. While there is general agreement that the DPRK public infrastructure in power and transport requires a large investment, there is no known inventory of the current state of these assets nor assessment of balance that should be struck between rehabilitation and new investment. Nor are there comprehensive assessments of the condition of urban infrastructure, especially water supply and sanitation and housing. More is known about the conditions of agriculture due to the investigations by UN agencies and ROK, but there is a need for a comprehensive assessment of irrigation rehabilitation and flood control investment requirements. Similarly, it is generally known that educational and health services in DRPK require both capital investment and large-scale financing for recurrent costs, particularly for supplies and salaries.

An early priority in a New International Engagement Framework will be a detailed needs assessment and preparation of a public investment program in collaboration with DPRK authorities. How such an assessment will be conducted and who will take the lead, will be issues needing to be addressed up-front by the international community and DPRK authorities. One option is that this be done by an inter-Korean team and presented to the international community to mobilize their support. Another would be to for DPRK to ask international agencies to conduct the assessment.

This could be a collaborative exercise by the World Bank, Asian Development Bank, International Monetary Fund and UNDP, similar to the assessment conducted for Iraq for a donors meeting in October 2002, or lead by one of these agencies. Since DPRK is not a member of any of the International Financial Institutions (IFIs), but does have an in-country mission of UNDP, it would be logical for UNDP to play a coordinating role in planning discussions with the DPRK authorities to provide in-country logistical assistance for such an assessment exercise. A third option would be to have the assessment commissioned by a core group of countries providing the political context for the New Engagement Framework and linking the assessment to political conditions associated with earlier agreements on security issues. This could be carried out either by a team representing the core group composition, or by an inter-Korean team or international organization team, working under terms of reference supplied by the core group and reporting to it. Which ever option is chosen for conducting the assessment, it will set a precedent for future aid mobilization modalities and aid coordination mechanisms.

Another aspect of the initial conditions in DPRK is the absorptive capacity of the DPRK government to use funds that may be provided to finance a public investment program. There are many questions about how resources will actually flow. While the experience of UN agencies, NGOs, inter-Korean projects and KEDO will be useful, DPRK’s present mechanisms for controlling flow of funds and managing public works will need to be evaluated for compliance with requirements of donors. Thus an institutional assessment will be needed to complement the needs assessment for public investment. This institutional assessment will determine the types of conditions and monitoring requirements that donors will attach to any future funding. Concern about possible diversion of resources to military use and corruption can be expected to be major issues for the international community, and a practical framework for dealing with these concerns will need to be worked out with the DPRK authorities. This is an area where the multilateral development banks and UNDP should be given lead responsibility to avoid different standards being demanded by different suppliers of funds. One area where external technical and financial assistance will be needed by DPRK at an early stage is in building the capacity to absorb foreign assistance both to accelerate the pace of economic reconstruction and also to meets the standards of efficiency and accountability that the international community will require. Use of public capital ultimately requires an accountability to the public, both in DPRK and in the countries that supply DPRK with foreign aid. Attention to this issue by international civil society watchdog groups should be expected.

Strategy for Economic Reform and Institution Building. Money alone will not be the answer to DPRK economic troubles. It will be necessary to design a public capital mobilization plan that fits a commonly accepted economic reform strategy and requirements for institution building in a realistic way. While DPRK will rely on foreign capital initially to kick-start its economy recovery, it is important that from the very beginning efforts are made to put in place policies and capacities that will allow the DPRK government increasingly to mobilize public resources domestically and allocate these for expenditures that support the economic reform and development program.

Technical assistance and training funded by foreign aid will be essential for building this capacity to mobilize public capital domestically.

Before either domestic or foreign public capital can be mobilized on a large scale, it will be necessary in a New Engagement Framework to support a process of reaching a workable consensus between DPRK authorities and foreign partners on what the economic reform strategy and development agenda will be. This will require analysis of options available to DPRK based on its own conditions and history, and assessment of the lessons of experience of other countries undertaking transition from socialist to market based economic systems. What should be expected is a debate between advocates of the "big bang" reform policy and advocates of paced reform. The implications of these different approaches on both political and financial dimensions of the management of change and the role of different foreign partners would vary greatly. Institutional limitations in DPRK can be expected to be a major factor affecting the ultimate choice. Thus, it will be critically important that the political context for the economic reform strategy be firmly established before significant public capital is mobilized and channeled to specific projects and programs. The opportunity costs of capital are significant in the DPRK context and the risk of waste of resources and undermining of domestic and foreign political support for the economic strategy should be minimized through a process of decision-making that creates a broad consensus of the best way to proceed and willingness to provide the level of financial support to make the strategy successful.

Engaging DPRK in policy dialogue will thus be needed from the very start, and how this is organized and processes adopted will also have a large effect on ways that public capital will be mobilized and the atmosphere of cooperation between DPRK and foreign partners. Mobilization efforts will be enhanced by building a culture of openness and dialogue with DPRK being willing to listen to the advice of foreigners, but ultimately making its own decisions in ways that promote self-confidence and political will to follow through in implementation. To achieve this openness and frank exchanges of views, DPRK will need to be willing to be much more transparent in sharing of information and cooperative investigations than it has in the past, and the international community will need to be open-minded about respecting cultural and historical practices in DPRK that may be significantly different than in other transition countries.

<u>Macroeconomic Framework.</u> Currently the DPRK economy is not guided by a macroeconomic policy, nor does it have the institutions and tools in place to exercise macroeconomic management Price reforms introduced in 2002 have resulted in inflationary pressures that DPRK is ill-equipped to constrain. Early in a New Engagement Framework, it will be necessary to assist DPRK in developing new capacities in this area through training and technical assistance. In parallel with work assessing public investment needs and determining the best economic reform and development strategy discussed above, it will be important to work with DPRK to construct a macroeconomic policy and financing plan that is compatible with these exercises. The feasibility of any framework will depend critically on the ability to mobilize the resources needed to fulfill the financing plan. Thus the public capital mobilization process will need to be carefully coordinated with the policy planning

process. This will require a close working relationship between DPRK authorities and advisors who are in close touch with major potential doors to the program. In many countries, the IMF and World Bank are called upon to perform this coordinating role. In DPRK's case, it does not yet have relations with these institutions. ROK has the macroeconomic expertise to provide DPRK with such advice, and to the extent that the two Koreas are seeking to deepen integration of their two economies, it will be important that ROK be closely involved in the macroeconomic policy dialogue with DPRK as this will also have a direct bearing on macroeconomic policy and management in ROK itself. Thus an issue that will need to be addressed is how to balance and coordinate the roles of the IFIs and ROK in macroeconomic surveillance, policy advice and technical assistance to DPRK.

Creditworthiness. Another issue that will need to be addressed is how to factor DPRK creditworthiness into public capital mobilization for DPRK.   The World Bank assesses country creditworthiness based on a number of factors, including GDP per capita and public debt servicing capacity. While the detailed information needed to establish creditworthiness for DPRK has not yet been made available, DPRK's low level of economic production and external trade deficits can be expected to constrain its ability to borrow on anything but highly concessional terms. In addition, DPRK does not have a good reputation as a borrower, and this perception will need to be overcome for public as well as private lenders to the DPRK government in the future. Domestic borrowing is a new phenomenon in DPRK, but the public bond program introduced in 2003 demonstrated a fundamental lack of appreciation for role of bonds in public finance, with elements of gambling in the design of the program. Similarly, DPRK has a large outstanding external debt on which it is not paying either interest or principal, that has been estimated to be as large as $12.5 billion.[3] Of this, a large portion is debt to Russia, incurred to the former Soviet Union. The implications are that DPRK is going to have to rely primarily on building a new tax system as the primary means to mobilize resources domestically, restructure its existing foreign debt, and build credibility as a borrower by creating new debt reporting and management capacities. It should also be expected that the international community will seek conditions for future financial assistance to DPRK for economic reconstruction that will lead to improvements in creditworthiness over time as part of the overall strategy for public resource mobilization. To the extent that DPRK will require grants and concessional loans from donors, it will be expected to comply with standards that have been established globally for access to development assistance. These were reconfirmed most recently at the International Conference on Financing for Development in Monterrey Mexico in 2002.

One issue that may arise if ROK and DPRK pursue a gradual economic integration policy is that ROK may be asked to guarantee loans made by other parties to the DPRK government. This would help overcome creditworthiness constraints in mobilizing resources for DPRK, but would also place a contingent liability on ROK. Providing such guarantees would be one way for ROK to avoid the shock of premature German-style integration, while accepting a burden that is larger than would normally be expected of a donor to another country.

[3] ROK Ministry of Unification; Bank of Korea

Membership in the International Financial Institutions. DPRK is not a member of any of the IFI's, although it has had informal contacts on several occasions. Mobilization of public capital for DPRK will be greatly facilitated by membership. This would allow DPRK to gain access to financial resources mobilized through well-established multilateral mechanisms, obtain access to knowledge resources and technical assistance from these agencies, and also leverage bilateral assistance through assurances that would be provided by the multilateral relationships. In order to obtain membership, DPRK will need to apply and meet technical and legal conditions for membership, and existing member governments will need to vote in favor of DRPK becoming a member. There are thus both technical and political requirements for membership that will need to be satisfied. It is possible, however, for DPRK to obtain services from the IFI's before formal membership, if existing members adopt a resolution calling for such assistance in their own interest.

Regional Economic Cooperation. Another factor that will influence the determination of modalities for mobilizing public capital for DPRK is the evolving agenda of regional economic cooperation in Northeast Asia. DPRK is a member of the Consultative Commission for the Tumen River Development Area and Northeast Asia (Tumen Commission), and has participated in the Tumen River Area Development Program (TRADP) sponsored by the UNDP. While this program languished in recent years, under a New Engagement Framework, renewed interest by China, Russia and Mongolia in expanding border cross-border trade and access to the DPRK port of Rajin can be expected to re-invigorate the TRADP framework. Since the Tumen Commission is the only formal inter-governmental body that presently exits to guide regional economic cooperation in this area, it is likely to be used to mobilize support for cooperative projects among local governments in this area.

Regional energy and transport links are also a topic of much discussion in Northeast Asia, as a New Engagement Framework with DPRK could also be expected to lead to deepening of discussions about how to finance a rail link from ROK through DPRK to Russia and China and how to proceed with power trade and gas pipeline projects that include DPRK. While such projects will most likely require private funding, public capital mobilization will also be required, and any regional projects will need to be linked to the public investment program discussed earlier for DPRK. Any such projects will also require multi-country political and legal agreements in addition to financing, so it will be necessary to develop modalities to address all the issues among the concerned states for this agenda to go forward.

Core Group and Second Circle. The Six Party talks framework that has emerged as the mechanism for political engagement with DPRK might well evolve to become an ongoing security dialogue forum. To the extent that a New Engagement Framework will link such on-going political and security arrangements with economic assistance, mobilization of foreign aid to support economic reform and development in DPRK may well be conditioned by the decisions of this core group. KEDO also represents a core group that has been centrally involved in engagement with DPRK since 1995. But the configuration of these two groups differs. If public capital mobilization in the future is going to be conducted within a framework of policies set by a core group, a question that will need to be addressed is adjustments to the memberships of these two groups. The Six Party talks presently exclude the European Union (EU), while the EU is an active member and contributor to KEDO. Since a future program to mobilize public capital for DPRK is likely to be broadly supported by European countries, the issue of EU participation in a core group can be expected to be an important one from their point of view.

Similarly, if KEDO is going to play a role in the future under a new mandate, reconfiguring the membership is also an issue that would arise. Neither Russia nor China are present members, but should participate in any future core group coordination efforts that KEDO might be asked to undertake.

Apart for questions about whether a core group will guide economic cooperation policies and resource mobilization efforts with DPRK, it will be necessary to consider how best to involve a "second circle" of countries that do not have a seat at the table for security negotiations, but will be important sources of public capital mobilization and support for economic reforms and institution building in DPRK in the future. Two Pacific Rim countries that are already active are Australia and Canada, and others such as Vietnam can provide valuable advice to DPRK based on their own experiences in transition to a market economy and working with multilateral institutions and bilateral donors in aid mobilization and management. Individual European countries also will want to be involved bilaterally and not only through EU and IFI channels. These include Switzerland, Sweden, Italy, Germany, and the UK. Finding ways to give "second circle" countries a voice in the New Engagement Framework will be important to the overall effort to help DPRK integrate with the international community and to have broad financial support for DPRK economic transition and development

Inter-Korean Economic Cooperation. Encouraging inter-Korean reconciliation is a strong motivator for the international community to provide public capital to DPRK. Thus it is likely that donor countries will be more forthcoming with resources if the two Koreas are pursuing a policy of deepening inter-Korean economic cooperation in parallel with improving social and political relations within a broadly supported security framework. Because unification is understood to be a long-term process requiring reduction in the large gap in the two economies and gradual harmonization of infrastructure, financial and legal systems, and product and labor markets, the inter-Korean economic agenda can be expected to evolve over time and will need to be calibrated to progress in economic reforms and capabilities in DPRK. For this reason, mechanisms will be needed to ensure that there is proper coordination between the financing of DPRK's economic development program and the inter-Korean program. While ROK is likely to be expected contribute a large share of public capital needed for DPRK to fulfill its side of the inter-Korean economic cooperation program, it will face limitations consistent with its own macroeconomic stability and economic growth needs. Thus the role of the international community will be to support the two Korea's in their process and supplement ROK resources with those mobilized from other donors, and to contribute knowledge and expertise from global experience that will bring value-added to what the two Koreans can do by themselves.

Normalization of Relations with Japan. When Japan normalized relations with ROK in 1965, it provided a financial package of $800 million.[4] This included a grant of $300 million to be disbursed over a 10 year period, a loan of $200 million to be disbursed over a 10 year period and repaid over 20 years with interest of 3.5%, and $300 million in private credits over 10 years from Japanese Banks and financial institutions. When Japan normalizes relations with DPRK, it is widely expected that DPRK will receive a financial package similar in composition to that received by ROK, but significantly larger in value to take into account the intervening time period. Estimates are in the $5-10 billion range. Even at the low end of this range, Japan can be expected to be a major supplier of public capital to DPRK. Thus the mobilization of public capital for DPRK will be heavily influenced by Japanese policy with regard to the timing of normalization of relations, size and composition of the financing package, modalities for transferring resources to DPRK, and conditionalities that may be applied by the Japanese government. The Japanese voice will carry significant weight both with DPRK and with other donors, whose own policies towards provision of capital to DPRK will need to be coordinated with Japanese priorities. Because of concerns about the risk of diversion of funds to the DPRK military, Japan will not want to place itself in a position where it is committing large sums of finance in advance of a more general political agreement with DPRK on both the multilateral security issues and bilateral issues of concern. Japan will also not want to be the only major player in provision of public capital, and after normalization of relations most likely will want close cooperation with the IFI's to multilateralize the risks of extending large scale capital support to DPRK.

China's Future Role. After playing a critical facilitator role during the Six Party talks process, China will be expected to continue to be proactive and collaborative in a New Engagement Framework. Thus China's economic assistance policy to DPRK in the future will need to be coordinated with the policies of other donors to a much greater extent than in the past and also be more transparent. This would be a significant departure from China's past economic relationship with DPRK, and would also be widely interpreted as a natural evolution of China's emergence as regional power, following on its success in expanding regional economic cooperation with Central Asia and ASEAN. It should be expected that China's willingness to develop more open and coordinated economic assistance relations with DPRK will also be reflected in future activism in Northeast Asia regional economic cooperation.

China's future role will also have an impact on economic assistance policies of other countries. If China expands participation in multilateral cooperation both through active collaboration with IFI activities in DPRK and in regional economic cooperation mechanisms such as TRADP and KEDO, there will be incentives for other donors to support these initiatives and provide complementary funding.

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[4] See Mark Manyin, "Japan-North Korea Relations: Selected Issues," Congressional Research Service, November 2003.

Human Rights and Environmental Protection A New Engagement Framework with DPRK will be shaped not only by political agreements on security and needs for economic reform and reconstruction, but also by human rights and environmental concerns. The policies of the DPRK authorities in these areas will affect the mobilization of capital from donor countries, especially those democracies where public funds for foreign aid are authorized through national legislatures. It can be expected that the U.S. and Europe will link their assistance programs to progress on human rights issues. Both the World Bank and Asian Development Bank (ADB) have detailed guidelines for ensuring both social and environmental safeguards in projects that they finance, and DPRK would be expected to abide by these standards, the same as any other borrower from these institutions. Most bilateral development assistance also requires conditionalities to ensure mitigation of adverse social and environmental impacts. Mobilizing public capital for DPRK will be much easier if the authorities engage in dialogue with foreign partners on these issues and develop policies and action plans that can be supported by the donors.

Strategies for Mobilizing Domestic Public Capital

While DPRK will require a large infusion of foreign capital to finance critical public investments needed to supplement policy reforms in kick-starting economic growth, this should be done in tandem with a strategy to foster significant growth in domestic public savings in the medium-term. These resources will be required for public investment to sustain growth while maintaining macroeconomic stability and meet expanding requirements for social expenditures and operations and maintenance of economic infrastructure. As in other socialist economies, DPRK does not have in place financial and legal institutions that will be needed to achieve this goal as the transition to market mechanisms takes place. Thus a high priority initially will be to design an institutional development plan and fiscal policy that is synchronized with the overall economic reform strategy.

This would be somewhat different under a “big bang” approach than a gradual approach. In the former case, the priority for fiscal policy would be to secure macroeconmic stability and supply public goods that the private sector cannot provide. In the latter case, fiscal reform would be a major driver of growth during transition, where the government can both use fiscal stimulus and intervene to give new economic actors incentives to generate growth.[5]

In both cases, it will eventually be necessary to address a number of fundamental issues in building new fiscal capability in DPRK. These include: State Owned Enterprise (SOE) reform and incentives for profitability and growth, restructuring the tax system, domestic debt strategy, role for contractual savings, and improvements in allocative efficiency of public expenditures. These issues are complex problems, and building the necessary institutional underpinnings to make significant progress will take time. Foreign aid, both in knowledge services and financial resources, should be calibrated to

[5] “The Current Progress and Future Directions of Fiscal Policy in North Korea,” Korea Institute of Public Finance, Seoul, 2003.

support DPRK's process of building these domestic capabilities so that the need for external public savings can diminish over a reasonable time period. The experience of Vietnam under its "Doi Moi" program would be a useful reference for DPRK and future donors in addressing this agenda.

State Owned Enterprise (SOE) Reform. Historically the State budget in DPRK has been financed principally by turnover tax and profits remittance tax on SOEs and agricultural cooperatives. The industrial sector also accounts for 70-80% of state revenue (excluding military). Thus the sharp contraction of the DPRK economy in the 1990's is reflected in the drop in central government revenues from 37.1 billion won in 1991 to 20.3 billion in 1996.[6] This drop largely reflects the decline of revenue from SOEs resulting from a breakdown of production. SOE performance was affected by a number of factors, including depletion of capital stock, outdated technologies, failures of central planning, great distortions in prices, lack of access to finance and intermediate inputs, the trade shock induced by the collapse of the former Soviet Union, interference of the Worker's Party in enterprise management, rigidity of the labor market, and absence of entrepreneurship. The revitalization of SOEs thus will be essential for any future effort to mobilize public resources domestically.

Beginning with Constitutional amendments in 1998, DPRK has begun to accept the idea of profit motive to encourage increased industrial production. In the economic reforms introduced in 2002, a number of initiatives were taken to promote enterprise reform, including permitting firms to obtain inputs from market-determined suppliers, reduction of the influence of Worker's Party representatives on management decisions at the firm level, placing a hard budget constraint on SOEs, and allowing more flexibility in labor management. The emergence of the informal market economy is also a factor. In a New Engagement Framework, a major priority will be to support growth of the market economy in a way that promotes leveling the playing field with SOEs, while at the same time improving the ability of SOEs to be autonomous and competitive business enterprises.[7] Tax revenues must be increased through buoyancy based on growth and profitability of the enterprise sector.

Restructuring the Tax System. Another major future priority will be to restructure the tax system of DPRK both to capture transactions in the market economy as well as State sector and to create incentives for enterprise investment and entrepreneurship. Turnover and profits remittance taxes should be replaced by income taxes for enterprises and individuals and a value-added tax on imports and domestic transactions.[8] The design and implementation of tax reform will need to parallel reform of the financial sector and development of a commercial banking system. The legal and administrative framework to support policy shifts will also need to be put in place, which will take time. Thus a phased approach will be needed and technical assistance provided to DPRK to support

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[6] Il Dong Koh, "North Korean Budgetary Structure and Analysis of Recent Budgetary Situation," Korea Development Institute, 1999.
[7] Chong Kee Park, "Fiscal System," Lee Jay Cho and Yoon Hyung Kim, Eds, Economic Systems in South and North Korea, Korea Development Institute, 1995
[8] Ibid.

the transformation of the public finance system. Resistance to tax reforms can be expected both at the enterprise and individual level, so tax administration and anti-corruption measures will need to be addressed as part of the agenda.

A related issue is the restructuring of the roles of central and local government in mobilization of public revenues. Already some steps have been taken to give local governments more authority to collect fees and local taxes, and some observers advocate rapid decentralization of the fiscal system following Chinese experience to promote the private economy.[9] There are risks, however, with over-rapid fiscal decentralization, as there is a need for capacity building at the local level, an accountability framework, and good coordination of local fiscal management with macroeconomic stabilization.[10]

Domestic Public Debt . In May 2003, DPRK introduced a bond scheme intended to mobilize private savings for government use. This scheme was designed as a lottery, where only a few bond holders would eventually receive interest on their investment. Not surprisingly, there reportedly have been few takers. Eventually, however, domestic debt will need to play a role in public finance in DPRK, both as a way to mobilize resources for public investment and as a tool of macroeconomic management. While this will require first growth in enterprise and private savings and legalization of property rights for various classes of assets, a New Engagement Framework should include assistance to develop public debt policies and management capacity that are consistent with international standards. DPRK does not have a good reputation as a public borrower, so investor confidence will need to be developed in the domestic population as well as for foreign investors and donors who supply ODA loans.

Contractual Savings. Similarly, DPRK will need to develop new mechanisms to finance healthcare and social security as it undergoes transition. The existing social security system, for example, has become essentially irrelevant to households participating in the informal market economy where prices far exceed social welfare payments. A New Engagement Framework should include a review of contractual savings schemes adopted by other socialist countries in transition and assistance to DPRK in developing new policies and programs to meet these essential human needs.

Allocative Efficiency. How well DPRK performs in reforming public expenditures will also have an impact on mobilization of resources from domestic as well as foreign sources. If public investment is diverted to unproductive expenditures or wasted through mismanagement and corruption, it will not have the buoyancy impact on economic growth and State revenues that will be needed. Reduction in military expenditures and redeployment of military assets and personnel to productive activities will require major attention and assistance in a New Engagement Framework. Price liberalization is also needed to foster more efficient allocation of resources throughout the economy, but DPRK will need support in managing price reforms in ways that will induce supply responses and contain inflationary pressures. Economic efficiency should

[9] Op-cit. Korea Institute of Public Finance, 2003.
[10] For a good discussion of these issues see Era Dabla-Norris and Paul Wade, “The Challenge of Fiscal Decentralization in Transition Countries,” IMF Working Paper WP/02/103, 2002.

also be given primary consideration in public investment planning, especially for infrastructure, in selection and prioritization of projects for both domestic and foreign funding. DPRK will need training and technical assistance as well as political discipline in making good public investment decisions.

Modalities for Mobilizing Foreign Public Capital

There are several basic options for arranging international cooperation with DPRK aimed at mobilizing Official Development Assistance (ODA). They differ from one another in two major respects. One is leadership: who convenes and chairs the meetings of donors. The other is the extent to which political in addition to economic considerations are explicitly addressed in the mandates and processes of these decision-making mechanisms. The choices that are made in establishing institutional arrangements for mobilizing ODA for DPRK will have lasting impact not only on DPRK, but on the conduct of relations among the countries of Northeast Asia and relations between Northeast Asia and the U.S and Europe. For this reason, the choices should be made with a full understanding of their implications. This section of the paper examines three approaches: Korean-led, World Bank/IMF-led, and Core Country Group-led. The strengths and limitations of each approach are discussed, along with some variations. This is followed by examination of issues relating to future options for KEDO, potential role for trust funds, and the proposal for a Northeast Asia Development Bank.

Two Koreas in the Lead. If eventual reunification of the two Koreas is the ultimate goal desired by both countries and supported by the international community, then a joint sponsorship framework is one option to consider. In this case, the agenda and process for coordinating mobilization of ODA resources for DPRK would be guided by the two Koreas together, and reinforce the objectives of reducing the gap between the two economies, deepening inter-Korean economic cooperation, and gradually integrating the two economic systems. This approach has the advantage of keeping the reunification goal at center stage and in providing a political incentive for the international community to mobilize resources and provide support for the reunification process for an extended period. The IFIs, EU and bilateral development assistance agencies could be commissioned through this framework to work with both Korea’s on the program, providing advice and technical assistance to both countries and financial support to DPRK to meet its public investment program requirements. In policy dialogue with the international donors, the two Koreas would describe what they were each doing individually and doing together to advance the overall economic agenda on the Korean peninsula, and explain where assistance from the international community would be most helpful

An institutional framework has already been set in place for inter-Korean economic dialogue and management of cooperation activities that operates in parallel with frameworks on social/cultural and security matters. It would be relatively easy to build on this existing inter-Korean economic cooperation framework, both to convene meetings with the international donor community and to monitor and supervise implementation of reforms and projects in DPRK. Capacities that have already been built up in ROK -- in the Ministry of Unification, Ministry of Economy and Finance, Bank of Korea, Korea Institute for International Economic Policy, and Korea Development Institute, – could rapidly be mobilized to support the international engagement framework while working with counterpart organs in DPRK to help them build their capacity to engage effectively.

One disadvantage of the Korean-led approach is that it could place major powers and other donors in an awkward position of supporting a joint Korean economic agenda that they may find objectionable for one reason or another. If the two Koreas get together and proceed with an agenda that is inimical to the interests of one or more major donors or perceived to be tilted politically, there is less leverage to influence a change of course than would be the case in the other approaches discussed below. This potential for pre-emption could be mitigated if processes were put in place for consultations with donors on major issues on an ongoing basis in both Seoul and Pyongyang. Building a culture of openness and cooperation would be essential for long-term success.

Traditional Consultative Group. The typical model used for other countries around the world is a Consultative Group chaired by the World Bank and prepared in close collaboration with the IMF and UNDP. In its early economic development stages, a Consultative Group was formed for ROK. While Consultative Group meetings have normally been held in Paris, either annually or on an occasional basis, in recent years it is common for these meetings also to be held in other centers such as Tokyo, or in the country concerned. Setting up a Consultative Group for DPRK along traditional lines would mean that DPRK would have to become a member of the IFI's at an early stage and work closely with the IFIs in economic and financial reporting and in preparation of reports used as the basis for the Consultative Group discussions. Because of the inter-Korean economic agenda and long-term unification goals, any IFI-led Consultative Group framework would need to be designed to work closely with ROK authorities and institutions to ensure that policy dialogue and financing plans are coordinated with the inter-Korean processes.

The advantages of the traditional Consultative Group are that it has well-established processes known to the donor community and is an efficient mechanism for coordinating policy dialogue and mobilizing formal commitments to finance a well-reasoned macroeconomic framework for economic development. It also would enable DPRK to learn rapidly the ways of the international financial system and develop intimate working relations with IFI staff responsible for managing the relationship and Consultative Group preparations. Since both the IMF and World Bank played central roles in the management of the ROK financial crisis of the late 1990's, and the IMF maintains a surveillance capability and routinely conducts Article IV Consultations with the ROK, the IFI's also would be well-positioned to play the lead coordinating role for discussions of the interaction of DPRK economic transition and development with ROK macroeconomic policy and management.

A disadvantage of the traditional model is that the IFIs are forbidden by their Articles of Agreement to take political considerations into account in the conduct of their work. For DPRK, it may be difficult to separate political dialogue from discussions of economic policy and mobilization of resources. Issues such as progress in implementation of security agreements, handling of human rights issues, and domestic political dynamics of change in both Koreas, are likely to be discussed as part of the context for extending ODA. Normally, for example, representatives of donor countries participating in Consultative Group meetings come from ministries of finance and development assistance organizations, but political discussions are usually led by foreign ministry representatives. A variation of the Consultative Group format that might overcome this liability would be to have the meetings co-chaired by the UN and World Bank, legitimizing the integration of political and economic dialogue in the same meetings.

Core Country Group Lead. If the Six Party framework for negotiating security agreements for DPRK is successful, it might naturally be expanded to address economic assistance issues as well, with some modifications. The pressure to link economic assistance with progress on political agreements is likely to be strong if a step-by-step road map approach is adopted by this group. In this approach, it would be necessary for the Core Group either to have a rotating chairmanship or elect one country to serve as chair for the economic cooperation meetings. Because donors to DPRK will include the IFIs, EU and “Second Circle” countries such as Australia and Canada, participation in the economic meetings would need to be expanded beyond the Six Country framework. Conduct of these meetings would be driven by assessments of progress on political agreements and consideration for implications for economic assistance. In this framework, the issues of concern to all the core countries would be given high priority, and mobilizing broader international support for DPRK would be considered in this context. A variant would be to use KEDO as the forum for economic discussions, if KEDO was to be given a new and wider mandate and membership expanded to include China and Russia (see below).

The advantage of the Core Country Group taking the lead on the ODA mobilization discussions is that the linkage to the political framework for international engagement with DPRK would be clear and explicit. The main disadvantage of this approach is that is that DPRK’s economic reform process and development would be shaped by the strong political interests of members of the Core Group and dominance of regional perspectives, and thus delay DPRK’s full integration in the global community and normal workings of the international financial system. Also, inter-Korean reconciliation would be given a second row seat to the other interests of the large powers, reinforcing a sense of dependency of both Korea’s, with potentially negative effects on public opinion in these countries. Some adjustments in the working modalities of the Core Group would also be needed to fit the requirements of economic policy dialogue and coordination between foreign policy and economic agency participation.

Future Options for KEDO. There are two ways that KEDO could be given a role in mobilization of public capital in a New Engagement Framework. Both would require changes in the existing KEDO mandate and membership. One would be to use KEDO as the primary mechanism to provide energy assistance to DPRK, keeping broadly with its present mandate, but expanding it to cover conventional energy supply (not nuclear), rehabilitation of the transmission system, and demand management activities. The package of such assistance would need to be shaped by an energy sector study that KEDO would undertake. This could be done in partnership with the World Bank and Asian Development Bank in order to take advantage of their expertise in studies of this kind. The package of assistance to the energy sector would need to be linked to the overall economic development strategy adopted for DPRK and resource mobilization coordinated with the more general ODA mobilization efforts managed through one of the frameworks discussed above. In this concept, KEDO would be one important actor in the development assistance to be provided to DPRK and would need to participate in the general aid coordination processes and have close cooperation with the IFIs, both to ensure consistency in policy dialogue and to enlist IFI resources in support of the energy sector program. In addition, KEDO could be the primary mechanism for reaching agreements among the countries of Northeast Asia on cross-border energy trade that involves DPRK, including potential power trade and gas trade. To undertake this role, both Russia and China would need to become KEDO members and its activities closely linked to the broader discussions of regional energy security. Relatively minor adjustments in the staffing and management of KEDO would be needed for it to be able to undertake this limited expansion in its role.

The other option would be to give KEDO a much broader mandate to become the "Korea *Economic* Development Organization," and serve as the primary modality for coordinating all discussions of economic strategy and development assistance for DPRK under the guidance of the KEDO members, who would need to be expanded to include China and Russia and thus represent an expanded Core Country Group that would also include the EU. In this concept, KEDO would be the instrument for linking the political and economic frameworks for engagement, where it was determined that the political framework would need to tightly guide economic discussions and commitments, not only for the core countries but for the international community more generally.

The main disadvantage of this approach is that KEDO was never conceived as an economic organization despite its mandate to provide heavy fuel oil and construct two Light Water Reactors. As a political organization, KEDO was been managed and staffed primarily by foreign affairs personnel, not energy experts or economists. For KEDO to assume a broader economic mandate, major adjustments would be needed in its staffing and management, as well as in its operating procedures. Another disadvantage is the inter-Korean economic relationship would be overshadowed by the KEDO organization, potentially causing some inconsistency in the policies adopted by KEDO for economic engagement with DPRK and dynamics of inter-Korean cooperation.

<u>Possible Role for Trust Funds.</u> DPRK requires large-scale public infrastructure investment that will need to be funded by ODA in the short and medium-term. Typically, funding for these types of projects comes mainly from the multilateral development banks and bilateral development assistance agencies such as the Japan Bank for

International Cooperation. Infrastructure funding is normally provided in the form of loans, not grants, even if the loans are at concessional terms for qualifying countries. Large-scale infrastructure projects require a lot of advance preparation. There needs to be a public investment program that is consistent with both an economic development strategy that is widely supported and a prudent macroeconomic management framework. There also need to be feasibility and engineering studies to ensure that both technical designs and costing is prepared properly. Donors will require environmental and social studies and mitigation plans, including plans and funding for resettlement of households affected by infrastructure projects. The IFI's also require international competitive bidding for contracts and this requires considerable preparation, especially for a country that has not participated in the international system of procurement before. For these reasons, even though DPRK's needs for infrastructure investment are high, there will be a period of several years required to undertake the prerequisite studies and preparations to absorb large amounts of ODA. During this time, high priority will have to be given to funding the studies, technical assistance and training that DPRK will need to prepare and implement a large program of international assistance.

The idea of a grant trust fund to launch this process has considerable merit. In order to reduce complications of multiple donor demands on DPRK administrative capacity, it would be efficient to establish a multilaterally-funded facility that is administered by a single agency or limited number of agencies to take a lead role in organizing a program to use such funds and to supervise their implementation. One option would be to give UNDP the lead role, since it also already has a trust fund for DPRK in place, and could ask the IFI's to assist in the execution of specific activities. Another option would be to set the trust fund up in one or more of the IFI's as has been done for a number of other situations, including East Timor and Bosnia-Herzegovina. The creation of such a trust fund could be done quickly, even before DPRK undergoes the process of obtaining membership in the IFI's, if the existing shareholders so desire. The advantage of establishing IFI-managed trust funds is that this would impel development of operational working relations between the IFI's and DPRK that will be needed in any case for them to play the role they will be expected to play in any of the aid coordination and management scenarios discussed above.

<u>Considerations Regarding the Proposal for a Northeast Asia Development Bank (NEADB)</u> The idea of establishing a new regional development bank to finance the infrastructure investment envisaged for expanding economic integration in Northeast Asia has been under active discussion in the region for a number of years. If such a new financing institution were to be created, it would be expected to be one source of funding for DPRK reconstruction and integration in the regional economy. The case for such an initiative rests partly on the assumption that it could mobilize incremental funds to those that would be mobilized through the existing World Bank and Asian Development Bank, and partly on the assumption that a different governance system would mean that different standards and conditionalities would be applied than those that would be

required by the existing IFI's.[11] In particular, the argument is made that the NEADB would provide political-risk coverage for countries such as DPRK.

Like the World Bank and Asian Development Bank, the idea is that the NEADB use a public capital structure to intermediate in the private capital markets in order to provide financing that the private sector would not undertake on its own. The "first tier" founding member countries would be China, DPRK, Japan, Mongolia, ROK, and Russia, who would be expected to subscribe 40% of the Bank's capital, with another 20% subscribed by "second tier" Asian countries and the remaining 40% subscribed by the U.S., Europe and others. Implicit in the NEADB concept is that this organization would respond to the political will of its "first tier" members, who would dominate decision-making and also staffing, becoming an important instrument for regional cooperation among governments that do not have a good track record working collaboratively as a group, compared with other regions of the world.

While these objectives are laudable, there are political, financial and administrative reasons to be skeptical about whether and how quickly an effective institution could be established. Politically, the first question is whether the U.S. and Europe would choose to participate and support the idea that a third development bank could contribute sufficient value-added to the capabilities of the World Bank and Asian Development Bank, to be worth the additional costs and administrative overhead that a new institution would imply. Alternatives would be to encourage these organizations to strengthen their capacity to support Northeast Asia regional development as well as DPRK economic reconstruction through internal organizational adjustments, including staffing. The question of Russia's membership in the Asian Development Bank would also need to be addressed, but this would be simpler than creating a new organization in order to include Russian participation. A second political question is how the NEADB would relate to the emerging Core Country Group framework that is evolving from the Six Party talks. In principle, the NEADB could be designed as an economic instrument of this political framework, but in this case the U.S. would need to be included as a "first tier member," which is not what the promoters of the NEADB concept had in mind. On the financial front, there are significant questions about how capital subscriptions and voting power would be distributed in the NEADB, and there are also questions about who would be the borrowers, other than DPRK and possibly Mongolia. It is difficult to believe that China and Russia would chose to borrow from a NEADB in which they are major shareholders, when they have large domestic capacity to finance infrastructure investments on their own, and have access to international capital markets as sovereign borrowers. From an administrative perspective, the question is how quickly could a new NEADB establish the operational policies and procedure and staffing and management to function effectively. For all these reasons, the establishment of a NEADB can be expected to be controversial, and in any case protracted. Efforts to mobilize capital for DPRK should not be distracted by the larger complications of the debate on creating a new financial institution for the region.

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[11] For a detailed discussion of the case for establishing a NEADB, see Stanley S. Katz, "Financing the Infrastructure Investment," in A Vision for Economic Cooperation in East Asia: China, Japan and Korea, Korea Development Institute, University of Hawaii Press, 2003.

Conclusions

A New Engagement Framework for DPRK will need to face up to important realities when it comes to mobilizing public financial resources. One is that the linkage of political and economic considerations needs to be handled very carefully to avoid problems that have been experienced in past assistance to DPRK and to ensure that future assistance is effective in meeting expectations both of DPRK authorities and the international community. A second reality is that there are many complex and difficult challenges to be met in transforming the DPRK economy, setting it on a sustainable growth path, and integrating with the ROK economy, regional economy and the international financial system. Open and constructive policy dialogue between DPRK and the donor community will be essential so that there is common understanding of what will be required to achieve results, especially in conditionalities that will be placed on access to resources by donors and supervision of implementation of donor-financed activities. A third reality is that building new institutional capacities and laying the groundwork of technical preparation for large infrastructure investments will take some time and require good coordination among those providing support to DPRK. To be successful, mobilizing resources for a New Engagement Framework for DPRK will require good will and commitment to sustained cooperation between DPRK and its foreign partners for some time to come.