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NORTH KOREA'S NUCLEAR CAPACITY AND THE PATH OF REFORM

1. BACKGROUND

1.1 The North Korean nuclear crisis dates back to the 1993, when IAEA inspections concluded that weapons grade plutonium had been extracted from spent fuel at North Korea's nuclear facility at Yongbyon. Failure of on-off negotiations between North Korea and the US resulted in a tense stand-off. Military conflict was averted in July 1994 through the conclusion of a deal between the two sides. Formalized as the Geneva Framework Agreement (GFA) of October 1994, the deal provided for energy assistance to North Korea (oil and the eventual supply of two light water nuclear reactors) in exchange for the disablement and eventual dismantling of existing nuclear facilities at Yongbyon and other locations.

1.2 By the end of 2002, the GFA had collapsed. The ostensible trigger was the alleged confirmation of a uranium-based nuclear programme by North Korean negotiators to their US counterparts in October 2002. This prompted US cessation of the supply of oil (500,000 tons annually) to North Korea. Food aid and support for the light water reactors were also suspended. In response to US sanctions and UN condemnation, North Korea expelled IAEA inspectors and restarted its Yongbyon reactor (including the reprocessing of 800 spent fuel rods) and declared its right to possess nuclear weapons.

1.3 Even without the alleged October 2002 disclosures, the GFA was problematic given the loopholes of the agreement (especially over disclosure and verification), slow implementation of the light water project, and North Korean attempts to extract further concessions (eg by ballistic missile testing in 1998). The most decisive factor of all, however, was the ideological hostility towards North Korea by the new George W. Bush administration. In the post-September 11 climate, compromise with a nuclear-proliferating, anti-democratic state like North Korea (that had been linked to terrorism) was unacceptable to the neo-conservative Bush administration.

1.4 To resolve the crisis, both North Korea and the US agreed to participate in the Chinese-sponsored six-party talks (North Korea, US, China, South Korea, Russia, Japan) which began in Beijing in August 2003. After four rounds lasting two years, an agreement of principle was signed in September 2005. The agreed declaration contained the following provisions:

- North Korean will denuclearize on a verifiable basis.
- US will refrain from attacking North Korea.
- US will refrain from reintroduction of nuclear weapons to South Korea.
- North Korea had the right to use civil nuclear energy.
- North Korea and US and Japan should seek to normalize diplomatic relations.
- North Korea will receive energy assistance from the five powers.

Implementation was to be based on the principle of "commitment for commitment, action for action".

1.5 The September Agreement soon ran into difficulties, especially over the modalities of implementation. For example, North Korea insisted on the delivery of a light water reactor (a process that would take years) before any denuclearization. In the same month, the US treasury imposed sanctions on Banco Delta Asia, a Macau-based bank allegedly involved with North Korean counterfeiting, resulting in the freezing of \$25 million of North Korean funds. The six-party process was halted and the situation deteriorated in 2006 as North Korea conducted a series of missile tests on 4 July and tested a nuclear weapon on 9 October. While the US was unable to secure support for comprehensive sanctions against North Korea, the tests did not go unpunished. South Korea suspended fertilizer and food aid for one year in response to the July missile tests, while China reduced its aid (by two-thirds) and supported the UN (Resolution 1718) condemnation of the nuclear test and sent a high level envoy to North Korea.

2. THE FEBRUARY 2007 AGREEMENT

Against the background of international isolation, and economic pressure from its principal aid providers, North Korea returned to the six-party talks in December 2006. Under Congressional pressure to re-engage and in the absence of progress in the Middle East, the Bush administration decided to re-focus its efforts on settling the North Korea issue. Progress was surprisingly quick, and agreement was reached at the six-party talks in February 2007. The February Agreement is divided into two phases.

2.1 Phase 1 provisions:

- North Korea will freeze its nuclear installations at Yongbyon and invite back the IAEA inspectors.
- North Korea will discuss with the six parties its nuclear programmes, including plutonium extracted from the operation of its Yongbyon reactor.
- North Korea and the US will begin bilateral talks aimed at establishing full diplomatic relations. The US will begin the process of removing North Korea from its list of terror-sponsoring states, and advance the dismantling of economic sanctions under the Trading with the Enemy Act.
- North Korea and Japan will start bilateral talks aimed at resolving "outstanding issues".
- The US will resolve the issue of sanctions against Banco Delta Asia (within 30 days of the agreement).
- North Korea will receive 50,000 tons of heavy oil.

2.2 Phase 2 provisions:

- North Korea will declare all its nuclear programmes and disable all nuclear facilities.
- North Korea will receive one million tons of heavy fuel oil (including the initial shipment of 50,000 tons).

2.3 North Korea received its frozen funds in Banco Delta Asia in June 2007. In July, IAEA inspectors returned to Yongbyon and confirmed that the nuclear installations were shut down. South Korea delivered 50,000 tons of heavy oil to North Korea. High-level US-North Korean in September opened the way for the arrival of US technicians to Yongbyon. A 31 December 2007 deadline for declaration of North Korean programmes was ostensibly agreed. After initial progress, the 31 December deadline was not adhered to. The US demanded that North Korea complete disablement of Yongbyon and provide a full account of past and existing nuclear activities. North Korea responded by insisting that it had declared all its programmes and called on the US to comply with its obligations on energy aid, economic sanctions and the terrorism blacklist.

3. COMPLICATING FACTORS

The current impasse (as of April 2008) is not surprising from the past history of denuclearization agreements with North Korea. Apart from the intrinsic problems of the February Agreement arising from the mechanics of denuclearization, and the sequencing of concessions (who gives up what, how much, and when?), the recent leadership change in South Korea and the impending one in the US present additional complicating factors.

3.1 Predictably, "denuclearization" is difficult to implement given the absence of trust and divergence of understanding between the US and North Korea. Implementation of the principle of denuclearization is likely to be subject to disagreements over full disclosure of the extent of North Korea's nuclear capacity, the meaning of "denuclearization" verification, and the reciprocal concessions that North Korea expects.

3.1.1 To denuclearize, North Korea first needs to give a full account of its capacities and that account needs to be acceptable to the other parties. Full disclosure of North Korea's nuclear programme includes not only the amount of weapons grade plutonium extracted from the 8,000 spent fuel rods after the reopening of the Yongbyon plant in 2003, but also the total amount of plutonium accumulated (since the opening of the Yongbyon plant in 1985), the number of nuclear weapons it possesses, and the any programmes outside of Yongbyon. All of these issues are problematic as the US estimates are likely to diverge from those given by North Korea. For example, the US claims that there is a nuclear programme based on highly enriched uranium, a claim denied by North Korea.

3.1.2 What does "denuclearization" mean? The US insists on the "disablement" of nuclear facilities to the extent that operation cannot easily be restarted. Does "denuclearization" apply to the capacity to make nuclear weapons or to North Korean possession of any nuclear capability, including civil? Here the North Koreans have indicated that they expect to have to be supplied with light water reactors (LWRs) as compensation for the closure of their existing reactors (the 1994 GFA also committed to providing North Korea with LWRs).

3.1.3 The verification regime under the February Agreement is limited. The role of the IAEA is confined to monitoring the freezing of the Yongbyon facility. The September 2007 discussions allowed for the arrival of US

technicians at Yongbyon. Thus the system of inspection and verification for any installations beyond Yongbyon will need to be negotiated with the North Koreans (who deny the existence of such facilities). Even if agreement can be reached on the existence of nuclear facilities, the mode of verification is likely to be contentious given North Korea's history of opposition to intrusive inspection.

3.1.4 What reciprocal concessions do the North Koreans expect? The February Agreement commits the other signatories to the provision of heavy oil (one million tons), US removal of North Korea from the terror blacklist and the ending of US economic sanctions. Statements from North Korea, however, point to expectations for more extensive concessions as the price for full denuclearization. These include oil shipments beyond the specified amount, the (longstanding) demand for the construction of LWRs, and the concomitant reduction of US military forces on the Korean peninsula. Even if these demands could be agreed in principle, their implementation will extend the denuclearization schedule for an indefinite period into the future. There is also strong US (and South Korean) expectation that aid and diplomatic normalization will also be accompanied by conventional force reduction on the North Korean side.

3.2 The US electoral cycle introduces an element of uncertainty. The prospect of improved relations at the end of the Clinton administration was halted by the new Bush administration in 2001. Therefore North Korea is watching and waiting for the outcome of the 2008 presidential contest (just as it did in 2004, when the six-party process stalled). North Korea is unlikely to commit fully to denuclearization unless it can be sure that the guarantees made by one administration will be maintained by its successor. North Korea is likely to be most apprehensive about a McCain victory. Senator McCain was a critic of the 1994 GFA and had advocated a more robust approach to "rogue states" (including North Korea) during the 1990s. It is worth quoting his recent comments on the subject of North Korea, which hint at a widening of the list of concessions expected by the US:

North Korea's totalitarian regime and impoverished society buck these trends [towards democracy]. It is unclear today whether North Korea is truly committed to verifiable denuclearization and a full accounting of all its nuclear materials and facilities, two steps that are necessary before any lasting diplomatic agreement can be reached. Future talks must take into account North Korea's ballistic missile programs, its abduction of Japanese citizens, and its support for terrorism and proliferation. (Source: Foreign Affairs, Volume 86 (6) November/December 2007, section 3 paragraph 3, html version)

3.3 The administration of newly inaugurated South Korean President Lee Myung-Bak has stated that it intends to take a less indulgent attitude towards North Korea than its predecessors. While the previous Roh administration reduced food aid in 2006 in response to North Korean testing of missiles and a nuclear device, it did not support US calls for comprehensive sanctions or the forceful interdiction of North Korean shipping under the Proliferation Security Initiative. Indeed, it maintained and expanded key projects (notably the Mount Kumgang Tourism Project and the Kaesong Special Economic Zone) that provide North Korea with much needed foreign exchange. Roh's approach reflects the belief that a generous approach towards

North Korea ultimately yields more benefit (in softening the North's attitude, promoting the development of civil society) than either confrontation or strict insistence on quid pro quos. By contrast, President Lee has indicated that he will take a more conditional approach towards North Korea meaning that economic aid will depend upon tangible results in the areas of denuclearization, demilitarization and human rights. Of course, President Lee's scope for manoeuvre will also depend on the result of the forthcoming April 2008 national assembly elections.

4. DENUCLEARIZATION AND NORTH KOREA'S REFORM PATH

Whether these complicating factors can be overcome depends on the North Korean leadership's vision of systemic change. A secure external environment (centred on improving relations with the US and the opportunities for aid and investment that flow from normalization) is a necessary but insufficient condition for the introduction of substantive market reform in North Korea. Equally important will be the acceptance of the principle of reform amongst North Korean leaders. Readiness for substantive reform will reinforce denuclearization and demilitarization. By contrast, a leadership preference for "muddling through" will have the opposite effect.

4.1 North Korea's leaders seek to remain in power indefinitely and will maintain a level of social control consistent with that objective. Any future post-Kim Jong-II non-dynastic leadership will also aspire to power retention using social control. Given the status accorded to the military as part of Kim Jong-II's post-1994 power consolidation and as a response to the 1990s economic crisis, it is likely that military leaders will play a leading role in any post-Kim leadership. Successful reform will depend on high status military leaders recognizing the priority of achieving a successful civilian economy.

4.2 The small size of North Korea and its weak position vis-a-vis South Korea means that the North Korean leadership feels more vulnerable than its counterparts in China or Vietnam. Accordingly, its approach to economic reform is likely to be more cautious.

4.3 Historically Kim Il-Sung and Kim Jong-II have been lukewarm about Chinese-style market reforms. Apart from ideological hostility, concerns about loss of economic control and social challenges to the regime always outweighed concerns about productivity. However, North Korean leaders seem to have reappraised the Chinese experience. There are grounds for expecting North Korea to increasingly copy aspects of Chinese reform.

4.3.1 China's initial agricultural reforms of 1978 (de-collectivization) simply sanctioned what was already taking place at the local level in response to food shortages. Similarly, North Korea's economic collapse of the 1990s led to the spontaneous rise of non-state economic activities (especially private farming, light manufacturing and primitive markets) as the state could no longer provide employment and goods for the desperate population. Other reforms include the 2002 wage-price reform (to reflect scarcities more accurately), accelerated development of special economic zones (notably Kaesong) and greater managerial autonomy.

4.3.2 The impressive results of China's modernization demonstrate to North Korean leaders a route for long term regime survival by promoting economic growth without surrendering the monopoly of power. This shift in attitude is reflected in Kim Jong-Il's praise for the Chinese model (especially the special economic zones), the dispatch of economics students to China, and in the enticement of Chinese entrepreneurs by the North Korean authorities.

4.3.3 Over the last decade, China's influence over the North Korean economy has greatly enhanced through its leading role as aid provider, trade partner (from 28-43% between 2001 and 2005) and foreign investor.

4.4 On the other hand, the North Korean government has also attempted to assert its control over the fledgling private economy (over foreign exchange, over cross-border trade) as the economic crisis has eased. It continues to stress the relevance of state owned industries and central economic management. This suggests that while China's experience is influential, North Korea is also likely to learn from Vietnam and South Korea, countries with greater affinity to North Korea in terms of size and centralist background.

4.4.1 The North Korean leaders may seek to maintain a substantial but revamped state industrial sector while inducing foreign participation in foreign exchange generating activities (working with state agencies via special economic zones, tourism projects, and mineral sector). This way, the state can retain control of the lead industrial sectors, minimize the spread of independent local entrepreneurs, keep cultural contacts with foreigners strictly regulated, and ease its foreign exchange constraints. Apart from employment rationalization (which will need to be severe), foreign expertise and investment (eg from South Korean conglomerates) will also be needed for the revamping of worthwhile state industries. Such a reform strategy represents the "development dictatorship" model, that is, North Korea's approximation of South Korea's centralized, state-directed capitalism of the 1960s-80s. Such a strategy is more consistent with North Korea's history of economic centralization (whereas Chinese provinces enjoyed a high degree of economic autonomy). Kim Jong-Il has also expressed admiration of the South Korean model.

4.4.2 North Korean leaders may be politically too sensitive, and unwilling to risk any kind of substantive economic reform. Instead they may seek to "muddle through" by making the minimal adjustments necessary to maintain the current levels of foreign exchange receipts and aid flows. Keeping the nuclear threat alive as a bargaining counter, would be consistent with muddling through. Such behaviour would deepen North Korea's isolation and reinforce its dependence on nuclear diplomacy. This is the scenario least conducive to denuclearization and least attractive to the region as a whole. Given their desperate need for economic regeneration (eg GDP growth in 2006 turned negative for the first time since 1999, a grain shortfall of one million tons by the end of 2007) to sustain power, even the most conservative North Korean leaders are likely to be aware of the limits of muddling through. Scenarios of a permanent gangster regime eking out a basic existence through aid extorted by nuclear diplomacy and the receipts of criminal activities (drug production and counterfeiting of goods and currency) are unrealistic.

4.5 Thus the choice between substantive reform/denuclearization versus muddling through/brinkmanship depends in large part on the readiness of North Korea's leaders to accept substantive reform. That readiness arises from their calculations about internal political risks and external security. Their perceptions about the intentions of the US will be crucial to shaping the latter calculation. By the signals it conveys, the US will be able to shape those perceptions in the direction of substantive reform/denuclearization.

4.5.1 The US should accept the North Korean political system as it stands and instead prioritize denuclearization and economic reform. It should look to the social transformation of North Korea over a long time frame driven by improved living standards, spread of the profit motive and generational change (ie North Korea as a slow motion replay of China or Vietnam). This means stepping away from the moral absolutism that has dominated much of the Bush administration (with few positive results).

4.5.2 The North Koreans will not denuclearize until they can be sure that deals will not become hostages to fluctuations in domestic US politics as in 2000. This raises the wider issue of how guarantees of aid and security can be carried across US administrations. Given the six party support of the current agreement, it has a more binding effect than the 1994 GFA. Progress on negotiation of a separate peace regime between the US, North Korea, China and South Korea (as called for under the February Agreement) will offer further reassurance to North Korea. These layers of multilateral reassurance will also make North Korean non-compliance with denuclearization difficult.

4.5.3 The new US administration should rapidly indicate that it is committed to the implementation of the February Agreement. While the Middle East and Afghanistan will remain higher priorities for US, a US policy of deliberate neglect towards North Korea will only induce the North Koreans to force the issue back onto the international agenda (eg through further nuclear and missile testing, transfer of nuclear and missile technology).

4.5.4 The US fears that North Korea's real agenda is to gain diplomatic normalization and other benefits without full denuclearization. What tends to be overlooked is the high value that North Korea places on developing friendly relations with the US. Beyond immediate economic benefits, North Korea seeks a relationship with the US in order to counter-balance China's growing influence on the Korean peninsula. As with Vietnam, there is potential for shared strategic interest between North Korea and the US. The dramatic improvements in US-China relations during the 1970s show how historical hostilities and divergence of political values can be put aside when there is sufficient political will motivated by shared interests.

31 March 2008