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North Korea has been both a puzzle and an irritant to the international community for more than half a century. This highly secretive autocratic state possesses nuclear weapons, yet it depends on handouts to stave off mass famine. And just when it seems to be inching toward a more rational relationship with its neighbors, an incident like the March 2010 sinking of a South Korean navy ship, *Cheonan*, reminds the outside world about how little it knows about how North Korea makes policy decisions.

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This outlaw behavior has typically met with international outrage and high-minded demands that North Korea be held accountable. In the end, however, the United States and the major regional players – China, Japan, South Korea and Russia – conclude they have little to gain and much to lose from confrontation. Sanctions are watered down, and North Korea hints that it could be bribed to refrain from further bad behavior.

This time around is probably no different. But the stakes seem especially high because the economy – and the regime that has managed it so badly – once again seem to be teetering. There has been much speculation not only about the succession, but also about the ability of North Korea's ruling gang to survive. Since the demise in 1994 of Kim Il-Sung (Great Leader, who had led the country since 1948), observers have periodically predicted

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the sudden collapse of the government in the face of rumors that Kim Jong-Il (Dear Leader, who succeeded his father) was in failing health. However, as the regime has survived economic crisis after crisis while maintaining one of the dozen largest conventional military establishments in the world, such predictions have become increasingly guarded.

Optimists believe that concessions to North Korea (combined with pressure from China) can mute its rogue tendencies. Pessimists point to a long history of abominable behavior, from the bombing murder of most of the South Korean government's cabinet in 1983, to its massive currency-counterfeiting and cigarette-smuggling operations, to its use of Japan as a missile-testing range. They insist that only relentless pressure through comprehensive economic sanctions will modify the country's belligerency.

Both camps, however, agree that progress in the economic and security arenas go hand in hand. Economic liberalization would improve economic performance and give the regime a bigger stake in the community of nations. By contrast, a retreat into ever-greater rigidity would put China, South Korea and Japan at greater risk of fallout – figurative and literal. A big question, then, in assessing North Korea's impact on the region is how the economy will evolve in coming years.

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ORGANIZED CRIME

Korea was a colony of Japan from 1905 until the end of World War II, and the North was briefly under the direct control of the Soviet Union thereafter. So the history of an independent North Korea really only begins in 1948. It is relatively well endowed with minerals, including coal and metal ores, though conspicuously lacking in oil and natural gas. By contrast, it has little arable land and highly variable weather – a glaring weakness because the leadership is committed to self-sufficiency in food.

The work force is literate, and there seem to be no fundamental cultural barriers to making it far more productive. But as long as the economy is so poorly managed, the question is moot. Handicapped by infrastructure and industrial capital stock that are hopelessly out of date, GDP per capita is a miserable $1,900 annually in purchasing power terms – less than that of Sudan, Laos or Cam-

bodia, and only a tad more than Chad.

The impact of adherence to a philosophy of extreme self-reliance, combined with flat-footed central planning, has been devastating. From 1995 to 1998, famine killed as many as one million people. Even in the best of times North Korea operates its obsolete manufacturing sector at only a small fraction of capacity for lack of fuel and spare parts. Meanwhile, the leadership's obsession with top-down control denies the economy the benefits of relatively cheap modern technologies. Mobile

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phones and Internet access are forbidden to all but the elite, and radio and television sets are manufactured to receive only government stations. Unauthorized travel within the country is banned.

Large segments of the population live in extreme deprivation. Goods available to a vast majority of North Korea's 23 million citizens are mainly agricultural products – the sector employs about 40 percent of the population. The bulk of the country's very limited resources go to maintaining a supersized army, developing and producing nuclear weapons and missile delivery systems, and providing a decent standard of living for the political and military elite.

Military control of so large a share of the nation's resources – between 15 and 30 percent of GDP – stemmed from Kim Jong-Il's early priorities. Instead of following China and other communist states toward market-based reforms after the death of the nation's patriarch, Kim Jong-Il invested heavily in the care and feeding of the military as a means of stabilizing his power. This strategy, dubbed "military-first politics" by Dear Leader himself, offered the bonus of protecting the regime against foreign threats, both real and imaginary.

Kim put forth an ingenious public rationale for this approach, turning the traditional "guns versus butter" trade-off on its head. He argued that defense would serve as the leading sector to spur development in other sectors – even in agriculture and light industry. This isn't quite as dumb as its sounds: in the post-Mao period, China permitted its armed force to develop its own diversified industrial base, which arguably served as an intermediate step toward market-based decentralization by giving the officer corps a direct interest in industrial productivity. But there isn't a shred of evidence that the approach has worked in North Korea.

Another leg to Kim's strategy for regime survival is what Charles Wolf of Rand calls the "court economy," a patronage system of sorts that funnels consumer goods to the nation's bureaucratic elite in return for support and a sense of legitimacy. Yet a third leg is the regime's organized-crime strategy in economic dealings with the rest of the world, which Kim uses to pay for the first two.

After defaulting on international debt in the 1970s, North Korea was frozen out of foreign capital markets and came to rely increasingly on illicit activities like drug trafficking, currency counterfeiting and insurance fraud to generate foreign exchange. Such crime-for-profit activities are reportedly orchestrated by a special office under the direction of the ruling Korean Workers Party. It is a surprisingly sophisticated operation, equal to the best of organized crime elsewhere. Indeed, there is considerable evidence that some of these activities involve complex transnational relations with various rogue-state and criminal networks.

North Korea's "rent seeking" also includes extortion: international payments for "protective services" – mainly promises to refrain from aggressive actions like the development of nuclear weapons and missile delivery systems. Payments often take the form of foreign aid in hard currency or commodity deliveries of fuel or food. Overall, the scale of this activity has been sufficient to provide a relatively comfortable life for North Korea's elite in the midst of economic ruin.

Unless things change drastically, the forty-fold GDP disparity between South and North Korea can be expected to widen because of the vicious circle in which the North has become entrapped. The circle begins with the country's economy in which state-planned and managed operations are inherently inefficient, a military-first policy drains resources

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from potentially productive sectors and the elite must be kept in the style to which it has grown accustomed. The resulting scarcities, in turn, prevent the country from improving infrastructure and investing in modern equipment, which leads to further deterioration in industrial and agricultural productivity. Low agricultural productivity leads to malnutrition, which diminishes labor force productivity. And since the elite's position has been secured by policies that inhibit growth, there is little incentive to change.

THE FUTURE AS REVEALED BY THE PAST

Though the motives of North Korea's leaders are open to interpretation, their past machinations do offer some insight into how the government will act in a period of economic trauma and transition in leadership. Consider some scenarios.

Muddling Through

In the base-case scenario, North Korea will pursue the same strategies that have kept its rulers on top for decades. Probably the key factor here is maintaining trade and investment flows from China and South Korea at levels adequate to satisfy the military and to generate survival rations for the masses.

The Special Economic Zone (SEZ) at Kaesong (some 50 miles from the South Korean border), created in 2003 and operated by the Hyundai Group, looms large here. It is used by some 120 South Korean manufacturers, who employ around 40,000 North Koreans at an average wage of about one-third of that

paid for comparable work in the South. All told, South Korea has invested roughly $600 million in Kaesong's infrastructure. Managers from the South run the factories, bringing in the necessary capital, equipment and technical expertise. South Korea even supplies the electricity – straight across the demilitarized zone.

The SEZ is walled off from the rest of the city, with worker housing provided by the North Korean government. The government chooses the workers. And while the gross wage rate is about three times that of the average North Korean worker, it's not known how much is diverted to government (and government officials') accounts.

Expansion of the SEZs would allow North Korea to bolster foreign exchange earnings without exposing the general populace to decadent Western influences. South Korea's motives for maintaining the SEZ are more political than economic: low wages can go only so far in compensating for the inefficiency of running an island economy in the midst of a police state. But one would expect that North Korea would like to make the model sufficiently attractive to induce other companies (and other Asian countries) to outsource production to isolated zones.

Whether this is practical is anyone's guess. Foreign investors would have little control over their work forces and no credible guarantee that their property wouldn't be confiscated.

Muddling through would also require North Korea to play its hand deftly, using a mix of extortion and promises of détente to keep the cash flowing. This may not be so difficult, though, as long as China's first priority is preventing a flood of refugees from North Korea and as long as South Korea considers the price of the status quo to be a bargain.

Flirting with the Chinese Model

Many observers doubt that the muddle-through approach is sustainable in the long run. No matter how carefully the government tries to wall off the SEZs, news of conditions beyond North Korea's borders are seeping through. And without some hope for a better life, North Koreans will increasingly question the regime's legitimacy. Indeed, to judge by reports from refugees, this process has already begun.

At some point, then, the government might well opt for economic liberalization as a

means of quieting discontent. It wouldn't be the first time: North Korea initiated a number of such changes in its economic system in the late 1990s and early 2000s. It was widely hoped at the time that these changes were the start of a trial-and-error process akin to China's reforms under Deng Xiaoping or Vietnam's more recent economic liberalization initiatives. But in contrast to China and Vietnam, North Korea's motives for reform smacked more of desperation than conviction that markets could legitimize the ruling elite.

In the 1990s, change was spurred by the collapse of the planned economy during the famine, when the public food distribution system designed to ensure survival rations ceased to function. As desperate North Koreans sought ways to feed their families, black markets (supplied by food smuggled from China or grown in private plots) sprang up. In hindsight, the government's decision to tolerate these markets seems purely tactical, unrelated to any larger vision of reform.

Reforms initiated in 2002 looked a bit more promising. Planning was partly ceded to local governments and factories. Wages were raised and linked to performance; prices for commodities were allowed to fluctuate according to supply and demand. And it became legal for families to sell food and consumer goods in local markets.

Note, too, that this was the time that the Kaesong special economic zone was established, and the exchange rate significantly devalued in what looked like an effort to position North Korea to compete in global markets. Eager to celebrate the opening of this bastion of autarky, analysts rushed to declare that the country had entered a new era. In the words of one, North Korea "crossed the Rubicon."

But in light of the timing, it's more likely that the reforms were simply another tactical lurch. In other economies that have transitioned from planning to markets, the state took the lead and tried to buttress the reforms by providing supporting institutions, like increased rule of law, property rights and regulatory reform. Marcus Noland of the Peterson Institute for International Economics and Stephan Haggard of the University of California at San Diego note that the North Korean case turned reform on its head, with change arising not out of a conscious top-down program, but as unintended (and in some respects, unwanted) byproducts of state failure. Comparisons have been made with the perestroika programs undertaken in desperation by Mikhail Gorbachev.

With free markets and no real institutional framework, North Korean refugees have reported that the 2002 reforms benefit the elite who run and profit from them, while making ordinary citizens even more vulnerable to scarcities.

While most North Koreans must now obtain a portion of their food from private markets, prices are typically 10 to 40 times higher than prices for state-rationed food (which is only sporadically available). And since just a tiny minority can afford to buy food on their official wages, the reforms effectively turned almost everyone into a scofflaw, hoarding, smuggling and demanding bribes on their own turf when they were able.

In 2005, the regime reversed course, banning private trade in grain and seizing privately held stockpiles in rural areas. Women under 40, the main cohort of traders, were barred from participating in the markets. "Antisocialist conscience investigation teams" were deployed to shut down the remaining markets. And travel restrictions were strengthened, especially along the relatively porous Chinese border. The government also expelled a number of foreign aid agencies, including the World Food Program, whose job

was to monitor the adequacy of food distribution in areas prone to shortages.

A similar sort of haphazard reform and reversal was apparent in the currency "reform" initiated in November 2009. The government announced it would knock two zeros off its currency, the won, ostensibly to fight inflation. People had just one week to trade in their old money for new notes, with each family permitted to exchange a maximum of 100,000 old won for 1,000 new won – less than $30. Here's the kicker: any cash in excess of the limit became invalid unless it was placed in bank accounts to which the depositors were not guaranteed future access.

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The life savings of what passes for a middle class in North Korea, along with merchants' working capital, were wiped out with the stroke of a pen. Thousands of people frantically tried to convert soon-to-be-worthless money into something of value. Prices of some goods rose hundredfold before traders shut down, realizing that their profits soon would be worthless, too. (Besides which, the reform would leave them without the money to restock.)

If there was any method to this apparent madness, the purpose of the currency reform was to destroy the budding private entrepreneurial class and to return ebbing power to those who live off the proceeds of government monopolies. While, in theory, virtually every adult works for the state, North Koreans do all they can to escape from its clutches. Farmers tend their own gardens as weeds overtake collective farms, and urban workers duck state assignments to peddle everything from metal scavenged from mothballed factories to televisions smuggled from China. Ironically, to cushion the blow of the currency reform, workers were promised that their salaries would be restored – in effect, giving them a large pay raise since old nominal salaries were now paid in the revalued currency.

All this implies that the Chinese model, however attractive it might appear to foreigners, does not mesh with the perceived interests of North Korea's rulers. Perhaps they are too isolated from the realities of the global economy to see the necessity of enduring economic reforms. Perhaps they know that they lack the technical skills to manage decentralized markets. Or perhaps their control over the levers of power is too insecure to give them the leeway to experiment.

But the country may once again be heading for a crisis in which business as usual simply won't cut it. Indeed, just a few months ago, the government tacked back toward freer exchange, allowing local markets to stay open longer and to sell food without restriction in order to stave off the threat of mass starvation.

Sudden Collapse

The fundamental economic collapse of a country with a huge conventional military, along with nuclear weapons and the means to deliver them, is without precedent. No one really knows, then, what would happen if already meager levels of production fell sharply, neighboring countries set conditions for helping that were unacceptable to North Korea's leadership, and control over the popula-

tion was lost. But it is possible to make an educated guess.

It is likely that large numbers of North Korean refugees would flee to the borders of China and South Korea, as they did in the 1990s famine. North Korea's rulers might be reduced to making side deals in which their safety and wealth would be protected in return for assurance that the military would stay in the barracks. Ultimately, the process would lead to some form of union between North and South, as Southerners were moved to take on the burden of impoverished Northerners by a combination of family ties, nationalism, pressure from the West and economic self-interest in ending the chaos.

There is general agreement that whatever the terms on which the North was absorbed, the cost would be enormous. In the latest forecast, a South Korean government think tank estimated that the price of reunification would amount to 2 percent of GDP for the next 60 years. Another government study estimated that renovating the North's dilapidated infrastructure would cost at least $1 trillion.

Foreign assessments are comparably daunting. In 2009, Credit Suisse estimated a cost of $1.5 trillion to raise North Korean incomes to 60 percent of those in the South. Peter Beck of Stanford believes that even this figure is far too low. He argues that raising income levels in the North to 80 percent of those in the South would become a political necessity and would cost $2 trillion to $5 trillion over 30 years.

But as high as they are, such figures are probably manageable for a couple of reasons. First, because South Korea has prospered mightily over the last four decades: with a GDP of some $1.4 trillion in purchasing power terms and a future growth rate of perhaps 3 percent, South Korea could spend $40 billion on the North in 2011 without reducing its current living standard. And $40 billion would double North Korea's income. Second, because the collapse of the North would allow the South to reduce its military outlays: while the South Korean defense budget is a secret, according to the World Bank it amounted to 2.6 percent of GDP in 2006. If that percentage remained constant, the budget was on the order of $30 billion in 2010.

To put the issue in further perspective, consider western Germany, which has been subsidizing the former East Germany to the tune of $100 billion annually since 1991. While South Korea's output is about half that of Germany, a comparable portion of the South Korean GDP would still amount to $50 billion this year. And, if the Korean economy grew at a modest 3 percent annually, the figure would rise to $90 billion in two decades.

THROUGH A GLASS, DARKLY

Ironically, no one (with the likely exception of a great majority of North Koreans) is eager to see North Korea collapse. Too much is at stake. China doesn't want a flood of refugees; many South Koreans fear the consequences of the economic dislocation. And nobody wants to face the increased prospect of military conflict during the transition, especially now that the North has nuclear weapons.

So the best guess is that, in the end, the North Korean regime and state will be given every opportunity to muddle through, whether or not it is willing to negotiate away its nuclear option. This doesn't mean that the economy (and the government) won't collapse one day. Indeed, it is hard to imagine a state so incompetent and so lacking in popular support surviving indefinitely. But the push will probably have to come from within. Sadly, we may have gotten to the point where there are no longer optimists when it comes to North Korea – only realists.