

## Who's Behind That Curtain? Unveiling Potential Leverage over Pyongyang

After more than a decade and a half of crises, negotiations, and agreements, North Korea is now believed to have produced enough nuclear material for several nuclear weapons. What now? As long as the North Korean regime believes that the status quo is sustainable, they will have little incentive to dismantle their nuclear program completely. Regardless of one's preferred endgame for the Korean peninsula, establishing effective levers of influence over North Korea is a vital first step in moving toward sustainable resolution of the nuclear issue.

It is currently unclear whether Pyongyang would agree to verifiable nuclear dismantlement in exchange for serious economic and political incentives from the United States. If such an agreement can be reached, it will pave the way for a nuclear-free peninsula. If it fails, the United States will have overwhelming international support to move toward a more coercive solution. Currently, Pyongyang simply responds to U.S. diplomatic overtures with threats and brinksmanship, a cycle that intensifies crises and the possibility of armed conflict on the peninsula. In return, the United States and other regional actors seem to have little ability to threaten or otherwise influence Pyongyang. Responding to the current situation by granting unreciprocated concessions to the North Koreans would likely exacerbate the problem; allowing North Korea to reap the economic benefits of broken promises will not lead to a sustainable solution.

Building an enduring solution requires understanding how to influence the North Korean regime. Although North Korea's power structure is noto-

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riously opaque, a clear group of elites, led by Kim Jong Il, hold the overwhelming balance of power. Three interrelated but somewhat conceptually distinct areas, or levers, of influence over the Pyongyang elites may exist: cultural-political, military, and economic. The U.S. military has traditionally served as the fulcrum of U.S. influence with North Korea, while cultural levers of influence held by South Korea and China seem to exist but are notoriously difficult to quantify and predict. Economic levers may offer a new mechanism for increasing the relative influence of the United States and its allies over Pyongyang. Although existing knowledge is limited by inherent uncertainties about the North Korean regime, including the nature of elite relationships and the bases of economic and political stability, data gathered from South Korean, U.S., and international sources have begun to paint a matrix of a North Korean economic system potentially vulnerable from multiple directions and sources.

Any effective, long-term resolution of the North Korean nuclear issue, whether through multilateral, bilateral, or no talks at all, will be successful only if all interested and influential states cooperate with one another. Although the road to Pyongyang traditionally has been through Beijing, careful examination of the potential cultural-political, military, and economic sources of influence available demonstrates that U.S. coordination with Japan and especially South Korea, particularly to crack down on Pyongyang's sources of hard currency, is also important. Combining each of these state's independent sources of influence on Pyongyang will maximize the potential to convince Kim Jong Il to abandon North Korea's nuclear program permanently.

## **Reading Tea Leaves: Potential Cultural-Political and Military Influence**

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### **CULTURAL-POLITICAL**

Deriving sources of cultural or political influence is inherently abstract; measuring it is very difficult. At first glance, the ability of any country culturally to influence Pyongyang seems weak. North Korea's *juche* philosophy of extreme self-reliance emphasizes the uniqueness of the North Korean experience, limiting its similarities with others. North Korea does, however, share a cultural heritage with South Korea and China. This type of influence seems to function either by providing policy role models, such as the Chinese economic model for reforming the North Korean economy, or by increasing trust in the minds of one country's elites about the calculations and advice of the leaders of another country with similar historical and ethnic experiences.

The United States obviously shares few cultural similarities with North Korea and therefore has little cultural or political influence. Other countries, however, may be able to exert some influence. In the past, the North Korean regime had two staunch allies: the Soviet Union and the People's Republic of China (PRC). With the collapse of the Soviet Union, an important link between North Korea and the outside world disappeared, and although North Korean–Russian ties have slightly improved in recent years, relations do not approach Soviet-era levels.

This great change has left China as North Korea's only remaining ally. China's relationship with North Korea has been prototypically described as being as close as "lips and teeth." Unfortunately, China's cultural influence on North Korea, although rooted in history and geography, has likely declined in recent years as Pyongyang's paranoia about its own stability has increased. Generational turnover among military elites has eliminated personal ties built from a sense of shared experiences in the Korean

War, while internal instability in North Korea has made Kim Jong Il wary of admitting any foreign influences that might accentuate disruptive trends. Chinese market reforms may serve as a positive model for economic growth, but they also have created perceptual and substantive differences between the experiences of elites in each country. Chinese elites, who now speak the language of market economics and worry about banking reform or foreign investment, have less in common with their still-isolated North Korean interlocutors than counterparts in previous generations. Such differences may limit China's cultural-political influence over North Korea.

On the bright side, some evidence indicates that North Korea is reconsidering its general rejection of Chinese-style economic reforms, although the steps are halting and the reasons not entirely clear. According to Shim Jae Won, a senior executive vice president at Hyundai involved in economic negotiations with North Korea, Kim Jong Il's visit to Chinese economic zones in Shanghai and Shenzhen may have changed North Korea's perspective.<sup>1</sup>

This statement suggests that the situation in North Korea has deteriorated to the point that the leadership is now willing to consider new measures and illustrates the country's potential susceptibility to new leverage strategies. Although the North Korean regime seems acutely aware of its relative international isolation, Pyongyang nevertheless remains very paranoid about establishing the types of links that could generate an influx of subversive influences. Creating special economic zones might allow foreign-

**China's cultural-political influence on North Korea has likely declined in recent years.**

ers unprecedented access to North Korea, leading to increased desire among the population for more freedoms and to a new conduit for refugee flows. Therefore, although it still has unique access to the North Korean leadership, allowing it at least to convey clear messages, Beijing may not have the same level of cultural leverage over North Korea that has been commonly assumed.

Conversely, South Korea's cultural-political influence on the North Korean population may very well be larger than is presumed. Anecdotal evidence reflected in the editorial pages of leading South Korean newspapers, survey data recently published by CSIS,<sup>2</sup> and the results of general elections in South Korea on April 15, 2004, that tripled the seats of the center-left Uri party collectively show that, concurrent with rising anti-Americanism, the South Korean public increasingly believes in the idea of a shared destiny with North Korea and seeks some sort of major reconciliation. The majority of South Koreans still oppose reunification (with the example of East Germany serving as an important reminder of the potentially massive economic costs), but the margin is narrowing.

Although it is impossible to say with certainty, given the North Korean regime's airtight control over the "education" of its population, a similar belief may exist within North Korea. State propaganda from Radio Pyongyang does seem to promote the idea that North and South Koreans are brothers and belong as one country. Several questions, however, remain unanswered: To what extent might a belief in a shared cultural destiny with South Korea animate North Korea's strategy? If such a shared belief does in fact influence North Korean behavior, what are the implications for designing the strategic levers most likely to effectively influence the North Korean leadership? Official high-level contacts between governmental officials from North and South Korea are still the exception rather than the rule, but increasing economic and lower-level political contacts could help bolster overall ties between the two countries, providing South Korea with unique cultural leverage in the medium term. Nevertheless, recent disputes about increasing refugee flows from North to South Korea and uncertainty about the next summit demonstrate that this process will be slow.

## **MILITARY**

Unlike cultural influence, military influence is more tangible. Military influence can function in a negative fashion through threats and coercive actions designed to deter or compel certain behaviors. Positive military incentives can involve the provision of financial assistance, equipment, or even assurances not to attack under certain circumstances. Given that North Korea's security strategy, especially its public justification, largely revolves around perceived

threats from the United States and, to a lesser extent, South Korea, developing military leverage over the North Korean regime seems quite possible.

U.S. military leverage theoretically functions both in a negative fashion, as U.S. deployments and commitments deter North Korean military adventurism, and in a positive fashion, because incentives to ratchet down military tension might elicit cooperative behavior from Pyongyang. This is not to say that Washington should make direct military concessions to Pyongyang in response to threats; doing so would serve to reinforce the North Korean belief that their foreign policy goals can be best achieved through brinkmanship. Yet, U.S. military power remains a potential source of leverage and will inevitably be employed as a piece of a negotiated agreement to dismantle North Korea's nuclear program or if a new nuclear bargain is not achieved.

Predictions about North Korean threat perceptions must take into account the multiple, credible interpretations of Kim Jong Il's motivations. Very little international support for U.S. military action against North Korea exists, making it difficult for the United States to leverage a military threat credibly unless the status quo on the peninsula deteriorates. Although the proposed U.S. withdrawal of some of its forces from South Korea has shaken up U.S.–Republic of Korea (ROK) ties, its impact on the U.S.–Democratic People's Republic of Korea (DPRK) military balance is likely to be very small. U.S. forces in South Korea have generally been viewed as a stopgap that will delay and damage, but not completely repel, an initial North Korean strike. Rather, U.S. air power and rapidly deployable reinforcements have always been critical.

One goal clearly articulated by the North Korean regime over the last decade that may explain its recent behavior has been to obtain a “complete, verifiable, and irreversible security assurance,”<sup>3</sup> a promise that the United States will not launch a preemptive or preventive military attack on North Korea. Another possibility, however, is that the negative security assurance demand is just a bargaining chip. U.S. negotiators have held out the possibility of a negative security assurance or other limited military concessions if North Korea made substantive concessions in its nuclear program, which the North Koreans have refused to make so far. For example, in the June 2004 six-party talks, the U.S. proposal for resolving the nuclear issue included an offer of a negative security assurance in response to North Korean nuclear dismantlement.<sup>4</sup> Yet, granting a negative security assurance to Pyongyang without receiving at least a verifiable freeze leading to the dis-

**North Korea may be more vulnerable to external economic pressure than many assume.**

mantlement of North Korea's nuclear program carries some risks. Pyongyang might simply pocket the negative security assurance and use the diplomatic momentum to shift negotiations to other issues, such as the deployment of U.S. troops on the peninsula, a peace treaty, or the formal treaty relationship between the United States and South Korea. The point is not the specific demand, but rather the idea that unreciprocated concessions may convince Pyongyang that it has the ability to forestall resolution of the nuclear issue with indefinite demands.

**Five possible primary sources of North Korean hard currency exist today.**

Some empirical evidence supports this fear. In 1991, North Korea claimed that U.S. nuclear weapons in South Korea were the critical factor motivating its nuclear program. When the United States withdrew its nuclear weapons from South Korea as part of a reconfiguration of U.S. forces following the collapse of the Soviet Union, North Korea shifted its demands, asking for an unprecedented level of access to South Korean and U.S. military facilities to “confirm” that the nuclear weapons had been withdrawn. This method of partial compliance, at best, while simultaneously shifting the goalposts or ratcheting up demands is well documented in North Korean negotiating tactics.<sup>5</sup>

Essentially, giving North Korea a security assurance without verifiable nuclear dismantlement is unlikely to create diplomatic momentum and risks delaying an ultimate solution by prematurely taking the stick out of U.S. hands.

By consistently raising issues such as the negative security assurance, Pyongyang could also be trying to set a trap for the United States, seeking to drive a wedge between the United States and Japan as well as South Korea no matter how Washington responds. If Washington grants a negative security assurance to Pyongyang, absent receiving verifiable concessions, it could create the perception in South Korea and especially Japan that the United States is insufficiently committed to resolving the nuclear dispute. Because of concern about military overextension due to deployments in the war on terrorism, U.S. actions could be perceived as a resource-based compromise, creating concern that the United States is willing to look the other way and accept de facto North Korean nuclear weapons. Conversely, a U.S. refusal to grant a negative security assurance to North Korea in the face of more cooperative behavior from North Korea could damage U.S. relations with Japan and especially South Korea by making the United States appear belligerent. These complications confront policymakers attempting to utilize U.S. military might to leverage North Korea.

Unlike North Korea's adversarial military relationship with the United States, North Korea has a traditionally close military relationship with China, giving Beijing a different sort of military leverage over Pyongyang. PRC intervention in the Korean War likely saved the North Korean regime, and close military contacts between the two countries continued throughout the Cold War. Contacts, including military technology transfers, provided Beijing with access to North Korean elites, giving China leverage. In recent years, due to economic and geostrategic reasons as well as generational turnover, ties have cooled. Some military to military ties between the People's Liberation Army (PLA) and the North Korean army remain intact, but the precise amount of cooperation remains uncertain.

In this ambiguous context, reported Chinese troop movements near the North Korean border in the fall of 2003 raise additional questions about the current state of Sino-North Korean military cooperation. PLA units reportedly replaced police units along the border. The PLA may have been setting up contingency plans for a potential refugee flood in case North Korea collapses or a war were to begin. At a minimum, Beijing may have been signaling that it takes the potential seriously. Instead of allowing North Korean refugees into China, highly trained PLA forces theoretically could push a few miles into North Korea and set up refugee camps on the North Korean side of the border, making it easier to deny permanent entry into China. Pyongyang may have concluded from this incident that China's support is not guaranteed in the case of a future crisis and that China is not confident in the future of the regime. Unfortunately, a lack of concrete information on this incident or of an explanation for Chinese behavior leaves room only for speculation. China may alternatively simply have conducted an entirely normal troop rotation but leaked word to try and convince the United States it was taking the North Korea issue more seriously, thus gaining diplomatic points with Washington.

Militarily leveraging the North Korean regime will be difficult. Although the United States possesses overwhelming military superiority, it is not clear if it can credibly threaten an attack at the present. Military power may be more positively utilized in the form of a negative security assurance to induce North Korean cooperation, but such incentives would also incur risks. China's military leverage over North Korea is similarly unclear. North Korea would certainly count on Chinese support in the event of a military contingency on the peninsula, but China's actual actions are difficult to predict.

## **Economic Leverage**

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Although plagued by its own uncertainties, largely as a result of the opacity of the North Korean economy, relatively more accurate conclusions can

be drawn about North Korea's economic vulnerabilities and the ability of the United States or East Asian actors to put economic pressure on North Korea to dismantle its nuclear program. The trick with economic leverage is to take care to threaten the economic prosperity of Kim Jong Il and the regime elites but not bluntly damage the North Korean economy as a whole, harming its already undernourished population. To accomplish this, attempts to wield economic leverage should target North Korean means of acquiring

**PSI has begun targeting nuclear and missile weapons exports successfully.**

hard currency. It will require establishing new multilateral initiatives focused on restricting North Korean profits from drug smuggling and counterfeit operations to complement existing, successful efforts to cut into North Korea's arms export profits, such as the Proliferation Security Initiative (PSI). Cutting the flow of remittances—wages from relatives of North Koreans living abroad—to North Korea will also help

target regime elites. The goal is to convince North Korea that its previous methods of generating hard currency are no longer sustainable, thus making the country's only option for economic survival the receipt of benefits if it irreversibly dismantles its nuclear program.

A successful strategy must therefore not only be able to give economic benefits to North Korean elites as an incentive for progress but also be able to threaten Kim Jong Il's economic affluence directly. An economic strategy that only focuses on incentives simply leaves room for Kim Jong Il to continue attempting to extract resources from the United States and its allies indefinitely without giving up his best bargaining chip, his nuclear program.

Determining the effective economic pressure points on the North Korean regime requires isolating the sources of prosperity for the North Korean leadership. Essentially, unless the United States and its allies develop the ability to hit Kim Jong Il where it hurts—in his wallet—the cycle of brinkmanship and intimidation is likely to continue. This is already part of U.S. strategy to some extent. Because of North Korea's political orientation as a Communist country that fought a war against the United States, exports of dangerous weapons, terrorist activities (most notably the destruction of Korean Air flight 007 in 1987), and human rights violations, however, U.S.–North Korean economic transactions are severely restricted under the Export Administration Act, the Arms Export Control Act, and various other regulations. As a result, Washington must influence other countries to alter their economic relationships with North Korea and constrict Pyongyang's sources of hard currency.

## **EVALUATING ECONOMIC LEVERAGE OVER THE DPRK**

Determining exactly what those economic vulnerabilities are is certainly not easy. The experience of the collapsing Communist states in Eastern Europe in 1989 highlights the challenges inherent in predicting economic and political trends in autocracies with command economies, particularly if one is trying to predict when a political regime might collapse (whether one is trying to cause the regime to collapse or avoid it and the subsequent consequences). When a regime is about to collapse, for example, a previously powerful central government reaches a tipping point where it rapidly loses control of the population. Unfortunately, predicting the precise timing of that tipping point is quite difficult. The case of Romania, the state in Eastern Europe that appeared the most centrally controlled and invulnerable to protest but collapsed the fastest, highlights this phenomenon.

North Korea is no exception, and the increasing flows of refugees out of the country could symbolize growing internal dissent that may snowball out of control. In just two days in July 2004, almost 500 North Korean refugees arrived in South Korea, up from about 1,200, according to some estimates, in all of 2002.<sup>6</sup> This could signal increasing dissatisfaction that, as in Eastern Europe, could rapidly erode the control of the regime. On the other hand, despite representing a large increase, the outflow may not threaten the viability of the Kim Jong Il regime.

Determining how North Korea may react to external economic pressure is also uncertain. It is quite possible, for example, that resource extractions from North Korea's citizenry can be increased, the elites could handle a large decrease in their standard of living, the government could convince other countries either to increase foreign aid or simply forgive the annual deficit (and escalating debt), or North Korea has other unknown sources of hard currency. Knowledge of the intricacies of the North Korean economy and government, especially its centers of gravity, is incomplete at best, highlighting the large degree of uncertainty that should surround these and other claims about leveraging North Korea. Despite this fundamental uncertainty about the North Korean economy, its revenue sources, and its dynamics, some evidence is available, especially for recent years. Improving policy will require increasing knowledge of the North Korean economy, but recommendations on the basis of existing data are still possible.

## **NORTH KOREA'S ECONOMY TODAY**

Some signs indicate that North Korea's economy has improved during the last few years. Data from the Korean Ministry of National Unification and the Bank of Korea (Seoul) show that gross national product growth aver-

aged 3.1 percent in 1999–2002, a reversal from annual decreases averaging 3.8 percent in 1995–1998 and 4.5 percent in 1991–1994.<sup>7</sup> The opening of rail and some road links with South Korea will facilitate an increase in inter-Korean trade; small-scale capitalist reforms, including new initiatives to allow internal markets in North Korea and joint investment projects with South Korea, promise to increase growth further. Although 6.5 million North Korean people, according to the CIA, out of a total population of approximately 22.7 million are currently at risk of starvation, the UN food agency recently reported that they probably had enough food to cover projected needs for the remainder of 2004.

**DPRK drug trafficking and counterfeit operations have increased during the last decade.**

Despite these improvements, North Korea's economy remains very vulnerable. Recent market reforms have made some analysts optimistic about the prospects for a North Korean soft landing—modest economic reforms that improve North Korea's economic conditions without introducing political instability, allowing for the sustainable perpetuation of the Kim Jong Il regime—yet these same reforms already are creating economic turbulence. Currency

reforms have massively devalued North Korea's currency, the won, sending commodity prices, especially food prices, skyrocketing. According to Michael Ragan, the head of the UN World Food Program in North Korea, the cost of a kilo of rice has inflated from 130 won in mid-2003 to 700 won in mid-2004. This latter figure is almost one-third the monthly salary of a laborer, meaning that, once rice and other food purchases are taken into account, some families are spending up to 80 percent of their income on food.<sup>8</sup>

Although its domestic economy has rebounded in recent years, North Korean elites appear to rely heavily on international contributions and income derived from illicit sources. This could imply that North Korea is more vulnerable to external economic pressure than many assume. North Korea's economy is quite small, with a 2003 gross domestic product (GDP) of almost \$23 billion, according to CIA sources.<sup>9</sup> Other estimates judge its economy to be even smaller, meaning that holding relatively small proportions of assets at risk should have a much greater impact on North Korea than it would on most other countries. Because North Korea does not publish official trade data, information on the country's trading patterns can be generated only through "mirror statistics," data gathered from Pyongyang's international partners. The data reveal a complex pattern of economic interactions, the most important being North Korea's persistent annual trade deficit, which rose to \$1.3 billion in 2003.<sup>10</sup>

The largest part of this deficit is held by China, which also conducts the greatest volume of trade with North Korea,<sup>11</sup> but the relative influence of North Korean trade with other countries is increasing.<sup>12</sup> Nicholas Eberstadt, an expert on the North Korean economy, argues that understanding North Korea's economy requires isolating its non-Chinese foreign trade because it is a large part of its economy and not directly financed by China. North Korea's trade deficit with countries other than China has risen from a low of \$50 million in 1997 (with North Korea's GDP for that year estimated at \$18 billion) to almost \$1 billion in 2002 and 2003. The trade deficit excluding China is equivalent to about 4 percent of North Korean GDP, compared to about 0.02 percent in 1997, while the trade deficit with China alone accounts for about a full percentage point, compared to about 2.7 percent in 1997. Consequently, even though China alone has the largest amount of economic influence, the other players combined now have great economic influence over North Korea.

In the last two years, South Korea's relative share of trade with North Korea has increased, becoming North Korea's second-largest trading partner. North Korea's trade with China, after inter-Korean trade is factored into the statistics for total trade volume, accounted for about 33 percent of North Korea's total trade volume in 2003. Right behind is South Korea, with about 23 percent. In comparison, trade with Thailand accounted for about 8 percent, Russia 5 percent, and India 3 percent. Japan, which was North Korea's largest export market in 2001, is currently North Korea's third-largest market. After adjustments for the use of mirror statistics, North Korea's overall global economic interactions grew from about \$2.5 billion in 1997 to just over \$3.2 billion in 2003. With a GDP of \$23 billion in 2003, presuming the largest estimate of the size of its economy, the total volume of foreign trade appears to be equivalent in size to about 13 percent of North Korea's GDP.

Essentially, North Korea runs a large trade deficit every year, but it is unclear how it pays for it. It also seems to run an annual budget deficit. Even if governmental revenues have increased in recent years, it is quite unlikely that North Korea can domestically generate the hard currency needed to balance its current account. Payment and default issues from the 1970s prohibit North Korea from receiving loans from the International Monetary Fund and the World Bank. Chinese aid does not cover North Korea's non-China trade deficit, meaning that North Korea must raise funds from other sources. (China simply does not provide the funds to underwrite it, probably believing they already give enough money to North Korea every year.) Reports sponsored by the U.S. House of Representatives and the Japanese government suggest that North Korea diverts international aid to support its military and free up governmental revenue for North Korea's nuclear and missile programs.<sup>13</sup>

Collectively, these factors suggest that North Korea has an annual need to import hard currency. Although impossible to know for sure, it also seems reasonable to assume that these cash infusions stabilize North Korea's economy. Given its likely budget deficit and increasing trade deficit, hard-currency importations are necessary to reduce the potential leverage of regional players and the threat of their undermining the careful isolationism practiced by the North Korean regime. Therefore, those economic interactions that fund North Korea's trade deficit may be the same interactions that allow for the prosperous survival of the North Korean leadership. Identifying these sources of revenue could help place the prosperity of North Korean elites at risk.

One way to unveil the economic assets most important to the North Korean elites is to search for national economic irregularities explainable only by the idiosyncrasies of elites in a command economy, such as the construction of palaces, disproportionate defense spending, and other activities. Research and analysis of North Korea's external economic activities reveals five possible primary sources of North Korean hard currency that, taken together, seem potentially substantial enough to fund the regime: weapons exports, illegal drug sales, counterfeit operations, remittances from abroad, and international aid.

## **WEAPONS EXPORTS**

North Korea's weapons exports traditionally have comprised an important part of its foreign policy for geostrategic and economic reasons. Countries that purchase weapons or weapons components from North Korea generally pay in cash, providing direct monetary support for the regime. Upper-level estimates from U.S. military analysts in South Korea placed North Korea's income from weapons exports at about \$560 million in 2001, representing almost 2 percent of the country's total legitimate economy.<sup>14</sup> Money from arms sales flows directly into the coffers of elites and helps fund North Korean nuclear and missile programs. Targeting these sales is an especially attractive option for U.S. policymakers seeking to develop sources of leverage over North Korean elites. This helped motivate the Bush administration's PSI.

North Korean weapons exports are mostly comprised of missile technology and nuclear expertise, with traditional clients including Pakistan and Iran. Although North Korea's weapons exports declined in the early 1990s, they also began to occupy an increasing proportion of the country's hard-currency reserves and total trade, due to the enormous relative decline in the size of the North Korean economy. In 1995–1999, Department of State data, considered a conservative estimate, showed that North Korea exported

an average of \$100 million in weapons technology annually, an enormous decline from its yearly average of \$404 million in the 1985–1989 period.<sup>15</sup> In 1999, North Korea's arms exports represented approximately 22 percent of its total exports, the second-largest percentage of weapons exports to total exports in the world, behind Eritrea.

Three significant changes in the international security environment during the last five years likely will reduce North Korean weapons export profits. First, improved U.S. relations with countries such as Libya, Egypt, and Pakistan have reduced North Korea's client list.<sup>16</sup> These changing market conditions have forced North Korea actively to seek new clients. In early 2004, for example, North Korean officials traveled to Nigeria in an attempt to sell it missile technology. Although Nigeria denied signing a deal with North Korea, definitive evidence has not yet been made public. The international opposition to the deal, which embarrassed Nigeria, demonstrates the obstacles North Korea will face in trying to create markets for future weapons exports. Second, early indications are that the PSI is successfully playing an important role in restricting North Korean nuclear and missile exports, further reducing the list of states willing to buy from North Korea. Third, those relationships that North Korea has been able to maintain now generally involve less-profitable component sales rather than the export of complete missile systems. Because it is easier to track complete missile systems, the recipients of exports do not want to be officially associated with the North Korean regime. As the relative technological level of the missile programs in countries such as Iran and Pakistan has risen in recent years, the market for complete missile sales has also declined. Altogether, these changes have begun to cut into a significant traditional source of North Korean hard currency.

**Multilateral or bilateral talks is a false dichotomy and ultimately holds little relevance.**

### **DRUG TRAFFICKING AND COUNTERFEIT OPERATIONS**

In contrast to successes in reducing weapons exports, North Korean drug trafficking and counterfeit operations have increased during the last decade. If anything, declining arms exports have elevated the importance of drug trafficking and counterfeiting in North Korea's economy. North Korea has emerged as a leading international drug dealer, primarily exporting heroin, methamphetamines, and opium. Unofficial reports claim that North Korea has dedicated 4,000–7,500 hectares of land to illicit drug production.<sup>17</sup> According to the highest estimates from U.S. military analysts in South Korea,

drug trafficking and counterfeiting may account for between \$500 million and \$1 billion a year, or the equivalent of 2–4 percent of North Korea’s total GDP, based on the GDP calculation above.<sup>18</sup> As with arms sales, profits from these illicit activities likely bolster North Korean foreign currency coffers, meaning they directly benefit regime elites and North Korea’s military programs.<sup>19</sup>

U.S. policy currently seeks to restrict North Korean drug trafficking and counterfeiting operations. The Bush administration is working with Japan and South Korea to restrict drug and counterfeit transfers through their

countries and has encouraged all countries to increase their counternarcotics and anticounterfeiting efforts with regard to North Korea.<sup>20</sup> Deputy Assistant Secretary of Defense for Counter Narcotics Andre Hollis argued before Congress in 2003 that the Department of Defense was reviewing its counternarcotics policy with regard to North Korea, exploring ways to implement a more effective strategy.<sup>21</sup>

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**U.S. options may be much broader than military threats and appealing to China.**

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These efforts, however, seem to lack diplomatic priority. First, although the 2003 International Narcotics Control Strategy Report by the State Department, released in March 2004, contains the harshest statements from the U.S. government to date concerning North Korean drug trafficking, North Korea has still not been officially designated a drug-producing nation under the Foreign Assistance Act.<sup>22</sup> This has likely not been declared because such a designation, requiring State Department confirmation that North Korea is utilizing more than 1,000 hectares of land for drug production, would require foreign aid cutoffs under the 1961 Foreign Assistance Act. Nevertheless, by continuing officially to equivocate on the extent and importance of North Korean drug trafficking, the administration makes it difficult to rally international support for a crackdown. Second, Raphael Perl, a U.S. government expert, argues that the State Department may currently view drug interdiction efforts as a diversion from the diplomatic focus on North Korea’s nuclear program, rather than as a complimentary element of the U.S. North Korea strategy.<sup>23</sup>

Although the domestic war on drugs in the United States reveals the difficulties involved in restricting illicit drug sales, if such leverage could be established over both drugs and counterfeit trade, it would offer the United States and its allies substantial leverage over North Korea. Achieving verbal agreements with the international community on this issue will be easy, but the challenge of monitoring North Koreans abroad, and especially of regu-

lating the travel and behavior of North Korean diplomats—an important conduit for drugs and counterfeit—will be quite difficult.

North Korea's drug trafficking strategy includes producing and selling drugs as well as coordinating those sales with North Korean diplomats. For example, Pyongyang has converted the activities of some of its agricultural facilities to opium production, and North Korean diplomats are known to carry drugs for export in their diplomatic pouches, allowing them to escape scrutiny much of the time. North Korean nationals and diplomats were arrested on drug trafficking charges 50 times during the 1990s in more than 20 countries.<sup>24</sup> Although China is the primary export route for drug trafficking, due to the relatively high number of North Korean diplomats in Beijing and connections with Chinese criminal organizations, drug busts uncovering North Korean drug trafficking took place in every major state surrounding North Korea over the last seven years, according to Kim Young Il, a former official in the North Korean National Security Agency.<sup>25</sup>

The North Korean regime also raises money through high-technology counterfeiting operations. Pyongyang has developed very sophisticated counterfeiting techniques, including producing U.S. \$100 bills as well as currency from other countries. As with drug trafficking, embassies and confidential diplomatic pouches form an important means for the transportation and dissemination of counterfeit bills.

Reliable data on the economic impact of North Korean drug trafficking and counterfeiting operations is almost impossible to gather, and estimates subsequently vary widely. Based on an assessment of publicly available U.S. governmental and nongovernmental sources on illicit North Korean activities, Perl has concluded that "conservative estimates suggest North Korean criminal activity, carefully targeted to meet specific needs, generated about \$85 million in 1997: \$71 million from drugs and \$15 million from counterfeiting."<sup>26</sup> Higher-end estimates of counterfeiting by the Economist Intelligence Unit place the possible economic impact of counterfeiting at almost \$100 million per year.<sup>27</sup>

Given North Korea's limited access to normal international markets and North Korean elites' tight control over the economy, drug trafficking and counterfeiting operations will likely increase. If the next U.S. administration and its allies can rein in these two sources of hard currency, leverage over North Korea would substantially increase.

### **CASH TRANSFERS AND INTERNATIONAL AID**

A final area of economic support for North Korean elites is pure hard currency in the form of remittances—direct cash transfers of wages earned by relatives of North Korean citizens living abroad, mostly from Japan, and of

**J**apan and South Korea possess more economic influence than most analysts recognize.

international aid, which includes food. Estimates of remittances and international aid for 2003 placed their combined value at about \$360 million, or the equivalent of a full percentage point of the North Korean economy. In some ways, credibly threatening this revenue stream would be simpler than threatening the revenue generated by weapons sales, drug trafficking, or counterfeiting operations. In the latter three cases, North Korea is exporting a (generally) illegal commodity, making it difficult to stop because the United States has little existing leverage over North Korea and because the people and countries providing money to Pyongyang are not the most reputable of

international actors. Leveraging the North Korean regime by placing financial transactions and aid at risk thus should be easier to manage as the actors that need to be influenced are neither Pyongyang itself nor black market dealers or rogue states, but rather include U.S. allies such as Germany, Japan, and South Korea.

Current U.S. foreign policy efforts attempt to restrict the amount of international aid received by North Korea and cut back on re-

mittances and other direct financial transfers (also mostly from Japan) while not exacerbating famine. From 2002 to 2003, driven by U.S. and Japanese restrictions, total international aid to North Korea declined from about \$258 million to \$160 million. Japanese remittances have long been a major source of income for the North Korean regime. Lax trade regulations in Japan allowed the General Association of Korean Residents in Japan, *Chosen Soren*, to funnel millions of dollars each year to North Korean elites. Work remittances from networks of North Koreans living in Japan and profits from pachinko parlors, a popular Japanese after-work diversion that combines pinball and slot machines, are transferred to North Korea. North Korean loyalists may own almost 30 percent of the pachinko business in Japan.

Eberstadt describes a presentation by the director general of the Japanese Agency for Public Security and Investigation before the Japanese Diet in 1994 estimating yearly remittance transfers from Japan to North Korea as averaging \$650-850 million.<sup>28</sup> The former Japanese foreign minister, Tsutomu Hata, once estimated annual transfers to North Korea to be as much as \$2 billion a year.<sup>29</sup> Based on a variety of indicators, however, Eberstadt himself argues that remittances were likely only about \$100 million annually throughout the 1980s and early 1990s.<sup>30</sup> Regardless, the level of financial transfers was substantial. Based on North Korea's GDP at the time, low estimates project these remittances to account for about 1 percent of the economy; higher projections rose up to almost 3 percent.

During the last few years, the Japanese financial pipeline to North Korea has clearly begun to close. After the North Korean missile test over Japan in 1998, popular dissatisfaction in Japan with North Korea's behavior reduced the number of those previously willing to ship remittances to North Korea. In 2002 the only Japanese bank that had a direct relationship with North Korea, Ashikaga Bank, suspended all direct transfers. In 2003, Tokyo began cracking down on commercial shipping between the two countries. Despite these actions, the Economist Intelligence Unit estimates that transfers of money from Japan to North Korea may still have been worth up to \$200 million dollars in 2003. The Diet even passed new laws in June 2004 making it easier for Japan to outlaw sending remittances to and trading with North Korea in the future. The new laws also target Mangyongbong-92, the only direct ferry between North Korea and Japan, as well as North Korean cargo ships. By more closely monitoring the cargos of Mangyongbong-92 and other ships that may end up in or come from North Korea, the new laws will restrict North Korea's ability to smuggle goods into Japan and the ability of North Korean expatriates to transfer money and other items into North Korea illicitly.

Japan's approach to the issue contrasts with South Korea's. Excluding the direct financial support it likely receives from China, which may be up to a billion dollars annually, the most important future source of economic support for the North Korean regime will likely come from South Korea. According to the International Food Aid Information System, from 1996 to 2002 South Korea trailed only the United States and China in giving food aid to North Korea.<sup>31</sup> South Korea's Ministry of Unification reported in April 2004 that South Korea had directly contributed \$622 million to North Korea from 1996 to April 2004, a total that excludes the \$321 million provided by South Korean nongovernmental organizations during the same period.<sup>32</sup> South Korea has provided \$72 million in rice aid per year to North Korea for the last few years, even purchasing rice from abroad in June 2004, due to domestic shortages, to deliver to North Korea. Of the estimated \$434 million in exports by the South to the North in 2003, most of it was reportedly in the form of aid rather than commercial trade. Moreover, the opening of inter-Korean rail and road links, scheduled for October 2004, may open the door to illicit transactions in addition to greater legal transactions. Such activities could complicate the ability credibly to threaten revenues from international aid and financial transfers.

### **Implications for Strategy: Go beyond China**

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Combating Pyongyang's very diverse set of legal and illegal contacts that generate its hard currency throughout the world requires a multilateral ap-

proach. The United States must work with the key countries involved to ensure that pressure is correctly, rather than indiscriminately, applied to North Korean elites. Building the capability to continue restricting weapons exports, to crack down on North Korean drug trafficking and counterfeiting operations, and to set clear conditions for aid and remittance flows may allow the United States and its allies to place the economic prosperity of North Korea's elites at risk, putting pressure on the North Korean regime in ways that the traditional package of U.S. economic sanctions have failed to

**E**ffective coordination of U.S. and South Korean strategy may prove rather challenging.

do. In the best case scenario, using multilateral cooperation to pressure North Korean elites directly will raise the cost of maintaining a nuclear program to levels impossible for the regime to sustain, leaving North Korea with little choice but to negotiate in good faith.

The limited U.S. presidential debate on North Korea focused on the importance of multilateral or bilateral talks, but this approach is a false dichotomy and ultimately

holds little relevance. What is important is whether Pyongyang will feel pressure if it refuses to be willing to reach a negotiated settlement and whether renewed North Korean brinksmanship will fail to elicit economic benefits for the regime. Without the credible ability to make the status quo worse for Pyongyang and to checkmate its traditional, flailing brinksmanship strategy to get more concessions, the United States and its allies will remain relatively powerless to influence Pyongyang's strategic choices.

In general, a serious lack of knowledge about the inner workings of the North Korean regime necessitates caution in attempts to interpret Pyongyang's behavior, including its demands for bilateral talks with Washington. Given the nuclear weapons program's centrality in North Korean strategy and its success both in eliciting economic gains and potentially prolonging the survival of the regime, North Korea will be extremely reticent to dismantle it completely, no matter how good the offer. When dealing with a country as economically and politically secluded as North Korea, the United States and its allies should be wary of accepting simple explanations for North Korean behavior. Essentially, it is unclear if anyone can really influence the hermit kingdom, but if leveraging the regime is possible, U.S. policymakers should consider that options may be much broader than military threats and appealing to China to use its influence.

According to the available data on the North Korean economy, Japan and South Korea possess more economic influence over North Korea than most

analysts recognize. Although building an international coalition to leverage North Korea will be difficult because each party has different interests and visions of the end state, it is far from impossible. The existing six-party talks, for example, could provide a building block for more substantive multilateral efforts.

Given recent developments in South Korea, however, effective coordination of U.S. and South Korean strategy may prove rather challenging. The election of President Roh Moo-hyun in South Korea and the victory of the center-left party in parliamentary elections signal growing support in South Korea for a more conciliatory strategy. Indeed, public opinion data along with South Korea's overwhelming support in the last parliamentary elections for Uri, North Korea's political party of choice in South Korea, reveal that South Koreans continue to favor more cooperative policies toward the DPRK.<sup>33</sup> For example, a JoonAng/CSIS/RAND survey revealed that, when faced with the choice of increasing cooperation with the United States or North Korea, more South Koreans chose North Korea (39 percent) than the United States (24 percent) (34 percent favored a balance). A July 2004 *Korea Times* poll showed that more than 60 percent of South Koreans believed aid to North Korea was either acceptable or should increase.<sup>34</sup> When South Korea and the United States publicly disagree about the basic tenor of strategy toward North Korea, the mixed signals encourage North Korea to stall for time during negotiations and continue extracting economic benefits from Seoul.

Yet, renewed U.S. efforts to resolve the nuclear crisis likely will require South Korean support to ensure success. Working with Seoul to develop a plan that combines efforts to place North Korea's hard-currency sources at risk with a credible, comprehensive offer for North Korea fully to resolve the nuclear crisis is one possible solution. Given the ease with which remittances, food and medical aid, tourism profits, and direct transfers from South Korean citizens can be diverted to ensure the prosperity of North Korean elites, attempting to improve oversight over the distribution of aid, especially, could help pressure those elites. Although North Korea has frequently demonstrated a willingness to let its people starve rather than permit the entrance of Western or even South Korean influences, North Korean elites may have no other choice. If the United States can successfully hold other sources of hard currency at risk, elite reliance on foreign aid revenues will increase, potentially making threats to withdraw or condition aid more effective. Even if Seoul were initially hesitant to wield its economic leverage over North Korea, initial U.S., Japanese, and other successes through strategies outlined above could work without South Korea; were the strategies to succeed, South Korea would likely join later.

Japan's preferred strategies toward North Korea are more difficult to ascertain. Tokyo's active efforts to cut down on the pachinko parlor pipeline, generally reduce remittances to North Korea, and pass laws legalizing further restrictions on economic interactions with North Korea all signal a willingness to get tough, particularly since North Korea launched a ballistic missile directly over Japan in August 1998. In May 2004, however, Japanese Prime Minister Junichiro Koizumi met with Kim Jong Il for the first time since September 2002 and secured the release of five Japanese nationals kidnapped by North Korea more than 20 years ago in exchange for millions of dollars worth of food and medical aid for North Korea. These results can be interpreted in two ways.

**Japan's preferred strategies toward North Korea are more difficult to ascertain.**

On one hand, the summit shows that credible economic threats, including the curtailment of remittances to North Korea, can influence the North Korean leadership and that North Korean leaders really might depend on the kinds of economic interactions described here to maintain their prosperity

and hold over the country. In September 2004, Japan's ruling Liberal Democratic Party released a statement calling on North Korea to resolve the kidnapping issue completely by accounting for other individuals believed to have been abducted by North Korea. The statement called for economic sanctions on North Korea if Pyongyang failed to positively respond.<sup>35</sup>

On the other hand, if North Korea manages to resolve the Japanese abduction issue completely (10 Japanese nationals admittedly kidnapped by North Korea are still unaccounted for), already great pressure for the normalization of political relations with North Korea would intensify, likely leading to a large-scale increase in economic interactions. Koizumi has publicly declared the normalization of relations with North Korea as a Japanese foreign policy goal. A world in which North Korea has normalized relations with Japan or South Korea but not with the United States would probably be a net positive for North Korea, giving the regime access to new sources of hard currency, bolstering the control of North Korean elites, and maintaining enough hostility with the United States to justify the national siege mentality used by the regime to keep strict control over its citizens. Such economic openings, however, might function as precisely the subversive influence the North Korean regime has previously feared and successfully avoided thus far. This possibility adds another layer of complexity to the situation.

Although China is not the only actor able to influence North Korea, China's relatively large influence over North Korea must be taken into con-

sideration. The difficulty is that Beijing appears to prefer the status quo, in which North Korea does not have a formally recognized nuclear arsenal that might scare South Korea or Japan into developing their own and the North Korean regime has not collapsed, which could release an economically costly wave of refugees into China or result in a U.S. troop presence on China's border if U.S. forces attempted to stabilize and reconstruct North Korea. Indefinite six-party talks also allow China to present itself as an honest broker, gaining it international diplomatic benefits. Because China wishes to avoid both the regional proliferation and North Korean collapse scenarios, however, it will likely cooperate with the United States if the status quo appears untenable.

Although the presumption that China is the only actor with the ability to effectively leverage North Korea is incorrect, the significance of its influence is undeniable. China's support for U.S. strategy is uncertain and potentially insufficient without Japanese and South Korean cooperation, but an active Chinese effort to thwart U.S. goals would almost certainly succeed. China could simply give North Korea more money, sell it weapons at cost, and help it continue to avoid the termination of the nuclear crisis. China thus still has important leverage over North Korea in the cultural-political, military, and economic arenas.

### **Making the Status Quo Uncomfortable for Pyongyang**

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North Korea's negotiating strategy on the nuclear issue during the last decade has relied on a divide-and-conquer approach. The DPRK presents different negotiating stances to the various interested parties and changes its demands over time, allowing it to generate misperceptions among allies and extract enough economic resources to maintain elite control. In some ways, this strategy has been enormously successful, reinforcing the lesson for North Korean elites that threats and brinkmanship pay off while cooperation invites risk. As long as Pyongyang believes that it can make economic gains without having to make verifiable and irreversible concessions, it has no incentive to make such concessions. The cycles of brinkmanship that result have left the United States few options but to grant additional concessions to North Korea or risk the peninsula eventually deteriorating into armed conflict.

Alternatively, Washington can expand its existing options by better understanding the significant role of Japanese and South Korean economic and even possibly cultural-political interactions with North Korea, integrating them into its existing, although sometimes overstated, awareness of China's influence. As difficult as it is to coordinate the interests of these four pow-

**Multilateral efforts are required to ensure pressure is correctly applied to North Korean elites.**

ers, it is important to recognize that sources of leverage over North Korea may exist among them. If coordinated, these four powers could make the status quo more uncomfortable for North Korea by cracking down on illicit North Korean economic activities in weapons transfers, drug trafficking, and counterfeiting while simultaneously controlling remittances and aid, as well as attempting to wield potential cultural-political and military sources of influence.

In this way, Washington can begin to turn the tables, convincing Pyongyang that the only sustainable path for the regime is one that leads to nuclear program dismantlement.

If China responds to such a concerted effort by Washington and its allies by massively increasing its aid to Pyongyang to cover North Korea's financial losses, at the very least it will let the United States and the international community know where

China stands on the North Korea issue, undermining China's claims to be an honest broker in the process and allowing the United States and its allies to move forward with a comprehensive strategy that takes China's actions into account. By uniting with its allies in a tough but reasonable approach with the strong support of other regional and international actors, however, the United States stands the best chance of bringing China on board.

Time does not appear to be on the U.S. side. Continuing de facto North Korean proliferation will encourage other potential proliferant states and undermine U.S. credibility in Asia. Without a multilateral strategy that effectively brings the United States and its allies together to use their available, potential cultural, political, military, and especially economic levers of influence, North Korea will continue to be able to extract unending concessions and maintain the initiative in the existing diplomatic stalemate.

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