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An Initial Assessment of the Potential Effects of Financial Sanctions on North Korea[1]

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In response to North Korea's second nuclear test on May 25, 2009, the UN Security Council passed Resolution 1874 on June 12. In an effort to demonstrate that this resolution would have "teeth," Washington worked closely with its friends and allies to ensure that financial sanctions comprised a core element of this measure. On the eve of its adoption, Susan Rice, the U.S. Ambassador to the UN, stated, "This sanctions regime, if passed by the Security Council, will bite, and bite in a significant way. We think that the message that the Council will send should it adopt this resolution is that North Korea's behavior is unacceptable, they must pay a price."[3] While financial sanctions are viewed as an important policy tool in dealing with North Korea, they remain poorly understood in terms of their disparate tactical purposes and their impact on North Korea. This paper outlines the different applications of financial sanctions, assesses some of the potential effects of these measures on North Korea, and examines policy implications for Washington.

An important distinction that needs to be made at the outset is that there are two main types of financial sanctions that are currently being applied to North Korea. The first are UN Security Council Resolution (UNSCR) 1874 financial sanctions. UNSCR 1874 not only reaffirms UNSCR 1718 financial sanctions (passed in October 2006

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[3] Remarks by Ambassador Susan E. Rice, U.S. Permanent Representative, on North Korea, at the Security Council Stakeout, June 10, 2009. http://usun.state.gov/briefing/statements/2009/125980.htm

following North Korea's first nuclear test), they provide for robust implementation — a feature lacking in UNSCR 1718's track record. Washington views the multilateral implementation of UNSCR 1874 financial sanctions as the most effective way to pressure Pyongyang to return to multilateral talks. Washington and the international community are essentially presenting Pyongyang with a choice. If Pyongyang continues to stay away from multilateral denuclearization negotiations, more financial sanctions will be applied on North Korea. If Pyongyang decides to return to denuclearization negotiations, the implementation of previously concluded agreements would resume along with the relevant economic, political, and diplomatic concessions. Washington is expecting Pyongyang to come to its senses and choose the latter option.

The second type is U.S. Treasury Department financial sanctions. Signed by President George W. Bush in June 2005, Executive Order 13382 authorizes U.S. government agencies to freeze the assets of WMD proliferators and their supporters, and isolate them financially.[4] Designations under E.O. 13382 prohibit all transactions between the designees and any U.S. person, and freeze any assets the designees may have under U.S. jurisdiction. Irrespective of North Korea's return to multilateral talks, these Treasury Department financial sanctions will continue, as they are designed to protect the U.S. financial system. Given that most of Pyongyang's international financial and commercial transactions are illicit in nature — e.g., money laundering, counterfeiting, production of fake brand-name drugs — the Treasury Department's priority focus regarding North Korea is to make sure that U.S. companies and individuals are advised on which DPRK entities may be engaged in illegal activities so they can be avoided.

In terms of the impact of both types of financial sanctions, their specific effects on North Korea are not clearly understood. While there is a wide difference in opinions regarding the impact of these sanctions, the common characteristic in these divergent views is that they are based more on individuals' intuition and experience, rather than facts. On the one hand, seasoned non-governmental organization (NGO) officials who run recurring projects in North Korea argue that these measures have a marginal impact as the North Korean regime has adapted to earlier financial sanctions by moving most

[4] E.O. 13382 listed DPRK and Iranian companies. It became the basis for expanding financial sanctions on both countries. "Executive Order 13382, *Blocking Property of Weapons of Mass Destruction Proliferators and Their Supporters*, June 28, 2005," *Federal Register*, Vol. 70, No. 126, July 1, 2005. www.treas.gov/offices/enforcement/ofac/legal/eo/whwmdeo.pdf

of its major financial and commercial activities to the Chinese side of the Sino-DPRK border. In doing so, they are reported to have become less susceptible to U.S. tactics of dissuading North Korea's business partners — both current and prospective — from doing deals with the reclusive regime. (With Beijing unlikely to substantively enforce sanctions for fear of destabilizing North Korea, the northeastern Chinese provinces constitute a haven for DPRK state trading company transactions.) These NGO officials particularly cite the Banco Delta Asia (BDA) incident[5] in Macao in the mid-2000s as an important lesson for Pyongyang — one that led to adjustments and modifications in the regime's ever evolving responses to U.S. sanctions.

The other group, comprising mostly current and former U.S. government officials, asserts that these financial sanctions are effective and only target specific North Korean companies and individuals. Following forensic financial investigations conducted by Treasury Department and U.S. law enforcement officials in Macau in the early 2000s, the U.S. government compiled detailed information about DPRK state trading companies and their links to the Korean Workers' Party (KWP) and the Korean People's Army (KPA). These officials point out that such careful targeting means that the North Korean people are not affected by the implementation of financial sanctions. U.S. officials view recent North Korean offers to engage Seoul and Washington in separate bilateral dialogues as a clear sign that these financial sanctions have teeth and are working as intended. However, former U.S. government officials who worked on these early Treasury Department financial measures note that the Kim Jong-il regime is adept at creating shell companies that disguise the activities of DPRK state trading companies. Consequently, the map of DPRK state trading company linkages based on prior forensic financial investigations may no longer be as useful as it once had been.

As this debate between coincidence and correlation regarding the impact of financial sanctions continues, there are significant policy implications for Washington's current approach to dealing with the Kim Jong-il regime. If UNSCR 1874-type financial sanctions do not have an impact, as argued by experienced NGO officials, then the current U.S. approach of applying these sanctions as part of a multilateral effort to

[5] A common misperception that persists is that the Treasury Department froze North Korean accounts in BDA following an investigation into illicit DPRK activities. In fact, the Monetary Authority of Macao, responding to a Treasury Department advisory, froze the North Korean accounts in order to protect the Macanese financial system from these illicit activities.

pressure Pyongyang to return to the Six-Party Talks may end up being ineffective. North Korea could further develop its nuclear programs and expand its proliferation activities while Washington concentrates on getting more cooperation from friends and allies on an approach it believes is working. If financial sanctions indeed turn out to have been ineffective, Washington's overestimation of, and over-reliance on, this particular policy instrument may leave the international community in a more difficult situation — i.e., a worst case scenario in which Pyongyang has increased the size of its nuclear arsenal and has also spread nuclear technology to other countries like Iran and Burma.

If UNSCR 1874 and Treasury Department financial sanctions turn out to have an impact on the Kim Jong-il regime, there may also be unintended consequences. Four hypotheses can be tested over time as events unfold and certain types of activity emerge. First, if financial sanctions end up constricting the revenue streams of key KPA- and KWP-affiliated companies, then they may inadvertently lead to a disruption in the balance of power among different groups comprising the DPRK leadership as some groups' business interests are truncated and others remain largely unaffected. Kim Jong-il or his successor could then be in the difficult position of having to redistribute business lines among KPA and KWP organizations for political considerations in an environment where the "North Korea, Inc."[6] commercial pie is already shrinking. Existing rivalries and tensions could be exacerbated by such a politically motivated commercial redistribution.

Second, if revenue streams dry up as a result of effective financial sanctions, then

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[6] Assessing regime stability in North Korea continues to be a major challenge for policy-makers and analysts. By examining how "North Korea, Inc." — the web of state trading companies affiliated to the KWP, the KPA, and the Cabinet — operates, we can develop a new framework for gauging regime stability. As interviews with defectors who previously worked in these state trading companies indicate, the regime is able to derive funds from North Korea, Inc. to maintain the loyalty of the North Korean elites and to provide a mechanism through which different branches of the North Korean state can generate funds for operating budgets. More information can be found in a May 2009 U.S. Institute of Peace report, titled: "North Korea, Inc.: Gaining Insights into Regime Stability from Recent Commercial Transactions." www.usip.org/files/resources/1_9.PDF

depleted Kim Jong-il regime coffers may eventually be replenished by the government and military's confiscation of goods at the provincial and county levels inside North Korea. In this scenario, the financial sanctions would affect the regime first. Through desperate compensatory measures like state-authorized confiscation, the secondary and tertiary effects of financial sanctions may be devastating for the North Korean people at the local levels. Reports about widespread seizures of goods in markets by state authorities may support this hypothesis.

Third, if a financial sanctions-weakened Kim Jong-il regime starts to stumble, Beijing may initiate a discreet policy of bailing out key DPRK state trading companies in an effort to ward off instability in a strategic bordering country. Cognizant of which DPRK state trading companies provide funds to elite branches of the KWP and the KPA, and specifically Kim Jong-il's inner circle, Beijing may make politically driven decisions regarding which companies it will prop up. In doing so, an increasingly isolated North Korea with no viable options may reluctantly grow more dependent on China. How Pyongyang decides to recalibrate its standing with Beijing in this situation may lead to a new round of brinkmanship in this complex bilateral relationship. Many PRC analysts assert that North Korea's first nuclear test in October 2006 was a political message for Beijing that Pyongyang will not be pushed around by its Chinese neighbor — a sentiment that apparently grew after a pattern emerged where Beijing, at the behest of Washington, increasingly pressured Pyongyang to make progress on denuclearization.

Fourth, if financial sanctions result in fewer countries doing business with North Korea because of fears of being disconnected from the U.S. financial system, then new transnational criminal organizations may appear as prospective business partners. Such counterparties may emerge, attracted by the ability to either charge more fees for doing financial transactions on Pyongyang's behalf or offering significantly less for North Korean products knowing that there are no other buyers. What makes these transnational criminal syndicates hard to detect is their ability to use a sophisticated collection of shell companies and underground networks, mostly in former Soviet bloc countries and failed states. Like the Hydra of Lerna, cutting off one of Pyongyang's current business partners may result in more growing in its place.

In conclusion, the recent application of financial sanctions on North Korea provides a unique opportunity to further understand the reclusive regime in terms of how it operates and reacts to external stimuli. As discussed above, it may have already adapted and modified North Korea, Inc. in order to weather the current multilateral implementation of financial sanctions. While the tale of Hercules' frustration in trying to defeat an adversary that appeared to effortlessly regenerate is a classic expression of a hero's struggle over hopelessness, his labor is rewarded twice. First, his persistence enabled him to eventually discover that the Hydra's weakness was that only one of its heads was immortal. Second, Hercules later tamed the centaur Nessus by using an arrow dipped in the Hydra's poisonous blood. Perhaps lessons learned from the implementation of financial sanctions on North Korea can be applied to Washington's efforts to tame Iran's nuclear ambitions. While this may be possible, an important interim step is figuring out ways to gauge the impact of financial sanctions on the Kim Jong-il regime. Without more analysis in this area, we may either overestimate or undervalue the effectiveness of this unique policy instrument with disastrous results in either case.