North Korean Trade Policy: Constraints and Options

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Executive Summary

Trade will be critical for boosting North Korean growth. Hence North Korean options in terms of trade policy deserve to be carefully examined. The paper aims to provide the best possible information to North Koreans willing to be better equipped for understanding and assessing the available trade policy options.

Section 1 spells out the key challenges faced by any North Korean trade policy: very little knowledge on North Korean trade potential (comparative advantages); very high international political tensions that should not be amplified by trade issues; a severe lack of appropriate institutions. It then defines the principles that any North Korean trade policy should follow for addressing these challenges: non-discrimination in terms of goods (the same tariff on every product) is best for revealing North Korean comparative advantages; non-discrimination in terms of countries ("most favored-nation") reduces as much as possible political tensions; an effort to find substitutes as costless as possible is the best answer to the lack of the appropriate institutions required by a modern trade policy.

Section 2 examines North Korean trade policy as negotiating tactics which are subjected to the strict constraint of the denuclearization issue. It first looks at the costs of non-accession to the WTO in the absence of a solution to the denuclearization issue. It then turns to the establishment of normal trade relations with North Korean major trading partners, in particular the US, once the denuclearization issue will start to get a satisfactory solution. Lastly, it briefly reviews a few points of WTO accession once the final solution of the denuclearization issue is met.

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Section 3 develops the dimension of trade policy as an economic strategy boosting North Korean growth. It first provides evidence that countries which have faced political and economic difficulties similar to those faced by North Korea have been extremely successful when they have adopted a trade policy based on the three principles developed in section 1. The section then spells out the rationale for including Free Economic Zones in this trade policy strategy. First, the *de facto* market access generated by FEZs should be a key bargaining chip in the trade negotiations leading to the establishment of normal bilateral trade relations with other countries—helping North Korea to define what should be conceded and what should not for its best interest. Second, FEZs will also boost North Korean development at costs as low as possible in terms of new infrastructures (an essential consideration since the North Korean is in such a huge need of new infrastructures). Last but not least, the section stresses the compatibility and consistency between the economic strategy and negotiating tactics components of trade policy.

Last but not least, section 4 examines the closer relations with South Korea in a bilateral setting. It spells out the benefits for both partners, but also the conditions to be met, hence the efforts to be made by both of them for maximizing these benefits. Then, the section looks briefly at North Korean options in the broader context of the burgeoning East Asian preferential trade agreements.

This paper deserves a final remark. Trade policy is only one component of the new policies needed for boosting North Korean growth. Exchange rate policy, macro-economic policies, labor market and structural policies establishing progressively competitive markets for goods, services, labor and capital in North Korea will also be decisive for achieving economic success. There is thus a need to examine the economically sound available options in all these crucial policies (as this paper tries to do on trade policy) in order to provide to North Koreans the best information possible—illustrating that the transition period is not doomed to be a free fall into a chaotic world.

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Introduction

In his August 21st press conference, Minister for Unification Ryu Kihl-jae developed three dimensions of President Park Geun-hye's 'trust politik' for the Korean peninsula: enhanced communication, security and international aid to infrastructure. Few observers would contend that building infrastructure is essential: North Korea lacks infrastructure to an extent rarely observed in the rest of the world.

That said, the experience of international aid to infrastructure is very mixed. Too often, such aid has been wasted in inadequate projects. There is thus a need to look at the key conditions which will make such aid beneficial to all North Koreans—not only to foreign contractors or North Korean intermediaries.

One of these key conditions is that aid to infrastructure should pay attention to North Korea trade potential—what North Korea needs to import and can export for boosting as much as possible its domestic growth. Indeed, this condition echoes South Korea's experience: the international aid received by South Korea did not boost its domestic economy (while fuelling corruption) until the early 1960s, when the country embarked on a very successful export-led policy [Krueger et al. 1989].

If trade is so important, then North Korean options in terms of trade policy deserve to be carefully examined. The aim of this paper is to provide the best information to North Koreans willing to be better equipped for understanding and assessing these various options. As the paper is not an academic article but a focused "think tank" piece, it treats the denuclearization issue only in its dimension of being a constraint on the available trade policy options, and it

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assumes the existence of a political will for opening the North Korean economy to the world economy.

One may then argue: why to bother to discuss the details of trade policy as long as these two basic assumptions are not met? But, this question raises in turn the following "twin" question which could be raised for every other important economic policy (fiscal, monetary, etc.). Is not some basic information on the available trade policy options an essential input that North Koreans need for deciding whether and how to move on the opening of their economy and/or on the denuclearization issue?

This piece presumes a positive answer to this twin question. As a result, it considers as critical to provide—without waiting longer—a brief review of the key problems to be faced by North Korean trade policy and of their main economically sound solutions. It also provides concrete examples from other countries showing to North Koreans that North Korean transition path to an open economy is not the fall into a chaotic world that many fear, but that it can be a reasoned and manageable shift to growth and development.

The paper is organized as follows.

- Section 1 examines the major domestic constraints that any North Korean trade policy will face, and it derives the corresponding guiding principles that an economically sound North Korean trade policy should follow.
- Section 2 looks at the first aspect of trade policy—i.e., negotiating tactics focusing on North Korean accession to the World Trade Organization (WTO) and on bilateral trade relations with the United States (US).
- Section 3 examines the second aspect of trade policy—i.e., an economic strategy needed for avoiding the long term heavy costs for the North Korean economy of an excessive focus on negotiating tactics. It presents concrete examples of a strategic use of trade policies by various countries sharing similarities with North Korea. It also shows the compatibility and consistency between the economic strategy and negotiating tactics components of the suggested trade policy—a crucial conclusion.
- Section 4 focuses on bilateral trade agreements between North and South Korea. Most of the existing studies on North Korean trade policy deal only with this question. However, economic analysis strongly suggests that the economic impact of bilateral

trade agreements depends critically upon the trade policy applied to the rest of the world—hence from choices spelled out in section 3.

As this paper is a think tank piece, it minimizes the review of the literature and the references, and uses simple but robust economic analysis.

Section 1. Three guiding principles

Any North Korean trade policy faces three very specific constraints: very little knowledge on North Korean trade potentials; very high international political tensions that should not be amplified by trade conflicts; a severe lack of appropriate institutions. These constraints help to define three guiding principles that any North Korean trade policy should fulfill as much as possible if it wants to be economically sound: non-discrimination in terms of goods (uniform tariff), non-discrimination in terms of countries (most-favored nation), and a systematic search of substitutes to currently missing institutions which are desirable and will need time to be created and fully operational.

How to reveal unknown North Korean comparative advantages? Don't discriminate in terms of goods (uniform tariff)

Designing a trade policy well adapted to North Korea faces a major challenge to an extent unknown in the rest of the world: the absence of trustable information on the North Korean economy which could help to guess its economic strengths and weaknesses ("comparative advantages" in economic jargon) in the world economy—in particular, the products that North Korea could produce and export successfully in today world economy.

The latest estimates of North Korean trade suggest two observations.

- They give an indication on how close the North Korean economy currently is. Its estimated exports and imports in 2012 amount to USD 2.9 and 3.9 billion, respectively, or roughly 8.7 and 11.8 percent of the estimated North Korean 2012 GDP [Bank of Korea 2013]. For comparison sake, least developed countries with roughly the same population size and GDP per capita than North Korea have an average total (export plus import) trade to GDP ratio of 60 percent—roughly three times higher than North Korea.

- The product composition of North Korean trade shown in Table 1 suggests that exports are dominated by mineral fuels (coal), ores (rare earth, zinc), apparel and fish products, while imports are much more diversified (as usually), with mineral fuels (oil), machinery and food products.

However, these data should be taken with great caution because they are both incomplete and distorted. They are incomplete because they miss the substantial flows of smuggled goods which are generated by the dysfunctional North Korean centrally-planned economy.[3] And they are distorted because the traded quantities reflect the prices used by North Korean state-owned monopolies and their related "private" operating units [Lankov 2013]. Such prices have probably very little to do with those that would exist in a well-functioning North Korean market economy. For instance, it is reported [Bruce 2012] that North Korean ores are sold at discount rate to Chinese intermediaries: that makes very difficult to estimate "undistorted" trade flows for this important export item since discount prices may partly inflate exported quantities.

Table 1. The product composition of North Korean trade, 2011

Exports					Imports				
		value	share	growth			value	share	growth
HS27	Mineral fuels	1149.1	46.6	189.6	HS27	Mineral fuels	771.0	24.3	61.0
HS26	Ores	405.7	16.5	61.5	HS84	Nuclear reactors, parts	277.3	8.8	13.1
HS62	Apparel, clothing not knitted	356.9	14.5	122.3	HS85	Electrical machinery	251.5	7.9	31.9
HS72	Iron and steel	154.8	6.3	42.6	HS87	Vehicles, other than railway	220.6	7.0	38.1
HS03	Fish and crusteceans	82.8	3.4	39.0	HS39	Plastics	110.9	3.5	31.4
HS79	Zinc products	65.3	2.6	37.0	HS54	Man-made filaments	109.7	3.5	38.2
HS61	Apparel, clothing knitted	57.6	2.3	122.8	HS10	Cereals	102.3	3.2	71.2
	All above	2272.2	92.2			All above	1843.3	58.2	
	Total exports	2464.4	100.0			Total imports	3167.2	100.0	

Source: KIEP 2012 (based on the World Trade Atlas).

In such circumstances, which principle should North Korean trade policy adopt in order to reveal the "true" North Korean comparative advantages? It should be to treat the same way every product that North Korea will import—it should not discriminate in terms of products. In other words, a country should impose the same tariff (or any other kind of trade barrier on import) on every product—the so-called "uniform tariff" principle in the economic analysis jargon.[4]

[3] Smuggling ensures additional trade, but at prices which may have very little to do with market prices because of the premium for covering the risks in a society with very harsh punishment in such circumstances.
[4] A similar reasoning could be made for barriers on exports, as underlined in the Annex.

Why? Because, with the same tariff on all the products, investors (large and small, foreign and domestic) will not be induced to invest in certain North Korean sectors because they are the most protected ones. For instance, they will not be induced to invest in product A in which North Korea has no comparative advantage but which would be protected from foreign competition by a high tariff of (say) 30 percent—instead of investing in a product B in which North Korea has some comparative advantage but which is protected only by a low tariff of (say) 6 percent. Protecting all the products by the same tariff rate will induce all the producers to invest in the products only on the basis of the North Korean economic potential of producing and exporting these products.

How to diffuse political international tensions? Don't discriminate in terms of countries ("most favored nation")

The current country composition of North Korean trade is heavily distorted by the trade sanctions related to the nuclear issue, and to a smaller extent by South Korea's support to intra-Korean trade.

- China's lax enforcement of trade sanctions has massively increased its share in North Korean trade (from 25 percent in 2002 to 70 percent in 2011). Of course, North Korean imports from China do not consist only in products of Chinese origin, but there is no available information on this aspect.
- South Korea's share fluctuates between 20 and 39 percent during the same period, reflecting the net effect of the negative impact of economic sanctions and the positive impact of South Korea's support (under the form of special tariff reductions, special financing and insurance schemes) to intra-Korean trade [Haggard and Noland 2012].

As a result, the share of North Korean trade with other countries than China and South Korea has gone down from 40 percent on average (early 2000s) to less than 10 percent (2011), with almost no trade between North Korea and Russia or the US, but with still some (small) trade flows with the EU (USD 105 millions) [KIEP 2012].

Such a concentrated country composition increases massively the risks and costs of trade conflicts mutating in political conflicts, and vice-versa. Such a situation is definitively not propitious for the long term growth of the North Korean economy.

In this context, it is important to stress that a well designed trade policy has the capacity—too often ignored—to diffuse political international tensions [Ahnlid 2012]. This capacity has been illustrated at the world level by the General Agreement on Trade and Tariffs (GATT) which, over its 47 years of existence (1948-1995) has contributed to unite an economic world initially deeply divided among developed, centrally-planned and developing economies. A very recent illustration of this capacity in North East Asia is South Korea’s participation to the negotiations on the Trans-Pacific Partnership. The benefits that South Korea can get from the TPP are massively dominated by the economic benefits of freer trade with Japan. Negotiating in the plurilateral TPP forum allows South Korea (and Japan) to enjoy such benefits that the current political frictions are making almost impossible to get via bilateral negotiations.

In such circumstances, which principle should the North Korean trade policy follow in order to diffuse political international tensions as much as possible? It is to treat the same way every partner—it should not discriminate among trading partners. More precisely, a country should treat the product of a trading partner no less favorably that the same product of any other partner—the so-called “most favored nation” principle in the GATT-WTO context.

How to face a lack of desirable institutions? Look for transitory simple substitutes

The literature on North Korea makes clear that the key pillars of a modern trade policy are not present in North Korea: very little trust among foreign and North Korean traders [Haggard, Lee and Noland 2011], distorted markets dominated by rents fuelled by official monopolies or officially-blessed black markets [Lankov 2013], no institutions but the rule of volatile personal relations [Haggard and Nelson 2012b and 2013a].

This situation raises a key problem because a modern trade policy relies on a vast array of elaborated institutions—from sophisticated Customs Office to the administrative bodies enforcing contingent protection instruments (antidumping or safeguard cases) to the agencies or committees enforcing tests and certifications of norms for products to the host of regulators in traded services, etc. All these institutions cannot be fully operational within a few years, or even within a decade for some of them.

Which principle then should the North Korean trade policy follow in order to buy the time necessary for building well designed and functioning institutions? It consists in relying, as much as possible, on simple and costless substitutes which could work as good proxies of these institutions in the early years of the market opening process. A first substitute of this kind is indeed provided by the two combined non-discrimination principles (uniform tariff and most-favored nation): if the tariff enforced by North Korea is the same for all the products imported from all its partners, then a sophisticated and huge Customs Office is not needed, with the very desirable consequence of reducing drastically incentives for corruption. Other substitutes (an appropriate use of free trade zones, reliance on foreign institutions, etc.) are briefly presented in sections 3 and 4.

Section 2. Trade policy as negotiating tactics

A first aspect of trade policy consists in negotiating trade deals. In this perspective, North Korea will face two key issues: North Korean participation to the World Trade Organization (WTO) and the establishment of "normal" bilateral trade relations, particularly with the US. As these two topics are highly dependent from the denuclearization issue, it makes sense to examine them in the following sequence: the impossibility of WTO membership without a solution to the denuclearization issue, the establishment of normal bilateral trade relations when the denuclearization issue will start to get a satisfactory solution, WTO membership once the final solution of the denuclearization issue is met.

WTO membership: out of reach without a solution to the denuclearization issue

As long as the denuclearization issue has not received a solution satisfactory for all the parties involved, there will be enough WTO Members to veto any attempt by North Korea to become a member (or even an observer) to the WTO. It could be argued that North Korea's accession could be put on vote at the WTO. But, there is almost no doubt that the deeply entrenched WTO tradition of a consensus for taking such crucial decisions will prevail in this case.

Which is the value of WTO membership for the North Korean economy? It consists in three elements, the two first being related to international affairs, the last one to domestic issues.

- The WTO is based on the most-favored nation (MFN) principle: any WTO Member automatically gets from every WTO partner the best tariff concession that this partner may have granted to any of the WTO Members. The MFN clause in a world forum like the WTO is very precious for a small economy like North Korea. It ensures North Korea that it will not be discriminated against, but rather will automatically benefit from concessions granted initially to (large) countries enjoying high negotiating leverage. That said, WTO law allows the non-application of the MFN principle in some instances, an important case for North Korea (see below the discussion of Article XXXV-GATT/XIII-WTO).

- The WTO forum is a very friendly forum for small and developing economies like North Korea because it allows such economies to make coalitions among themselves or with one (or more) large economy having similar interests on the issue at stake. As a result, the WTO forum can increase (sometimes massively) the small Members' negotiating leverage which would be minimal when negotiating bilaterally with a large country.
- Lastly, the value of the WTO from a domestic perspective is to lock the tariff cuts decided by the Members thanks to a mechanism called "bound tariffs". When binding a tariff imposed on a given product, a WTO Member commits itself not to increase in the future the tariff on this product above the negotiated bound level (say 12 percent). If it reneges on its commitment by increasing the tariff above the bound level (12 percent in our example), it has to pay appropriate compensations to its trading partners hurt by such a policy reversal. And if the reneging country does not pay these compensations, WTO law allows its trading partners to retaliate—making any reneging very costly. During the last six decades, this "binding" mechanism has helped many governments to fight domestic lobbies willing to reverse an ongoing openness policy.

The binding mechanism deserves a specific remark in the case of North Korea. Non-accession to the WTO does not mean that North Korea cannot start an economically sound progressive opening of its markets before its WTO accession. It can do such an opening either unilaterally or, as examined below, in the context of bilateral trade relations. But, the absence of the WTO binding mechanism will make more difficult for North Korea to keep its markets open because domestic interests hurt by the openness policy often lobby hard for reversing (in part or in totality) this policy. In short, non-accession to the WTO makes the domestic political will even more crucial and decisive—and that is a hard condition to fulfill in the long run. This difficulty has been one of the key reasons why China has decided to join the WTO, after a long period (from the 1980s to 2001) of successful but sometimes quite hesitant unilateral market opening measures. To sum up, non-accession to the WTO may not be such a serious impediment to the North Korean trade policy in the short run, but it may become a substantial one as time flows.

The transition to WTO membership and the North Korea-US trade relations

The transition period for the WTO accession could be short or long, depending whether a satisfactory solution to the denuclearization issue will emerge rapidly or will require a long process. During this transition period, the bilateral trade relations between North Korea and its key partners—China, the EU, Japan, the US and, of course, South Korea—will play a very important role on their own merits (they will open these very large markets to North Korean goods and services) as well as in relation to the WTO accession process (because this process relies on a set of bilateral negotiations between North Korea and its "major" trading partners which include all the above-mentioned countries).

The North Korea-US trade relations are expected to raise the most difficult issues largely because the US Congress has a key role in shaping the US trade policy, whereas the role of the governments (Executives) is dominant in the other countries. Congress makes things more difficult because it deals with international political issues and trade matters in a very specific parliamentary environment dominated by domestic considerations.

For nonmarket economies, this specificity is embodied in the so-called "Jackson-Vanik" amendment [Cooper 2012]. In January 1975, Congress included this amendment in the 1974 US Trade Act. Under this amendment, the US can deny the MFN status to any trading partner (be a WTO Member or not) that was not receiving such treatment by January 1975, as long as the partner in question denies its citizens the right of "freedom of emigration".[5] Since 1974, Congress has sometimes interpreted the "freedom of emigration" provision in somewhat different terms—for instance, "human rights for workers" in the case of China.

The Jackson-Vanik amendment gives to US trade negotiators an alternative to the Article XXXV of GATT (XIII of WTO) which allows any WTO Member to "opt out" the most-

5 This condition specifically targeted the prohibition imposed on Soviet Jews to emigrate Israel.

favored nation clause against newly acceding Member. This so-called "non-application" decision has been rarely used in the GATT-WTO history (except against Japan in the 1960s-1980s) with less than half-a-dozen cases in the late 2000s. Such a rarity is not surprising: it is hard to see why a WTO Member will agree on the accession of a new Member, and then will opt out because of trade considerations.[6]

In fact, the Jackson-Vanik amendment gives a much better leverage to the US when dealing with a trading partner than the "non-application" WTO provision because it has two faces:

- It makes very costly for the US trading partner to export to the US because US tariffs in the absence of the MFN status are much higher than those applied under the MFN provision.
- It includes a "sweetener": it allows the US President to get from Congress an annual waiver of the denial of the MFN status to the trading partner in question if the US President believes that such a waiver would encourage a positive evolution of the trading partner in question with respect to the conditions imposed by Congress under the "freedom of emigration" heading.

In other words, the annual waiver makes the trading partner very well aware of the massive benefits (much lower tariffs) associated to the MFN status (called "permanent normal trade relations" or PNTR in US trade law). As a result, it creates an important leverage for the US during bilateral trade negotiations with its trading partner. It is so all the more because the Jackson-Vanik amendment opens the possibility of a substantial disconnection between WTO accession and the Congress' granting of the PNTR (MFN) status to the nonmarket economy.

This leverage can be illustrated with the establishment of the bilateral trade negotiations between the US and Vietnam. Table 2 shows a clear synchronization between the use of the Jackson-Viner amendment and trade deals between the US and Vietnam:

- The Presidential first annual waiver followed an agreement on intellectual property rights in the entertainment sector (copyrights owner).
- A renewable three-years bilateral trade agreement and an Agreement on Garments and Textile preceded the US agreement on Vietnam's WTO accession.
- Two bilateral agreements (on Maritime issues and on the Trade and Investment Framework) followed immediately the Congress' law granting PNTR to Vietnam.

6 Such a case has occurred between the US and Philippines, with the US voting in favor of Philippines' accession while invoking Article XXXV against it in 1951 [Cooper 2012].

Table 2. Milestones in Vietnam-US trade relations

1989	May	First discussions on normalization of bilateral ties
1991	April	US "roadmap" plan for phased normalisation of Vietnam-US ties
1994	February	US lifts its trade embargo on Vietnam
1995	January	Vietnam's formal request for WTO accession
1996	May	US presents Vietnam with trade agreement blueprint
1997	April	Vietnam-US agreement on providing legal protection for copyrights owners
1998	March	Presidential waiver of the Jackson-Vanik agreement on Vietnam
1999	July	Principle of a bilateral trade agreement (BTA) signed
2000	July	Conclusion of the Vietnam-US BTA (to be renewed every three years)
2001	November	BTA ratification by Vietnam's National Assembly
2001	December	BTA entry into force
2002	June	First major US antidumping case against Vietnam (catfish)
2003	July	Vietnam-US Garnment and Textile Agreement signed
2004	January	Second major US antidumping case against Vietnam (shrimp)
2004	December	BTA renewed by the US
2006	May	Vietnam-US agreement on Vietnam's WTO accession
2006	November	Ratification of Vietnam's WTO Accession Protocol by Vietnam's National Assembly
2006	December	US Congress passes US law granting PNTR to Vietnam.
2007	January	Vietnam becomes the 150th Member
2007	March	Vietnam-US Maritime Agreement signed
2007	June	Vietnam-US Trade and Investment Framework Agreement

Source: USTR website.

The Jackson-Vanik amendment deserves two final remarks that are useful to keep in mind in the case of a North Korea-US trade relations.

- On the one hand, denying MFN status is always a double-edge sword for the US: if the US denies MFN status to a trading partner, the trading partner denies such status to the US. But, the cost of this symmetry for the US is very sensitive to the economic size of the US negotiating partner. If the trading partner is a small economy, the costs for the US are negligible, and the Jackson-Vanik leverage in favor of the US is high. It is much less the case if the US negotiating partner is a large economy. It is not accidental that China got PNTR status a year before its WTO accession, Russia four months before, Vietnam almost at the same time that it became WTO Member, and Mongolia more than two years after its WTO accession.
- On the other hand, North Korea does not face the same political, economic and trade environment than the Vietnam of the 1990s and 2000s, and all these differences tend to reduce the leverage of the Jackson-Vanik amendment on North Korea. The North Korea-China relations are somewhat different from those between Vietnam and China, and the size of the Chinese economy is much larger today than two decades ago. Other

countries will also play a much more active role in the case of North Korea: South Korea of course (including the size of its own economy), but also the EU which did not pay much attention to Vietnam in the 1990s-2000s.

That said, the Vietnam case gives a last, extremely important lesson: it is to go beyond pure negotiating tactics during these early trade negotiations, and to have already set up an economically sound trade policy strategy—the point examined in section 3—in order to be clear on what to concede and on what to stand firm. Of course, this is not an easy task, if only because major trading partners (the US, China, the EU) will try to get concessions from North Korea that fit their own interests—whether they will benefit the North Korean economy or not.

In this respect, Vietnam was not successful because it did not develop a trade policy as an economic strategy. It was negotiating without a clear idea of what would be the most economically sound options. Hence, it ultimately decided to protect its state-owned firms which were operating in import-competing sectors of little interest for the US (hence under little US pressure to open these Vietnamese markets). This approach is still a key source of the current fragility of Vietnam's economic performance: the poor results of the still highly protected and subsidized state-owned firms and the associated high level of corruption is still endangering the remarkable success achieved by the Vietnamese private sector since the 1990s [Pincus and alii, 2012, page 25].

<u>What to do when WTO membership will be available?</u>

Once the denuclearization issue will be solved, the accession (or observer status) of North Korea to the WTO would become possible under the status of a "customs territory", with the same rights and obligations than any country. Such a membership status is currently used by key WTO Members, such as Hong Kong, Macao and Taiwan. North Korean accession will require negotiations on terms to be agreed with the existing WTO Members.

North Korean accession to the WTO deserves an important remark: again, it should be carefully assessed with the help of a trade policy strategy (see section 3).

This assessment is best illustrated by one of the very first decisions to make in the WTO forum: the qualification of the North Korean economy in the WTO context. Its very low GDP per capita would allow North Korea to accede to the WTO as a 'least-developed country' (LDC), rather than as a "developing economy". As this choice will be largely a North Korean decision, it is important to underscore the ambivalent features of the apparently attractive LDC status.

Such a status looks attractive from a negotiating tactic perspective because it opens widely the markets of the industrial countries without requiring from the LDC in question to open its own markets. However, such a status is not promising from an economic strategy perspective. Both economic analysis and the last 60 years of actual trade policies show that free access to the markets of other countries is not conducive to growth and development for a country if the country in question does not open its own markets to foreign competition.

Last but not least, the apparent attraction of the LDC status will be further diminished by the concessions that will be requested from North Korea by the major trading partners in the context of its Protocol of Accession. It should be noted that, since 1995, the accession process has become (much) tougher for candidate countries, as best illustrated with China's Protocol of Accession. This is because the major existing WTO Members have increasingly used their negotiating leverage to extract the maximum concessions from the candidate country during the accession negotiations. When negotiating North Korean accession, the WTO Members are likely to remember that North Korea was an industrial power house in the first half of the 20th century—hence they are likely to be very demanding. It will be then essential for North Korea to have a clear sense of trade policy as an economic strategy.

Section 3. Trade policy as an economic strategy

A North Korean trade policy limited to negotiating tactics has a very costly downside due to the fact that North Korea's negotiating partners are looking for concessions from North Korea that are not necessarily the best from the perspective of North Korean long term growth. These risks are best illustrated by the US-Vietnam case. The US negotiators did not try to open certain sectors in which Vietnam has no comparative advantages simply because they were no US interests interested in getting market access to these Vietnam's sectors dominated by state-owned enterprises. As a result, today Vietnam's tariff structure still protects these sectors, inhibiting the reallocation of Vietnamese resources to more promising sectors, hence handicapping Vietnam's growth. The aim of a trade policy as an economic strategy is to know what could be conceded because it boosts North Korean long-term growth, and what should not be conceded.

Looking for successful references

The best way to conceive a North Korean trade policy as an economic strategy is to look at trade policies adopted by countries:

- having some important economic and political similarities with North Korea (initial heavy reliance on raw material exports, initial low GDP per capita, tough transition from non-market economies, etc.),
- having followed the three broad guidelines spelled out in the first section—non-discrimination in terms of goods and countries and looked for substitutes to missing institutions,

and which have exhibited a very successful growth once they adopted these trade policies.

Of course, looking at reference countries deserves a *caveat*. Trade policy is only one of the many economic policies (fiscal, budgetary, macroeconomic, etc.), hence it is not the only source of these successful growth stories. However, adopting non-discrimination in terms of goods (uniform tariff) and countries (most-favored nation) and caring about trade-related institutions have been often accompanied in the countries examined below by similarly minded other policies, such as flat income tax and unique domestic indirect tax rate (non-discrimination among tax-payers), minimal industrial policy or subsidy policies (non-discrimination among domestic firms), etc.

When looking for reference countries, most studies on North Korea have turned to (Eastern) Germany—probably because of the unification dimension. However, this reference is not appropriate for the following economic and political reasons.

- From an economic point of view, Eastern Germany was in 1989 one of the best run economies in the Soviet Union's block. Its GDP per capita amounted to 43 percent of Western Germany's GDP in 1991. By contrast, the North Korean GDP per capita in

2012 is estimated to be 6 percent of the South Korean GDP per capita (1400 USD vs. 22590 USD [Bank of Korea 2013]). Moreover, the Eastern German economy relied on an infrastructure which was still operational, even if it were ageing rapidly due to a lack of investments. If corruption was high as in any centrally-planned economy, it remained within acceptable limits.

- From a political perspective, it became rapidly clear that Soviet Union, then Russia, would not interfere with German reunification. There were compelling reasons for such a hands-off behavior: Russia became absorbed by its own transition problems and had no enough financial resources to intervene, two factors leading to the feeling of its decline as a world super-power. China is in a very different economic, financial and political situation.

In fact, the only useful lesson from German reunification is a word of caution. Despite the much better initial economic and political situation in Eastern Germany than the one prevailing in the Korean Peninsula and a booming world economy in the early 1990s, the German integration process is still a work in progress a quarter of century years later. In 2011, the Eastern German GDP amounted to 71 percent of the Western German GDP per capita—a gap big enough to still feed some nostalgia of the communist era among some Eastern Germans [Scharioth 2012].

In sharp contrast, six (at least) countries meet reasonably well the criteria mentioned above: the three Baltic countries (Estonia, Latvia, Lithuania), Chile, Georgia and Mongolia. Note that none of these criteria was met by Eastern Germany.

Table 3 provides a few key indicators on these six countries.[7] The World Bank Doing Business rankings (on 189 countries) show excellent performances of the former nonmarket economies included in the reference group of countries. The good correlation between the global ranking (Ease of doing business)and the ranking related to trade policy (Trading across borders) illustrate the point made above that a sound trade policy is part and parcel of a global package of sound economic policies. Mongolia's ranking is still in the first half of the 189 countries surveyed by Doing Business, and its Trading across borders ranking reflects to a large extent the costs of being a far away land-locked country (80 percent of the costs of

[7] As a reminder, North Korean GDP per capita is estimated to 1,000-1,200 (2005) US dollar [Bank of Korea 2013], and its population is to 24 million of inhabitants.

"trading across borders" are due to inland transport and handling).[8] The World Economic Forum Global Competitiveness rankings (on 148 countries) may look less impressive, but it should be stressed that they are biased in favor of relatively large economies (one of their key components is the size of the domestic economy).

Table 3. A brief presentation of six countries of interest for North Korea

	Estonia	Latvia	Lithuania	Georgia	Mongolia	Chile
Broad economic indicators						
Year [a]	1995	1995	1995	2004	1997	1984
GDP per capita [b]	4449	3159	3987	1244	611	3085
GDP per capita [c]	9891	6592	8350	1988	1628	13865
Population	1.6	2.6	3.6	4.7	2.8	11.9
Broad political indicators						
Domestic problems [d]	medium (24%)	medium (27%)	low (6%)	high		medium
International problems	low/medium	medium	low	high		low
Trade policy indicators						
WTO Accession	1999	1999	2001	2000	1997	1949
PNTR status [e]				2000	1999	--
Uniform tariff	yes (0.5%) [h]	close (10%) [h]	close (3%) [h]	close (1.5%)	close (15%)[i]	yes (30%)[j]
Governance 1 [f]	22	24	17	8	76	34
Governance 2 [f]	7	17	15	43	181	40
Governance 3 [g]	32	52	48	72	107	34

Notes: [a] year of (or closest from) the adoption of an economically sound trade policy. [b] in constant 2005 US dollars, for the year mentioned above[c] in constant 2005 US dollars for 2012. [d] for Estonia, Latvia and Lithuania, percentage of Russian population in total population; for Georgia, see Annex A. [e] US Permanent normal trade relation status. [f] Governance 1: Ease of doing business ranking. Governance 2: Trading across borders ranking. [g] Governance 3: Global Competitiveness ranking. [h] initial uniform tariff rate; since 2004, the country enforces the EU tariff schedule. [i] initial uniform tariff rate; today uniform tariff rate is 5 percent. [j] initial uniform tariff rate; today uniform tariff rate is 5 percent (see below).
Sources: World Bank database for GDP and population. WTO and Table A1 for uniform tariff protection. Doing Business for Governance 1 and 2 (189 countries). World Economic Forum for Governance 3 (148 countries).

The most instructive case: Chile

What follows focuses on Chile because, as it was the first country in the world to implement a trade strategy based on the three guiding principles, it offers a better understanding of the implementation issues of key interest for North Korea. Annex A provides a brief description of what happened in the other reference countries.

In particular, the Chile's case is best suited to make the difference between the two non-discrimination principles—uniform tariff and MFN status—and a free trade policy (zero tariff rate). From a political perspective, this difference is essential because a free trade policy is

[8] The main other reason of Mongolia's less shining results is related to too loose macro-economic policies.

such a tough policy to sell (less than a handful of countries have done that since the early 19^{th} century).

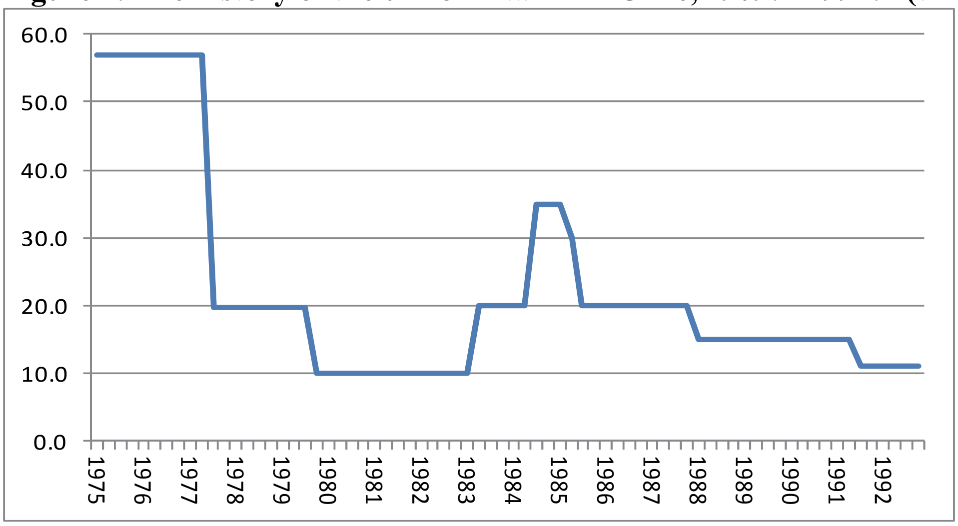
It is thus crucial to understand that an uniform and MFN tariff higher than zero on all the imported goods remains the best instrument to reveal North Korean comparative advantages for the following reasons:

- As said in section 1, under an uniform tariff schedule, investors (large and small, foreign and domestic) will not be induced to invest in certain North Korean sectors because they are the most protected ones. For instance, they will not be induced to invest in product A in which North Korea has no comparative advantage but which would be protected from foreign competition by a high tariff of (say) 30 percent—instead of investing in a product B in which North Korea has some comparative advantage but which is protected only by a low tariff of (say) 12 percent. Protecting all the products by the same MFN tariff rate will induce all the producers to invest in the products only on the basis of the economic potential of producing and exporting these products.
- The "neutrality" (in terms of goods) of an uniform and MFN tariff offers no obstacle to a fast diversification of the domestic economy (diversification is key for boosting confidence in North Korea economic potentials among domestic or foreign investors, hence is one of the most powerful forces to attract foreign investors with fresh ideas). This is because the tariff is the same whichever good is produced. By contrast, if tariffs differ among products, keeping in tune with quite unpredictable diversification requires to lower the tariffs on some products compared to the tariffs on other goods. Such a process is a politically daunting task because it mobilizes all the powerful domestic lobbies involved in the production of the products which would be relatively less protected. It requires thus considerable time, hence is unlikely to be in tune with the (possibly fast) evolving comparative advantages of North Korea.
- Last but not least, such a neutrality reduces considerably the risks of corruption in the Customs administration. This factor is crucial for making North Korea an attractive place for investors. It is also crucial since tariff revenues will be the main source of domestic fiscal resources in North Korea for the first decisive years of transition. Georgia offers a good illustration of the fast impact of a (relatively) uniform and MFN tariff policy in this domain: in less than four years, Georgia shifted from the 133th

most corrupted country (in 2004) to the 55th (in 2013)—achieving a better rank than some EU Member States [Transparency International 2013].

As economic analysis shows [Tarr 2000], arguments against an uniform tariff are related to specific circumstances: terms of trade effects, "strategic," infant or restructuring industry considerations, revenue or balance of payments purposes, tariffs as a negotiating tool at the WTO. None of these arguments are important for North Korea at the beginning of its transition. Terms of trade effects and strategic industries assume that North Korea would enjoy market power in some world markets, a very unlikely situation. Infant or restructuring considerations are precisely those that should be avoided because of the deep level of ignorance about North Korean comparative advantages. Revenue or balance of payments problems are better handled by macro-economic policies. The case of the WTO was addressed in section 2.

Figure 1. The history of the uniform tariff in Chile, 1979:1-1991:4 (trimester basis)



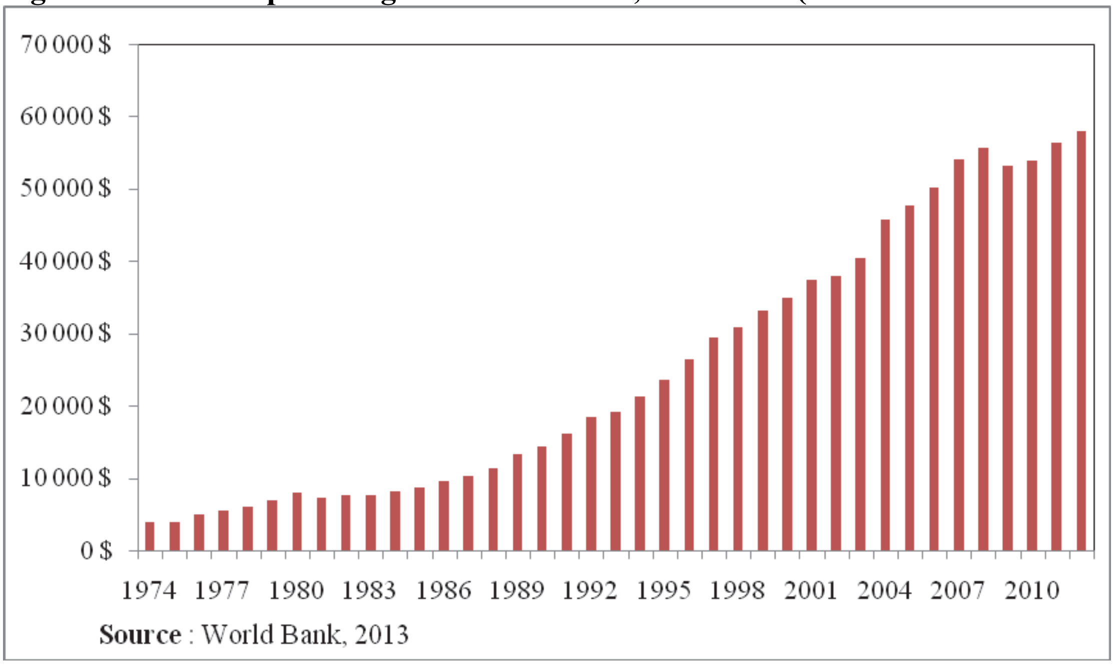
Source: Corbo, 1997

Chile is thus the best illustration of how an "uniform, MFN and non-zero" tariff policy can boost growth and diversification, and how to manage such a policy in detail [Corbo 1997]. In 1973, Chile's average tariff was 105 percent (with many peaks as high as 750 percent, combined with many quotas and a multiple-exchange rate system). In 1975, the average tariff was still 57 percent, as shown in Figure 1. The Chilean government was already talking about an uniform and MFN tariff rate of 10 percent, but it took four years to reach this target. Indeed, this policy did not work well at the beginning: domestic and foreign investors did not realize the benefits of an uniform 10 percent tariff, hence lobbied heavily against it. The economic crisis of 1982-1984 forced the Chilean government to backtrack, increasing the tariff rate first to 20 percent and then to 35 percent. However—crucially—the tariff was kept uniform.

In March 1985, the Chilean government started again the process to cut the 30 percent tariff. During the previous years, domestic producers begun then to realize that the level of the uniform tariff had no real impact on their investment decisions since no product was treated more favorably than the others. As a result, despite major political changes—Chile shifted back to a democratic regime—there was no opposition to the subsequent series of tariff cuts from 30 percent to 11 percent between 1985 and 1992 (today, the Chilean uniform and MFN applied tariff is 6 percent). Remarkably, the private sector itself has been often demanding these further tariff cuts which were thus often decided unilaterally by Chile.

The reason behind such a change of mind was that, as illustrated in Figure 2, Chile witnessed a take off (unabated since then) of its exports magnified by a fast diversification of its export structure—from overly dominant exports of copper to a much more diverse export structure, including with many farm and food products.

Figure 2. Chile's exports of goods and services, 1974-2012 (2005 constant US dollars)



The key question raised by the Chilean case is then: at which initial level should the uniform and MFN tariff rate be fixed? The history of the Chilean tariff policy provides a crucial lesson: what counts is not hastiness, but perseverance. In fact, an initially "low uniform" tariff runs the risk to be misunderstood (businesses being obsessed by the "low" aspect and not paying enough attention to the "uniform" aspect) hence can generate political failure—as indeed, it did in 1983 in Chile. So, it may be politically useful to start by imposing a "high uniform" tariff rate.

This lesson raises the question: how high is "high"? In a North Korean economy which may have a substantial number of state-owned enterprises left for some time, the initial tariff level should take into account three considerations:

- The higher the initial uniform tariff is, the stronger the pressures for getting exceptions may be, undercutting the "uniformity" aspect of the tariff policy. These pressures will be most likely exerted by the most powerful domestic state-owned enterprises which will fight for high tariffs on the goods they produce and for low tariffs on the imported products they use as inputs. Once powerful state-owned enterprises get the tailor-made tariff structure they want, it is very difficult to modify this structure. Hence, a distorted economy emerges progressively, with a highly protected and increasingly inefficient sector of state-owned enterprises which exposes the whole domestic economy to increasing systemic risks, even if the rest of the economy is vibrant—as illustrated by today Vietnam.
- There is no reason to impose a tariff higher than the level of protection currently prevailing *de facto* in the North Korea economy. With the collapse of the North Korean system of centrally-planned distribution, most goods are supplied and purchased on "grey" markets. This situation can be analyzed as equivalent to a myriad of different local "tariffs" on the imported goods all over the North Korean territory. The level of these tariffs depends on the local costs of the risky import business: the local corruption costs, the super-profits that local traders want to get, the level of local competition, etc. Collecting a good information on these grey prices all over the North Korean territory could provide a sense of these implicit local tariffs, hence of the average tariff protection of the North Korean economy before starting the reforms.
- Finally, the North Korean uniform tariff should not be above the highest South Korean tariffs in order to prepare the Korean reunification process since the start of the reforms. In manufacturing, the highest South Korean MFN "bound" tariff is 35 percent (textiles, minerals, all products which indeed may have a future in the North

Korean economy) while the highest South Korean MFN “applied” tariff is 16 percent.[9]

Depending the result of the study on grey prices in North Korea, the possible initial uniform tariff rate for manufactured goods could then range from 16 to 35 percent at most. A tariff within such a range should give enough breathing space to domestic and foreign investors for discovering the products in which North Korea has comparative advantages. As and when the North Korean economy will improve, this initially high uniform tariff should be reduced—but always by respecting the “uniformity” principle.

Free Economic Zones (FEZs)

The problem of a high uniform tariff is that it makes expensive the intermediate goods and the machines that North Korea will need to import massively in order to start and develop its new productions. A first solution to this problem could be a system of drawbacks (duties on goods utilized in North Korean production are given back to the producers importing them) which has been routinely used by South Korea. But, such a system requires skilled, efficient and uncorrupted Customs Office—an institution that South Korea has nowadays, but that will take years to build in North Korea (as it did in South Korea).

Figure 3. The existing FEZs in North Korea, 2013

[9] There are exceptions in the chemical sector, as shown by Table 4 below. The agricultural sector is examined below because the maximum South Korean tariffs are extremely high (from 300 to 900 percent).

A much simpler solution are the FEZs which are well defined territories devoted to production in which goods can be imported from the rest of the world at a zero or very low tariff—hence by definition immune to the above-mentioned disincentives generated by a high uniform tariff over the whole North Korean territory.

FEZs are an attractive solution for North Korea for three reasons:

- It is a structure already used by North Korea which, as shown by Figure 3, operates four FEZs: Gaeseong on the border with South Korea, Rajin-Sonbong ("Rason") on the border with Russia, Sinuiju and Hwanggeumpyong on the border with China.
- FEZs offer an efficient solution to the huge systemic problem of the North Korean economy: its severe lack of infrastructure. It will take time to build all the roads and railways that would be necessary for industrializing the whole North Korean territory. FEZs on North Korean coasts would minimize the immediate and heavy requirements in terms of infrastructure. Instead of shifting goods and equipments to every part of the North Korean territory, it is much less expensive and faster to allow North Korean workers to go to the FEZs.
- As FEZs require swift and accurate customs controls, they need efficient Customs authorities. Being limited areas of the North Korean territory, FEZs could rapidly benefit from the technical support of the South Korean Customs administration which is one of the most efficient Customs in the world. FEZs may then be the best testing ground for introducing into North Korea modern customs techniques. For instance, traded goods are classified according to a list of products called the 'Harmonized System' (mentioned above). The HS is fully normalized at the world level only for its six first digit. It would make sense for North Korea to go further by adopting for its FEZs the South Korean HS classification which is more detailed, and also by adopting the South Korean Customs' detailed interpretations that such a list requires when dealing with millions of different products. Following the South Korean Customs 'handbook' is a key contribution to generate frugal institutions in North Korea.

Finally, FEZs have the capacity to address three key problems extremely important for a successful transition:

- They will exert a healthy pressure to reduce the initially high uniform MFN tariff adopted for the rest of the North Korean territory. The co-existence on the North Korean territory of FEZs (with a zero or very low uniform tariff) and of the rest of the territory (with an initially high uniform tariff) will inevitably generate smuggling if it lasts long (all the more because of the long tradition of smuggling in North Korea). The only way to manage this risk is to reduce progressively the initially high uniform tariff in the North Korean territory not devoted to FEZs.
- As a result, and somewhat paradoxically, FEZs will represent an improvement on the current high level of fragmentation of the North Korean domestic economy—today, there is no such a thing as a North Korean "Single Market" for most goods and services. This fragmentation flows from the fact that the price signals delivered by the black markets are likely to be very different from those which would be provided by well-functioning domestic markets. Pyongyang is largely isolated from the rest of the North Korean territory, the regions close to the Chinese border are to some extent connected to the Chinese economy, while the rest of the territory suffers from a terrible lack of transport infrastructure.

For these reasons, creating more FEZs in North Korea can be seen as an efficient measure to combine with a initially—but decreasing over time—high uniform MFN tariff for the rest of the North Korean territory.

Last but not least, FEZs will constitute an essential element of North Korean negotiating tactics in two respects:

- They will play a key role in the bilateral deals that North Korea will have to negotiate on the road to WTO accession because they represent a market opening which should be substantial enough to make happy the trading partners of North Korea. In other words, rather than open such or such products with respect to such and such trading partners in a discriminatory way (at the risk of protecting for ever the only sectors which have no interest for North Korean trading partners and which will be a burden for the North Korean growth, as it has happened in Vietnam) North Korea will open in a non-discriminatory way the most modern parts of its territory and economy.
- FEZs would not be able to play fully their role of driving export forces if they are not part of the network of the preferential trade agreements negotiated by South Korea

during the last decade. This is not the case today. For instance, goods produced in the Gaeseong complex are excluded from the coverage of the current free trade agreements between South Korea and the EU or the US—hence not eligible for the zero tariffs that South Korean goods start to enjoy in the EU or US markets. As stressed in Box 2, the “internationalization” of Gaeseong has the explicit objective to make the goods made in Gaeseong eligible to the status of goods from South Korean origin in the preferential trade agreements involving South Korea.

Box 2. “Internationalizing” the Gaeseong industrial complex: testing the potential of trade policy to diffuse political tensions

The Gaeseong industrial complex provides a fascinating illustration of this capacity of trade policy to diffuse political tensions. In early 2013, the complex was at the epicenter of the tensions in the Korean Peninsula, and one of the best illustrations of how bilateral trade agreements can be subjected to and magnify international tensions [Messerlin 2013]. The recent decision taken jointly a few months later (in August 2013) by the North and South Korean authorities to “internationalize” the Gaeseong complex (see Box 1) is a huge step in using the above-described capacity of trade policy to reduce political tensions: involving other countries in Gaeseong will change dramatically the status of the Gaeseong complex by making it implicitly more “WTO-like”.

In August 14, 2013, South and North Korea agreed on the normalization of Gaeseong Industrial Complex (GIC) after 133 days of seizure. The joint declaration stated that no further closure of activities at GIC should occur by blockage of workers, or their retreat, and emphasized on the neutrality of the GIC from political tensions. In this joint declaration, the two parties have also agreed on concrete measures for internationalizing the GIC which would include (i) an active promotion of foreign enterprises in GIC, (ii) institutional reforms in labor, taxation, wages, insurance policies to international standard, (iii) the implementation of special tariff rate for exports to third country and (iv) an opening of a South-North joint Foreign Investment Fair.
http://www.yonhapnews.co.kr/bulletin/2013/08/14/0200000000AKR20130814209200043.HTML.

In September 11, 2013, the second meeting of the South-North GIC Joint Committee, which was established by the Joint declaration on the normalization of GIC, has agreed on opening a common foreign investment fair for foreign enterprises in October 2013 in GIC. Such an “internationalization” process would require further elaboration on the side of the South Korean government by addressing institutional issues such as taxes and the possibility to make the goods produced in GIC recognized as products of South Korean origin in the context of the free trade agreements signed by Korea (for instance with the EU and the US). The Joint committee has also agreed on the composition of a “Commercial Arbitration Council” to serve as a dispute settlement body for disputes arising in GIC. The Commercial

Arbitration Council was initially agreed in 2003 between South and North Korea, but it has not been put into practice.
http://www.yonhapnews.co.kr/politics/2013/09/11/0505000000AKR20130911069153043.HTML

The compatibility and consistency between the economic strategy and the negotiating tactics components

North Korea's economic interest would thus seem best ensured by a trade policy based on two components: an uniform tariff rate, possibly high at the beginning but decreasing at a progressive but firm pace, and a set of FEZs with a very low uniform tariff rate since the beginning which will be tha anchor of North Korean industrial growth.

Is such a package acceptable for North Kora's negotiating partners? The answer is yes—meaning that such an economic strategy is perfectly defensible in bilateral negotiations. The certainty to have almost immediate easy access to North Korean production centers (FEZs) should please the interests of the negotiating partners in equipment industries of all kinds. And the perspective of a progressive dismantlement of the initially high uniform tariff imposed at the borders of the rest of the North Korea territory should also be an acceptable package for the interests of the consumer goods industries of North Korea's trading partners—all the more because the North Korean income will be the main constraint to North Korean imports for a long time.

As a result, what the negotiating partners will try to ensure is the stability of such a North Korean trade policy. In other words, they will essentially request "bindings": the binding of the progressive reduction of the initially high uniform tariff, the binding of the final rate of this tariff, and the binding of the market access to FEZs. By the same token, they will make less urgent the question of the WTO membership of North Korea.

Section 5. Closer relations with South Korea

As said in the introduction, most of the studies focusing on the North Korean trade policy have focused on the closer trade relations to be established between North and South Korea (see for instance, Chun and Rhee [2012]). Such a focus is easy to understand, and it has deep roots in a long political debate in South Korea—from President Kim Dae-Jung's visit to North Korea and to the 6.15 North-South Joint Declaration in June 2000 to President Roh Moo-hyun in the North-South Korea Summit in May 2007. This perspective has been renewed with President Park Geun-hye stressing Korean unification as a "jackpot" for the whole East Asian region at the 2014 Davos Forum.

What follows builds on these studies by presenting the pros and the cons of a "free trade agreement" and a "custom union". But, it does not try to "rank" these options, nor to make recommendations because they clearly involve political considerations which are beyond the scope of this modest paper (they also raise constitutional issues which are beyond the scope of this paper).

A free trade agreement (FTA) between North and South Korea

In a free trade agreement, each partner eliminates its tariffs on goods imported from the other partner, but keeps its own tariffs on goods imported from the rest of the world. North Korea will thus eliminate its tariffs on South Korean goods only (and conversely). There are three options for dismantling the intra-Korean tariff barriers:

- the first one (used by the EU in its early years 1958-1969) consists in a cut of an equal percentage every year over a given period (a 10 percent annual cut in the EU case);
- the second option has been much debated during the Doha Round: it consists in applying a 'Swiss' formula which would cut the higher tariffs by a larger percentage than the smaller tariffs. This second option would only be implemented by South Korea if the North Korean tariff is uniform. Its advantage is that it accelerates North Korean market access to the most protected South Korean markets;
- the third one would be an asymmetrical tariff dismantlement, whereby South Korea would eliminate all its tariffs (not only the highest ones) faster than North Korea.

That said, today FTAs aim to address the many other major trade issues confronted by a modern economy, such as industrial norms, regulations in services, intellectual property rights, public procurement, state-owned enterprises (SOEs), etc. These so-called "21st century" trade issues are much more challenging than mere tariff cuts, and the FTA between North and South Korea should pay attention to two aspects—one from the North Korean perspective, the other one from the South Korean perspective.

The North Korean perspective. These 21st century trade issues are often very intensive in regulations and institutions: technical norms requires technical agencies and certification bodies; services markets need to be well regulated. These issues are also often costly for consumers (for instance, environmental norms). A North-South Korean FTA should thus pay great attention not to overburden the initially limited and fragile institutions in North Korea, nor to impose too high costs on North Korean consumers who, for a long time, will remain too poor for being ready to pay for such aspects of a modern economy. The right balance could be achieved in two alternative ways:

- An unique FTA text could cover the whole range of issues in an ambitious way, but its schedule of implementation at least on the North Korean side would be designed with great care in order to take into account North Korean capacities to absorb or deliver the FTA provisions. The EU took this approach in its early years. The Treaty of Rome has the deepest and widest set of provisions covering all the topics conceivable in the late 1950s. But its implementation was very progressive: ten years for dismantling the intra-EU industrial tariffs starting in 1958, ten years for crafting and implementing an agricultural policy starting from 1964, a slow and still incomplete elimination of the non-tariff barriers starting in the late 1960s, a still unfinished agenda of services liberalization starting in the late 1980s, etc. Unfortunately, the EU forgot this careful approach when it included additional Members States—putting too much burden on some of them (from Greece to Romania to Cyprus) with the consequences revealed since the 2008 Financial Crisis.
- Alternatively, the FTA between South and North Korea could follow a tradition more frequent in Asia. It would consist in a series of texts negotiated over time and covering more and more domains in an increasingly deep manner. The best illustration of this approach is the Economic Cooperation Framework Agreement between China Mainland and Taiwan.

The South Korean perspective. It is important to stress that concluding a FTA with North Korea would also be demanding to South Korea. In particular, it would require an internal in-depth evaluation of the intrinsic quality of the regulations enforced in South Korea in order to assess which ones are good enough to be included in the FTA and which ones should be revised before any inclusion in the FTA (as best illustrated by the South Korean agricultural policy).[10] It is a great pity that this fully fledged regulatory assessment programme has not been done in the EU before the accession of the Central European countries. This absence of assessment has forced the Central European countries to adopt hastily a huge amount of unrevised regulations (once, the Polish Parliament adopted some 150 new laws in one package) which happened to be often much too expensive for their level of income. And, it has left the Western EU Member States with out-dated regulations the consequences of which are visible in today EU economic performance.

A custom union between North and South Korea

Another option would be a "custom union" between North and South Korea. In a customs union, each partner eliminates its tariffs on the goods imported from the other partner (same as FTA) and will implement the same tariffs than its partners on goods imported from the rest of the world. Compared to a North-South Korean FTA, this option raises a few additional key issues which are challenging for both South and North Korea.

First, the custom union requires that North and South Korea will adopt the same tariff with respect to the rest of the world. This is not simple matter because the current South Korean tariff structure is very different from the EU tariff structure at the time of Eastern Germany accession—in fact, it is much less capable to reveal the North Korean comparative advantages than the EU tariff structure of the early 1990s.

This is because, as illustrated by Table 4, South Korea has often higher average and peak applied MFN tariffs than the EU. It has also a wider range of MFN tariffs (with peaks two to three times larger than EU tariff peaks), and much larger differences between applied and bound tariffs ("tariff water") than the EU.[11] In other words, it may easily happen that some goods in which North Korea would have no comparative advantages may be protected by high South Korean tariffs, while some goods in which North Korea would have comparative advantages may be protected by low South Korean tariffs. Such a tariff structure at odd with

[10] Such a process would enormously benefit from the creation in Seoul of an institution such as the Australian Productivity Commission which would be asked to review the South Korean regulations.

[11] That said, South Korea has the KOREU and KORUS PTAs—that is, counter-forces to protectionist incentives to increase South Korean applied tariffs up to the bound level in order to solve transition problems in North Korea.

North Korean comparative advantages will tend to shift North Korean resources in sectors in which North Korea will be inefficient—hence waste North Korean resources.

Table 4. Tariff structures of South Korea and the EU

	South Korea					European Union				
	Final bound duties			MFN applied		Final bound duties			MFN applied	
	avg	max	bound	avg	max	avg	max	bound	avg	max
Animal products	26	89	100	22	89	24	140	100	23	140
Dairy products	70	176	100	68	176	58	226	100	55	205
Fruits, vegetables	64	887	100	58	887	10	170	100	12	170
Coffe, tea	74	514	100	54	514	0	25	100	6	25
Cereals and prepa.	161	800	100	134	800	20	167	100	16	167
Oilseeds	44	630	100	37	630	7	171	100	7	171
Sugar	32	243	100	17	243	28	131	100	29	131
Beverages	43	270	100	32	270	22	175	100	19	162
Cotton	2	2	100	0	0	0	0	100	0	0
Other ag. products	21	754	100	16	754	4	131	100	5	131
Fish	15	32	54	16	47	11	26	100	10	26
Minerals, metals	8	35	96	5	8	2	12	100	2	12
Petroleum	9	13	80	5	8	2	5	100	3	5
Chemicals	6	373	98	6	317	5	17	100	5	17
Wood, paper	3	13	89	2	10	1	10	100	1	10
Textiles	17	30	99	9	13	7	12	100	7	12
Clothing	28	35	100	13	13	12	12	100	12	12
Leather, footwear	12	16	98	8	16	4	17	100	4	17
Non-elec. Machinery	10	20	97	6	13	2	10	100	2	10
Elec. Machinery	9	20	74	6	13	3	14	100	3	14
Transport equip.	8	20	81	6	10	4	22	100	4	22
Manufactures, nes	10	16	95	7	13	3	14	100	3	14

Note: For simplicity sake, figures have been rounded. Source: WTO website, Tariff profiles.

That said, the PTAs signed by South Korea (such as the Korea-EU or the Korea-US trade agreements) means that, on average, the South Korean tariff structure is *de facto* much closer to zero than shown in Table 4. But, the MFN tariffs are those which count in a trade agreement, and South Korea has no PTAs with many countries—among them China and Japan—which are critical sources of cheap products for the poor North Korean consumers and of equipment for North Korean producers.

In short, from a producer perspective, the non-uniform feature of the South Korean MFN tariffs may be detrimental to some emerging or potential North Korean comparative advantages. Hence, building a Korean customs union should require from South Korea to unilaterally 'flatten' its existing MFN tariff schedule in order to help North Korea to realize better where lie its comparative advantages.

Turning from producers to consumers, the South Korean tariff structure raises another important question: to which extent the current South Korean tariff structure protects more the "cheap" goods than the luxury goods? If it taxes more the cheap goods than the luxury goods, the custom union would be more favorable for the goods consumed by the North Korean "upper-class" (closer to South Korean consumers) at the detriment of those demanded by the other North Koreans. If too strong, such a distortion has obvious political consequences for the reunification objective since it would make more difficult a remake of the "Han River miracle", namely the low income differences among the various layers of the South Korean population during the first decades of South Korea's growth.

The last consequence of a custom union between North and South Korea is that North Korea would automatically "join" the WTO with the same concessions and obligations than South Korea (this is not inconsistent with section 1 since a North-South Korean customs union is inconceivable without a satisfactory solution of the nuclear issue). This would be similar to what happened to Eastern Germany (Estonia and Latvia acceded to the WTO in 1999 and Lithuania in 2001, that is, before their full accession to the EU in 2004). By becoming part of the Federal Republic of Germany, Eastern Germany was immediately subjected to all the WTO concessions and obligations of the EU—from tariffs to industrial norms to sanitary and phyto-sanitary measures to trade facilitation to intellectual property rights, to public procurement, etc. As underlined below, this huge package of obligations has proven a difficult still ongoing process for Eastern Germany.

<u>North Korea and the negotiations of PTAs in Asia</u>

As well known, there are many ongoing negotiations on preferential trade agreements in Asia: China-Japan-Korea, Regional Comprehensive Economic Partnership (RCEP), Economic Cooperation Framework Agreement (ECFA), Trans-Pacific Partnership (TPP), to name a few. In addition, at the January 2010 China-South Korea Summit, President Lee Myung-bak proposed a bilateral FTA between the two countries. In June 2103, the China-South Korea Summit agreed to accelerate these trade talks.

This situation opens two main options to North Korea. First is to try to become a full participant to (some of) these negotiations. This option faces a major problem: most of these negotiations are advanced enough to make difficult to include a late-comer—which has a thin experience in such complex negotiations and faces such a deep shortage of trained negotiators, as North Korea.

The second option for North Korea would then to include an 'association' provision in its PTA with South Korea that would design the appropriate procedures for North Korea to participate in the South Korean negotiations on PTAs in Asia (and in the rest of the world).

Concluding remarks

This paper provides the main information on economically-sound trade policy options available to North Korea. Section 1 spells out the key guiding principles that such a trade policy should follow in order to boost North Korean domestic growth as much as possible. These principles consist in non-discrimination in terms of goods (same tariff on every product) and countries (most favored-nation) and in a great effort to design trade policy components in such a way that there will provide costless substitutes to a (long-lasting in some cases) lack of appropriate institutions required by a modern trade policy.

Section 2 examines North Korean options in terms of trade policy as negotiating tactics. It focuses two issues: the North Korean accession to the WTO and the establishment of normal trade relations with North Korean major trading partners, in particular the US, both issues being strictly constrained by the denuclearization issue.

Section 3 develops the dimension of trade policy as an economic strategy boosting North Korean growth. It shows that countries which have faced political and economic difficulties very similar to those faced by North Korea have been extremely successful when they have adopted a trade policy based on the non-discrimination principles spelled out in section 1. This section also argues that Free Economic Zones should be see as a full component of this trade policy strategy. FEZs could both facilitate trade negotiations with other countries—helping to define what should be conceded and what should not for the best interest of North Korea—and boost North Korean development at costs as low as possible in terms of new infrastructure (an essential consideration since the North Korean is in such a huge need of new infrastructures). Finally, the section stresses the compatibility between such an economic strategy and the negotiating tactics.

Last but not least, section 4 examines the closer relations with South Korea in a bilateral setting as well as those in the broader context of the burgeoning East Asian preferential trade agreements.

The paper deserves a final remark. As underlined in several instances, trade policy is only one component of the new policies needed for boosting North Korean growth. Exchange rate policy, macro-economic policies, labor market and structural policies establishing progressively competitive markets for goods, services, labor and capital in North Korea will also be decisive for achieving economic success. The major economically sound available options in all these crucial policies should also be examined in papers like this one on trade policy in order to provide to North Koreans the best information possible—illustrating once again that the transition period is not doomed to be a free fall into a chaotic world.

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Annex A. The Baltic and Georgian experiences

As underlined in section 3, the Baltic countries (Estonia, Latvia, Lithuania) are interesting experiences. They also have little idea about their comparative advantages (in the USSR, productions were allocated among the various Soviet Republics by central planners much more concerned by creating artificial economic inter-dependency among the Soviet Republics than by promoting economic efficiency), they face a more fragile domestic and international situation because Russia was less ready for a hands-off policy with respect to former members of the USSR and the shares of Russians in their populations ranged from being small to substantial. Georgia faced the same constraints even more severely (Russia has been persistently unfriendly to Georgia to the point of going to war with it and fuelling the secession of two provinces), with huge economic distortions (dating from Stalin era) and corruption (Georgia was said to be the most corrupted Soviet Republic in the USSR).

The Baltics have favored relatively radical choices—in trade policy as well as in other economic policies—Estonia being the most extreme and consistent in this matter, and Georgia followed their examples after 2006. Table A1 summarizes these policies which consist in very few measures:

- the elimination of almost all the tariffs and tariff-equivalents (licenses, quotas, etc.) on both imports and export (in the European centrally-controlled economies, barriers to exports were often as constraining as barriers to imports).[12]
- a very short list of exceptions (5% of the products in Latvia) largely concentrated on agricultural products and on the export side.[13]
- the abolition of state-owned enterprises in external trade activities.
- the currency regime, that is, how easy it will be for traders to find foreign currencies at a good rate.[14]

[12] . The export constraints which were maintained were limited to few politically sensitive products. This is important because barriers on exports are equivalent to barriers on imports, hence could have re-introduced a substantial dose of protection if they were many.

[13] There are roughly 6,000-7,000 products in a trade tariff structure defined at the HS-6 digit.

[14] The foreign exchange measures are crucial, but they are not discussed in this paper because they are much more tightly related to the broad monetary and budgetary policies than to the trade policy *per se*.

It is interesting to note that all these measures were very frugal in terms of institutions. There was no or very little need of administrations for granting licenses and quotas since most of them were eliminated. The degree of freedom of the Custom Offices was quite limited since the vast majority of goods were subjected to the same low tariff rate, leaving no possibility for the customs officers to play with various tariffs in exchange of bribes. The abolition of state-owned enterprises in external trade activities was not only justified by the absence of market power of any of these countries in the world markets, but it also eliminated the need to create a competition authority for monitoring the (likely) costly monopolistic behavior of these enterprises (as sole importers or exporters) with respect to North Korean firms.

Table A1. Key components of trade policy reforms: the Baltics and Georgia.

		Estonia	Latvia	Lithuania	Georgia [a]
Import restraints	Tariffs	0.5% for statistical purpose.	Average tariff of 10%, low rates on inputs.	Unweighted average of 3.2% with a 0-30% range; 75% have a zero tariff; inputs have low rates.	average tariff of 1.5%, 85% tariff lines are duty free, the rest has a 12% tariff.
	Licenses and quotas	None.	No licences, but specific duties on 150 products (defined at HS-6 digit).	About 10 products.	None.
Export restraints	Taxes	Taxes for cultural items only. 0.5% on other items.	383 tariff lines (defined at HS-6 digits) subjected to 1 to 100% export taxes, with 90 percent of them below 10%. Mostly agricultural products, metals, raw materials (sands, wood, leather).	15 products (defined at HS-4 to 5 digits) subjected to export taxes ranging from - to 50%, with 90% of them below 10%.	None.
	Licenses and quotas	Tobacco, alcohol, some agriculturaland forest products, metals, broadcast equipment, oil shale, petroleum and mineral oil.	None.	None, except for temporary bans on red clover seed, untreated oak and ash timber.	Minimal export restrictions (health, environment, culture).
State trading		None.	None.	None.	None.
Foreign exchange		Convertible current account with a currency board mechanism since 1992; no surrender requirement since early 1994; virtual capital account convertibility.	Convertible with wide access to foreign exchange through commercial bureaus; no surrender requirement.	Convertible since 1992; currency board since April 1994; no surrender requirement.	Floating exchange rate.

Source: For the Baltics: Michalopoulos and Tarr [1996]. For Georgia: WTO Trade Policy Review [2010].

Table A2 shows the GDP growth of all the Central European countries having joined the EU—hence having benefited from the same support from the EU (Georgia is not included in Table A2 because it did not enjoyed this situation but has faced a very different international environment, including war). It shows clearly that, over 18 years, the growth performance of the Baltics has been better than the growth performance associated to more progressive trade policies implemented by other Central European countries.

Table A2. GDP per capita of the Central European EU Member States, 1995-2013

	Growth rates (%)				GDP per capita			
	GDP per capita		GNI per capita		current $		Slovenia=100	
	current $	PPP [a]	current $	PPP [a]	1995	2012	1995	2012
Baltic countries								
Estonia	12.2	8.1	n.a	7.8	2629	16316	25.0	73.9
Latvia	12.3	8.2	11.9	8.2	2107	14009	20.0	63.4
Lithuania	12.6	8.3	12.0	8.0	2178	14150	20.7	64.1
Other Central European EU Member States								
Bulgaria	11.9	6.6	10.4	6.6	1555	6986	14.8	31.6
Croatia	9.3	5.8	6.6	5.6	4722	13227	44.9	59.9
Czech Republic	9.0	4.4	11.5	3.9	5596	18608	53.2	84.2
Hungary	7.1	5.3	6.9	5.0	4411	12622	41.9	57.1
Poland	9.4	6.7	9.1	6.5	3603	12708	34.2	57.5
Romania	11.7	7.2	11.7	7.1	1564	7943	14.9	36.0
Slovak Republic	9.4	6.8	10.1	6.7	4710	16934	44.8	76.7
Slovenia	7.2	4.7	6.9	4.5	10524	22092	100.0	100.0

Note: [a]: PPP: purchasing power parity. Source: World Bank