

Asia: Cutting Through the Noise Series

Issue VI – North Korea Under the Radar

December 2017

Key Takeaways:

- In our view, North Korea is a rational actor set on executing a three-stage plan: 1) obtaining nuclear weapon capabilities; 2) forcing bilateral talks by escalating tensions in Asia; and 3) earning recognition as a legitimate nuclear power.
- Beyond the newspaper headlines and rhetoric, North Korea's underlying economy appears to be strengthening despite the country's isolation.
- The true impact of sanctions may prove to be muted, and there is ample risk of miscalculations on all sides.
- We argue that the ultimate endgame for North Korea is the achievement of normalized relations as a legitimate nuclear nation-state.

A Three-Stage Roadmap

Since President Trump was sworn into office, the perception of risk surrounding North Korea has risen to levels not seen since

2006, when Kim Jong-un's father and predecessor, Kim Jong-il, presided over the country's first nuclear weapon test. At present, significant progress in the younger Kim's quest to develop nuclear-tipped intercontinental ballistic missiles (ICBMs) capable of reaching the continental US—coupled with a relatively unorthodox US administration—is threatening to significantly alter the Korean peninsula's geopolitical equilibrium. We posit that North Korea is in the midst of executing a three-stage roadmap to achieve its ultimate objective of gaining political capital and financial leverage by monetizing its nuclear capabilities. Underpinning this plan is a greatly underappreciated factor lying outside of the geopolitical sphere: the growing strength of North Korea's local economy.

Stage One: Arms and Independence

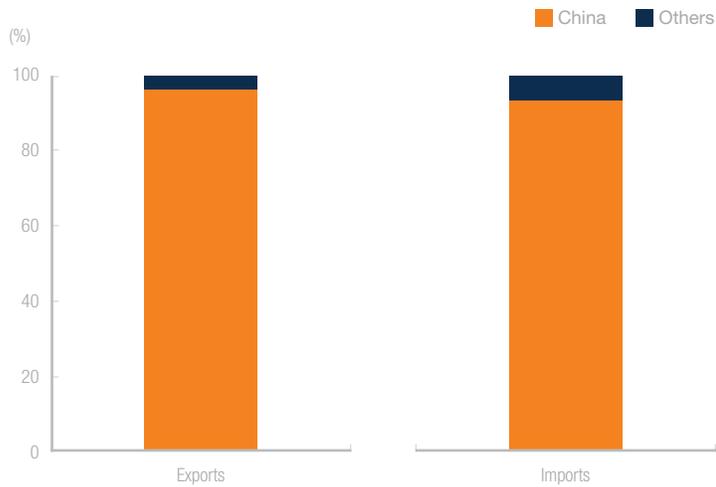
The first stage of Kim's plan involves the development of nuclear weapons followed by a distancing from China. Since the Korean War armistice was signed in 1953, China has been the de facto caretaker of North Korea, safeguarding a finely balanced peace on the Korean peninsula. What is underestimated about this relationship is its degree of lopsidedness: China's role as guardian provides the country with major political leverage without fundamentally

benefitting North Korea. While China's economy has seen unprecedented growth from its embrace of free trade and financial market liberalization, North Korea remains a hermit kingdom mired in poverty.

Underappreciated by the Western media is the growing dissatisfaction among North Korea's power brokers with the current situation. Indeed, after decades of languishing in China's shadow, North Korea has grown increasingly aware that the political and economic dividends from its ally's patronage have been withering.

North Korea's Dependence on China

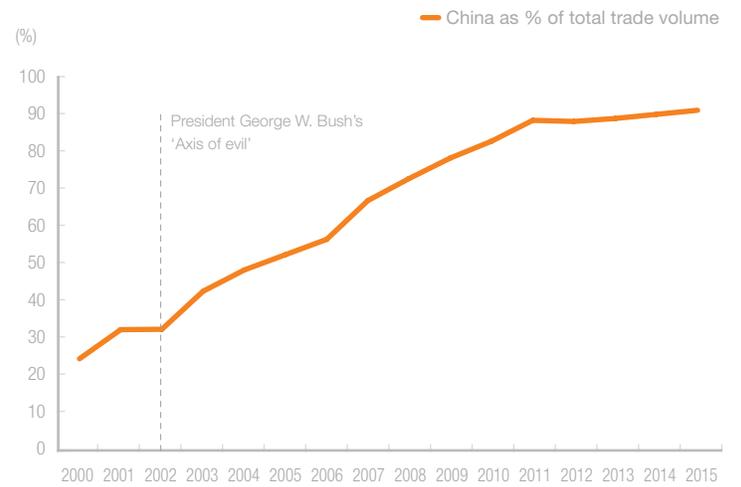
Source: Statistics Korea (Accessed in 2017)



Note: Exports / Imports figure based on 2015 data

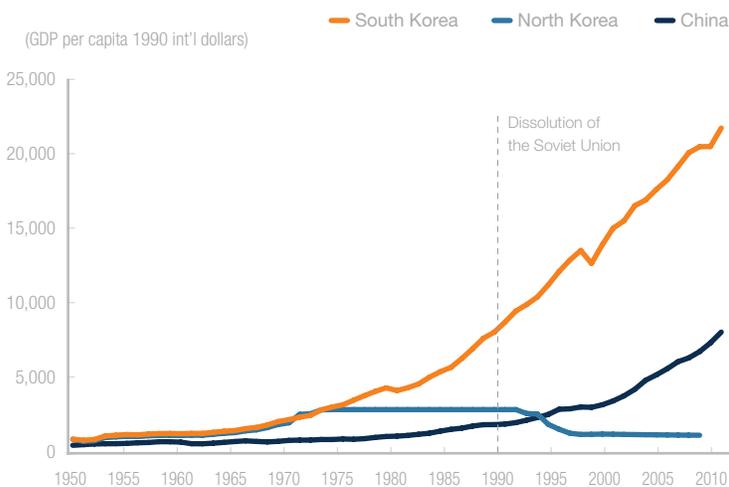
US Trade Sanctions Make North Korea Reliant on China

Source: Statistics of Korea (Accessed in 2017)



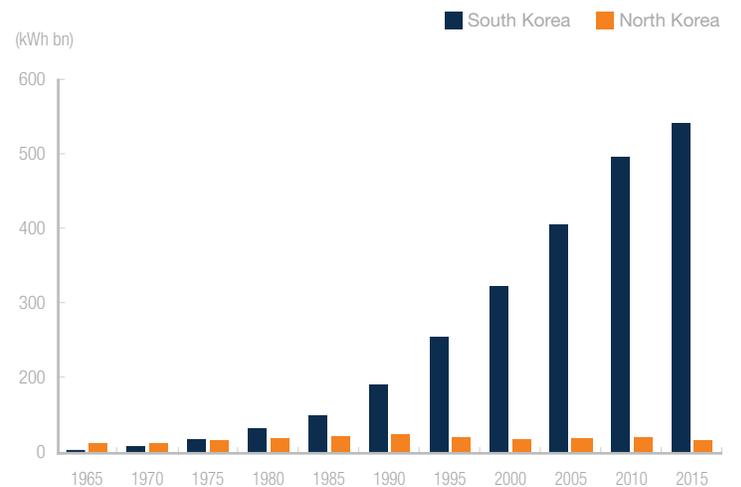
North Korea Left Behind by its Neighbors

Source: Maddison Project Database (2017)



No Sign of China's Infrastructure Projects for North Korea

Source: Statistics Korea (Accessed in 2017)



Against this backdrop, escaping from China’s shadow will be imperative for Kim’s regime. After all, if the world believes that China has firm control over its neighbor, Kim and his allies have no leverage. While the ongoing distancing of North Korea from China—facilitated by the development of nuclear weapons—may cause economic damage in the short term, it is a prerequisite for the acquisition of bargaining power on the global stage.

Stage Two: Forcing Bilateral Talks

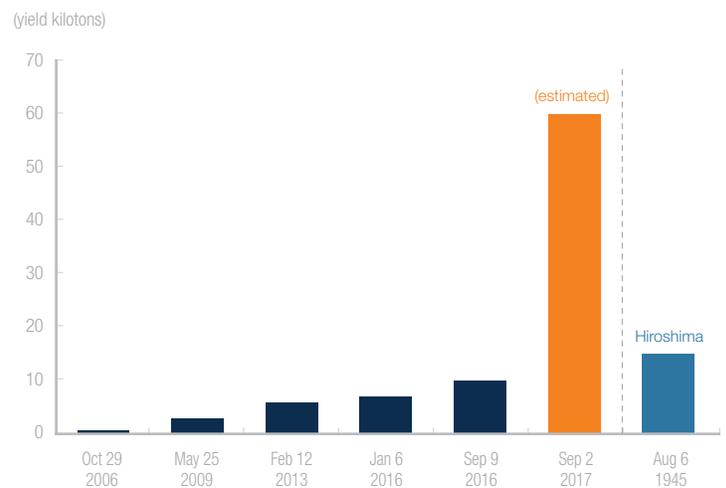
Currently, North Korea is moving toward stage two of its strategy: forcing its way into bilateral talks with the US. For most of its history, North Korea has regularly threatened to attack the US mainland and create a “sea of fire.” In recent years, such bombastic threats have been accompanied by demands for one-on-one negotiations with the US (as opposed to six-nation talks).

In 2015, Iran agreed to draw down its nuclear program in exchange for the lifting of sanctions and the promise of foreign investment. The parallels between Iran’s and North Korea’s situations cannot be lost on Kim Jong-un. Indeed, it appears as though bilateral talks with the US are part of North Korea’s strategy to monetize nuclear weapons and regain political independence.

The machinations and savvy of North Korea have consistently been underappreciated. Historically, North Korea has engaged in a form of calculated saber-rattling, ending its threats after achieving maximum bargaining power. This time around, emboldened by its burgeoning nuclear capabilities, North Korea appears willing to prolong the saber-rattling for an extended period to secure a place at the negotiating table.

North Korea’s Nuclear Progress

Source: Mirae Asset Daewoo Alpha Strategy Team



Stage Three: Engagement and Recognition

Ultimately, Kim Jong-un wants to reach a settlement granting North Korea recognition as a legitimate nuclear nation, as well as unlimited economic upside from the lifting of sanctions. In other words, North Korea is seeking engagement with and recognition from the US. As reported in the New York Times: “Since early last summer, North Korean officials have publicly said that they have entered the last stage in the development of their nuclear force, implying that they have an endpoint in mind. A senior North Korean official privately told us: ‘If we feel we have enough, the primary emphasis will be on economic growth.’”¹

At the current pace, North Korea is projected to develop ICBMs capable of reaching the West Coast of the US within the next few years. Meanwhile, the US and the United Nations continue to ramp up their economic sanctions in the hopes of a change in the stance of Kim Jong-un, who has displayed meticulous strategic planning and risk management up to this point. Thus far, economic sanctions have proven to be toothless against a regime that shows little regard for the well-being of its people. In fact, in the face of the international community’s efforts to isolate North Korea, there are signs pointing to on-the-ground, market-driven progress.

¹ New York Times “How Trump Should Talk to North Korea” (November 7 2017)

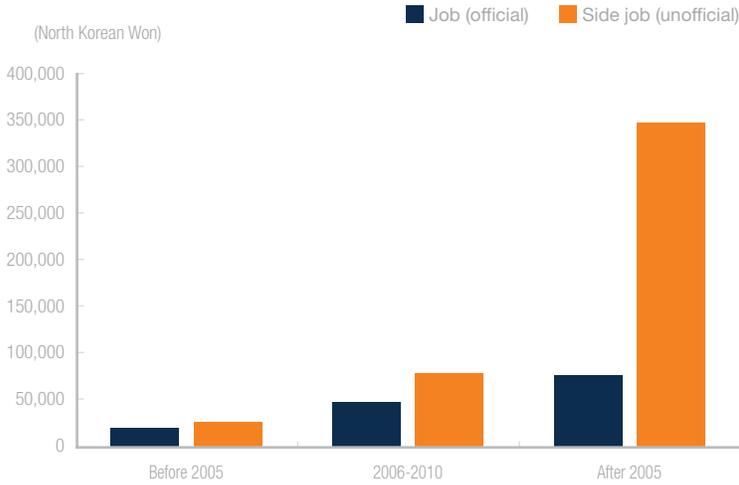
North Korea's Economic Resilience

We believe that there is a hidden strength to North Korea's economy. Kim Jong-un is establishing strong support via economic reforms centered on building up the middle class. In fact, there is evidence

that North Korea is displaying an economic vibrancy not seen for over a decade despite US-directed sanctions and a reduction in aid from China.

Kim Embracing Capitalism?

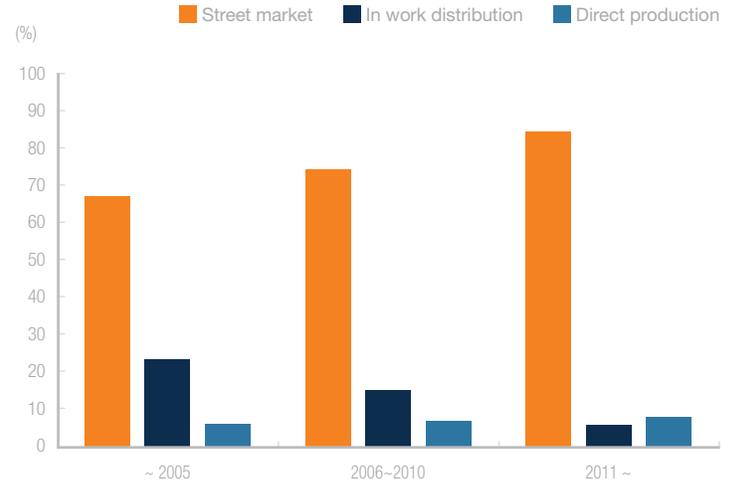
Source: Korea Development Institute (Accessed in 2017)



It would seem that North Korea is stealthily making progress in market reform. If the available data and analysis are anywhere close to being correct, the latest UN sanctions, which are designed to strip

Means of Living

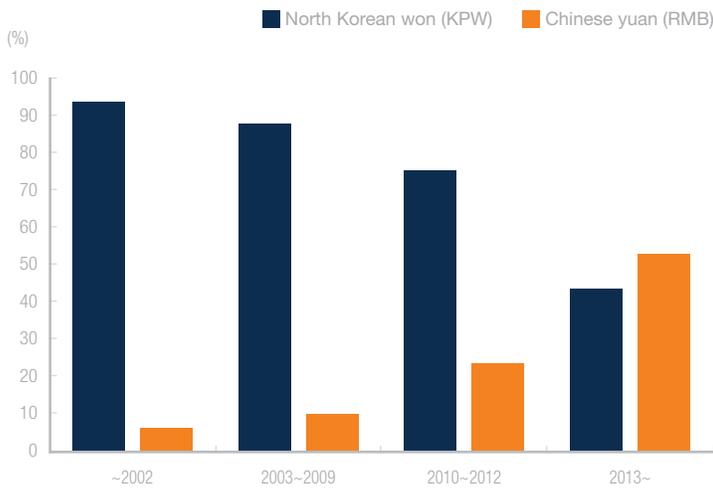
Source: Korea Development Institute (Accessed in 2017)



US\$1 billion in exports from North Korea, will not have the desired impact. Ultimately, North Korea is playing the long game, seeking rewards many multiples greater than that figure.

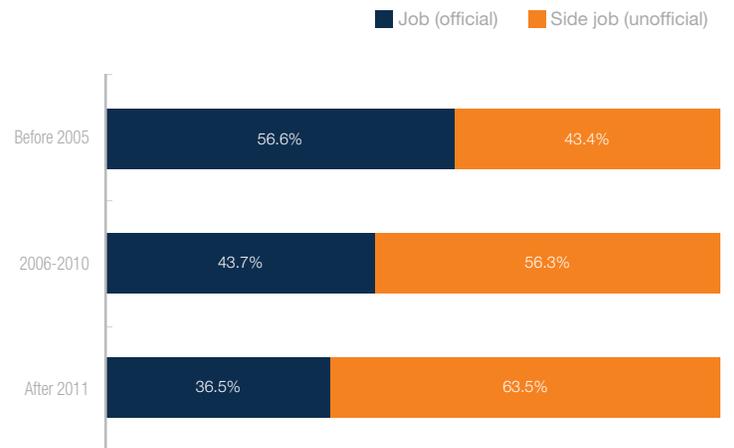
Rising Usage of RMB Indicates Real Commerce Activities

Source: Korea Development Institute (Accessed in 2017)



Average Ratio Official/Unofficial Jobs to Total Income

Source: Korea Development Institute (Accessed in 2017)



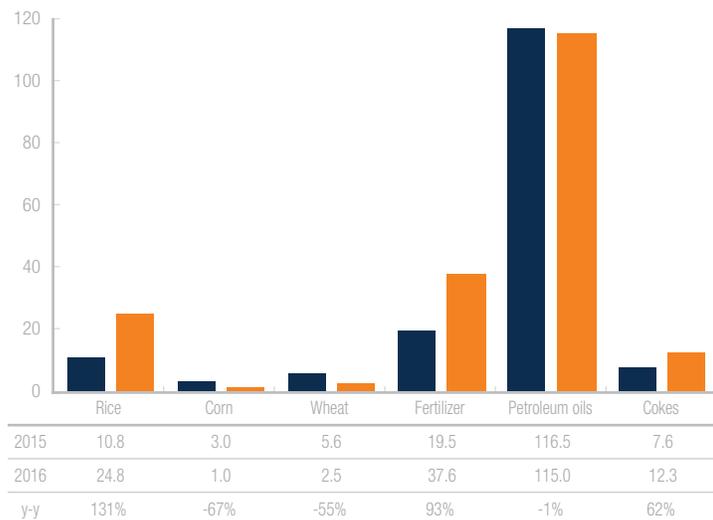
China buys an estimated US\$100 million worth of coal annually from North Korea.² But neither economic sanctions nor the severing of trade relations will deter North Korea's efforts to monetize decades of sacrifice and investment. This resolve is supported by rare constructive policy actions implemented by Kim; specifically, the North Korean regime has been allowing its citizens to engage in

basic trading and commerce activities. We have increasingly been seeing anecdotal evidence of an emerging consumer class benefiting from the trading of goods made from Chinese raw materials. North Korea may be making strides in productivity and income growth reminiscent of China in the 1990s.

China's Oil Exports to North Korea Are Crucial

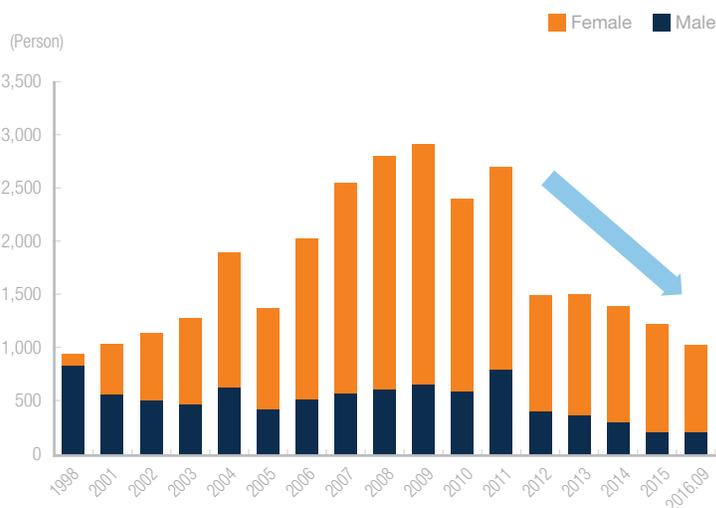
Source: Korea International Trade Association (Accessed in 2017)

(North Korea imports from China USD mn)



Declining North Korea Defectors to South Korea

Source: Korea Development Institute (Accessed in 2017)



Sanctions and Risk Perception

In August 2017, the US and Japan proposed oil sanctions on Kim's region for the first time. Oil is the most important commodity for North Korea, as it is critical to military operations and winter heating. For decades, China has reluctantly agreed to UN sanctions on North Korea but has continued to be the sole supplier of energy to its neighbor, knowing full well that cutting off oil supply could fatally sever the two countries' already tenuous alliance. Therefore, China's ultimate decision on oil sanctions will be a critical turning point for the escalation of North Korea risk for financial markets.

From a geopolitical perspective, the perception of North Korea risk has remained elevated. However, financial markets remain largely indifferent to the saber-rattling—which may raise the stakes even more. Going forward, Kim could be tempted to elevate tensions to test the US response. As disputes escalate on the Korean peninsula, so too will the price of North Korea's demands. (Notably, China's response to external demands to pressure North Korea will be closely linked to looming trade negotiations.) In our view, investors should look out for the transition point between stages two and three of Kim Jong-un's grand plan, which will take place when North Korea

² KITA (2017)

perfects the technology to fire a nuclear-armed ICBM to the US West Coast. At that point, the bargaining power of Kim's regime, as well as market jitters, will be at peak levels.

Pricing In Normalization

All in all, however, given that Northeast Asia (i.e., China, Japan, and South Korea), generates US\$17.5 trillion in GDP, or 23.5% of the global total, we believe that it is unlikely that the relevant parties will allow a tail-risk event to break out.³ In addition, a broad-based desire to contain the threat of nuclear technology sales to terrorist organizations is perhaps a greater reason for cooler heads to prevail. As such, looking past dramatic news flows, we argue that investors should cautiously begin to consider scenarios wherein bilateral and/or multi-stakeholder negotiations occur for eventual economic gains on the Korean peninsula. Nonetheless, it should be noted that major shifts in stance by the US and UN will be required in order for such scenarios to actually materialize. In the meantime, a greater appreciation for North Korea's strategy and its long-term goals is advised for Western leaders and investors.

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³ International Monetary Fund World Economic Outlook (October 2017)

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