

REGIONAL INTEGRATION IN EAST ASIA AND PERSPECTIVES FOR ECONOMIC TRANSFORMATION IN NORTH KOREA - LESSONS FROM EUROPE

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While the political situation on the Korean peninsula has worsened dramatically since October 2002 when North Korea admitted to running a nuclear weapons program, the careful opening process of the North Korean economy witnessed in the recent years nevertheless has continued, forced upon the country by the disastrous economic situation. This enhances the chances for a double integration of North Korea - namely, nationally, with the far more advanced South Korea, and regionally, into the nascent economic integration area of Northeast Asia. Both processes can reinforce each other, but can also be to some extent substitutes for each other. Especially in the case of an economic transformation process without far-reaching political reforms, like in the case of China, regional integration seems more likely than national economic integra-

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tion. This paper analyzes the role of economic integration for the transformation process: In Eastern Europe, transformation preceded economic integration. In the case of Korea, economic integration can be seen as being parallel to transformation, or even anteceding it.

I. Introduction

The dramatically worsened political situation on the Korean peninsula after the exposition of North Korea's nuclear ambitions in October 2002, and the ongoing bold and often outrageous North Korean rhetoric of absolute allegiance to the Kim dynasty and their style of socialism tend to shift attention away from the fact that the careful economic opening process over the recent years has never been revoked, and indeed, continues. North Korea, finally, seems to be embracing at least marginal economic change. This, however, is not important if this change is due to a change of ideology or due to an attempt to save the isolationist ideology of self-reliance, and as long as real changes are the outcome of this opening process.¹

While the economic reform measures of mid-2002, when prices and wages were adjusted, seemed to have failed to stimulate production

1 Most probably it is the latter. Indeed, without the traumatic experience of widespread famine and the economy at the brink of collapse, there possibly would be no changes. For an account of the famine see Noland, M. - S. Robinson - T. Wang, *Famine in North Korea: Causes and Cures*, *Economic Development and Cultural Change*, Vol. 49, No. 4, pp. 741-767, Natsios, A. S. (2001), *The Great North Korean Famine*, Washington D.C., United States Institute of Peace Press; McKay, M. (2002), *The Food Crisis in the DPRK: Prospects for Policy Reform*, *International Journal of Korean Unification Studies*, Vol. 11, No. 2, pp. 143-172. Among the pressures from famine is its demographic impact; see Goodkind, D. - L. West, *The North Korean Famine and its Demographic Impact*, *Population and Development Review*, Vol. 27, No. 2, pp. 219-238.

until now, and only resulted in open inflation² in that they resemble the reforms of the late phase of Soviet socialism in Russia and Central and Eastern Europe, they nevertheless might have an impact on the change of North Korea's economic system. Ironically, the political crisis, which on the one hand leads to further isolation of the country, on the other hand makes economic reform even more necessary, since international aid has sharply reduced, affecting the import possibilities of the DPRK.³ Two questions arise for North Korea - namely, the question of the steps of necessary reform and of their sequencing. These questions have been intensely debated on in the case of the transformation of Central and Eastern European (CEE) states. While experiences in transformation and the sequencing of transformation steps have been discussed with respect to North Korea, the aspect of integration into the EU has been to a lesser degree the focus of research⁴ - this will be explored in this paper.

Early on in the transformation of post-socialist states in Europe, a consensus of necessary reform steps emerged (dubbed the "Washington consensus," since it was formulated in the international, Washing-

2 The reforms included a considerable raise in prices and wages (with the former being much higher than the latter), the introduction of the Euro as a new, parallel currency, and the extension of markets (former "farmers' markets" to include all kinds of goods with semi-free price formation. The former measures could reduce the monetary overhang in domestic and foreign currency (formerly mainly the US \$), but led to open inflation.

3 For an analysis of the DPRK's import policy see Lim, K. T. - Kim, J. - Y. (2002), Economic and Political Changes and Import Demand Behavior of North Korea, *Journal of Economic Development*, Vol. 27, No. 1, pp. 137-150.

4 For a discussion see Hernandi, A. (2002), Hungarian Lessons for North Korea's Economic Transition, *International Journal of Korean Unification Studies*, Vol. 11, No. 2, pp. 201- 219. The term "economic integration" has only been used in relation to both Korean states, for example in Lee, C. H. (1993), Korean Unification: Issues in Transition and Economic Union, Kiel Working Papers, No. 590, Kiel: Institute for World Economics, and Choi, Y. B. (ed.) (2001), *Perspectives on Korean Unification and Economic Integration* (Cheltenham: Elgar).

ton-based institutions involved in reforms in Latin America), a debate broke out about sequencing - i.e. the juxtaposition of “shock therapy” (a big bang transformation with all steps of transformation simultaneously) and “gradualism” (a step-by-step approach) in the early 1990s. However, later, this debate became meaningless, since outcomes of states initially choosing a similar approach differed widely. Then, a new form of sequencing debate became necessary when the CEE attempted to enter the European Communities (EC, today European Union EU): Should the transformation states be allowed to enter EC unreformed, or should they have to complete reforms before entering the EC? Only East Germany, which was absorbed by West Germany, became immediately part of the EC, while other CEE had to fulfill the so-called “Copenhagen criteria” before they were allowed to enter the EC (now EU) after protracted negotiations. The road towards EU accession gave candidate countries a roadmap for policy formulation (the Copenhagen criteria) and reduced uncertainty about their institutional development, and thereby, was crucial also in attracting investors.

The experience of European transformation countries also contains valuable lessons for North Korea for two reasons: First, the transformation processes in CEE and the former Soviet Union provide us with a number of observations on institutional development beginning with, to a large degree, similar initial conditions and similar international environment. Thereby, they come as close as possible to a situation of controlled experiments which are usually lacking in social sciences. While our initial understanding of transformation based on simplified policy choices like “shock therapy” or “gradualism” was limited, the inclusion of institutional factors and the understanding of economies as embedded in a specific culture widened the lessons to be learned from transformation states.⁵ Second, North Korea, while a Northeast

5 For an extended discussion of this methodological statement see Seliger, B. (2000),

Asian country and a political system *sui generis*, resembling a dynastic despot more than a communist party dictatorship, nevertheless has important similarities with Central and Eastern Europe - this concerns the industry structure especially, besides the common history of becoming a part of the Soviet influence sphere in the late 1940s, and at least similarly designed state organs. There has been, before the collapse of the early- and mid-1990s, an asymmetric strong development of the heavy industry at the expense of and including the agriculture and light industries. Therefore, problems in raising productivity for the economy, which had been easier in the largely agricultural countries of China and Vietnam, more closely resemble the difficulties in CEE and the former Soviet Union.

Can international economic integration also be beneficial for North Korea? And where in the sequence of reform steps should economic integration be included? This question is discussed in the latter parts of this paper and organized as follows: In the second section, the experiences from CEE in sequencing are reviewed. The third section discusses the relationship between economic integration and economic transformation. This is followed by an analysis of the potential of economic integration in East Asia for North Korea, followed by a short conclusion.

II. Sequencing in Transformation: Experiences from Central and Eastern Europe and the North Korean Case

After an initial discussion in the mid-1990s, a broad consensus of transformation steps (called the *Washington consensus*, since it was based on the experience of Washington-based international institutions

Politische Ökonomie der Systemtransformation - Stand der Forschung, ungelöste Probleme und eine Fallstudie zu Südkorea, Witten discussion papers, No. 68, Witten: University of Witten/ Herdecke.

The Washington Consensus includes the following policy and institutional changes (Williamson 1990, 1997):

- * Fiscal laxity -> fiscal austerity
- * Incoherent tax code -> tax reform
- * Closed markets -> liberalization of trade and finance
- * Official and black market exchange rate -> unified exchange rate systems
- * Closeness of economy to foreign capital -> attraction of FDI
- * Collectively owned firms -> privatization
- * High degree of regulation, esp. price regulation -> deregulation
- in the extended version: creation of property rights

Sources: Williamson, J. (1990), What Washington Means by Policy Reform, Ders. (ed.), *Latin American Adjustment: How much has happened?* Institute for International Economics, Washington D.C., Williamson, J. (1997), The Washington Consensus Revisited, L. Emmerij (ed.), *Economics and Development in the XXIst Century*, Washington, D.C.: Inter-American Development Bank.

with reforms in Latin America) emerged.

However, soon after, shortcomings of this “cookbook recipe” for transformation became clear when countries with similar initial steps of transformation showed vastly differing results. The role of institutions, especially, emerged as a “missing link” for transformation theory, but also, the role of the state and cultural influences on transformation outcomes were identified as important areas of research. When the steps of transformation are, at least generally, known, one important question remains to be solved - namely the question of, in what sequence reform steps should be taken. This as well concerns broader categories of reforms, for example the question, if political or economic reform should precede each other as more concrete questions as in the example about the relationship between liberalization of prices, privati-

zation and deregulation. Obviously, the question of sequencing is not independent from the question of how much and in what way the political regime is changed. Leaving this question open for the moment, let us turn to the experiences from Central and Eastern Europe (CEE) and East Asia in the sequencing of reforms.

In CEE the different pace and sequence of reform steps led to the juxtaposition of two strategies of transformation, or namely, 'shock therapy versus gradualism,' which absorbed much of the energy of the early theoretical transformation debate.⁶ Should transformation be carried out through a 'big bang' with all the reforms necessary for transition applied to a market economy enacted simultaneously, or should transformation follow a careful step-by-step approach? An important argument in this debate was politico-economic, concerning the costs of transformation. Advisors for shock therapy argued that the unavoidable costs of transformation would increase opposition to reform, and therefore, only a speedy reform would guarantee irrevocability.⁷ Advisors for gradualism argued that a gradual approach could help avoid certain costs of transformation and could also spread the occurrence of these costs over a longer period, making reforms more palatable.⁸

In reality, neither shock therapy nor gradualism worked as expected, since the original blueprints for transformation like the 'Washington consensus' proved to be insufficient for reform and the day-to-day

6 For an example see Dhanji, F. (1991), Transformation Programs: Content and Sequencing, *American Economic Review*, Vol. 81, No. 2, pp. 323-328; Falk, M. - N. Funke (1993), Zur Sequenz von Reformschritten: Erste Erfahrungen aus dem Transformationsprozeß in Mittel- und Osteuropa, *Die Weltwirtschaft*, No. 2, pp. 186-206; Hoen, H. W. (1996), "Shock versus Gradualism" in Central Europe Reconsidered, *Comparative Economic Studies*, Vol. 38, No. 1, pp. 1-20; Heybey, B. - P. Murrell (1999), The Relationship between Economic Growth and the Speed of Liberalization during Transition, *Journal of Policy Reform*, Vol. 3, No. 2, pp. 121-137.

7 Sachs, J. D. (1994), Understanding "shock therapy," Occasional Paper No. 7, Social Market Foundation (London: Social Market Foundation).

8 Dewatripont, M. F. - G. Roland (1992), The virtues of gradualism and legitimacy in the transition to a market economy, *The Economic Journal*, Vol. 102, pp. 291-300.

decision-making in transformation countries, often in inexperienced coalition governments, led rather to a process of muddling through. Countries originally trying to enact shock therapy, like Poland or Estonia, did not take into account the time-consuming process of institution-building. At best, reforms became a reality much slower than expected, and often, some problems still exist today - for example, those of restructuring inefficient state-owned enterprises have not been fully solved. At worst, as in Russia's case, half-hearted reforms can lead to massive opposition and chaotic economic times. The only partial exception, as discussed earlier, was the German unification process, where West Germany completely absorbed the former German Democratic Republic, resulting in exorbitant costs.⁹

Countries in CEE, originally following a gradualist approach such as Hungary or Slovakia, at best saw that the reforms were inconsequential and did not result in the expected performance, followed by a second phase where reforms were accelerated (in Hungary's case, ironically, by the post-socialist government of Gyula Horn). At worst, gradualist strategies brought about no progress at all, as in some Balkan countries such as Rumania before 1996, and especially in Belarus.

Economic theorists extended their theories to incorporate the role of institutions, good governance and cultural factors to explain the vastly differing performance of transformation countries following the same strategy.¹⁰ Today, there are two results of the sequencing debate: In

9 Seliger, B. (2001a), Ten Years after German Unification: Are there any Lessons for Korean Unification?, *International Journal of Korean Unification*, Vol. 10, No. 1, pp. 117-141.

10 For an example, see Herrmann-Pillath, C. (1998), 'Wirtschaftspolitische Steuerung versus institutionelle Selbstorganisation politisch-ökonomischer Systeme: Die Transformation post-sozialistischer Volkswirtschaften,' *Selbstorganisation, Jahrbuch für Komplexität in den Natur-, Sozial- und Geisteswissenschaften* 9, pp. 333-360. Herrmann-Pillath, C. (1999a), 'Was ist und wie betreibt man wirtschaftskulturelle Transformationsforschung?,' *Hans-Herrmann Hoehmann (ed.), Eine unterschätzte Dimension? Zur Rolle wirtschaftskultureller Faktoren in der osteuropäischen Transformation* (Bremen:

CEE, those countries following shock therapy were overall (with the important exception of Russia) more successful than the countries following gradualist approaches. However, the reasons for such were different from what was originally anticipated - the strategy itself was not important because the implementation of a coherent framework for the market economy in a short time period often failed: Rather, shock therapy was often a sign of a greater desire to achieve change, and regardless of the time aspect, countries opting for shock therapy generally enacted more thorough reforms, and vice versa, countries opting for gradual reforms, also often restricted the scope of reforms.

The second observation had concerned, until now, experiences from East Asia that have not been discussed, especially from China. Here, some forms of gradual reform were highly successful: The gradual liberalization of targeted sectors, often first of all agriculture and rural or communal enterprises and the introduction of special economic zones, resulted in constant and high growth rates, and so, guaranteed wide approval for further reforms. However, this approach was an economic transformation without a political transformation, meaning that the costs in terms of human rights were enormous. Under these conditions, gradualist reform in East Asia can be judged as successful.¹¹

Temmen), pp. 40-60. Herrmann-Pillath, C. (1999b) 'Staat und Transformation - Theoretische Reflektionen über einige offene Fragen der Forschung,' Hans-Herrmann Hoehmann (ed.), *Spontaner oder gestalteter Prozess? Die Rolle des Staates in der Wirtschaftstransformation osteuropäischer Länder* (Baden-Baden: Nomos), pp. 371-390; Ahrens, J. (2002), *Governance and Economic Development: a Comparative Institutional Approach*, Cheltenham: Elgar. See also the overview in Seliger, B. (2002a), *Towards a More General Theory of Transformation*, *Eastern European Economics*, Vol. 40, No. 1, pp. 36-62.

11 For the role of the state in Chinese transformation see Liew, L. H. (1995), *Gradualism in China's Economic Reform and the Role for a Strong Central State*, *Journal of Economic Issues*, Vol. 29, No. 3, pp. 883-895. Another factor in explaining the stunning high growth rates in China has been the devastation of the economy, and especially, the agricultural sector through Maoism, which later allowed a relatively easy catching-up phase.

For the North Korean transformation process, still both ways and any form of a mixture of them are possible. While North Korea had begun some kind of superficial reform and opening in the late 1980s and accelerated it after the food crisis became uncontrollable in the mid-1990s, domestic reforms are largely symbolic (like the inclusion of private property into the constitution).¹² The small, but slowly growing number of foreign or South Korean invested firms could develop towards a dual economy with a thriving private and lagging state-owned sector like in China, but for now, the developments in North Korea, including the establishment of special economic zones, are not comparable to the growth of private industries in China, as in Shenzhen.¹³ Gradual transformation, as discussed above, would partly resolve the headaches of Korean politicians fearing the collapse of the North and the subsequent costs of unification. But still, this collapse is a real possibility when the opening process translates into domestic opposition to the North's regime.

The growing, albeit small involvement of international economic and political factors, including the introduction of special economic zones, the participation in the ASEAN Regional Forum and diplomatic relationships with European states, all lead to the question of how growing international involvement and possible international integration might change the prospects of economic reform in North Korea.

12 The extent of de facto reforms in North Korea is difficult to measure. However, like in the ending phase of socialism in CEE, the growing shadow economy plays an important role for transformation even before political transformation begins; see Chun, H. - T. (1999), The Second Economy in North Korea, *Seoul Journal of Economics*, Vol. 12, No. 2, pp. 173-194; Jeong, S. - J. (2000), Expansion of North Korea's Second Economy and Change in Governance Structure, *The Economics of Korean Unification*, Vol. 5, No. 1, pp. 148-161.

13 For a comparison of the Chinese and North Korean special economic zones see Seliger, B. (2003 forthcoming), Die nordkoreanischen Sonderwirtschaftszonen - eine Wiederholung des chinesischen Erfolgsmodells? in P. Kollner (ed.), *Korea Jahrbuch 2003* (Hamburg: Institut für Asienkunde).

Again, this question reveals similarities with developments in CEE, where economic integration with the EC, and later the EU, became the foremost political goal of the mid-1990s. Thus, the next section looks into the relationship between economic transformation and integration in the case of European transformation countries.

III. Economic Transformation and Economic Integration

While the sequencing debate in CEE has become in recent years less intense, a new pattern of sequencing has been of increasing interest - namely, the relationship between economic transformation and economic integration. To a lesser extent, this new debate also has been interesting in East Asian transformation countries. In CEE, the economic reform agenda shifted more and more from the initial tasks of transformation to those of integration, especially in the accession to the European Union (EU).

The relationship between integration and transformation is not a clear priority. Trade opening and increased *de facto* integration (as measured in trade interdependence and price differentials) can be seen as a catalyst for economic transformation. In particular, it creates competition in former socialist countries, which were characterized by a monopolistic industry structure. In this sense, it reinforces a competitive policy. In Europe, early trade integration for most categories of goods was achieved through association agreements, or the so-called Europe agreements, which allowed free trade between the EU and transformation countries from the mid-1990s. *De iure* integration, like full membership in an integration area, has been seen as a result of transformation in the European context. This result of successful transformation was measurable in the Copenhagen criteria.¹⁴ However, this

14 The EU took a similar approach in the case of the Economic and Monetary Union,

Figure 1. Transformation and Integration - the CEE Experience

Macroeconomic Reform —>	Accession to European Economic and(=<=?)
(Inflation, exchange regime, soft budget constraint, budget deficits)	Monetary Union (Fulfillment of Maastricht Criteria)
Microeconomic Reform —>	Capacity to Compete within the Single Market
(Price Reform, trade liberalization privatization, creation of markets and competition, competition policy)	(Restructuring and modernization)
Institutional Reform —>	Institutional Preparation for the EU
(Law reform, property rights tax reform, banking system)	(Introduction of <i>acquis communautaire</i>)
Timeline →	

Source: Piazzolo, D. (2000), *Eastern Europe between Transition and Accession: An Analysis of Reform Requirements*, Kiel Working Paper No. 991 (Kiel: Institute for World Economics), p. 3.

is not necessary - economic communities can decide for early integration (for example, proto-membership without full rights and obligations, or, as a lesser form of observer status) to enhance transformation by the initial steps of opening.

For CEE, transformation can be divided into three large areas - namely, macroeconomic stabilization, microeconomic reform and creation of the institutional framework. In the 1990s, with the ongoing transformation process, in all three areas, the goals of transforma-

where membership was linked to the so-called “Maastricht criteria,” which also can be measured.

tion were gradually substituted by those of integration into the EU, as figure 1 indicates. Again, East Germany, with its unification process, followed a different path - namely an immediate integration into the EU after the end of transformation of formal institutions with unification in October 1990.¹⁵ For CEE, the path to integration is much more complicated.

The EU had always been more than an economic integration area, and namely, also a political community based on the same principles of government and ethical foundations.¹⁶ However, the large economic gap between CEE and the EU as well as the considerable resulting budgetary implications of EU enlargement made immediate enlargement impossible. Political and economic criteria set up for accession candidates in Copenhagen in 1993 was the basis for ongoing membership negotiations, but equally important is the EU reform to cope with the 12 new accession candidates.¹⁷ Basically, this means that only countries having matured in their reform process can enter the EU - transformation precedes integration.

15 This was not only a logical consequence of the profoundness of EU integration, which created a unified Germany without inclusion of East Germany into the EU - an impossibility. EU integration also was the cornerstone of strategic considerations of France and the United Kingdom, fearing an independent, non-aligned Germany at the center of Europe. For an analysis see Albach, H. (1993), *German Unification and Europe*, Working Paper No. 2, Forschungsprojekt "Transformationsprozesse in ehemals Volkseigenen Betrieben" (Vallendar: Wissenschaftliche Hochschule für Unternehmensführung).

16 The desire to join the 'community of democracies' was important in the Southern European enlargements in 1981 and 1986 when the new democracies of Greece, Spain and Portugal entered the EC. Today, for example, the Baltic states have similar, political reasons for their pursuit of integration.

17 Here is not the place for an extensive discussion of the Eastern enlargement process of the EU. See however, Seliger, B. (1999a), *Ubi certamen, ibi corona*, Frankfurt/Main: Peter Lang, and for the role of institutional competition and external constraints in the enlargement process; Seliger, B. (2002b) *Institutional Competition and External Constraints of Transformation*, *Journal of International and Area Studies*, Vol. 9, No. 1, pp. 103-122.

This becomes clear when one is looking at the details of accession criteria. The Copenhagen criteria states that, "Membership requires that the candidate country...":

- "...achieve stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities."
- "...have the existence of a functioning market economy as well as the capacity to cope with competitive pressures and market forces within the Union."
- "...have the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union."

Politically, accession countries are expected not just to subscribe to the principles of democracy and the rule of law, but actually put them into practice in daily life. They also need to ensure stability of the various institutions that enable public authorities, such as the judiciary, the police, and local government, to function effectively and consolidate democracy. Respect for fundamental rights is a prerequisite of membership and is enshrined in the Council of Europe's Convention for the Protection of Human Rights and Fundamental Freedoms, as well as the protocol allowing citizens to take cases to the European Court of Human Rights. Freedom of expression and association and the independence of the media must also be ensured. The integration of minority populations into society is a condition of democratic stability.

A number of texts governing the protection of national minorities have been adopted by the Council of Europe, in particular, the Framework Convention for the Protection of National Minorities, which safeguards the individual rights of persons belonging to minority groups.

The economic criteria: the existence of a functioning market economy and the capacity to withstand competitive pressures and market

forces within the Union.

Proof of the existence of a functioning market economy requires a number of conditions to be met:

- Equilibrium between demand and supply established by the free interplay of market forces; liberalized prices
- Absence of barriers to market entry and exit
- The legal system, including the regulation of property rights, in place; enforceable laws and contracts
- Macroeconomic stability achieved, including price stability, sustainable public finances and external accounts
- Broad consensus on economic policy, meaning there is no danger of returning to a centrally planned economy
- Sufficiently developed financial sector to channel savings towards investment

A minimum level of economic competitiveness is required in order to withstand the competitive pressures and market forces at play within the Union. Significant factors to be taken into account include:

- A sufficient degree of macroeconomic stability, so that economic agents can make decisions in a predictable and stable climate
- A sufficient amount of human and physical capital, including infrastructure (energy, transport and telecommunications), education and research - at an appropriate cost
- The extent to which the government influences competitiveness through trade policy, competition policy, State aids, support for SMEs, etc.
- The volume and nature of goods already being traded with Member States
- The proportion of small firms in the economy. Other criteria: the obligations of membership

In applying for membership, the accession countries had to accept the complete *acquis communautaire*, i.e. the sum of all treaties, rules, and regulations in the existing EU, including political, economic and monetary union. The candidate countries must contribute to and support the Common Foreign and Security Policy. All these criteria, however, do not guarantee membership since the ability of the EU to absorb new members must be guaranteed before enlargement.

In East Asia, economic integration is much less prominent than in Europe, nevertheless, the role of regional and international integration is growing.¹⁸ Again, for the transformation countries, the minimum degree of transformation is the precondition for entering integration areas. In APEC, for example, this includes adherence to the long-term goal of free trade between member states, and in the WTO, it means a number of preconditions in trade policy, including bilateral agreements with affected WTO members. Given the much more superficial nature of the East Asian integration process, especially the lack of institutionalization, this degree is much lower than the comparable degree for CEE, and to a greater extent, economic transformation and integration into the nascent East Asian integration area are mixed.¹⁹

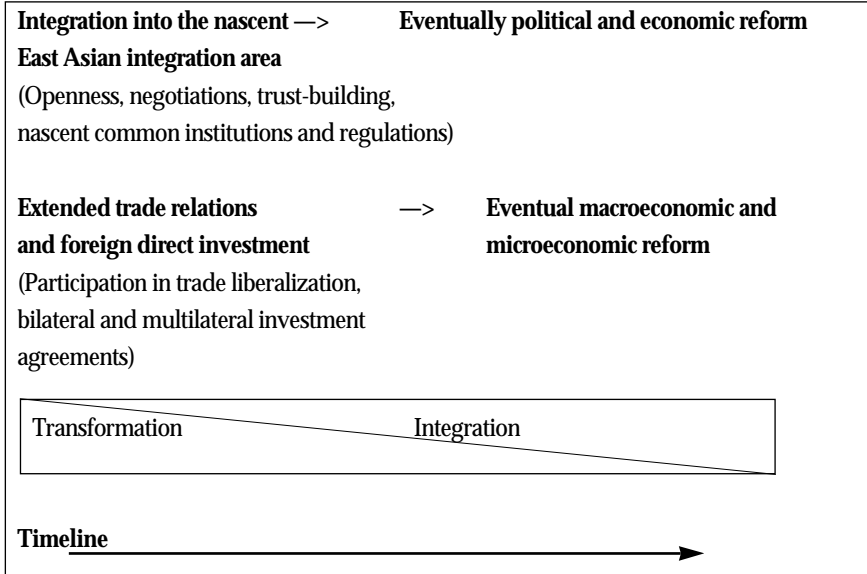
What are the perspectives for North Korea? The economic debate about transformation in North Korea, especially in the early 1990s when a breakdown of communism seemed imminent, focused on the possibilities of a “soft or hard landing” for the North Korean economy. In this sense, North Korea watchers had their own sequencing debate.²⁰

18 See Seliger, B. (2002c), Economic Integration in Northeast Asia: Preconditions and Possible Trajectories, *Global Economic Review*, Vol. 31, No. 4, pp. 17-38.

19 For example, the admission of practically and completely unprepared members into the EU, like the incident with Laos and Cambodia in the ASEAN, would not at all have been possible.

20 See Noland, M. - S. Robinson - L. - G. Liu (1998), The Costs and Benefits of Korean Unification, Institute for International Economics, Working Paper No. 98 (Washington, D.C.: Institute for International Economics); Noland, M. - S. Robinson - T. Wang (2000), *Rigorous Speculation: the Collapse and Revival of North Korean Economy*,

Figure 2. Transformation and Integration - the North Korean Case



The role of economic integration for North Korea was not a factor in this context. Recently, the possibility to link integration and transformation has become clearer, as the inclusion of North Korea into the ASEAN Regional Forum (ARF) demonstrates.²¹ Concerning the nascent integration area in East Asia, with a focus on trade and, to a lesser extent, investment, without budgetary consequences of integration, even if increased aid may be the reward for integration, with no common institutions requiring common political systems, seemingly

World Development, Vol. 28, No. 10, pp. 1767-1787; Hale, C. (2002), North Korea in a State of Evolution: the Correlation between the Legal Framework and the Changing Dynamic of Politics and the Economy, *Korea Observer*, Vol. 33, No. 3, pp. 363-400; Lee, J. C. (2002), The Implications of North Korea's Reform Program and its Effects on State Capacity, *Korea & World Affairs*, Vol. 26, No. 3, pp. 357-364.

21 See also Mansourov, A. Y. (1999), The North Korean Crisis and Regional Cooperation, in: Akaha, T. (ed.), *Politics and Economics in Northeast Asia: Nationalism and Regionalism in Contention* (Basingstoke: Macmillan), pp. 247-275.

favorable is an early extension of East Asian economic integration to North Korea. An important additional aspect from the point of view of North Korea is that economic integration allows for much needed technical aid for transformation and technological exchange, without relying on South Korea - its adversary.

In this sense, the relationship between integration and transformation in North Korea's case is vice versa to that of CEE. In the next section, the possibilities of various economic integration areas enhancing the transformation process of North Korea are discussed.

IV. The Role of Regional Integration for North Korean Transformation

Until recently, the role of North Korea in East Asian economic integration has been seen only as one of the obstacles to closer co-operation in Northeast Asia. The two parallel developments increase the interest in the relationship between economic integration in East Asia and North Korean economic transformation. First, the issue of economic integration itself became much more important in policy discussions in East Asia since 1990, even though the results have been, until now, not very impressive.²² Second, the cautious opening of North Korea, forced

22 For an overview of economic integration in East Asia see Higgot, R. (1998), *The Pacific and beyond: APEC, ASEM and regional economic management*, in Thompson, G. (ed.), *Economic Dynamism in the Asia-Pacific* (Routledge: London/New York), pp. 335-355; Yamazawa, I. (1998), *Economic Integration in the Asia-Pacific Region*, in Thompson, G. (ed.), *Economic Dynamism in Asia-Pacific* (Routledge: London/New York), pp. 163-184; Seliger, B. (2000a), *Wirtschaftliche Integration in Ostasien - ein Überblick* (Economic Integration in East Asia - an Overview), *Wirtschaftswissenschaftliches Studium*, No. 7, July, pp. 33-37. For Korea's position in East Asian economic integration see Seliger, B. (2001b), *Südkorea und die wirtschaftliche Integration Ostasiens - politische und wirtschaftliche Herausforderungen*, in P. Kollner (ed.), *Koreajahrbuch 2001* (Hamburg: Institut für Asienkunde), pp. 141-157.

upon the hermit state by economic catastrophe, leads to the question of whether or not East Asian integration can be helpful to enhancing the North Korean transformation process. Economic integration in this sense has three aspects: A geographical aspect, a functional aspect, and an institutional aspect.

Geographically, North Korea can act as a bridge between South Korea and Japan on one side, to Russia and the European countries on the other side. Therefore, the plan to revive railway links between North and South Korea received great interest in the last two years. The 'iron silk road' via the Trans-Siberian railroad to Europe could greatly reduce transportation costs for South Korean industries and allow North Korea to profit from this transit system.²³ However, until now, the euphoria over the 'iron silk road' seems to be highly premature due to the exorbitant costs of re-linking the railroads, especially through the inner-Korean border, technical problems due to different railroad systems, and the uncertainty over transportation in the Russian Far East. Also, North Korean interest in the railway project cooled off considerably in the last year, and after the first explorations of the negotiated trajectory, there has been no further progress. However, if one day the railroad is realized, it will aid to modernizing the transportation system in North Korea, and also, provide a closer link to the region of the Russian Far East, which had been, until now, a neglected region in Northeast Asian economic co-operation.²⁴

Functionally, economic integration in the form of bilateral or multi-

23 For a discussion see Simonia, N. A. (2001), TKR-TSR Linkage and its Impact on the ROK-DPRK-Russia Relationship, *Journal of East Asian Affairs*, Vol. 15, No. 2, pp. 180-202; Lee, J. Y. (2001) (The Trans-Siberian Bridge: Activation Opportunities), *Studies on Russian Economic Development*, Vol. 12, No. 6, pp. 644-648.

24 For the role of the Russian Far East in East Asian economic integration see Seliger, B. (1999b), The Double Integration: Siberia as Part of Russia, and Siberia as Part of Northeast Asia, Paper Presented at the International Conference, Relations between Korea and Siberia, Korean-Siberian Economic Association, November 27, 1999, Proceedings, pp. 51-76.

lateral agreements is the precondition for increased trade and investment. North Korea could act as a 'prolonged workbench' for companies from the region - i.e. specialize according to its comparative advantage of low-labor cost, and thereby, it can earn urgently needed foreign currency and slowly upgrade its production facilities and management qualifications. However, there is also another important function, which is namely the possibility for North Korea to adapt its economic system to one of a politically accepted role model similar to China. While South Korea and Japan are economically the most successful states of the region, ideologically, they are difficult to imagine as role models for North Korea's economic transformation under the current political regime.²⁵ China, with its apparent reconciliation of successful market reforms and the maintenance of a suppressive political regime, has more appeal to North Korea. While China as a role model is not necessarily linked to East Asian integration, such an integration process has two additional benefits: First, it creates more ample opportunity and necessity for opening, simply due to more frequent meetings with less media attention, and until now, even the contacts to China, its closest ally, are not especially firm and profound.²⁶ Second, it allows for rapprochement towards South Korea and Japan and reform of the economy within a politically more acceptable framework. If contacts are carried out within a regional framework, less ideological

25 For the relationship between regime survival and economic policy see Kim, C.N. (2000), *Pyongyang's Dilemma of Reform and Opening: How to Compromise Economic Benefits with Political Risks*, *Korea and World Affairs*, Vol. 24, No. 2, pp. 247-276; Snyder, S. (2000), *North Korea's Challenge of Regime Survival: Internal Problems and Implications for the Future*, *Pacific Affairs*, Vol. 73, No. 4, pp. 517-533.

26 For an overview of North Korea's external relations see Namkoong, Y. (1999), *North Korean External Economic Policies and Inter-Korean Economic Cooperation*, *International Area Review*, Vol. 2, No. 2, pp. 69-91; Noland, M. (2001), *North Korea's External Economic Relations*, <http://www.iie.com/PAPERS/noland0201-1.htm>, to be published in S. S. Kim - T. H. Lee (eds.), *Northeast Asia: New Patterns of Conflict and Cooperation* (Rowman & Littlefield).

confrontation is probable, since the contacts are less prominent and more routine business.

Last but not least, there remains the question of which institutional framework is best for achieving the aforementioned goals of economic integration. Here, it is most realistic to discuss the existing (and nascent) integration projects, especially Asia Pacific Economic Co-operation (APEC), Association of Southeast Asian Nations (ASEAN) plus three (China, Japan, Korea), and membership in international organizations like the Asian Development Bank (ADB), World Trade Organization (WTO), and the International Monetary Fund (IMF). APEC was founded in 1989 with concrete goals concerning the Uruguay-round of the GATT negotiations, but later developed an ambitious program of trade liberalization of a dual track system with speedy liberalization for developed member states and slower liberalization for developing member states.²⁷ Liberalization goals are in accordance with international liberalization in the WTO framework ('open regionalism') and no strong, common institutions are planned. In the time before the Asian crisis, APEC attracted a lot of attention from outsiders since it promised access to the fast growing Asian markets. This led to geographical extension and the inclusion of Latin American states and Russia, in that APEC now reaches, from Eastern Europe, North and South America, East Asia and Oceania. The geographical extension, while a proof of APEC's attractiveness, nevertheless led to serious problems, with a current stoppage of new membership applications. Today, the agenda of member states of APEC is much too heterogeneous to allow for a clear direction of integration. The failure of the Seattle round of WTO negotiations, where various APEC states like Japan and Korea together with the EU were a major obstacle to a more

27 For a history and evaluation of APEC see Ahn, H. (1999), *APEC After 10 Years: Is APEC Sustainable?* KIEP Working Paper 99-08 (Seoul: Korea Institute for International Economic Policy) and Pascha, W. - T. Goydke (2000), *Zehn Jahre APEC*, *Wirtschaftswissenschaftliches Studium*, Vol. 29, No. 11, pp. 616-621.

extensive liberalization agenda, proved this clearly. Moreover, since the Asian crisis, many of the East Asian APEC member states have been riddled with domestic problems and found quite diverse answers to these problems.²⁸ For North Korea, the presence and intellectual leadership of the USA in the APEC process would particularly pose a problem in accepting APEC membership. But also, the liberalization goals, laid down in the Bogor declaration (1994) and the subsequent Osaka Action Agenda (1995) and Manila Action Plan (1996), are an obstacle at least to North Korea's full membership.

More successful could be the concentration of efforts of the nascent ASEAN plus three (China, Japan, South Korea) area to include the North Korea problem in its agenda, and eventually, create an ASEAN plus four. Since 1997, the ASEAN plus three group has been meeting as an 'Asia only' group without the specific anti-Western appeal of Malaysian Prime Minister Mahatir's proposal for an 'East Asian caucus.' The relative success of ASEAN, especially the planned launch of its ASEAN Free Trade Area (AFTA), would be incomplete without the inclusion of the three major North Korean economic powers, which played an important role as investors and trading partners in the Southeast Asian region, and which for various political and historical reasons, were unable to form their own integration area.

Thus far, the ASEAN plus three has not presented an agenda for integration, but has mainly been active in designing new regional macroeconomic structures since after the Asian crisis. This resulted in the Chiang Mai initiative, a system of currency swap and repurchase agreements meant to stabilize the exchange rates in the region. A study group, in existence since last year, presented a proposal for a more extensive agenda in the following ASEAN plus three meeting held in

28 Seliger, B. (2000b), Die Interdependenz von Wirtschaftsordnung und politischer Ordnung - das Beispiel der Asienkrise (the interdependence of economic and political system - the example of the Asian crisis), in: E. Keynes (ed.), *Willensbildungsprozesse und Demokratie* (Frankfurt/ Main: Peter Lang Verlag).

Brunei in November 2001. For the possible role of the ASEAN plus three for North Korea, the fact that no agenda has been fixed as of yet is rather an advantage since it reduces the requirements for participation or observer status to a minimum of political will. China as an important player in the ASEAN plus three may help to make the problematic membership of Japan and South Korea — its archenemies — more acceptable. The membership would be similar to the ARF, but with the focus more on economic questions, which from the point of view of North Korea under any scenario of political development is preferable.

In a scenario of no political change, with the current leadership remaining in power for an indeterminable time, regional integration can be the first step for a cautious opening and offers the possibility for more multilaterally co-ordinated aid.²⁹ Also, gradually, a modernization process of industry can begin, relying on various sources of foreign investment. In any scenario of political change, where either by incremental change or by collapsed leadership in economic system changes, regional integration can not only be helpful economically, but also resolve rising geopolitical questions through possible Korean unification. Economically, foreign competitors, instead of South Korean investment only, can increase the degree of competition in North Korea, thereby transforming the old monopolistic structure.³⁰ The macro and microeconomic advantages of any type of FDI are well known. However, in the case of national unification, it is often forgotten or neglected due to pressure from domestic companies eager to expand their oligopolistic power to the unified area.

The last possibility for greater economic integration is the participa-

29 Whether this aid is desirable from the point of view of South Korea, is an entirely different question. However, aid can be the bait for North Korea to accept opening, and thereby, the possibility for changes in the political system in the long run.

30 This could also have a beneficial impact on South Korea, which is largely dominated by domestic conglomerates in the form of narrow oligopolies, reinforced by vertical and horizontal integration of firms.

tion of North Korea in multilateral organizations such as the ADB, WTO or IMF. Membership would offer many advantages, especially concerning North Korea's macroeconomic unstable situation.³¹ Principally, the case of the former socialist countries joining the IMF long before any transformation process shows the compatibility of a political socialist system with these organizations. However, the information requirements and the conditionality of all possible aid make application for the ADB seem premature. Changes required would be much too drastic for the current political regime - namely, forcing it to abandon their protective shield against change in their reclusion. The Pyongyang declaration between chairman Kim Jong-il of North Korea and Prime Minister Koizumi Junichiro of Japan in September 2002 hinted at a form of official assistance through the channels of ADB - however, the price being in the form of political opening, which in this case means disclosing the fate of abducted Japanese citizens, proved to be too high. From the discussion above, it becomes clear that the ASEAN plus three is the most appropriate framework for efforts to extend East Asian economic integration with North Korea, offering flexibility of agenda and including the appropriate participants.³²

31 For a discussion see Babson, B. (2002), *The International Financial Institutions and the DPRK: Prospects and Constraints*, Vancouver, Program on Canada-Asia Policy Studies, Institute of Asian Research, University of British Columbia.

32 In this paper, the role of special economic zones as an instrument for geographically constrained regional integration and opening cannot be extensively discussed. While the imitation of special economic zones in the Chinese style has been a goal of North Korea since the early 1990s, their policy has been a failure until now; see for the largest zone, Rajin-Sonbong, Kim, I. S. (2001), *The Rajin-Sonbong Economic and Trade Zone (RSETZ): the sources of difficulties and lessons for the future*, *North Korea in Transition: Prospects for Economic and Social Reform* (based on papers from the conference developing infrastructure in North Korea for economic cooperation between the South and the North, Korea University, Seoul, Nov. 1998), pp. 301-333. Among the biggest differences between the Chinese and the North Korean approach are the high costs and inflexible labor market structures, insufficient institutional support, insufficient infrastructural investment

V. Conclusion

In this paper, the lessons of economic transformation in CEE and their implications for North Korea have been discussed. While the lessons from CEE and especially the German unification process provide us with all the necessary ingredients for economic change, there are important lessons not yet learned as to how these ingredients interact and how states must determine the appropriate mix of these ingredients for successful transformation. To reiterate with the cooking metaphor, our cookbook thus far only contains the ingredients, but not the cooking recipe itself. The complexity of change in transformation societies makes it extremely difficult to single out the role that specific policies play in transformation. Comparative research of transformation countries is the only method we have to address this question, but due to the discussed complexity of the interplay of informal and formal institutions, cultural and historical backgrounds, and the politics of transformation, more research is needed, as well positivity and normativeness for a deeper understanding of transformation, and eventually, for policy recommendations.

A concrete recipe necessarily depends foremost on North Korea's political development, the question of a soft or hard landing, and a prolonged suppressive regime or a sudden change. All scenarios, however, should pay more attention to the possibilities offered by economic integration in East Asia for North Korea. Economic integration is helpful in all scenarios, but especially in the scenario that is most probable now - namely, that of incremental political and economic change. Further research in this area seems to be a promising field and may yield valuable policy recommendations also for South Korea's approach to

and the completely changed regional economy since the early 1990s. For an extensive discussion see Seliger, B. (2003 forthcoming), *Die nordkoreanischen Sonderwirtschaftszonen - eine Wiederholung des chinesischen Erfolgsmodells?*, in P. Köllner (ed.), *Koreajahrbuch 2003*, forthcoming (Institut für Asienkunde, Hamburg).

unification. The most obvious of these recommendations for South Korea is the necessity to maintain friendly relations and indeed attempt everything to deepen economic interdependence with neighbors. While South Korea is eager for economic exchange and became for example an important investor in China, political relations to both neighboring states are still not very well developed. Changing this could mean achieving two goals with one policy, or namely, an enhanced geo-political position in Northeast Asia for South Korea and a new channel for supporting change in North Korea.

However, the agenda does not apply to South Korea alone and the dialogue between the EU and the DPRK, which began in the recent years, should also include a discussion of regional economic integration as an instrument to improve DPRK's economy as well as the relevant European lessons.³³

33 For an overview of the EU-DPRK dialogue see Yoon, D. R., Economic implications of improved DPRK-EU relations, *Journal of East Asian Affairs*, Vol. 15, No. 2, pp. 324-343; Frank, R. (2002), EU - North Korean relations: no effort without reason, *International Journal of Korean Unification Studies*, Vol. 11, No. 2, pp. 87-119.