

**IMPLICATIONS OF A “BOLD SWITCHOVER” IN SECURITY  
POLICY FOR INVOLVING THE INTERNATIONAL FINANCIAL  
INSTITUTIONS IN FINANCING NORTH KOREAN ECONOMIC  
DEVELOPMENT**

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\*\* The views expressed in this paper are solely those of the author and do not necessarily reflect those of the World Bank, International Monetary Fund, Asian Development Bank, their Executive Directors, or the countries they represent.

## EXECUTIVE SUMMARY

This paper examines issues that would need to be addressed in mobilizing international aid to support a “bold switchover” in DPRK security policy, and to build a future role in the DPRK for International Financial Institutions (IFIs) such as the World Bank.

### *Main Argument*

The DPRK does not currently belong to the major IFIs, but building a relationship would bring significant benefits and also challenges for the DPRK and for the international community:

- The IFIs can play a potentially important role in helping the DPRK, and for providing necessary aid coordination, but this will require political will both for the DPRK and for the major IFI shareholders.
- Membership in the IFIs requires that the DPRK accept international norms for information sharing, conduct in economic relations, and access to IFI resources.
- Access to concessional finance from the World Bank would be governed by the policies adopted for the 14<sup>th</sup> replenishment of the International Development Association, and the amount allocated would depend largely on performance assessment.
- Special Trust Funds administered by the World Bank are useful in post-conflict situations and should be considered for the DPRK as an interim step.
- In the North Korean context it is especially important that there be good coordination of political aid and development aid.

### *Policy Implications*

- There will need to be a phased process of the DPRK developing a relationship with the World Bank and coordination of development aid.
- The adoption of mechanisms such as the Transition Results Matrix should be considered for the DPRK context to ensure needed discipline in setting priorities and coordinating political aid and development aid to achieve agreed outcomes.

## **Introduction**

If the Democratic Peoples Republic of Korea (DPRK) were to pursue a “bold switchover” in its security posture that would involve relaxing its “military-first” policy and transforming relations with its neighbors and the international community at large, the opportunity to pursue rapid economic transformation and development would also be irresistible. Both the DPRK leadership and the international community would have strong incentives to anchor a new security environment with significant economic benefits for the North Korean people. The challenges, however, would be enormous, especially in managing domestic political economy implications of the policy shift, developing a realistic economic development strategy that would be linked to a military demobilization and redeployment strategy, establishing new working relationships with foreign partners providing foreign aid and private investment, and absorbing effectively external finance and technical assistance. Among the first questions to be addressed in this scenario is whether the DPRK would choose to join the International Financial Institutions (IFIs) and build a relationship with them that would allow them to play the central role in policy dialogue, development finance, and donor coordination that they perform in other developing countries.

This paper examines issues that would need to be addressed both by the DPRK government and by the international community in mobilizing international aid to support transition in the DPRK and in building a future role for the IFIs, in particular the World Bank. The central argument is that because of the unique conditions of the DPRK context, there is a potential major role for the IFIs, but that this will require major shifts in the way that the DPRK shares information, develops economic policies and institutional capacities, and works with foreign partners. Thus there will need to be a phased process of developing a relationship with the World Bank and careful coordination of political aid and development aid. The paper begins with a review of the potential role for the IFIs, discusses issues related to membership and implications for the DPRK, assesses eligibility and potential allocation of concessional funding from the International Development Association, discusses the role of Special Trust Funds in post-conflict situations and how this might apply to the DPRK, examines the relationships of political aid and development aid in the DPRK context, and finally,

draws the implications of these assessments for a strategy of support from the World Bank and other donors and proposes a framework for a roadmap.

### **Potential Role for the International Financial Institutions**

A “bold switchover” policy would potentially trigger a dramatic reallocation of resources in the DPRK economy that would stimulate economic growth through improved efficiency of resource use. The costs of transition, however, can be expected to be large and the equity outcomes highly uncertain, depending on the strategies and policies adopted for the transition. To accomplish a transformation that would put the DPRK economy on a sustainable growth path, both an infusion of capital investment and resources for managing the social costs of transition would need to be forthcoming. As the DPRK’s public finance and banking institutions are not capable of mobilizing domestic savings to finance these needs in the short and medium-term, large-scale external financing through Official Development Assistance (ODA) and foreign private investment will be needed. The DPRK will also need advice and technical assistance to design economic development strategies and policies that give donors and private investors the confidence that the DPRK can utilize external assistance and investment appropriately. Resolving the DPRK’s long-standing external debt arrears and improving debt management capacity will be an essential part of this agenda. In addition to the issues of designing future economic development strategies and policies, mobilizing foreign capital and knowledge resources, and building investor confidence, the DPRK will need help in coordinating dialogue with donors and investors, establishing aid management capacity, and coordinating the implementation of projects and programs supported by donors.

The IFIs have the capacity and experience to support the DPRK in addressing these challenges.<sup>1</sup> The International Monetary Fund (IMF) is particularly important for the future DPRK because of the role it can play in helping the DPRK to develop statistical information on its financial condition and economic performance that will be essential for the confidence building of donors and investors. It will be impossible for the DPRK to move from humanitarian and political aid to development aid and private

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<sup>1</sup> For a full discussion of the potential roles for the IFIs see Babson (2002 and 2003).

investment from the international community without meeting the basic requirements of routine and transparent reporting on the macro economy and financial sector. Approvals of bilateral commitments of ODA for most donors will require a credible macroeconomic framework, and the IMF endorsement of this framework will be a major determinant of the willingness of donors to commit large-scale ODA to the DPRK. Similarly, the IMF will be a critical player in the resolution of the DPRK's external debt overhang from its past through the Paris Club. This will be important not only for the DPRK's ability to mobilize future ODA but also to improve the country's creditworthiness ratings and investment climate for foreign investors.

The World Bank is also a potentially highly important partner for the DPRK. The World Bank has global experience both in supporting economic transition from planned to market economies, and in post-conflict reconstruction and transition from humanitarian to development assistance. Moreover, the World Bank has a history of close relations and programs with the ROK, China and Russia, as borrowers, and with the U.S. and Japan as its two largest shareholders. Thus the World Bank is well-positioned to work closely with the Six Party Talks countries in developing a program of support for the future DPRK under a "bold switchover" policy. Through the Consultative Group mechanism, the World Bank also can provide the over-arching coordination needed for support for a coherent transition and development program from the broader international community and ensure effective coordination in policy dialogue with the DPRK and in aid mobilization and implementation.

The Asian Development Bank (ADB) likewise has an important potential future role in the DPRK. Like the World Bank, it can help mobilize capital for investment and provide technical assistance, supplementing the resources that are mobilized bilaterally and through the World Bank. The ADB also has developed a good sub-regional development expertise, especially through its successful sponsorship of the Greater Mekong Sub-Region (GMS) initiative. The ADB has supported regional development activities in Northeast Asia through studies conducted in collaboration with the Tumen River Area Development Program (TRADP) of which DPRK is a participating member. However, the fact that Russia is not a member of the ADB would require that special arrangements be made for ADB to work with Russia in a coordinated regional program for economic integration of the DPRK in Northeast Asia.

## **Implications for the DPRK of a Potential Future Role for the IFIs**

For the DPRK to benefit from the potential roles that the IFIs can play, it would need to understand how they would approach developing a relationship and the kinds of initial activities that would be needed before gaining access to their financial resources. The non-financial aspects of the relationship would be much more important initially, and would focus on training and capacity building, development strategy and policy dialogue, and pre-investment activities.

### ***Training and Capacity Building***

The DPRK will need a very large program of training and capacity building and it can be expected that the IFIs would contribute to this in a number of ways. The World Bank Institute (WBI) provides a variety of learning services, including designing and delivering courses and seminars, promoting knowledge networks and communities of practice, and providing technical and policy advice. The IMF Institute also provides similar programs for macroeconomic and financial system policy, monitoring and management; and the ADB Institute promotes research on development models and organizes policy discussions and learning opportunities. Taking advantage of these learning resources would require that the DPRK develop capacity for mobilizing the participants for both in-country and overseas learning programs on a large scale, work with the training agencies to design programs tailored to high priority needs, and utilize the knowledge gained afterwards. Good coordination with other suppliers of training and knowledge services would also be important.

The Global Development Learning Network (GDLN) initiated by the World Bank provides access to knowledge and experience in practical aspects of development through innovative programming using the latest information technology tools. If the DPRK government adopts a policy of allowing connections to the international information networks, the GDLN (and the internet more generally) can be a highly effective tool to promote learning for government officials, university students and business managers. But the implications of exposing a broad spectrum of North Korean people to detailed knowledge of development and business practices in the outside world would need to be accepted by the government.

Equally significant in implications would be the transfer of knowledge and experience that comes informally through cooperative activities such as studies and pre-investment preparations by teams of IFI staff working with counterparts from various ministries. This on-the-job learning opportunity at the technical level is extremely important for the process of building working relations, successful implementation of large-scale development projects, and meeting various requirements of the funding agencies. To be effective, IFI staff would need to have ready access to their counterparts, be allowed to work together as teams to accomplish tasks, and rely on professional and open relations for problem-solving at the lowest level possible when issues arise.

### ***Economic Recovery and Development Strategy and Importance of Policy Dialogue***

Any relationship that the DPRK develops with the IFIs will require early attention to building a shared understanding of the DPRK's particular economic and social conditions, what immediate steps should be taken to promote economic recovery, and what development strategy would be most effective for the DPRK to achieve its goals and objectives that can also be supported by the IFIs in keeping with their mandates and general policies. Reaching such understandings will require open sharing of information and a process of mutual learning. Policy dialogue is a primary foundation stone for IFI action in support of any country's development. One way this is accomplished is through joint studies of relevant topics. These typically include needs assessments, public investment and expenditure reviews, sector studies, and seminars on a variety of topics related to development planning and management. This implies that the DPRK would need to be able to accommodate groups of experts interacting with officials at various levels on policy-related issues. A clear framework for decision making across major stakeholder groups within the DPRK would be important to enable policy dialogue to be meaningful and effective.

### ***Pre-Investment Activities***

IFI lending requires more than just agreement on development strategy and policies. Pre-investment activities also require assessments of a government's legal system, internal financial management capabilities (including controls over the budget,

its administration and audit standards), technical preparation of projects, assessments of environmental and social impacts of proposed investments and preparation of mitigation plans, and adoption of policies and procedures relating to procurement of goods and services that meet IFI requirements. These pre-investment activities cross many government agencies, so managing internal coordination within the government is an essential part of a working relationship with the IFIs who also need access to all the concerned agencies in the conduct of their work.

### **General Requirements for Relations with the IFIs**

The DPRK is not a member of any of the IFIs and relations are essentially non-existent. Since the food crisis of the mid- 1990's, however, there have been overtures and sporadic contacts between the DPRK and the IFIs. In 1997, the DPRK sent a letter to the ADB seeking to explore the possibility of membership that came as a surprise and was rejected by the major shareholders. In September 1997, the IMF sent a fact finding mission to the DPRK and submitted a report of its findings to its Board of Executive Directors. In February 1998, the World Bank sent an exploratory mission to the DPRK to build understanding of the benefits and requirements of developing relations. After the inter-Korean summit of 2000, informal contacts took place outside of the DPRK and a formal invitation was issued to the DPRK to participate as a "Special Guest" in the IMF/World Bank Annual Meetings in 2000. But the DPRK declined this invitation and after the events of October 2002 and the ensuing nuclear crisis, direct contacts ceased.

If relations between the DPRK and the IFIs were to develop in the wake of a "bold switchover" policy, there are two essential requirements for moving forward. First, the DPRK would need to want to build the relationship and accept the international norms that would accompany the development of relations. And second, the shareholders would need to support any provision of the resources of the IFIs, both knowledge and financial, to the DPRK.

The first issue to be addressed in building any relationship is establishing communications and counterparts. Designations of responsibility for managing the development of the relationship and coordinating communications are needed on both



sides. Individuals need also be assigned to carry out these responsibilities and be allocated resources to conduct their activities. There are no fixed rules for assignment of lead counterpart relationships for countries except that they be financial agencies, but typically the Central Bank is given the lead role for developing relations with the IMF and the Ministry of Finance is given this responsibility for the multilateral development banks. It is important that there be good internal communications within the DPRK government and within the IFIs themselves to avoid miscommunication and misunderstandings during the early phases of relationship building. Education of policy makers, mid-level officials and technical staff is very important at this stage. Equally important is control over official communications and approvals for actions between the two sides.

To obtain membership, a country needs first to apply formally, meet the legal requirements for membership, and receive a vote of approval from the Boards of Governors. To join the IMF, this requires 85% support of the voting power of the shareholders. It is also a legal requirement that membership in the IMF precede membership in the World Bank, although it has been common practice to process both applications in parallel in a coordinated way. Within the World Bank, it is a requirement that a country first join the International Bank for Reconstruction and Development (IBRD), and then is eligible for membership in its other organs, the International Development Association (IDA), the International Finance Corporation (IFC), and the Multilateral Investment Guarantee Agency (MIGA). In the case of the DPRK, there would be potential benefits from becoming members of all these organs of the World Bank. While it is not a formal legal requirement that a country join the IMF before joining the ADB, in reality, the Board of Governors should not be expected to vote in favor of a DPRK application for membership if it has not already been accepted as a member of the IMF. Similar rules apply to access to the ADB Official Capital Resources (OCR) and Asian Development Fund (ADF) that apply to membership in the IBRD and IDA of the World Bank.

It is not, however, necessary to become a member of the IFIs to receive assistance from them. If the Boards of Executive Directors adopt a resolution that it is in the interests of existing members that the IFI provide assistance to the DPRK, then it is legally possible to do so. In practice this falls into three categories. The first is

technical assistance and training that is designed primarily to help potential members prepare themselves for the application process and to meet the legal and technical requirements for membership. The second is analytical work and technical assistance related to post-conflict recovery and economic reconstruction planning. And the third is assistance that is provided through special trust funds established by donors and the World Bank, where the Bank is asked to administer the fund and provide other services such as aid coordination.

### **Implications for the DPRK of IMF Membership**

If the DPRK decides to pursue membership in the IMF, it must abide by the basic obligations of membership, which include:

- A code of conduct specified in the IMF Articles of Agreement that includes a pledge to cooperate with all other member countries in resolving international monetary problems and to share information on financial, fiscal, economic, and exchange policies that have international ramifications.
- Pay a quota subscription.
- Refrain from restrictions on exchange of foreign currency.
- Strive for openness in economic policies affecting other countries.

The requirements for sharing of detailed financial and economic information and for pursuit of open foreign economic relations would represent very significant departures from the policies that the DPRK has pursued in the past.<sup>2</sup> Along with this comes the commitment to routine Article IV Consultations that the IMF conducts with all its members, in which assessments of economic policies and performance are made by the Fund staff and discussed with the Board of Executive Directors. This surveillance function would not have been accepted by the DPRK in the past as too intrusive, but it is the price for joining the international financial system. Moreover, the IMF assessments are increasingly being made public as the Fund strives to broaden the

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<sup>2</sup> Section 5 of Article VII of the Articles of Agreement specifies among other requirements that data on national holdings of gold, production of gold, and export and import of gold must be reported. This will pose a particularly poignant demand on the DPRK as a significant gold producer.

transparency of its activities. Openness and transparency are basic values in the international community that the DPRK would need to accept if it desires to participate in the international system and be eligible for the financial assistance that comes with membership in the Fund.

The requirement to pay a quota subscription first requires determining what the DPRK quota would be.<sup>3</sup> Broadly speaking, quotas in the IMF are determined by the relative size of a country's economy in the total world economy. A number of factors are taken into consideration in making this determination, including GDP, current account transactions, and official reserves. When a country joins the IMF, it receives an initial quota in the same range as other countries considered comparable in size and characteristics. The quota determines the maximum subscription that the country is required to pay the IMF, the country's voting power in IMF decisions, and the limits of access to IMF financing. For example, under Stand-By and Extended Arrangements, a country can borrow up to 100% of its quota annually and 300% cumulatively.

The implication for the DPRK of the requirement to determine its quota before joining the IMF is that considerable technical effort will be needed to calculate an acceptable GDP figure for the DPRK and to assemble data on current account transactions and official reserves that would meet the minimum requirements of the Fund. This means that not only would the DPRK need to provide this information before it has secured approval for membership, but also that technical assistance from the Fund staff would most likely be needed to help prepare for meeting the requirements of membership. The quota is also important for the DPRK as a critical determinant of the amount of financing that it could draw upon from the Fund's resources. The smaller the quota the smaller this amount will be. This makes it even more important that the Fund staff be able to obtain information about the DPRK economy that is accurate enough to be credible to the IMF Board of Executive Directors when they consider an application for membership and formulate a recommendation to the Board of Governors for their formal voting.

An issue peculiar to the Korean peninsula can also be expected to surface during the early stages of the development of a relationship of the DPRK with the IMF. This involves the question of how to treat inter-Korean trade and financial transactions. Both

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<sup>3</sup> See IMF Quotas – A Factsheet, September 2005. <http://www.imf.org/external/np/facts/quotas.htm>.

countries treat these as intra-Korean economic transactions and do not report them as international transactions. But if the DPRK is to join the IMF as a sovereign state, then cross-border transactions with the ROK will have to fall under international norms. It will therefore be necessary to work out understandings of how to handle the implications of this issue for international reporting to the Fund for both Koreas.

### **Implications of Membership in the IBRD**

Application for membership in the IBRD follows a similar process as that to the IMF and often is conducted in parallel. Capital subscriptions are based on IMF quotas but are determined separately. Capital shares determine the voting power of a country in decisions of the IBRD, but unlike the Fund are not related to limitations on access to financing. Creditworthiness and access to other sources of long-term external finance are the prime considerations for access to IBRD loans.

In addition to the financial and economic reporting required by the IMF, the IBRD requires annual external debt reporting of its members. This is required for assessing country creditworthiness and access to IBRD loans. In addition, the Articles of Agreement of the IBRD specify general conditions that apply to all loans, regardless of the borrowing country.

The DPRK does not have a good credit reputation, and this will affect the willingness of both donors and private investors to provide future loans to the DPRK government and enterprises. An important consequence of the DPRK decision to seek membership in the IBRD is the opportunity to receive technical assistance to improve its external debt management and reporting. Even though the DPRK is unlikely to be creditworthy to receive IBRD loans for some considerable time, its compliance with IBRD external debt reporting and efforts to improve its performance in servicing existing debt will send important signals to other potential suppliers of funding to support its economic development.

Another important requirement of IBRD loans that also applies to IDA credits, is that “the Bank shall make arrangements to ensure that the proceeds of the loan are used only for the purposes that the loan was granted, with due attention to considerations of economy and efficiency and without regard to political or other non-

economic influences or considerations.<sup>4</sup> There are a number of implications of this provision for the future involvement of the World Bank with the DPRK.

First is that transparent processes of procurement of goods and services and financial accounting for the payments made from proceeds of loans or credits would be an essential part of any relationship. The Bank has made major efforts in recent years to improve its policies and procedures to deal with the risks of corruption or inadvertent misuse of resources, and can be expected to give high priority to the establishment of capabilities to address this issue in any future activities with the DPRK. This applies as well to the application of various safeguard policies that have been adopted as World Bank policy in mitigating potential negative impacts of development investments on the environment and social conditions. A very close working relationship will need to be developed between Bank staff and North Korean counterparts to integrate the disciplines required of World Bank financing into the normal practices of the DPRK government. Close supervision of projects supported by the World Bank will also be required with transparent monitoring and results-oriented evaluation of impacts.

A second major implication of the requirements of the Articles of Agreement, is the need to give due consideration to economy and efficiency. The economic logic and rationale for investments financed by the IBRD or IDA will need to be explicit and political influence and non-economic factors will not be given credence. This aspect of foreign aid has been largely absent from international support for the DPRK in the past, and likewise will impose new disciplines on the way the DPRK government works with donors, especially for projects receiving finance from the multilateral development banks. At the same time, the World Bank will not support projects that are politically motivated and do not have a strong economic rationale on the part of other major donors, such as the ROK or China.

The type of working relationship required to provide development assistance from the World Bank will be significantly different from the delivery and supervision of humanitarian assistance that the DPRK has received from the World Food Program and other agencies over the past ten years. An important factor is that World Bank financing will play a much stronger role in building state capacity than humanitarian

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<sup>4</sup> Article III, Section 5 (b) of the IBRD Articles of Agreement and Article IV, Section 1 (g) of the IDA Articles of Agreement.

aid flows, which are provided primarily outside the state budget and do not normally focus on institutional capacity building. At the same time, requirements for transparent fiduciary practices will require a much closer working relationship between Bank staff and North Korean counterparts, with more direct access to government data and discussion of state public finance and delivery systems. The transition from humanitarian aid to development assistance thus will involve major changes in the way that the DPRK works in partnership with donors, and its working relationship with the World Bank will be a critical factor in willingness of donors to expand their support as absorptive capacity increases.

### **Access to IDA Resources: Application of IDA 14 Policies to the DPRK**

In addition to the general conditions that apply to countries that become members of the IDA that are set forth in its Articles of Agreement and By-Laws, access to IDA resources is governed by policies developed by the IDA Deputies representing the donor members and then endorsed by the Board of Executive Directors for approval by the Governors. If the DPRK were to become a member of IDA, the policies adopted for the Fourteenth Replenishment of IDA would apply as regards eligibility to receive IDA resources, allocations to individual countries, and use of IDA resources.

The IDA 14 Replenishment was approved in April 2005 and will cover the period July 2005 through June 2008. Under this agreement, \$33 billion will be made available over the three year period to 81 of the world's poorest countries (not including the DPRK), where the vast majority of people live on less than \$2 per day. Eligibility is for countries with annual per capita income of less than \$965 in 2004 and which are not creditworthy for IBRD lending.

#### ***Eligibility***

The first task for the DPRK would be to assess its eligibility for access to IDA 14 resources. The data required to make this assessment would be collected largely through the process of determining the IMF quota and through the external debt reporting requirement of membership in the IBRD. There are no present reliable estimates of the DPRK per capita income, and thus a major effort will be needed to calculate estimates that are acceptable to the IMF and World Bank. But it is reasonable

to assume that after these efforts have been made, the DPRK would meet the eligibility criteria for access to IDA resources.

### ***Allocation***

Having made a determination about eligibility, the next task would be to assess what allocation the DPRK could receive under IDA 14 guidelines. The main factor that determines the allocation of IDA resources among eligible countries is each country's performance in implementing policies that promote economic growth and poverty reduction. Per capita income is also a factor with the poorest of the eligible countries receiving a higher allocation at the same performance level as less poor countries.

Performance assessments are highly structured and are conducted annually for all IDA borrowers. The method used is the Country Policy and Institutional Assessment (CPIA), which comprises 16 criteria grouped in four equally weighted clusters.<sup>5</sup> These include: economic management, structural policies, policies for social inclusion and equity, and public sector management and institutions.

### **CPIA Performance Criteria**

- A. *Economic Management***
  - 1. Macroeconomic Management
  - 2. Fiscal Policy
  - 3. Debt Policy
- B. *Structural Policies***
  - 4. Trade
  - 5. Financial Sector
  - 6. Business Regulatory Environment
- C. *Policies for Social Inclusion and Equity***
  - 7. Gender Equity
  - 8. Equity of Public Resource Use
  - 9. Building Human Resources
  - 10. Social Protection and Labor
  - 11. Policies and Institutions for Social Equity
- D. *Public Sector Management and Institutions***
  - 12. Property Rights and Rule-Based Governance
  - 13. Quality of Budgetary and Financial Management
  - 14. Efficiency of Revenue Mobilization
  - 15. Quality of Public Administration
  - 16. Transparency, Accountability, and Corruption in the Public Sector

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<sup>5</sup> For a detailed description of the CPIA system of performance assessment and IDA allocation formulas, see World Bank (2005), Annex 1.

There are a number of implications of the use of the CPIA assessment for allocation of IDA resources in the DPRK context. First is that in order to make this assessment, a great deal of information will need to be collected and evaluated, going far beyond the information required for membership in the IMF and IBRD. Much of this information and assessment also will be about public institutions and their capacities as well as policies and their impacts. To prepare the CPIA assessment will require extensive discussions between the staff of the World Bank and officials of the DPRK at different levels and across many agencies, and a willingness of the DPRK to make this information and officials available. At the beginning of the process a high priority will need to be given to education and training of DPRK officials in the concepts and methodologies involved and their rationale.

A second implication is that the amount of IDA finance that would be allocated to the DPRK would depend largely on the rating it receives from the first CPIA assessment. While performance in implementation of on-going IDA-funded projects is also a factor in the allocation formula, this would have little influence on the first allocation for the DPRK, although absorptive capacity constraints identified through the institutional assessment would be taken into consideration both in the allocation and initial selection of projects for funding. A governance factor is also used in the formula to calculate an overall Country Performance Rating (CPR). The IDA country allocation is then calculated on the basis of the CPR, population size and GNP per capita.

Country-specific CPRs make a big difference in the amount of IDA resources that are allocated. The CPR is based on a scale of 1 to 6. If the DPRK were to receive a rating similar to that of other poor performing countries, it could expect to receive an allocation in the range of \$25-60 million a year. For example, Zimbabwe has a CPR of 0.9 and an allocation of \$1 per capita. Haiti has a CPR of 1.5 and an allocation of \$2 per capita. And Angola has a CPR of 1.9 and an allocation of \$2.75 per capita. On the other end of the scale, if the DPRK were to receive the same rating as Vietnam, i.e., A CPR of 3.42 and allocation of \$9 per capita, then it could expect an allocation in the \$200 million per year range.

It is clear that if the DPRK aspires to a high-end IDA allocation, it will need to devote a great deal of political will to achieve the ratings required, and this may take some time as a practical matter, even if the political will is forthcoming.



Moreover, it is also clear that even with a high performance rating and allocation, IDA funding would be a fraction of what the DPRK will need for its economic development in the medium-term. Infrastructure investment alone in energy, transport, water resources, and housing, will require levels of funding much greater than the resources that IDA could provide under the most optimistic circumstances. Access to the ADF resources of the ADB follows a similar approach as that for IDA and the total resource base is much smaller.

The implications are that the DPRK will need to look beyond the World Bank and ADB for the capital required to meet its investment needs for economic development. This will require a multi-donor program of support for the DPRK that combines multilateral and bilateral development aid in a coherent program of assistance. It will also require mobilizing private capital not only for industrial investment but also for public infrastructure. To ensure both mobilization and efficient absorption of ODA and incentives for private investment over a period of years, the DPRK would need to establish both a strong track record of performance and reliability in carrying out its policies and promises. Whether the DPRK would be ready for this level of commitment to its own economic development following adoption of a “bold switchover” policy in security, and whether it would be capable of meeting the expectations of donors and investors in the medium-term, are serious questions.

### ***Special Themes for IDA 14***

In addition to the issues related to eligibility and allocation of IDA resources, the IDA 14 guidelines embrace a number of initiatives to improve the impact of IDA. These also would need to be taken into consideration in the development of an IDA assistance program for the DPRK.

*Strategic Priorities.* IDA’s top priority is poverty reduction, and the twin pillars of its strategy are to foster the climate and conditions for sustainable growth, investment and job creation that are inclusive of poor people, and to empower poor people to participate in development and investing in them. For the IDA 14 period, particular attention is being given to supporting efforts by countries to meet the Millennium Development Goals that have been endorsed as a global endeavor. The implication for the DPRK of this fundamental orientation of IDA is that any economic

development strategy that would be supported by IDA must be pro-poor and address the needs and opportunities for the lowest income groups in the DPRK society. IDA will require both focus on the poor and participation of the poor in an inclusive approach to meeting their needs. The values embedded in this strategy are also congruent with human rights values that are being broadly advocated in the international community for the DPRK. The social dimension of economic transformation and accommodating the priorities of donors will thus pose significant challenges for the DPRK leadership in implementing a “big switchover” policy that embraces social policy as well as security and economic development.

*Results Measurement System.* Globally, the development assistance community is placing a high priority on results. Consequently, under IDA 14, the World Bank is upgrading its results monitoring capacity, both on aggregate country development outcomes and on the contribution of IDA to those outcomes. Progress will be monitored on 14 indicators. At the country level, results-based country assistance strategies will give increased attention to outcomes of prioritized IDA investments. This focus on results would be particularly important in the DPRK context, as there are many uncertainties about how resources would be managed to achieve the intended objectives. Measuring results requires collecting information both on aggregate and at the project-level. If the DPRK is going to build a working relationship with the World Bank, then this level of cooperation will be an essential part from the very beginning.

*How IDA Works with Development Partners.* The global development community has recognized the benefits of harmonization and alignment among donors and development partners for overall development effectiveness. During IDA 14, the World Bank will play a proactive role in coordinating efforts to strengthen statistical capacity and use of statistics in IDA countries and will work with other donors to build a better harmonized development assistance system with lower transaction costs, based on a common framework of results, alignment of donor efforts, and stronger and more transparent financial management capacity in IDA countries. There is an opportunity for the DPRK as a newcomer to the development business to build partner-led and harmonized and aligned development assistance programs from the outset of a major new relationship with the international community. Incorporating the lessons learned from global experience and consensus on best practices could be a major benefit for the

DPRK. Vietnam offers good models of development cooperation from this perspective. It could also be argued that the partner-led model that the OECD/DAC advocates as best practice for development effectiveness, is compatible with the DPRK's *Juche* philosophy, and if a partnership based on these principles could be formed in the DPRK, significant results could be achieved in a relatively short timeframe. The World Bank could facilitate the development of a first-class donor cooperation system for the DPRK, if it is willing to adopt a best practice development policy along with a "big switchover" security policy.

*Private Sector Development.* The World Bank believes that a vibrant and competitive private sector is a key to growth and poverty reduction. Under IDA 14, the World Bank will strive to extend the reach of markets through investment climate reform, with a special focus on ways to encourage thriving micro, small and medium-scale enterprises. A second area for emphasis will be improving access to basic infrastructure through private participation. Both of these themes are highly relevant in the DPRK context, and could be a major area for collaboration between the World Bank and the DPRK, if the government adopts a policy of supporting the growth of market mechanisms and small scale enterprises. As a practical matter, private participation in infrastructure investment is most likely to be with foreign not domestic partners, potentially in the energy and transport sectors. Facilitating the development of projects with such private participation would be an area where the involvement of the World Bank could be highly effective. This would be augmented if the DPRK chooses to become a member of the IFC and MIGA as well as the IBRD and IDA.

*Transparency and Disclosure.* IDA donors and the World Bank place a high priority on transparency. It contributes to the development process by drawing more stakeholders, supporters and ideas into the process, facilitates communication and coordination among development partners, and improves development effectiveness by fostering public integrity and accountability for results. IDA also plans to broaden transparency in its own operations, including full disclosure of CPIA ratings that are used for IDA allocations. Transparency has never been a high value for the DPRK, but any future relationship with the World Bank and IDA assistance will require a high degree of transparency. Efforts to hide or obfuscate realities from the donors or the public will not be tolerated.

## Special Trust Funds

In recent years there have been a number of situations where the World Bank has been asked to establish and manage Special Trust Funds for countries emerging from conflict. Such funds have been established for non-member states in the case of the West Bank and Gaza, Bosnia-Herzegovina, Kosovo, and Timor-Leste. More recently, Special Trust Funds have also been set up for existing members facing special circumstances, in the Sudan, Afghanistan, and Iraq. Typically these Special Trust Funds are established based on a resolution of the Board of Executive Directors at the World Bank, and operate under rules and procedures negotiated and adopted for each country on a case-by case basis. The trust funds pool finance from donors that participate in contributing to the fund, and disburse in accordance with the operational rules of the fund, normally on a grant basis. In these cases the World Bank has been appointed trustee of the fund, and a donor council of contributors approves programs for use of the funds. In the case of the Timor-Leste fund, the ADB is also given an implementing agency role together with the World Bank.<sup>6</sup>

The advantage of Special Trust Funds in a post-conflict situation is that they can help bridge the transition from humanitarian aid to development assistance and can help bridge political aid given to improve the security environment and the transition to peacetime with the start-up of economic reconstruction and development. In the context of the DPRK, the idea of establishing a Special Trust Fund at an appropriate political moment to facilitate both of these transitions is very appealing. Certainly a decision of the DPRK to adopt a “big switchover” security policy would be sufficient to trigger a willingness in the donor community to establish such a fund for the DPRK. The specific roles and procedures governing the fund would need to be negotiated to fit the special circumstances on the Korean peninsula, but this would not be a particularly difficult undertaking. The administration of the fund likewise could be assigned to either an entity created specifically for this purpose or to an existing multilateral organization, such as the UN, UNDP or World Bank, all of which have experience in delivery special assistance in post conflict environments. The fact that Special Trust Funds for other post-conflict situations have been established in the World Bank, would

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<sup>6</sup> For a detailed description of the operations of Special Trust Funds, see the European Commission Interim Evaluation of the Trust Fund for Timor Leste, (2004).

seem to indicate that this would be a suitable arrangement for the DPRK as well, since the mechanisms for administration, monitoring and reporting are all well-established. To do this however, would require that the Board of Executive Directors adopt a resolution authorizing the World Bank to undertake such a responsibility and to develop a working relationship with the DPRK, even if the membership process was still at an early stage.

### **Need for a Phased Development of the Role of the World Bank in the DPRK**

It is not at all self evident that the DPRK would be ready to meet the requirements of a full-scale relationship with the World Bank, even if it adopted a major shift in its security policy and political relations with the international community. Given the lack of any historical relationship, it will be necessary to begin with a mutual education process. A phased approach would therefore be a logical strategy to follow, with each stage providing the foundation for an expanded relationship and scale of assistance in the next. A possible sequence would be:

- Phase 1: Education and training activities and cooperation in a comprehensive economic assessment and development strategy dialogue.
- Phase 2: Establishment of a Special Trust Fund to finance a program of high priority training, technical assistance, sector and institutional assessments, and pre-investment studies. An initial donor coordination mechanism should accompany the establishment of the trust fund.
- Phase 3: Membership in the IMF, IBRD and IDA and the initiation of an IDA assistance program, along with the establishment of a Consultative Group for the DPRK. Membership in the IFC and MIGA would also be appropriate in this phase.
- Phase 4 (longer-term): Graduation to IBRD borrowing and support for accession to the World Trade Organization.

The first phase could be about one year in duration and the second phase three to four years in duration. Phase 3 could overlap with phase 2 and last as long as deemed necessary, with the goal of moving to phase 4 as soon as performance permits.

## **Linkages of Political Aid and Development Aid in the DPRK Context**

Money is fungible. Thus foreign aid given for whatever reason can allow domestic resources to be allocated to other priorities, unless there are clear and transparent agreements and accountabilities for use of all resources available to a government. Also, while the motivation for external aid given to a country may be for humanitarian, political or economic development objectives, the impacts that flow from decisions to extend aid for any of these reasons have consequences for the economy and the incentives environment for the major economic stakeholders. For these reasons, it is important to look beyond the motivational frameworks for supplying aid to the DPRK to manage effectively an external economic engagement strategy that will accomplish the objectives that underlie the motivational equations. The experiences of the past decade of assistance provided to the DPRK for various motivations are by and large not happy ones. Thus it is important to strive to ensure that any future assistance program for the DPRK be based on international norms and coherent policy coordination among the donors.<sup>7</sup>

If the DPRK adopts a “bold switchover” in its security policy and also normalizes relations with Japan, it can be expected that a significant amount of politically motivated aid would be forthcoming to the DPRK. The major suppliers of this aid would be the Six Party Talks countries, but it can be expected that the European Union and countries such as Australia and Canada would also choose to participate. These countries would also likely become important future suppliers of development assistance to the DPRK, both bilaterally and through the multilateral organizations, including the World Bank and the ADB.

There are a number of implications of a scenario where both political aid and development aid would flow to the DPRK. First is that it is important that political aid not undermine the incentives for the DPRK to pursue economic reforms and development policies that are in its own long-term interest. Second, it is important that neither political aid nor development aid undermine the political achievements that underlie the willingness to undertake a “bold switchover” in security policy. Both the DPRK’s political security and economic security must be reinforced by the way aid is

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<sup>7</sup> Lancaster (2004) provides a good analysis of aid and international norms in the DPRK case. Babson (2004) assesses lessons from experience, as does Haggard and Noland (2005).

provided and managed. Third is that synergies should be exploited between aid that is provided for political reasons and aid that is provided through development assistance based on international norms. This is particularly critical in the coordination of military manpower redeployment with job creation and new skills training opportunities, the transfer of military assets to civilian economic use, the priorities and policies needed to make best use of infrastructure construction that is funded through political aid, and the integration of investments and activities funded by political aid with a comprehensive economic development strategy. And fourth, it is important that aid provided bilaterally be coordinated with aid provided multilaterally and that there is an overall coherence to the transfer and absorption of external resources into the DPRK.

A tool that has been developed for other post-conflict situations might be appropriate for the DPRK context in this scenario. The Results Transition Matrix (TRM) is a mechanism for coordinating the planning of activities and assistance provided by donors in a time-phased manner. It has been developed by the World Bank and United Nations Development Group in collaboration with other donors and is now in use in Haiti, Timor-Leste, Liberia, Sudan, and Central African Republic.<sup>8</sup> The TRM aims to:

- Provide a management tool for national authorities to use as a calendar for focusing on key actions.
- Explicitly identify the links between political-security issues and economic-social issues.
- Articulate a compact between the national authorities and their population and provide a framework for demonstrating benefits and gains achieved during the transition.
- Serve as a catalyst for harmonization among donors, allowing for improved donor coordination and articulating a compact between the national government and international donors.

The experience so far with this recently developed tool is that the process of developing a results-based TRM, by identifying key priorities and balancing comprehensiveness with selectivity, can help the government get in control, discipline donors, and foster coordination and harmonization.

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<sup>8</sup> For a detailed description and assessment of lessons of experience, see “An Operational Note on Transitional Results Matrices,” World Bank and United Nations Development Group, (2005).

## **A Proposed Strategy for a Phased Roadmap Using a Transition Result Matrix**

By combining a phased approach to building a role for the World Bank in the DPRK with a Transitional Results Matrix supported by donors providing both political aid and development assistance to the DPRK, it is possible to imagine that a roadmap could be created to move forward with a complex and challenging agenda, if the DPRK were to adopt a “bold switchover” policy. The creation of realistic expectations about what is feasible to accomplish in specific timeframes is a critical requirement to build trust and confidence in developing new working relationships between the DPRK and foreign partners. To do this, discussions at a high level on the overall policy of the future involvement of the IFIs in the DPRK will be needed. The World Bank can play a pivotal role in the planning and implementing such a process, if the DPRK is willing to proceed in this way, and if the major shareholders and stakeholders in the future of the DPRK and Northeast Asia support a bold approach to economic and social development as well as security re-alignment.



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