

What's next for North Korea?

December, 2011 – Christopher Vale, CEO & KR Min, Senior Research Analyst

North Korea announced at noon Seoul time yesterday that its leader Kim Jong Il, the Dear leader, had passed away of 'exhaustion' while on a domestic train trip on December 17. A flavour of North Korea can be garnered from the fact the state television announcer wept as they read the news, while thousands in the main square in Pyongyang chanted in unison and waved 'Kimjongilia', a flower named after the deceased leader. The son of Kim Il Sung (the Great Leader), Kim ruled North Korea for 17 years after coming to power in July 1994. The South Korean army and government were put on full alert and developments will be closely watched worldwide. Given the uncertainty it will unquestionably cause the market, the impact is clearly negative, at least in the short term. Having said that, history tells us not to panic. The most recent 'flare ups' were the North Korean torpedo attacks on a South Korean warship on 26 March 2010 (killing 46 sailors) and the firing of artillery shells on Yeonpyeong Island on 23rd November 2010 (killing 2 soldiers and 2 civilians). In both cases, the market digested concerns and regained pre-accident levels within a week. Post the announcement on Monday the Kospi index lost 3.4%, but regained some of that today. The Korean Won fell 1.6% to a 2 month low of 1177 per dollar but regained all of that today.



Kim Jong Il. Source: MBC News.

Kim Jong Il was a chain smoking recluse who it is understood had a stroke in August 2008 and was also rumoured to have contracted pancreatic cancer. He was officially 69 and Russian records indicate he was born in Siberia in February 1941. His family returned to Pyongyang post WW11 in 1945 (his father was a major in the Russian Red Army). He graduated from Pyongyang (Kim Il Sung) University in 1964, became heir-designate in 1974 and made co-ruler in 1984. As head of party's propaganda department he was seen as responsible for 'deifying' his father and leading the North Korean version of the cultural revolution.

Until the early 1970s, North Korea's command economy performed well relative to the capitalist South, but then the South economy took off and the North focussed on grandiose schemes commemorating the 'Kim' dynasty. He did allow tourists in the late 1990s to Mount Geumgang, but since a South Korean tourist was shot there in 2008 this has also been stopped. Because Kim Jong Il took over from his father in 1994, i.e. post the Berlin wall coming down in 1989, he no longer had Russian backing - specifically aid. This has left China as the main benefactor accounting for 83% of North Korea's trade. Economic reform has been minimal with only a small opening of the Gaesong Industrial Complex (100 South Korean companies) in 1998. His major recent legacy was his withdrawal from the Nuclear Non Proliferation Treaty in 2003 leading to the 6 party talks (US, Russia, Japan, China, N&S Korea). In 2009 he said it would withdraw permanently from these talks and after the UN denounced a ballistic missile test, received further UN sanctions. His perceived skill in 'playing a weak hand' was exemplified by leveraging the detention of 2 female US journalists in 2009 winning a visit by former US president Clinton to garner their release.



Source: FN News



*Kim Jong-eun.
Source: MBC News*

Some will say Kim Jong Il defied global condemnation to build nuclear weapons while his people starved. He leaves behind an economy less than 3% the size of South Korea's and which has relied on economic handouts since the 1990s when an estimated 2 million died from famine. He put in place a succession plan last year when his little known third son Kim Jong-eun (the Brilliant Leader or the Great Successor) was appointed as general and vice chairman of the Central Military Commission. The chances of a regime change have increased either by coup or a failed attempt to reform the political and/or economic system. There is also a slight chance that regime change could lead to anarchy and civil war.

Obviously talk of reunification will be raised, so as a starting comment, one similar to Germany is not on the cards. German reunification is estimated to have cost almost 50% of German GDP (over 10 years) while this would be much larger for South Korea (i.e. ruling this out). Simply, East Germany had 1/4 of the West's population whilst North Korea is 1/2 of the South. East Germany was relatively rich with GDP per head 1/4 of the West whilst North Korea is estimated at 1/10 of the South. 40% of the North is estimated to suffer from

malnutrition according to the world food program. However, if reunification isn't the goal but normalisation of relations is, there are various advantages. Germany exchanged currencies at 1-1 whereas in this case, South Korean and other capital could employ surplus North Korean labour more cheaply (more like Hong Kong companies moving into Southern China in the 1960s/70s and 80s). Huge savings could be made in the North by cutting the North Korean military (around 30% of GDP). In 2010 President Lee Myung Bak did float the idea of a reunification tax however, the South has consistently pursued a policy of fiscal prudence towards the North and this is likely to continue. Having said that, South Korean debt to GDP is 30% and they aim for a balanced budget by 2014. This does in theory at least leave significant scope for debt financing were the regime in the North to collapse.

We are one day on from the announcement of Kim Jong Il's death and it seems that succession is working in a fairly smooth way. It looks as if the 'leadership' group in North Korea are following some sort of 'manual' prepared a while ago according to press release, and aggressive action by the North is not expected in the short term even if that has been prevalent in the past at times such as these. There are though, some who believe that Kim Jong-eun won't last and he will eventually step down or be forced out. This certainly would cause major anxiety in markets were it to happen.

It is clear that China was informed first of the death and it is also likely given their desperate economic situation that more dependency on China is expected in the future. Rather like the recent transition in Myanmar, it could be that this dynastic change results in further opening of the North in the form of more economic zones or capital aid from China as an economic 'kick-start' once the political dust has settled (for example China might send more oil or rice as a goodwill gesture). Up until his death, Kim Jong Il had been aggressive in negotiating with the US for receiving aid in exchange for some degree of nuclear abandonment. Thus, a resumption of the 6 party talks along these lines could be anticipated in time.

This leadership change in the North could also have significant electoral effects in the South because the South has National Assembly Elections in April and Presidential ones in December. The current President, Lee Myun Bak, whose current popularity is at a relative low point, is of the Grand National Party who historically has taken a tough stance with the North and this could be more popular in the short term and thus, boost his party's vote. On the other hand, if the North shows encouraging signs of a more conciliatory approach, or even opens up a little, then it could help the opposition or newly emerging political groups in the South such as Ahn, Chul Soo, a possible Presidential candidate in 2012. A previous President, Kim Dae Yung, from the opposition party, won the Nobel Peace prize, somewhat prematurely it seems, for his reconciliation efforts with the Northern Stalinist Dictator Kim Jong Il.

The new leader, the 28 year old Kim Jong-eun, who takes over is, unusually for dynastic successions, the third and youngest son, as opposed to the eldest. He and his elder brother Jong Chul were born to a Japanese-Korean dancer and were both educated in Swiss boarding schools. There is another, the eldest brother, a step brother, Kim Jong Nam, who resides in exile in Macau and Beijing. It will be interesting to follow China's treatment of him given the appointment of his younger sibling as successor. There are also 4 sisters from various wives or mistresses of Kim Jong II, of which little is known. Perhaps more significantly, when the new leader Kim Jong-eun was made a 4 star general about a year ago, his Aunt, Kim Kyong Hui, and her husband were also made generals or as some portrayed this – 'protectors'.

The funeral of Kim Jong II will be held on December 28th following a ten day period of national mourning during which period all entertainment, such that there is in North Korea, will be banned. Kim Jong II had 20 years to prepare to take over and establish himself as the successor from his father, Kim Il Sung, benefiting from his cult of personality. Kim Jong-eun has had barely a year to do the same. It is rumoured that the grandson has deliberately been modelled on, and made to look like, the grandfather to further this cult. His grandfather invaded the South in 1950 causing the Korean war, which claimed 3 million lives, and they remain technically at war. It is why the North has 1.1m troops and the South 680,000 either side of the Korean DMZ (demilitarized zone) which runs along the 38th parallel and why the US still has 28,000 troops stationed in the South, 61 years on.

If Kim Jong-eun, the Great Successor, opens up the North and becomes the great reformer, it could have major consequences. When the Japanese ran Korea pre WWII, all the industry was in the North and there are significant mineral resources, unlike the South. They could also supply cheap workers for the South's major corporates whilst reducing the global defence bill. This is the optimistic scenario. The other extreme is that without a unifying leader, fighting breaks out amongst factions leading either to war, starvation, and on an even worse scale, anarchy or floods of refugees over the border (into China rather than the South). China and Kim Jong-eun will be working towards stability and progress at all costs.

Sources: Bloomberg, RBS and BoAML.