

Statement before the
House Committee on Financial Services
Subcommittee on Monetary Policy and Trade

“Restricting North Korea’s Access to Finance”

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Introduction

Chairman Barr, Ranking Member Moore, and Members of the Subcommittee, it is an honor to appear before you today to discuss how to restrict North Korea's access to finance to prevent the country's weapons development. I'm particularly honored to be on the panel with Mr. Bill Newcomb, who has mentored me and many others in researching the North Korean regime's illicit activities.

As requested by the Subcommittee, I'll be providing a summary of my research into the North Korean regime's accumulated learning in evading sanctions – particularly through its elite state trading companies, commercial partners in China and Southeast Asia, and the nesting of illicit procurement within licit commercial activities.

The key takeaway is not that the North Korean regime has been evading sanctions – they've been engaged in this activity for decades. Rather it's the story of how North Korea's sanctions evasion techniques have improved significantly because of North Korea, Inc.'s migration to the Chinese marketplace. As a result, U.S. policymakers need to factor in these growing gaps and consider under-utilized measures – like Chinese domestic policy tools – to disrupt Chinese-North Korean business partnerships and restrict North Korea's access to finance.

Understanding North Korea, Inc.

My MIT colleague, Dr. Jim Walsh, and I recently completed a three-year study assessing the application of targeted sanctions to halt the North Korean regime's nuclear and ballistic missile programs. Based on interviews with former managers of "North Korea, Inc." – the web of state trading companies (STCs) that the regime operates to procure licit and illicit items – we were able to map North Korea, Inc.'s practices, partners, and pathways.¹

We found that STC managers were able to significantly increase the effectiveness of their procurement activities by 1) hiring more capable Chinese middlemen who can more effectively handle financing, logistics, and doing business with private Chinese firms and foreign firms operating in China, 2) taking up residence and embedding themselves on the mainland, which increases their effectiveness, 3) expanding the use of Hong Kong and Southeast Asian regional commercial and banking hubs, and 4) increasing the use of embassies as a vehicle for procurement.²

1) The Unique Role of Chinese Middlemen

By working directly with local Chinese middlemen, North Korean STC managers have been able to better evade sanctions. These middlemen charge their North Korean clients a fee to purchase

¹ John Park and Jim Walsh, "Stopping North Korea, Inc.: Sanctions Effectiveness and Unintended Consequences," MIT Security Studies Program, August 2016. Accessed at: https://drive.google.com/file/d/0B_ph0c6i87C_eGhCOGRhUVFaU28/view

² Park and Walsh, "Stopping North Korea, Inc.," p. 3.

dual-use technologies – items that can be used for either civilian or military purposes, such as industrial equipment and components.

Following the application of additional rounds of sanctions, these local Chinese middlemen began to charge larger fees to reflect the increased risk of doing business with North Korean STC clients. Instead of impeding procurement activities, we found that additional sanctions have actually attracted more capable middlemen, incentivized by a bigger payday. The North Korean regime has financed these larger paydays by drawing on sizeable slush funds on the mainland that it amassed during the lucrative North Korea-China coal trade in the late 2000s.³

2) Embedding in Commercial Hubs in China

Using diplomatic credentials, former North Korean STC managers noted that they were able to reside longer in commercial hubs on the mainland. What's new was not that STC managers had been engaged in procurement activities – they've been doing so for decades – rather it was how and where they had conducted business. Previously, STC managers would go on the equivalent of a business trip from Pyongyang to Eastern Europe to procure an item ordered by the regime. They acquired very limited information about local market dynamics on such transactional trips.

What was striking about interviewing former STC managers was the normalcy of their business practices. Like American or European expatriate businessmen, they explained the challenges and opportunities of operating in a particular local market in Asia. Gaining the tacit business knowledge that resides in these networks was critical to increasing the procurement effectiveness of North Korean managers.⁴ By acting more like regular businessmen, STC managers were able to form improved business partnerships with local middlemen.

3) Leveraging Commercial and Banking Hubs in Hong Kong and Southeast Asia

North Korean STC managers have operated in Hong Kong and Southeast Asian hubs for many years. As global trends in trading and banking shifted to this part of Asia, these managers have benefited from increased access to business partners with an international reach. In the case of Hong Kong, we documented how a former STC manager based there was able to procure high tech medical equipment from Japan through a local business partner. This partner filled out all the required documentation using the details from its own registrations and licenses. It also coordinated with other companies on the logistics of delivery.⁵

In the case of Singapore, it has been a particularly useful venue for North Korean STC managers to pay local firms to arrange wire transfers for payments to foreign counterparties. As Singapore

³ John Park, "To Curb North Korea's Nuclear Program, Follow the Money," *The Conversation*, September 20, 2016. Accessed at: <http://theconversation.com/to-curb-north-koreas-nuclear-program-follow-the-money-65462>

⁴ Ibid.

⁵ Park and Walsh, "Stopping North Korea, Inc.," p. 25.

has rapidly risen to be a global center for money management, opportunities abound for the North Korean regime to benefit from illicit financial service offerings.⁶

4) Extensive Use of Embassies as a Vehicle for Procurement

North Korean embassies serve two key functions with respect to the operation of North Korea, Inc.'s illicit activities. The first is serving as a vehicle for procuring controlled items in a foreign country. Former North Korean STC managers note that the regime co-locates shell companies with its embassies in countries that offer unique access to sought-after items ordered by the regime. Business cards of these shell companies list the local embassy's address and fax number. The second function is the ability to credential an STC manager as a North Korean diplomat. In addition to gaining valuable tacit business knowledge by embedding in a country for a longer duration, STC managers are also able to use diplomatic pouches for illicit purposes related to transporting a banned item or couriering unreported cash.⁷

The Sanctions Conundrum

In examining U.S.-led efforts to counter these sanctions evasion techniques, we observed what we call the "sanctions conundrum" – one of the key negative unintended consequences of applying more sanctions on North Korea, Inc. The net effect of sanctions was that they, in practice, ended up increasing the regime's procurement capabilities. Because of the elevated risk of doing business, an STC had to pay higher commission fees to private Chinese companies that played a middleman role. The elevation of risks and rewards attracted more capable, professional middlemen into illicit network activities on behalf of North Korean clients.⁸

Accelerating this trend in this niche marketplace was the Chinese middlemen's monetization of political relationships. Linked to local corrupt Chinese officials, the private companies used portions of the elevated commission fees to clear a path for efficiently completing a procurement transaction on behalf of a North Korean client. In sum, targeted sanctions – unintentionally and counterintuitively – helped to create more efficient markets in China for North Korea, Inc.

If one were to view sanctions as the antibiotics in the U.S. national security toolkit, increasing the dosage on the North Korean regime has triggered, in some instances, the development of drug-resistance. This resistance is in the form of alternative, more effective commercial channels. We need to better target sanctions and strengthen law enforcement and other measures, based on an improved understanding of how North Korea, Inc. has devised innovative techniques to evade them.

Stopping North Korea, Inc. by Disrupting its Business Partnerships in China

An important starting point is setting the strategic goal of disrupting the North Korean regime's procurement networks. While we need to develop ways to bolster the impact of sanctions, we

⁶ Park and Walsh, "Stopping North Korea, Inc.," p. 26.

⁷ Park and Walsh, "Stopping North Korea, Inc.," p. 27.

⁸ Park and Walsh, "Stopping North Korea, Inc.," p. 31.

should also explore other policy tools. Diversifying the set of policy tools and coordinating with different policy actors will significantly constrain the remarkably open space within which North Korea, Inc. currently operates.

If we widen the aperture and view the target as the business partnership between a private Chinese company linked to a local corrupt party official on one side and an elite North Korean STC on the other, we can apply tailored policy tools to disrupt this partnership. These specialized partnerships have created largely unconstrained opportunities for the North Korean regime to procure the critical components for its nuclear and ballistic missile development programs.

Using the definition of technology as the knowledge of techniques and processes, these partnerships constitute a “dual-use” technology in that they are essentially commercial channels that can be readily used to move either illicit or licit goods. A key reason behind the procurement effectiveness of these business partnerships is that they hide in the open. Given the massive quantity of business transactions that occur daily in the Chinese marketplace, filling out documents, signing contracts, and taking out insurance on freight enables illicit consignments to “blend in.” A top priority is to disrupt these partnerships upstream – before the procured item moves through this dual-use technology and literally becomes a part of globalized trade flows.

In addition to the policy recommendations offered by my distinguished colleagues on the panel, I’d like to bring to the Subcommittee’s attention the “Three Antis” which are a set of China’s domestic policy tools – anti-corruption apparatus, anti-narcotics campaign, and anti-counterfeiting activities.⁹ U.S. policymakers can coordinate closely with their Chinese counterparts on redirecting these Chinese domestic policy tools to counter North Korean procurement in China. (Contrary to common perception there are precedents of bilateral cooperation, such as the U.S.-China Joint Working Group on the Nonproliferation of WMD, which was established during the July 2014 round of the Strategic and Economic Dialogue). With respect to current policy cooperation, the U.S.-China Comprehensive Economic Dialogue (CED) and the U.S.-China Diplomatic and Security Dialogue (D&SD) could serve as effective mechanisms for building and sustaining high-level political support. Collaboration on the “Three Antis” would advance the U.S. and China’s common goal of stopping North Korea, Inc.’s illicit activities in China.

1) Anti-Corruption Apparatus

Perhaps the highest impact policy tool in disrupting North Korea, Inc. is China’s anti-corruption apparatus. The September 2016 case of the Dandong Hongxiang Industrial Development Company¹⁰ serves as an important precedent for scaling up the application of the anti-corruption apparatus to target corrupt party officials involved in these Sino-North Korean business partnerships. Given the link between private Chinese middlemen and local corrupt party officials, using the anti-corruption apparatus for this specialized function would have an

⁹ Park and Walsh, “Stopping North Korea, Inc.,” p. 47.

¹⁰ “In China’s Shadow: Exposing North Korean Overseas Networks,” Asan Institute for Policy Studies and C4ADS, August 2016. Accessed at: <https://c4ads.org/reports/>

immediate impact on procurement deals. Of all the policy tools, this substantial one is readily available, but dependent on the senior Chinese leadership's decision to go down this path. The United States should use policy cooperation mechanisms like the CED and D&SD to regularly provide commercial intelligence to the Chinese authorities so that they can apply their domestic policy tools on Chinese entities engaged in criminal activities. Secondary sanctions could raise the appeal of pursuing this path.

2) Anti-Narcotics Campaign

An open secret in China's northeastern provinces is that there's an expanding narcotics problem emanating from North Korea. Called "ice," this cheap and potent form of methamphetamine is produced in large quantities in North Korean pharmaceutical factories. Drawing on the precedent of Sino-U.S. cooperation in the late 2000s when China was confronting an inflow of opiates through its border with Afghanistan, there's an opportunity to adapt the previous program to China's northeastern provinces. Although aimed at the narcotics trade, the positive spillover effect of increased Chinese law enforcement activities would further constrain the areas in which North Korea, Inc. and its Chinese partners operate.

3) Anti-Counterfeiting Activities

The North Korean regime is well documented as the creator of "supernotes" – counterfeited US\$100 bills. What's not so well known in the West is that there's strong concern in China that its neighbor has been counterfeiting Chinese currency. From Beijing's perspective, this criminal activity is a direct threat to China's economic security. U.S. policymakers could leverage this Chinese concern to elevate channels of bilateral cooperation drawing on U.S. experience tracking down the North Korean regime's sophisticated counterfeiting operations. Given the high threat level, the United States should encourage China to further expand the deployment of Chinese law enforcement resources trained on counterfeiting activities, with special authorization to investigate and inspect consignments and facilities.

Objectively assessing how criminal North Korean activities affect China's national interests yields a clear view of areas of common ground upon which we can build a common cause in stopping North Korea, Inc. In this endeavor, it's important to reassure the Chinese authorities that these measures are intended to "sanitize" China's growing bilateral trade with North Korea, not to cut it off. The majority of the bilateral trade is in non-sanctioned goods and services that are a significant element of the economies of Chinese provinces near the border with North Korea.

Conclusion

Stopping North Korea, Inc.'s illicit procurement and blocking its access to finance constitute a top priority in slowing down the regime's rapid advances in its nuclear and ballistic missile programs. The work of the Subcommittee, the panel members, as well as sanctions-focused officials is critical in finding new, adaptive, and effective ways to counter the North Korean regime's WMD threat to the United States, its Northeast Asian allies, and the international community.

Thank you.