

June 19, 2017

The Second Korean War: Part I

Tensions with North Korea have been escalating in recent months. The regime has tested numerous missiles and claims to be capable of building nuclear warheads, which, combined with an intercontinental ballistic missile (ICBM), would make the Hermit Kingdom a direct threat to the U.S. Such a situation is intolerable to the U.S., and thus there is rising concern about an American military response.

In Part I of this report, we will recap the Korean War, focusing on the lessons learned by all sides of the conflict. We will discuss North Korea's political development through the postwar period and the fall of communism. This examination will frame North Korea's geopolitical situation. The next step will be to analyze U.S. policy with North Korea and why these policies have failed to change the regime's behavior.

In Part II, we will use this backdrop to discuss what a war on the peninsula would look like, including the military goals of the U.S. and North Korea. This analysis will include the military assets that are in place and the signals being sent by the U.S. that military action is under consideration. War isn't the only outcome; stronger sanctions and a blockade are possible, and the chances of success and likelihood of implementation will be considered. As always, we will conclude with market ramifications.

Echoes of the Korean War

After extensive consultations with the leadership of the Soviet Union and the People's Republic of China (PRC), Stalin and Mao, respectively, Kim Il-sung, the leader of North Korea, prepared to attack South Korea. Stalin believed that the U.S. would not risk a wider war by intervening in South Korea. After all, if the U.S. was willing to allow Mao to win China, it seemed likely that the U.S. would not consider Korea important enough to defend. Mao was less confident of American behavior but didn't act to stop Kim. On June 25, 1950, North Korean troops moved south of the 38th parallel and the war began.

Although Truman's Secretary of State Dean Acheson didn't include South Korea on his Asian Defense Perimeter, the president was worried that if the U.S. didn't respond to communist aggression after China fell, it might embolden Stalin and Mao to become even more aggressive. Stalin was threatening Europe and thus taking a stand seemed necessary. It doesn't appear that Stalin expected a U.S. military response; on the other hand, if one came, it would not be a major problem for the Soviets. The U.S.S.R. was not deeply invested in Kim Il-sung and so, from Stalin's perspective, Kim's adventure wasn't a major risk.

Initially, North Korean troops enjoyed great success, rolling South Korean troops and a few American forces into a corner in southeastern Korea. Soon after, the infusion of U.N. troops, spearheaded by the U.S. military, halted the North Korean advance. Gen. Douglas MacArthur later that year launched the amphibious assault at Inchon. The attack was successful with allied troops

routing North Korean forces. Unfortunately, MacArthur overplayed his position as he pushed North Korean troops toward the border with China on the Yalu River. American intelligence did not expect China to intervene given that it was still consolidating its power after the Nationalists fled to Taiwan. But Mao did not want U.S. troops on his border and ordered a counterattack that eventually pushed the allies to the 38th parallel. Although the conflict continued until November 1954, it was really a stalemate by the summer of 1951.

One lesson learned by North Korea was that it really had no outside power concerned about its survival. Kim Il-sung was lured into the war by Stalin but the Soviet leader was more than willing to let the North Korean communists languish rather than risk losing his own troops. China intervened in the conflict but was only willing to suffer massive losses in order to create a buffer state between South Korea, allied with the West, and the PRC. If China felt it didn't need a buffer, it would not need North Korea. Another lesson learned was that the Kim regime viewed America as irrational and dangerous. It seemed odd that the U.S. would be willing to risk war for a part of the world that wasn't a direct security threat and, at the same time, America was so resource rich that it could conduct such wars and not face a crisis if it lost or fought to a draw. Such an adversary is frightening because it can seemingly carry out war on a whim.

The U.S. also learned lessons from the Korean War. First, hegemon wars can be successfully fought to a stalemate. For a hegemon, winning doesn't necessarily require unconditional surrender; merely signaling a willingness to engage can deter behavior. The U.S. inclination to use force

in a region that wasn't a direct security threat to the U.S. showed that it was willing to engage in such wars to prevent communist expansion. Second, the U.S. learned that China would not acquiesce to an unfriendly state on an easily accessible border. In other words, the Yalu River was too close for comfort to China and it was willing to go to war to create a buffer.

The Post-Korean War Period

Kim Il-sung became the leader of the Democratic People's Republic of Korea (DPRK), the nation that emerged after the war. Kim ran North Korea in a manner known as an "oriental despot."¹ A cult of personality developed around Kim. His government centralized power, created a command economy by ending most market activity, erected an effective internal security force and severely restricted emigration. Kim Il-sung's governing philosophy was known as "juche," which is generally represented by a centralized economy, a strongly nationalist/anti-colonial foreign policy and an autarkic trade policy. Essentially, Kim tried to pull the DPRK out of the world.

Kim Il-sung's son and successor, Kim Jong-il, continued his father's governing principles and created a flavor of governance of his own, called "songun," which focuses state resources on the

¹ This designation came from Karl Marx, who officially described it as the "Asiatic Mode of Production." This mode of production is characterized by state ownership of the means of production, political centralization and autarky. Marx argued that areas of Asia were "asleep in history" and didn't evolve until an external force, such as Western influences, caused change. Marxist scholars have disputed this characterization, suggesting that this theory may simply have reflected Marx's Western prejudice. See: <https://www.stratfor.com/article/oriental-despotism>.

military. During his regime, the non-military sector was starved for assets to ensure the military could protect the state. Kim Il-sung’s grandson and current leader, Kim Jong-un, has created his own ruling philosophy known as “byungin,” which shifts the focus to the non-military economy with an emphasis on nuclear weapons. The current leader’s philosophy should probably be characterized as “juche + nukes.”

The collapse of communism in the U.S.S.R. and China, in all but name, has been a major challenge for North Korea. The Soviets were the primary supporters of the DPRK; by 1988, 60% of North Korea’s trade was with the Soviet Union. Much of North Korea’s imports from the U.S.S.R. were in the form of oil sold at deeply discounted prices.² By the fall of the Soviet Union, North Korea owed the Soviets nearly \$11.0 bn; in 2011, Russia agreed to write off 90% of the debt in return for favored investment status. It isn’t obvious that Russia gained anything from the agreement as there were few projects in North Korea that were attractive to Russia.

In the aftermath of the collapse of the Soviet Union, China has become North Korea’s largest trading partner. About 57% of North Korea’s imports come from China and the latter accepts 42% of its exports. India and Pakistan also trade with North Korea.

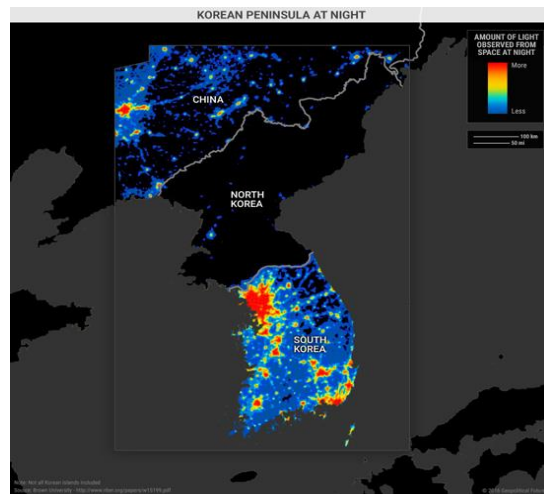
The poor performance of the North Korean economy is a testament to the failure of the Kim dynasty. The following table highlights the differences between North and South Korea.

² The Soviets provided similar aid to Cuba.

Indicator	North Korea	South Korea
Infant Mortality	24.5 deaths/1k live births	3.93 deaths/1k live births
Maternal Mortality	81 deaths/100k live births	16 deaths/100k live births
Male life expectancy	60.0 years	76.7 years
Female life expectancy	73.9 years	83.1 years
GDP per capita	\$1,800 (2011)	\$31,900 (2011)

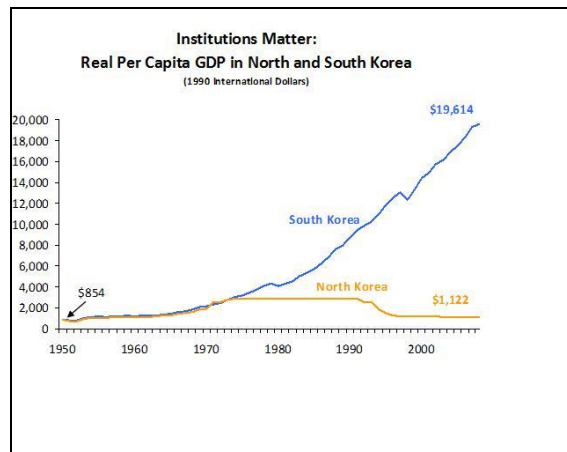
(Source: <http://www.indexmundi.com/factbook/compare/south-korea.north-korea>)

This famous space map highlights the failures of North Korea’s economic policy. Note the lack of electric illumination between China and South Korea.



(Source: Mauldineconomics.com)

The differences in development are also stark. After the war, the economies of North and South Korea on a per capita basis were nearly equal in size. Now, the latter is 17.5x larger.



(Source: AEI)

The economic problems of North Korea, especially after the collapse of the Soviet Union, have shaped the DPRK's geopolitics.

The Geopolitics of North Korea

North Korea is in a difficult situation.

Russia isn't much of a patron anymore. The Kim regime holds almost no value for its primary ally, China, except as a buffer state. The U.S. views North Korea as a constant threat and has designated North Korea as a member of the "axis of evil."³ As we have noted above, its economy is in shambles. The lack of natural resources combined with autarky is almost unworkable.

In response to this difficult situation, the Kims have done the following:

1. The demilitarized zone (DMZ) along the 38th parallel is heavily defended with some 21k of artillery pieces, including rocket launchers, various self-propelled and fixed guns and mortars. Much of the equipment is Soviet era, so it is old and may not work perfectly but there is enough of it to still inflict damage. In case of a war, Seoul is a mere 35 miles from the DMZ which means the capital and largest city in South Korea, with about 10 million people, is well within range of North Korean artillery. The loss of life in a full-scale barrage would be massive. In addition, the DMZ is riddled with tunnels and land mines; tunnels would allow North Korean troops to enter South Korea, while the land mines would slow an invasion of North Korea.
2. North Korea has embarked on a nuclear weapons program along with missile development. After the 2003 Iraq War and the removal of Muammar Gaddafi from power, the leadership in North

Korea became worried about regime change. To prevent an American-led invasion, Kim Jong-il and Kim Jong-un have both pursued a nuclear program. The premise is that Hussein and Gaddafi would still be alive and well if they had maintained their nuclear programs.

3. North Korea has used the nuclear program and other threats to extract aid from the rest of the world, but primarily from the U.S. Over the years, the regime has promised to stop its program in return for aid. Unfortunately, it has persistently violated agreements. So far, it has not faced significant retaliation for its behavior simply because the U.S. hasn't viewed North Korea as a problem worth expending significant American resources on.

Since the Clinton administration, the basic U.S. policy plan seems to have been to wait out the regime and hope that its dire economic straits would eventually lead the government to collapse. This policy has failed for two reasons. First, the Kim dynasty has built a personality cult and a state security apparatus that has been effective enough to keep it in power. The North Korean people seem willing to absorb severe deprivations, making sanctions ineffective. Second, China and, to a lesser extent, South Korea, have tended to offer enough support to keep the regime from imploding. The Chinese don't want to lose the buffer North Korea provides and South Korea would prefer to avoid the costs of unification. It observed the costs Germany faced when West Germany absorbed East Germany, and given that the latter was the "jewel" of communist economies, the costs of absorbing North Korea would be monumental. These factors have kept the status quo in place.

³ A term created by President G.W. Bush.

Part II

Next week, we will conclude our analysis of the potential for war on the Korean peninsula.

Bill O’Grady
June 19, 2017

This report was prepared by Bill O’Grady of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.

Confluence Investment Management LLC

Confluence Investment Management LLC is an independent, SEC Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence’s investment philosophy is based upon independent, fundamental research that integrates the firm’s evaluation of market cycles, macroeconomics and geopolitical analysis with a value-driven, fundamental company-specific approach. The firm’s portfolio management philosophy begins by assessing risk, and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.