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## **North Korea: An Update**

The Kim regime has become increasingly belligerent, launching a number of ballistic missiles and testing what appears to be a hydrogen device. It is also claiming it has miniaturized a warhead, meaning, if true, North Korea is a nuclear power.

The U.S. has indicated this development is unacceptable. Although the Trump administration still says that “all options are on the table,” a full-scale war would be catastrophic and may be impossible to contain. The U.S. wants China to bring North Korea to heel; so far, the Xi government has been reluctant to push hard against Pyongyang. Meanwhile, Japan and South Korea are becoming increasingly worried about North Korea’s behavior.

Although the Hermit Kingdom has been the topic of reports on numerous occasions, an update on the basic geopolitical issue of North Korea is warranted given the volume of recent news. In this report, we will examine the motivations of North Korea and surrounding powers. As always, we will conclude with potential market ramifications.

### **North Korea’s Goals**

**Regime preservation:** The primary goal of the Kim regime is to remain in power. It views the U.S. as the primary threat to its future existence. Although regime change in North Korea is a goal of the U.S., it is not a primary one. The U.S. has mostly pursued this aim through sanctions and isolation, with the idea that communist economies

eventually collapse under their own inefficiencies. Although that worked with the Soviet Union and Eastern Europe (and, arguably, with China), Cuba and North Korea remain stubborn holdouts of Marxism. After President Bush declared North Korea a member of the “axis of evil” (along with Iran and Iraq), and the U.S. forcibly removed Saddam Hussein and Muammar Gaddafi from power, the Kim regime decided that it cannot protect itself from regime change without nuclear weapons.

**Korean unification:** The Kim regime wants to unify the Korean peninsula under the control of the dynasty. Needless to say, the South Koreans oppose this goal. For years, North Korea was convinced that the U.S. was the only power standing between it and unification. However, from the 1970s forward, the South Korean economy has massively outpaced North Korean growth. Still, the regime continues to indicate that it wants to unify the peninsula and believes that nuclear weapons will further this aim. With a deliverable nuclear weapon, it can threaten the U.S. if it comes to the aid of South Korea in an invasion. North Korea is assuming the U.S. will be reluctant to defend South Korea if the Kim regime can directly threaten the U.S. mainland.

**Independence from China and Japan:** The Korean Peninsula saw periodic invasions from Japan and China from the 11<sup>th</sup> century into the 20<sup>th</sup> century. Over numerous periods, Korean leaders have had to deal with aggressive emperors from China and Japan and, at times, fallen under their control. Korean leaders have a long history of playing outside powers against each other

and, to some extent, current tensions have similarities to these earlier periods. In any case, avoiding undue influence from Japan and China is a goal; this is part of the reason South Korea is generally tolerant of U.S. presence on its territory. From the perspective of South Korea, an ally from outside the region is more tolerable than aligning with China or Japan, who were former colonizers of the Korean peninsula.

### **South Korea's Goals**

***Independence from North Korea:*** Although unification is always a goal for all Koreans, for South Korea, it's a bit like St. Augustine's wayward prayer.<sup>1</sup> In reality, the costs of unification would be substantial if the peninsula is unified under Seoul. Although there would be benefits, such as an increase in the labor force and new areas to develop, it will take years for the North to achieve economic parity with the South. Although unification will always be a long-term goal, the South is in no rush to achieve that goal anytime soon.

***Continued economic development:*** South Korea is a significant economic power, with the 30<sup>th</sup> largest per capita GDP.<sup>2</sup> However, MSCI still considers South Korea an emerging market, primarily because its capital markets are not fully open. The country is well on its way to developed status. It does not want to see this progress lost to either a conventional or unconventional war.

***Independence from China and Japan:*** See the above point under North Korea's goals.

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<sup>1</sup> Roughly, "Lord, make me chaste, just not yet." The Confessions of St. Augustine, Book VIII. See: <http://www.sacred-texts.com/chr/augconf/aug08.htm>.

<sup>2</sup> IMF calculation; this compares to estimates of North Korea's per capita GDP of \$1,700 by the CIA.

### **Russia's Goals**

***Keeping what it has:*** Russia's geopolitics mostly focus on the region west of the Urals; the Far East reaches of the Russian empire are not unimportant but are less of a priority. It wants to protect what it has but it also knows it can't easily project power from its holdings in the region. After all, Russia sold Alaska to the U.S., a clear indication that projecting power in this part of the world has historically been a lower priority.

***Maintaining influence:*** The Putin government wants to project power on the global stage. The ability to restrain American power through its UNSC veto and by negotiating sanctions both have value to Russia. On the other hand, Russia is less likely to intervene economically or militarily in North Korea. It was heavily involved in supporting the Kim regime during the Cold War, but China essentially replaced Russia in this role when the U.S.S.R. fell.

### **China's Goals**

***Maintaining a buffer state:*** China does not want hostile troops on its borders. Although India has contentious relations with China, the Himalayas reduce the potential for a land war and thus the presence of the Indian Army on its border isn't a major concern. However, if North Korea were to fall and the peninsula unified under Seoul, China would have American troops in close proximity. Thus, Beijing has an interest in propping up the Kim regime to keep a degree of separation between China and U.S. troops.

***A reliable client state in North Korea:*** Not only does Beijing want a buffer state but it also wants a compliant government in Pyongyang. It doesn't want a regime that causes friction with its neighbors or triggers an event that would require China to come to North Korea's aid.

***A pacified region:*** As discussed below, the U.S. essentially took over the defense of Japan and South Korea. Although China occasionally chafes at U.S. military activity in the region, it has greater concern about a remilitarized Japan and an aggressive South Korea. Thus, China would prefer the U.S. continue its military role of constraining Japan and South Korea. Of course, it would also prefer the U.S. cede the South China Sea to Beijing.

### **Japan's Goals**

***A non-threatening North Korea:*** Japan relies on the U.S. to provide its defense, a policy first created after WWII. The U.S. created a pacifist constitution for Japan; the country is reluctant to deploy its military and thus belligerence from its neighbors is a serious concern. Japan actually has a well-trained and funded military. If it changes its security doctrine, it would be a formidable military power. We note that PM Abe has been agitating for an easing of constitutional constraints against the use of military force. If North Korea continues to threaten Japan and the U.S. begins to appear less reliable in providing security, Japan may be forced to jettison its current pacifist foreign policy stance.

### **U.S. Goals**

***A stable Far East:*** The U.S. is the global hegemon. Although U.S. administrations have indicated that they would support regime change in Pyongyang, under normal conditions, North Korea just isn't important enough to expend a significant degree of resources to execute the removal of the Kim regime. In fact, the Korean War occurred, in part, because Russia didn't believe the U.S. would go to war to defend Seoul because it was outside of America's area of concern. The Truman administration decided that ceding South Korea might lead the Soviets to take aggressive steps

elsewhere and so, contrary to expectations, the U.S. went to war on the peninsula.<sup>3</sup>

### ***No direct threat to the U.S. from North Korea:***

Otto von Bismarck has been attributed with the quote, "The U.S. is fortunate in that it is surrounded by two weak powers and fish." The U.S. has rarely faced an attack on the continental 48 states; America's geographic isolation helps make the U.S. an effective hegemon. The U.S. doesn't need to spend significant resources defending its borders and thus can project power at less cost. Nations that possess deliverable nuclear weapons can directly threaten the U.S., but America's protection from such an attack is twofold, mutual assured destruction and restrictions on nuclear proliferation. In reality, only Russia and China are legitimate nuclear threats to the U.S. and both realize that a nuclear attack would trigger massive retaliation. The U.S. has been able, through the non-proliferation treaty, to keep the number of nuclear powers manageable. However, every new nation that acquires a nuclear bomb increases the likelihood of a rogue nation attacking the U.S. or an ally. In addition, the more nuclear nations, the greater the likelihood that a rogue power would expand proliferation or, worse, allow a hostile non-state power to acquire a weapon. Thus, the U.S. doesn't want any new nation getting a nuclear weapon, but especially not a country like North Korea that acts in an unstable and belligerent manner.

### **North Korea and Incongruent Goals**

The U.S., South Korea, China, Russia and Japan are all satisfied with the status quo. Although not necessarily ideal for any of

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<sup>3</sup> It's important to remember that U.S. policymakers were averse to showing weakness because appeasement during the 1930s was blamed for the rise of Hitler.

these nations, a divided Korean peninsula is acceptable. However, this scenario isn't acceptable to North Korea. The Kim regime does not feel secure, fearing the U.S. wants to remove the dynasty from power. Thus, it feels the only guarantee that it won't be invaded is to possess a nuclear weapon that can be delivered to the continental U.S. As a result, the regime has consistently pursued weapons and missile technology to threaten the U.S.

North Korea's actions undermine the goals of most of the nations we have discussed above. The U.S. doesn't want to be directly threatened with nuclear weapons from a rogue nation. China wants a compliant buffer state and regionally demilitarized states. The Kim regime's constant threats to the U.S. and neighboring nations is "bad for business" and suggests that China doesn't have controlling influence over North Korea's behavior. Japan and South Korea are obviously afraid of North Korean belligerence but have relied on the U.S. security umbrella since WWII. Russia's primary interest is to keep the U.S. distracted, so it tends to offer modest protection to the Kim regime but isn't willing to expend significant efforts to support the regime.

### **The Result of North Korea's Actions**

North Korea has managed to cause the following effects:

**The U.S. security guarantee is now being questioned.** During the Cold War, some European nations worried that the U.S. might refrain from launching nuclear missiles at Moscow if the Soviets attacked Europe. The saying was, "Will any American president be willing to lose New York to protect Paris?" In response to this concern, France opted to have its own nuclear deterrent. If North Korea can strike

the U.S. with a deliverable thermonuclear weapon, Japan and South Korea fear that the U.S. may not defend them if they are attacked by North Korea and Pyongyang threatens to launch a missile against the U.S. mainland. In other words, just like France, Japan worries, "Will any American president be willing to lose Los Angeles to protect Tokyo?" If Japan or South Korea concludes the answer to this hypothetical question is "no," then both nations may decide they need their own nuclear deterrents. In the case of Japan, it also may prompt a change in its constitution to remilitarize.

**The frozen conflict in the Far East will potentially thaw.** The U.S., as part of its postwar hegemony, froze three global conflict zones. It took over the defense of Europe to solve the "German Problem." Germany no longer had to worry about being invaded by its neighbors and the nations surrounding Germany no longer had to fear German aggression. The second conflict zone the U.S. froze was the Middle East. The U.S. purposely maintained the colonial borders in the region and allowed authoritarian leaders to remain in power to prevent wars that would establish nations based on religious, ethnic and tribal distributions. The third area was the Far East. China and Japan are traditional enemies; China tried to invade Japan in the Mongol period and Japan invaded China in the 1930s. When the U.S. took over Japan's security, China no longer had to worry about being invaded by Japan and Japan was protected from China by the U.S. The U.S. proved it would protect South Korea through its actions in the Korean War.

If the U.S. can no longer be relied upon to protect South Korea and Japan, forcing the two nations to expand their militaries, then China would suddenly face a potential threat

from Japan and perhaps a lesser threat from South Korea. North Korea's actions are essentially increasing the risk of a geopolitical event across the region.

**China needs to calculate how valuable North Korea's buffer status is given the rising costs it is imposing on Beijing.**

China clearly views North Korea as an asset; however, its behavior is imposing higher costs. Every nuclear test presents some risk of radioactive fallout in northern China. Its provocations might start a war that could, at best, lead to a humanitarian crisis on its border and, at worst, involve China in a hot war on the peninsula. We suspect the recent assassination<sup>4</sup> of Kim Jong-un's older brother was designed to remove a candidate for leadership in North Korea. China's relations with North Korea have become increasingly strained but we doubt Xi Jinping wants to have an international incident before the Chinese Communist Party conference on October 19. After the conference, Xi may decide that the cost/benefit situation with the Kims is not positive and consider implementing an economic embargo on North Korea. The risk is that North Korea lashes out by attacking the U.S. or a regional power as Kim fears he will fall from power.

**The Goal of Diplomacy**

Although talking to North Korea has not generally worked well, it should probably not be abandoned. The official U.S. policy is that we will not tolerate North Korea with nuclear weapons, but that "ship has sailed." Essentially, all the powers in the region are comfortable with the status quo, so the goal

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<sup>4</sup> <http://www.confluenceinvestment.com/weekly-geopolitical-report-assassination-kim-jong-nam-march-6-2017/>

of diplomacy should be to make North Korea comfortable with that situation, too. This outcome would mean accepting the Hermit Kingdom as a nuclear power and promising to stop supporting regime change. North Korea would be required to give up its goal of forced reunification. Is this an ideal outcome? Not at all. There are serious concerns about a nuclear-armed North Korea. But, if that agreement is unacceptable, then the U.S. must decide whether it will go to war with North Korea before it can deliver a nuclear weapon and risk a bloody conflict,<sup>5</sup> or somehow convince China to apply an economic embargo. Our assessment is that the latter isn't likely in the near term because it seems that China, although unhappy with Pyongyang, does not want to overthrow the regime. Thus, it appears that the U.S. must either accept North Korea's nuclear status or take a risk on war.

**Ramifications**

Needless to say, a war would likely trigger a recession in the U.S. and a bear market in equities. Treasuries, the yen and gold would benefit. We don't think war is probable; instead, we fear North Korea will become a nuclear power that will need to be contained. More likely, we are going to see the re-militarization of Japan and South Korea acquire its own nuclear deterrent. This will create a more risky world.

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<sup>5</sup> <http://www.confluenceinvestment.com/weekly-geopolitical-report-second-korean-war-part-june-19-2017/> and <http://www.confluenceinvestment.com/weekly-geopolitical-report-second-korean-war-part-ii-june-26-2017/>

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