

Testimony of William J. Newcomb
March 10, 2011

North Korea's Sea of Fire: Bullying, Brinkmanship and Blackmail
House Committee on Foreign Affairs

North Korea's Illicit Activities

*Excerpt from: Report of the Panel of Experts established pursuant to resolution
1874 (2009) United Nations S/2010/571 5 November 2010*

*The Democratic People's Republic of Korea relies heavily for its foreign exchange earnings on a very limited range of exports, including rice, pig iron, rolled steel, cement, machinery of various types, chemicals, magnetite (iron ore), textiles, armaments and gold. The military sector has also been given a prominent export role and concentrates on developing overseas markets for its locally produced military arms and equipment. However, these exports are now subject to Security Council measures that prohibit Member States from importing or exporting such items to or from the Democratic People's Republic of Korea. To supplement its foreign earnings, **the Democratic People's Republic of Korea has long also been engaged in illicit and questionable international transactions. These transactions are reported to include the surreptitious transfer of nuclear-related and ballistic missile-related equipment, know-how and technology, illicit drug and cigarette smuggling and counterfeiting of currencies and cigarettes.** A number of these surreptitious procurement and transfer techniques are now being used also to circumvent the Security Council-mandated controls placed on the country's exports and imports.¹*

As shown in the emphasized portion of the excerpt above, the report issued last fall by an international Panel of Experts appointed by the UN Secretary General to review implementation of UNSCR 1718 and 1874 is refreshingly free of ambiguity and finessed expressions about the DPRK regime's culpability in the operation of a wide variety of criminal and proliferation activities. Evidence of the North Korean

¹ Emphasis added.

regime's direction of long-running criminal enterprises is largely, but not entirely, circumstantial, yet it also is extensive and compelling.²

Even so, various official reports on North Korea's involvement in illicit activities often adopt language which provides the regime and its defenders at least a modicum of wiggle room. Similarly, many governments over the years found it convenient to accept, if not actually believe, DPRK denials of state complicity when North Korean diplomatic officials and trade representatives were caught attempting to smuggle drugs or pass counterfeit currency. North Korea explained that these merely were cases of officials gone wrong; return them to us, Pyongyang would request, and we will prosecute them. All too often, governments decided to quietly drop prosecutions or allow those caught to leave or flee. Governments today, however, appear more willing to publicly put the blame on the regime itself and, when possible, bring to trial those caught.

In addition to recognition of North Korea's criminal conduct in the Panel of Expert's report, Executive Order 13551 issued last August contains explicit references to DPRK counterfeiting, narcotics smuggling, and money laundering, and identifies them as well as recent serious provocative actions as constituting an "unusual and extraordinary threat to the national security, foreign policy, and economy of the United States." The E.O. authority was simultaneously used to designate certain North Korean persons and organizations involved in arms trading, narcotics, and money laundering. Most importantly, it served to spotlight U.S. concerns about these entities for other governments and, especially, money center banks that might have dealings with them.

This new clarity about the Kim Jong Il regime's direction of criminal enterprises gives grounds for cautious optimism for a renewal of efforts towards stepped up international diplomatic, financial, and law enforcement cooperation to counter

² For a rigorous review of publically available evidence see Sheena E. Chestnut's award-winning thesis, *The "Sopranos State"? North Korean Involvement in Criminal Activity and Implications for International Security*; Honors Program for International Security Studies, Center for International Security and Cooperation, Stanford University, 20 May 2005.

and contain North Korea's illicit and proliferation activities.³ More and determined action in this direction, of course, would speak louder than words.

Overview of DPRK Illicit Activities

DPRK involvement in illicit activities dates back to the mid-1970s, if not earlier, when customs authorities and police in various countries began to apprehend DPRK officials smuggling narcotics, mostly heroin and opium. The range of illegal undertakings over the years has expanded well beyond trade in narcotics to include manufacture and distribution of a very high quality counterfeit currency known as supernote; production and sale of counterfeit pharmaceuticals; production and sale of counterfeit cigarettes, packaging, and revenue stamps; large scale insurance fraud; gun running to terrorist groups; smuggling of contraband; and money laundering. North Korea deals frequently with transnational crime groups to better hide its own hand and widen market access. While citizens of nearby economies, particularly Japan, China, and Taiwan, are its primary targets, other victims in recent years include residents of Thailand, the Philippines, Peru, and the United States.

Official involvement with illicit activities on a large scale appears to have begun in the early to mid-1990s, probably in reaction to enormous and increasing financial pressures. The demise of the USSR, the DPRK's economic patron, caused multiple, cascading problems in agriculture and industry that would soon develop into widespread famine and result in an economic collapse. China was not only refusing to step up its assistance, but Beijing had ended special bilateral arrangements and was attempting to put trade on a normal hard-currency settlement basis. International credit was mostly unavailable because of the DPRK's repeated defaults on debts acquired in the early 1970s, and exports were

³ For a detailed history of a prior effort to restrict the illicit activities and finances of the Kim Jong Il regime, see David L. Asher, "Pressuring Kim Jong Il: The North Korean Illicit Activities Initiative, 2001-2006" in David L. Asher, Victor D. Comras and Patrick M. Cronin, *Pressure: Coercive Economic Statecraft and U.S. National Security*, Center for a New American Security, January, 2011.

down.⁴ Also falling off were annual remittances from ethnic Koreans in Japan, who had been providing significant funds that had helped the regime bridge a chronic gap between hard-currency export earnings and expenditures on imports.⁵

Ranked in terms of annual earnings, illicit activities of most importance to the DPRK are (1) trade in counterfeit cigarettes, (2) narco-trafficking, and (3) printing and distribution of supernote. Proceeds from insurance fraud, which can be sizable in some years, are episodic. While the DPRK's output of fake pharmaceuticals is believed to be large, international drug companies have not made public any estimates about DPRK earnings.

Counterfeit Cigarettes. North Korea in the early 1990s apparently established its counterfeit cigarette manufacturing industry.⁶ Reflecting findings of undercover investigators, a coalition of international tobacco companies in 2005 produced a report that estimated the DPRK had 10-12 counterfeit cigarette plants, and an annual production capacity amounting to 2 billion packs. This figure would make North Korea one of the world's largest producers of counterfeit cigarettes. The report estimated annual gross earnings ranged from \$520 million to \$720 million.⁷

⁴ For a brief review of negative trade trends and consequences during the early 1990s, see Marcus Noland, *Avoiding the Apocalypse: The Future of the Two Koreas*, Institute for International Economics, Washington, DC, June, 2000, pp. 88-90.

⁵ See Nicholas Eberstadt, "Financial Transfers from Japan to North Korea: Estimating the Unreported Flows," *Asian Survey*, 36(5), 1996, pp. 523-542.

⁶ This dating of the origin of the plants is roughly consistent with early indications of DPRK involvement in counterfeiting cigarettes. "A 1995 Associated Press article reported the seizure by Taiwanese authorities of 20 shipping containers of counterfeit cigarette wrappers destined for North Korea. According to officials of the cigarette company whose label and trademark were being violated, the seized materials could have been used to package cigarettes with a retail value of \$1 billion." Quotation extracted from testimony of William Bach, Director, Office of African, Asian, and European Affairs, Bureau for International Narcotics and Law Enforcement Affairs, Department of State on May 20, 2003 at a Hearing on Drugs, Counterfeiting and Arms Trade: The North Korean Connection before The Senate Committee on Governmental Affairs, Subcommittee on Financial Management, the Budget, and International Security.

⁷ For a summary of DPRK counterfeit cigarette production and distribution, see Liana Sun Wyler and Dick K. Nanto, *North Korean Crime for Profit Activities*, Congressional Research Service,

Some of the cigarette factories are owned and operated by Chinese criminal gangs; others are run by DPRK entities, including the army. In addition to Asian destinations, a large number of shipments of counterfeit cigarettes have been directed to U.S. ports. The highly successful Smoking Dragon and Royal Charm sting operations managed by the FBI, and involving extensive assistance and coordination by the Secret Service, DEA, and ICE, centered on smuggling of DPRK counterfeit cigarettes, along with large quantities of methamphetamines and supernote.

Narco-trafficking. In the mid-to-late 1990s, North Korea began to ramp up production and trade in narcotics, especially methamphetamines. Much of the output was destined for the large, nearby Japanese market—estimated at over 2 million full-time and occasional users. Drugs were transported sometimes on North Korea’s own cargo ships, but probably more often on Japanese fishing boats that would pick up their cargos at sea from DPRK mother ships. Some shipments were intercepted; between 1998 and 2002 Japanese police confiscated more than 1500 kilograms of methamphetamines that they linked conclusively to the DPRK. Many more likely got through. DPRK-produced methamphetamines were known for their very high quality, about 98% pure, which helped police pinpoint the origin of some of the seized drugs. At that time, Japanese authorities believed that North Korea accounted for roughly 30% of the methamphetamines smuggled into the country.

During these years, Taiwan too seized large quantities of methamphetamines and heroin from North Korea. In perhaps the best known incident of DPRK narco-trafficking, in April, 2003, Australian Special Forces seized the DPRK MV *Pong Su* following a four-day chase after discovering the ship engaged in landing 150 kilograms of heroin at a remote beach on the coast.⁸

August 25, 2008. For the original report, see *Production of Counterfeit Cigarettes in the Democratic People’s Republic of Korea (DPRK)*; Coalition of Tobacco Companies Report, June 29, 2005.

⁸ These and other incidents of DPRK narcotics trafficking are tracked annually in the Department of State’s International Narcotics Control Strategy Report (INCSR). While these reports offer detailed accounts about circumstances of seizures and probable sourcing of

After the *Pong Su* incident, the DPRK's direct involvement in narco-trafficking appears to have been sharply curtailed. The Department of State's recently published INCSR for 2011 notes,

"No confirmed instances of large-scale drug trafficking involving the DPRK state or its nationals were reported in 2010. This is the eighth consecutive year that there were no known instances of large-scale methamphetamine or heroin trafficking to either Japan or Taiwan with direct DPRK state institution involvement."

Reports continue of narco-trafficking along the DPRK-PRC border. In addition, a South Korean press report from 2008 quotes the head of the Philippine Drug Enforcement Agency as believing the largest seizure of methamphetamines made that year was likely from North Korea. According to the PDEA Director, "an influx of methamphetamines from clandestine North Korean factories cut the street price of the drug by half."⁹ This news report, however, cannot be independently confirmed. It thus remains unclear if publicity over the *Pong Su* prompted the regime to reduce manufacture and sale of narcotics or simply to pull back from direct involvement in shipping and distribution. In future, progress in Japan and the Republic of Korea in developing tests using gas chromatography to establish drug origin may provide conclusive evidence about whether or not North Korea has halted its involvement with methamphetamines or has continued to be a major player in the Asian drug market.

Supernote. North Korea's production and distribution of counterfeit U.S. currency likely has received more press attention than any of its other illicit activities. These counterfeits are difficult to distinguish from genuine U.S. currency at the retail level but are detected by machines larger banks typically use to examine cash receipts. Concerns have surfaced in recent years that the DPRK counterfeits other currencies too, perhaps including the Euro and possibly those of several other Asian countries. To my knowledge, suspect notes have not yet

narcotics, the INCSRs for many years set very high the evidentiary bar for confirming the regime's involvement, preferring the phrase "likely, but not certain."

⁹ "N. Korean Meth 'Flooding Asia Pacific,'" *Chosen Ilbo*, June 2, 2008.

http://english.chosun.com/site/data/html_dir/2008/06/02/2008060261023.html, accessed March 5, 2011.

been made available for forensic analysis, which might substantiate this allegation. Governments are naturally protective of the reputation of their currency and wary of undermining public confidence.

The U.S. experience with supernote shows that other governments are right to be concerned. Extensive press coverage in the Philippines, Thailand, Taiwan, and Peru about large quantities of supernote placed in circulation in each case triggered a run on the US dollar. For a time, many banks in those countries refused to handle US notes, even for their own customers.

Between 1989, when the first supernote was detected by a bank teller in the Philippines, and late last year, the U.S. has seized \$63 million in counterfeit \$100 and \$50 Federal Reserve Notes. Estimates vary widely on how much supernote the DPRK may be printing and distributing and on how much is in general circulation. The Secret Service labels supernote a quality problem, not a quantity problem. Casinos and money changers are obvious targets of distributors, but once detected, it becomes very difficult to pass additional large amounts. It is a very attractive product, however, for small-scale operators, and, evidently, not too difficult to acquire from DPRK-cutouts, according to interviews and testimony delivered in some recent prosecutions for possession and distribution.¹⁰

Widespread Involvement and Shared Culpability¹¹

Illicit activities ensnare government ministries, party organizations, military outfits, security and intelligence service units, and state-owned banks, business conglomerates, and even small provincial and locally-operated firms. North Korea's criminal businesses routinely make use of many of the nation's key organizations. North Korea's Foreign Trade Bank has engaged in money

¹⁰ For example see the case of Chen Chiang Liu, reported by David Rose, "North Korea's Dollar Store," *Vanity Fair*, August 5, 2009, web exclusive, vanityfair.com, accessed March 6, 2011.

¹¹ This section and the following one draw heavily from an earlier paper I authored, *Countering DPRK Illicit Activities*, written in support of a project: Improving Regional Security and Denuclearizing the Korean Peninsula: U.S. Policy Interests and Options. The principal author of the final report was Joel Wit, *U.S. Strategy towards North Korea: Rebuilding Dialogue and Engagement* and published by the US Korea Institute at SAIS and the Weatherhead East Asian Institute at Columbia University; October 2009.

laundering.¹² The Korea National Insurance Company (KNIC), according to a recent account by Mr. Kim Kwang-jin who was the company's representative in Singapore, embraced fraud as its business model.¹³ Much of the DPRK's narcotics trafficking, counterfeiting, and probably gun-running, most likely is run by the intelligence services, which involve others as needed. Operations Department head, General O Kuk-ryol was recently identified as the manager of the DPRK's counterfeit currency program.¹⁴ Several of General O's family members also were said to be involved, as well as family members of other highly ranked persons.¹⁵

As Kim Kwang-jin and other defectors have reported, many representatives who were dispatched overseas were tasked with raising sizable sums for Kim Jong Il. Those who would fail to send enough cash to Kim's Office 39, which handles fund-raising, could face recall. Similarly, most embassies are underfunded, and staff somehow must make up the difference between the limited funds allocated and the large stack of bills that come due. Embassy and other representatives posted overseas are also expected to contribute to annual "loyalty" payments raised for delivery to Kim on his birthday. Defectors who had served overseas speak about how a trip home could impoverish them from outlays of cash and luxuries they were expected to provide superiors. Results were what counted towards a favorable rating and retaining a post, not methods employed in raising cash.

¹² A description of how the Foreign Trade Bank made unauthorized use of an account opened by UNDP to send money to DPRK representatives abroad via accounts in the name of International Finance and Trade Joint Company, a DPRK front company, at Banco Delta Asia is provided in *United Nations Development Program: A Case Study of North Korea*; Staff Report, Permanent Subcommittee on Investigations, United States Senate; Released January 24, 2008.

¹³ "Global Insurance Fraud by North Korea Outlined," *The Washington Post*; June 18, 2009.

¹⁴ "N. Korea General tied to forged \$100 bills," *The Washington Times*; June 2, 2009. The article names General O as a recently promoted member of the country's powerful National Military Commission. A 2009 chart prepared by the Open Source Center lists General O as head of the Operations Department. A separate report discussing General O's appointment also named him as head of the Operations Department and stated that oversight of this 2000-person strong espionage service was transferred from the Korean Workers Party to the NDC. ("In North Korea, Ailing Kim Begins Shifting Power to the Military;" *Fox News*; May 1, 2009.)

¹⁵ "North Korean Elite Linked to Crime," *Washington Times*, May 24, 2010.

North Koreans are caught up in a culture that is conflating privilege with corruption and oppression. One of the features of this system is that the DPRK has created a “criminal class” overwhelmingly comprised of the families of elites, who receive educational and occupational advantages and favoritism in selection for coveted foreign postings. The uncomfortable (and inconvenient) truth about DPRK illicit dealings is that many DPRK counterparts in Six Party Talks, North Korean participants in financial working group meetings, officials in charge of foreign investment, trade, bank, and insurance company representatives abroad, and senior serving diplomats are tainted by superintending, facilitating, or participating in criminal acts. Those who may somehow have evaded complicity would certainly not be able to avoid a general awareness of officially directed illicit activities.

And, crime pays. Revenues from illicit activities and sales of weapons are estimated to cover a large portion of the DPRK’s sizable annual trade deficit. Although financial pressure on state coffers during the desperate times of the 1990s may have given impetus to the growth of illicit activities, proceeds of crime appear to be retained by those granted one or another “criminal franchise” and by top leaders. Authorization to undertake illicit foreign-currency-earning activity likely is particularly prized by cash-strapped North Korean organizations and businesses. Despite apparent substitutability between dollars earned from selling counterfeit cigarettes and dollars received from exporting DPRK-branded smokes, there is an important distinction between selling contraband and legitimate goods—profits of the former escape the national budget process and potentially provide a larger residual payoff to those involved, particularly if some of the hard currency earnings can be banked abroad and put to work. Kim can use proceeds funneled to his coffers to cement loyalty of elites, further work on nuclear and other WMD projects, and supplement funds available to the security services that shore up his regime.

Crime could provide less tangible payoffs as well. The regime, and especially the DPRK military, could tap into well-developed criminal connections to help it acquire advanced technologies for WMD programs, assist in covert transportation

of proliferation-related materials, and influence foreign government officials.¹⁶ The UN Panel of Experts report also called attention to this risk:¹⁷

*“The Democratic People’s Republic of Korea maintains a wide network of trade offices that work in close conjunction with its diplomatic missions overseas. These offices are charged with both procurement and developing select trade opportunities of interest to the Democratic People’s Republic of Korea’s leadership, including arranging and handling its illicit trade and covert acquisitions. Some of these activities have been aimed principally at identifying opportunistic markets for both licit and illicit exports. While much of the country’s illicit or covert acquisition activities are handled by these offices, **the Democratic People’s Republic of Korea has also established links with overseas criminal networks to carry out these activities, including the transportation and distribution of illicit and smuggled cargoes. This may also include weapons of mass destruction-sensitive goods and arms and related materiel smuggling.**”*

Countering DPRK Illicit Activities

U.S. bilateral and multilateral negotiations to persuade the DPRK to abandon its nuclear programs and give up its nuclear weapons and weapons-grade material, halt sales of ballistic missiles, and prevent further DPRK proliferation of WMD programs, routinely have failed to take fully into account the criminal nature of the state. Negotiations have been based on an underlying premise that objectives can be hierarchically ranked; that crime (and human rights) is strategically of less immediate importance than DPRK development of nuclear weapons; and that holding North Korea to account for its criminal conduct would distract from and could be detrimental to successful nuclear negotiations. This had the effect of yoking U.S. objectives together in tandem, and has allowed the one on which least progress is made to set the pace.

¹⁶ A lengthy treatment of the nuclear smuggling risks of a DPRK crime-proliferation nexus can be found in Sheena Chestnut “Illicit Activity and Proliferation: North Korean Smuggling Networks,” *International Security*, Vol. 32, No. 1, pp. 80-111.

¹⁷ UN S/2010/571 [op.cit.](#) p. 20; emphasis added.

Effective law enforcement efforts to counter DPRK criminality must have an international scope and unambiguous, top-level political support to gain the full and willing cooperation of foreign government, police, and judicial authorities. With political support lacking or flip-flopping enough to call U.S. commitment over the long term into question, even the most vigorous law enforcement efforts would likely achieve only modest results. Because of resource constraints, law enforcement officials must constantly decide if continuing the game is worth the candle. This weighing of investigative costs versus chances of getting a conviction gives additional leverage to those who might want inconveniently-timed investigations to be put on a back-burner.

A similar test could be run of the rationality of continuing to follow a negotiating strategy based on prioritization and sequencing of strategic objectives. Such a calculation would estimate subjectively determined costs of quiet acquiescence to certain ongoing criminal conduct versus the probability of attaining nuclear negotiation objectives at some distant future date. The negotiating record of the past two decades suggests that the probability of success is quite low.¹⁸ Moreover, assisting the DPRK in avoiding the moral hazards of its choices reinforces the regime's own notions that significant gains can be achieved through extortion and that consequences of egregious acts can be evaded by reaching a "political" understanding—a tactic it has successfully employed numerous times.

The adoption in recent years of additional financial and trade sanctions by the UN Security Council and the U.S. Treasury Department could provide a strong foundation for new and expanded containment efforts. Treasury for the past two decades has labored successfully to strengthen international anti-money

¹⁸ At best, the Agreed Framework for a time got the DPRK to shift to a slower path of weapons-development but evidently did not dissuade them from seeking the capability to produce nuclear weapons. North Korea's willingness to assist Syria in constructing a reactor—cooperation that evidently dates back some years--suggests that the DPRK may have calculated it could use offshore sourcing to work around the agreed upon constraints on domestic production of weapons-grade nuclear materials.

laundering efforts, particularly through support of the Financial Action Task Force. The adoption of tougher “know your customer” rules has complicated DPRK use of money-center banks to move proceeds of illicit activities and proliferation.

Moreover, North Korea remains especially vulnerable to financial measures. First, it is a poor country and loss of access to relatively small amounts of funds can cause distress. Second, by engaging in illicit activities, North Korea becomes the subject of international law enforcement investigations that can leverage open otherwise protected financial information and put a crimp in illicit earnings. Third, the DPRK has isolated itself from the international financial community, and the DPRK must either courier cash or draw upon balances held in bank accounts abroad to pay for imports of goods and services. Finally, these are “smart” sanctions that target specifically illicit earnings of elites and proceeds from sales of weapons and WMD-related goods.

UNSCR 1874 is disrupting DPRK military sales, and the financial pinch may prompt the leadership to expand its involvement in criminal activities. An even more alarming prospect would be DPRK attempts to profit again from its nuclear know-how; North Korea is known to ignore redlines, evidenced by dealings with Syria and earlier with Libya. North Korea reportedly is increasing its stockpile of enriched uranium, likely in excess of its own domestic requirements. Iran, a major arms client, would be an attractive market.

North Korea’s increasingly desperate economic condition, the uncertain outcome of looming leadership succession, and the possibility that the leadership’s ability to control the scale of criminal and proliferation activity might lessen or be lost gives urgency to renewing strong, internationally coordinated efforts to push back and counter DPRK illicit activities.

United States House of Representatives
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