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NOTES ON THE NORTH KOREA RISK

Berenberg Macro Flash

The headlines on North Korea are scary. However, the probabilities of an extreme military escalation seem to be so minimal that they should not affect economic trends and strategic investment decisions very much.

Start with the most important considerations:

1) North Korea's abhorrent dictator Kim Jong-un keeps defying the United Nations and is uttering wild threats against the US and other countries. However, I am not aware of any evidence that Kim Jong-un is genuinely suicidal. That he would lose any serious military conflict seems to be one of the few certainties in this situation.
2) Whatever his penchant for off-the-cuff remarks, US president Donald Trump has surrounded himself with experienced military leaders such as his chief of staff John Kelly, his national security advisor H.R. McMaster and his defence minister James Mattis. Trump's recent decision to send more troops to Afghanistan suggests that he does listen to military advice.
3) So far, Trump has tried to tackle the thorny issue with and through China rather than without China. That makes sense. China seems to have no interest at all in a destabilising major conflict on its doorstep. This also helps to mitigate the risks.

Standoffs can theoretically get out of hand if the various sides misjudge each other's intentions and reactions badly. Still, by far the most likely – and standard - interpretation remains that North Korea's leader, with the show of defiance and the rapid development of lethal weapons, wants to extract some kind of promise that the US and its allies will not try to overthrow his terrible North Korean regime. His bad sabre-rattling could thus be the prelude to an attempt to strike an implicit or explicit deal. While the current exchange of threats is unnerving, the impact of these tensions on the world economy is likely to be minor and short-lived. Markets get used to noise over time and should eventually return to the trends they had before Kim Jong-un stepped up the testing of missiles.

For the sake of argument, let us nonetheless ponder the scenario we consider extremely unlikely: what if the situation were to escalate into a hot war? If Kim Jong-un were to start a conflict on the Korean peninsula, the human consequences could be devastating. North Korea would suffer badly. Before the US and its allies could take out all North Korean nuclear and conventional artillery capabilities, Kim Jong-un might also inflict serious civilian casualties on the South Korean metropolis of Seoul, just 60km south of the border. In such a one-sided conflict, the hot war would probably be over shortly, though. For the world economy and world markets, the impact of this hypothetical scenario could be that of a Fukushima-style event writ large: a short massive shock to markets and some regional economies including Japan followed by a recovery with no more than a temporary impact on economies outside the region itself.

In the extremely unlikely case of a major military conflict in Korea, one key challenge would be for the US and China to agree on a post-conflict future for North Korea soon: who would do what to stabilise which part of the country afterwards so that US and Chinese forces would not come too close to each other? Would North Korea be re-established as a country – or under which Chinese-influenced conditions would it be re-united with South Korea? Settling these issues would be tough. But the tail risk that the US and China would not find some understanding and slide towards a serious confrontation instead looks minuscule. China and the US would have nothing to gain and a lot to lose from any such conflict. Tiny tail risks are part of life. However, the awareness of such minuscule risks should play no major role for the economic outlook and investment decisions, in my view.

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