A NEW INTERNATIONAL ENGAGEMENT FRAMEWORK FOR NORTH KOREA?

Contending Perspectives

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Prospects and Preconditions for Market Economic Transformation in North Korea

Anders Åslund

Since 1989, approximately 30 countries have attempted to move from a socialist system to a market economy in Europe and Asia. The outcomes have been remarkably different. Most have succeeded. In Central Europe and the Baltic countries, normal West European democracies and market economies have been established. In Belarus, Turkmenistan, and Uzbekistan, by contrast, little has happened but the exit of the Communist Party, while dictatorship and socialist economies persist. State ownership and state regulation predominate, and dictatorship remains firm. China and Vietnam have undertaken successful market economic transformation, while their Communist parties remain in power. Other countries fall somewhere in between. Thus, the outcome of postcommunist transformation is by no means given. It varies with initial conditions, the economic policy pursued, and policies of the outside world.[1]

Two true Stalinist states soldier on: Cuba and North Korea. These holdouts cannot be expected to last much longer. This paper offers a discussion of which economic policies might be relevant for North Korea in light of the experiences of the transformation of other postcommunist countries. I do not claim expertise on North Korea, about which my knowledge is rudimentary at best. Yet Communist systems have many features in common, and if one studies many of these economies, one knows what to look for. I have tried to establish relevant North Korean peculiarities and see parallels with countries in the former Soviet bloc that appear reasonable.[2] What lessons can be learned from those countries, and to what extent may they be appli-

1 An overall source for this paper is Åslund (2002).

2 I thank Nicholas Eberstadt and Marcus Noland for providing answers to my empirical questions about North Korea.

cable to a future North Korean transformation? Trying to draw the most appropriate parallels, I suggest a scenario for how North Korean Communism may crumble. A key question, of course, is whether the North Korean state will crumble or not. Having drawn up such a scenario, I proceed to prescribe advisable policy actions with regard to economic liberalization, financial stabilization, privatization, and foreign assistance.[3]

North Korean Peculiarities and Relevant Parallels from Other Postcommunist Countries

The postcommunist countries can roughly be divided into four different groups. One consists of China and Vietnam, where market economic reform was initiated by the old Communist establishment. Their outstanding feature was that more than 70 percent of the labor force was employed in agriculture, which made their transition comparatively easy. Quasi property rights could swiftly be introduced in agriculture (Sachs and Woo 1994, 101–45). By contrast, in 1995 no more than 31 percent of the North Korean labor force was employed in agriculture and as much as 37 percent in manufacturing (Eberstadt 2001a, table 5). Because of these structural differences, the Chinese and Vietnamese models appear unattainable. By contrast, Marcus Noland (2004, 60) plausibly argues: "North Korea is probably the world's most distorted economy." These distortions involve all aspects of the economy—its structure, extreme protectionism, prices, and exchange rate.

The Central European and Baltic countries form another group of postcommunist countries. Politically, they had a well-developed public debate before the end of Communism, with strong civil societies. They just needed the signal from Moscow that they were allowed to do their own thing. In Central Europe, economic distortions were comparatively limited. Hungary and Poland had already developed market socialism and had substantial private sectors. No parallel with North Korea is apparent, and their concrete experiences do not appear particularly relevant for that country.

The situation in the former Soviet Union is much more applicable from an economic point of view. Private ownership in the Soviet Union was very limited. Centralized state allocation dominated. Prices and exchange rates were highly distorted. A fiscal crisis was well developed before the collapse of communism. Yet, the former Soviet Union was more reformed and open and had far more markets than North Korea. Post-Soviet cases give us some guidance, but we would expect the situation in North Korea to turn much worse.

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3 Jeffrey Sachs has published beautiful outlines for what needs to be done after Communism, and they remain true (Sachs 1990, 19–24; 1991, 101–4; Sachs and Lipton 1990, 47–66). A broad relevant literature has developed, notably World Bank (1996), EBRD (1999), Fischer and Gelb (1991, 91–105), Shleifer and Vishny (1998).

With little doubt, the country most similar to North Korea was Albania. Like North Korea, it was a highly national Marxist-Leninist dictatorship, although more orthodox and less original. All power was concentrated in the leader, around whom an incredible personality cult had developed. Even more extreme than contemporary North Korea, Albania had no legal private enterprise. The economy was totally monopolized, essentially with one domestic producer for each product. Foreign trade was completely centralized, and prices were totally distorted. For all practical purposes, no exchange rate existed. Admittedly, Albania is much smaller than North Korea, and it was probably poorer. Yet, no other postcommunist country is likely to tell us as much about the transition in North Korea as Albania.

An additional query concerning North Korea is whether the state itself will collapse and be absorbed by South Korea and, if so, how that will happen. The obvious example is the German unification. However, the parallel is not as self-evident as it may appear. The fundamental difference is that East Germany was continuously subject to Soviet military occupation, which is of course not the case with North Korea. Another East German peculiarity was that the people were very well-informed thanks to West German television, which covered the whole country. Finally, the country experienced a huge and continuous escape of millions of citizens to West Germany, and the refugees were given automatic West German citizenship. Nor is the Vietnamese unification applicable, because it amounted to straightforward military conquest.

A few other examples may be worth contemplating. Moldova was taken from Romania by the Soviet Union during World War II but, although the populations are ethnically united, unification is not a serious issue. Austria is ethnically German and was united with Germany before World War II, but unification with Germany is not suggested by anyone today. Another example is that, after the breakup of the Soviet Union, many thought Belarus would rejoin Russia, as the Belarusian nation is in dispute, but that has not happened so far because the Belarusian elite preferred its independence. Nations are not born but built, and they are vested in their elites. In recent history, it is more common that two nations part company than that two countries of one nation join hands. After a half century of independence, North Korea has developed a strong elite of its own that is unlikely to give up power voluntarily. Considering that few countries are as strange as North Korea, the North Koreans' understanding of their South Korean brethren must be minimal. Why would they then want to merge their state with them?

Nor is it obvious that South Korea would like to absorb North Korea immediately. Economically, the German unification is deterring. The costs to West German taxpayers have been huge—on the order of $150 billion a year. Most of this money has been wasted on social welfare, and East Germans have been caught in a social welfare trap, rendering it unprofitable for them to work, as social benefits have been more ample than wages. Huge public investment in East German infrastructure has proved extremely unprofitable. It is common to blame the currency union, which valued the East German *mark* at an artificially high rate, but a more appropriate target would be the West German trade unions, which insisted on excessive wages in the East for their own benefit. The result was the highest official unemployment in any postcommunist country, rising to 35 percent, as East German labor was priced out of the market. As a consequence, millions of East Germans migrated to the West during the decade after unification. Regardless of policy, the large migration was difficult to avoid after the early unification.

Because of West German insistence on restitution of property to refugees in the West, East Germans did not get much out of the privatization either. Unemployed and deprived, stuck in their social welfare trap, the East Germans grew regretful and voted for left-wing parties and more social welfare, tipping the political balance in unified Germany to the left, so that liberal economic reforms could not be undertaken. Hence, the whole of Germany has been ossified, leading to minimal growth in both the East and the West, at a high cost to society (Pickel and Wiesenthal 1997; Siebert 1992; World Bank 2002). Today Germany is often described as the sick man of Europe, and its sickness is a direct consequence of its unsuccessful unification. Why would anybody like to repeat such a costly failure?

The West German population was four times larger than East Germany's, while South Korea's population is only twice as large as North Korea's. Moreover, West Germany was much richer than South Korea is today. A unification with North Korea could destabilize South Korea both economically and politically, which would harm North Korea as well. Therefore, I shall assume that the North Korean state does not collapse but remains independent during the course of its transformation, which appears to have started already.

A Scenario for North Korean Transformation

The Albanian transformation was instigated by three factors. First, the original despot Enver Hoxha died in 1985. Second, the country was absolutely isolated internationally, and the previously large amount of aid from, first, the Soviet Union and, later, China ceased. Third, the unreformed and autarkic economy ossified and started declining. In addition, the East European revolutions of 1989 had substantial impact on the few thinking members of the elite. As the regime hesitated, it crumbled. Elections were held in the early summer of 1991. While the Communists won, the hard-liners lost out. The ruling elite stayed in power, but it was divided into roughly three groups—hard-liners, reform Communists, and anticommunist opposition. While the small elite fought among themselves, the country ended up in near anarchy by the summer of 1991. The absence of civil society led to a striking lack of compromise and civil peace while the Communist Party stayed strong. Eventually a minor civil war erupted in 1997, but it was swiftly contained.

The situation in North Korea appears reminiscent. Kim Il-sung died in 1994. North Korea is isolated. The difference is that substantial humanitarian assistance of more than $1 billion per year has been given to North Korea for the past few years. As Marcus Noland (2004) argues, this "humanitarian" assistance is likely to prolong the life of the regime. In a country where power and knowledge have been so extremely concentrated, as in North Korea, the old elite is likely to feed all future political groups. As in Albania, an uncompromising anti-Communist Party is likely to emerge, which is more anticommunist than democratic, while a strong, recalcitrant Communist Party is likely to persist. The weaker that civil society was before the end of communism, the less probability of democracy or sophisticated policy in any sphere (Åslund 2002).

The North Korean economic system appears to be unraveling. The economic reforms of July 2002 are largely first-generation Soviet-type reforms, focusing on better incentives within the old system rather than systemic changes. After an enterprise has fulfilled its planned production obligations, it is allowed to trade with its surplus on the open market with retained earnings. Another element has been administratively increased wages and prices. Agricultural procurement prices, especially, have been boosted to make it more attractive to sell grain to the state. Parallel private trade in foodstuffs is permitted (Noland 2004, 46–9; Oh 2003). In short, these reforms can be described as tinkering with the old Soviet-type system, allowing more power to state enterprise managers, more material incentives, and more marginal markets. To a student of Soviet reforms, this sounds like the not-very-successful Kosygin reforms in the 1960s (Kornai 1992, chap. 15, 360–79).

It is interesting that North Korea has immediately moved ahead to what can be described as second-generation reforms, involving elements of market socialism. For food, in particular, the private market appears to have become dominant. Attempts have been made to adjust prices and wages to markets. State enterprises have been given foreign trade rights, further enhancing the rights of their managers. Two huge devaluations were undertaken in August 2002 and October 2003, respectively, in attempts to catch up with the black market exchange rate (Noland 2004, 49–50). This does not sound like the orderly Hungarian economic reforms or even the Polish reforms; it sounds rather worse, as during the Soviet economic crisis around 1990, when Mikhail Gorbachev's regime entered its death throes (Åslund 1991).

Several elements are noteworthy. No concept or blueprint for economic reform appears to exist. Wild price increases of up to 60,000 percent suggest not only massive distortions but also an absence of macroeconomic thinking, which was characteristic of the Soviet Union. Few knew the budget balance or money emission. They were not allowed to study Western economics, so how could they understand the implications of a large budget deficit or the issuance of money? Dollarization is apparently already advanced. Under these circumstances, hyperinflation is likely to be around the corner, and economic collapse usually follows (Åslund 1995).

Again, the Albanian example is illustrative. In the summer of 1991, Albanian output plummeted and probably halved during the third quarter (Åslund and Sjöberg 1992, 135–50). A confluence of factors contributed. The key was that the state could no longer demand that enterprise managers attain plan targets. The stick was gone, and the production of many goods was disrupted. Another reason was that state regulation remained in place, so goods that were no longer produced in sufficient quantities in the country could not be imported. Any regulation could cause enormous damage in this setup. Meanwhile, the combination of collapsing production, declining tax collection, and rising wage demands boosted the budget deficit and led to a financial crisis. The outcome was one of the greatest declines of output recorded in any country in peacetime. Although North Korea has already gone through a decline in output of as much as 25 percent from 1989 to 1999 (Noland 2004), it could face an even worse collapse now, which should also lead to a political unraveling because few societies go through hyperinflation without major political disruption.

Something else also seems to be going on in North Korea. Toward the end of the Soviet Union's existence, state enterprise managers indulged in massive rent seeking, transferring the profits from their enterprises to their private trading companies and accounts. The North Korean system, with large differences between black market prices and state prices as well as between the official exchange rate and the black market rate, appears ideal for the rent seeking so characteristic of the end of the Soviet system (Åslund 1995; Hellman 1998, 203–34).

But there is a way out. Albania recovered fast, and for the next eight years it maintained an average gross domestic product (GDP) growth of 8 percent a year, although it suffered a setback of 7 percent in 1997 because of civil disorder (EBRD 2003). Overall, Albania has been the most dynamic transition country. Essentially, three cures helped:

- It undertook quite a radical liberalization and financial stabilization, allowing economic revival and a growth of 10 percent as early as 1993.
- Albania carried out a radical land reform in the summer of 1991 in spite of anarchy. The government simply declared that every collective farmer was entitled to a certain area of land, but it was up to the peasants themselves to take it. The peasants did so instantly, and, after having set on the land for a brief moment, they started producing briskly (Åslund and Sjöberg 1992). This land reform can be compared with the Chinese agricultural reform that brought about a similar change. This was perhaps the most important cure of the three.
- Huge foreign assistance was also instrumental. At the time, tiny Albania was by far the poorest country in Europe. It no longer is, and the Euro-

> pean Union flooded the country with aid to avoid emigration and instability. Initially, foreign assistance reached as much as 40 percent of GDP. It has financed both large budget deficits and large current account deficits. In relation to GDP, no other transition country has received as large a volume of foreign assistance as Albania (though some developing countries have received even more to little benefit (World Bank 2003, 338–40).

Postcommunist economic reform strategies have been well elaborated. First of all, a political breakthrough must occur, which is a very domestic and idiosyncratic matter. But, as the Polish reformer Leszek Balcerowicz (1994, 75–89) has emphasized, there is a window of opportunity or moment of extraordinary politics when people focus on the long-term interest of the nation as a whole. This is the key to the politics of reform. For instance, Poland, Estonia, and Albania succeeded in undertaking sufficient reforms during that short period of time, while most notably Belarus, Turkmenistan, and Uzbekistan failed to do so.

Several elements should preferably be part of a successful reform process. A political leader needs to acquire political legitimacy, best of all through a democratic vote. Political leaders need to elaborate a reform program, which a newly elected parliament preferably should adopt. A comprehensive but small reform program then should be swiftly implemented. It should contain the pillars of the new system; it is vital not to get bogged down in too many details, which only cause delays and rarely matter at the first stage. The keys in the early transition are far-reaching deregulation of prices, trade, and enterprise combined with a rigorous macroeconomic stabilization program and international assistance consisting of both advice and financing. As soon as possible, privatization should be initiated, especially small-scale privatization (Åslund 2002). Inevitably, a transition is messy, and the North Korean transition has the potential of being very messy. Yet, North Korea has several great advantages. First, as a latecomer, it can benefit from the lessons learned from other postcommunist countries. Second, the existence of a successful peer country, that is, South Korea, will greatly facilitate its transition. Third, plenty of international financing is available for North Korea's transition.

Yet, a system as rigid as North Korea's is likely to experience a horrendous economic crisis, and, regardless of how small its output is at present, the economy will probably plummet (Winiecki 1991, 669–76). Extreme financial destabilization is probable, and rent seeking will no doubt be extraordinary. The best cure comprises liberalization, financial stabilization, and privatization, but it will be severely contested and difficult. This concurs with the general lessons from postcommunist transformation that the more democracy, radical liberalization, stabilization, and privatization, the greater the economic growth (Berg et al. 1999; De Melo et al. 1997, 17–72; Havrylyshyn 2001, 53–87).

Early and Profound Liberalization

An outstanding feature of North Korea's current economic situation is shortages. People who have always lived in a socialist economy characterized by shortages cannot imagine they will go away. A market economy can overcome this very fast, but only if it is sufficiently free. Therefore, a radical deregulation of prices and markets brings an immediate political benefit, while a gradual liberalization agitates people.

Also strong economic reasons favor far-reaching and early liberalization. If enterprises cannot acquire inputs, they will produce less, and output can start plummeting, as happened at the end of the Soviet Union and Albania. Furthermore, if workers cannot find anything to buy for their money but have to spend hours queuing or searching for goods, they have little incentive to work more and will naturally work less. A free market, by nature, will provide a better allocation of goods and services, while a semi-liberalized market may cause new distortions (Boycko 1991, 35–45).

Finally, arguments of social justice cry out for far-reaching liberalization. All socialist economies are characterized by their privileged access to goods and services for the elite. In the transition, one of the greatest problems has been rent seeking, as some businesspeople with special access bought goods at low prices fixed by the state while selling these goods on free markets at prices that could be up to 100 times higher (Hellman 1998; Åslund 2002). This rent seeking has generated so-called oligarchs, attracting the greatest political reaction in postcommunist countries. Both shortages and rent seeking can be brought to an end with a swift deregulation.

The required response is the liberalization of virtually all prices of goods and services. Otherwise no supply effect might be apparent. In Poland, which undertook a truly radical liberalization, people just went out into the street and started selling their surplus stocks immediately after price liberalization. In Russia, by contrast, it took quite some time before many goods appeared in the market because the liberalization was not full-fledged. For North Korea, nearly complete price liberalization would be vital. Price increases for a few goods often arouse public reactions and riots, while comprehensive price liberalization is calmly accepted, as it is rightly perceived as a change of the whole economic system and not as an act of redistribution.

Some exceptions are usually made. A few food staples, such as bread and milk, are often left aside, which might accommodate a fearful public. Rents, heating, electricity, and gas for households as well as public transportation are similarly almost always subject to some price regulation in response to political demands. The greatest danger to reform is the continued regulation of wholesale prices of commodities such as energy, metals, and agricultural goods. In the former Soviet Union, such domestic prices were often fixed at artificially low levels to allow a few monopolistic traders to sell these commodities abroad at a level several times higher and pocket the profit, mostly offshore, which contributed to capital flight.

The liberalization of imports is one of the most popular actions in a postcommunist transformation because all kinds of hitherto unknown goods suddenly become available on the domestic market. Because the exchange rate has usually plummeted already, domestic products are incredibly inexpensive, so no competition between imports and viable domestic produce arises. Many countries, ranging from Poland and Estonia to Russia, abolished all import tariffs and quotas at the same time as they liberalized prices. Where this did not happen, for instance, in Ukraine, the dearth of goods continued and a few rent seekers profiteered by privileged foreign trade rights. North Korea should go for full liberalization of imports at the same time as it liberalizes most prices.

The deregulation of exports was, contrary to expectations, very difficult to accomplish in the post-Soviet countries. Because of the prevalent shortages there, a popular misperception was that "the country would become empty" if exports were freed, reflecting the assumption that everybody would prefer to sell everything elsewhere for real money. Behind this popular view was a more sinister objective concealed. Profiteers who bought commodities at home at low state prices needed restrictions on exports to benefit fully from their booty, and domestic price controls for commodities would make little sense if they could be freely traded.

At present, the difference between the black and official exchange rates is huge in North Korea. There is hardly an easier way of making piles of money than arbitraging between an artificial official exchange rate and a free rate. This is a source of rent seeking that must be closed as soon as possible. Huge devaluations as in August 2002, from 2.1 *won* per dollar to 150 *won* per dollar, cannot solve this problem (Noland 2004, 50). After each devaluation to another fixed rate, a new black exchange rate will evolve if the free market exchange rate is plummeting. The exchange rate needs to be unified; as long as the market rate is sinking, the only way of doing so is to let the exchange rate float. The single exchange rate should apply to all transactions regardless of who undertakes them and for what purpose.

A common belief under communism is that people have lost their entrepreneurial spirit. Russians even thought they had degenerated genetically. With the first opening of the market, however, this myth faltered. Yet, many bureaucratic impediments remain. They may not appear significant just after a democratic revolution, when the old bureaucracy is shell-shocked, but sooner than anybody can imagine, they will return with a vengeance. Therefore, it is vital to undertake a full-fledged liberalization of enterprise early on; necessary regulations can be introduced later. The best example was set by Poland, which adopted a simple ruling that anybody could sell anything anywhere at any price at any time. Instantly, thousands of people went out into the streets and started trading. North Korea should follow Poland's example, which led to the early revival of the Polish economy and a swift surge of millions of new small enterprises.

Rigorous but Difficult Financial Stabilization

When communism collapses, inflation is likely to explode for many reasons. A large monetary overhang of unsatisfied demand is in place.[4] The flow of wages presumably exceeds the flow of consumer goods, and imbalances are probably even worse in the enterprise sphere. At the time of revolution, wages and public expenditures typically go out of control. In a Communist state, the Ministry of Finance and the central bank are weak, subordinate institutions, while the state planning committee and industrial ministries are superior. Money is not only passive but is subdivided into enterprise account money and cash. Multiple technical payment problems will lead to arrears and demand for enterprise subsidies and monetary emissions (Sachs and Lipton 1993, 127–62). Naturally, price liberalization will unleash all these inflationary forces.

With retail price increases of 40,000 to 60,000 percent for such key goods as grain already being undertaken (Noland 2004, 48), North Korea is probably already in the throes of hyperinflation. The erratic and huge increases in both prices and wages suggest that large budget deficits and monetary emissions are in place, but this information appears not to be publicly available. That hyperinflation is probably inevitable in North Korea is a strong argument for South Korea not to undertake an instant unification with the North, because then also South Korea could be dragged down by a horrendous macroeconomic destabilization. A nightmare for the South would be that the North could issue credits in its currency and would of course do so without any comprehension whatsoever. If the North needs to maintain its own currency, it will also need to keep its own central bank and Ministry of Finance.

A fundamental lesson from the Soviet transformation is that hardly anybody in the former Soviet Union knew anything about macroeconomics, the teaching of which was banned under communism (Åslund 1995). Fortunately, Russia had a few economists who had managed to study macroeconomics on their own, but presumably nobody in North Korea knows anything at all about macroeconomics. A fair guess is that hardly anybody knows the size of the budget deficit or monetary emission as a share of GDP and that nobody knows that these two phenomena cause inflation. It is even possible that no measure of monetary emission exists.

A number of actions are initially necessary. Nowhere are outside economic advisers as necessary as on macroeconomic stabilization. Whoever wants to

4 A helpful overall presentation is Wyplosz (1999).

learn about these matters must be given a swift course in the fundamentals about the nature and causes of inflation. The International Monetary Fund (IMF) is the obvious lead agency on macroeconomic stabilization. North Korea should be admitted as a member of the IMF, the World Bank, and the Asian Development Bank (ADB) as early as possible, and its macroeconomic stabilization should be based on an early standby agreement with the IMF. Although great and swift efforts must be made to establish the real statistical picture, policymakers will have to work for a long time with the most rudimentary data at hand, forcing them to act on principle rather than calculation.

The initial tasks are technical: unify cash and enterprise money and facilitate payments, for instance, by allowing cash payments throughout the economy. The functioning of payments must take precedence over any state control function. Fiscal and monetary powers must be concentrated in the Ministry of Finance and the central bank, which will be priority targets for technical assistance.

As the old system is withering, public expenditures are likely to explode for many reasons. First of all, knowledge of the negative effects of budget deficits is likely to be missing. Various groups may be pandering to the population with wage increases and higher social expenditures. After the transition has started, state enterprises typically come to the fore, and that process seems to be well under way in North Korea. They demand the indexation of their working capital, subsidized credits, and direct subsidies. Given the absence of civil society, the apparent pressure from workers and the population at large will soon be transformed to a pressure from the economic elite, that is, the state enterprise managers (Hellman 1998).

The key task in the early transition is therefore to control public expenditures. Any overall cut of public expenditures should be avoided. Instead, a few major categories of costs of a systemic nature should be cut. Four key items to cut are price subsidies, foreign trade subsidies, enterprise subsidies, and military expenditures. Price subsidies disappear with price liberalization, and foreign trade subsidies with the liberalization of foreign trade. To cut enterprise subsidies is much more difficult, and, as late as 1998, combined direct and indirect enterprise subsidies in Russia amounted to 16 percent of GDP. Throughout the former Soviet Union, it turned out to be surprisingly easy to cut military expenditures, while a major mistake was not to eliminate the secret police. The political economy of the cuts should be to openly target certain elites while leaving most social expenditures, notably health care and education, in place.

The aim should be to keep public expenditures down so that taxes can be kept low. Given the extraordinary power of the elite, which is bound to continue after the end of Communist rule, high public expenditures will inevitably be focused on the elite rather than directed to the poor and suffering. The former Soviet Union has increasingly moved to few, low, and flat taxes with broad tax bases. A certain enterprise tax is sensible, but it could stop at 30 percent. Payroll taxes tend to rise excessively in socialist countries, so they should not be higher than 15 percent. Some sales taxes and excise taxes make sense, as does the flat income tax of 13 percent in Russia. Small entrepreneurs, whether peasants or craftspeople, should be subject only to a fixed lump-sum tax, which requires no accounts and cannot be changed with income in any given period. This has driven Ukraine's economic recovery (Åslund 2002). In any case, North Korea should opt for low taxes and public expenditures. A reasonable revenue for a country at North Korea's level of economic development would probably be 15 percent of GDP, which requires few and small taxes (Tanzi and Tsibouris 2000). Initially, a budget deficit might arise, and the international community should be prepared to finance at least 10 percent of GDP in the early stages of North Korea's transition.

The key task of financial stabilization is to introduce a demand barrier and impose hard budget constraints on all enterprises. Then, surplus stocks that people and enterprises have hoarded will enter the market. Financial stabilization will also bring inflation under control—that is, get it under 40 percent a year. Inflation is not likely to become very low for many years. One reason is that it takes time to get the right relative prices, and prices more easily adjust under moderate inflation. Another is that the exchange rate is bound to plummet because of hyperinflation, and much of the real revaluation under the recovery is likely to come in the form of inflation rather than nominal revaluation.

One of the great disputes at the beginning of each transition is what exchange rate policy to choose and, possibly, what exchange rate to pick. As long as the exchange rate has not been unified and no financial stabilization undertaken, a reasonable exchange rate is nothing but guesswork. Currency reserves are likely to run out, and then exchange rates typically end up in free falls; in Albania and Mongolia, inexperienced and uncontrolled central bankers gambled away each country's whole currency reserve. High inflation and uncontrolled money emission may then drive the exchange rate extremely low even in a relatively rich country such as Russia, where the free market exchange rate fell so low that an average monthly wage amounted to merely $6 in December 1991.

In North Korea, an even more devastating devaluation is likely. In an extreme financial destabilization, a pegged or fixed exchange rate can provide a badly needed nominal anchor, which worked well in some countries, notably Poland. The problem is that a temporary peg is often maintained for too long. A currency board, which provides a more long-term fixation of the exchange rate, is usually considered valid only for small and very open economies and certainly not for commodity producers, exposed to extreme fluctuations on world markets (Williamson 1995). While the choice of exchange rate regime is a subject of dispute, there is no doubt that substantial currency reserves are vital for the success of financial stabilization. Their early introduction can prevent an excessive devaluation and, thus, an excessive inflation. Such reserves can and should be provided by the international community, notably the IMF.

Professional economists tend to be preoccupied with bank systems and financial markets, but those institutions do not matter much in the early transition, when the main need is to impose hard budget constraints to force enterprises to start working normally. While it is true that economic growth and financial depth are correlated, financial markets need time to develop. Premature attempts at boosting them tend to lead to financial crises rather than any tangible benefit.

Privatization: Critical for Systemic Change

Privatization is always difficult because it involves a large number of concrete properties to which multiple people and groups lay claims. Many principles collide. For the North Korean case, a certain prioritization can be made.[5]

First, an early and broad privatization is vital to create a critical mass of private enterprises to make the market economic transformation irreversible. Among former Communist countries, Belarus, Turkmenistan, and Uzbekistan have failed to do so. Second, to make the privatization socially and politically acceptable, privatization should focus on the broad groups with the strongest claim to property—employees, tenants, and the population at large. For the same reasons, priority should be given to North Korean nationals. Third, restitution would be a bad idea, especially as many South Koreans have claim to property in the North. East Germany has illustrated the hazards. Restitution overwhelmed the courts for years, leading to many properties remaining idle; and because the East Germans were excluded from that privatization they became very regretful and many voted for the Communist Party in spite of huge subsidies from West Germany. Fourth, state revenues are of little or no relevance; it is far more important to cross the hurdle to a capitalist system swiftly. Tax revenues after the economy has got going will swiftly exceed the possible privatization dues from run-down Communist enterprises. Fifth, new property rights should be clearly defined, definite, and transferable with minimal liens. In short, the main task is to spread as much state property as possible to as many North Koreans as possible while minimizing political acrimony. Sixth, foreign direct investment should not be an early aim. Foreign investors will not understand much of North Korea in the initial transition, and they are not well suited to invest or run enterprises there. The nascent legal system will be a mess for years. This means that the simplest and most decentralized methods of privatization are the best. They should focus on ordinary North Koreans in order to em-

5 A useful summary of the experiences is Havrylyshyn and McGettigan (2000, 257–86).

power them and facilitate the transition to capitalism. Objects that appear to be difficult to privatize, such as infrastructure, can be left for later.[6]

The easiest task is to give small enterprises to the their employees for a token payment. Small-scale privatization usually occurs early. It takes some time to arrange, but then it goes fast because everybody wants to get a piece of the action. Two conditions are important. First, it has to be done by the local authorities because their administrative capacity is required. Often local authorities are convinced to sell when they are facing a shortage of funding. Second, property rights must be individualized. Managers often try to keep the property collective for their own benefit. Small-scale privatization is usually popular and arouses little political controversy.

In parallel, agricultural land should be given to those who till it. Land reform usually happens early in countries where agriculture is important regardless of what happens to other reforms. Presumably, North Korea should take its cue from China and undertake a swift distribution of all land to the peasants. A maximal area for each peasant needs to be set, and transferable property titles are preferable although that feature may wait for some time because transferable titles cause controversy: people fear outside purchases of huge areas of land. In Russia and Ukraine, estates with hundreds of thousands of hectares of land have already been formed. In North Korea, by contrast, overpopulation in the countryside will probably lead to fragmentation of farms into very small family farms, which promotes intensive cultivation of the land.

Housing should simply be given away to the tenants. Nobody else can lay reasonable claim to housing. People feel more secure if they own their apartments and houses, and they receive a bit of capital that they can mortgage in due time.

From the very outset, a large sector of small enterprises should arise if total freedom of small entrepreneurs is permitted. Individual entrepreneurs, primarily in trade and crafts, can swiftly employ more than 10 percent of the labor force, providing the poor with incomes, labor, and supplies all at once. North Korea has an extremely small service sector, employing about 30 percent of the labor force (Eberstadt 2001a, table 5), and it could easily absorb an additional one-fifth of the labor force. This employment would naturally occur in small enterprises in retail trade and crafts, as has occurred in many postcommunist countries. Critical for such success is deregulation.

The privatization of large and medium-size enterprises is always technically difficult and politically controversial. No doubt, as transition starts, North Korean state enterprise managers soon will lay claim to the enterprises they manage for the state. They will be strong enough to block any privatization if they do not get their cut. Thus, we have to accept that they

6 Compare with Boycko et al. (1995).

will claim their share. They can be balanced partly by their employees, who should also get their share—preferably twice as much as their managers. Finally, a mass privatization through vouchers to the population at large is beneficial. At least the population gets something, privatization becomes definite, and a free float of outside stocks is created. Thanks to spread and transferable stocks, outside owners can in due time purchase the privatized enterprises. The critical condition to fulfill is empowerment of the locals (Boycko et al. 1995).

Certain major enterprises or assets—the telecommunications company, public utilities, mines, and metallurgical companies—can probably be sold to foreign strategic investors and could be sold through international tenders. However, it would be dangerous to harbor any illusions about early foreign direct investment in a country that is as unknown and different as North Korea. It will take time before private foreign direct investment takes off. Privatization is also a way of empowering North Koreans, so a broad South Korean purchase of North Korean enterprises—as West Germans bought East German enterprises—is neither economically nor politically nor socially desirable.

During early transition, a strange hysteria tends to prevail about the shape of enterprises. Everybody thinks that all enterprises will collapse and that everybody will be unemployed, but in reality virtually all companies are making huge profits because of high inflation. The point is that enterprises have more time for their restructuring than people tend to believe. Therefore, there is no reason to be afraid of bankruptcy, which is wrongly perceived as the destruction of physical assets. Instead, bankruptcy is an effective means of accomplishing a clean financial break. Old claims are sorted out; enterprises are forced to pay, which is a major problem in transition; and good physical assets can be put up for auction to new owners without any mysterious concealed liens. In fact, bankruptcy—understood only by chance to be a helpful technique—turned out to be one of the most efficient means of privatization in Poland.

Technically, privatization is the most complex task of transition, requiring a large amount of technical assistance to organize the privatization administration, to design privatization legislation and techniques, and to assess enterprise values. These tasks have typically been carried out by the U.S. Agency for International Development (USAID) and the World Bank, which have great competence in privatization.

Vital Foreign Assistance

Naturally, foreign assistance can play a great role in North Korea's transition to a market economy.[7] However, not all aid is useful, and some is even harmful, benefiting rent seekers and impeding reform.

Right now, North Korea needs and receives humanitarian food assistance. Obviously this will have to continue to avoid starvation, but the huge size of the assistance appears to help maintain the moribund regime. As soon as North Korea is liberalized, foreign donors might pay attention so that foreign food assistance does not amount to dumping, driving domestic peasants out of business. The best way of avoiding that calamity is to sell food aid on the market to the benefit of the state budget.

Presumably, no North Koreans have the relevant knowledge or experience to handle the postcommunist transition. International technical assistance—that is, consulting—is badly needed in this area. First, a few outstanding economists are required in order to aid the leading North Korean economic policymakers with the overall economic reform agenda. The same economists would naturally take care of advice on financial stabilization directed at the Ministry of Finance and the central bank. It is practical to create one central office of economic research for the government and the central bank, which should gather together the leading economic advisors. Because all relevant statistics are uniquely absent in North Korea (Eberstadt 2001b), international donors need to focus on quickly establishing some kind of statistical system. (Initially, policymakers should take care not to bother about what the statistics say because they will be so bad that they will disinform more than they inform. In the absence of plausible data, policymakers have to act on principle more than on anything else.) Privatization in all its forms requires large and expensive technical assistance for a long time. For financial stabilization, the IMF is the key international agency, and the World Bank complements the IMF with a broader structural agenda. USAID has had much experience with post-Soviet transformation and could serve as the leading bilateral agency. The Japanese and South Korean aid agencies should also come in with technical assistance. Technical assistance is cheap because the North Korean reform government will be able to absorb the inputs of only a limited number of consultants.

The funding of financial stabilization will be the big cost in the early transition. These costs fall into three groups:

- **International reserves.** The international reserves of the central bank are likely to be minimal. To stop the free fall of the exchange rate, the international community needs to replenish international reserves from the outset of a financial stabilization policy. Preferably, such reserves should be kept at a safe place abroad during the chaos of the early transition. Financial stabilization must be based on a standby program with the IMF, and that agency can provide the necessary loans for the replenishment of international reserves.

7 This section draws primarily on Sachs (1994, 501–23) and Åslund (2002).

- **Foreign debt servicing.** North Korea has been in default on its foreign debt since the 1970s. It needs to renegotiate its outstanding debts in the Paris Club for government debt, and most likely the country will have to ask for some debt relief as the penalties on the defaulted debt will be huge. An agreement with the Paris Club also presupposes a functioning IMF program.
- **Budget financing.** North Korea is likely to have a large budget deficit at the outset, and international financing will be the only possible source to cover it. Essentially, five donors—IMF, World Bank, ADB, Japan, and South Korea (the United States does not offer such support)—appear plausible.

An idea that is as common as it is flawed is that international assistance should focus on the private sector. The simple fact is that governments are not very good at enterprise investment, and abroad they are even worse at it. Similarly, attempts at large infrastructure investment projects in early transitions have generally been unsuccessful in the former Soviet Union. The key task during initial transition is to impose hard budget constraints, which is the opposite of providing soft government funding. Similarly, the World Bank and the European Bank for Reconstruction and Development have tried to boost bank lending in the early transition in most postcommunist countries. The unfortunate result has been that virtually all banks supported by these two financial organizations have gone bankrupt. Nascent commercial banks should be encouraged to be cautious and learn their new trade rather than indulge in excessive risk taking. The World Bank and the ADB are well placed to assist with infrastructure investments, to which South Korea and Japan presumably want to contribute as well.

Nor is it realistic that foreign agencies do much to finance the social sector. The international financing of social benefits is usually politically unacceptable in the donor community. Yet, education should be seen as investment in human capital. Especially in the case of North Korea, it is vital that a substantial group of young people receive relevant education in economics, other social sciences, law, and business administration. A large number of students should be financed for both undergraduate and graduate education abroad in economics, business administration, law, politics, and other social sciences because a critical mass of young North Koreans thinking competently about these subjects is crucial for the early success of transformation. Foreigners, even South Koreans, cannot fulfill that role because they know so little about how North Korean society really works.

The amount of assistance that may come into question appears to be exaggerated. The absorption capacity of North Korea is likely to be quite limited. North Korea's GDP per capita is probably very small in current dollars. Nicholas Eberstadt (2001b, table 6) notes that North Korea claimed that its GNP per capita was as low as $239 in 1995 in a submission to the United

Nations. In 1992, the Russian GDP in current dollars was as little as $80 billion. North Korea has only one-seventh of Russia's population, it is clearly a less developed country, and it appears to be suffering worse macroeconomic havoc. Therefore, a common figure of about $20 billion in GDP is likely to be reduced to a fraction of not more than $10 billion. This also suggests limitations in North Korean absorption capacity. For a longer period, international assistance of a maximum of 20 percent of GDP appears possible for North Korea to absorb (World Bank 2003, 338–40). Assuming a steadily revalued currency, this could mean an absorption capacity of something like $20 billion to $40 billion over a decade.

One of the biggest early financing needs is macroeconomic stabilization, notably to replenish international reserves. The World Bank (2003, 203) records that North Korean exports have plummeted by two-thirds in a decade, from $1,857 million in 1990 to $661 million in 2001.[8] The standard requirement for international reserves is three months of imports. If imports were about $800 million, this would only amount to $200 million, which is a trifle in terms of international financing.

At present, North Korea already receives about $1 billion a year in international assistance. That might amount to as much as 10 percent of GDP a year—a very high level. This would mean that the Kim Jong-il regime is entirely maintained by foreign assistance, which could also explain why the steadily falling GDP was turned around in 1999 (Noland 2004, 22). If so, the current assistance is very difficult to defend.

Conclusions

North Korea is likely to go through a horrendous crisis when its socialist economic system crumbles. The less outside support the country is given, the earlier that crisis is likely to come. In any case, the process of swift economic disruption is probably already under way. Strong indicators are decentralizing economic reforms, empowerment of state enterprise managers, emergence of substantial private markets, and huge price and wage increases as well as massive devaluations. All this suggests a swift economic collapse, with hyperinflation reminiscent of the economic collapse of the Soviet Union or Albania. It is not obvious that this will lead to instant Korean unification. South Korea could be seriously destabilized by a collapsing North Korean economy, and the North Korean elite would hardly like to be dispossessed. The example of the German unification is a potent deterrent.

Both the North Korean preconditions and the precedents of other postcommunist countries suggest that the country needs to undertake as radical a market reform as it can, but success will not come easily. Three keys—thorough deregulation, radical financial stabilization, and a swift

8 See Noland (2000, 89) for a discussion.

privatization—are politically possible, however. Foreign assistance will be vital for the success of these reforms; it is essential that foreign assistance come early and be brought in to support market reform rather than the rent-seeking interests of the old establishment. The amounts required are likely to be much smaller than usually discussed because the absorption capacity of the North Korean economy is likely to be very limited.

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Possible Forms of International Cooperation and Assistance to North Korea

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