Currency "Reform" in North Korea

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"It's the economy, stupid!"
(attributed to James Carville, 1992 presidential campaign)

Free elections are not part of North Korea's political fabric, but Kim Jong-Il and his advisors are undoubtedly aware that the regime's legitimacy will be challenged if it fails to meet its promise of achieving a strong and prosperous nation by 2012, particularly if it faces a leadership transition. The November 30 announcement of currency reform, entailing redenomination of the North Korean won such that 100 old won = 1 new won, appears to be a gamble that it can achieve that objective in an ideologically acceptable manner. It is a huge bet.

As clarified and adjusted over the course of the subsequent weeks (according to press reports, as official announcements remain lacking) the measures required residents to exchange old won for new won currency up to a limit of 500,000 old won per individual—equivalent to $200 or less at unofficial market rates. Amounts in excess of the limit could be exchanged if deposited in a bank account, although amounts in excess of 1,000,000 old won could be so deposited only if a legitimate means of accumulation was shown. Some reports indicated that a subsidized exchange rate of 10 old won for 1 new won was available for small amounts deposited in a bank rather than exchanged for new currency.

The subsequent move to ban possession of foreign currency appears to be aimed at reinforcing the currency reform, or at least at dealing with the perception that the elite and the more successful traders were able to escape the financial losses that smaller traders suffered.

Why, and Why Now?

A currency redenomination entails some direct costs for the government but can serve legitimate purposes, particularly if inflation is rampant or has been higher than desirable for a long period of time. Apart from reducing the inconvenience of dealing with large numbers, a redenomination can help reinforce the effectiveness of a rigorous anti-inflationary policy. However, North Korea's motivation appears to be only loosely connected with the usual notion of such policy.

In an interview with the Chosun Shinbo, a Japanese newspaper sympathetic to the DPRK, an official of the DPRK's central bank suggested that inflation had undermined the government's efforts to cope with the challenges created by natural disasters and the collapse of the Soviet union, and that the currency reform was a key part of those efforts, all geared to achieve the goal of becoming a strong and prosperous nation by 2012. Of course, this official statement cannot be taken as a transparent and truthful rendition of the regime's thinking.

Most observers see the measures as aimed at curbing the role of markets, which came to play a significant role in North Korea's economy after the reforms of July 2002, and forcing economic activity back into the planned economy. Some expansion of market activity was expected and even intended by these reforms, but their progenitors must have been surprised and increasingly dismayed by the scale and speed of the expansion, and by its revelation of the true worth of the local currency. Writing in The Korea Herald on December 3, Ruediger Frank said that "the most dangerous result of these reforms was the emergence of a new group of people who became wealthy enough to develop individual ambitions and to break out of the state-imposed collectivism." In his view, the situation threatens to undermine domestic order as "reality increasingly deviates from ideological claims to a degree that makes propaganda just ridiculous in the eyes of the population. People may still fear and obey their government, but they don't trust it anymore."

The New Year's Joint Editorial that lays out the DPRK's policy vision places great emphasis on raising living standards. Mentioning this goal on multiple occasions, the Editorial makes clear that it is to be achieved through the planned economy, not the market, even though the focus is to be on light industry and agriculture, where markets would normally be expected to play a comparatively greater role. This appears to be at least a partial disavowal of the decentralization theme of the 2002 reforms.

The Strategy

The decision-making process in Pyongyang is anything but transparent, so discerning a strategy is little better than speculation. Nevertheless, a number of developments are consistent with the hypothesis that Kim Jong-Il decided in the course of 2009 that more drastic measures were required to halt the dangerous trend of the rise of the market economy at the expense of the planned economy. One report suggests that in September he issued a directive that the two could not coexist and concludes that the currency reform was the consequence of that directive.

But Kim probably recognized the need to cushion the adverse impact of squeezing the market economy. This could explain the DPRK's move in August to reverse its antagonistic policy toward ROK President Lee Myung-Bak and to move to restore North-South cooperation on projects that earned substantial revenue for the North. The visit of China's Premier Wen Jiabao in late October may have been the occasion of bargaining to obtain promises of economic assistance. Other possibly related measures include:

- the announcement on December 16 of a number of new economic laws and regulations affecting commodities, real estate, and import of capital goods;
- indications of an effort to attract foreign direct investment, as indicated inter alia in comments to visiting U.S. experts in late November about the availability to foreign investors of reliable, inexpensive labor and in questions—posed during a tour of industrial parks in the Northeast Asia region by a joint team of ROK and DPRK officials—about wages, operating systems, and insurance and accounting systems; and
- indications that Kim Jong-Il had expressed interest in resurrecting the Rajin-Songbong free trade zone.

It is also possible that the authorities expected and welcomed the prospect of depreciation of the North Korean won against foreign currencies, after taking into account the redenomination, in private markets. There are reports that it has depreciated significantly against the Chinese yuan—if so, there could be a substantial boost of exports to China in informal trade, and a decline in imports from China.

It may be unrealistic to speculate that the DPRK would go so far as to move toward an agreement to give up its nuclear program in order to obtain removal of the sanctions imposed under UN Resolution 1874, but their removal was reportedly avidly sought by DPRK officials during the visit of Stephen Bosworth, U.S. special representative for North Korea policy, in early December.

The Future

Few western observers would predict success for this shift of course of the DPRK's economic policy. In the short run, success may be possible if it is defined as shrinking the relative size of the market economy compared to the planned economy. Improvement of living standards may be possible if harvests hold up, assistance from China increases, and revenue from Gaeseong and other industrial parks can be sharply expanded. But long-term growth requires rational investment and productive use of labor. There is no reason to expect that either attribute will emerge in a recentralized economy, particularly after so many have tasted the forbidden fruit.