

NORTH KOREAN ECONOMIC REFORM: AN UNCERTAIN FUTURE FOR A THIRD-WAY EXPLORATION

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I. Introduction

Four years have passed since the adoption on July 1, 2002, of new economic measures in North Korea (Democratic People's Republic of Korea [DPRK]). Whether these abrupt measures can be defined as economic reform policy adjustment or an admission of mistakes still remains to be argued.¹ The new policy reflects the ongoing preliminary market economy development in some parts of the country, the reform of the central planning system, and approval of the existing market mechanism within the society (Seliger 2004; Lee and Yoon 2004); in addition, the new policy accelerates the noticeable changes in North Korea's social and economic relations as well as its economic operations. When the reforms were announced, North Korea did not boldly admit that these new measures were economic reforms; now, after several years, officials of North Korea formally accept the word "reform" in their discussions with foreigners.

Therefore, whatever the criterion, the reform of wages and prices can be regarded as a significant and positive step. The reform might be called a watershed for North Korean transformation should the DPRK really move in that direction down the road in the future. Recently, however, we are observing some reversals on the part of the North relating to the degree of opening to the outside; it appears that the DPRK wants to control or resist the possible expansion of influence brought by a loosening of society. These anti-liberalization and anti-infiltration measures include demanding that the World Food Program (WFP) and other humanitarian organizations operating in the North Korea withdraw from the country (transferring humanitarian aid to more long-term development assistance) although the country still needs food, cutting off or limiting access to many places to those who are monitoring food distribution by the WFP, and resuming partially the old official public distribution system (PDS). This implies that top North Korean leaders (particularly Kim Jong-il and the military) have some concern about their fast-loosening grip on the society and their people. More important, the strong backlash from the United States and Japan over the lingering nuclear crisis and North Korea's newly launched missile has led the DPRK into a much deeper quagmire, which certainly will delay the course of North Korean economic reform.

Given this complicated background, it is worthwhile studying and explaining the reform with North Korean characteristics in the context of its inner contradictions and unfavorable outside environment. We will attempt to gauge its leaders' way of thinking in introducing reform; get a better understanding their reform style, the restrained scope, and its social impact on North Korean people (living standards, food situation,

1. Andrei Lankov (2005) argues that North Korea's price reform does not mean much, that it is just the admission of a situation that had existed for a few years.

mind-set); and predict the possible trend in the future. Any valuable assessment of and conclusion about North Korean reform cannot be based on a single standard model, theory, or mind-set. This paper will address several issues: the dynamic force of the reforms, the current experimental type and impact on North Korean politics and society, the limits and impediments of the reform, and the trends of the reform. This study uses induction and inference based on various facts, field reports, and experiential cognition, plus some comparisons with the Chinese reform model.

II. Dynamic Force of Reform: Survival, or Building a Powerful State, or Both?

The measures (including the past decrees) announced by North Korean leaders in July 2002—allowing free markets, a private economy, increases in prices and wages, and currency devaluation—can be interpreted in several ways. One interpretation is that they were necessary for regime survival or were simply an acknowledgment of reality, which means that Kim Jong-il or his economic bureaucrats do not have real interest in the reforms or the willingness to push forward a bold and well-planned reform, that the reforms were simply the result of the inability of the government to provide minimum nourishment for its people. If this is the case, they will be regarded as temporary measures.² Others believe the DPRK is learning from China's model and is building itself into a powerful state out of the admiration of the DPRK leaders for China's achievements emanating from its reform.

Both ideas are possible. The July 2002 measures could have been taken mainly out of considerations for survival; they were possibly a *modus vivendi* and a passive response toward the existing unofficial markets. North Korean farmers' markets had existed since the 1980s and had proliferated quickly in the early 1990s (Lee and Yoon 2004, 49), serving as a replacement for or as a supplement to the PDS because they provided food and other agricultural products to ordinary people. The elevation of the role of the farmers' markets did not grow out of the government's encouragement or arrangement; instead it was a natural development out of economic necessity or a kind of instinctive response to starvation and the dire economy. Thus, the markets of course received the government's acquiescence.³ When the government learned it

2. Lee and Yoon (2004, 56) believe the reforms were not active reform measures directed toward a specific goal; Andrei Lankov (2004) describes the reform as a final recognition of grim economic reality.

3. In the last four years, the government has switched its position and opinion on the markets from reservation to support because the markets had become an indispensable part of the North Korean people's lives, but the government still maintains some suspicion and concern. Thus, the government has stipulated rigid rules to control the markets' activities.

was the free markets that were selling food that had led to the uncontrollable increase in grain prices, the government in October 2005 quickly reactivated the PDS.

The July 2002 measures indeed recognized one very important thing: that prices in the free market, in varying degrees, could determine or indicate economic trends and greatly affect the official planning economy (resource distribution). Before July 2002, the prices for food and fuel in the markets had already seriously departed from official prices, which were failing to control the real pricing system, and thus the costs of services and electricity in the real economy were much higher than the government-denominated prices. The official exchange rate of the North Korean *won* compared with the U.S. dollar existed only in name, and it could not be enforced in the private markets. Furthermore, because the DPRK had to import a large quantity of goods from China to alleviate its serious shortages, those transactions would have to be in renminbi or U.S. dollars; therefore, the DPRK had to raise the prices of its own goods in the markets and devalue its currency to reflect the real value of the imported goods.

While the government nearly lost control over the real prices in the markets, the people could not continue to depend on small sums of valueless money to buy staples in the markets. In addition, the government would be unable to keep on distributing foodstuffs and staples in a regular way because the distribution prices did not reflect reality; neither would the government be able to use devalued money to allocate the promised quotas of products and profits to enterprises, let alone control a large share of national income and compile the annual budget for public finance.⁴ Because of the profits available in the black markets, farmers and other dealers would prefer to sell goods there. Thus the informal markets finally became the main factor determining the division of labor and the distribution of resources, and the informal markets absorbed large amounts of resources and assets and took them away from the state (Lim 2005, 7). It might be correct to conclude that the mid-2005 measures were taken when the country was on the verge of economic collapse and were taken in order to adapt to the situation.⁵

In addition, the July 2002 reforms could have been the DPRK's starting point in deciding to follow the market trends and mechanisms that were already operating within the economic system, so as to extricate the government bureaucracy from its powerlessness in its economic predicament. We could conclude that the economic

4. For the DPRK's budget planning process and the PDS function, see Lee and Yoon (2004, 47).

5. I use the term "economic collapse" in a line with the definition supplied by Eberstadt (2004, 65); that is, the breakdown of the division of labor in the national economy.

changes were partly the result of the DPRK officials' thorough and well-thought-through economic design since the adjustment formally started in 1998 when the new constitution was promulgated. The constitution in fact includes a more flexible economic system (with some private economic activities) and the freedom of travel (Oh 2003, 72). Thus, as far as the leadership is concerned, the measures could be strategic rather than tactical (Newcomb 2003, 59).

This judgment could be further supported by Kim Jong-il's secret visit to Shanghai and Beijing in January 2001, when Kim appeared to want to learn from Chinese experiences and transplant part of them into North Korea. During this trip, for the first time he openly exclaimed about China's achievements and admitted China's policy correctness. Soon after he returned to North Korea, the North Korean media began to broadcast propaganda about "new thinking—substantive benefits." *Rodong Shinmun* wrote on 20 November 2002: "While we should adhere to the socialist principle, we need to improve the system." In October of 2001, Kim Jong-il issued an order for reform, which laid out the basic principles for the July 2002 reform (Lim 2006, 1). Against this backdrop, the July 2002 measures were issued.

Kim's China trip and Chinese experiences did not directly relate to the July 2002 economic measures, however, because he did not seek China's advice on prices, wages, and PDS reform. On the contrary, his interests fell into much broader issues that were reflected in his visits to the Shanghai GM Automotive Company, a Buick plant; the Shanghai Huahong NEC Electronic Company, China's most advanced semiconductor plant; the Shanghai Bell Company; the Zhangjiang Hi-Tech Park; the Sunqiao Modern Agricultural Development Zone; the Pudong New District; the Software Development Institute; the Human Genome Research Institute; the Lujiazui Finance and Trade Zone; and the Shanghai Stock Exchange. All these had a common characteristic: foreign investment and management plus high technology. He appeared to travel to China mainly to learn how to build North Korea into a prosperous and powerful country through introducing foreign investment and developing information technology and high-tech industries. The spirit of the July economic measures reflected Kim's trip to China, and the reform measures paved the way for North Korean economists in the government to map out the price-and-wage reform measures later.⁶

In mid-2002, Kim's power base had been solidified, inter-Korean relations were in full swing, and Kim's main worries were possibly the economic situation at home and the apparent new hard-line policy of President George W. Bush toward his nation. Thus, his attention was partly diverted to his political ambition for seeking economic

6. Thus, North Korea has said that its adjustments to prices and wages are "for a strong and prosperous state." See Seliger (2004, 80–81).

achievement—remolding North Korea into a second Shanghai. (Kim was very attracted by China’s wonders and great changes).⁷

Kim Jong-il’s conception of reform to attain the target of building a powerful country could have two focal points. One is opening North Korean society to foreign investment and technology and setting up more special economic zones; another is to reform the DPRK’s internal system to attain a more efficient, flexible, and competitive country. This is reflected mainly in Kim’s paper, “Directives for Economic Management,” issued at the end of 2001. The paper included the decentralization of central planning, admitting to market principles—competition and the positive interaction between supply and demand—and adjusting or supplementing the role of the market in the planning system for material transactions (Oh 2003, 73).

But Kim by no means demonstrated that improving people’s survival was an important consideration; on the contrary, his interests were more on the enhancement of North Korea’s overall national economic power and the change of North Korea’s economic landscape. Indeed, during his January 2006 visit to China, ostensibly prodded by the shocking contrast between the two countries, Kim expressed his dissatisfaction with North Korea’s very backward economic situation but did not indicate that he was much worried about so-called regime survival. It appeared Kim understood the imperative for fundamental reform amid the current economic situation because North Korea had already survived the worst conditions of famine in the mid-1990s. He might have been more worried about the expansion of Western and South Korean influence through outsiders’ direct contact with North Korean people as well as the aftermath of the refugee exodus.

North Korea has a regime that cares less about people’s lives in comparison with its attention to the power, stability, and privileges of its leadership. Most important are the maintenance of power, nationalistic glory, and the paramount leader’s historic achievements. Thus, even though the Korean people desperately need food, the government has told the WFP and other humanitarian organizations to suspend their food assistance, lest the country rely too much on Western countries’ assistance. The North Korean leaders might think that it is unnecessary for their people to be better off—the leaders get as much as they need—if at the same time they are being influenced ideologically by the West (feeling that the foreigners from the nongovernmental organizations [NGOs] have been intruding for a long time). In fact,

7. According to Cheng Peng, vice chairman of the Korea-China Friendship and Culture Exchange Company, who was interviewed by *China Management Daily* (*Zhongguo Jingying Bao*), on 10 March 2005, the goal or strategy of becoming a powerful country consists of three dimensions: diplomatically exerting influence on the world (a nuclear program is an important leverage), building a large and strong military force, and improving the economic system and capability through reform.

if most people could be kept alive through a more even distribution of the increased grain rations from NGOs, the North Korean regime would be in a more secure position.⁸

In a nutshell, the dynamic of North Korean reform was, first, the situational pressure (or the spontaneous forces of its people) (Seliger 2006, 68) against which the North Korean leadership had to partly adapt the country's ineffective and struggling economic system to its newly emerged market system and then, second, it was Kim Jong-il's strong desire to build a prosperous and powerful country, similar to China, that pushed North Korea to further open up. No doubt, the North Korean leadership structured the reform for their distinctive approach. The external environment and internal conditions they face are a powerful, capitalist, and compatriotic South Korea; a hostile superpower, the United States, in a status of semi-war; their desire not to abandon their rigid ideology that controls people's minds; their intent not to give up the personality cult of Kim Jong-il; and their intent to retain their basic socialist architecture and principles. Constrained and determined by these conditions, a third way approach emerges—something between the Stalinist system and the model of China and Vietnam.

We could infer that what Kim Jong-il wants to learn from China is mainly those hardware experiences—special economic zones, foreign investment, and the introduction of advanced technology—not the software experiences—the liberalization of people's minds (from dominant Communism and Marxism), the opening of cultural communication with people overseas, free exchange and contact with foreign people, the private funding of enterprises, free commercial competition, a gradually improved investment environment, free operation of the system of production, and free markets.⁹ Wishful thinking might lead them to expect, like China, huge inflows of foreign capital and advanced technology to cure their economic illness if only they would partly and moderately apply market mechanisms and open selected areas to foreign countries.

Regardless of the kind of reform or how practical or premature the initial goal or design, seeking the substantive benefits and making economic progress (all the while not undermining the country's stability) will be the most important principles (Li 2006, 2).¹⁰ Therefore, in the face of endless economic problems and given the positive function of the law of market economy, the July of 2002 reforms will not just stop at current levels; they will be pushed forward and become irreversible.

8. Ruediger Frank (2005) provides a vivid description of this kind of distribution of rations.

9. Kim tends to focus on technological marvels rather than the institutional infrastructure that has made these technological developments possible (Lim 2006).

10. The North Koreans, of course, state that the first goal of reform is to bring benefits to the people; the second is that enterprises make a profit.

III. Review of the Reform: Type and Positive Implications

North Korea now has two levels (or focuses) of reform in its design. One is Kim Jong-il's ambitious goal that was mentioned previously. This level of reform, except for the special economic zones, is currently problematic because of the regional environment (the nuclear issue and the U.S. and Japanese sanctions) as well as the constraints of North Korea's internal political and economic status. Therefore, such large changes will be put on hold until the situation matures and the second level reform achieves progress. The second level reform—microeconomic and macroeconomic policy and system change—is now well under way and is being directed by the cabinet and the technocrats concerned.

Because North Korea operates in its own political, social, and economic conditions and China's experiences are not thought to be quite applicable to that country, when reform began in North Korea, it took on a gradual and mixed approach. Consequently, that process inevitably encountered an obvious paradox: the North Korean leadership tried to set limits on the reforms, refusing to fully introduce market mechanisms into its socialist economy while the grass-roots reforms developed quickly, yet they had to make concessions to reality from time to time—when policy and regulation could not operate effectively—so as to adjust policies to the situation. Because of this paradox, even after four years of reform, outsiders (maybe even including some North Korean leaders) still cannot not clearly see the leadership's intent and predetermined boundaries of change.¹¹

Taking the July 2002 reform as a first stage, North Korea's reforms can be divided into several stages and forms over the long run; the price and wage reforms are the first stage. Why did the DPRK choose prices, wages, and PDS issues to be the start of the reform experiment instead of the country's most demanding sector—agriculture? Although the reasons are still unknown, there are three likely explanations:

- They didn't want to touch upon the sensitive issue of ownership at first; instead, in their minds, the changes in the circulation sector would have less impact on the foundation or principles of socialism;
- Issues of prices and wages are regarded as the most imperative for economic reforms in North Korea, given that this invisible hand could well regulate the country's ravaged economy and bring into balance the relation between supply and demand; thus, some sort of production could be resumed and market competition would gradually appear; and

11. U.S. Department of State analyst William J. Newcomb (2003) expressed his surprise about the vagueness of the reform.

- The government was unable to sustain the prices of the main consumer goods by means of subsidy and had to increase wages for those people working in the service and heavy-industry sectors to allow them to make ends meet and have enough money to maintain their lives.

In this first round of reform there are several aspects that are quite similar to China's reform from the 1980s to the middle of the 1990s. First, the expansion of complex markets and monetization of the distribution system have replaced the rationing system. Now, except for the grain coupon, all the other coupons for daily necessities have been abolished in North Korea, and the subsidy for enterprises also has been suspended. According to the Ministry of Unification in Seoul, by the end of September 2005 markets throughout North Korea increased and now total 95; in addition, there are great numbers of small stores, convenience shops, food stalls, and private restaurants. In Pyongyang, there are two large markets, and across the country there are 300 markets altogether (Seliger 2004, 81) in which various goods are on display. North Korean people can buy almost everything if they have sufficient money. In addition to these markets for food and daily necessities, there are other two markets: material transaction markets and imported raw materials transaction markets, where the government will control only the total amount of the transaction lest it has too decisive an impact on the official allocation system for industrial products.

The booming markets in North Korea serve at least several functions: supplementing the supply of people's daily necessities, stimulating production, and promoting internal and external trade. Comparable with China, in North Korea there exists a variety of markets that supply goods ranging from agricultural products, industrial material, light industrial and textile products, and artwork to daily necessities. Gradually all these markets have replaced the central planning allocation system.

During July 2002, food, fuel, and electricity prices were ordered to be increased 26-fold on average, rice prices rose 550-fold, and public transport fares increased 20-fold; prices were now approximating the prices in free markets or they reflected the real cost of the service (International Crisis Group 2005, 4). Thereafter, the prices were allowed to fluctuate along with the status of supply and demand in the free markets. Currently most consumer and industrial goods have both market prices and state-regulated prices, and the market price becomes, *de facto*, the official price index although the state has resumed regulating grain prices in the PDS and maintains an administered structure of prices (Noland 2004, 24). In terms of the development trend and China's experience, as North Korean enterprises gradually become used to free prices—particularly when their management situation allows them to meet the challenges of the ebb and flow of prices—the state will definitely combine its two-track price structure into one.

Second, as for the foreign exchange rate, it has soared in the black market since the reform began. Now 6,000 North Korean *won* equal one U.S. dollar (it used to be 3,500 *won*) and 3,000–3,600 *won* equal one euro (the official rate is 180 *won* to the euro). Obviously, North Korean authorities are unable to control the sharp devaluation of the North Korean *won*. Thus, what the DPRK authorities would like to do is, through the country's established Foreign Exchange Transaction Center, openly engage in buying and selling U.S. dollars and euros on the basis of the floating market rate; transactions of this center are not subject to the rules governing transactions falling within the officially allocated accounts of foreign exchange. The North Koreans have learned this technique from China, though passively, since China set up such a body in Shanghai at the end of the twentieth century.

Third, the compulsory planning system requirements for enterprises have been greatly diluted, and the state enterprises have more autonomous management rights. The Pyongyang government has now decentralized management rights, more or less, to the local governments and the enterprises. The managers, rather than the party secretaries, will be in charge of production affairs, and they can formulate their production plans and pricing and be responsible for covering their enterprises' own costs (Noland 2004, 24). Although we do not know how much maneuvering room is available to management, it can be assumed that after the enterprise fulfills its production quotas for specified products and hands in the profits (taxes) required by the state, it could partly reorient its production toward marketing or exporting to China and use the remaining profits for investment in profitable products or service sectors (this policy is called the right of partly flexible management).¹² Because of flexibility and successfully diversified production, some enterprises will be able to pay more bonuses to the workers as incentives.¹³ More important, according to the director of the WFP in a speech in August 2004, some factories have been tenanted, that is, management of those factories has been outsourced to contractors for a designated period of time. This development resembles China's reform of state enterprises during the past decade, in which there were four focal points: introducing the contract and equity system to the factories, giving enterprises autonomous rights, giving managers exclusive responsibility, and the government adopting a policy of "grasping the large enterprises and releasing the small enterprises."

12. In the early 1980s, China adopted the policy of levying a tax instead of extracting profits from enterprises. The large and profitable enterprises must pay income tax of around 33 percent of the profits and 17 percent of added-value tax to the government. Remaining profits were left for the enterprises to do with what they pleased. For small or unprofitable enterprises, the tax could be reduced to 27 percent, 18 percent, or less. North Korea will probably follow China's example, depending on conditions in North Korea. The problem for North Korea is now the low rate of operations and lack of electricity and material.

13. At a maximum, a worker could earn 7,000–8,000 *won* in salary plus a bonus.

Fourth, the size of countryside production teams has been shrunk. To increase agricultural productivity and efficiency, North Korea has reduced the number of members of its production teams—the smallest unit in the country—from around 25 to 7 or 8, and on these teams most members are relatives. Above the level of these teams are the production squads, each of which manages 3–5 teams. On that score, it seems the DPRK has not completely patterned itself on China's model—allocating the land to the households.¹⁴ This shows that North Korea still wants to maintain the basic form of the collective farm (public economy) and that the leadership worries it might lose its most important public assets—land as well as the political power growing from control of the land; it would be unable to control the farmers' production arrangements—which crops they grow and how much.

This policy adjustment also somewhat reflects the essence of China's agricultural reform: let the farmers feel they work for themselves and give them the rights to dispose of (sell) their redundant grains and other farming and sideline products (cash crops such as vegetables, fruits, and tobacco). Since the reform policy was adopted (causing the state's procurement prices for grains to rise), the farmers have more income and both their enthusiasm for their jobs and their productivity have increased.¹⁵ On 31 May 2005, *Chosun Ilbo* reported a Bank of Korea estimate that the gross domestic product (GDP) of the DPRK grew by 2.2 percent in 2004, and the improved productivity of the agricultural and fishery industries and the increase of mining output contributed to the growth. By this time, according to a 19 June 2006 report in *JoongAng Ilbo*, every household had a family agricultural plot of 100 square meters, and farmers could sell crops from these plots to the complex markets. Some of these farmers soon became rich. Of course, the effects of the reforms varied from farm to farm; some are better and others may still remain poor (Zellweger 2006).

Fifth, more private and public capital has been flowing from China into the North Korean commercial and mining sectors. North Korea is actively pursuing this strategy because:

- China's investment is more dependable politically; North Korea does not want to open to South Korea on a large scale;¹⁶

14. It was reported that, in early 2005, North Korea was considering letting farmers become tenants on some communal farms lands, but after one year of research and investigation, this plan was postponed.

15. This point might be debatable because the increase in productivity varies from farm to farm, and different outside observers may make different judgments based upon where they visit. The favorable weather, South Korean fertilizer assistance, economic incentives, and applications of new agricultural technology all contributed to the harvests for 2003–05.

16. Cheng Peng, vice chairman of Korea-China Friendship and Culture Exchange Company, pointed this out in an interview in *China Management Daily* (*Zhongguo Jingying Bao*), on 10 March 2005.

- There are wide economic complementarities: China has plenty of money, low-priced goods, and reform experience; also China needs new markets in which to sell its oversupply of products and more energy to bolster its fast-developing economy; North Korea, in contrast, is short of money and goods but has sufficient raw materials;
- Both sides have similar cultural and political backgrounds, and they understand each other well; and
- China's renminbi is a hard currency.

North Korea needs to modernize its management of its state-run department stores to improve service and the goods on display and for sale. These stores are the image of Pyongyang, the basis of the public commercial economy, and the main source of people's consumption. If the sharp contrast between the empty and worn-out stores and the abundant, booming free markets persists, people will lose all confidence in the public economy. Thus, investment by private entrepreneurs from China to improve management and the supply of goods could prop up those stores to ensure their survival, rebuild the public commercial economy, bring vigor and energy to the DPRK's commercial sector, and form a counterweight to the competition of the free markets. Currently there are three China–North Korea cooperative department stores in Pyongyang.

Cooperation with China in the Korean mining sector is also a new, experimental field for North Korea. North Korea has plenty of mining resources, ranging from coal, copper, and iron ore to gold and magnetite. Because the North Korean mines are either running below normal capacity or are at a complete standstill because of a lack of electricity and funding, the North Koreans might well become much broader in their thinking as they begin to understand how the North can play on its resource advantage in exchange for goods that are greatly in demand in the North. China–North Korea cooperation in the mining sector has many merits:

- China brings new technology and management expertise to the state enterprises;
- North Korea's underused resources are put to better use;
- Other economic sectors in North Korea will greatly benefit from the newly produced electricity and other energy;
- Mining workers will have better lives;

- Success will pave the way for North Korea to open more underused and backward industrial sectors to foreign investment; and
- The North's long-standing problem of international payments and exchange could be lessened as the country could use its resources to pay its bills.

Although Kathi Zellweger (2006) reported that North Korea's "energy supply was better than before and power cuts in Pyongyang became fewer," we do not know for sure that recent Chinese investment has led to the improvement of North Korea's energy situation. However, China's aid to improve North Korea's hydroelectric power and wind power generation and China's investment in coal mining has most likely contributed to improvements in North Korea's energy situation.

IV. Impacts and Limits of the Experiment: A Critical and Comparative Assessment

Thus far, North Korea's reforms are not proceeding smoothly and effectively, and they have not brought many benefits to most of North Korea's population, except that the free markets and sidewalk businesses are thriving. Some foreign investment and goods are coming into the country, which heightens inflation (hyperinflation); makes insecure the salary that the state pays its workers; increases the price of rice; and increases the shortage of grain,¹⁷ meats, eggs, protein, and vegetable oils.¹⁸ Most people's money is now less valuable, and they have trouble affording the higher prices of basic commodities. Many families still exist on meals of maize porridge and acorns.¹⁹

It is too early to conclude, however, that the reform is a complete failure or that it has no substantive significance in pure economic terms. In addition to the positive sector changes mentioned above, there are several social side effects that should not be underestimated.

First, the number of beneficiaries (including farmers and businesspeople in trading companies) is growing; among them are the children of prominent senior cadres, who

17. The size of the daily ration for the average resident of North Korea is now 200–250 grams of rice. Originally it was 300 grams. One kilogram of rice costs 1,050 *won*, half of a worker's monthly wage.

18. According to South Korea's Ministry of Unification, other price increases in North Korea include grain, with an 18-fold increase; salt, 15-fold increase; socks, 73-fold increase; and cold noodles, 20-fold increase.

19. Tony Banbury (2005), WFP regional director for Asia, observed that a meal in Pyongyang may cost the equivalent of five to seven times an average monthly wage. Some Koreans—only a very thin stratum of society—are able to afford that.

already have earned sufficient money to become the first batch of rich people (Banbury 2005). This development is good for the transition from an authoritarian society and is bad for social justice. Both China and Russia have encountered similar situations. From their advantageous positions gained through nepotism, bribery, and other means, well-connected and smart people developed an early commercial instinct,²⁰ and they took the chance of transferring national assets to themselves when they saw loopholes in the loosening centralized power system. They made good use of the differentials between dual-price systems and the insufficiency of commodity supply to gain large profits. While market prices have been soaring, social corruption spreading, and most people's incomes shrinking, the number of rich people is growing and they are gaining forces to move to the forefront of further reform. These processes will help to erode North Korea's authoritarian society and slowly destroy it.

Second, since the implementation of the July 2002 economic reform, the amount of DPRK-made goods sold domestically has shrunk, while imports from China have risen noticeably (ISIS 2005). Thus, the reform itself has not produced many of the effects of the market dynamic, but the reform makes it easier for North Korea to trade with China and other countries.

Over the short run, the growing amounts of imported goods from China will greatly weaken North Korea's national economic development and render the country heavily dependent on China economically. Over the long run, imports from China will stimulate wealthy people to consume more, North Korean retailers to sell more, and light-industry to reorient itself and introduce labor-intensive investment from China and South Korea. Doing business with China will encourage DPRK officials to understand that, according to the theory of contemporary trade, a normal country would rather engage in the regional division of work and obtain necessary goods through international trade as it makes use of comparative advantage than produce everything domestically to meet people's needs.

Third, it seems now that urban workers are the biggest losers since the reform. Their state salaries are no longer guaranteed, so they have to rely on factories to pay their salaries (Banbury 2005). However, if the factories do not run normally, the workers will not get enough income to live on. Certainly it is a terrible situation for those people, but this result also can also be turned into pressure on the state, the factories, and the workers to change their past mode of production, their way of life, and the old concept of relying on the state for everything. Usually in the first period of a transitional society (with more competition), economic activity and daily life will be in a mess; after some time, the situation will gradually develop into one that is relatively balanced.

20. In China, they will be called *guandao* (quasi-official mongers) and in Russia, they may be called financial oligarchs.

During the early part of the transition, some people will need to find a new way to survive and the others may find their living conditions worse and they will be more vulnerable, which in turn will pressure the government to try to build a social insurance and safety system. In a nutshell, this is an inevitable stage that a centrally planned economy experiences during marketization.

Fourth, people's concepts will change. People in North Korea will have more chance to get cultural products (videotapes and radios, for example) from China and South Korea, so they will be more informed and knowledgeable about the outside (Seliger 2006, 64). Another aspect is the development of a commercialized mind. Now many people take the concept of making money as the foremost goal of human beings. They try to find every possible means and seek all kinds of chances to earn money. In an anecdotal report, the "taste of money" is believed to have penetrated North Korean society, and, in line with this change, the people are more aware of the costs of goods and services (Zellweger 2006). This was the same situation widely seen in China when many people from different walks of life swarmed into the field of business as China commenced its reform. Doing business as private enterprise would make a huge impact on all levels of the socialist bureaucratic system, on ideological doctrinarism, and on all the people of China. People (particularly workers in cottage industries, peddlers, and wholesalers) were able to evade disciplinary and political control and monitoring from their bosses, the so-called working units, and the managing offices of the neighborhood. As a result, people gained more social and political freedom.

While affirming those points of long- and short-term positive significance and some similarities to the Chinese model in North Korea's reform, we have to admit this reform has not achieved evident success in terms of people's living standards, productivity, gross domestic product (GDP), the supply of basic commodities, and the operation of normal factories. According to a top Chinese financial official, Lou Jiwei (2006), the analytical framework of a "Washington consensus" can be applied to the assessment of the degree of success of the command economy vis-à-vis the market economy.

North Korea's reform lacks macroeconomic stability and opening up. The DPRK has not solved the problem of free market access, and the reform of state enterprises has started only a little. Only the price changes seemingly reflect the relationship between supply and demand, but this reflection is somewhat distorted and market prices are still greatly influenced by official prices. As for opening up, the North's selected countries are mainly China and South Korea. The reasons that North Korea's reform is lacking are complicated.

First, reforms in prices and wages should be regarded as necessary and imperative steps in light of the grave deviation between official prices and the markets, the supply

and demand. However, North Korea has made at least three key technical mistakes in promoting wage and price reforms:

- The changes made to prices and wages were too great, and the speed of the adjustment was too fast (it could even be called shock therapy). The sudden 70-fold devaluation of the *won* did help close the gap between the real value of imported goods and the selling prices in the DPRK markets, but it accelerated the devaluation of the *won* because of North Korea's very low economic output, high inflation, and lack of goods to export. In China, the renminbi was devalued approximately 4–5 times its original official price (the real devaluation was only two times—1:1.71 in 1981 and 1:8.62 in 1994) to the U.S. dollar beginning at the end of 1970s up until the early of 1990s. China maintained a dual exchange rate arrangement to secure the tight balance of its international payments until the mid-1990s when its economy was deeply integrated into world economy. Also, North Korea failed to design a trial period and institute a tight monetary policy. As a consequence, the producers, the dealers, and the markets—taken by surprise—could misinterpret the government's message and lose confidence in the government's ability to control monetary stability. Hence, inflation was inevitable.
- Too firm a belief in the role of market forces in regulating disequilibrium in an economy with a severe supply shortage caused by an obsolete industry will be problematic in North Korea. Before conducting its price reform, the DPRK should have controlled most staple foods and basic commodities in advance in order to regulate market fluctuations and create a ceiling on prices to contain the expected price increases. (This was also the Chinese experience.)
- The North Koreans did not use well the economic levers—taxes and subsidies—to encourage farmers to expand their grain production (at least maintain the current quota levels and acreage devoted to grain) and turn over to the state at the market price or sell part of the harvest on the free markets at a controlled price. Given the fact that North Korea is unable to grow enough grain for its basic needs under current conditions, the country needs to manage its grain production quota for a long time, until the national economy functions well and could trade its industrial goods for food in the international markets. It is also important that the DPRK adopt the Chinese model of the household contract system (ownership reform) in order to create incentives for the farmers to produce more grain. Of course, it is also necessary at this stage to reactivate the PDS as a main source for rice and cereals.

Second, one of the reasons that North Korea has failed to create a more vital economy and arrive at a relative balance between supply and demand through market mechanisms

was the absence of minimum normal production before reforms were attempted. In other words, the moribund North Korean economy—decrepit factory facilities; shortages of energy, raw materials, capital, and technology; breakdown of interindustry supply relationships (Newcomb 2003)—prevents the country from improving itself through its own policy adjustments and market forces. Domestic reform in North Korea must be synchronized with a broad and brave opening to the outside, not the timid opening and a reform for tinkering with the system. Only through outside forces can the DPRK break down the current economic structure and upgrade its outdated facilities and let the market forces become the real effective mechanism in spurring productivity and solving their most pressing problem—supply shortage.²¹

Third, when talking about the policy of opening to the outside world, we must relate the policy to relieving North Korea of its political constraints. When China initiated its reform and policy of keeping an open door, Deng Xiaoping and the party first took a bold ideological measure of seeking to eliminate the political bind on the minds of officials and the people; this included conducting a full debate about the rationale of the reorientation of the theories of Marxism and Mao Zedong in a backward socialist country and the liberalization of people's minds to reach creative thinking about reform. At that time, people had almost no political taboos, no more cults of personality, and freedom to travel, and freedom to choose however they wanted to make a living. They could also directly communicate with foreigners, read Western materials, watch Western films, and, particularly, enjoy the fact that many sectors of the economy were open to foreign investment.

North Korea lacks such a resolute will, for it is afraid that South Koreans and foreigners coming and investing in the North Korea will change people's minds and do away with their political innocence, destabilize the regime's grip, and lead to a crisis of confidence among the people about the party and the legitimacy of Kim Jong-il. The crucial key is Kim Jong-il himself. He has not issued any order to demystify his father or himself, and no one dares to do anything much beyond orthodox practice and process. Because the North Korean leadership does not want to change strategically, the liberal and enlivened mood of reform cannot be formed, and government bureaucrats, factory managers, and citizens will not come up with creative ideas or an entrepreneurial attitude about reform and find prescriptions for their economic illness. Although some officials and researchers have learned abroad about market economy theory and approaches, and they tested those theories and approaches when they came back home, they have not been able to be successful because of North Korea's lack of an environment for a market economy and foreign investment.

21. Newcomb (2003) stressed the point that foreign investors were crucial to the success of the reform.

Fourth, North Korea's reform lacks a systematic design and a correct sequence. Reform is a systematic project; it needs carefully coordinated work and change in all parts of the system. For example, when the reform of prices and wages was adopted, synchronized steps should have been taken in the areas of industrial production, sale of products (pricing), supply of materials, and public utilities, that is, monetization and marketization for all related economic process.

In China, after agricultural reform, there occurred a debate about which of the following reform measures should take precedence—enterprise or prices. The result was the former because, if price reform was undertaken ahead of enterprise reform, when the markets prices signaled a change, the lagging enterprises would not be sensitive and respond well to that market message. If that occurred, prices would fail to play an adjusting or leading role (Lou 2006). As a consequence, China adopted the strategy of encouraging state enterprises to emphasize their market survival first, through autonomy based on gradual price adjustments (a dual-price system). Complete price reform in China was addressed a bit later. But in North Korea, they did this in the reverse: price reform came first, so now they must reform the enterprises thoroughly and get them into the markets as quickly as possible.

Only under balanced reform can factory managers have the possibility of exploring ways to make their factories survive, reduce their costs, seek profits, and guarantee employees better wages to meet the rising prices for daily necessities. With balanced reform, the value and prices of all industrial and agricultural products can maintain a relative consistency and have a balanced interaction.

Fifth, they failed to gradually diversify the country's capital and management structure in the industrial sector during the past two years. If more foreign investment and private capital could be allowed in the state enterprises and if able individuals (tenants) could manage the affairs of the enterprises within a contracted, specified time (there must be requirement for tax, production efficiency, and long-term development), North Korea's decaying industry could find a path to survival and reduce its losses and low productivity. In other words, state authorities could use such a strategy to focus on supporting a few leading state enterprises with the potential to recover while they privatize, incorporate, or sell the hopeless enterprises to foreign business investors and collective economic entities.

In the meantime, they could divert part of their attention to developing labor-intensive enterprises in the towns; these enterprises would not use many of the state's resources and would not be burdened by employing a large number of inefficient employees. Enterprises need a preferential policy, technological guidance from the authorities, and loans from the banks; in return, they would produce more cheap goods for the

markets (increasing the country's GDP growth substantially) and even export to the outside and earn foreign currency. They also could improve the working and living conditions of the farmers who grow grains by letting every member of the family work in these enterprises. These changes would rejuvenate the inefficient state enterprises.

Finally, North Korea has not yet tapped the potential of its land. In China (including Hong Kong), to solve the problem of funding to improve urban infrastructure (new high-rise buildings, bridges, roads, and electric power stations) to attract foreign investment, improve people's living conditions, and sustain a high growth rate for industrial development, the country had to fully enforce the policy of differential land rent. Therefore, China's coastal cities lent many of their golden urban areas to various foreign conglomerates and tycoons in exchange for their huge funding for developing or improving the demanding infrastructure.

It seems that North Korea just now has realized the subtle value of using tomorrow's money for today's work (Wang 2005). For example, North Korea set up real estate departments within the governing cabinet as well as in cities, counties, and regional offices beginning in March 2005. According to some reports, the government has issued a new policy on land, which stated that ordinary people could lease public lands for a long period of time, and the state will further enforce rents on properties and increase land-use fees levied on enterprises for their use of public lands. Domestic enterprises, foreign enterprises, and individuals can bid on road development projects and long-term management rights, and the government will grant permission for the sale or transfer of land and houses to those real estate businesspeople and companies that construct the apartments or hold the ownership or the right to use the property. This is a new development for North Korea (IFES 2006), but as far as we know this measure has not been widely implemented. If it had been, their difficulties funding building infrastructure and remodeling enterprises would be greatly lessened.

The most noticeable evidence of this experiment is seen in China–North Korea economic cooperation. In July 2005 two Chinese companies from the city of Hunchun signed an agreement with North Korea to lease the port of Rajin (quays no. 3 and 4) for development and management for 50 years. Operations would be the responsibility of a new joint venture, Rason International Goods Transportation, Inc., with each side holding 50 percent of the shares, in exchange for the city of Hunchun's pledge to build highways from the port of Rajin to a commercial development zone in the city of Rason, remodel quay no. 3, and build three additional quays for the port of Rajin plus a duty-free assembling zone and industrial zone in the near future.

V. Future Trends of Reform: Deepening Adjustment but No Revolutionary Change

Generally speaking, in facing the new emerging problems and formidable obstacles in the course of reform, North Korean authorities will be unlikely to revert to the time preceding reform because the spilled water can't be gathered up again,²² and, most important, people's ideas are undergoing great change and individualism is increasing. Thus, North Korea's leadership will have to explore some ways to improve the worsening economic situation while proceeding with reform in a more realistic, a bit expansive, and a concerted approach so as to minimize the negative impact and maximize the designed effects.

Many North Korean economic officials will gradually realize where their main problems lie—in the institutions—but changing institutions in North Korea is taboo and authority cannot be exceeded. So what they will be able to do is a kind of revamping within the bounds of the system. The next steps, presumably, are as follows:

First, because the demand-side reforms failed to stimulate the supply side to raise production, in the next step North Korea might consider focusing its reform on the state enterprises, making great efforts to recover part of the state factories' operation. The state planning commission probably would go beyond change at the managerial level and allow the markets to play additional roles and lead the allocation of resources for factory production. The state planning commission might sever leadership relations with most of the enterprises. Subsequently, the enterprises would have direct relationships with each other through different markets and financial institutions. Of course, the crux for enterprise development lies in the increase in the number of qualified entrepreneurs, the establishment of an efficient governance structure, and the cultivation of the ranks of creative entrepreneurs in the movement toward ownership change. Businesspeople might have to turn enterprises' state assets into the proxy's liabilities, finally.

Enterprises, as part of additional reforms, will not be expected to turn over their profits but, instead, will be taxed. In prospective reforms, North Korean authorities probably would invest heavily in some large enterprises, similar to the South Korean *chaebol*. This strategy has actually already been put into practice, and the North's conglomerates can now be seen in many advertisements: Pugang, Daesong, Sungri, Rungra, and the subcompany of Korea Ryonbong General Corporation. One of the companies claimed it had capital of \$20 million and turnover of \$150 million.

22. Many things have changed since the reform: people are now used to new wages, new arrangements, and new markets as the planning and distribution apparatus broke down (Newcomb 2003).

Second, policy changes pertaining to the above reforms might occur in the banking system as well. Currently all North Korean banks are administrative financial institutions, with the national budget, not people's and corporations' deposits, as their source of funds. Thus, they have to implement all the economic plans formulated by the central government and provide funds and loans to the state enterprises, cooperative farms, and other official organizations without strict scrutiny and strings attached. Their accounting does not depend on costs and benefits. In a market economy, however, people usually want to deposit their money in banks.

Given the sharp decline of total revenues in North Korea and a budget (\$19.2 billion in 1994 and \$10.0 billion in 2000), the government and all the banks will have to make efforts to attract deposits from the people to make up the part of their gap in funding that is badly needed by the construction industry. The government needs to commercialize the banking system and provide that all finance transactions will proceed through banks only and all the deposits and bonds must pay interest. This kind of reform is imperative because the government needs to be relieved of its burden as the financier for enterprises. The government must be more detached and use fiscal and financial policy—through the banks' commercial activities—to guarantee macroeconomic stability; adjust to market activities and trends; prompt enterprises to better understand the costs and risks of the loans they get from the banks; and help them to efficiently and carefully manage their production activities according to market needs, the prospects for products, and the laws of finance.

Third, the North Korean leadership will adopt a policy of opening a bit to the outside world. Because the preliminary success of reform measures will rely partly on breaking up the bottleneck of energy deficiency as well as on the massive inflow of foreign investment, North Korean authorities will have to formulate a more flexible policy to attract diverse foreign investments. It is reported that the government is considering allowing sole foreign ventures and banks to be set up in areas other than the special economic zones, and currently one joint-venture bank has been established in Pyongyang.²³ Because of the stalemate in the talks about nuclear proliferation and the U.S.-imposed economic sanctions, North Korea currently must seek investment from China, South Korea, and Europe. Publicity about an investment promotion fair in North Korea indicates the North has designated approximately 20 sectors for priority investment; the top ones are equipment for smelting operations, development of mining resources and processing, transportation, and production of machinery. There is no

23. The Global Group, a London-based banking and investment group, opened a branch bank in Pyongyang in late May 2005; this was the first joint-venture bank between a UK company and the DPRK.

doubt that currently North Korea is still focusing on China for three kinds of cooperation:²⁴

- Chinese companies will further expand their investments in the mining and extraction industries in North Korea and will update North Korea's electricity grid and transportation lines. For example, China's Jilin Province will provide electricity to North Korea.
- More Chinese private capital will go into North Korean retailing sectors. The tenants that invest will increase investment in the labor-intensive industries, including the building of small dams, hydroelectric power stations, and fertilizer factories. These are expected to help alleviate the North's shortage of electricity, fertilizer, and other daily necessities as well as contain inflation in the markets. The DPRK now levies an income tax of only 5 percent and an import duty of only 5 percent on the profits of the Chinese department stores and big markets. The DPRK also gives Chinese businesspeople latitude in exchanging currency.
- China and North Korea will set up more international free-trading areas, free ports, duty-free assembling zones, and industrial zones in the near future in the border region. According to *Chosun Ilbo* on 23 October 2005, one of the rewards for China will be the construction of a railway line from Tumen to Chongjin, which subsequently would open up new trading routes between Pyongyang and Shenyang, and increase trade among Chongjin, Rajin, and Tumen.

In addition, North Korea will attempt to build more special economic zones (SEZs) in different regions as it further improves and expands the Mt. Kumgang tourism project and the Kaesong industrial complex so as to form interconnected industrial hubs or belts with different orientations and functions: labor-intensive products for export, high-tech industries, tourism, and increased agricultural production. It is believed that North Korea wants to divide the roles of China, South Korea, and Japan and involve them in the development of different SEZs, for example, in the areas of the Yalu River (Amrok), Kaesong, and Rason (World Weekly 2006). So far, the SEZs are set up along the China–South Korea border, but when North Korea accumulates enough experience in managing those areas and obtains some success, the country will consider setting up more SEZs in the interior and coastal areas.

24. On February 10, 2006, www.xinhua.org reported that, in 2004, North Korea received a total of \$59 million in foreign investment; China was the largest investor with investments of \$50 million. Three hundred foreign companies entered the country, and Chinese companies accounted for 40 percent of those companies.

The Sinuiju Special Autonomous Region (SAR) is still high on the North Koreans' agenda; this can be seen by the ongoing construction of the bridge linking Dandong, China, to Sinuiju (second Yalu River bridge). Once built, it will become the shortest route between China and North Korea. Also, selected North Korean workers are building a huge housing complex in Sinuiju (Kwon 2006); Bidan Island, next to Sinuiju, has long been reported to be developed into a financial center; and, according to a well-informed source, the two countries have discussed the arrangement of allowing foreign investors to enter Sinuiju on one-day visas as the North Korean officials craft a plan for developing and opening up Sinuiju (Kwon 2006).

In other words, North Korea has accepted some of China's advice as well as its role in developing Sinuiju. In Kim Jong-il's mind, Sinuiju is the most desirable region for a high-tech SAR, leading to the realization of his dream of building North Korea into a new Hong Kong. More important, such a plan is seen to have few political risks. Of course, the final say does not depend solely on Kim Jong-il; he needs China's full support.

Whether these plans can be implemented and achieved does not fully depend on the economic factors; success also depends on political elements. Internally, such plans need:

- Kim Jong-il's decision to relax the government's political grip on the North Korean people and all levels of officials, which would enhance the collective functions of leadership and the transparency of the party and the government's decision making.
- The replacement of North Korea's military-first strategy with an economic development-first strategy. As a substantive step, the military needs to be controlled by the top civilian officials of the party, and the power of the military elites around Kim Jong-il needs to be curtailed. It is ridiculous that the Defense Commission plays the paramount role—even above the party (the Central Committee and the Politburo)—in a Communist state. For consistency, it is also important to integrate the Second Economic Committee into the unified production and resources allocation system under the cabinet. Also, the suppressed political and cultural environment should be changed. People should have more freedom to acquire information and knowledge from abroad, to travel to foreign countries for study and to visit relatives, to contact foreigners, to pursue their own cultural preferences, and to express their own political loyalties (the bottom line, however, is not to challenge the party leadership).

The country's external relations need to correctly reflect the internal policy of pragmatism. If Kim Jong-il would completely drop the country's nuclear program and

its plans for weapons of mass destruction, a path would open for attracting massive foreign investment, revitalizing the country's dire economy, and successful reform.²⁵ If the six-party talks remain deadlocked or North Korea conducts more nuclear tests, however, the U.S. and Japanese financial and economic sanctions will not be removed or relaxed. Consequently, North Korean companies and banks at home and overseas as well as foreign banks doing business with North Korean companies would face grave difficulties in promoting trade and tourism, attracting foreign investment, and offering services for customers because all normal economic activity is accompanied by money transactions. If Kim Jong-il still clings to the belief that military power and nuclear weapons are more important than economic programs in pursuing his goal of being a powerful and prosperous country, his reform will not go far and his goal is be unlikely to be achieved.

VI. Conclusion

North Korea has embarked on substantive reform; its dynamic is a mixture of regime survival and Kim Jong-il's fantastic thinking about becoming a powerful country. We should take a dichotomous approach toward this kind of reform. On the one hand, it hasn't brought evident positive results to the people, and everything is still in a mess. On the other hand, people's ideas, ways of living, and ways of earning are undergoing great change, and North Korean society is no longer monolithic. The failure of North Korean reform has complicated causes—misunderstanding of the interwoven problems of its system, an underestimation of the inapplicability of the role of price as a lever in a deficient economy, the lack of sophisticated design and systematic and incremental coordination, and the innate limitations of the country's political system and environment.

In light of the countervailing and constrained characteristics, we are not certain whether North Korea's reform will lead to a kind of partial success. Therefore, we cannot totally exclude the likelihood that North Korea's political ossification and deteriorating economy will intensify people's loathing toward the new policy and thus give rise to possible social turmoil or a change of personnel in the upper leadership.

We should not simply apply the Chinese and Vietnamese model when we judge North Korea's reform, which is regarded as an exploration of a third way of reform—a mixed experience from Chinese and Vietnamese reform and Eastern European economic transition, with no revolutionary changes to its system but an overall opening up. It is still possible that some positive effects of North Korea's reform will emerge

25. In addition to support from various countries, South Korea would offer a tempting array of assistance programs to North Korea if the six-party talks were to reach a comprehensive agreement.

gradually. Even if the North Korean system does not reform fundamentally, the country's partial opening policy toward China, South Korea, and United Nations organizations (with the resulting large amounts of capital flowing into the country) and its deepening reform in enterprises, the price system, and the ownership system in the countryside may create the chance for North Korea to alleviate some of its difficulties by offering more food in the markets and prompting the country's economy to regain some vitality in certain sectors.²⁶

In sum, the crux of the real success of the country's reform lies in changes to its ideology and state strategy as well as the settlement of the nuclear crisis and the improvement of relations with Washington and Tokyo, but it will be very difficult for the current North Korean government to realize these goals.

26. In March 2006, the WFP unveiled a new two-year \$100 million aid package in Pyongyang.

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