

Korea's Economy 2010

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NORTH KOREA'S ECONOMIC DEVELOPMENT AND EXTERNAL RELATIONS

THE ROCKY ROAD FOR MODERNIZING THE NORTH KOREAN ECONOMY

By Bradley O. Babson

Rocky roads conjure images of pitfalls and jarring bumps on a tortuous journey toward some desired destination, without assurance that some calamity will not bar the way to the hoped-for end of the journey. This seems to be the case today for the course of the North Korean economy. The leadership has set high expectations for North Korea to become a “strong and prosperous nation” by 2012, the 100th birthday of the father of the nation, Kim Il-sung. Such a destination seems implausible to outsiders without major breakthroughs in both the security and economic challenges facing the country. In its 1 January 2010 New Year’s editorial, the leadership outlined in terms very different than in previous years its policies for reaching this destination, including improving dramatically its relationship with the United States and giving priority to improving radically the people’s living standard through accelerating development of light industry and agriculture. The editorial also recognized the important role of expanding international trade, drawing on science and technology, and improving the economic management system to achieve these goals.

It is hard to disagree with this framing of national aspirations. The international community generally and most economic experts would support the objective of improving the welfare of ordinary North Korean people and the priority that needs to be given to agriculture and light manufacturing in meeting this objective. Broad-based sustainable economic growth will also require expanding international trade and increasing productivity through improved technologies, and most observers would heartily agree that improving economic management is critically needed. But here the room for general agreement hits the wall. The policies that the government has embarked upon in late 2009 and early 2010 to attain these objectives are not ones that most outside observers believe will succeed; indeed, most believe they will create more

difficulties for attaining the national goals than the problems they were intended to redress.

Assessment of Recent Initiatives

The recent policy initiatives stem from directives issued by the Supreme People’s Assembly and the cabinet:

- Currency reform;
- Setting of new state prices for staple goods;
- Realignment of state-set wages;
- Ban on possession and use of foreign currency;
- Closing of wholesale markets;
- Revision of the Real Estate Management Law, Commodities Consumption Level Law, and General Equipment Import Law;
- Ban on sale of manufactured goods in permanent markets and requirement that all such goods be sold in state-sanctioned retail stores at state-set prices;
- Reversion to farmers markets from general markets;
- Redesignation of the city of Rason as a municipality to attract more foreign investment and trade with China and Russia;
- Compulsory mobilization of people for fertilizer production and collecting scrap metal, paper, rubber, vinyl, and other materials for light industry;
- “40-day battle” to enforce closure of markets through police and security forces crackdowns on complaints, “grasshopper trading,” and “alley trading”; and

- Launching an “all-out-offensive” media campaign to motivate people to work hard to meet the economic goals.

Taken together these initiatives signal a deliberate and comprehensive effort to redraw the lines between the state-directed people’s economy and the largely unregulated market economy, implemented through changes in the financial system, rules governing the activities of markets and enterprises, ideological appeals to and coercive mobilization of labor, and enforcement through the state security apparatus. Precursors to this effort in the past year were the 150- and 100-day campaigns of labor mobilization, sporadic efforts to curtail market activities, and increasing criminalization of market economic activities.¹

The language of the New Year’s editorial describes the economic policies and the measures that are being taken to implement them in terms that clearly are intended to reassert the legitimacy and control of the Korean Workers’ Party (KWP) over the people’s economy: “Now, based on the brilliant achievements of the great revolutionary upsurge, the Party is unfolding unprecedentedly grand plans and operations to bring about a decisive turn in the people’s standard of living.” This is explicitly tied to the 65th anniversary of the creation of the KWP in October 2010. From its inception, the legitimacy of the KWP has been rooted in its claim to deliver welfare for the people, principally through the public distribution system (PDS) covering both food and basic consumer goods. In 2005, at the time of the 60th anniversary of the KWP, the first steps were taken to attempt to roll back the market reforms introduced in 2002–03, with the effort to ban the sale of rice in the markets and reinvigorate the role of the PDS for grains. This 2005 initiative ultimately failed, as various ways were found to circumvent the directives from the state and the grain markets continued to thrive and grow. An interesting contrast with the present initiatives is the retention of the role of farmers markets for food distribution while suppressing general consumer goods markets.

The centrality and ideological framing of the KWP in the New Year’s editorial also needs to be assessed in

the context of the formalization of military-first politics in the constitution and the removal of references to socialism in the changes adopted in April 2009 by the Supreme People’s Assembly. The National Defense Commission seems now to be the preeminent policy-making body in the government and firmly in charge of the cabinet as well as the military organs of the state. The effort to reassert the socialist state-directed economic system under the guidance of the KWP at first glance seems contradictory to the potentially more pragmatic policy directions embodied in the revised constitution.

One possible explanation is a continuing effort to segment the military economy and court economy from the people’s economy. Recent reports of efforts to attract foreign investment in mining from China and Europe, explore joint projects with South Korean companies, and pursue military sales abroad despite UN sanctions reinforce the view that North Korea seeks to strengthen the economic power of the military and governing elite through both licit and illicit centrally managed foreign exchange-earning activities. These efforts may have been perceived as threatened by the self-interested motives of traders and officials benefiting from the expanding wealth-making opportunities in the markets for consumer goods and intermediate industrial goods. Indeed, the expansion and diversification of markets most likely have undermined the traditional segmentation of the military, court, and people’s economies, as both enterprises and households have responded to market incentives and diverted resources and loyalties away from the military and court economies toward private gain.

Widespread corruption has been a significant by-product that also undermines the ability of the leadership to maintain control of its own agenda. The full-scale attack on markets and private wealth generation can thus be understood as motivated less by an ideological attachment to old-style socialism and more by the perceived need to retain the traditional political economy that concentrates accumulation of wealth and economic power in the hands of the governing elite. The threat to this system by the expanding market economy finally crossed a red line of tolerance. It is

1. For a detailed discussion see Stephan Haggard and Marcus Noland, “The Winter of Their Discontent: Pyongyang Attacks the Market,” Policy Brief no. PB10-1 (Washington, D.C.: Peterson Institute for International Economics, January 2010).

telling that, despite the enshrinement of military-first politics, the KWP and cabinet, not the military or National Defense Commission, have been put in the driver's seat for this anti-market drive and will also take the blame if the effort fails and popular discontent forces changes in policy.

Other motivations for the reform initiatives include rationalizing the out-of-kilter pricing between the formal and informal economies, reducing inflation, and providing an income boost to workers, which altogether would be welcomed by the general working population and facilitate expanded trade and investment with other countries. These are valid economic objectives, and the timing of implementation may well have been linked to the leadership succession process to build support for the emergence of the next generation of the Kim dynasty in leadership and associating it with the new economic management policies. Both the economic and political motivations are understandable, but the design of the measures and implementation success required a degree of sophistication that is lacking in North Korea's policymaking circles.

Thus, this experiment in reform of economic management seems like a high-stakes gamble for the legitimacy of the KWP and, indeed, the regime itself. The early track record is not promising. Instead of the KWP being perceived as the benefactor of social welfare, it is now increasingly seen as the destroyer of personal savings and threatening the security of the household. The implementation of the currency reform in December 2009 encountered strong popular resistance and had to be modified through a series of concessions to households and enterprises. Instead of taming inflation, it rapidly resulted in hoarding, flight to foreign currencies, accelerating inflation, and sharp depreciation of the *won* in the black market. There are also reports of return to barter trade stemming from price volatility and uncertainty. The rise in purchasing power for farmers, miners, and state industrial workers from the currency and price reforms that was intended

to offset the losses to traders in the markets has been short-lived.²

Even the elite and powerful are not immune from this reframing of the relations of the state to the household. The ban on possession and use of foreign currency, if implemented to the letter of the law, will destroy the wealth of an economically powerful segment of society. More likely it will drive this group to hoard and hide, waiting for a better day. The early resumption of coercive labor mobilization in the rural areas and crackdowns by the security services on public resistance to the new rules will only reinforce a redefined social contract between the state and the people that would seem to be a far cry from the promises of radical improvement of the welfare of the common people promised in the New Year's editorial. Confusion and anger are outcomes that will not endear the people to the KWP, the cabinet, or the next regime leader. Indeed, reports of the sacking of leading officials and uneven implementation and enforcement of the reforms indicate that popular resistance is already having an effect.

Another contributing factor to the likely failure of these reform initiatives is financial incompetence. Quite apart from political motivations, the North Korean leadership and senior policymakers do not seem to have made any serious effort to understand money and how to manage it. Historically, North Korea has been one of the least monetized economies in the world.³ This is anachronistic today, as all of North Korea's economic relations are with market economies, including particularly China, and as the domestic economy has evolved in essentially unmanaged ways financially for the past decade as it has legalized and tried to incorporate markets in the domestic economic system and expand foreign investment and trade.

Despite education and training efforts—mainly by Europeans in recent years—to expose North Korean officials to modern financial practices,⁴ managers of

2. "Public Sentiment Worsens over Market Closure," *North Korea Today* (Good Friends), no. 326, January 2010.

3. Nicholas Eberstadt, "North Korean Money Troubles," *Wall Street Journal*, January 11, 2010.

4. For a good discussion of these efforts, see Bernhard Seliger, "Engagement on the Margins: Capacity Building in North Korea," *Korea's Economy 2009* (2009): 67.

the North Korean economy have not addressed the basic policy and institutional issues needed to build a modern financial system that will serve domestic economic development and integration with the international economy. This involves both mobilization and efficient use of domestic savings through taxes and the banking system and the attraction and use of foreign savings through official development assistance and foreign direct investment. Despite socialist ideology, capital matters; and North Korea is starved of capital for economic development. This poses a fundamental obstacle to attainment of the economic goals that the state has set for a strong and prosperous nation by 2012.

In the implementation of the recent currency reforms, the role of bank deposits seems to have been given some attention, as permission has been given to convert a much larger amount of local currency held in bank accounts than was given to convert cash. This suggests that the aim is not just to destroy private wealth *per se*, but to gain more control over monetary assets and promote the potential role of the banking system for domestic savings mobilization and macroeconomic management. Apart from state enterprises using the banking system for interfirm payments, however, it is hard to imagine in the present environment either enterprises or households choosing to hold savings in bank deposits in domestic currency if it is at all possible to hold assets in forms more likely to retain value and less vulnerable to government expropriation. In the foreign currency reform, no attention so far has been given to the possibility of reintroducing foreign exchange certificates or setting up a multiple exchange rate system to create incentives for foreign trade and investment in the foreign exchange regime, although there may well be further steps taken in this area.⁵

Anticipation of progress in the security arena and relations with the United States envisaged in the New Year's editorial bring with them expectation of an infusion of finance, whether this comes from the bargaining for denuclearization or an improvement in the environment for development assistance and

foreign investment. The prospect of such an infusion poses challenges for North Korea, as any such transfers will require adherence to international standards for administration and transparent reporting on uses of funds. The mechanism that has been chosen to respond to these challenges is to set up a state development bank under the guidance of a new entity, named the Taepung International Investment Group, established by the National Defense Commission.⁶ This group will serve as an external economic coordinating body with representation on the board of directors from the National Defense Commission, Korea Asia-Pacific Peace Commission, the cabinet, and the Ministry of Finance. It can be expected this new group will evolve into a major new player in North Korea's efforts to attract and control foreign finances for economic development. Because the board includes representatives from the military, the KWP, and the cabinet, it also represents the first organized effort to integrate financial management across the people's, the military, and the court economies. Whether this will lead to systemic change in the financial system or is just a way to direct and supervise funds coming from abroad linked to the security negotiations process will have major consequences for the future path of modernizing the North Korean economy as a whole.

While North Korea is actively preparing for an infusion of foreign capital from an improving external political environment and is seeking foreign investment and increased trade from South Korea and China in any case, regardless of progress on the nuclear talks, the recently announced ban on imported consumer goods and efforts to deepen domestic value-added in natural resources exports will likely depress, not increase, foreign investment in the short term. Furthermore, the currency reform as it has been designed and implemented coupled with the ban on possession and use of foreign currencies and curtailment of markets are likely to add to the challenge of mobilizing and allocating efficiently resources for economic growth. It is doubtful the KWP will find a practical way to raise productivity and household incomes in the situation they have created. Thus, despite the comprehensive efforts

5. For a good discussion of issues and options in the foreign exchange regime, see Rudiger Frank, "Hard Currency and Socialism: The Ban on Foreign Exchange in North Korea," *Nautilus Policy Forum Online*, 8 January 2010.

6. Korean Central News Agency (KCNA), 20 January 2010.

now under way to change the economic management system, the path toward modernization of the North Korean economy seems rocky, indeed, and fraught with potential for failure to achieve desired results.

Indeed, belated recognition that the currency reform and market suppression initiatives failed to achieve the intended economic and political results has led to reports of public apologies on the part of senior Cabinet officials, uneven implementation of the market suppression directives, and indications of relaxation of some foreign currency rules. Rolling back on these reforms will not be easy, as the damage to the credibility of the government and adaptive steps already taken by households to protect their own interests militate against any return to the prior status quo. How well the leadership manages to balance its declared political and ideological objectives with regaining public trust and support and reshaping an economic strategy that will deliver on the promises of the New Year's editorial will be a major challenge over the coming weeks and months.

An Alternative Vision for Modernization of the North Korean Economy

Kim Jong-il appears to have made a bad choice, but there is an alternative. A reversal of course could also lead to a reversal of fortune. The main elements of the alternative course are:⁷

- Encouraging expansion of markets and decentralized decision making by enterprises, collective farms, households, and local governments;
- Supporting adoption of appropriate regulations for enterprises, banks, and markets in a mixed economy and refocusing the PDS on providing social safety nets for vulnerable groups such as the elderly and disabled;
- Promoting more transparency, openness, accountability, and systemic integration while reversing secrecy and fragmentation that protect inefficient and unacceptable practices; publishing economic and financial statistics would be a major step as

would adherence to international norms in public accountability such as audits and independent scrutiny of decision making;

- Supporting development of a rules-based financial system and credible legal enforcement system to support trade and investment, while deterring money laundering and illicit transactions;
- Encouraging development of a business culture based on internationally accepted commercial practices, such as honoring contracts, while resisting corruption and rent seeking;
- Supporting expansion of opportunities for knowledge sharing for modernization, mutual learning, and trust building; and
- Supporting the younger generation's gaining access to knowledge and relationships that reinforce their confidence in building a better future.

Such an agenda coupled with the legitimate national aspirations outlined in the New Year's editorial could form the basis for a cooperative economic relationship with the international community. Although North Korea would understandably be focused on mobilizing financial assistance, knowledge engagement would be a high priority, both to reinforce the motivation to proceed with reforms that would be feasible and desirable and also to improve capacity to implement new policies and practices. Workshops, study tours, training, and academic exchanges would all contribute to this process. Technical assistance, joint studies, and demonstration projects would also be important ways to build cooperative working relationships and trust and to set the stage for larger and more complex activities. Without such efforts, finance funneled to North Korea would not likely be used in the most productive ways or leverage impact of needed policy reforms.

Implications for Future Engagement Strategies

A recent task force report makes the case for expanded and long-term economic engagement with North Ko-

7. For a full discussion, see Bradley O. Babson, "Transformation and Modernization of North Korea: Implications for Future Engagement Policy," October 2009, www.nautilus.org/DPRKPolicy/Babson.pdf.

rea, regardless of the pace of progress on the security issues, under the belief that this would foster gradual reform toward a more market-friendly economy and opening up.⁸ In light of the new economic developments inside North Korea, a high priority should be to establish dialogue between economic and financial experts from market economies and North Korean economic officials and academics, so the North Koreans can better understand the logic and practical consequences of the policies and measures that North Korea is now pursuing and to provide ways to exchange views on the issues. Although it is not likely that the North Korean leadership will change course in the short term, it would be desirable to provide officials responsible for the economy with knowledge and advice that might influence the internal policy debates that take place within the North Korean government and strengthen capacities for market economic management to encourage confidence in rebuilding a role for market mechanisms. Also, because the New Year's editorial embraces the goal of improved relations with the United States through a permanent peace regime and eventual denuclearization, some process of engagement on the security issues can be expected. Any such process will need to include discussions of economic relations and assistance. These now need to take into account the new arrangements and internal dynamics that have been set in motion in recent weeks.

Future engagement in the context of the six-party-talks process will need to address some practical questions of how to approach the economic issues:

- Timing and triggers for removal of economic sanctions;
- Agreements on the scale, modalities, timing, and sources of economic assistance linked to the denuclearization process; and
- Setting new rules of the game for providing development assistance and foreign investment in the context of a more general peace agreement.

It is likely that this agenda will require substantial technical input from economic and finance experts.

The Energy and Economic Assistance Working Group will need to consider new membership, the establishment of technical advisory groups to assist in devising sensible answers to these questions, or both of these initiatives. Track-two meetings of experts could also help to clarify issues and build consensus for approaches to be discussed at the official level.

Another issue needing to be resolved is the overall strategy for economic assistance. One is a gradual road-map approach, with discrete phases based on technical and economic logic as well as explicit political criteria. One benefit of this is to provide incentives for sequenced steps in reaching denuclearization and a peace regime. Another is the ability to adapt the road map to build in learning from experience as the process unfolds. It would be important in this strategy not to move the goal posts for political reasons, as this would serve only to reinforce mistrust, whereas the strategy should be anchored in trust building.

An alternative is a version of the grand-bargain strategy proposed by President Lee Myung-bak of South Korea. Here the basic elements of a multidimensional bargain would be agreed up front; they would cover denuclearization and peace-regime objectives as well as North Korean economic modernization and integration in the international economy. Although the contours of a grand bargain may be possible to articulate, the details of any agreement and implementation pose conceptual as well as practical challenges that have not yet been well articulated. The recent initiative of the North Koreans to reshape their approach to economic management will complicate any effort to pursue a grand-bargain strategy, at least in the short term. The attack on the markets makes inter-Korean economic integration a more distant dream, and the foundations for a bargain on terms that would be mutually agreeable for economic systems moving in opposite directions would seem fragile at best. A more practical strategy may be to seek first to stem the tide of anti-market policy measures and then attempt to reverse the policy by identifying practices that would make this less threatening and more acceptable to the North Korean authorities. A second phase would then aim to help put in place an economic system as well

8. "North Korea Inside Out: The Case for Economic Engagement" (Asia Society Center on U.S.-China Relations and University of California Institute on Global Conflict and Cooperation, December 2009).

as a development plan that can be supported internally and externally that might be more conducive to a grand-bargain approach. In any case, a significant expansion of dialogue among economic and finance experts would be needed to work out feasible and acceptable solutions.

Regardless of the strategy chosen for engaging North Korea on economic issues, questions of coordinating positions and division of labor among the six-party countries and also other international economic players, such as the UN development agencies and international financial institutions (IFIs), will need to be addressed. The future role of the UN Development Program (UNDP) in particular needs to be clarified, as it prepares a new three-year program of assistance and puts into operation new arrangements for conducting development assistance activities inside North Korea. If international economic cooperation does expand, then development assistance coordination mechanisms will need to be put in place both within the North Korean government and among the donors. UNDP's role in supporting this will be important.

The potential entry of the IFIs into this equation is another factor that needs consideration. These institutions could play a critical role in assessing North Korea's recent policy choices and experience in implementing them. They can also provide politically neutral advice and technical assistance in charting a new path forward that can help North Korea move toward modernization of the economy in a way that can work both internally and be supported internationally.

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