

North Korea's Economic Reforms and Security Intentions

Testimony of Dr. Victor D. Cha
Associate Professor of Government and D.S. Song Chair in Asian Studies
Georgetown University

Committee on Foreign Relations Committee
United States Senate
March 2, 2004

Senator Lugar and distinguished committee members, I thank you for the opportunity to testify again before your committee. I have been asked to comment on the status of North Korea's economy. I do this not as an economist but as a political scientist, and therefore may be ill-equipped to answer specific microeconomic questions about the North's reforms. Nevertheless, I hope I can offer some political judgments about the likely success of these reforms. In particular, I will try to shed light on complex relationship between these economic reforms and the path toward a peaceful resolution of the nuclear weapons dispute with Pyongyang. My brief remarks here summarize written testimony that I respectfully request be submitted for the record.

Overview of North Korea's Economic Reforms

The July 2002 market liberalization reforms undertaken by North Korea are generally associated with four measures. The first is a basic monetization of the economy. The government abolished the coupon system for food rations, relaxed price controls, thereby allowing supply and demand to determine prices. In order to meet the rise in prices, the government also hiked wage levels – for some sectors by as much as 20-fold [110 won/month to 2000 won/month, and for other “special” wage sectors by as much as 60-fold (government officials, soldiers, miners, farmers)]. Small-scale markets have sprouted up all over North Korea and the public distribution system has broken down.

Second, the government abandoned the artificially high value of the North Korean won, depreciating their currency from 2.2 won to \$1 US to 150 won to \$1 US. This measure was aimed at inducing foreign investment and providing export incentives for domestic firms. The “unofficial” value of the currency has depreciated further since the reforms (some estimate 700 won or even lower).

Third, the government decentralized economic decisions. Measures entailed cutting government subsidies, allowing farmers markets to operate, and transplanting managerial decisions for industry and agriculture from the central government into the hands of local production units. Enterprises have to cover their own costs. Managers have to meet hard budget constraints.

Fourth, the government pressed forward with special administrative and industrial zones to induce foreign investment. The Sinuiju Special Administrative District is a proposal

for an open economic zone for foreign businesses designed to exist completely outside DPRK regular legal strictures. The Kaesong Industrial District is another project designed in particular to attract small and medium-sized South Korean businesses, and the Kumgang Mountain site provides hard currency from tourism. All three projects sought to avoid the mistakes and failures of the first Rajin-Sonbong project attempted by the North in 1991, although these projects are still hampered by the lack of adequate infrastructure among other problems.

Significance

There is no denying the significance of the July 2002 reforms. They represent the first attempt in the regime's history at widescale economic change. In addition, while DPRK propaganda still maintains anti-capitalist rhetoric and spurns market economic principles (unlike the cases of China and Vietnam), the regime now admits flaws in the socialist style economy as the source of the problem rather than blaming its economic woes on outside actors.

“...the socialist economic management method is still immature and not perfect....If we stick to this hackneyed and outdated method, which is not applicable to the realities of today, then we will be unable to develop our economy.”¹

By decentralizing decisions, and separating the local economy from the central economy, local governments and counties can set their own production levels and prices, which encourages competition. State-owned enterprises have incentives now to meet government production targets and then sell surplus on the open market for profit.² Visitors to North Korea note a new, albeit limited, spirit of entrepreneurship. Caritas and other international relief organizations report makeshift small-scale markets with kiosks selling drinks, cigarettes, and cookies as the public distribution system has basically broken down.³

Dangers

The fact that these reforms are significant does not, however, make them successful. The obstacles to success are many; allow me to delineate three of the more prominent ones. First, one should not interpret the July 2002 measures as the equivalent of North Korea's religious “conversion” to capitalism. Neither the language nor the nature of these initial reforms appear to have the same conviction of those seen in China or Vietnam. Moreover, many of the reforms arguably are situationally- rather than dispositionally-motivated – i.e., they constituted coping mechanisms to deal with immediate problems

¹ Editorial Comment, *Rodong Shinmun*, November 21, 2001.

² Marcus Noland, “West-Bound Train Leaving the Station: Pyongyang on the Reform Track” October 14-15, 2002 <http://www.iie.com/publications/papers/noland1002.htm> accessed February 25, 2004.

³ “NK Embarks on Initial Phase of Market Economy,” *Korea Update* Vol. 14, No. 10 (September 30, 2003)

rather than a wholesale, prescient shift in economic ideology. Pyongyang authorized monetization of the economy and authorization of farmers markets to buy and sell goods, for example, largely because the public distribution system had broken down. Similarly, local managers were given more leeway not because the central government “trusted” their entrepreneurial capabilities, but because plunging outputs and high absentee rates for workers required some drastic measures.

Second, the economic reforms will test the government’s ability to deal with the triple horns of inflation, economic losers, and urban poor created by the monetization of the economy. Low supply and low output have led to massive increases in prices and further devaluation of the won. By comparison, in 1979 China’s initial price reforms drove up the price of rice by 25 percent. In North Korea, the price has gone up by at least 600 percent, and the won has depreciated from 150 won (to \$1 US) to at least 700 won.⁴ The reforms probably enabled Kim Jong-il to gain control of the economy by hurting those black marketers who held large amounts of won before the currency devaluation, but fixed income workers have been badly hit by the rise in prices. In addition, there are many workers being laid off by companies forced to cut costs. Finally, there is fragmentary evidence that even those sectors of the labor force favored with the largest wage hikes (6000 won) are discontented. Defectors coming across the Chinese border complain that the promise of higher wages has not been kept, with workers receiving only 800 won and then nothing after October 2003.⁵ The upshot is that “money illusion” is quickly wearing off in North Korea, giving way to a new class of urban poor, potentially numbering in the millions that could be difficult to control.

Third, the ultimate success of the reforms rests on the North’s capacity 1) to secure international food supplies until the reforms start to increase agricultural output domestically; 2) to secure loans to finance shortages in cash-flow for managerial enterprises; and 3) to obtain technical training in accounting, fiscal policy, finance and other requisite skills.⁶ The North’s ability to secure this magnitude of help will depend on a satisfactory resolution of the nuclear crisis (the relationship between the economic reforms and North Korea intentions on the nuclear program is discussed below). In the interim, however, Pyongyang has been able to muddle through with the help of aid from China and South Korea. North Korea needs to meet the upward pressure on prices created by the reforms with either increased production (not feasible yet) or increased imports. The growth in North Korean imports over the past two years has largely been financed by aid inflows from Seoul and Beijing. As Nicholas Eberstadt argues, Chinese aid goes beyond what is publicly reported, with the best indicator probably being the

⁴ Oh Seung-yul, “Changes in the North Korean Economy: New Policies and Limitations,.” in *Korea’s Economy 2003*, Korea Economic Institute, Washington DC, 2003, pp. 74-76; *Transition Newsletter* World Bank at www.worldbank.org/transitionnewsletter/janfebmar03/pgs1-6htm Accessed February 25, 2004. For more extreme estimates as high as 50,000 won to \$ 1 US, see *Asia Times* October 22, 2003 (Jamie Miyazaki, “Adam Smith Comes to North Korea”) <http://www.atimes.com/atimes/Korea/EJ22Dg01.html> accessed February 25, 2004.

⁵ *Transition Newsletter* World Bank at www.worldbank.org/transitionnewsletter/janfebmar03/pgs1-6htm accessed Feb 25, 2004.

⁶ Ruediger Frank, “North Korea: Gigantic Change and a Gigantic Chance Nautilus Policy Forum Online, May 9, 2003 http://www.nautilus.org/fora/security/0331_Frank.html accessed February 25, 2004.

trade deficit between the two countries: “The DPRK’s seemingly permanent merchandise trade deficit with China actually constitutes a broader and perhaps more accurate measure of Beijing’s true aid levels for Pyongyang (insofar as neither party seems to think the sums accumulated in that imbalance will ever be corrected or repaid).”⁷ In addition to Chinese aid, the North has received easily over \$1 billion in aid from South Korea, over 1 million tons of food from Japan, and over \$ 1 billion in aid from the United States since the mid-1990s. Indeed, these aid “revenues” have probably constituted the most successful part of its economy today.

Perhaps the most interesting discussions about North Korea’s economic reforms are the political questions and judgments they instigate rather than the success of the reforms themselves.

Rich Nation, Strong Army?

First, do these economic reforms constitute North Korea’s primary path out of its current decrepit state? In other words, do the nature of these reforms – on a grander scale – promise the Kim Jong-Il regime its stated goal of “kangsong taeguk” or rich nation/strong army? I answer this question not as an economist but as a political scientist when I say that I do not believe such a goal is achievable. My pessimism stems not so much from the flawed nature of the reforms (flawed as they are), but from the larger political lessons that history has taught us about closed regimes that attempt such reforms. Kim Jong-Il, like many totalitarian leaders before him, faces a fundamental and almost inescapable reform dilemma – he needs to open up to survive, but in the process of opening up, he unleashes the forces that lead to the regime’s demise. Resisting the system in North Korea today is virtually impossible because the society is so closed. The masses are preoccupied with basic subsistence. And the elite seek only to ensure their relative share of the sparse gains that could be had from the system rather than contemplating a change of it. Any opening begins to generate a spiral of expectations and inexorable forces for change – the overturning of systems like North Korea occur not when things are at their absolute worst, but when they begin to get better.

Arguably, the first step in this direction was taken with the July 2002 price reforms. These reforms have affected a much wider swath of society (in terms of inflation, currency value, etc.) than a closed off special economic zone. Hence, what is good economically for North Korea may be bad for the Kim Jong-il regime. Could the DPRK leader hold things together as he seeks economic reform? History’s wastebin is littered with other similarly-intentioned dictators.

Time on Whose Side?

Another question raised by the DPRK’s economic reforms – in combination with international relief aid – is whether they suffice in providing the regime enough resources to continue muddling through. The public policy debate on North Korea implicitly refers to this as the “time is on whose side?” question. Some believe time is on the side of the United States and allies as it can simply wait out the DPRK regime, applying constrictive

⁷ Nicholas Eberstadt, “North Korea’s Survival Game,” unpub. paper, presented at the AEI- *Chosun Ilbo* meeting, February 12-13, 2004, Washington DC.

measures like the proliferation security initiative, thereby slowly allowing the regime to collapse of its own weight. Indeed, some estimates put the DPRK's revenues from missile sales and illicit activities at nearly one-tenth their former value as a result of PSI measures. Others believe time is on the side of the North Koreans as Pyongyang feels no pressure (diplomatic or otherwise) to stop building their nuclear weapons programs while they continue to subsist on international goodwill and contributions to their "aid-based economy." Proponents of the former view implicitly believe that the US objective is regime change. Proponents of the latter view believe the North Korean objective is to become the newest nuclear weapons state.

The answer to this question, in my opinion, is somewhere between these two extremes and is entirely dependent on tactics (rather than the goals of the US and DPRK). Whose side time is on depends *not* on the success of Pyongyang's economic reforms but on the unreported aid that continues to flow from South Korea and China to the North. North Korea can continue to muddle through in the face of international donor fatigue, the complete cessation of humanitarian aid from Japan, and other aid sources as long as Seoul and Beijing continue to aid North Korea. Reliable numbers on South Korea's unreported aid are difficult to come by. Since 1995, the ROK Unification Ministry estimates that \$2.4 billion in aid has been provided to North Korea by Japan, the US, South Korea, the EU, and the UN (food, fertilizer, medicine, and fuel oil). But one suspects that there is another story behind the official statistics. As one long-time international aid worker very familiar with North Korea put it figuratively, "North Korea has its own "911" number --- access to state-of-the-art health care, agricultural support, and aid...and that number rings in Seoul."⁸ In the case of China, it has been reported that Beijing provides some \$470 million in aid annually to North Korea, amounting to 70-90 percent of fuel imports and 30 percent of grain imports.⁹ China has reportedly increased shipments of corn and wheat in early 2003; and last fall during the visit of Wu Bangguo reportedly offered \$50 million in aid. Japanese media reported that the aid was nominally for a glassworks plant, but Pyongyang could spend the aid at their discretion.¹⁰ China has also increased trade in 2003 with NK by nearly 40 percent according to the Korean International Trade Association. North Korean fuel imports from China rose 53.2 percent to \$187 million reflecting the end of US shipments of HFO. If these aid inflows were to cease or constrict in any way, North Korea would feel significantly more pressure in the status quo than they do now despite the activities of the PSI.

Economic Intentions, Security Preferences?

The economic reforms, regardless of their ultimate success, are significant for the political debate over North Korea. Many argue that the unprecedented and far-reaching nature of the reforms demonstrate North Korean intentions to seek integration into the international community, to receiving engagement by the US and allies, and to trade their

⁸ Off-the-record comments by international relief worker.

⁹ Pan, Philip P. "China Treads Carefully Around North Korea," *Washington Post*, January 10, 2003, p. A14.

¹⁰ Michael Chambers, "Managing a Truculent Ally: China and North Korea, 2003," unpub. Manuscript, Fairbank Institute, Harvard University, February 23, 2004; "China's Top Legislator Meets DPRK premier," Beijing Xinhua, October 30, 2003; "China to Provide Grant-in-aid to DPRK, Pyongyang KCNA, October 30, 2003; International Herald Tribune, Jan 12, 2004;

nuclear programs for help from the outside world. The danger of fixating on the economic reforms, however, is that we may be attributing much more to North Korean security preferences than exist in fact. There is no logical link between DPRK desires to reform on the economic front and a change in their security intentions. To seek economic reforms *and* pursue a ramping up of national power through nuclear weapons and ballistic missiles is not only plausible, but also fully consistent with the concept of “rich nation, strong army.” This is not to deny that there could be economic arguments for pursuing WMD programs to augment/replace their conventional military. But the point is that the DPRK could divorce its economic intentions from its security preferences. Economic reform does not necessarily mean they are equally interested in trading away their nuclear weapons – a common and mistaken assumption made by many analyses of the economic reforms. Pyongyang could, in fact, want to have its cake and eat it.

The Stakes for North Korea and the “Libya model”

Perhaps the most important lesson of studying North Korea’s economic reforms is the simple and most parsimonious one – the stakes are not only high, but the survival of the regime hinges on their success. In this sense, the stakes for North Korea in terms of potential gains are arguably even higher than those experienced by Libya. Libyan leader Gaddafi’s announcement to allow unconditional international inspections and disarmament of the country’s nuclear programs in return for the promise of international support has elicited many observations of how different the North Korea and North African cases are. Gaddafi’s ear was had by a group of open-minded reformists (including his son). Secret negotiations through the British – and outside any inter-agency process – took place for years before an agreement. And as North Koreans are fond of saying, Libya did not yet have nuclear weapons when it agreed to dismantlement.

Despite these differences, there are a number of striking similarities between the two cases. Both countries had very hostile relations with the United States. Both initially sought nuclear weapons, not for the purpose of trading them away, but for the purpose of keeping them. Both suffered from international sanctions and pariah status for years. Moreover, Libya was an active supporter of terrorism more recently than North Korea. And the United States actually attacked Libya, followed by a period of UN sanctions, neither of which have occurred yet in the North Korea case. Given these comparisons, arguably Libya’s turnaround was a *harder* case than that of North Korea. The fact that North Korea may already have nuclear weapons (i.e., compared with Libya’s potential capabilities) is immaterial to the comparison. As noted, both countries pursue WMD for the purpose of keeping them initially. It was only after a period of compellent sanctions that Tripoli made the critical calculation that moving in the direction of nuclear weapons made the regime less, not more secure. This is the same compellent challenge I believe we face with North Korea.