North Korea's Halfway Reform Goes Awry

The first results are coming in, and they don't look good. The timid efforts of the North Korean leadership to streamline the economy through price and wage increases brought little relief: the economy is in a shambles. In an effort to find a way out, the Pyongyang leadership is playing the nuclear card and hopes to get more assistance from abroad. South Korea seems ready to go along, as it wants to avoid paying the bill for a sudden collapse of the North Korean regime and the consequent reunification of the country. It learned its lesson from Germany.

In October 2001 a memo from North Korea’s leader, Kim Jong II, quietly filtered through the North Korean bureaucracy. "State subsidies should be removed," the North Korean leader wrote. In essence, Kim urged embracing—if ever so reluctantly—a market economy.

The deteriorating situation in North Korea helped spur the economic shift. The outdated state controls had paralyzed the economy. Before July the government had paid farmers less than one North Korean won for a kilogram (2.2 pounds) of rice, then "sold" it in the public distribution system for 1/10th of that price—virtually a free system. But the rationing system could not provide enough food, so families were forced to buy more rice on the black market at 40 to 50 won per kilogram, almost half of an office worker’s monthly salary, as set by the state (in the black market $1 now equals 700 North Korean won).

Shift Out of Desperation

On July 1, 2002, workers suddenly saw their wages increase 20-fold. At the same time the official price of rice rocketed to 550 times the old nominal price. The rationing system, for years central to workers’ survival, shrank. Bills for rent and utilities—until that time paid by the state—suddenly arrived on their doorsteps. "We are reactivating the whole field of the national economy," Kim Yong Nam, head of North Korea’s Supreme People’s Assembly, told UN officials.

The July policy shifts suddenly bumped the price paid to rice farmers to 40 won per kilogram to stimulate them to grow more, and the government now sells the rice at 440 won per kilogram to citizens, ending the state subsidy. To make the sales possible, the government boosted monthly wages from 110 won to 2,000 won for an average office worker. Physical laborers now get even higher wages, up to 6,000 won per month for such tough work as coal mining. Schooling, medical care, and child care will still be free. The authorities said that they would continue the food ration distribution system for families without wage earners, which now amount to a significant number in a country where hundreds of thousands have died from starvation.

The government has also readjusted the value of the won from an artificially set rate of 2.15 won per dollar to 150 won per dollar. It has loosened some restrictions on foreign ownership in joint business ventures and has declared that local governments, local party structures, and factory managers will have more decision-making authority, though overall planning will remain in the hands of the central government.

How enterprises could pay higher salaries if they cannot make a profit is not clear, especially considering the depleted infrastructure, the limited availability of electricity, the broken
transportation systems, and the exhausted and unfertilized farmland. Even if enterprises wanted to take advantage of new market opportunities, they were unable to produce more goods. "They wanted to redirect material from the black market to the official system, but without price liberalization they couldn’t maintain it. If the measures they’ve taken are the last ones of reform, it’s doomed to fail, but if they are a start, then there is hope," predicted Oh Seung Yul, an economist and director at the Korea Institute for National Unification in Seoul a government-sponsored center that studies North Korea, last summer.

Economic Implosion?

According to the latest reports the half-measures worsened rather than improved the situation. Because they were unmatched by supply-side measures to boost output, the drastic price and wage increases of last July are proving inflationary, for example, the price of rice jumped 50 to 300 percent between November 2002 and January 2003. The country’s already low standard of living is deteriorating rapidly as economic activity dries up notes a new report by the Hong Kong and Shanghai Banking Corporation (HSBC). The report says that the rhetoric of Pyongyang’s nuclear confrontation with the United States has masked the real issue, which it says is the North’s economic implosion. "With international donations of food and energy drying up and limited scope for market-based reforms to work, this is a system battling against the clock," it said. It warns that the risk is rising that if the North collapses, South Korea will face the turmoil of an unplanned reunification, with all the attendant social and economic costs. The HSBC concludes: "The unprecedented squeeze on resources, with no sign of a way out, meant the risk of unplanned and earlier-than-expected reunification had risen."

The bank, which based its report on a visit to North Korea by one of its Hong Kong-based economists, says it believes the North is gambling on negotiating a nonaggression treaty with the United States that would allow Pyongyang to downsize its army and shift resources to the civilian economy. "North Korea only has one domestic option to fix its economy—mass demilitarization," said HSBC. North Korea has more than a million men and women under arms, one of the largest standing armies in the world. Even as Kim Jong Il ratchets up nuclear tension on the Korean peninsula in the hope of wringing concessions from the United States, the crisis over food and energy supplies is worsening according to the HSBC report.

In November 2002 the board of the Korean Peninsula Energy Development Organization (made up of Japan, South Korea, the United States, and the EU) decided to suspend sending heavy fuel oil to North Korea, thereby reducing North Korea’s electricity generation capacity by more than 6 percent. Under a 1995 agreement the Korean Peninsula Energy Development Organization agreed to supply the North with 500,000 tons of heavy fuel oil a year in exchange for Pyongyang freezing its nuclear program until light-water reactors promised under the deal had been constructed. Deliveries came to an end after North Korea said in October that it had continued its nuclear weapons program in secret since 1994. The HSBC report says the supply of electricity for heating has dropped by 31 percent in recent months.

The World Food Program, which aims to feed 28 percent of the North Korean population—or 6.4 million people—in 2003, says that from pledged commitments so far it expects to meet only 14 percent of its goal. In 2001 Japan and the United States were North Korea’s two largest food donors other than China, whose bilateral food donations are not monitored by the UN. Japan, however, suspended its food aid in 2002 following the admission by Pyongyang that it had abducted Japanese citizens in the past. The United States followed suit amid the nuclear tension, but has since changed its mind. U.S. Secretary of State Colin Powell announced that the United States would give North Korea at least 40,000 tons of food this year. He said it might give 60,000 tons more, with the final amount dependent on North Korea giving monitors the freedom to make sure the food reaches those in need.

North Korean refugees in China confirm this grim prognosis. "A lot of families are starving," says a 26-year-old woman who crossed the border in December according to the Wall Street Journal. North Korea’s economic decline has hastened since the reforms implemented in
July to revitalize a decrepit economy loosened price controls and awarded wage rises to offset the resulting high prices. Instead the reforms have unleashed inflation that has boosted the price of staple foods by as much as 400 percent, putting them even further out of reach of average North Koreans. Salary increases promised by the government in July to cushion the impact of higher prices have not arrived. A coal miner who crossed the border in late January to find food for his family says he was initially pleased by the reforms, which promised large pay raises to miners in recognition of the energy sector’s importance to the economy. “We were supposed to get 2,500 won a month, but we only got 800 won, and that ended in October,” he says.

The refugees’ descriptions of life inside North Korea seem to vindicate the predictions of economists who warned what would happen if Kim Jong Il did not follow July's reforms with a broader opening to outside investment. Park Su-hk Sam, chief economist at the North Korea Studies Division of the Bank of Korea, said that without bolder liberalization, inflation and reduced spending power would inevitably lead to rising dissatisfaction among North Koreans.

The North Korean won now trades unofficially at around 700 won to the dollar, according to the refugees and Chinese entrepreneurs who recently visited the North. That compares with about 200 won just after the reforms, and makes importing food and supplies even harder. Many factories ordered to pay their own way under the reform mandate have been shut down, leaving thousands of people with no way to buy food. With no raw materials, gasoline, or oil, much of what remains of North Korea’s industrial infrastructure is grinding to a halt, say Chinese officials.

China has cut back on oil supplies provided at low interest rates after Pyongyang stopped payments, according to a Chinese official who deals frequently with North Korean bureaucrats. He says the dire economic situation partly explains Kim Jong Il’s willingness to risk everything by threatening to build nuclear weapons, apparently hoping to extract concessions from the outside world. According to the official, "Kim expected big investments from the U.S., Japan and South Korea after the reforms, but they didn’t come," reports the Wall Street Journal.

**Reunification?**

Roh Moo-Hyun, the new president of South Korea, has made it clear that he will pursue his predecessor’s policy of engagement with North Korea, now referred to as the peace and prosperity policy. Seoul’s policy is based on its calculation that gradual reunification is a far less costly option than that presented by the North’s precipitate collapse.

North Korea is a huge contingent liability for South Korea. The income gap between North and South has widened in the last decade. Until the mid-1970s, the North was more industrialized and enjoyed a higher per capita income; however, South Korea has since transformed itself into a robust, advanced, industrialized democracy, with total trade in 2000 amounting to 139 times that of the North and GDP per capita around 13 times higher. In the North, agriculture accounts for 30 percent of GDP and military spending for another 31 percent.

No official cost estimate for reunification is available, but South Korea prefers a gradualist approach in the knowledge that it will have to absorb the bulk of the costs. A popular approach is to estimate net government costs based on the German case, and assuming gradual reunification. With many costs excluded, this model produces lower-end estimates in the range of $200 to $500 billion over 5 to 10 years, but the economic gulf between the two Koreas dwarfs that of pre-unified Germany, magnifying the costs. Whereas East German GDP per capita was 25 percent that of West Germany’s in 1990, North Korea’s is currently 8 percent of the South’s and the gap is widening. Moreover, while the East Germany-West Germany population ratio was 1:4, the North Korea-South Korea ratio is 1:2.

The total state and private investment required to narrow the inter-Korean income gap to 60
percent—the minimum thought necessary to prevent a mass exodus to the South after reunification—has been put at between $600 billion and $1,700 billion, or nearly four times South Korea’s current GDP. South Korea would be unable to bear these costs alone, which would swallow hundreds of billions of dollars in crisis management and rapid reconstruction of the North’s agriculture, industry, infrastructure, and social services. Sudden collapse is the worst scenario. In addition, a likely influx of refugees from the previously sealed North, estimated at up to 2 million by the German Economic Institute, would severely test the South’s absorptive capacity.

Since 1995, according to the South’s Reunification Ministry, international donors—mainly Japan, South Korea, the United States, the EU, and the UN—have contributed $2.4 billion in aid (composed of food, fertilizer, medicine, and fuel oil) to North Korea, with South Korea paying the most. Despite offering low wages (the North’s labor costs are a mere 0.6 percent of those in South Korea), its extremely difficult operating conditions, which include political uncertainty, poor infrastructure, and low profitability, have left most South Korean firms struggling to find profitable outlets in the North. The government has approved 50 cooperation projects since 1992, with only 6 new projects worth $7.3 million approved since the June 2000 inter-Korean summit. Inter-Korean trade was $400 million in 2001, barely higher than a decade ago. South-bound trade is mostly in agricultural goods, fishery products, and textiles. North-bound exports are more aid than trade. Hyundai’s tourism venture to the North’s Mount Kumgang resort has guaranteed Pyongyang royalties worth $144 million through mid-2005, but is a loss-making enterprise.

Reconnection work on the inter-Korean rail and road system was agreed on in June 2000. While the South has progressed with its track sections, work on the North’s portions, financed by Seoul, remained stalled until recently. Cross-border freight links, which are still planned to operate from 2003, would shrink inter-Korean transportation costs to one-quarter of current shipping rates. South Korea also has ambitious plans to build "iron silk roads" connecting the South Korean rail system to those of China and the Russian Far East. If the trans-Korean and trans-Siberian lines were connected, shipment times to Western Europe would halve to 20 days. Seoul’s objective to promote itself as a trade hub in Northeast Asia has met with EU support and is also likely to be of interest to Japanese exporters; however, inter-Korean relations will not prosper as long as the nuclear issue remains unresolved.

*Based on reports from Oxford Analytica, the international research group based in Oxford, U.K.; the Washington Post; the Wall Street Journal; and news agencies.*