STATEMENT OF

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HEARINGS ON

LIFE INSIDE NORTH KOREA

5 June 2003

Subcommittee on East Asian and Pacific Affairs
United States Senate

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The Democratic People's Republic of Korea (DPRK) or North Korea has been experiencing an on-going food crisis for more than a decade. A famine in the late 1990s resulted in the deaths of perhaps 600,000 to 1 million people out of a pre-famine population of roughly 21 million. Since then, a combination of humanitarian food aid and development assistance has ameliorated the situation somewhat, but according to the World Food Programme (WFP) and other observers, the country is once again on the precipice of another famine.

Given the expenditure preferences of the regime, the North Korean economy does not produce enough output to sustain the population biologically, and population maintenance is increasingly aid-dependent. Yet the October 2002 revelation of a nuclear weapons program based on highly enriched uranium (in addition to a plutonium-based program acknowledged a decade earlier), undertaken in contravention of several international agreements, and North Korea's subsequent withdrawal from the Nuclear Nonproliferation Treaty have put continued international assistance in doubt.

The situation is further complicated by internal economic policy changes initiated in mid-2002. In this regard, this testimony will make three basic points:

- Food availability is precarious, and it would not be surprising to observe increases in mortality.
- Industrial revitalization is the only sustainable solution to the food crisis.
- North Korea is likely to continue a policy of muddling through, implying a continuation of the food emergency.

Recent Developments

In July 2002, the government of North Korea announced changes in economic policy that could be regarded as having four components: marketization, inflation, special economic zones, and aid-seeking.

Marketization

With respect to food, the government has implemented a policy of increasing the procurement prices of grains (to increase the volume of food entering the public distribution system [PDS]) along with dramatically increasing PDS prices to consumers, with the retail prices of grains rising from 40,000 to 60,000 percent in the span of six months during the first half of 2002. On the supply side, the increase in agricultural procurement prices was presumably undertaken to increase the actual amount of food entering the PDS. Yet North Korean agriculture is highly input-intensive (i.e., it makes extensive use of chemical fertilizers and insecticides, electrically powered irrigation etc.), and the ultimate impact of the reforms on agricultural yields could be strongly influenced by what happens in the industrial sector. Moreover, while PDS prices have remained largely unchanged since 1 July, 2002, market prices have increased significantly, and it is unclear if the policy is having its intended effect or if farmers are diverting output to the market.

On the demand side, the government appears to be trying to ensure survival rations through the PDS--the rationing system through which most people historically obtained food--with food purchased in the market supplementing the PDS rations for those who can afford it. Some have questioned the extent to which this is a real policy change and how much this is simply a ratification of system-fraying that had already occurred—there is considerable evidence that most food, for example, was already being distributed through markets, not the PDS. But this may indeed be precisely the motivation behind the increases in producer prices--with little supply entering the PDS, people increasingly obtained their food from non-state sources, and by bringing more supply into state-controlled channels, the government can try to reduce the extent to which food is allocated purely on the basis of purchasing power. Indeed, given the growing inequality in the distribution of income and wealth within North Korea, which could be expected to accentuate differences in access to food and the already highly stressed nature of the North Korean society, it would not be surprising to observe increases in mortality rates. The state may also be motivated by broader anti-market ideological considerations as discussed below. Yet another motivation may be to reduce the fiscal strain imposed by the implicit subsidy provided to urban consumers.

In the industrial sector, the policy changes could be interpreted as an attempt to implement a Chinese-style dual-price strategy. In essence, the Chinese instructed their state-owned enterprises to continue to fulfill the plan, but once planned production obligations were fulfilled, the enterprises were free to hire factors and produce products for sale on the open market. In other words, the plan was essentially frozen in time, and marginal growth occurred according to market dictates. Enterprises have been instructed that they are responsible for covering their own costs—that is, no more state subsidies. Yet it is unclear to what extent managers have been given the power to hire, fire, and promote workers, or to what extent remuneration will be determined by the market. Moreover, there has been no mention of the military's privileged position within the economy, and domestic propaganda continues to emphasize a "military-first" political path.

The state has administratively raised wage levels, with certain favored groups such as military personnel, party officials, scientists, and coal miners receiving supernormal increases. (For example, it has been reported that the wage increases for military personnel and miners have been on the order of 1,500 percent, that for agricultural workers may be on the order of 900 percent, but the increases for office workers and less essential employees are less.) This alteration of real wages across occupational groups could be interpreted as an attempt to enhance the role of material incentives in labor allocation.

The state continues to maintain an administered price structure, though by fiat, the state prices are being brought in line with prices observed in the markets. This is problematic (as it has proven in other transitional economies): the state has told the enterprises that they must cover costs, yet it continues to administer prices, and in the absence of any formal bankruptcy or other "exit" mechanism, there is no prescribed method for enterprises that cannot cover costs to cease operations, nor, in the absence of a social safety net, how workers from closed enterprises would survive. What is likely to occur is the maintenance of operations by these enterprises supported by implicit subsidies, either through national or local government budgets or through recourse to a reconstructed banking system. Indeed, the North Koreans have sent officials to China to study the Chinese banking system, which although may well have virtues, is also the primary mechanism through which money-losing state-owned firms are kept alive.

The consensus among most outside observers is that, at this writing, marketization has not delivered as hoped. The behavior of enterprise managers appears to be similar to that observed prior to the policy changes. The jury is still out on the impact on the agricultural system, since the impact of changed incentives would not be readily apparent until the 2003 spring planting decisions.

Inflation

At the same time the government announced the marketization initiatives, it also announced tremendous administered increases in wages and prices. To get a grasp on the magnitude of these price changes, consider this: when China raised the price of grains at the start of its reforms in November 1979, the increase was on the order of 25 percent. In comparison, North Korea has raised the prices of corn and rice by more than 40,000 percent. In the absence of huge supply responses, the result will be an enormous jump in the price level and possibly even hyperinflation. Access to foreign currency may act as insurance against inflation, and in fact, the black market value of the North Korean *won* has dropped steadily since the reforms were announced. At the same time, the government apparently continues to insist that foreign-invested enterprises pay wages in hard currencies (at wage rates that exceed those of China and Vietnam). This curious policy has the effect of blunting the competitiveness-boosting impact of the devaluation by aborting the adjustment of relative costs.

Moreover, when China began its reforms in 1979, more than 70 percent of the population was in the agricultural sector. (The same held true for Vietnam when it began reforming the following decade.) In contrast, North Korea has perhaps half that share employed in agriculture. This has two profound implications: first, the population share, which is directly benefiting from the increase in producer prices for agricultural goods, is roughly half as big as in China and Vietnam. This means that reform in North Korea is more likely to create losers and with them the possibility of unrest. Second, the relatively smaller size of the agricultural sector suggests that the positive supply response will not be as great in the North Korean case as compared to China or Vietnam either. Again, this increases the likelihood of reform, creating losers and unrest.

Those with access to foreign exchange, such as senior party officials, will be relatively insulated from this phenomenon. Agricultural workers may benefit from "automatic" pay increases as the price of grain rises, but salaried workers without access to foreign exchange will fall behind. In other words, the process of marketization and inflation will contribute to the exacerbation of existing social differences in North Korea. The implications for "losers" could be quite severe. According to a WFP survey, most urban households are food insecure, spending more than 80 percent of their incomes on food.

Make no mistake about it: North Korea has moved from the realm of elite to the realm of mass politics. Unlike the diplomatic initiatives of the past several years, these developments will affect the entire population, not just a few elites. And while there is a consensus that marketization is a necessary component of economic revitalization, the inflationary part of the package would appear to be both unnecessary and destructive. (If one wanted to increase the relative wages of coal miners by 40 percent, one could simply give them a 40 percent raise—one does not need to increase the overall price level by a factor of 10, and the nominal wages of coal miners by a factor of 14 to effect the same real wage increase.)

So why do it? There are several possible explanations, but in the interests of brevity I will focus on one: namely that the inflation policy is intentional and is a product of Kim Jong-il's reputed antipathy toward private economic activity beyond state control. One effect of inflation is to reduce the value of existing *won* holdings. (For example, if the price level increases by a factor of 10, the real value of existing *won* holdings is literally decimated.) Historically, state-administered inflations and their cousins, currency reforms, have been used by socialist governments to wipe out currency "overhangs" (excess monetary stock claims on goods in circulation), more specifically to target black marketers and others engaged in economic activity outside state strictures, who hold large stocks of the domestic currency. (In a currency reform, residents are literally required to turn in their existing holdings—subject to a ceiling, of course—for newly issued notes.) In July it was announced that the blue ("foreigner's") won foreign exchange certificates would be replaced by the normal brown ("people's") won, though it is unclear if these are convertible into foreign currency. The other shoe dropped in December 2002 when the authorities announced that the circulation of US dollars was prohibited and that all residents, foreign and domestic alike, would have to turn in their dollars to be exchanged for euros which the central bank did not have. In the case of North Korea, the episode that is now unfolding will be the fourth such one in the country's five-decade history.

In yet another wheeze to extract resources from the population, in March 2003 the government announced the issuance of "People's Life Bonds," which despite their name would seem to more closely resemble lottery tickets than bonds as conventionally understood. These instruments have a 10-year maturity, with principal repaid in annual installments beginning in year five (there does not appear to be any provision for interest payments and no money for such payments has been budgeted). For the first two years of the program, there would be semi-annual drawings (annually thereafter) with winners to receive their principal plus prizes. No information has been provided on the expected odds or prize values other than that the drawings are to be based on an "open and objective" principle. The government's announcement states, without irony, that "the bonds are backed by the full faith and credit of the DPRK government." Committees have been established in every province, city, county, institute, factory, village, and town to promote the scheme—citizens purchasing these "bonds" will be performing a "patriotic deed." Both the characteristics of the instrument and the mass campaign to sell it suggest that politics, not personal finance, will be its main attraction.

The hypothesis has the strength of linking what appears to be a gratuitous economic policy to politics—Kim Jong-il not only rewards favored constituencies by providing them with real income increases and by going the inflation/currency reform route but he also punishes his enemies. This line of reasoning is not purely speculative: it has been reported that one of the motivations behind unifying prices in the PDS and farmers' markets has been to reduce the need of consumers to visit farmers' markets and to "assist in the prevention of illegal sales activities" that took place when the price in the farmers' market was much higher than the state price. A number of unconfirmed reports indicate that the government has placed a price ceiling on staple goods in the farmers' markets as an anti-inflationary device. The increase in the procurement price for grain has reportedly been motivated, at least in part, to counter the supply response of the farmers, who were diverting acreage away from grain to tobacco and using grain to produce liquor for sale.

The problem with this explanation is that having gone through this experience several times in the past, North Korean traders are not gullible: they quickly get out of won in favor of dollars, yen, and yuan, and the black market value of the won has declined steadily since the policy changes were announced. (Indeed, even North Koreans working on cooperative farms reportedly prefer trinkets as a store of value to the local currency.) As a consequence, these blows, aimed at traders, may fall more squarely on the North Korean masses, especially those in regions and occupations in which opportunities to obtain foreign currencies are limited.

Special Economic Zones

The third component of the North Korean economic policy change is the formation of various sorts of special economic zones. The first such zone was established in the Rajin-Sonbong region in the extreme northeast of the country in 1991. It has proved to be a failure for a variety of reasons including its geographic isolation, poor infrastructure, onerous rules, and interference in enterprise management by party officials. The one major investment has been the establishment of a combination hotel/casino/bank. Given the obvious scope for illicit activity associated with such a horizontally integrated endeavor, the result has been less Hong Kong than Macau North.

In September 2002 the North Korean government announced the establishment of a special administrative region (SAR) at Sinuiju. In certain respects the location of the new zone was not surprising: the North Koreans had been talking about doing something in the Sinuiju area since 1998. Yet in other respects the announcement was extraordinary. The North Koreans announced that the zone would exist completely outside North Korea's usual legal structures; that it would have its own flag and issue its own passports; and that land could be leased for fifty years. To top it off, the SAR would not be run by a North Korean but by a Chinese-born entrepreneur with Dutch citizenship, named Yang Bin, who was promptly arrested by Chinese authorities on tax evasion charges.

Ultimately, the planned industrial park at Kaesong, oriented toward South Korea, may have a bigger impact on the economy than either the Rajin-Sonbong or Sinuiju zones.

Aid-seeking

The fourth component of the economic plan consisted of passing the hat. In September 2002, during the first-ever meeting between the heads of government of Japan and North Korea, Chairman Kim managed to extract from Prime Minister Koizumi a commitment to provide a large financial transfer to North Korea as part of the diplomatic normalization process to settle post-colonial claims, despite the shaky state of Japanese public finances. However, Kim's bald admission that North Korean agents had indeed kidnapped 12 Japanese citizens and that most of the abductees were dead set off a political firestorm in Japan. This revelation, together with the April 2003 admission that North Korea possesses nuclear weapons in contravention to multiple international agreements, has effectively killed the diplomatic rapprochement and with it the prospects of a large capital infusion from Japan, as well as already dim prospects of admission to international financial institutions such as the World Bank and Asian Development Bank.

Conclusions

North Korea is into its second decade of food crisis. It experienced a famine in the 1990s that killed perhaps 3 to 5 percent of the pre-famine population. Yet remarkably little has changed since then; grain production has not recovered; and inexpertly enacted policy changes, a deteriorating diplomatic environment, donor fatigue, and an utterly ruthless government have brought the country once again to the precipice of famine.

It did not have to be this way. Morocco, for example, a country of similar size and in certain respects with similar economic characteristics as the DPRK, suffered a similar fall in domestic output in the late 1990s, but a combination of increased exports and increased foreign borrowing allowed it to cover its food deficit through imports. Times were hard, but Morocco did not experience famine.

Unlike other communist countries that have experienced famine, the case of North Korea represents less the introduction of misguided policies than the cumulative effect of two generations of economic mismanagement and social engineering. As a consequence, the policies are so imbedded in the social and political fabric of the country that they may well prove more difficult to reverse than has been the case elsewhere. The country could improve food availability by freeing up resources currently devoted to the military, but as long as the country pursues “military-first” politics, this is unlikely.

Aid is not a viable long-term solution to the North Korean food crisis—the food gap is too large, and the political sustainability of aid too precarious. And while incentive reforms could contribute to productivity increases in agriculture, given the economic fundamentals of the DPRK—a high ratio of population to arable land, relatively high northerly latitude, and short growing season—it is doubtful whether a food security strategy based on domestic agricultural revitalization is advisable either. Only trade-opening strategies in the industrial sector and systemic reforms are likely to meet human needs and obviate the need for concessional assistance.[1] The ultimate resolution to North Korea’s food problem requires the revitalization of its industrial economy. To achieve food security, North Korea should open up externally; export manufactures, mining products, and some niche agricultural, forest, and fisheries products; and import bulk grains—like its neighbors South Korea, China, and Japan do.

Such a prospective development, in turn, is hampered by both domestic and external impediments. It is not at all clear that the current leadership is willing to countenance the erosion of state control that would accompany the degree of marketization necessary to revitalize the economy. The opposite would seem more plausible, namely, that Kim Jong-il has reluctantly concluded that the old methods are inadequate to revive the economy and out of political necessity is embracing marketization, inflation, and the former colonial master in a desperate bid to revitalize--

[1] For substantiation, see the simulations reported by Marcus Noland, Sherman Robinson, and Tao Wang, “Famine in North Korea: Causes and Cures,” *Economic Development and Cultural Change* 49, no. 4 (2001).

though not fundamentally change--a moribund system. If this interpretation is correct, then we should expect hesitancy in the implementation of reforms and a strong reliance on the international social safety net supplied by the rest of the world. In this respect the outcome of the diplomatic maneuvering over the North Korean nuclear weapons program is of critical importance.

Even if a serious reform program were attempted, it is by no means preordained that such a program would be successful. The three robust predictors of success in reforming centrally planned economies are the degree of macroeconomic stability at the time that reform is initiated; the legacy of a functional pre-socialist commercial legal system; and the size of the agricultural sector.[2] North Korea is already experiencing significant macroeconomic instability and in terms of the sectoral composition of output and employment, the North Korean economy more closely resembles Romania and parts of the former Soviet Union than it does the agriculture-led Asian reformers, China and Vietnam.[3] Finally, the divided nature of the Korean peninsula and dynastic aspects of the North Korean regime present real ideological and political problems for would-be reformers in the North, namely how to re-interpret the *juche* ideology of the virtually deified founding leader Kim Il-sung as market-oriented globalization (especially when most of the increased economic interdependence would be with rival South Korea and former colonial master Japan), and indeed, how to preserve the whole raison d'etre of the regime as it begins to look increasingly like a third-rate South Korea.

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[2] See Anders Åslund, Peter Boone, and Simon Johnson. "How To Stabilize: Lessons from Post-Communist Countries," *Brookings Papers on Economic Activity* 1: 217-313 (1996).

[3] See Marcus Noland, *Avoiding the Apocalypse: The Future of the Two Koreas*, Washington, Institute for International Economics, (2000).

Even if the North were able to successfully navigate these shoals domestically, it is hard to see the initiative coming to fruition as long as the country remains, in essence, a pariah state, brandishing its nuclear weapons and missiles, subject to continual diplomatic sanctions by the United States, Japan, and other powers. Capital is a coward and foreigners will not invest in such an environment. There will be no permanent solution to the North Korean food crisis until there is a resolution of its profound diplomatic problems, and indeed, the diplomatic disputes have already substantially impeded the humanitarian aid program and its ameliorative impact. If a reduction of external tensions could be achieved, however, it would not only pave the way for expanded commerce but also could potentially yield a sizeable peace dividend that would facilitate increased food imports.

Even this would not be easy, however. North Korea is not a member of the International Monetary Fund or any of the multilateral development banks, and, to date, contact with these organizations has been minimal, limited to a couple of informational missions of brief duration. As multiple observers have emphasized, the DPRK's institutional capacity for managing development projects is woeful. In all likelihood, a prolonged period of technical assistance and capacity-building would be needed before substantial lending could occur. Once lending was underway, the initial focus would have to be on rehabilitating North Korea's badly deteriorated infrastructure as a necessary precursor to expanded private investment, for example by improving transportation links between mining areas and ports. The upside, of course, is that the degree of isolation and distortion embodied in the North Korean economy is so profound that with policy reform, investment and technology transfer, and expanded ties to the outside world (or even its immediate neighbors), the potential efficiency gains are enormous.[4]

And what if the diplomatic tumblers do not fall into place? The leadership of the DPRK regards "survival" as the first in a lexicographic set of preferences, and the regime has a history of confounding predictions of its demise. Moreover, for the last decade it has been enabled by neighbors who, for their own reasons, prefer its continued existence to its disappearance. The amount of external assistance necessary to keep it on "survival rations" is not large.[5] Considerable research suggests that in the absence of a firm ideological commitment to reform, the provision of aid impedes policy change by enabling governments to avoid difficult and painful policy choices. There is little evidence that North Korea is seriously committed to reform--as opposed to regime maintenance--and as a consequence, it is reasonable to suppose that the availability of outside assistance will encourage the perpetuation of a strategy of muddling through. The problem is that such a strategy in all likelihood implies the continuation of the food crisis.

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[4] See Marcus Noland, Sherman Robinson, and Tao Wang,"Rigorous Speculation: The Collapse and Revival of the North Korean Economy," *World Development* 28, no. 10 (2000) pp. 1767-88.

[5] See Anthony Michell, "The Current North Korean Economy," in Marcus Noland ed. *Economic Integration on the Korean Peninsula*, Washington: Institute for International Economics (1998).