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The Elusive Nature of North Korean Reform

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SUMMARY The new leader of North Korea, Kim Jong-un, appears to be fostering a new political enthusiasm for reform. Is this all theatrics? Or does it signify a substantive policy shift? Reform is possible: Kim Jong-un may have the necessary resolve to successfully push reform; officials associated with the last reform attempt are still present and may truly be able to bring lessons learned to bear on a new reform effort; and, importantly, both China and South Korea are likely to be supportive of a sincere attempt at reform. But while the projected image is positive and progressive, rumors coming out of North Korea illustrate unsettled and contradictory impulses of government policy. Provocations such as missile and nuclear tests may deter potential partners from engaging with North Korea. It appears likely, unfortunately, that any "reform" will be of a partial sort—benefitting the people of Pyongyang, the elite, the state, and the party—and not a genuine shift in policy that might improve conditions for the country at large.

Kim Jong-un offered North Koreans happy days, in contrast to the 'Arduous March' of his father's rule

On April 15, 2012, North Korea's newly installed leader Kim Jong-un gave a 20-minute televised speech (available on YouTube) to mark the centenary of the birth of the country's founder and his grandfather, Kim Il-sung. The contrast with his recently departed father, Kim Jong-il, whose only recorded public utterance was the single sentence, "Long live the People's Revolutionary Army," was self-evident. The new leader followed up with a slew of public appearances, including a pop concert complete with miniskirted dancers and Disney characters, accompanied by his glamorous young wife, and a visit to an amusement park, complete with rollercoaster ride. More recently, he rang in the new year with a televised New Year's Day address that left the global press breathless. Out with the Man Behind the Green Curtain, in with Camelot.

Whether this change in the theatrical aspect of politics translates into substantive policy change is less clear. Apart from some details, the New Year's Day speech could have been one of the New Year's Day joint editorials released over the past dozen or so years. Under Kim Jong-un, greater rhetorical emphasis has been placed on economic development as a policy goal. Organizationally there appears to an elevation of leadership by civilian-led ministries, and by implication, a waning of the central role of the military enshrined in the country's "military-first" ideology. Vice Marshall Ri Yong-ho, chief of the Korean People's Army General Staff (concurrently a member of the Presidium of the Political Bureau, a member of the Political Bureau of the Central Committee, and vice-chairman of the Central Military Commission of the Workers' Party of Korea), was sacked. Delegations have been sent abroad to study the practices of more prosperous countries.

The scrambled signals emanating from Pyongyang raise questions about both the goals and the capacities of the new leadership. In that April 2012 maidenhead speech, against a backdrop of worsening economic conditions, Kim Jong-un offered North Koreans happy days: "It is our party's resolute determination to let our people who are the best in the world — our people who have overcome all obstacles and ordeals to uphold the party faithfully — not tighten their belts again and enjoy the wealth and prosperity of socialism as much as they like," in implicit contrast to the "Arduous March" of his father's rule.

Six weeks later, on May 30, the *Rodong Sinmun*, the official newspaper of the Central Committee of the Workers' Party of Korea, recommended belt-tightening: "Reinforcing military power, however, is not as easy and simple as it sounds. Funds, as well as up-to-date technology, are necessary. The work of reinforcing the military power is one that cannot succeed without a firm determination and tightening one's belt. The party and the people of countries waging the revolution have to reinforce their military power in spite of all difficulties."

Amid these possible tensions over the direction of policy, allocation of resources across competing uses, and the jockeying for influence by different groups within the regime, the government has signaled — and possibly backtracked — on a number of reforms. It would not be the first time that reforms were initiated only to be reversed. Will it be different this time?

The Return of Macroeconomic Instability

Prices in North Korea skyrocketed following a botched currency reform in November 2009.[1] The confiscatory initiative wiped out the savings of many North Korean households, destroyed the working capital of many businesses that had emerged out of the famine of the 1990s, and damaged the credibility of the North Korean *won* as a currency. Since the situation began to stabilize in early 2011, the market value of the North Korean won has depreciated at a rate of more than 100 percent annually.[2] Rice prices have risen at a similar rate, corn prices even faster. Since the spring, the price of rice has increased at an annualized rate of more than 150 percent per year, and the volatility of prices has as well. (See figure on page 3.)

The inflation is a manifestation of fundamental institutional weaknesses. The state, with its bloated million-man army and numerous money-losing

state enterprises, has an enormous demand for resources but lacks reliable ways of raising revenue. It has been unable to establish an effective tax system since the demise of central planning in the 1990s. It cannot float bonds, and the country has no real banking system to speak of. Instead, the state relies on haphazard tax collection and a lottery system ("People's Life Bonds") and most importantly, the printing press.

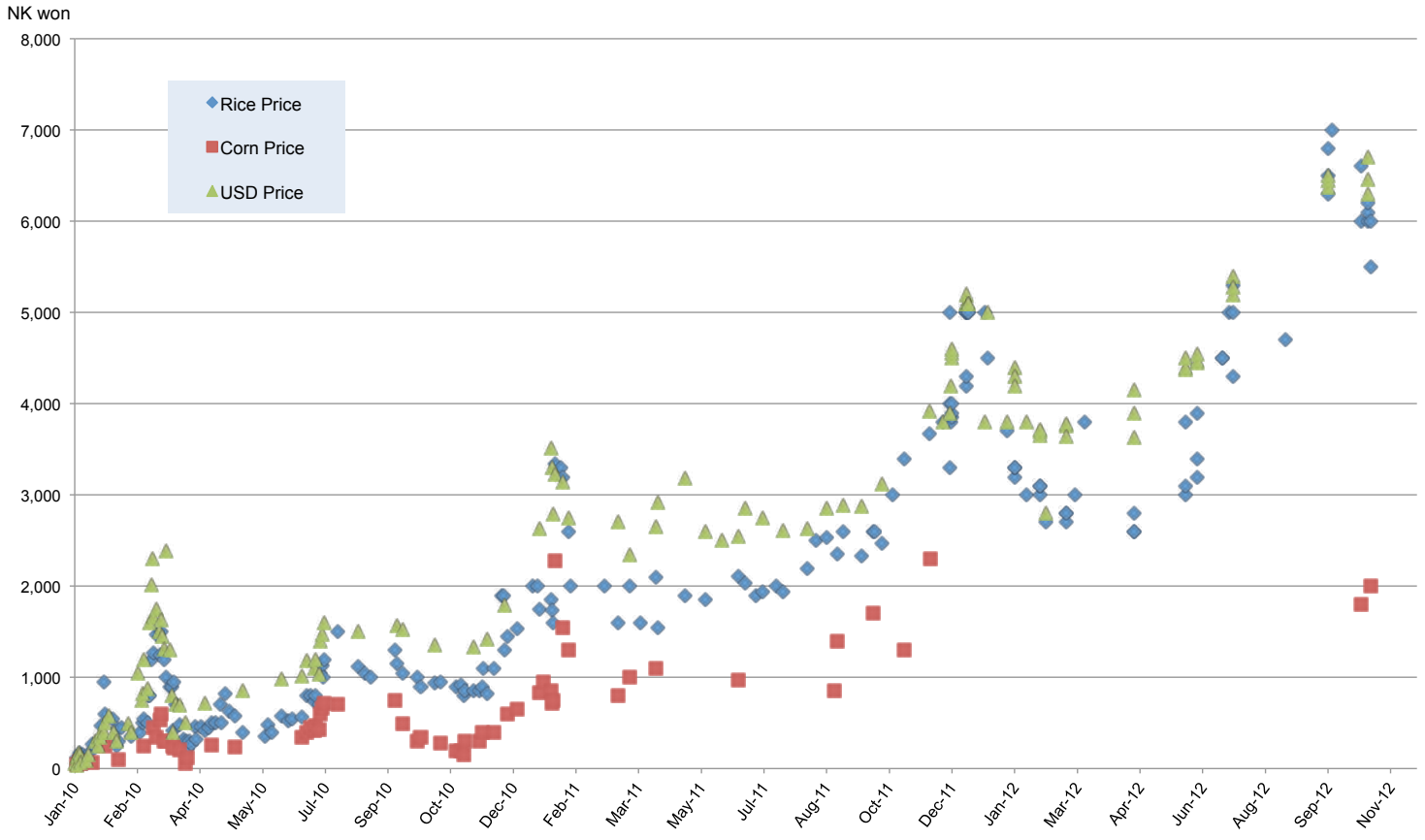
As a reaction to this ongoing monetization of the government deficit, enterprises hoard foreign exchange and engage in various ruses to keep it out of the state's hands.[3] The cycle further depresses the real value of the North Korean won and worsens inflation.

These effects are felt most acutely for households without access to foreign exchange, which acts as a hedge against inflation. In recent months these effects have been reinforced by escalating grain prices that appear to be the product of poor local harvests and rising world prices. The rise in corn prices is particularly worrisome. In comparison to rice, corn is a cheaper, less preferred grain. A rise in the price of corn relative to rice can therefore be interpreted as a signal of cash-strapped households tightening their belts. Distress has been confirmed by international relief agencies.

The upshot is a widening gap between the privileged capital city Pyongyang with its traffic jams and cell phones and the hinterlands with

Rising Rice and Corn Prices in North Korea (January 2010–November 2012)

Increasingly active NGOs and the growing availability of cell phones in the Chinese border region have facilitated the monitoring of price trends. Here, the rising prices of both corn and grain are evidence of household hardship, but it is the rising price of corn, a less-preferred grain, that suggests serious household belt-tightening.



their worsening food insecurity. Political economist Stephan Haggard has called this phenomenon "Pyongyang illusion" and believes that it may well go beyond typically observed urban- or capital-bias in governance and represents an attempt by an insecure regime to forestall any Tahrir Square type activity in the capital city.[4]

Rumors of Reform

Against this backdrop, stories began emerging from North Korea of policy changes that have come to be known as the "June 28 measures," named for the date on which they were reputedly announced to party cadre. The government has not officially confirmed the existence of any New Economic Management Method or reform package, and a September meeting of the rubberstamp Supreme People's Assembly passed without any announcement of economic policy change.

The outlines of policy change appear to be clearest with respect to the agricultural sector, though considerable uncertainty remains as to what the state may actually be doing. There is a consensus, derived from secondhand reports of what was allegedly told to the cadres as well as direct reporting with farmers, that the state planned to reduce the size of work teams on the cooperative (collective) farms from roughly 100 people to something like 6–10 people, which might begin to approximate the household responsibility system introduced in China in the late 1970s. The North Korean agricultural system is notorious for the degree of central micromanagement, and these subunits would be given more autonomy in decision making though it is unclear if that enhanced authority over planting decisions would extend to the choice of crops. Authority would shift from office-bound managers to subunit leaders in the field.

As in the previous period of reform, 1998–2004, policy changes appear to in part simply ratify facts on the ground

Farmers would be able to retain output beyond their production quota. It is not clear how the quota would be determined and in pilot projects a decade ago, farmers complained about unrealistic target-setting formulas.[5] Apart from in-kind consumption or barter, it is not entirely clear how the farmers would be allowed to dispose of their surplus. Farmers are not permitted to sell grain legally in the market, so either that restriction must be relaxed, or it is possible that farmers would be allowed to sell their surplus back to the state at some unspecified price. One visitor reported being told that the farmers would be able to sell their grain at approved locations at set prices fixed by the state. Farmers would have to pay for inputs such as fertilizer at prices set by the state, either in cash, or in grain at a conversion rate set by the state. In short, the policy changes would permit greater autonomy and introduce enhanced material incentives, but the state — not the market — would retain a central role in determining the prices of both inputs and outputs.

Approximately once every decade, North Korea has experienced urban food shortages and each time the state's response has been the same: to send the army to the co-ops and seize grain. So the timing of the announcement — midway through the harvest cycle, when forecasters were predicting a weak harvest due to poor weather earlier in the year — immediately raised questions as to whether the government would have the patience to see the reforms through. One press source has already reported that the policy changes are being postponed until next year.[6]

Similar though less specific reforms have been touted for manufacturing and services. Enterprise managers would pay a fixed share of revenues to the state as a tax and would be able to retain the remainder. State-owned enterprises would be permitted to enter into joint ventures with registered investors, including domestic ones. As in the previous period of reform, 1998–2004, these changes appear to in part simply ratify facts on the ground. Following the failed November 2009 currency reform, markets literally disintermediated and ceased functioning. The collateral damage reportedly included prestige housing construction projects associated with the Kim Il-sung centenary. While the projects were being carried out by state-owned construction firms, it appears that some inputs such

as cement were being sourced through the market. When the market dried up so did access to inputs and the projects ground to a halt. The rumored changes appear to in effect recognize the role of what is an emerging class of private business people capable of mobilizing cash and inputs to complete projects. One press report indicates that such individuals involved in apartment block construction are compensated by being allocated apartments which they can then sell.[7]

North Korea is thought to have considerable underground mineral resources (estimates range well into the trillions of dollars) and not surprisingly considerable interest has focused on this sector.[8] Earlier this year Kim Jong-un gave a widely circulated speech on land management in which among other things, according to *Rodong Sinmun,* "he underscored the need to hold in check such practices as developing underground resources at random or creating disorder in their development."[9] According to one source the government followed through with audits "because some powerful government entities — e.g., security departments, law enforcement agencies, Prosecutor's office and Armed Forces — had ownership but, in its judgment, failed to make a tangible contribution to the economy as they attracted uncoordinated investments for foreign exchange revenue."[10] The article quotes an unnamed party official to the effect that "the government will compensate foreign investors and take full control" in problem cases "to allow for more systematic development." According to the story, this process of auditing, restructuring, and possibly reassigning property rights is not limited to mines, but applies to other assets as well.[11]

It would be a mistake to characterize North Korea as unchanging or completely opaque

There are multiple ways of interpreting this putative policy. As depicted in the report, it could be good governance: imposing order on a lawless situation in which special interests simply seized state assets for their parochial benefit. Or the policy could amount to machine politics during a period of leadership consolidation—reallocating rents from special interests associated with the old leader to other groups loyal to the new leader. Or it could be a ruse to expropriate foreigners, a major concern of Chinese investors.[12] These fears have been made manifest by the case of the Xiyang Group, a Chinese mining company, that took the extraordinary move of going public with an astonishing tale of malfeasance, abuse, and ultimately expropriation by North Korean authorities. Even after the North Korean government publicly rebuked the group, the Chinese government did nothing to quiet the dispute.[13] The Xiyang case has been followed by additional examples of North Korean expropriation of Chinese miners.[14]

Yet at the same time it is expropriating private investors, according to one report, in a bid to secure foreign assistance in developing its mineral wealth, "North Korea has granted China exclusive rights to explore all of its underground resources in its latest attempt to use foreign assistance to boost its economy."[15] The report may be inaccurate, and the exclusive right is for exploration, not extraction. Nevertheless these reports illustrate the unsettled, and possibly contradictory, impulses of North Korean policy.

Realities of "Reform"

It would be a mistake to characterize North Korea as unchanging or completely opaque. The theatrical aspects of politics have clearly changed with the arrival of Kim Jong-un. But the real question is whether a change in style translates into meaningful policy change. There are three reasons to believe that it might.

The first is the leader himself. Whether he is more cosmopolitan (educated partly in Switzerland) or simply more desperate, Kim Jong-un may be more willing to grasp the nettle of reform than was his father.

Second, officials associated with the last reform push, undertaken in 2002, are being rehabilitated. Normally, one would not interpret past failure as an indicator of future success, and it may well be that the current crop of North Korean policymakers are simply not up to the task. But at a minimum, those who went through the 2002 process should have at least learned some negative lessons in what pitfalls

to avoid and be better positioned to get it right this time.

Finally, China is growing tired of North Korea's continually outstretched hand. If the North made any sincere attempt to reform, China could be expected to respond with alacrity, providing financial and technical support. The Chinese case demonstrates that under the right conditions, murky property rights are not an insurmountable barrier to development. But the economic fundamentals of the two countries differ in some key ways.[16] The North Korean economy is so distorted that incremental relaxation of control could generate significant gains. But it would be unrealistic to expect Chinese-style performance to result from the adoption of the "China model" in North Korea.

North Korea's third nuclear test undercuts external political support for more engagement-friendly policies

South Korea is the country's second largest trading partner, where interaction is largely confined to a handful of enclave projects. Trade and investment relations are highly contingent on South Korean direct and indirect public support.[17] But after five years of very difficult relations under current President Lee Myung-bak, North-South relations are likely to improve in February 2013 when Park Geun-hye, who has articulated a "Trustpolitik" policy of greater engagement in the context of her broader vision of a "New Korea" that takes a more prominent and activist position in world affairs, takes office.[18] China will be supportive. If North Korea ceased provocations, South Korea would be supportive as well.

But ultimately whether it turns out different this time depends decisively on North Korea, and developments thus far raise basic questions about both the regime's fundamental interests and the quality of decision making at the top. It may well be that the leadership wants a more prosperous country but simple desire does not mean that they are capable of formulating and implementing economic reforms, or even wish to reform the system, as opposed to making marginal improvements in its functioning.

Some of the hesitancy may be explained by continuing tensions within the regime, and possibly incomplete consolidation of power by Kim Jong-un. But another explanation is that the regime may be defining its core constituencies ever more narrowly — that when Kim Jong-un speaks of no more belt-tightening he is referring to the residents of Pyongyang and other key groups, not the nation as a whole.

In this context, the decision to test a missile in December 2012, in contravention of two United Nations Security Council (UNSC) resolutions, gives pause. The Security Council predictably expanded existing sanctions the following month, unanimously adopting UNSC Resolution 2087. The third nuclear test, conducted February 2013, undercuts political support for more engagement-friendly policies by both the incoming Park government and the second Obama Administration. Tepid external support will in turn reduce North Korea's interest in reform and increase its reliance on China.

Given the personalist leadership style, the weakness of the business-enabling environment, and increasing reliance on the extractive sector to support the economy, it is likely that even "reform" will be of a partial sort, more akin to contemporary Uzbekistan (a corrupt, semi-reformed economy based on resource extraction) than the ideals of the Washington Consensus (with its emphasis on transparency and free markets). Gains are likely to be appropriated to a significant extent by the interlocking elite defined by the Kim family, the state (including the military), and the party.

NOTES

[1] Stephan Haggard and Marcus Noland, "The Winter of Their Discontent: Pyongyang Attacks the Market," *Policy Brief* 10-1, (Washington: Peterson Institute for International Economics, January 2010).

[2] Cited inflation estimates were derived from seasonally adjusted linear regressions on logged price data. But the reported series may well exhibit upward bias and greater volatility relative to the "true" price series. For a more complete discussion of the sources and statistical problems posed by these data, see Stephan Haggard and Marcus Noland, "Famine in North Korea Redux?," *Journal of Asian Economics* 20, no. 4 (2009): 384–95.

[3] Marcus Noland, "Money (That's What I Want)" *North Korea: Witness to Transformation* blog, 10 January 2012, accessed 1 November 2012, http://www.piie.com/blogs/nk/?p=4432.

[4] Stephan Haggard, "The Pyongyang Illusion," *North Korea: Witness to Transformation* blog, 5 November 2011, accessed 1 November 2012, http://www.piie.com/blogs/nk/?p=3488.

[5] Stephan Haggard and Marcus Noland, *Famine in North Korea: Markets, Aid, and Reform* (New York: Columbia University Press, 2007).

[6] Lee Sang Yong, "6.28 Agriculture Policy on the Back Foot," *Daily NK,* 12 October 2012, accessed 31 October, http://www.dailynk.com/english/read.php?cataId=nk01500&num=9907.

[7] Choi Song Min, "Rich Traders Invest in Chongjin Construction," *Daily NK,* 10 August 2012, accessed 31 October 2012, http://www.dailynk.com/english/read.php?cataId=nk01500&num=9662.

[8] For examples see "N. Korea's Mineral Resources Potentially Worth $9.7 Tril.: Report," *Korea Times,* 26 August 2012, accessed 31 October 2012, http://www.koreatimes.co.kr/www/news/nation/2012/08/120_118220.html; and Marcus Noland, "The Resource Curse Comes to North Korea," *North Korea: Witness to Transformation* blog, 17 May 2012, accessed 31 October 2012, http://www.piie.com/blogs/nk/?p=6077.

[9] "Kim Jong Un Makes Public New Work on Land Management," *Rodong Sinmun,* 9 May 2012, accessed 31 October 2012, http://www.rodong.rep.kp/InterEn/index.php?strPageID=SF01_02_01&newsID=2012-05-09-0002&chAction=L.

[10] Good Friends, *North Korea Today,* no. 457, 30 May 2012, accessed 31 October 2012, http://goodfriendsusa.blogspot.com/2012/06/north-korea-today-no-457-may-30-2012.html.

[11] This was vividly illustrated by a report in the *Daily NK* which cites the Japanese newspaper Mainichi Shinbum claiming that it had obtained a document from the Ministry of People's Safety that reputedly read in part, "It is unacceptable to extract or trade in any natural resources for profit without the approval of the state…natural resources should not be sold to other countries at will…Serious infringements will be punishable by death." Kim Da Seul, "Death to Mineral Thieves!," *Daily NK,* 10 August 2012, accessed 31 October 2012, http://www.dailynk.com/english/read.php?cataId=nk00100&num=9663.

[12] Stephan Haggard, Jennifer Lee, and Marcus Noland, "Integration in the Absence of Institutions," *Journal of Asian Economics* 23, no. 2 (2012):130–45.

[13] See Stephan Haggard, "Chinese Investment in the DPRK: Shanghaied!," *North Korea: Witness to Transformation* blog, 16 August 2012, accessed 31 October 2012, http://www.piie.com/blogs/nk/?p=7158. On the North Korean response, see Stephan Haggard, "Escalation: More on the Xiyang Dispute," *North Korea: Witness to Transformation* blog, 13 September 2012, accessed 31 October 2012, http://www.piie.com/blogs/nk/?p=7432.

[14] Stephan Haggard, "Ripping Off Foreigners II: China Edition," *North Korea: Witness to Transformation* blog, 24 October 2012, accessed 31 October 2012, http://www.piie.com/blogs/nk/?p=7909.

[15] Arirang News, "N. Korea Grants China Exclusive Rights to Explore Buried Resources," 25 September 2012, accessed 31 October 2012, http://www.arirang.co.kr/News/News_View.asp?nseq=137594&code=Ne2&category=2.

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

[17] Stephan Haggard and Marcus Noland, "The Microeconomics of North-South Korea Cross-Border Integration," *International Economic Journal* 26, no. 3 (2012): 407-30.

[18] "Trustpolitik" is a policy of engagement and reconciliation based on "mutually reinforcing political-military confidence building measures combined with social and economic exchange and cooperation," reminiscent of West German leader Willy Brandt's "Ostpolitik" approach to relations with East Germany. See *North Korea: Witness to Transformation* blog, 17 November 2012, http://www.piie.com/blogs/nk/?p=8088.

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