

# A Study on the Reality and Prospect of Economic Reform in North Korea:

Tasks for Successful Transformation of the North Korean System

■ Kim, Young-Yoon



KOREA INSTITUTE FOR NATIONAL UNIFICATION

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The Analyses, comments and other opinions contained in this monograph are those of the author and do not necessarily represent the views of the Korea Institute for National Unification.

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# I. Introduction

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The new economic management measures taken by North Korea on July 1<sup>st</sup>, 2002 have had positive as well as negative effects on the society. Currently, while there appears, on the one hand, to be a change in the consciousness of the common people toward capitalism, economic insecurity and social corruption are deepening on the other. Of course, the merits and demerits of the reform may not be phenomena unique to North Korea; it is an inevitable process when socialistic countries carry out economic reform. Nevertheless, we should pay attention to North Korea's economic reform and the struggles in enhancing the economic homogeneity between South and North Korea. We also want to probe the possibility of concurrent growth by maximizing the positive achievements of North Korea's economic reform while minimizing negative side effects.

The purpose of this study is to discuss the direction of change in North Korea resulting from economic reform. If the economic changes of North Korea are considered in the context of reform, it will be meaningful to suggest the conditions and methods of successful reform. Successful reform here is defined as the

economy of North Korea acquiring market mechanisms without overturning the regime and with minimal downside. South Korea may help North Korea to achieve this goal.

This study is the result of many discussions with scholars, government officials and experts on North Korea. Also, the efforts to analyze the realities and side-effects of North Korea's economic reform after the "July 1<sup>st</sup> Measure" (originally July 1<sup>st</sup> Economic Management Measure, hereinafter, July 1<sup>st</sup> Measure) were made through in-depth interviews with *Saeteomin* (refugees). The North Korean press media (*Kyongjaeyeongu*, *Chosun Shinbo*) and broadcast media (*Pyongyang*, *Joongang Tongshin*), resources and articles from the Ministry of Unification, and scholars in South Korea are also referred to. The subjects of case study are China and Vietnam because they are located in Asia and have tried economic reform on the basis of a socialist political constitution.

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## **II. General Considerations on Socialistic Economic Reform**

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### **1. Socialistic Economic Reform**

The heart of the matter is whether the economic reform of North Korea is heading towards a capitalistic market economy, which means the extension of the private sector into areas such as demand, wages, and the exchange rates. In the long run, this should lead to a change in the socialist system. Economic reform without change in the socialist system does not seem to be an attractive theme. The economic reform of North Korea should be considered in the context of transforming the socialist economic system.

The transformation of the economic system means the end of the existing economic order or rules of economic activity and the beginning of a new order or rules for the economy. It can alternatively be considered that the economic order or institutional mechanisms become operated by a whole new set of rules.

If it is true that the total sum of the institutional mechanisms forms the economic system itself, then the ultimate goal of economic reform then is the transformation of institutional mechanisms. Transformation of the socialist economic system into

a market economy refers to the transformation of the institutional mechanisms that make up the socialist economy. Therefore, it is presupposed that the introduction and application of legal/institutional mechanisms are as described in the following paragraphs.

First, prices should be liberalized. Free pricing is imperative and is the most preferred method for enabling the competitive market. Neither the control of supply or the demand for goods nor the optimal distribution of resources is possible without free pricing through a competitive market.

Second, the suppliers and consumers should participate in or withdraw from the market without any legal/institutional restrictions, and the profits/surplus should be distributed to suppliers and consumers themselves. If the profits from competition are not distributed by the individual participants, entrants will not desire to participate in the market. Therefore, the competitive market only works on the basis of a private ownership system.

Third, an open economy rather than a state monopoly is required to enable individual subjects of economy to deal with foreign trade and the transfer of capital. For this purpose, the currency should be convertible in order to be used as a foreign means of payment, and the price of goods should be decided without any differences between domestic and foreign prices.

In the case of North Korea's economic reform, the above points of reform are necessary to serve as a prototype of ideal economic reform.

There are two approaches to the economic reform that is concerned with the transformation of the system: a radical approach and a gradual approach. There are ample grounds for controversy with regard to which approach has the greater advantage in securing successful economic reform. In the case of the former East Germany, the radical approach was applied due to the political and

social conditions of the time. However, this approach was the very reason why there were so many aftereffects. It is also true that some of the eastern European countries, including the former Soviet Union, which had chosen the gradual approach, had suffered from sluggish growth for an extended period of time. More important is clarifying the purposes of the economic reform such as the introduction of market economy functions and/or minimizing the economic/social costs during the reform process.

## **2. The Side Effects of Economic Reform**

The side effects of economic reform refer to the undesirable economical/social phenomenon derived from the economic reform process. In the case of socialist economic reform, however, there exist several different points of view. From one perspective, the side effects of North Korea's economic reform can be regarded as positive with regard to the market economy. Therefore, the analysis of the side effects of economic reform may focus on the negative ripple effects, which can be embraced by both South and North Korea.

Usually, countries in the course of system transformation tend to encounter various kinds of predictable side effects. One of the most common problems is inflation. In a market economy, inflation is generally understood as currency expansion, but in the theory of effective demand, it is regarded as social total demand (the sum of consumption demand and investment demand) that exceeds social total supply (the sum of consumption demand and savings). Nowadays, however, inflation is generally understood as a continuous increase of price levels.

Socialist countries like North Korea are facing economies of shortage due to chronic excess demand and underproduction.

Because prices in the public section cannot deal with this phenomenon, suppressed inflation occurs. The reason for excess demand in socialist economic systems is that the planned investments always exceed planned savings because investors do not bear the costs of investment (investment cost), investments always exceed saving. In households, the planned investment (demand) always exceeds planned saving (income). Prices of vital consumption goods are suppressed by the government, and thus the demand for these goods always exceeds supply. While excessive demand can be controlled by a market's price determining function, there is nothing except rationing to control demand exceeding the capacity of production while prices are controlled by the government. Inflation influences redistribution of income and wealth, balance of payments, and economic growth. It also broadens the inequality of wealth and turns around the order of haves and have-nots.

The most significant side effect of reform in the socialist system is reform corruption. Reform corruption is different from other types of corruptions in its character and pattern. It is more systematic, and the scale is larger than other types of corruption. The most typical corruption is related with the bureaucrats. This particular type of corruption, which is one of the most important weaknesses of bureaucracy, is a deviant behavior of organizations or individuals. The ultimate goal of it is "survival," and the problems of political/economic/social/cultural structure are combined with it.<sup>1</sup>

In a socialist system, the administrators of the party or government usually try illegal trades to achieve their goal. These kinds of corruption are often overlooked or do not evoke any

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<sup>1</sup> See Kim, Sung-Cheol, *A Study on the Bureaucrat Corruption in North Korea* (Korean) (Seoul: Korea Institute for National Unification, 1994).

serious problems, but in the long run, they contradict the interests of the system itself. Bureaucratic corruption is not limited to the individual deviant behavior, but also allows the common people to evade the control of authorities. It is not surprising to find trivial corruption in any society, including in socialist systems. The question is raised, however, when the corruption becomes increasingly massive and systematic in character in the process of reform. The distribution of resources and investments for economic growth is disturbed when the determination of the government is distorted due to recurring corruption, embezzlement, and bribery throughout the system. Moreover, it may threaten the very survival of the reformatory government, and evoke public uprisings or riots to punish tax evaders or corrupt bureaucrats.



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## III. Case Studies

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### 1. Economic Reform in China

#### A. The Transformation into a Market Economy in China

The core of the economic reform in China can be summarized as transforming into a market economy. The main point of this transformation was allowing the market to take the basic role of resource distribution under the macroscopic control of the government. A socialist market economy in China should retain the basic institutions of socialism. The public ownership system was primary, but individual, private, and foreign capital economies needed to be developed at the same time. Of course, the state owned companies and collective ownership companies have had to take the central role. China changed its standpoint about its plan and improved the method of planning, and confirmed reasonable strategic goals for national economic and social development. Also they made rational plans for expectations of economic development, control of the total amount of resources, the structure of primary

industry, and allocation of labor forces. In addition, they concentrated on the provision of funds and resources, and considered efficiency and equality under the law of the distribution according to work done.

The process of establishing a market mechanism in China can be specified as described in the following paragraphs.

First, China decreased the size of the planned economy. Individual production units were authorized to take the function of markets by decreasing government controlled production items and increasing the goods sold by producers. To discourage the planned economy section and encourage market mechanisms, the government took several actions: ① reduction of the number and importance of planned goods, ② enlargement of direct sales of individual production units, ③ reduction of the number and importance of government-determined prices, ④ enlargement of the commercial network in order to facilitate market trading of production/consumption goods.

Second, China reformed the pricing mechanism. Following the reduction of planned economy areas, governmental controls over prices were loosened and the prices were determined by demand. Therefore, more than 4/5 of total retail sales were determined by supply and demand in the marketplace. The prices of raw materials like fuel and the cost of transport were increased, while the prices of general items were liberalized.

Third, China transformed the seller's market under the socialist system into a buyer's market. Also the producer's market was transformed into the consumer's market through the introduction of a competitive market of free pricing. This action eliminated governmental control over providing consumer goods and price determination.

Fourth, China introduced various forms of ownership. The number of the state-owned companies was decreased, while the

number of private companies was increased. The right of self-determination for companies was also expanded. An increase of non-state-owned companies played a critical role in filling up the shortage of consumer goods and light industrial goods.

Fifth, China strengthened reform in the area of foreign trade. The amount of convertible currency was increased and policies to facilitate exports and the introduction of foreign capital were promoted. By restricting government subsidies that cover up losses (up to 40% of the amount of exports) from foreign trade, companies were able to improve their spontaneous growth. The market exchange rate was modified by changing the foreign exchange control law from a dual exchange rate system to single exchange rate system. Furthermore, the government created special economic zones and the effect of their development spread to the other areas. The special economic zones, base and buffer zones of the system, became wealthy first, and then their economic strength helped other areas to develop, like the “spot-line-surface strategy.” Special economic zones in China took various roles as bases of inducing foreign capital and facilitating exports, introducing and spreading production and management skills, facilitating the advance of reform policies, and inducing economic development of the mid-western area.

## **B. The Primary Factors and Lessons of Chinese Economic Reform**

The primary factor behind successful economic reform in China is the methodology of reform, which is described more specifically below.

First, one of the keys of success was the rich labor force in agriculture. Because China, as a developing country, had a large

labor force in agriculture, its transition into industry itself could grow the economy.

Second, decentralization originated in the Mao-era played a critical role in the formation and evolution of the market. After reform, state-owned companies and individual regions began to compete with each other.

Third, Hong Kong and the Chinese emigrant capital in Taiwan and South-eastern Asia brought some positive effects to reform in China. These countries took a role not only as trade partners and investors connecting China to the world but also as educators who taught the principles of a market economy.

Fourth, the enthusiastic commercial spirit of the Chinese people contributed to success. The salesmanship that supported traditional China had not disappeared in socialist China, contributing a lot to the process of reform.

Fifth, agricultural reform was successful, and these achievements spread to non-agricultural or urban sectors. Because agricultural reform was easier than non-agricultural reform, people could have the actual feeling of achievement from agricultural reform and the consequent independent farming.

Sixth, the purposes and means of reform were not overly radical, as was the government's intention. Economic reform in China was pursued under the premise of maintaining the socialist system; therefore, existing human and material resources could be fully utilized. Because they did not aim at private ownership reform, they could evade inequality and the conflicts associated with redistribution of existing resources.

The success of Chinese economic reform gives a number of lessons;

First, the leaders of reform have to change their own ways of thinking. In the case of China, the political leaders recognized the problems of the existing model and tried to equip themselves with

“pragmatism.”

Second, internal reform should be accompanied by changes in the resource allocation system. In the case of China, as the decentralization of the company administration system came first, technocrats could accumulate the requisite knowledge regarding marketization.

Third, pivotal points were the transformation in agriculture and foreign trade. Changes in agriculture were a driving force of the internal reform, and the open-economy policy firmly supported internal reform through the attraction of foreign capital. While the “Household Responsibility System” produced on average 15.8% growth during 1979~83, Hong Kong and Taiwanese capital flowed into opened cities such as Shenzhen, Xiamen, Zhuhai, Shantou.

Fourth, the key point of Chinese reform was the establishment of an effective market mechanism, which was an inevitable element of the reform.

## **2. Economic Reform in Vietnam**

### **A. Process of Economic Reform**

In December 1986, the Vietnamese government proclaimed the so-called “Doi Moi Policy” to adopt a market economy system and to hasten the opening of the economy. “Doi” means “change” and “Moi” means “renew.” The practical conversion into a market economy system in Vietnam was realized through the economic reform policy called “Doi Moi.”

The purpose of “Doi Moi” can be summarized as follows: ① top priority to the development of agriculture, light industry and handicraft manufacturing, ② the decentralization of the economic system, ③ change of the resource allocation system,

④ the reinforcement of economic cooperation with foreign countries. By giving top priority to agriculture, the government made sure to produce enough food and consumer goods, and facilitated the accumulation of capital. To develop light industry and handicraft manufacturing, they adjusted priorities to reduce investment in heavy industry. To decentralize the economic system, they reformed the “official price” and the “contract system” to concentrate on autonomous family-owned or small businesses. The government also introduced an incentive system and reformed the production subsidy system, and tried to reinforce economic cooperation with non-communist countries.

In December 1987, the “New Land Law” was enacted to attribute the ownership of the land to all people. All land was managed by the government although the right to use the land was attributed to individuals. Users were allowed a long-term lease up to 15 years unless their rights and duties were abided by. The purpose of the “Foreigner Investment Law” enacted in December 1987 was for encouraging joint ventures with foreign capital that possessed advanced technologies and for helping the country to acquire advanced management skills and for training economic bureaucrats and skilled workers.

After 1988, more drastic reform and opening policies were adopted.

First, the dual bank system was introduced, and the functions of the central bank and state-owned commercial bank were separated.

Second, agriculture was fundamentally reformed. A portion of farmland was distributed to farming households in proportion to the number of family members, and a “bidding style production contract system” was applied to the remaining land. Farmers who were granted the farmland were allowed to sell 40~50% of the production (except for deductions like production costs, taxes, and

welfare payments) in the market price at their discretion.

Third, the “National Investment Cooperation Committee” was established to induce foreign investment and to take exclusive responsibility to guide, induce, and plan foreign investment. Also “The Foreign Exchange Control Law” and “The Import-Export Customs Law” were enacted to deal with legal problems concerned with import and export businesses.

Fourth, reform on the price system was carried out. Transforming a “controlled price system” to a “negotiated price system” in agriculture was actually nothing but an introduction of a market price system. By transforming to a “negotiated price system” with the exception of several items in industry, the right to determine the price was granted to individual companies.

Fifth, state-owned companies were reformed to ensure independent management rights. A director system was introduced in state-owned companies, and businesses in non-state-owned sectors were activated by the newly enacted “Private Company Law” and “the Corporation Act.” In management, while governmental interference was minimized, autonomy and independence were maximized.

## **B. The Factors of Economic Reform and Its Lessons**

Along with these measures, the Vietnamese government adopted the following special actions to secure a market economy.

First, a private ownership and heirship system was adopted to encourage private management, and the activities of private companies were secured by law.

Second, effective decentralization transformed the economy into a market economy system. The price was readjusted to a realistic level, and the wage system was reformed. A consumer price subsidy

policy was abolished, and real wages in the state-owned sector were increased to improve labor productivity. Various kinds of subsidies for the state-owned companies were decreased, and a negotiated price system between sellers and buyers was settled instead of the official price system set by the central government.

Third, the intervention of bureaucrats in business was decreased, and a self-supporting accounting system was introduced. A compensation system was applied to wages according to the efforts of employers in state-owned companies. They could have autonomy concerning production, distribution, financing and so on by transforming the economic management system, which previously had been controlled by administrative restrictions and regulations.

Fourth, the financial reform including taxation and the government expenditure system was changed. Financial support from the government to state-owned companies was gradually abolished, and financial income was secured through the taxation system. Tax reform was accompanied by enactment of the Value Added Tax (VAT) and the revision of corporation income tax instead of a sales tax and profit tax.

Fifth, price system reform made the price control system relics of the past, and it also encouraged a modern financial system and facilitated the raising of investment funds.

Sixth, the door was open for non-socialist countries to promote the supply of resources and foreign direct investment. Normalization of diplomatic relations with U.S. was greatly responsible for Vietnam's successful economic reform. Normalization made it possible for Vietnam to satisfy the conditions for preferential treatment such as Most Favorite Nation (MFN) status. As a result, more U.S. companies invested in Vietnam and companies from other developed countries like Japan, France, German and Australia enlarged investments in Vietnam as well.

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## **IV. Economic Reform and Its Side Effects in North Korea: Reality and Evaluation**

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### **1. Main Points and Characteristics of Economic Reform in North Korea**

The “economic reform” of North Korea originated from the revision of the socialist constitution at the First session of the 10<sup>th</sup> Supreme People’s Assembly (September 5, 1998). The revised constitution focused on the enlargement of private ownership, legalization of the self-supporting accounting system, abolition of governmental supervising rights over foreign trade, encouragement for the development of special economic zones, permission for the right to freedom of residence and movement, and the actualization of tacit private economic activity within the basic framework of a socialist planned economy system. North Korea pursued the measures outlined below for economic reform after the revision of the socialistic constitution.

First, the improved price system was made to balance the price of the products and to increase the quantity/quality of products. On the 50<sup>th</sup> anniversary of “On the governmental control over the price through newly established National Price Commission,” an

editorial titled “*Important Task to Carry out the Price Simplification Policy of the Party*” emphasized the need for price control and said “determining prices according to the supply and demand of goods is a normal process.”<sup>2</sup>

Second, the ownership system of the means of production was reformed. The old constitution attributed ownership of the means of production to the state, cooperation organizations, and individuals, but the revised constitution enlarged the scope of ownership for the social cooperation organizations along with the state and individuals (Revised Constitution, Article 20). This means that the social organizations, which do business for profit, can own the means of production.

Third, the autonomy and profitability of companies was emphasized. To rationalize company management, they had to focus on a secure self-supporting accounting system, the effective use of economic space, and the improvement of productivity and quality control. The possibility of transforming production focused on quantity to production focused on profitability also was suggested (Revised Constitution, Article 33) as cost, price, and profitability were considered the most important parts of economic management.

Fourth, the monetary incentive system was enlarged to distribute profits to individuals to some extent according to their contribution to production. In addition to the “private profit-oriented side job,” the private ownership of the “income from legal profit-oriented activity” was also allowed (Article 24).

Fifth, North Korea attempted a gradual opening policy through strengthening foreign trade and participating in the international economic system, instead of its traditional foreign economic policy. The main body of foreign trade was bound by national monopoly but was enlarged to the social/cooperative organizations. With

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<sup>2</sup> *The Rhodong Shinmun* (The labor newspaper), November 25, 1996.

newly established legal support, they could deal in foreign trade of their own. Some practical measures were made to prepare for marketization of special economic zones and “free economic trade zones.”

On July 1<sup>st</sup>, 2002, North Korea introduced new economic management measures. And then in September 2002, the “Economic Construction Policy in *Son-gun* (military-first) Era” was brought up as a new economic method. In 2003, young technocrats were promoted to facilitate a shift in generations. In 2004, while the cabinet’s responsibility to control the economy was reinforced to lead economic reform, the responsibility of the party and military in the economic area was decreased.

The realities of economic reform in North Korea after the “July 1<sup>st</sup> Measure” (originally July 1<sup>st</sup> Economic Management Measure, hereinafter, July 1st Measure) are summarized below.

First, price (25 times) and wage (18 times) were increased according to the realities of market in July 2002, and the exchange rate (70 times) was actualized in August of the same year. The price of public welfare goods and services, which had been suppressed for political reasons, soared to 25 times to reflect the costs and profits. The food rationing system was not abolished, but the price of rations was hugely increased. The wages of blue-collar laborers was also increased from 85~110 won to 2,000 won. At the same time, the incentive system was reinforced, and the responsibility for deciding prices was partly transferred to the lower administrative units. Even the official price was influenced by the market situation and adjusted regularly, and each province, factory and company was allowed to determine the price of its products. Farmer’s markets (“Nongmin sijang”) were transformed into general markets (“Chonghap sijang”) (March 2003), and transactions at market prices were allowed. The government announced the highest price of each item, so it controlled

unreasonable price levels and allowed merchants to adjust the price autonomously.

The purpose of the “July 1<sup>st</sup> Measure” was encouraging motivation for the common people by increasing wages and prices. More income leads to stronger purchasing power and a differentiated wage system could be one effective monetary incentives.

Second, the North Korean government pursued a sounder national financial footing through the “July 1<sup>st</sup> Measure.” Specifically, various kinds of subsidies were abolished, the number of national budget supported organizations was reduced, and new financial income resources were created. The prices for rice, housing, energy, transportation services, which had been almost free, were normalized, and the budget for price supports was reduced. The government also tried to find new sources of tax revenue such as land rental fees, while the budgeting system organization itself, totally dependent on the national budget, was allowed to conduct business for profit. By collecting national payments (“Gukganapbugum”) on the basis of “earned income,” an indirect tax style of “transaction profit (Kuraesuipgum)” was incorporated into direct tax style “national company profit (“Gukgakiupiikgum”),” and this action simplified the source of budget income.<sup>3</sup>

Third, subsequent to the “July 1<sup>st</sup> Measure,” the exchange rate was actualized. As the national exchange rate system was replaced with a foreign trade exchange rate system in August 2002, the exchange rate for the U.S. dollar soared 70 times from 2.2 won to 153 won, while the “foreign currency exchange place” was created in the general market where ordinary people could exchange money at the black market rate. This actually meant the appearance

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<sup>3</sup> The Supreme People’s Assembly (March, 2002) reported that the national company profit took 77.6% of the budget income for 2003.

of a dual exchange rate system.

Fourth, management of the production unit in agriculture was subdivided into family units, so each unit became smaller from 7~8 people to 4~5 people. From January 2004, *Pojeon Damdang-je*, the family unit farming system, was applied as an example. Governmental responsibility in production and distribution of grain was decreased within the framework of collective farming, while the autonomy of cooperative farms were strengthened and the incentive system was enlarged to improve productivity. The free rationing system and the double grain price system were abolished, so the price of grain dramatically increased from July 2002. In the past, rice was purchased by the government as expensively as 82 “jeon” per kilogram and sold as cheaply as 8 “jeon,” but from July 2002 the price soared to 44 “won,” including the purchase price of 40 “won” and the transportation costs.

Fifth, the autonomy of individual companies was strengthened as the extent of governmental planning was decreased in the production activity of each company and the responsibility of the manager was reinforced. Responsibility for the financial operation of companies was enlarged and effective use of money was encouraged. The “accounting law” was enacted in March 2003, thereby the ultimate goal of company management was changed from “reduction of cost” to “increase of net income” (April, 2004, “treasure law” Article 34). From 2004, a company’s right to determine and pay wages was enlarged; for example, the upper limit of wages was abolished, and the distribution of profits, except national payments, was allowed.<sup>4</sup> Meanwhile, the government itself had allocated labor to the factory or company, the individual

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<sup>4</sup> *The Chogook* (June, 2004), the monthly magazine of Choch’ongnyŏn, reported that “the shoe factory in Pyongyang will increase the wage to 10,000 won, and the fabric factory in “Seongyo” will raise the current wage of 4,000 won 3~5 times.”

company was allowed to send surplus labor to the mine or farm to increase the flexibility of labor management.

Sixth, North Korea accepts the market as one of the legal system of distributing goods. The market is regarded not as a target of control but a “part of the socialist distribution system of goods.” In Pyongyang, “farmer’s markets” in every district are called just the “market.” The market has been renamed to reflect reality because farm products as well as industrial products are traded (*Chosun Shinbo*, April 1, 2003). In the past, the same products everywhere had the same price (the ‘single price system’), but after the reforms, there is now a double price system with official prices and market prices.

Seventh, North Korea has shown a strong will to activate economic cooperation with foreign countries, and more ‘special economic zones’ are appearing. Special zones like ‘Mt. Geumgang’ (October, 2002) and ‘Gaesung’ (November, 2002) were newly added to attract more foreign capital. Concerning economic cooperation with South Korea, North Korea has adopted 14 statements of mutual agreement and 22 laws and rules to move ahead with plans like the development of the ‘Gaesung industrial zone’ with an area of 28,000 pyoung, and the development of another 1 million ‘pyoung (3.3 meter<sup>2</sup>)’ as the first steps, and the opening of an overland route to ‘Mt. Geumgang.’ Besides these developments, it seems that North Korea is also trying to vitalize foreign trade through the decentralization of trade. Previously, foreign trade was operated through the central government, but now it is allowed by individual cities (si)/county (gun)/company. Specialized companies in each industry were found to increase efficiency through consolidating trade management organizations. In January 2004, North Korea created the “International Trade Arbitration Committee” under the Ministry of Foreign Trade and allowed for the founding of foreign law consulting firms in North

Korea to solve legal problems concerned with foreign investments. The minimum wage was decreased from 80~120 dollars to 38 dollars to induce foreign investment.

**Table 1.** Main Contents of Economic Reform in North Korea after the “July 1<sup>st</sup> Measure”

Area	Specific Area	Main Contents
<b>Management of the Economy</b>	Consciousness	<ul style="list-style-type: none"> <li>- New ways of thinking</li> <li>- Encouragement of consciousness and behavior</li> </ul>
	Law, Institution	<ul style="list-style-type: none"> <li>- Enactment or revision of the laws concerning the economy: Law of People’s Economic Planning, Law of Loss Compensation, Inheritance Law, Agricultural Law, Law for Foreign Investment Banks, Treasury Law, Accounting Law, Commercial Law</li> </ul>
<b>Macro Economy</b>	Price, Wage	<ul style="list-style-type: none"> <li>- Realization of prices and wages</li> </ul>
	Treasury	<ul style="list-style-type: none"> <li>- Abolition of subsidies</li> <li>- Reduction of the budget system organizations</li> <li>- Collection of National Payment according to earned income</li> <li>- Enactment of National Company Profit</li> <li>- Change of the Local Payment System</li> <li>- Enhancement of the Provincial Budget System</li> <li>- Issue of the public bonds</li> <li>- Enactment of Central Bank Law and Transition to the Dual Bank System</li> </ul>
<b>Industry</b>	Agriculture	<ul style="list-style-type: none"> <li>- Improvement of Unit Management System, Reduction of the size of the unit</li> <li>- Introduction of Pojeon Damdang-je</li> <li>- Abolition of the Foods Rationing System and Introduction of Dual Price System for Grain</li> </ul>
	Production in Company	<ul style="list-style-type: none"> <li>- Strengthening of responsibility of management, Enlargement of Autonomous Management System (Labor and Wage Management)</li> <li>- Allowance of Trade Market for Companies</li> <li>- Enlargement of responsibility for financial operation of companies</li> </ul>

Area	Specific Area	Main Contents
<b>Merchandising, Distribution</b>	Commercial Management	<ul style="list-style-type: none"> <li>- Establishment of Goods Supply System excluding foods</li> <li>- Introduction of Consignment Sale System in the State-owned Stores</li> <li>- Allowance of rice and industrial goods sales in the marketplace</li> <li>- Renaming of the Farmer's Market as General Market</li> </ul>
	Distribution	<ul style="list-style-type: none"> <li>- Establishment of the General Market</li> <li>- Allowance of the Selling Counter Business</li> <li>- Dualization of the State-owned Restaurant and Restaurant of Agreement System</li> <li>- Allowance of private operations such as consigned purchasing</li> </ul>
<b>Foreign Economy</b>	Special Economy Zones	<ul style="list-style-type: none"> <li>- Additional opening of (Shineuiju), Mt. Geumgang, Gaesung</li> </ul>
	Trade Management	<ul style="list-style-type: none"> <li>- Foreign Trade by City, County, and Company Level (Decentralization)</li> </ul>
	Law and Institution for Foreign Trade	<ul style="list-style-type: none"> <li>- Actualization of the exchange rate</li> <li>- Installation of the Foreign Currency Exchange Place</li> <li>- Change of the Foreign Payment System</li> <li>- Decrease of the minimum wage</li> <li>- Enhancement of investor relations</li> <li>- Special favor for investments by overseas Koreans</li> </ul>

## 2. Side Effects of Economic Reform in North Korea

According to the point of view, the side effects of economic reform can be seen either as positive or negative. Marketization and its effect of reduction in the planned sector of the economy and the changes of consciousness toward mammonism for the general public is a negative phenomenon from the viewpoint of North Korea but positive for South Korea. In this chapter, both the side effects and ripple effects of economic reform in North Korea will be considered in the economic and social context, mainly focused on the negative aspects.

## **A. Economic Aspect**

One of the most important causes of economic/social side effects resulting from North Korean reforms seems to be the consequent increase in inflation. In other words, inflation is a main source of side effects in North Korea. Inflation brings discrimination of incomes and broadens the gap between the haves and have-nots, causing people to suffer from poverty. This poverty may likely lead to various kinds of social problems including illegal behaviors.

At this point of time, four years from the beginning of reforms, inflation in North Korea is so serious that it would be enough evidence to conclude that the reform failed. Despite the “July 1<sup>st</sup> Measure,” state owned stores cannot deal with the chronic shortage of goods and prices in marketplaces are repeatedly soaring. Since 2003, the average rate of price increase in the informal sector has been more than 100% annually. The price of rice, the leading index of the North Korean price level, is moving in a large range, and one time soaring almost 20 times compared to the year of the “July 1<sup>st</sup> Measure.” For this reason, North Korean authorities have prohibited the trade of rice in markets from October 2005 and revived the rationing system.

The most important reason for inflation is the collapse of the rationing system, which caused shortages of food and daily commodities. Now in North Korea, the planned economy system is differentiating the planned sector from the private sector such as farmer’s market. As the rationing system is collapsing, people do not have any other means except to depend upon the farmer’s markets. In other words, they have to get food and daily necessities from the marketplace instead of rations.

Most factories and companies in North Korea are not operating at their full capacities. The average rate of operation is less than 15~20%. This situation facilitates unemployment and expels jobless

workers into labor market. This is a serious deepening of social polarization.

An increase in unlicensed sales is another side effect of the economic reform. This implies there is a “softening process” of the socialist planned economy. There are increasing cases of disposing products or deciding prices arbitrarily. The “Socialist Criminal Law” of 2004 has many important differences from the earlier legislation; for example, article 160 lay down less than 2 years of penal servitude for supervisors of organizations who give products to unrelated individuals illegally. This shows that there are lots of such cases like misappropriation or arbitrary disposal of products. Considering article 167 that defines installing and using a telephone arbitrarily as a crime, it can be inferred that there are increasing cases of installing telephones illegally for the people who have money but cannot follow the normal procedures. Economic hardship has made it difficult even to install a telephone. Further, article 170 is concerned with the price system. According to this article, anyone who decides a price arbitrary or changes the official price will face punishment, signaling that some prices had been decided arbitrarily after the “July 1<sup>st</sup> Measure.”

## **B. Social Aspect**

There are serious problems concerning corruption in North Korea. High-ranking officials in the party or government used to waste the public purse illegally, and even encouraged their subordinates outspokenly to embezzle or misappropriate public money. Bureaucrats in economy or administration related department try to find a sponsor in the party or government, and they do not hesitate to employ corrupt methods under the belief that their sponsor will protect them in case of discovery. Bureaucrats steal goods in the process of handling them. On cooperative farms, high

officials plot together to pilfer grains like rice, while officials who handle the distribution steal rations.

Bribery is common in almost every class in North Korea. To be promoted in a company or public office, to get all sorts of the special favors, North Koreans give and take bribes. It is necessary to bribe somebody to be placed in a good job, to get a house, to be admitted to university, to join the Labor Party, to get travel license, and in many other situations. There is an invisible link between the underground economy and public sector to form a consensual relationship. As corruption is prevalent in the whole societal structural, it is possible to say that corruption is guaranteed institutionally, in a sense.

There are changes on the sense of value and mode of behavior of the North Korean people under this situation. The ruling values of socialism are eroding. As the market plays a critical role for survival, a new sense of values is forming. The realization is spreading among North Korean people that South Korea is not the sworn foe anymore but is a partner to cooperate with. North Koreans are also becoming aware of capitalistic values that focus on money and profit and the need to cooperate with the international community. Changes in the economy are creating a market-friendly consciousness that includes individualism and pragmatism while loosening the grip of the socialist ideology.

Most of all, the change of consciousness on money has evolved into mammonism, which now dominates all areas of life. Contrarily, faith in collective labor is fading. Most North Korean people are indifferent to economic activities in the formal section. Because North Koreans cannot make a living with their formal wages, they concentrate their efforts on side jobs or small businesses of their own rather than do their best at the regular jobs. Each company and factory is more interested in the acquisition of foreign currency than its own business, and everybody wants to make more money

beyond regular salaries through extra businesses. With the allowance in part of private trade between individuals, the gap between the haves, who quickly adopted the principles of the market economy, and have-nots, who were slower to adapt, is widening more and more.

After the “July 1<sup>st</sup> Measure” in 2002, there have been various deviant behaviors that threaten the very bases of socialism in North Korea. Economic crimes like stealing and plundering are not rare any more, and these have become serious social problems. Crimes related to foreign currency are soaring as well.

The revised criminal law includes articles for crimes such as forgery of currency (Article 99), use of forged currency (Article 100), forgery of securities (Article 101), use of forged securities (Article 102), illegal issuing of cashless payment means (Article 103), illegal trade of foreign currency (Article 104), diversion of North Korean currency to the other countries (Article 105), and violation of the foreign exchange control rules (Article 106). In addition to the existing articles such as destruction, illegal digging, and smuggling of historical relics (Article 196-198); violation of copyright (Article 199, 200); child violation and protection rules (Article 207); medical accident and unauthorized medical treatment (Article 209-211); manufacturing, trading, and smuggling of narcotics (Article 216-218) have also been created. The following articles have been supplemented: involvement with decadent business (Article 193, 194); listening to the broadcasts of hostile countries; collecting, keeping, distributing subversive printed materials (Article 195); intrusion into the computer network, destruction and distribution of information (Article 201-203); neglecting compulsory education (Article 204, 205); acquisition, trade, and use of human organs, fetuses, and blood (Article 214); manufacture and trade of fake medicine and food (Article 215).

### 3. Evaluation and Prospects of North Korean Economic Reform

In the four years since the “July 1<sup>st</sup> Measure,” South Koreans have been forming a broad spectrum of opinions and viewpoints on the economy of North Korea. Some experts suggest that economic reform in North Korea is changing from “the reform of internal system” to “the reform of system itself,”<sup>5</sup> and the direction of reforms is shifting toward a gradual marketization.<sup>6</sup> Others argue that fundamental change regarding with economic system has not started yet,<sup>7</sup> therefore, the current reforms are to reinforce the socialist system in North Korea.<sup>8</sup>

With regard to the prospects for the economy of North Korea, every expert agrees upon the actions necessary for real economic reform, including the “July 1<sup>st</sup> Measure,” as the elimination of inefficiency in the existing system and a reflection of economic realities which, until now, had been distorted. But, there are two contrasting point of views, and these are that North Korea’s

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<sup>5</sup> Yim, Hyeon-Jin · Jeong, Young-Cheol, “Economic Reform in North Korea: Is it a Road to Capitalism?,” (Korean), North Korea Graduate School in Kyungnam University, *Studies on Modern North Korea*, Vol. 7, No. 1 (2004), pp. 123-166.

<sup>6</sup> Jeong, Se-Jin, “A Study on North Korean Economic Change on the Viewpoint of the Transitology,” (Korean), The Korean Association of International Studies, *Treatises on International Politics*, Vol. 26 (2003), pp. 209-229.

<sup>7</sup> Shin, Ji-Ho, “Evaluation and Prospect of the July 1<sup>st</sup> Measure,” (Korean), a paper published in the symposium of the Society on North Korea Studies (December 6, 2002).

<sup>8</sup> Cho, Dong-Ho, “Normalization of the Planned Economy System: Analysis and Prospect of the Recent Economic Actions in North Korea,” (Korean), *KDI Policies Forum* (2002), pp. 14-16; Yeon, Ha-Cheong, “The July 1<sup>st</sup> Measure in North Korea and Out Tasks,” (Korean), *KDI North Korean Economic Review* (September, 2002), p. 27.

economy will develop toward marketization and the time is not yet ripe for exact evaluation. In this section, the economic reform taking place in North Korea will be reviewed from the simple viewpoint of marketization. In other words, asking the question, is the economic reform in North Korea truly focusing on marketization?

### **A. Evaluation on Marketizational Motive of Economic Reform in North Korea**

The main point of economic/social changes in a socialist system is the introduction of a market mechanism. Marketization – transformation to the market economy – means replacement of the existing economic order and rules of socialism with the new orders and rules of the market economy. Ultimately, economic reform in North Korea should be evaluated by the measure of change occurring within the system as well as the change of the system itself.

It can be said that North Korea has achieved marketization when the economic functions as outlined in the following paragraphs have been applied.

First, the market should play a role as an economic coordinating system. However, there is currently no substantial evidence of this kind of market function in the economic reform of North Korea. Such a function is appearing faintly only in the black market. Except for foods, the rationing system was abolished after July 1<sup>st</sup>, 2002, so people can now buy goods in state-owned stores with cash. Even though one may suggest that abolition of the rationing system and trade of goods based on product cost and profit are evidence of the monetary economy, it does not mean that the price is decided by demand and supply or by individual economic units autonomously. Although North Korea introduced and applied the

elements of a market economy, it is different from the capitalistic market because it is operated by socialist principles and the planning of the government. For example, the price is “controlled by the government within the economic control system,” and the range of its variation should stay within 5 to 10%. There are the general markets, but they are a part of state-owned enterprises. Of course, there is a possibility that this kind of North Korean marketization will be developed and expanded gradually to the capitalistic market. There are some grounds for this expectation: ① the rationing function of the government is continuously being replaced by the farmer’s market; ② various undercover arrangements between companies fill up the deficiency of resource supply function of the central government; ③ lower units like companies and factories are getting more autonomy; ④ self-help actions are thriving among the most executive members and ordinary people, and ⑤ various economic activities which are deviations from the traditional framework of the planned economy will be continuously allowed by tacit consent of the authorities.

Second, the private property ownership system should be improved. Since the means of production in a market economy system are the private property of each individual who is a member of the society, anybody can use or dispose of these means arbitrarily within the extent of the given legal order. Also, inheritance rights as well as property rights should be admitted. The revised constitution of 1998 enlarged the extent of ownership of the means of production. Nevertheless, a private property system allowing for private ownership of the means of production has not changed even after the “July 1<sup>st</sup> Measure.” The North Korean government defines the private ownership system as “the evil exploitation system for capitalists who want to monopolize the means of production, infringe on the self-reliance of working class, and feather their nests.” It bluntly announces that the private ownership of companies

should never be allowed.

Third, a decentralized determination system should be established. The forms of the determination system are largely classified according to the degree of centralization such as complete centralization, administrative decentralization, manipulative decentralization, and complete decentralization. A complete centralization or complete decentralization determination system is rarely seen in reality. Under administrative decentralization, the central authority determines basic matters and the more specific matters are handed over to a lower level of authority. Direct order or restriction on determination rights control the lower level of authority. In contrast, determination rights are not so narrowly restricted under manipulative decentralization, and the market mechanism takes a critical role. Considering the above definitions, North Korea is still following an administrative decentralization system. There are some signals, of course, that show autonomy and efficiency of economy such as the decrease of the central planned index, the increase of autonomy for the provincial economy, and the abolition of “averagism” and the introduction of a competitive system. In this sense, it can be said that North Korea is in transition from administrative decentralization to manipulative decentralization. There are some examples of the decentralized information system such as allowance for factories and companies to trade raw materials and parts and the master plan for the general wholesale market to supply raw materials (*Chosun Shinbo*, April 28, 2003).

Fourth, material motivation and incentives are needed. Motivation stimulates people to do something, and it is the main source of economic activity and the driving force of the change and development for a whole society. Individual economic behavior is determined by the purpose of the behavior and incentives which are provided by society. In the case of North Korea, while it is

true that the motivation for survival is stronger, one cannot totally ignore the material incentive system. North Korea tried to settle distribution according to labor, which was helpful to increase productivity. This means an incentive system that encourages motivation and increases productivity. In other words, it is a whole new system of “distribution according to the work done.” Actually, after the piece rate with material incentive system was settled, money began circulating in North Korean society. More than half of a laborer’s wage is coming from the piece rate.

## **B. Evaluation on Economic/Social Aspects**

First of all, it is not believed that the North Korean authorities have a serious intent to achieve the marketization. The most important variable of the change in North Korea is the intent of the highest policy determiner toward reform and opening. With Kim Jong-il’s “new thinking” and concentration on science and technology, North Korea is attempting to throw obsolete ideas away and pursue fundamental reform to adjust to the new environment. Although North Korea may try to changeover to reform and opening under the realization of the limitations of a self-reliant national economy, it cannot be regarded as reform toward the market economy. For instance, the following comments from Pyongyang suggests North Korea’s point of view about reform and opening: “After dissolution of the Soviet Union, Russia’s national power was rapidly weakened. Its economy is all topsy-turvy, society is in a mess, and its military strength, which once vied with the U.S., has gradually withered. Even if economic cooperation with the capitalist countries is solidified, Chosun will never follow the policy of China such as ‘to make all people rich, we should make some people rich first.’”

The reform and opening toward marketization in North Korea

should begin with denial of the existing order. Kim Jong-il needs to deny the Kim Il-sung era completely and go through a critical reappraisal. In reality, however, it is impossible to denounce the Kim Il-sung era completely in a “Leader System” country like North Korea, and, therefore, only partial reform and opening is possible according to Kim Jong-il’s resolution.

Although North Korea is moving toward economic/social reform with improvement on the price system, allowance of autonomous management for companies and factories, and gradual abolition of the rationing system after the “July 1<sup>st</sup> Measure,” it is regarded as reform within the socialist system because the socialist principles and the framework of economy’s control system remain intact.

Second, there is an obvious intention to adhere to the socialist planned economy system in the newly enacted or revised economy law and criminal law. The foreword of the code of law points out that the purpose of publication is to make the ordinary public fully realize “our own socialist policies” of the government. Each law describes illegal behaviors of responsible workers in detail concerning the establishment and carrying out of the people’s planned economy system, for example, irresponsible conduct in foreign economic activities, illegal management of economy, illegal trade of state-owned houses, violation of *juche* ideology in agricultural techniques, violation of merchandizing discipline, violation of price-business-discipline, and so on. The fact that these kinds of stipulations are described in detail reflects the intention to adhere to the socialist system. On the other hand, these laws are counterevidence that anti-socialist economic behaviors are increasing in the process of the economic reform and opening.

Third, even though economic reform reveals its limitations because of shortages in investment, energy, and raw materials, commercial transactions are activating as productivity in labor-intensive industries like agriculture and light industry is

improved. Grain production has increased steadily due to improvements in motivation and efficient land utilization (3.95 million tons in 2001, 4.13 million tons in 2002, 4.25 million tons in 2003, and 4.31 million tons in 2004). Growth in light industry (2.3% in 2003) is observable as well as managers in factories and companies, who have been allowed autonomous management, concentrate on creating profits. The most animated field is merchandising and distribution. With the growth of the general market, 9.8% of growth rate in wholesale/retail section significantly exceeds 1.8% of the average overall growth rate.

A foreigner who visited North Korea in March 2003 remarked, "I hardly believed that I was in North Korea when I visited the *Tongil*-street market." His remark suggests that the results of reform reveal itself in the area of merchandising and distribution. The "general market" in North Korea is not a simple one that trades the surplus products of companies, but a tool for satisfying social/collective demands.<sup>9</sup>

Fourth, the changes in consciousness occurring throughout the society will promote marketization in North Korea in the long run. Before everything, most people and companies become aware of the market economy as the areas of government planning decrease while consciousness of the market economy increases. The change in consciousness through reform leads to the awakening of potential for change among the people. For example, people's daily lives are being transformed from survival-oriented to profit-oriented through their private economic activities.

Generally, economic reform has encouraged people to focus on their private interests rather than public ones and practical values rather than ideological ones. As a result, "privatization" is expedited

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<sup>9</sup> Internal document of the Ministry of Unification, "This Year's Trend of the Change on the Operation of the Farmer's Market," (Korean), p. 3.

in the whole of people's lives. It is similar to the situation in Soviet Union and Eastern European countries before 1990, but the intensity of change is far lower. It is hard to anticipate that the changes in the sense of values in the North Korean people will evoke fundamental reform on the political system because it is rather a materialistic pragmatism. Moreover, they have not experienced civil society, so their way of thinking is still similar to that of a dynastic era.

Comparing marketization in North Korea with the ones of other socialist countries like China and Vietnam shows clearly that the economic reform in North Korea does not have the characteristics of fundamental changes to the system.

First, the content and quality of the reform in North Korea are far beyond of China and Vietnam. North Korea has totally different point of view toward the reform from other countries. In China, the economic reform focused on the improvement of productivity in the context of pragmatism, and pursued changes in the system and opening simultaneously since 1978. Vietnam's "Doi Moi" in 1986 also concentrated on economic reform and opening at the same time. In case of North Korea, however, inefficiency in the system has not been removed since it pursued limited opening with a few special economic zones while the socialist system itself remained intact.

Second, since state-owned industry control an overwhelming portion of the North Korean economy and the planning authority restricts the development of the non-state-owned or private sector, the opportunity for non-state-owned or private businesses to be developed is much less than that of China or Vietnam.

Third, although it is true that international politics have many disadvantages for North Korea, the country itself does not express the desire to be involved on the international stage. On the contrary, North Korea adheres to self-reliant national economy policies, and

this is a major difference from the economic reform of other socialist countries.

Fourth, there are some advantages for North Korea to pursue reform vigorously such as the industry structure that focuses on manufacturing, a far smaller sized economy than China, and the possibility for powerful developmental dictatorship. Nevertheless, Kim Jong-il's intention is not complete economic reform. North Korea shows strong volition toward keeping to the fundamentals of socialism, and this is the reason why the reform in North Korea is so lethargic.

### **C. Evaluation and Prospect of North Korean Economy**

Economic reform in North Korea was not aimed at marketization from the beginning. North Korea experienced terrible economic suffering known as the “march of hardship” in the 1990s. In the meantime, as the economy of the non-official sector has dramatically expanded, the planned economy system was nearly paralyzed. People desperately needed some solutions to survive. From the mid 1990s, people purchased up to 60% of their foods and 70% of their daily commodities from the farmer's market. This was an abnormal expansion of the non-official economy sector. For this reason, the North Korean government tried to reduce the non-official sector and improve the operation of the official, planned sector. This was the direct motive behind the “July 1<sup>st</sup> Measure” in 2002 and the series of subsequent related actions. In other words, it is more reasonable to think that economic reform in North Korea did not aim to transform to a market economy system but for normalization of the official sector.

However, considering the characteristics of the “July 1<sup>st</sup> Measure,” it seems that there is a possibility to advance marketization.<sup>10</sup> One can call this “marketization North Korean

style.” Even though North Korea introduced the elements of a market economy, it is a market of “their own form,” shaped by socialist principles and with operation through government planning.

Although “marketization North Korean style” is not marketization in the strict sense, it is true that there are some sprouts of marketization blossoming in the following accounts.

First, North Korea has formalized its reforms. The country had avoided using terms like “economic reform” and “market” but has begun using these officially since June 2004. There are some examples that suggest the possibility for real marketization such as a change of viewpoint toward the market<sup>11</sup> from an object for control to a part of the distribution mechanism,<sup>12</sup> and with the intention to link markets with economic reform.<sup>13</sup> North Korea has adopted policies to utilize the market as a tool of increasing financial income by collecting “the market rental fee.”<sup>14</sup> Markets in North Korea are not simple marketing locations in which surplus

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<sup>10</sup> Hong, Ik-Pyo · Dong, Yong-Seung · Lee, Jeong-Cheol, *Recent Change on Price/Distribution System in North Korea and the Tasks on Reform: A Comparative Study to China* (Korean), the policy studies in Korea Institute for International Economic Policy 04-15 (2004), p. xiii.

<sup>11</sup> “(...) the market is a part of the distribution... (we) should not ignore the function of market in spite of socialism.” *The Chosun Shinbo* (June 16, 2003).

<sup>12</sup> “The government admits the market as a part of distribution, not the object of control. The farmer’s markets in Pyongyang became the (general) market. It is because not only farm products but various kinds of industrial products are trading.” *The Chosun Shinbo* (April 1, 2003).

<sup>13</sup> “The characteristic of the economic reform in Chosun is bold and flexible policies like the establishment of the general market.” *The Chosun Shinbo* (June 16, 2003); “Because we don't have any experience of the market, we are going to induce various cooperation like training the experts and introducing experiences from other countries.” *The Chosun Joongang Tongsin* (June 10, 2003).

<sup>14</sup> *The Joongang Ilbo* (June 26, 2003).

products are traded, but they are a tool for satisfying the social/collective needs that rapidly increased after the “July 1<sup>st</sup> Measure.”<sup>15</sup>

Second, North Korea has been trying to suppress the money supply in the distribution market. The government takes actions like issuing government bonds to suppress the increase of money supply and attribute the remaining money to economic development. In other words, government bonds are a tool to collect the excessive money supply that results from inflation. This is a typical policy from the monetary economic theory in the capitalist economics textbook.

Third, prices are set flexibly to a certain extent. The government had determined the price arbitrarily in the past, but after the “July 1<sup>st</sup> Measure” buyers and sellers could decide the price by demand and supply in the range of 5~10% of the government determined price.<sup>16</sup> This means that there is room for the influence of demand and supply on the basis of the official price.

Fourth, factories and companies are operated in order to generate profit, implying that autonomy in management has been enlarging through the introduction of the self-supporting accounting system.

Fifth, preparations for economic opening are being observed. North Korea established the “Institution for Capitalistic Market Economy System” under the Ministry of Trade in 2000 to elaborate more than 60 laws concerned with foreign investment. The country also joined several international economic organizations and agreements: International Bar-Code Organization, International Textile and Clothing Bureau, International Chamber of Commerce (ICC), Society for Worldwide Interbank Financial Telecommuni-

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<sup>15</sup> Internal document of the Ministry of Unification, “This Year’s Trend of the Change on the Operation of the Farmer’s Market,” (Korean), (2005) p. 3.

<sup>16</sup> The comment of Kim, Yong-Sul, the vice Minister of the Ministry of Trade in North Korea (September 2002).

cation (SWIFT), along with some agreements on intellectual property.

In this respect, it can be said that economic reform in North Korea is in a rudimentary stage. If the reform in this stage is successful, the country can pursue more drastic reform. The introduction of an “earned income index” enhances the autonomy of factories and companies. When awareness of “one can earn money as much as he or she works” is settled, economic reform in North Korea cannot but move toward “market socialism” like China with a pragmatic focus such as “it is a good cat if it catches the mouse, no matter black or white.” The “earned income index” will bring changes. Most importantly, it will change “the measure of evaluation on a company’s performance from how much it produced to how much it earned, and companies can dispose of more of the surplus at their own disposal.”<sup>17</sup>

One of the most interesting things in North Korean reform is the limited autonomy for companies and income differentiation. These enable companies to prepare for a competitive environment and enables individuals to consume according to their demands.

There are some elements that are expected to bring about positive effects for systematic change in North Korea. These are: ① a decrease of the government planned sector; ② an increase of uninterrupted sales; ③ an enlargement of rights for each production unit for purchase, produce, sell, and price; ④ an enlargement of options for consumer goods because of the reduction of the rationing system; ⑤ an increase in importance of provincial finance; ⑥ an enlargement of ownership for social cooperative organizations and profit-making side jobs for individuals ⑦ an adjustment of the exchange rate and creation of special economic

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<sup>17</sup> Park, Hyeong-Jung, “Achievement of the July 1<sup>st</sup> Measure and the Prospect of the Economic Reform,” (Korean), Institute for Peace Affairs & Hans Seidel Foundation, 2004 Seminar for Unification (May 24, 2004).

zones; and ⑧ an application of the incentive system.

On the other hand, there are some negative elements, specifically: ① an absence of a free pricing system, which is the critical part of marketization; ② imperfect reform on the ownership system of the means of production including land; ③ an absence of economic special zones for independent foreign companies; and ④ limitations in the incentive system. One of the important standards of change in the North Korean economy is the reform of agriculture. Although there are some forward-looking changes, such as reduction of the size of units and allowance for arbitrary disposal rights of surplus production, these are not enough to secure fundamental reform like a farming system in family units or motivation through market mechanisms as appeared in the early stage of reform in China and brought about fast growth.

However, it seems that there is no other way for North Korea except importing more of the principles of the market economy. Of course, it is too early to decide whether it would have a positive impact on the changes taking place in North Korean society and economy, as occurred in China and Vietnam.

If the North Korean economy continues to develop in the direction of a reduction of the formal sector and enlargement of the non-formal one, it is predictable that there will be some negative phenomena. These are described in the following paragraphs.

First, inflation will continue to aggravate the ordinary people's poverty. When the shortage economy now being experienced in North Korea is considered, there is a stern possibility of deterioration for the ordinary people's daily lives despite the positive effects of the "July 1<sup>st</sup> Measure."

Second, behaviors that deviate from the socialist criteria will increase. The government had all the responsibility in the past, but now, people are facing the harsh reality that everyone should be responsible for his or her own survival. In other words, there

is the possibility of creating animosity among ordinary people toward the government. This may reduce people's faith in the Labor Party and the government as well as their belief in *juche* ideology. More specifically, there is a real possibility for the following to develop: ① antipathy against the idolization of Kim Jong-il; ② a weakening of collectivism and a strengthening of individualism; ③ a surging of mammonism and corruption; ④ a spreading of sense of the failure of socialism; ⑤ the phenomenon of "the rich get richer, the poor get poorer" and a decline of the socialist welfare system; ⑥ a prevalence of "moneymaking" for survival (for example, focusing on one's own kitchen garden rather than the collective farm, smuggling out products or machinery from the farm or factory, etc); ⑦ popularity of foreign trade companies, hotels, overseas branches of government, and chances for overseas training; and ⑧ the possibility of the collapse of the existing resource management system of the planned economy.

Third, as contacts with foreigners and the economic interchanges increase, there are possibilities for many problems. The following articles of criminal law attest to the phenomenon of increases in the economic interaction with foreigners, for example, "try to make foreign money illegally" (Article 125), "try to utilize the source of foreign money illegally with domestic money or goods" (Article 126), or "inflict huge losses because of incapable or irresponsible economic activities with other countries" (Article 124). These articles show that the authorities have uneasiness and are cautious toward foreign trading despite admission of the inevitability of it.

Fourth, it is expected that new economic goods in service areas will be developed. Currently, there is an article that prohibits the illegal issue of cashless payment means (Article 103). This suggests that credit cards are available in North Korea already. Further, as article concerned with a "violation of the rights for trademarks" shows that trademarks are under protection as a good. There are

a variety of subjects of economic activities including not only “individuals” (Article 11) and “managers of organizations, companies, and institution” (Article 111) but also corporate bodies (Article 112). This means there are needs for restriction as mediation and other business activities are starting to appear.

Fifth, there is the possibility of more serious corruption of bureaucrats accompanying further economic reform. It is because of the changes in policy allowing for more chances for bureaucrats to pursue their own economic interests. When there is a time difference between the practical execution of a reform policy and the enforcement of related laws and rules to prevent the malfunction of the policy, the bureaucrats who are well versed in the principles of organizational operation tend to become involved in various kinds of corruption. Without any private companies, the probability of corruption may increase because there are no other subjects but bureaucrats who can make contact with foreigners.



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## V. Tasks for Successful System Transformation through the Economic Reform

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### 1. Premises for Successful Economic Reform

The most serious problem with North Korean economic reform is the fact that reform is not reform-like. “Being not reform-like” means it does not have enough elements of system transformation such as marketization. In case of the North Korean economy, it is impossible to make success or overcome the shortages of the economy with “reform within the system,” that is, “operating the economy in order to produce as much profit as possible within the framework of socialist principles.”<sup>18</sup> Even though the market system is allowed in the area of distribution, there will be limitations in increasing productivity unless complete autonomy is allowed.

In this aspect, the pending question of the economic reform in North Korea is the marketization or liberalization of the economy. To support economic liberalization, the following actions are

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<sup>18</sup> “Let’s Enhance the Dignity and Prestige of the Republic Along with the Great Banner of Son-gun,” (Korean), *The Rohdong Shinmun* (January 1, 2003).

needed as described below.

The most important is the preparation for economic insecurity through political security. There is a high probability that the flames of economic problems will leap into crisis for the whole society as the actions for change are not supported by the supply system. There are certain potential sources of social insecurity such as critical or conservative viewpoints among the bureaucrats and military, impoverishment of the people attended by a scarcity of materials and a rise in prices, economic uncertainty and difficulties in policy making based on insufficient operating capacity, and a deepening gap between the haves and have-nots. Because this uncertainty may aggravate dependency of the North Korean economy on China or South Korea and cause an alienation of people from the government, it is necessary to establish political/economic/social actions for internal control. In the process of problem solving, it is important to pursue cooperation with neighboring countries, like China, without giving too much importance to any certain country.

Under the current conditions, including poor productivity, support from other countries is very important. To mitigate the shortage of supplies such as foods, daily commodities, and raw materials within a short period, there is no other way than to induce more foreign aid. Investments from South Korea and other foreign companies and financial supports from international financing organizations are needed as well to enhance productivity. In addition, cooperation with foreign countries should be strengthened to guarantee the North Korean regime. The future of the country depends on the policies of other countries, especially the U.S., rather than its own political direction or internal development.<sup>19</sup>

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<sup>19</sup> Park, Hyeong-Jung, *Ability, Direction, Speed, and Tendency for Change in North Korea* (Korean), (Seoul: Korea Institute for National Unification, 2001), p. 167.

It is hard to expect active economic reform to be pursued in the middle of the insecurities of the North's regime. In order to conclude international agreements on the security of the North Korean regime, the most impending task is the solution of the nuclear issue through diplomatic means.

In this respect, improvement in the relationship with the U.S. is as important as systematic reform in North Korea. Foreign investment induced to North Korea is far less than that of China, which has pursued economic opening from the late 1970s, or Vietnam, which started its reform later than North Korea. China and Vietnam have successfully attracted foreign investment through normalization of relationships with western countries including the U.S. and have pursued systematic reform and economic opening simultaneously. In conclusion, it seems that successful reform and opening for North Korea depends on a proper internal reform program and the improvement of relationship with the U.S.

## **2. Direction of Economic Reform for North Korea**

If above premises are satisfied, North Korea can pursue economic reform in the following directions as outlined below.

First, the internal environment across the economy should advance toward more practical marketization, specifically: ① the future of the economy should be clearly set with there vision of laws concerning the transition to a market economy; ② a functional price system should be constructed in order to allow competitive pricing through demand and supply except for special cases of governmental interruption; ③ the private ownership of the means of production and liberalization of trade or disposal of those means of production is needed in order to motivate companies to maximum efficiency; ④ the entrance or withdrawal from a market, job choice, founding companies, and business activities should be

liberalized; and ⑤ a financial system should be established based on the order of the market economy. It is desirable that these actions take place simultaneously in a short term.

Second, foreign trade should be liberalized, specifically: ① capital flow in foreign trade should be liberalized, but the variable exchange rate according to purchasing power is more desirable than a fixed exchange rate system; and ② after liberalization of capital flows, goods and services should be transferred freely. In addition, protective trade policies are desirable in order to avoid decreases in domestic production and employment according to increases in demand for foreign products.

Third, various complementary measures are needed to deal with the problems concerning market-ization. Specifically, ① monetary and financial policies are needed to balance between the real market and the monetary market, and it is also important to seek the security of monetary value to avoid inflation. Also, ② sales activities should be supported by various kinds of tax systems, and ③ the social security system and infrastructure should be developed. The income distribution system needs to be improved, while monopoly companies should be controlled properly. Further, organizations and institutions should be established to support various kinds of economic activities, and other supplementary actions are needed to support the rationalization of companies to improve productivity and to deal with market failure. Lastly, ④ public goods (i.e., education, media, public health, and culture) should be enhanced to strengthen the function of the market.

In addition, it is necessary to prepare for the assorted problems as follows: ① inflation, ② unemployment, ③ negligence according to decentralization, ④ human resources and the institutional mechanism in order to abuse of power and corruption, ⑤ guidance for sense of value in order to overcome ideological confusion, ⑥ protests from those who have vested rights, ⑦ bringing up and

training for company managers, and ⑧ educational efforts to make people adjust to the market economy.<sup>20</sup>

Along with marketization, a serious problem may be raised concerning the financial resources needed for economic development. If the amount of the national budget is enlarged artificially to secure the necessary financial resources, it may cause a terrible shock to the economy. As marketization goes through, it is likely that the center of balance will be transferred to exports. For this reason, a strategy is needed to support the financial policies of the export sector represented by the special economic zones. Most importantly for this matter, a commercial financing institution should be established to support the private sector.

### **3. Specific Tasks**

#### **A. Enlargement, Improvement, and Development of the “July 1<sup>st</sup> Measure”**

North Korea should maintain the underlying tone of the “July 1<sup>st</sup> Measure.” It is virtually impossible to turn back the emerging monetary economy, which is represented by the increase of wage and prices, to its past state. Although the effects of the “July 1<sup>st</sup> Measure” are not so significant, the reformative action itself should continue to proceed in the directions discussed below.

##### **(1) Agricultural Reform**

When the cases of China and Vietnam are referred to, practical economic reform in North Korea should start in the agricultural

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<sup>20</sup> Lee, Seo-Haeng, “Doi-Moi Policy in Vietnam and the Prospect of the Opening in North Korea,” (Korean), *The Results of Opening Policy in Vietnam and Its Meaning to North Korea*, 2003 Research Contract of the Education Center for Unification (2003), pp. 112-113.

sector. In other words, North Korea needs to concentrate on agricultural reform with all its strength. First, fundamental reform of the ownership system is imperative to increase the severely depressed motivation of farmers. For actual privatization, the existing cooperative farming system should be discarded. In addition, autonomous rights to sell products at market prices, rental of farms, choice of crops and farming methods should be allowed. If rental rights are transferred to capable farmers, it will lead to the establishment of commercialized farming which can pursue economies of scale.

## **(2) Strengthening the Link Between Market and Economic Reform Measures**

Market activities should be greatly expanded, and market functions should be strengthened. It is important to link the market and economic reform by gradual increases in the commercial transactions in the market. The increase of commercial transactions in the market may drive subsequent reform measures to facilitate the process. In this respect, subsequent measures should be linked with a free-pricing system.

For this purpose, it is necessary to continuously expand and strengthen the upgraded price system of the “July 1<sup>st</sup> Measure.” This will replace the official price system. Each company should have expanded rights to decide the price of its products. Although the official price system by the government will not disappear for some time,<sup>21</sup> prices should be decided by the principle of supply and demand in the long run. Since it is almost impossible to supply goods through a state-owned store network, commercial transactions made through the marketplace should be activated. The

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<sup>21</sup> *The Chosun Shinbo* (July 26, 2002).

North Korean people will learn the way to spend their increasing incomes through the institutionalized market and get familiar with effective household expenditure.

On the other hand, a free-pricing system depends on reasonable reform of the pricing structure. China, in the initial stage of reform, took the following measures in order to reform its unreasonable pricing system: the price ratio of each product was regulated, the existing official price was divided into a government-guided price and a market price through diversification of price control methods, then the right to decide the price was entrusted to subordinate organizations by decentralization of the price decision.

The case of China suggests that the liberalization in North Korea should be based on the big picture, an expansion of the market price and a reduction of the planned price. There are several important details for consideration in this area: ① absurdity in comparable pricing between each product should be removed ② the price control method should be diversified; ③ the right to decide prices should be entrusted to each company or provincial government through decentralization of the pricing decision; and ④ the stages of price reform should be created cautiously.<sup>22</sup> On the other hand, it is desirable that some items, such as basic consumer goods, rental fees for housing, public utility charges, fuel, and so on, are excluded from the liberalization of prices. For these items, it is beneficial that the government fill in the gaps between the market price and the real price and raises prices gradually according to increase in income. The sequence of price reform is important, too. It seems desirable to liberalize agricultural products first followed by light industrial products. This is because reform

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<sup>22</sup> Cho, Myeong-Cheol, "Support Plan for the Market Education in North Korea," (Korean), *Direction of the Reform and Opening in North Korea and the Tasks of International Cooperation* (Korea Institute for Foreign Economic Policies, 2001), p. 125.

in agriculture is easier as most products there are traded at market price already.

### **(3) Benefits for Individual Economic Subject**

The economic reform in North Korea should take actions to secure actual benefits for individual economic subjects. For this purpose, the reinforcing measures as follows are needed for both workers and companies.

First, the differentiated wage system should be strengthened. After the “July 1<sup>st</sup> Measure,” employees in North Korea started getting differentiated wages according to their input efforts. This should be strengthened to set the distribution principle of “more work, more income.” The application of this principle will inspire workers to realize the need for effective consumption and economies of scale. In addition, strengthened incentives will increase the real income of the workers, and the increase of productivity, financial income, and supply of goods will follow in turn. This is the reason why the government should take actions to increase each worker’s income. If the government reduces various costs of production such as rental fees, water, electricity, fertilizer costs, and so on, the share for each farmer will increase. This will reinforce motivation to work harder and improve the quality of the products for workers.

In companies, some actions are needed to encourage workers to satisfy the needs of consumers. Young managers who have strong drive and practical skills should be placed in the foreground, and make them do their best to increase production and income. Transition in the ways of thinking for the government is requires the following: ① an autonomous wage system; ② a wage system that can make differentiated wages as a strong incentive; ③ responsible management of companies; and ④ improvement

of the productive environment such as the supply of raw materials and electricity. For the authorities, the establishment of a secure supply system for production is imperative.

Second, the focus should be placed on the autonomy and profitability of companies. As early as 1998, the revised constitution of North Korea emphasized the self-supporting accounting system, utilizing the economic space, improvement of productivity and quality control as reasonable company management characteristics. Because the revised constitution also deals with costs, prices, and profitability, production focused on quantity should be converted into production focused on profitability. The management of companies should be based upon the self-supporting accounting system to secure greater economic efficiency. The most important thing to improve labor productivity in North Korean companies is reform on prices, wages, and the human resources management system. Managers should have complete responsibility for human resources management, finance and marketing. If the results of the self-supporting accounting system are positive, subsequent actions will be required to secure more advanced forms of management.

#### **(4) Reform on Companies**

To achieve the purpose of marketization, the reform on companies is important to secure more effective company management. One of the most important things for company reform is not only separating ownership and management but also eliminating the interference of the government. In North Korea, the plans of the government still retain plenary powers for production and management. The government controls almost everything, such as supply of resources for production and the sales and pricing of the products. Companies should hand over most

of their profits to the government in order to fulfill the national budget income. However, management losses should be compensated for by the government as well. Under this system, managers cannot take active roles in management, and it is difficult to expect improvements in technique and efficiency. In order to secure autonomous management, each company should be allowed to control the money for management under its own decisions. Instead of the system in which most fixed and liquid capital items are distributed by the government, a whole new system is required. Under the new system, capital should be procured by the companies themselves, while fixed capital should be distributed by the government on the condition of interest payments. In addition, the institutional mechanisms are also required to issue bonds or stocks and get the loan from banks directly under the responsibility of each company to secure independent procurement of funds. Instead of the political guidance and administrative interference from the party, the managers of each company should have practical responsibility.

## **(5) Reinforcement of Incentive System**

North Korea needs to convert the old practice of administrative orders and mobilization of the public into a financial incentive system. Most of all, a differentiated incentive system based on contributions to production will reinforce individual competitiveness. In North Korea, “income from legal profit-making activities” can be retained as private property. This practice needs to be advanced to allow private economic activities like individual merchandising. As the instruments of financial incentives, the following actions have already been enacted: a unit contract system as an advanced form of the unit management system in collective farms, downsizing of units, actualization of production plans according

to the achievements of the past, and rights for arbitrary disposal of surplus products. These actions should be advanced to more sophisticated systems like a “farm household contract,” which allows the renting of land and machinery for individual farm households. In addition, these actions need to be spread into manufacturing and other commercial areas. It is desirable to be connected with land rental and private ownership for means of production in individual service areas. A rent system for land should be spread all over the country and then these actions will be a springboard to catch up to Chinese reform. In the beginning, service shops such as beauty salons or restaurants as well as farmer’s markets should be allowed.

## **(6) Reform in the Monetary and Financial Area**

Reform of the monetary/financial area is also needed. If the reform is successful, the effective distribution of resources and firm development of the economy are possible. To achieve this goal, reform needs to be pursued in both monetary and financial areas. In the aspect of budget income, while the amount of profit for state-owned companies should be reduced and the reserve for the company should be enlarged, the rate charged for taxes should be lowered. In the aspect of budget expenditure, various kinds of subsidies for social/cultural events should be reduced gradually. Instead of the practice of allowing almost every fixed or fluid capital to be spent from the “budget for the people’s economy,” fluid capital needs to be allotted from the reserve of companies or borrowed from banks. In the financial area, the function of the financial market should be introduced in order to secure the internal accumulation of capital and reasonable investment. For this purpose, the current mono-banking system needs to be transformed into a two-tier banking system, meaning the separation of the

central bank and commercial banking completely.

In addition, the capital market should be activated to secure the flawless flow of money, and the issue and circulation of securities, such as stocks and national bonds, should be activated as well. The central bank needs to be freed from standardized and monopolized financial functions, so it can be faithful to its own functions like the issuing of coinage, roles as a national treasury, and other foreign currency-related services. It is also needed to found special banks for each industry by stages in order to secure efficiency; for example, the non-governmental foreign exchange business should be assigned to a bank that has a specialty in foreign trade. Auxiliary financial institutions like insurance companies and credit unions are needed to increase capital mobilization. It is important as well to establish financial markets for short term, national bonds, financial bonds, company bonds, and a stock market as prime tools for macro-economy regulation.

### **(7) Strengthening of Foreign Economic Cooperation**

There is no other way for North Korea than to pursue foreign economic cooperation. First of all, it is important to enlarge the main bodies to the level of the lower companies. The revised constitution of North Korea already established a foothold for liberalization of foreign trade by providing it a legal basis. It enlarged the main body of foreign trade from the government to the social/cooperative organizations. It is necessary to take subsequent actions, such as the joint ventures in special economic zones and the foundation of foreign trade companies, to enlarge the number of countries and items for trade. It is desirable to encourage the foundation and operation of various kinds of companies in special economic zones and to create special economic zones for bonded processing trade, not only in

Najin-Seonbong, Gaesung, and Mt. Geumgang but also Nampo, Wonsan, Haeju, Cheongjin, and others. To increase export capacity, it is necessary to take actions to devalue the exchange rate against the U.S. dollar. Devaluation of the North Korean won currency will cause the following effects: ① a decrease in the amount of foreign currency and other materials for black market and smuggling; ② an increase of exporting in the official planned economy sector and inducing foreign investment; and ③ an increase in the organic relationship between domestic and foreign prices. If exports from factories and companies are increasing, the North Korean government should take action to allow individual companies the responsibility for inducing foreign investment. In addition, a more active attitude toward joint corporations and foreign trade is required to ensure improvement of foreign relationships and vitalization of the domestic economy.

## **B. Reform Tasks in Social Context**

It is important to settle the rule of law related with economic activities as soon as possible. One of the most fundamental premises of an activated market economy is “the rule of law.” Without it, uncertainty in economic activities is increased. The indispensable condition to secure a successful transition from an economy of order to an economy of the market is the establishment of the rule of law and the principle of a law-governed society.

The market is not an artificial mechanism to create but is a spontaneous order. Transition to a market economy does not mean that a market should be created. In order to form and develop a spontaneous order named market, every member of the society should behave according to the rule of just conduct. In other words, the rule of law is imperative. Without it, the order of the market cannot be self-formative nor have self-sufficient power. To secure

the rule of law, at least three kinds of laws, property law, contract law, and tort law, need be established.

The function of property law is to clarify the extent of ownership and the area of free economic activity for individuals, as such the extent of autonomy is described in this law. Each individual has maximum sovereignty within this extent and does not need allow any arbitrary intervention of the government. If this sovereignty is not secure, no participants can make plans for economic activities without anxiety. The function of the contract law is to secure voluntary trade or exchange between economic main bodies. The function of tort law is to prescribe the responsibility for intentional or unintentional harms that may occur in the economic contact. It facilitates economic/social contacts and trades and exchanges. The authorities should establish a minimal set of laws and secure the rule of law, and then the government should reduce bureaucratic interventions and unnecessary restrictions.

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## VI . Conclusion

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### 1. The Role of South Korea

South Korea has very important roles to play during the North Korean economic reform. These are described in the following paragraphs.

First, South Korea needs to develop a more intimate relationship with technocrats in North Korea in order to induce the gradual change of the *juche* ideology and military-first policy, which are the root and trunk of the North Korean regime. The bureaucrats who are responsible for economic policies in the Labor Party, Planning committee, or Department of Treasury have had few opportunities to acquire knowledge concerning market economies. The first step of reform and opening in North Korea is to secure a bridgehead with the competent leadership. It is people who make reform and opening. It is, therefore, desirable to invite intelligent North Korean technocrats as an observation team for the South Korean economy or to foster cooperation concerning education on the workings of a market economy.

Second, it will be an effective method of cooperation if South

Korea can help to mitigate shortages of daily commodities in North Korea through making the most of the informal economic sector in North Korea. Activating the informal sector is good for the country, making use of surplus labor and creating income and helping to resolve the shortage of daily commodities. One of the ways of cooperation in order to activate informal sector in North Korea is to induce transactions of South Korean goods in the farmer's markets and the 'general markets.' In addition, it is also useful to encourage the private businesses prevalent in informal sector to upgrade to cooperative profit-making businesses. Small business owners in similar types of business can found a cooperative company with joint investment. Alternatively, home manufacturers who are assigned to factories or companies could stand alone as a cooperative company. Additionally, it is desirable, as an instructional example, to allow private business activities in the special economic zones. The purpose of these actions is to provide opportunities for creating employment and income through free, small-scale economic activities and to induce investment of foreign capital.

Third, the distribution system needs practical reorganization. Most of the ordinary people in North Korea have experiences with side jobs or private trade. The income from private trade greatly exceeds regular salaries.<sup>23</sup>

In this area, the market mechanism in which the price is decided by demand and supply is already settled. If this change of consciousness — the market mechanism being more important than labor in the planned economy sector — is prevalent, the experiences of the people should be combined with the tasks of economic reform. First of all, awareness of the need for reorganization in

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<sup>23</sup> Interview with Kim, OO, the Refugee from North Korea (September 26, 2006).

the distribution system should be the origin of a series of economic reforms. In other words, ordinary people who are engaged in private trade need to learn how to increase their income.<sup>24</sup> After that, South Korea should take action to support North Korea so that the foods and daily commodities from South Korea can be traded in North Korean markets. Goods from aid, like daily commodities, should be allowed for trade in the general markets. At the company level, it is important to combine production/distribution/marketing as a whole, so jointly produced goods should be traded in the domestic market. For example, if the direct transaction market for South Korean goods is established at Mt. Geumgang, Gaesung industrial park, and Pyongyang or part of goods produced in Gaesung industrial park are sold in the North Korean domestic market, it could induce changes in North Korea.

Fourth, a direct trading system between South and North Korea should be created, meaning that South and North Korea could trade directly with each other without any mediating third country. If this system were to be established, lots of inefficiencies (problems in communication, advancing claims, inconvenience of payment, time and cost, etc.) would be resolved. It will contribute to the activation of trade between South and North Korea by creating direct channels of communication. Agreement on the place of origin will reduce inefficiency like the dual paperwork or indirect payment, and eliminate the possibility of fraud exports from the third country.

In the long run, direct trade will contribute to the recovery and development of the North Korean economy and the increase of

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<sup>24</sup> See the following comment: “In the past, the sweet potatoes allotted through the commercial network were spoilt or untasty due to the poor storage, but now selling counters for the roasted sweetpotatoes are appearing. Because we can buy the exact amount we needs, it becomes a profitable business.” *The Joongang Ilbo* (February 27, 2003).

rights and interests of related South Korean companies. The two sides have already made an agreement on the enlargement of direct trade in the sixth round of inter-Korea economic cooperation talks (August 28, 2003). To activate direct trade, a support system dealing with material aspects as well as institutional aspects is needed. The main concerns in establishing a material support system are the installation of channels for negotiation, reconnection of mail and phone lines, direct transportation on land and by sea, and the resolution of distribution problems. In the institutional aspects, it is required to prepare descriptions of the items and extent of direct trade, confirmation of the place of origin, introduce a direct payment system, coordination of various kinds of conflicts, and preparation for the risk of suits in the WTO concerning the direct trade system.

## **2. Final Comments**

Although it is predictable that there will be continuous change in the North Korean economy and society, there are some doubts concerning the perpetuation of reform. North Korea is afraid of the ideological confusion that may accompany reforms. Every environmental element requires the enlargement of opening for North Korea. The country, however, has not devoted all of its potential to internal reform and external opening because of the potential shockwave to the security of its government. Even though the North Korean government is fully aware of the need for opening, it does not pursue more than economic recovery in order to avoid any internal confusion and insecurity. In this respect, the future of North Korean reform and change is not promising.

There are three possible scenarios concerning the future of North Korea. First, if the nuclear issue is resolved, the North Korean government may continue successful economic reform with the

support of the international community. Alternatively, if the international community interferes negatively and reduces support, the stagnation of the North Korean economy may deepen and the possibility of regime change may increase. Finally, the regime may collapse by international embargo. It is hard to expect the collapse of the Kim Jong-il regime from the inside, at least at this point in time. There is no sign of power struggle or conflict, and the power elites including Kim Jong-il at the top are ruling over the country as strongly as before. The insecurity of the regime will be a problem when the ordinary people in North Korea have lots of complains and protests due to the aggravation of the economy. However, the legitimacy of the North Korean regime is not based upon economic achievement but the *juche* ideology and the military-first policy. In other words, economic aggravation itself is not directly linked to the insecurity of the regime.

On the other hand, it seems almost impossible for the actions in the enacted or revised laws to return North Korean society to the socialist system of the past. If North Korea tries to go back to a socialist system, it will cause greater social confusion. Although difficult to apply to North Korean society, it is generally held that revolution is most likely to happen when economic and social conditions are rapidly degenerating in the middle of gradual improvement.<sup>25</sup> The main body of a revolution is not the people who have been suppressed for a long time but the people who have enjoyed the fruits of improved economic and social conditions. In other words, people who have been deprived of the benefits from social and economic developments all of a sudden will, willingly, jump to revolution in order to take back the benefits they once had enjoyed. This means that a little freedom may be

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<sup>25</sup> Davies, J. C., *Toward a Theory of Revolution* (1962); *The J-curve of rising and declining satisfactions as a cause of some great revolutions and a contained rebellion* (1969).

more dangerous than no freedom at all. If an autocratic government allows modest freedoms to improve political or social conditions and then tries to go back to the original severe dictatorship, people may be compelled to protest vigorously. The example of Mikhail Gorbachev shows this clearly; putting him under house arrest after Perestroika and Glasnost provoked the huge public resistance.

In this respect, if the reform actions of North Korea are not supported by the supply system, there is the possibility that the economic side effects may trigger a crisis in the society at large. In addition, this kind of insecurity may deepen the dependency of North Korean economy on China and South Korea and hasten a breakaway of the people. Nevertheless, it is hard to expect that North Korea will collapse through internal rupture. Social control is secure enough to handle such problems, and the internalized *juche* ideology is strong enough to support the regime. The critical determiner of the future of North Korea is the policies of other countries, especially the policies of the U.S., rather than the country's internal situation. Changes in North Korea will be hastened by external stimuli, namely, the policies of neighboring countries like South Korea, the U.S., and Japan.

South Korea should prepare for dealing with a crisis of North Korea. There are lots of possibilities that may cause a crisis in North Korean society such as conservative and critical points of view toward reform from bureaucrats and the military, aggravation of people's economic security due to difficulties of supply and rises in prices, concerns on economic crisis according to the insufficient operation of the production system, and the broadening gap between the haves and the have-nots. South Korea needs to take a tolerant attitude to endure these kinds of difficulties and should prepare to take political, economic, and social actions for the management of North Korea.





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