

## **Pragmatism or Intransigence? Cuban Lessons for North Korean Economic Reform**

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### **NORTH KOREAN LEADER'S CHINA VISIT**

**L**ast January 2001 North Korean leader Kim Jong-il traveled to China, where he visited the Stock Exchange and a semiconductor plant in Pudong, Shanghai. Kim's visit to China, was especially notable because it came immediately after his remarks in *Rodong Sinmun* exhorting the concept of "new thinking" to the people of North Korea. It was largely viewed as a fact-finding trip in preparation for the reclusive North's full-fledged reform and opening. Some even speculate that Kim's visit to the Pudong area, the symbol of China's reform and opening, indicates that North Korea will adopt the Chinese reform model.

Actually, high hopes for North Korea's reform and opening have mounted over the years. Such expectations were fueled by a number of policies that the government adopted during the 1990s. Since 1994, Pyongyang has stressed three priorities; agriculture, light industry and trade, while working to improve the lives of its people. In 1998, the North Korean constitution was revised to include social organizations as ownership entities and allowed social cooperative organizations to

possess farming machines and implements. Other gestures of opening included designating the Rajin-Sonbong Free Economic Trade Zone, agreeing to the Mt. Kumgang tourism project and participating in talks to establish an industrial park in Kaesong. However, such changes are selective and limited, and still fall short of reform and opening in the fundamental sense of modifying the economic mechanism or expanding private ownership.

In a socialist system, economic reform means transition from a centralized planned model to a decentralized market-oriented economy. At the same time, measures such as decentralizing trade policies, expanding export or attracting foreign investment must be introduced in order to join the global market. To undertake those transition measures, North Korea needs a model that can present a direction for change. Such circumstances stir interest and speculation over Kim Jong-il's visit to China and the possibility of North Korea adopting the Chinese model.

In broad terms, the Chinese model refers to the whole gradual process of market reform which contrasts with the radical transition of the Soviet Union and East European countries. In narrow terms, it refers to China's ground rules for reform and the strategies which it entailed. North Korea, in its reform and opening, may adopt the Chinese model in its broad terms, but not in its narrow terms, as the country's situation is quite different from what China's was when it embarked on reform. Moreover, disparities exist in North Korea's economic attractions for investment.

Actually, Cuba's road to economic reform, in place since 1993, may have more implications for the North. During the Cold War, Cuba sought to transform itself economically without any change in the country's leadership. It surmounted its foreign exchange crisis by promoting tourism, even when foreigners showed no interest in investing. This situation bears a striking resemblance to North Korea's. Therefore, in the course of the country's reform and opening, Cuba's economic reform of the 1990s could be a meaningful model.

## WHY THE CUBAN MODEL AND NOT THE CHINESE?

### *The Difference Between North Korea and China*

The initial conditions in North Korea and China are different. Generally what matters for reform in a socialist state are: the political structure at the outset of reform; the macroeconomic environment; and the structural link with international markets.

First, economic reform requires the top echelon's commitment to change, along with a principal force among the ruling elites that can drive reform. China's economic reform was driven by reformist elites who reappeared after the end of the Cultural Revolution in 1977, and in Vietnam, it was propelled within the collective ruling system of the party. In comparison, North Korea is challenged to carry out policy changes while maintaining existing leadership and political ideology.

Second, economic reform is a policy response to macroeconomic hardship such as the weakening of the commodities market, the absence of a capital market, the lack of infrastructure or an aggravating balance of trade. Economic policies to overcome a crisis are to some degree influenced by political and global circumstances but more importantly, by the characteristics of the country's economic structure. Before undertaking economic reform China had growth potential, i.e., the farming population in its non-government sector as well as a highly decentralized economy. However, North Korea has an Eastern European-style industrial structure, heavily dependent on manufacturing, and an economic structure which is hardly decentralized.

Third, in the late 1970s, China was able to leverage its attractive domestic market to induce the capital it needed, while participating in the international market economy by stimulating its export industry. North Korea faces a different global environment. Blocked by U.S. economic sanctions, the country faces mounting challenges in raising capital and exporting its goods. North Korea, of course has the

advantage of learning from its neighbor's reform, but such an advantage will be extremely limited because macroeconomic circumstances thus, the road to reform have little in common with China.

#### *Value as an Investment Destination*

While a country's internal conditions are important initially for reform and opening, its value as an investment target is judged externally, i.e., by outside investors. North Korea has also built a reform strategy, but it is very different. China is often cited as the model example of a socialist country in gradual transition. Externally the country successfully joined the global economic framework by attracting foreign capital and increasing exports while internally it streamlined its industrial structure with imported technologies, created jobs and sought to convert its economic system.

The first reason North Korea cannot easily adopt China's reform strategy is the differences in the process of reform. If China's strategy of accumulative proliferation has been to gradually expand regions and investment conditions. North Korea's strategy has been to carry out reform and opening in limited areas but preventing all-out opening and minimize the threat to the regime. While China's special economic zones represent an intermediate step to market-oriented reform as the testing ground for capitalism, North Korea's economic zones are kept isolated from the country's internal system.

Second, the difference in the size of the domestic markets determines what forms of investment are attracted. China offers a gigantic market with the world's greatest purchasing power. At the beginning of the country's opening, despite unsatisfactory systems, an unstable financial sector and political risks, foreign companies rushed in because of the land's enormously attractive domestic market. The Chinese government, at the same time, used its domestic-market card to the fullest to attract foreign capital. Interested in obtaining modern technologies and managerial techniques, yet committed to protecting

its domestic enterprises, China preferred joint ventures, granting domestic sales rights based on equity ratios. North Korea, on the other hand, has a small domestic market with ambiguous prospects for domestic sales as the country will maintain its planned economy.

*Common Attributes of North Korea and Cuba*

Cuba's economic policies since 1993 present many implications to North Korea. First, their international environments are similar. In the 1990s when the Cold War had become a thing of the past for nearly all countries around the world, North Korea and Cuba were left to face a regional neo-Cold War environment. The U.S. strengthened its economic sanctions against Cuba and raised political pressure.<sup>1)</sup> But Cuba and North Korea made different choices. Amid draconian sanctions of the U.S., Cuba worked untiringly to reform its policy-making process, to modify economic policies and open tourism. In light of the Cuba's decision to move on, North Korea's failure to adopt reform policies cannot be attributed solely to the international environment.

Second, Cuba's reform process is the only case of reform driven by classic socialist leadership. In particular, the Cuban leadership's more flexible policy response to the country's economic crisis is noteworthy. For example, in the course of attempting to overcome economic hardship, the Cuban leadership announced the "rectification program" similar to North Korea's "arduous march." Yet when those traditional tactics failed, it acted to implement a series of structural reforms in 1993.

Third, both countries are relatively less attractive to foreign investors. North Korea and Cuba both have small domestic markets and are geoeconomically unfit to serve as a stronghold of production.

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1) U.S. economic sanctions against Cuba were reinforced during the 1990s. The U.S. Congress passed the Cuba Democracy Act in 1992 and the further-strengthened *Libertad* (Helms-Burton Act) in 1996.

Furthermore, both are subject to U.S. economic sanctions and present high investment risks. Nonetheless, through aggressive reform efforts Cuba secured substitute capital from Spain, Canada and Mexico.

The last similarity is in the role of tourism. Constantly strengthening its infrastructure, Cuba reconstructed its tourism industry and used it to overcome its foreign exchange crisis. Tourism is an industrial policy and needs macroeconomic adjustment. This offers a lesson to North Korea in its development of a tourism industry.

### CUBAN ECONOMIC REFORM OF THE 1990S

#### *Cuba: Dependent Development and the Economic Crisis*

Cuba is the leading example of a socialist dependent development. Since the revolution in 1959 Cuba has relied solely on sugar as its core industry and depended heavily on trade. Export of sugar and sugar products accounted for 77% of the country's total exports during 1984 and 1989. Trade with the Soviet bloc was especially high, with the USSR and Eastern Europe accounting for 70% of Cuba's foreign commerce.

Dissolution of the socialist trade bloc in the late 1980s devastated the Cuban economy. External impact quickly translated into less exports, trade losses and a foreign exchange shortage. Subsidies from the Soviet Union equaling 15% of its GDP, plummeted in 1989, and Mikhail Gorbachev demanded hard currency for sugar imported from and oil exported to Cuba. With the fall of the Berlin Wall (July, 1990)<sup>2)</sup>, the disbanding of COMECON<sup>3)</sup>, and finally, Boris Yeltsin's rise to power, Cuba's international trade structure collapsed.

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2) East Germany was Cuba's second largest trading partner. With the fall of the Berlin Wall, trade quickly shrank as Cuba was required to pay in hard currency for its imports of machinery, computers and chemicals.

Cuba's sudden economic crisis led to deficit financing and inflation in black markets. Deficit spending jumped from 9.4% of GDP in 1990 to 30.4% in 1993, and the vicious circle of foreign exchange shortage, devaluation of currency, deficit spending, inflation and black market expansion began.

### *Failure of Conventional Methods*

At the start of the crisis, Cuba responded with a traditional socialist approach. In February 1986, the Third Congress of the Cuban Communist Party adopted the "rectification process."<sup>4</sup> Initiated as an ideological campaign rather than an economic policy, it aimed to eradicate violations, corruption, cynicism and waste. Called, "*la campaña de rectificación de errores y tendencias negativas* (a campaign of rectification of errors and negative tendencies)," it promoted the exclusion of market-oriented mechanisms and the strengthening of centralization.

Major economic policies included, denial of profit; abolition of farmer's markets; prohibition and restriction of private commerce and private housing construction; reintroduction of production brigades; reduction of surplus laborers, strengthening of labor standards, emphasis on spiritual awakening; measures for macroeconomic stabilization, i.e. reduction of trade and budget deficits; and eradication of financial crime and corruption.<sup>5</sup> However, given the

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3) Once the CMEA was dissolved, following its last 13th General Assembly in Moscow in January 1991, East European countries switched trade with Cuba from fraternal trade to commercial transactions.

4) Carmelo Mesa-Lago, "Cuba, A Unique Case of Antimarket Reform: The Rectification Process Experience," in Andres Solimano et. al., *Rebuilding Capitalism: Alternative Roads after Socialism and Dirigisme* (Ann Arbor: University of Michigan Press, 1994), p.207.

5) Jorge F. Pérez-Lopez, "The Cuban Economy: Rectification in a Changing World," *Cambridge Journal of Economics* Vol.16 (1992), pp.115-116.

**<Table 1> Cuba's Financial Status**

		1989-93	1993-96	1996-98
Earnings	Transaction tax & trade tax	-4.8	-8.7	-0.4
	Others	2.0	1.4	-1.3
	Total	-2.8	-7.3	-1.7
Expenditures	Social security	6.0	-6.1	0.2
	National defense and security	-1.8	-2.3	0.1
	Subsidies	20.4	-26.5	-0.6
	investment	-2.4	-4.0	-2.2
	Others	-1.4	3.7	0.4
Deficit		-23.6	28.1	4.1
Liquidity increase		12	-29	-0.3
Unofficial free market price		202	-230	-
GDP price deflator		14	-18	3.4

\*Note: Fiscal indicators are ratio variances against GDP; financial and price indicators are annual average variances

\*Source: Ernesto Hernández-cata , "The Fall and Recovery of the Cuban Economy in the 1990s: Mirage or Reality," ASCE (2000), p. 27.

magnitude of Cuba's situation, such conventional tactics no longer worked. Cuba's economy deteriorated into serious crisis and the collapse of its international trade structure was imminent.

#### *The Switchover to Economic Reform*

From late 1993 Cuba began its journey toward economic reform, in a structural sense. Trade in U.S. currency was legalized and conditions for Cuban-Americans visiting their homeland were eased as part of the country's attempt to raise foreign currency. "Dollarization" quelled the skyrocketing inflation and stimulated

circulation of hidden dollars that was donated to families by Cuban-Americans.

Among Cuba's domestic economic policies, the most noticeable were in agriculture, finance and tourism.

#### (1) Agricultural Reform

Cuba's mechanized agriculture, highly dependent on fuel and fertilizers, was hard hit by reduced imports of oil from the Soviet Union and farming equipment from Eastern Europe. With the shortage of resources, exacerbated by chronically low worker morale, the country's agricultural crisis escalated.

On September 1993, Cuba released its agricultural reform plan, the focal point of which was the revamping of the state farm system. The reform plan defined cooperatives as the basic units of production (*las unidades básicas de producción cooperativas*: UBPC). The plan granted independence in management and allowed independent profit. In addition, farmers were granted land-use. Following the plan, 387 state-owned farms totaling 4,770,000 ha (71% of the country's total farmland) and employing 600,000, were reorganized into some 2500 to 2600 cooperatives.

#### (2) Financial and Fiscal Reform

Fiscal reform becomes more important in socialist countries, like Cuba and North Korea, if they are highly dependent on a large public sector and a centralized planned economy. Normally, fiscal reform is undertaken to support changes in ownership, that is, reform of state-owned firms and expansion of private commerce. Reform of state-owned enterprises requires introduction of a corporate income taxes system and promotion of private commerce entails personal income taxes and indirect taxes.

The Law Number 73 of the tax codes adopted by Cuban authorities in August 1994 set out the general taxation system. The newly adopted law separates direct taxes and indirect taxes and imposes a 35% corporate tax on all corporate profits.<sup>6)</sup> The corporate

**<Table 2> Contribution to Cuba's Real GDP Growth**

Year	Real GDP Growth Rate	Contribution to Real GDP Growth		
		Capital	Labor Increase	TFP Increase
1990-93	-10.0	0.3	-0.3	-9.9
1994-96	3.7	-2.3	-0.3	6.2
1997-98	1.9	-1.6	0.7	2.7

\* Source: Ernesto Hernández-Catá, p.30

income taxes accounted for 30% of direct taxes and 12% of financial gains in 1998.<sup>7)</sup> The law also introduced a personal income tax, imposing it mainly on self-employed individuals' salary, interest income and foreign exchange gains.<sup>8)</sup> Indirect taxes included the transaction tax and the trade tax, which varied slightly by region.

Considerable changes were made in Cuba's financial policy. The change in its foreign exchange policy, the switch from planned exchange rates to market exchange rates stimulated foreign investment and curtailed the country's black market. Actually, the reason that economies such as Cuba and North Korea became so distorted in the face of collapse of the international socialist regime was price flexibility. If exchange rates and prices do not rise in response to shortages, the black market proliferates and private individuals choose foreign currency over the local legal tender, leading to corruption and flow of resources to nonproductive sectors.

6) An income tax was already imposed on joint ventures and private enterprises.

7) In 1998, Cuba's national finance accounted for 48.3% of the GDP (62.6% in 1994). Tax revenues accounted for 35.8% of the GDP, of which 21.4% was from indirect tax and 14.3% from direct taxes. Lorenzo L. Pérez, "Fiscal Reforms in Transition Economics: Implications for Cuba," Annual Meeting of the Association for the Study of the Cuban Economy (2000), p. 226.

8) Personal income tax is up to 300 pesos 5% and from 60,000 pesos 50%. However, with a deficient tax office, tax collection is inadequate. In 1998, personal income tax was only 3% of the tax revenues.

Changes in a foreign exchange policy are also closely related to stimulating foreign investment, as they considerably influence a foreign investment company's wages, local sourcing of raw materials and local financing.

### (3) Development of Tourism

In an economy with a weak industrial structure and poor conventional industries, tourism can be the main source of hard-currency earnings. Realizing this importance, the Cuban government promoted the industry as the heart of its economy (*el turismo es el corazón de la economía*). To boost its tourism sector, Cuba set out to establish an infrastructure for tourism by adopting a market exchange rate system. It also legalized private commerce in areas such as lodging, actively forming joint ventures for hotels and resorts, and stimulating foreign investment. International factors also helped. Western tourists, hit by economic slumps, preferred vacationing in the Caribbean islands which offered low prices and a relatively safe environment.

The number of tourism joint ventures, a mere two in 1988, grew to 13 in 1997. By 1996 the country's hard-currency earnings from tourism amounted to 1.4 billion dollars, providing jobs for 60,000 workers. By 1998, tourism had created a domestic consumption of 460 million dollars.

The number of tourists also mushroomed from less than 300,000 in 1988 to 1.4 million in 1998.<sup>9)</sup> While tourists to Cuba accounted for 3% of travellers to the Caribbean in 1987, that ratio grew to 7% by the end of 1997. Cuba's tourism sector has grown 20% every year on average since 1990.<sup>10)</sup>

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9) Tourism earnings in 1998 is estimated at 1.8 billion dollars. Garry H. Maybarduk, "The State of the Cuban Economy 1998-1999," ASCE (1999).

10) More precisely, from 1990 to 1997, while Cuba's tourism sector grew 19.3% annually on average, tourism in the Caribbean grew 4.3%.

**<Table 3> TFP Increase and Non-Government Sector Employment (1991~1998)**

	1991	1992	1993	1994	1995	1996	1997	1998
TFP Increase Rate (%)	-11.8	-9.3	-12.4	4.5	4.7	9.5	3.1	2.3
Non-state-own sector employment (%) (% vs total employment)	6.2	6.9	8.6	19.0	22.3	22.7	24.0	26.1

\* Source: Ernesto Hernández-Catá, p. 33.

### *Assessment of Economic Reform*

Cuba's economy began its quick recovery in 1994. In contrast to the negative growths from 1990 to 1993, the economy has maintained strong growth since achieving 0.7% growth in 1994.

What enabled such recovery since 1994?<sup>11)</sup> Would the increased earnings in tourism and the higher exports of tobacco, nickel and liquor, without any attempts at actual reform, have been sufficient impetus? Or is it the result of full-blown reform policies in place since 1993? Cuba's economic growth can be attributed to increased total factor productivity (TFP), rather than input of capital and labor. As outlined in <Table 3> variances in labor and capital investment are minor<sup>12)</sup> while growth is considerable in TPF.

Restated, it is not capital and labor, but technical, economic and

11) Opinions differ on what lies behind Cuba's economic recovery between 1994 and 1996. The first view is that the statistics cannot be trusted, the second is that it was a result of macroeconomic stabilization and restructuring in 1993 and 1994, while the third is that it was caused by favorable demand. Refer to Ernesto Hernández-Catá, "The Fall and Recovery of the Cuban Economy in the 1990s: Mirage or Reality," ASCE (2000).

12) Exports of goods and services continuously declined in 1994 and 1995, but picked up, starting in 1996. Sugar production was at a standstill and investment was also slow.

institutional factors that played an important role. Ernesto Hernández-Catá points to the influence of newly free labor markets and prices as the drivers behind increased productivity. Apparently TFP increase and higher employment in non-state-owned sectors are closely correlated.

### WHAT IS CUBA'S LESSON TO NORTH KOREA?

Cuba's economic reform offers three lessons to North Korea. First, facing U.S. economic sanctions, North Korea needs to make efforts to develop other alternative markets. Second, it must make parallel efforts to promote economic reform. Third, only through true structural reform can it revive its economy.

#### *The Search for an Alternative Market Under U.S. Economic Sanctions*

One extremely important factor in North Korea's decision on economic reform is external; U.S. economic sanctions against the North. Easing sanctions can lead to various developments.

Nonetheless, the example of Cuba demonstrates that economic reform is possible even in the face of U.S. economic sanctions. Interactions with the outside world, namely the European Union and Canada, enhanced Cuba's national image and is even stirring demands within the U.S. to lift sanctions. Undoubtedly Cuba and North Korea are strategically different to the United States. At the same time, considering the security situation in Northeast Asia and the divided Korean peninsula, the influence of external factors on Pyongyang's economic policies would most certainly have an influence. Still, the initiative to break the vicious circle of international tension and adherence of the regime lies not in the international environment, but in North Korea's sole decision.

In this respect, what is needed are realistic alternatives such as expanding economic cooperations with South Korea, the EU or

Southeast Asia. Alternative markets will only be secured when Pyongyang makes aggressive efforts to create an environment for investment, improves its systems and embarks on economic reform.

*No Reform, No Opening*

North Korea's attempts to designate special economic zones, including discussions about building an industrial complex in Kaesong, are noteworthy. However, if these attempts to open its doors are to prove successful, internal efforts to modify economic policies must be carried out in parallel.

First, industrial policies must be revised. Pyongyang's current strategy of developing heavy industries around munitions production poses a barrier to its joining the global economy. The most favorable strategy for North Korea at the moment is transformation of its military-oriented economy to labor-intensive industries. This signifies to the North that it must reshuffle its economy around export industries, mainly light industries.

Second, labor policies must be changed to enhance productivity. If Pyongyang maintains the same labor management policy that it currently applies to the light-water reactor project, special economic zones will no doubt fail. Practices such as the setting of wage levels irrelevant to productivity and indirect payment of wages will in no way benefit North Korean workers.

Third, foreign exchange policies need to be modified. In the light-water reactor project, North Korean workers' minimum wage is 110 dollars per person, but the North Korean government pays its workers 220 in North Korean won. On the black market, a dollar is traded for 150 to 200 won. So, in reality, 220 won amounts to merely one or two dollars. Also, wage increases in dollar terms fattens the foreign currency pockets of the North Korean regime, it does not translate into wage hikes for North Korean workers because the value of North Korean currency is so low.

*No Reform, No Economic Recovery*

The Bank of Korea estimated that North Korea's economy grew 6.2% in 1999 and 1.3% in 2000, significant growths compared to the continued negative growth rates since 1990. Nonetheless, North Korea's economy remains at risk. First, it has not recovered to pre-crisis levels. North Korea's actual GDP may have improved 6.2% in 1999, but that is only 75% of the growth recorded in 1985. Facility operation rates remain low with shortages of raw materials and energy, and outdated equipment. Second, current trends of recovery result from increased input of foreign resources, not from increased total factory productivity delivered through internal reforms. Foreign aid, a significant factor in North Korea's economy, jumped more than 50%, from an annual average of 240 million dollars between 1995 and 1997 to 360 million dollars in 1999.

Securing foreign aid through diplomatic measures has its limits. Not only is it unsustainable, it is an unstable source that is highly dependent on the international state of affairs. Naturally an economy dependent on aid is highly sensitive to external factors. The Cuban example demonstrates that only an economy's potential for growth fueled by economic reform can bring actual recovery.