

## **A Shift Toward Capitalism? Recent Economic Reforms in North Korea**

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### **INTRODUCTION**

**O**n July 1, 2002, North Korea launched a number of comprehensive economic reforms: A substantial increase in both prices and wages; a shift in the price-fixing mechanism; changes in the distribution system; decentralization of national planning; an increase in the autonomy of enterprise management; the opening of the distribution market for production methods; differentiated distribution; and a social security system reform. The far-reaching reform package has been met with mixed reactions. Some say it represents the communist nation's move toward a market economy, while others say that it is a band-aid approach to the planned economic system. Still others question whether the ambitious moves will pay off or not.

Pyongyang has termed the reform package an "economic adjustment policy" for the construction of a strong and prosperous state, stressing that it will further solidify the nation's socialist principles and planned economic system while improving the quality of life of its citizens. Yet, as Gordon White pointed out,

market reform within the framework of socialism is like “getting on the back of a tiger.”<sup>1)</sup> Regardless of the intentions of the North, no one knows where those efforts will lead. The leadership thus faces huge challenges in implementing its new and comprehensive reform package.

Meanwhile, a string of recently adopted economic reform measures is very significant in the context of realignment of regional order in Northeast Asia and its improved relations with Seoul. The North Korea-Russia summit meeting August, 2002, the North Korea-Japan summit meeting September, 2002, and the recent movement toward normalization with the U.S.—all indicate that recent reform measures by Pyongyang will have a positive impact on the stabilization of the East Asian region.

This paper will therefore summarize the major contents of the latest reform package introduced by North Korea, based on related domestic and overseas data disclosed since July. The background and the characteristics of the measures will be analyzed; first, to identify potential stumbling blocks on the road to successful reform, and second, to identify tasks it may have to deal with in years to come.

#### MAJOR CONTENTS OF THE ECONOMIC REFORM PACKAGE

A core feature of the package is the huge hike in prices and wages, as reported by the *Choson Shinbo*, the organ of the General Association of Korean Residents in Japan. All wages and prices increased, including workers' wages as of July 2002. For example, bus fares in Pyongyang increased from 2 won to 10 won, and the price tag on rice rose from 0.8 won per kilogram to 44 won. Overall prices increased from 10- to 20-fold or more. And the purchase price

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1) Gordon White, *Riding the Tiger: The Politics of Economic Reform in Post-Mao China* (Stanford: Stanford University Press, 1993).

of rice increased from 0.8 won per kilogram to 40 won, or more than 50-fold. Sales prices in national retail shops soared from 0.08 won per kilogram to 44 won, more than 550 times higher.<sup>2)</sup>

The dramatic hike adjusted the distorted pricing system: it mitigated the price gap between peasant markets and national stores; prices for other goods and products are adjusted on the basis of the rice price<sup>3)</sup>; local factories that primarily produce various daily commodities and retail goods were given limited authority to set their own prices, thus decentralizing the pricing process.<sup>4)</sup>

Meanwhile, wages for residents increased commensurate with the price increases in the market and ensuing inflation. Levels for wage hikes were fixed for different occupational categories: wages are now 17-20 times higher for soldiers and miners and 15-17 times higher for ordinary laborers. The wages for an average North Korean worker, previously 100-150 won a month, have increased to 2,000 won. At the same time, wages for miners have risen to 6,000 won.

The use of foreign exchange-coupons was reportedly scrapped and the dollar-to-won exchange rate will depreciate from 2.15 won to a dollar to 150 won, equivalent to a 75-fold decrease in the value of the won. One possible reason is that the foreign exchange-coupons have become worthless and dollars are traded in the black market at far higher rates than the official one. Another goal could be to reduce the price gap between international and local market rates.<sup>5)</sup>

A significant reform in the economic management system is the

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2) *Choson Shinbo*, July 26, 2002.

3) In the past, North Korea considered only prices for water, electricity or fertilizer, as production costs when setting the rice price. Now, however, international market rates and domestic supply and demand are also factored in.

4) While the state sets pricing standards, responsible local factories can set specific prices with approval of a supervisory organization.

5) China abolished convertible notes as of January 1994, shifting from a dual foreign exchange rate to a single, depreciating the exchange rate by 50%. In doing so, China achieved transparency in its foreign currency control system, increased export competitiveness, and stimulated foreign investment. North Korea is apparently

**Table 1. Major Economic Reforms by North Korea**

(Unit: North Korean Won)

Classification	Item/Stratum	Unit	Prices set by North Korean government		
			Before Reform (A)	After Reform (B)	Price Increase (B/A, Times)
Price	Rice	1kg	0.08	44	550
	Corn	1kg	0.07	33	471
	Diesel Oil	1kl	1	38	38
	Electricity	1kWh	0.035	2.1	60
	Streetcar Fare	one way	0.1	1	10
	Subway Fare	per sector	0.1	2	20
	Train Fare (Sleeping Car)	Pyongsong(North Pyongan Province)-Namyang(North Hamgyong Province)	50	3,000	60
	Entrance Fee	Beach of Song-do	3	50	17
	Rent	Pyongyang area	0.03% of income	Monthly 2 NKW/1m <sup>2</sup>	—
	Wage	Laborer	Monthly	110	2,000
Miner		Monthly	—	6,000	—
Manager of Trading Company		Monthly	150	3,000	20
Exchange rate		NKW/dollar	2.15	150	—

Source: Summarized from various sources.

increased autonomy of enterprises. This measure was aimed to increase the independence of factories and to offer better treatment to producers in order to address the underlying problems of the North Korean economy, namely insufficient supply. Enterprises with

expecting the same effects with the recent increase in the exchange rate. For the short-term, however, Pyongyang will experience financial difficulty and an increased burden on private enterprise due to increased imports.

increased autonomy and consequently, more management responsibility will not only be more conscientious about the whole process of production—from material purchases to sales, but also more motivated to improve.

In October 2002, North Korean leader Kim Jong-il laid out a framework of enterprise reform along with economic management guidelines: the Cabinet State Planning Commission would draw up major economic indexes of strategic importance, as in the past, while local governments and companies would draft detailed plans; prices and standards for goods would be determined by each factory under the monitoring of higher authorities; factories would also take charge of selling their output.<sup>6)</sup>

According to a recent report in the *Choson Shinbo*, “In relation to improvements in enterprise operations management, bottom-up efforts are being made to resolve the lack of raw materials and to correctly implement an autonomous accounting system.” That system is designed to encourage businesses to use self-procured materials to boost production and generate profits to be distributed based on individual efforts, thereby stimulating the labor force to work harder.

Rural areas are also impacted by the wave of economic reform. The greatest attention is being paid to the rural household contract responsibility system implemented in China in the early 1980s. Pyongyang is reportedly seeking ways to restructure the existing work squad management system<sup>7)</sup> for farms into a family-based one.

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6) Kim Jong-il, “About Improving and Reinforcing Management of the Socialist Economy,” (October 2001), quoted from *Joongang-ilbo*, August 2, 2002.

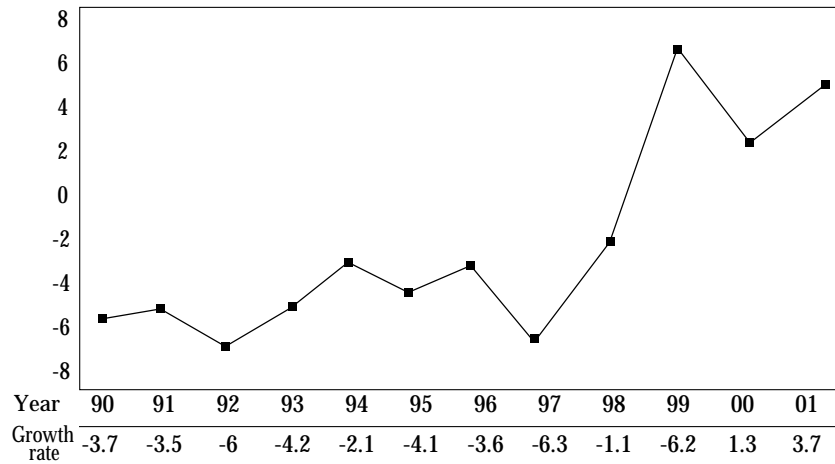
7) In this system, squads are organized on collective farms. Allocation of harvest profits is based on agricultural equipment supply and the number of days worked. The system was recognized as encouraging farm members to participate actively in farm management. Jung Kyung-bin, “Management and operation of collective farms,” *The County of Juche, Vol. 2* (Pyongyang: Pyongyang Press, 1989), pp. 46-49.

Since 1996, with decreased productivity in agriculture, North Korea has been forced to change its unit-based system, and has provided incentives to encourage labor output. More specifically, the size of a unit was decreased from 10-25 members to 5-7. Also, output assignments were realigned. For example, the 1996 production plan was set a little below the level achieved by adding the average harvest of 1993-1995 to the average harvest for the 10 years before 1993 and then dividing them by the total number of years (normally 10 %). By doing so, greater output was built into the system. Finally, squads were allowed to keep or dispose of any surplus.

#### **BACKGROUND OF ECONOMIC REFORM: MEASURES AND ASSESSMENT**

The primary motivation for North Korea's reforms is the sagging national economy, which has disrupted economic order and devastated the lives of North Koreans. Pyongyang has become increasingly isolated since the early 1990s following the collapse of the former socialist bloc. Severe economic difficulty resulted in negative economic growth from 1990 to 1998. The years 1995 to 1997 were named "the period of the arduous march" and the year of 1998, "the desperate march for socialism," reflecting the nation's desperate economic situation.

Since the official launch of the Kim Jong-il regime in September 1998, Pyongyang has adjusted its economic priorities of agriculture, light industry, and trade-first ideology (economic goals for 1994-1996, the buffer period) to focus on developing heavy industry, while concurrently developing agriculture and light industry. This shift appears to have resulted from the recognition that the economic strategy for the buffer period could not effectively revive the economy. Over the past two to three years, the North Korean authorities have therefore increased investment on core infrastructure industries such as energy, railroad transportation and

**Figure 1. Trends in North Korean Economic Growth**

heavy and chemical industry to restore the economy's self-sustainability. These efforts, combined with increased international support, helped the North Korean economy to rebound in 1998. Thanks largely to improvements in agriculture, fishing, mining industries and construction, the economic growth rate in 1994 was 6.2 percent, the first positive trend since 1990.

However, these achievements are the results of increased utilization of certain factories and growth in the construction sector. That rise is due to efforts to hire unemployed laborers with the help of the international community. The real economy is still in the doldrums, however, with no immediate turnaround in sight. In particular, the heavy industry sector that accounts for a significant portion of the industry spectrum is still reeling from continuing low production. Moreover, food and energy shortages are not being resolved internally by the North, but rather by external assistance. The latest reform measures can be seen as the inevitable choice for the Kim Jong-il regime in its efforts to achieve a full-fledged economic recovery, to maintain internal security and to improve international relations.

The other reason for reform is the contracted national economy and the expansion of private economy that led to collapse of the economic order. Throughout the 1990s, the North Korean economy suffered chronic shortages in production, inefficient management, and a heavy financial burden, resulting in virtual paralysis of the planned economy and all official economic sectors. As a result, the private economic sector (black market) appeared, accelerating the diversion of material and labor to the private economic sector and compounding confusion in the official economic sector.

The recent price and wage hikes are therefore expected to reduce the national financial burden as well as close the gap between the prices set by the state and those quoted by the peasant market. This seems to have been aimed at restoring operations of national stores (official sector). Until now, the government has bought raw materials at high prices and provided them to factories, enterprises and cooperative farms at low prices, which disturbed supply and demand costs.<sup>8)</sup> In addition, Pyongyang increased prices to the level of the peasant market to induce suppliers to sell goods in the national stores, not in the peasant market. This was no doubt implemented to stem black market transactions, to attract black market customers to the official sector and to restore order to the ration system.

Lastly, the reform package was introduced to bring stability to the lives of the North Korean people after ten years of economic chaos.<sup>9)</sup> Even with ration tickets, chronic shortages made it difficult to buy daily commodities. People were forced to shop at the peasant

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8) This measure returns a 4 won-per-kilogram profit as it buys at 40 won per kilogram and sells to at 44 won.

9) In this context, *Rodong Shinmun* (August 4, 2002) recently carried an editorial titled "Economic Policy of the Party and Improvement of People's Lives," that stated, "The party considers improvement of people's lives as its prime goal. We have a deep interest in the people and have made plans to achieve our goal within a specific time-frame."

market despite high prices. Ordinary North Koreans and particularly, the so-called nucleus class, i.e., party members, soldiers, office workers and intellectuals, have suffered most as they had no other choice but to rely on the official ration system. Higher echelon citizens, foreign currency earners and those who can afford to pay extra have led relatively comfortable lives.

The wage increase is expected to improve the lives of the nucleus class, which will in turn have a positive impact on the stability and the sustainability of the regime. In addition, authorities have confirmed that the existing rationing system will continue by ensuring sufficient wages to buy rice with a ration ticket issued to give equal access to food. The system will also continue in areas such as free mandatory education, free medical care, social insurance, regular vacations, the honorary soldier preference system and other free public services.

#### *The Characteristics of Economic Reform*

It is fair to say that recent efforts at economic reform are different from the past because they focus on eliminating inefficiency in the existing system, correcting distorted economic realities and improving the lives of the North Korean people. The elements of reform are mainly rationalization of prices, decentralization of economic management and strengthening of the currency in economic activity.

First of all, price adjustments and subsequent wage increases can be seen as price rationalization based on national control, which differs from those introduced by China, Russia, and other socialist countries in Eastern Europe in the early phase of their economic system transformation.<sup>10)</sup> In efforts to transform their systems, those

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10) The recent price hike in North Korea is similar to the one China implemented in 1979. In the early days of reform, China increased most prices including those on rice, production materials, utilities, agricultural and industrial commodities, and

countries scrapped nationally-set prices and introduced market prices across the board, or gradually reduced the areas where national prices were applicable while increasing the market price application. Although the North decentralized some pricing with the recent economic reform, it has basically adhered to the state pricing system. The *Choson Shinbo*, July 26, 2002, quoted a North Korean pricing official as saying, "When production is stimulated in the near future, prices can be readjusted according to supply and demand, but private suppliers will not be able to determine their own prices. Prices will be controlled strictly by the central and local administrative units. The market principle will not be completely reflected in the prices." This clearly shows that the price reform is not based on the market economy. After all, the recent measure was aimed to bring state-set prices closer to peasant market prices: first, to avoid a dual price system, and second, to seek optimal distribution of resources through state pricing and adjustment.

The second characteristic of recent economic reform is the stress on decentralization of economic management and practice, which is related to the overall economy in terms of planning, price setting, management of factories and enterprises, and supply of raw materials. In establishing a plan, the State Planning Commission is still entrusted with full authority for strategically significant indexes and national projects. As for other specific projects, responsible institutions, enterprises and local authorities will also do the planning. In local economic areas, specific indexes, except important ones like total industrial production amount and basic construction investment, can be set by local units according to their unique circumstances. The central government is still responsible for setting

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wages. It was aimed at rationalizing prices to efficiently distribute resources and decreasing the financial deficit. In this sense, the recent North Korean move is similar to Chinese price reforms. China accepted, however, limited price liberalization, and officially recognized fixed prices and negotiation prices, in which market elements inserted, together with the planned price.

price standards, but individual factories and enterprises can, under supervision, set material prices. While there has been no market for raw, or auxiliary materials, material supply markets were open and factories and enterprises were allowed to trade designated materials and accessories on the market. This indicates that the centralized material supply system has been relaxed to a great degree, and as a result, individual enterprises must make independent efforts in order to secure needed materials. Indeed, factories and enterprises have been given more management autonomy, and the socialist distribution principle has been strictly implemented to boost labor incentive among individual workers and work units.

The third feature shows that the North Korean economy has improved its economic management system by shifting the focus from in-kind products to currency. Except for food, the ration system has been scrapped in most of the areas, strengthening the function of currency. In the past, North Korean currency was used only as a meaning for exchange of products. Now, through the rationalization of prices, currency has become the standard measurement of product value. Future development in this area will be worth watching as the expanded currency function in the North Korean market is highly likely to bring expanded market function in the longer term.

However, it is premature to say whether North Korea will earnestly introduce market economic reforms as China did, or whether they will further broaden the scope of reform and opening. It is clear that the regime has introduced some elements of a market economy but it is not yet headed full-tilt toward a market economy. While the latest string of measures are positive signs that Pyongyang is getting closer to a market economy, it should be remembered that market freedom is not the goal. The underlying intention of the North Korean authorities is to normalize the planned economy system by enhancing efficiency and productivity in industry, and to restore the official economic sector in order to absorb or contract the private economic sector. In its July 26, 2002 issue, the *Choson Shinbo* commented, “a new economic management system that pursues

profits within the socialist planned economy..." This also reflects Pyongyang's intention.

### PROSPECTS AND TASKS

Since North Korea recently tried to introduce some changes, it is still rather difficult to understand what the change is all about, or whether efforts will succeed. It is also unclear whether Pyongyang will pursue full-blown reform and opening like China did. Still, there is a distinct possibility of continued follow-up measures related to economic reform. In particular, huge changes will impact the North Korean economy and the lives of ordinary people, creating unexpected problems. Additional measures and new reform strategies will no doubt be needed to address these problems.

The North will face many difficulties in implementing economic reform measures. Since considerable time will be needed to restore the production sector in the North, the most immediate problem is the short-term lack of supply. In particular, the serious lack of electricity and other social overhead capital (SOC) and raw materials make it almost impossible to increase supply any time soon. In addition, despite the decentralization of pricing authority, the nation still retains pricing authority in a fundamental sense, so it is unlikely that resources can be allocated efficiently according to market principles right now. Any attempt to do so through national pricing could cause rigidity in prices as the change of supply and demand cannot immediately be reflected in prices in the real world. Ultimately, to overcome this short-term lack of material, Pyongyang will be compelled to ask the international community for food and daily necessities. In parallel it will try to open up to the outside world, first, for the sake of transforming its system and second for inducing foreign investment.

Pyongyang's initial task is to encourage citizens to break away from their long-held dependence on centrally-controlled

management systems and practices, but it will take considerable time for North Koreans to adapt to changes. Moreover, the bureaucracy of the North is so accustomed to a traditional planned economy that there are bound to be collateral effects and differences of opinions.

Secondly, North Korean authorities must strive to prevent price distortion by rationalizing prices and wages on a regular schedule. In order to enhance the efficiency in resource distribution according to market function, price liberalization should continue. In parallel, the banking system will mitigate inflationary pressures and facilitate the supply of capital to enterprises. Establishing these measures will also take a long time. Since the North does not yet want full price liberalization and expanded market functions, it will gradually introduce rationalized prices and wages.

Thirdly, regulatory controls are expected to be further strengthened in the private economy sector including the peasant market. While authorities will allow free supply of daily commodities, they will impose rigid controls on other regulated items. Of course, given the fact that North Koreans go to the peasant market to buy necessities and many people are earning an income through the market, the peasant market cannot be shut down. However, if the price gap between the peasant market and national stores is allowed to widen and the national stores and official economic sectors are further contracted by the expansion of the private economy sector, then various regulations will have to be imposed.

Fourth, the self-supporting accounting system is likely to be further strengthened. The core changes in economic management in the North are aimed at ensuring that enterprises make a profit. The strategy is to expand by management autonomy. For this, the self-supporting accounting system will likely be strengthened for each factory and enterprise to induce managers to be responsible.

Fifth, the practical gains and profits of distribution centers will be further emphasized while purchasing stores and price functions will be increased. Thanks to recent reforms, North Korean

distribution centers can purchase rice and sell it to the public and earn a profit of about 4 won per 1 kilogram (in the past they suffered a 0.72 won loss). As a result, each distribution center is expected to work hard to secure and provide products to gain profits. In addition, some consumer prices can be set through contracts between producers and distribution centers (cooperative stores and purchase stores). Under the auspices of the pricing bureau, distribution centers are now permitted to engage in various profitable activities, and this demands our attention.

Sixth, it is likely that the import of consumer goods and some raw materials will skyrocket due to expanded need of supply for the domestic market. North Korean authorities are concerned that lack of those goods might destabilize the market while stimulating peasant markets, rendering the recent reform measures ineffective. Recent active moves by North Korean trade companies to import consumer goods from China are related to this concern.

Seventh, the North will seek more foreign investment by opening to the outside world. Considering current factory utilization and supplies of energy and raw and auxiliary materials in the North, the opening up is inevitable. And since Pyongyang desperately needs food, daily necessities, and raw materials, it is particularly important to address the supply shortages immediately. Also, to enhance its production base and restore the economy, Pyongyang needs investment from Seoul and other countries as well as financial assistance from global financial organizations. Therefore, North Korea will work hard to establish trust within the international community. It will likely increase the number of special economic zones, like the one in Shinuiju, possibly in Nampo, Kaesong, and Wonsan. It will proactively work to introduce necessary laws and regulations conducive to foreign investment and assistance.