North Korea and its Money Problem

Lessons from South Korea and China

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William B Brown
NAEIA.COM
Money Not a New Issue for North Korea

• 1976 “Debt Default Delays Development”

• First socialist country’s debt default, on $1.4 bn W. European loans.

• **Lessons:** NK opened before it reformed.*
  Lenders as much at fault as Pyongyang.

*Reform here means switching from command economy’s fixed price system, and widespread use of rations, to a market economy’s flexible, supply and demand based system, and widespread use of real money.*
2002 “Track 2” Lessons from S. Korea and China

June 9, 1961  Hwan-to-Won Switchover:

-- BASKETCASE ECONOMY
-- 1000 hwan exchanged for 100 won, overnight. Bank deposits awarded 20 percent annual interest.
-- New banking system provided real positive interest on savings.
-- US switched from debilitating commodity aid to balance of payments support.
-- Normalization with Japan secured more than $1 billion reserves, opened Japan market.
-- Won valued at reasonably cheap rate to encourage exports.

Result:
-- Korean savings rate rose from lowest in the world (1960) to highest in the world (1980).
-- Savings built foundation for foreign borrowing and surge in indigenous investment. FDI plays small role.
-- External demand maintained by exports; internal demand by private investment.


December 1978, China’s “Gaige Kaifa”

Again, the order is important, reform then open.

-- Deng allows de-collectivization experiment in Anhui province to be extended through entire country. By 1983 country is rid of collective farms. Household responsibility system allows family farming but with controlled prices.

-- Huge success. Farm productivity rose by 1/3 in five years, releases 100 million workers to town and village enterprises that supply agriculture and begins export drive.

China rapidly proceeds to open goods and services and labor markets. Slower to open real property and capital markets. With money economy replacing ration economy, strong monetary, fiscal discipline is employed to prevent hyperinflation. State gradually privatizes smaller state enterprises and other capital assets to maintain fiscal balance, raise productivity. FDI adds to expanding domestic investment in what becomes an investment driven boom.
Kim Jong Il Era Half-step “reforms”

North Korea’s 2002 “reforms”
To the delegation, I pictured North Korea’s then ongoing 2002 reforms, as a useful half step. Legalized goods markets very helpful to productivity increases but failed to address conflict between fixed and market price systems. No private investment incentives. Leads to hyperinflation and huge gaps between fixed price and market prices and thus corruption of both systems, distorted decision making.

North Korean reactions—acknowledge big problem with inflation and low state wages but cool to idea of Chinese-style de-collectivization. Predict big changes in NK economic policy in future.

2002--2010

Bouts of hyperinflation followed by 2005 retrenchment on reform. Culminates in 2009 won redenomination fiasco and widespread circulation US dollars and RMB.

-- Price discrepancy between fixed and market prices remains about 50 times.
-- Leads to high levels of official corruption.
-- State industry remains dominate but central plan falters, may have collapsed.
-- No clear de-collectivization of farms.
-- Productivity and investment levels extremely low.
Kim Jong Un Era—State-Private Divergence, Mixed Dollarization, Sanctioned trade

• No actions against goods markets, foreign currencies—both expand.
• Expansion of private labor but state’s ration based employment remains dominant. Big divergence in wage structure.
• Halts inflation, stabilizes unofficial exchange rate at 8,000 per dollar – compared to 130 won per dollar official rate.
• Similar extreme divergence between fixed state prices and market prices.
• Encounters ever stiffer sanctions on exports, some imports. Exports collapse in 2017-18. Imports plunge as well, especially capital goods.
• April 2018 –Kim announces economic development is only priority of the state and the party. Emphasis on self-reliance.
• Pursues showcase tourist and residential projects.
• Reaches out to China, South Korea, and US for sanctions relief, investment.
North Korea won per US dollar: 2012-2018
China-NK Trade: 2012-18
By quarter, million US dollars

China Imports
China Exports
China-NK Trade Surplus: 2012-18
By quarter, million US dollars

Average deficit 2010-2016
How do they maintain pegged like won?

• Dollarization helps for a while.
  • First good savings vehicle for population. Savings likely rise, subduing inflation.

• Drawing down foreign exchange reserves.
  • Unknown how much FX exists, either in state hands or in circulation.

• Partner trade data doesn’t accurately reflect current account.
  • But problem with respect to sudden, late 2017 shift.

• Unrecorded inflow on capital account
  • Chinese investors in Korean residences, etc.

• Extremely tight won policy.
  • Fiscal surplus—enabled by selling/licensing state property
  • No loans given to state enterprises.
  • No needed state wage increases, forced work
  • Raising state fees in lieu of taxes, on everything.

See: http://blog.keia.org/2018/03/pyongyang-controlling-won/
Why do they maintain pegged won?

• Afraid of sudden break in exchange rate and renewed hyperinflation.
• In mixed dollarized/won environment, catastrophic social unrest could develop.
• Is pressure beginning to rise?
NK Won per US dollar: Past 14 months
won per dollar
NK Won per US dollar: Last 14 months
NK Won per Chinese Yuan: Past 14 months
Implied Cross Rate: Yuan per Dollar
yuan per dollar
What have they learned?

• Importance of stable money.
  • Huge boost to private production
  • But can they keep it that way?
• De-collectivization? Private property?
  • Experimenting but highly resistant.
  • Useful way to balance state budget
• Importance of self-reliance, import substitution.

• West, and South Korea, still look like free sources of investment, if managed well.

And what have we learned?

• Past efforts to encourage reform have failed, dismally.
• New approach to North Koreans is needed.