

North Korea's Economy and Marketization

AMID SEVERE GLOBAL SANCTIONS

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Overview

► Economy Under Severe Strain

- 2017 Kim announced prosperity drive, raising expectations for externally enabled growth. But in 2019 he talks belt tightening, self reliance.
- Weak productivity, inefficiency, not lack of resources, makes North Korea one of poorest, that is least productive, countries in the world.
- UN nuclear sanctions are having a large impact, but not quite as expected.
- Monetary system has stabilized but monetary, fiscal policy very tight. Government is starving itself, privatizing assets. Little investment.
- Is there hope for reform under Kim Jong Un?
 - “Bottom Up” Marketization Underway
 - “Top Down” Macro / Micro Support Needed

How Can We Press for Reform?

Definitions

What is a Market ?

Marketization: More than
“marketplace”

Definitions

What is a Market?

- Many buyers
- Many sellers
- Rules, Structure
 - Time, currency, behavior
- Compete for best price
- Market clears with flex price
- Usually most efficient outcome
- Decentralized, unplanned
- **Law of One Price**

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Marketization: Much more than “marketplaces”

- Goods Markets
- Services Markets
- **Labor Markets**
- Real Estate/Land Markets
- Capital/Finance Markets
- Foreign Exchange Markets

Outline

10 -15 minutes each

- Korea's Economic Geography, Resources, History
- The Marxist (Socialist/**Command**/Centrally Planned) System
- NK's broken, but not finished, command economy—half centralized, half decentralized creates dual prices for everything, and huge inefficiencies
- Chinese sanctions creating financial headaches for Kim
- Potential US Role

Break

Discussion

Economic Geography, Resources, and History

- ▶ Not really a “Hermit Kingdom, until maybe 2017
 - Ancient Korea traded with China, Japan
 - Extensive industrialization and trade during Japanese occupation, through WWII. Networked railroads.
 - Soviet bloc made extensive investments and trade linked to central plans of all of them.
 - Opened to western and Japanese investment in 1970s—promptly defaulted on debts.
 - Even in 2016, large trade volume with China.
- ▶ And North Korea never really “self reliant”. Perpetual goods trade deficit financed by remittances and foreign aid.

Natural Comparative Advantages

Comparative Advantages (natural)

- Anthracite Coal
- Iron Ore
- Cement
- Non-ferrous metals
- Sea industries, fisheries
- Hydropower

Comparative Disadvantages

- Petroleum
- Coking coal
- Arable Land- Food

Constructed, modern day, comparative advantages.

Comparative Advantages (constructed)

- Textiles/shoes L
- Tourism L,G
- Anthracite Coal
- Non-ferrous metals
- Sea industries, fisheries
- Assembly –i.e. watches L
- Computer applications L
- Conventional military

Comparative Disadvantages

- Petroleum, natural gas
- Coking coal
- Arable Land- Food
- Aluminum
- Machinery, electronics

Kim Il Song's “Command Economy” System

- ▶ Also known as Marxist, Socialist, Centrally Planned, Communist.
- ▶ Imposed on North Korea by Soviet Union in 1945; held together longer there than anywhere. No other country comes close.
- ▶ Some similarities to traditional anti – capitalist Confucian and religious systems.

- ▶ **What are key attributes of a Command Economy? How does it differ from a decentralized capitalist market system?**

Kim Il Song's Idealized Command Economy

- ▶ Public (state or collective) ownership of “means of production” including land.
- ▶ No private trade in capital.
- ▶ Absence of real money—ration ticket economy a powerful control device.
- ▶ Distribution of goods to public by ration ticket; to industry by five-year or seven-year input-output plans.
- ▶ State invests forced savings (surplus of production less consumption). Investment usually a high share of GDP, together with forced labor creates input driven growth.
- ▶ Foreign trade by state-to-state barter agreement with Soviet bloc and China. Trade with non-socialist countries based on credit. Not repaid.
- ▶ Tight border, immigration controls.
- ▶ Markets: small farmer’s markets allowed. No legal labor, or capital markets.
- ▶ Real estate—some legacy homes retained private ownership, small private farmer’s gardens.
- ▶ **Result—with much Soviet bloc aid, economy industrialized and grew through 1960s. Per capita higher than South Korea .**

Long Economic Transition—But to what end?

Planned economy slowed in 1970s, 80's and failed after mid-1990s Great Famine as the government couldn't provide rations. But it didn't go away. Now an odd, dysfunctional, hybrid. Partly command and partly unregulated, market system.

Absence of rations has induced market activity. Planned system requires tight control over prices. When it can't deliver essential goods, even food, people start to trade and natural prices, dictated by supply and demand, take over.

Economy has thus transitioned from a ration system under KIS to a bad, inflation prone money system under KCI, to a dollarized system under KJU.

Dollarization solves inflation problem, for the moment.

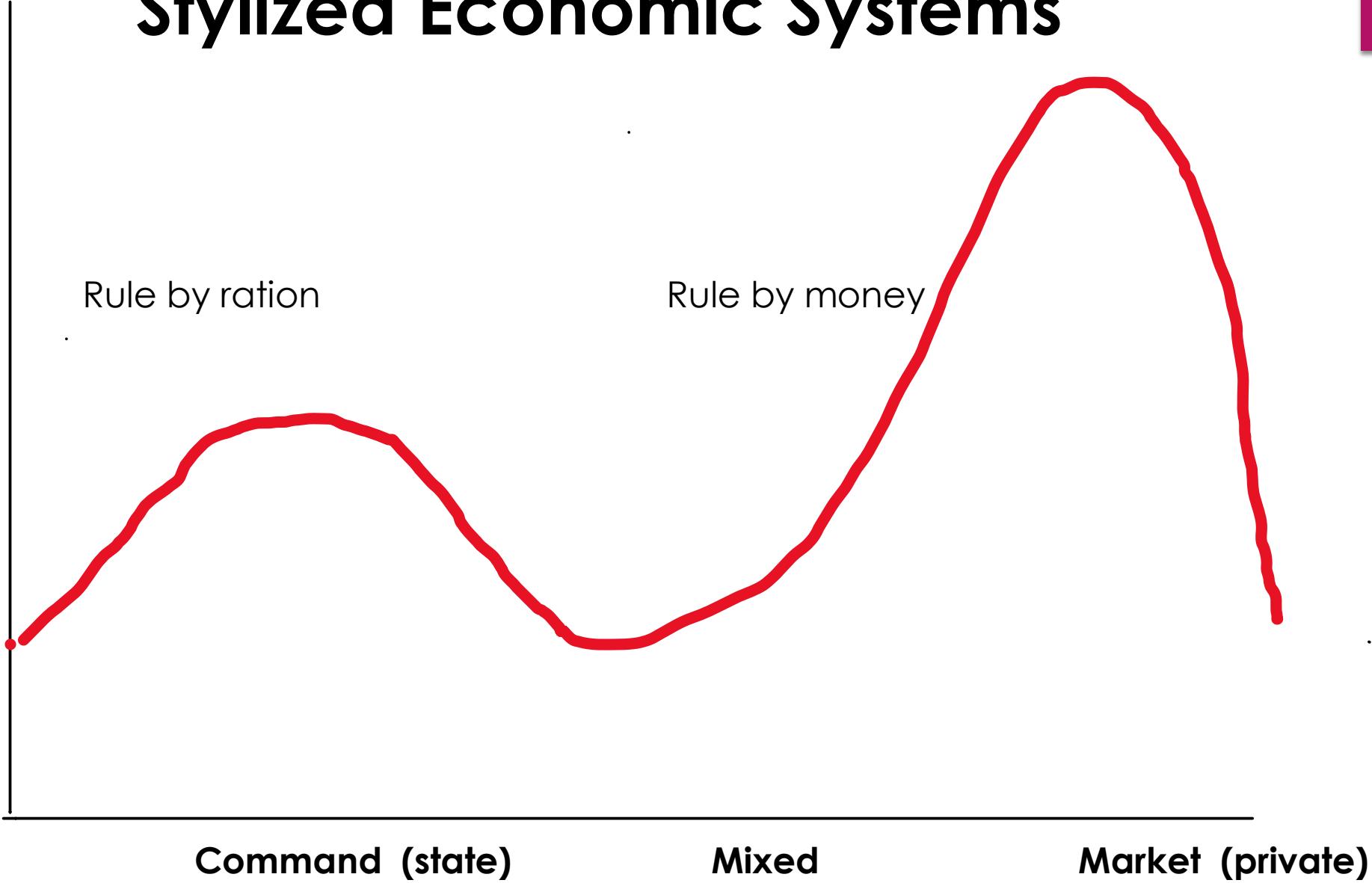
- ▶ NK Won/yuan/dollars all circulate legally in NK, in markets, in factory transactions, even inside the government. Won used for small items, yuan for imported Chinese items, and US dollars for big items--housing, and most importantly, for private savings. And there seems to be a reasonably well -working market for exchanging currency. Prices stable.
- ▶ But command economy using a very different ration price structure still exists— collective farms and millions of state workers and the huge military. Maybe half market, half command.

Production
efficiency

Stylized Economic Systems

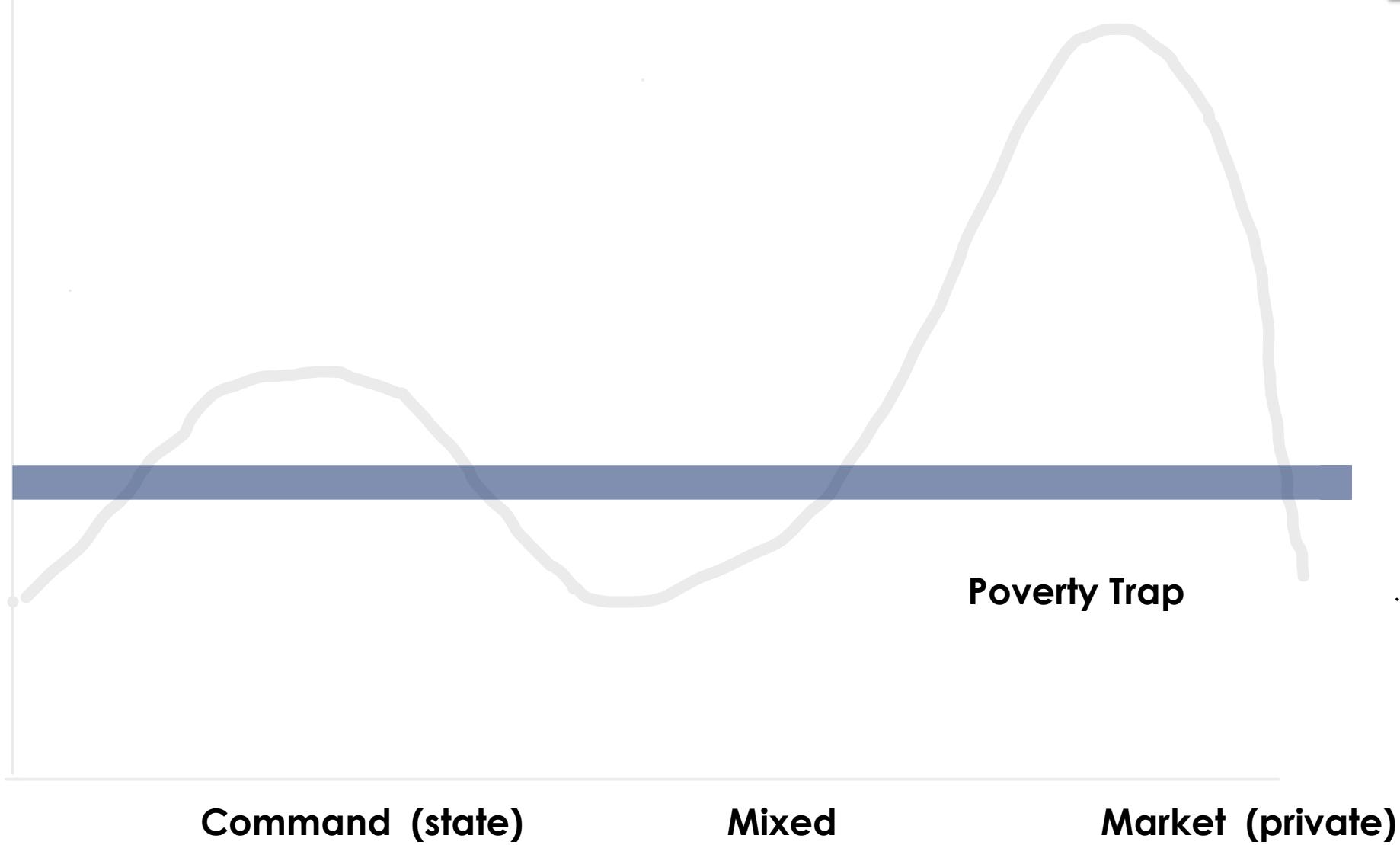
Rule by ration

Rule by money



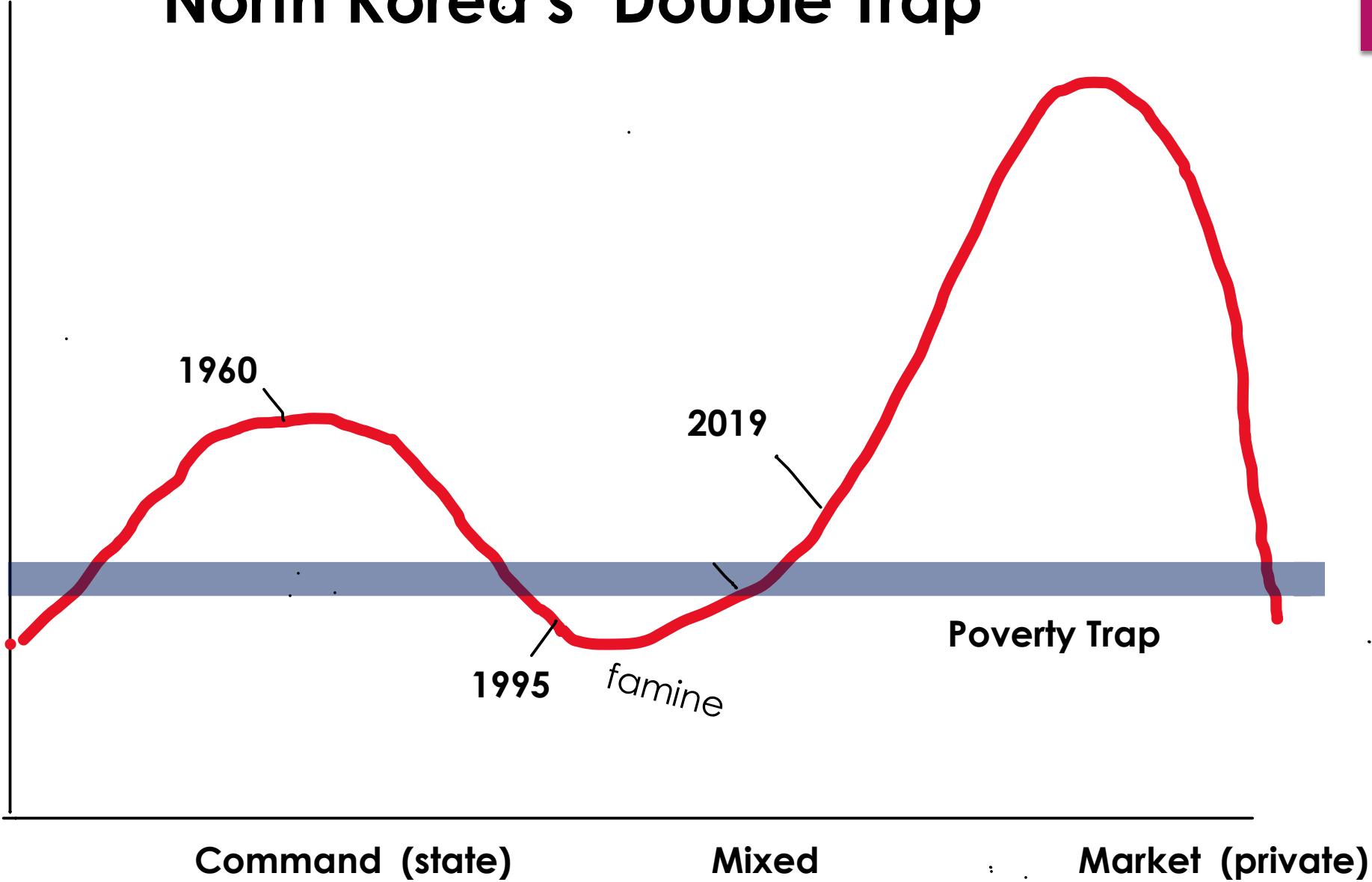
Production
efficiency

Poverty Trap



Production
Efficiency

North Korea's Double Trap

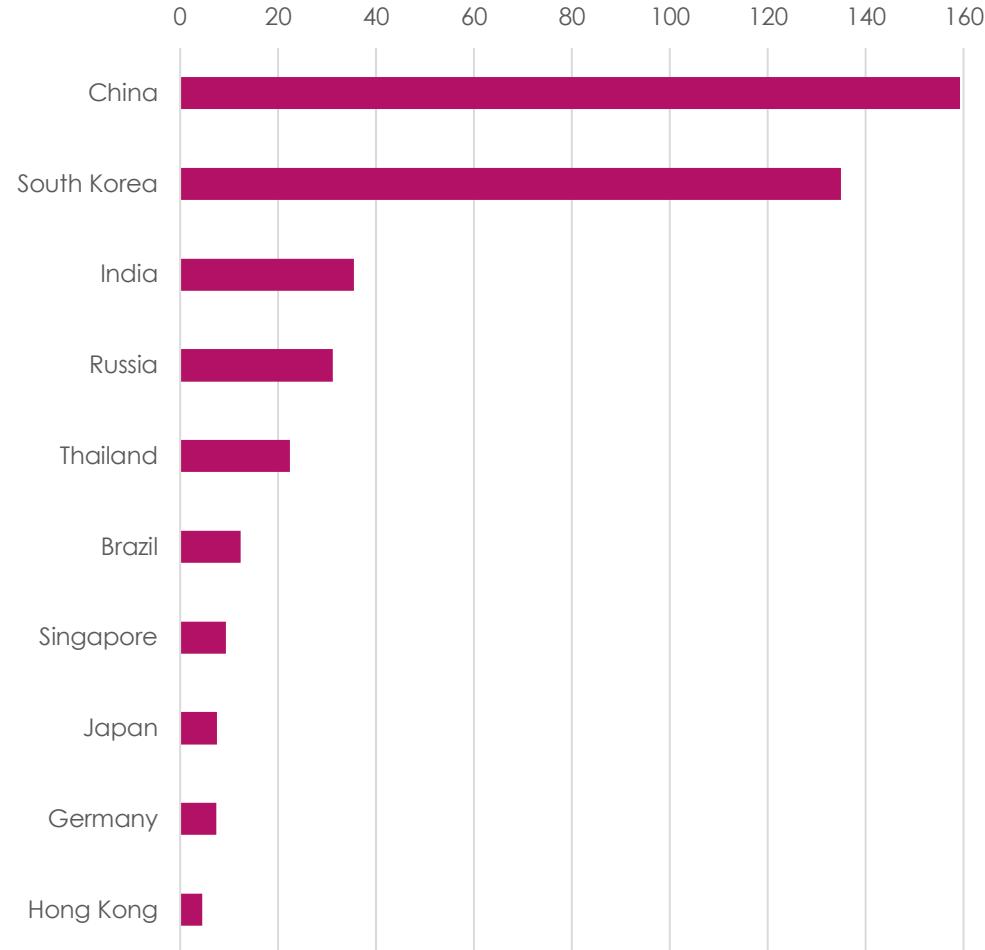


China dominates North Korea Trade

- ▶ Currently more than 90 percent of North Korea's trade is with China.
- ▶ After Korean War through the 1980s, Soviet Union and Eastern Europe were largest partners.
- ▶ Japan and Western Europe raised trade in 1970s and 1980s to high levels.
- ▶ Debt default, collapse of Soviet Union, Japanese sanctions and huge expansion of China's trade economy, shifted almost all trade to China in 2000s.
- ▶ Not unusual that big contiguous partner dominates trade.

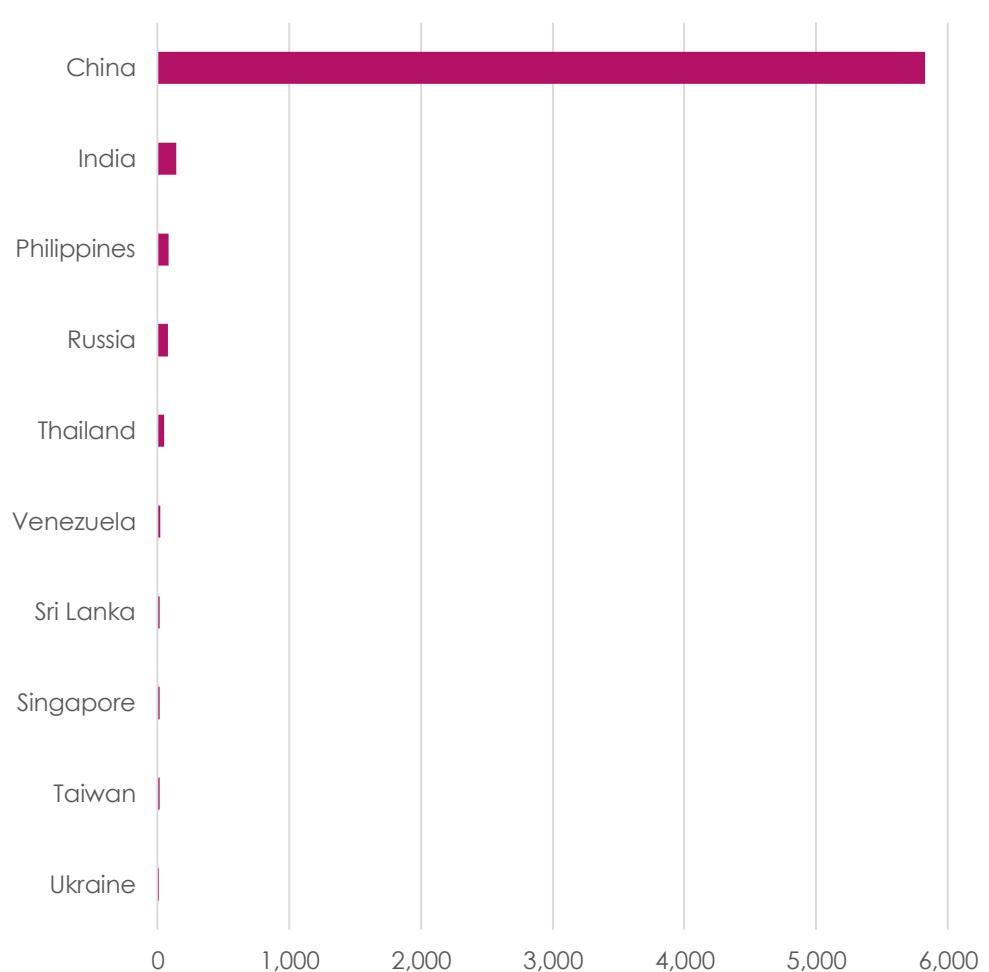
North Korea: Top Ten Trade Partners, 2006

million dollars



North Korea: Top Ten Trade Partners, 2016

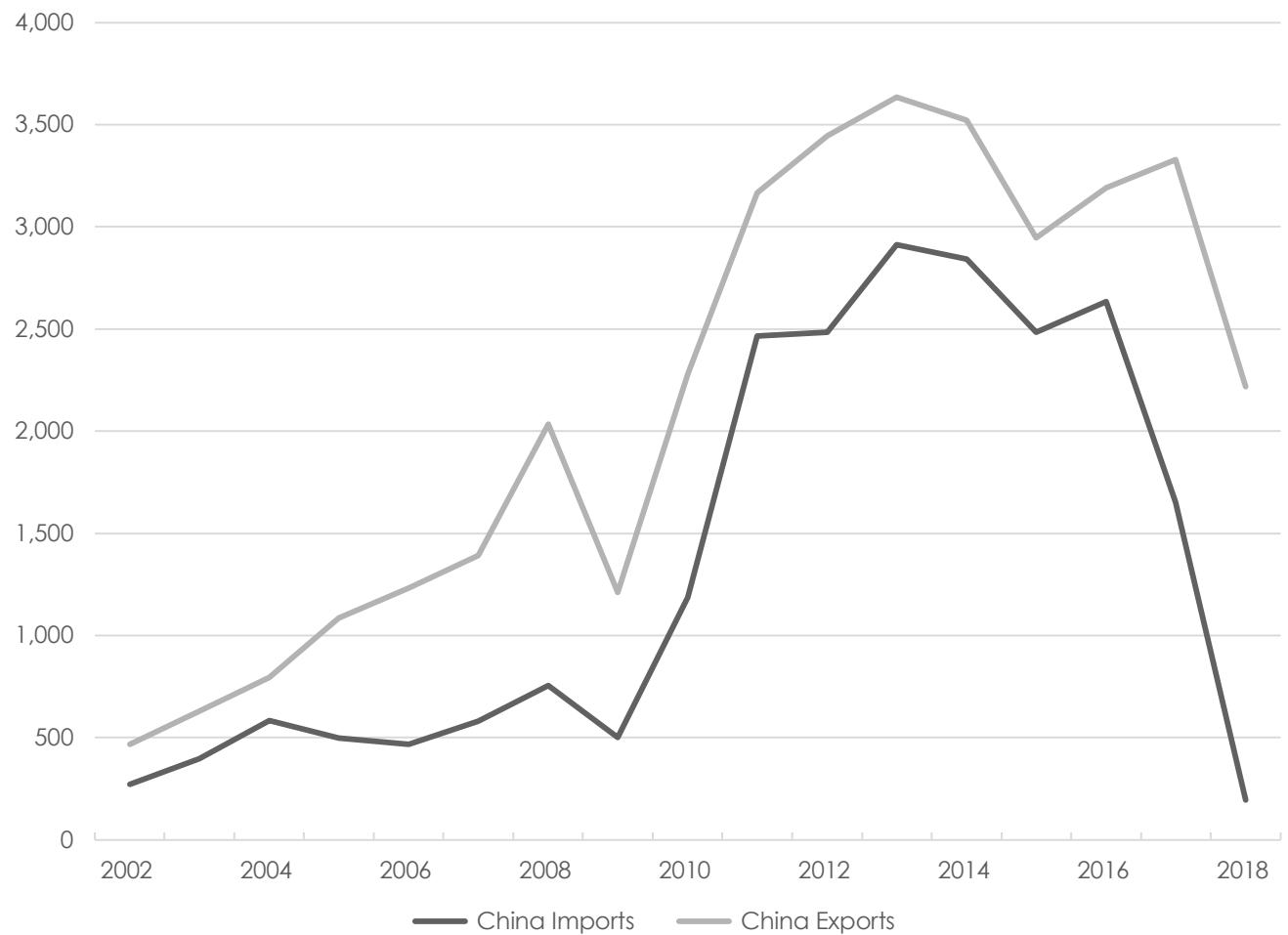
million dollars



China-UN
2016-7
Nuclear
sanctions
create
trade,
financial
crisis.

China-North Korea Trade: 2001-2018

million US dollars



	2017	2018	% ch	Jan-18	Jan-19
China Exports	3,328	2,218	-33	169	167
of which					
Soybean oil	111.4	135.6	2211.9	9.7	
Cereals	32.6	25.7	-21	0.1	0.5
Milled	35.5	65.9	86		
Seafood	102.1	70.6	-31	6.9	7.2
Agriculture plus	349.7	478.9	37	42.3	34.4
Plastics	231.4	221.8	-4		
Clocks & watches (parts)	2	36.9		1.7	9.1
Woven syn fiber	205.4	126	-39		
Fertilizer	36.4	84.8	126		
Vehicles	202	1.9	-99		
Trucks #	6170	20			
Autos #	3269	46	-99		
Electric Machinery	338	7.7	-98		
Non-Electric Machinery	268	7	-97		
China Imports	1,651	194.6	-88	36.4	20.1
Clock & Watches	1.8	31.1		1.2	6.8
Coal	401.7	0	-100	0	0

North Korea-China Trade

Year-to-date , Jan-July

Million US Dollars

Source: China Customs,

North Korea Imports

	2016	2017	2018	2019
<u>Total</u>	<u>1,596</u>	<u>1,956</u>	<u>1,158</u>	<u>1,352</u>
Plastics	98	130	15	16
Soybeans	92	144	72	104
Fibres	36	33	63	41
Fertilizer	36	34	63	42
Apparel	89	131	65	76
Tobacco	23	19	36	43
Grain	5	2	5	35
Timing devices	2	1	16	51
Elec Machinery	198	149	8	8
N-Elec Machinery	169	136	7	7
Vehicles	121	112	2	2

North Korea Exports Jan-July

	2016	2017	2018	2019
Total	1,343	994	105	124
Clocks	-	-	10	32
Ferrosilicon	10	11	13	16
Tungsten	0	0	11	10
Molybdeum	2	3	3	5
Wigs	1	3	10	15
Electricity	1	5	5	7
Graphite	3	7	10	-
Magnesite	14	11	5	-
Optics	1	3	6	9
Footware parts	0	1	1	3
Carbide	-	-	-	1
98 Special	-	-	-	5

Net North Korea Goods Deficit with China, Jan-Jul

	2016	2017	2018	2019*
	253	961	1,053	1,228

Annual	2016	2017	2018	2019*
	558	1,672	2,024	2,216

Rest of current account plus small net investment on capital account may total about \$500 million per year meaning current monthly outflow would be running about \$150 million. Does not include Chinese aid deliveries of all NK crude oil consumption, about 500,000 tons per year.

Petroleum Issue

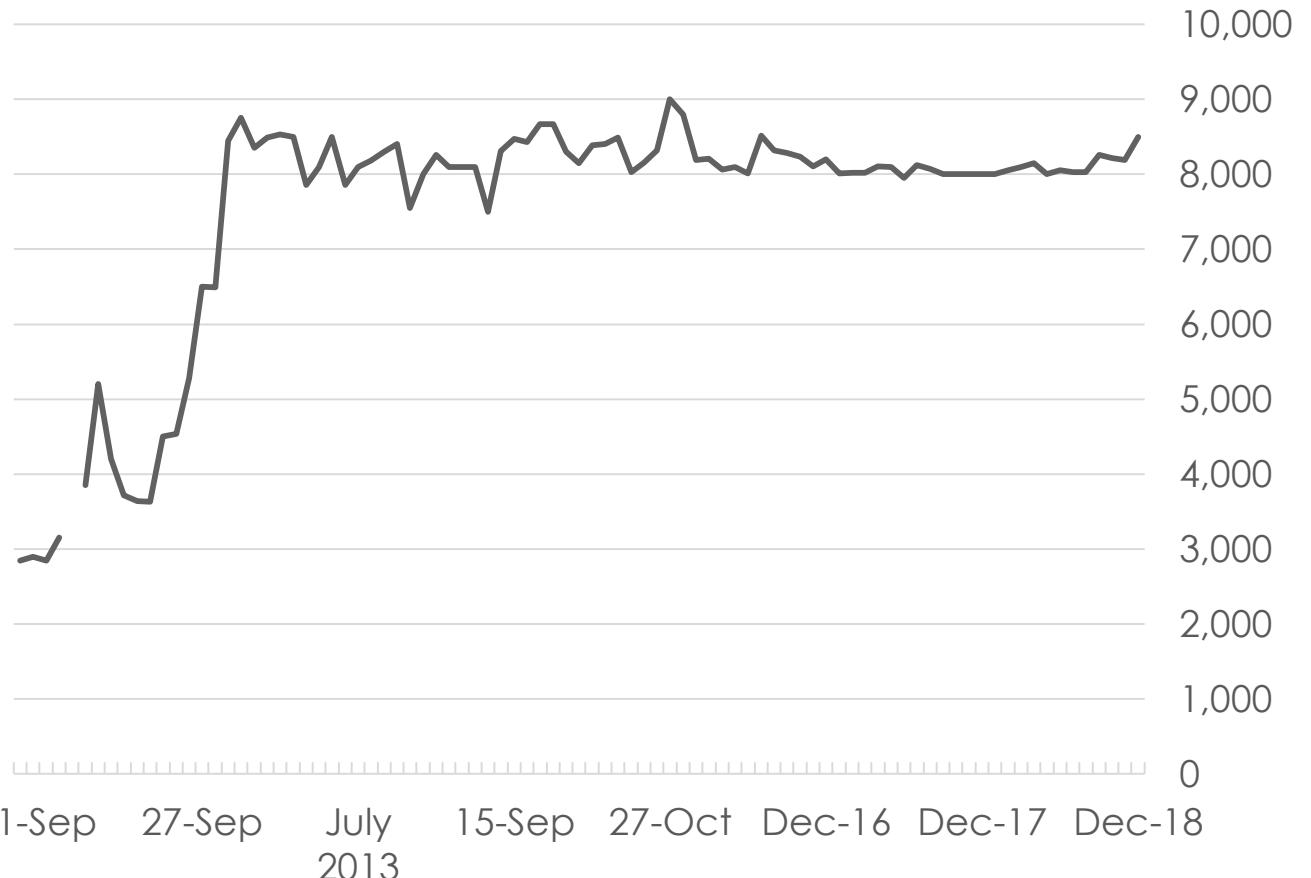
- ▶ Almost all petroleum consumed by North Korea comes from China.
- ▶ Most is delivered free via pipeline and is refined in North Korea in Chinese supplied refinery. (500,000 tons of crude per year.) Allowed by UNSC.
- ▶ Several hundred thousand tons of refined products is usually imported at market prices, mostly from China, some from Russia. These are capped by UNSC.
- ▶ Ship-to-ship transfers are seen in which gasoline, diesel fuels are transferred from foreign ships to smaller North Korean ships, avoiding customs and the UN sanctions.
- ▶ Gasoline is sold in North Korean markets at higher than world prices.

Why does China allow this?

- ▶ Crude oil provision may be China's last big weapon to use on Kim should Kim engage in nuclear or ICBM test.
- ▶ Ship to ship transfers profits are very high, corrupting everyone's sanctions enforcement.
- ▶ China may consider petroleum is last lifeline to regime and doesn't want to go further.

Won
stabilized
despite
export
collapse

North Korea won per US dollar: 2012-2018



We need non-existent balance of payments data to accurately analyze exchange rate.

Current Account plus capital account = change in foreign exchange reserves.

Current account = net goods trade plus net services trade plus net income plus net remittances

Capital account = net direct investment inflow plus portfolio inflow plus bank borrowing. (North Korea is virtually bankrupt so assume this is 0.)

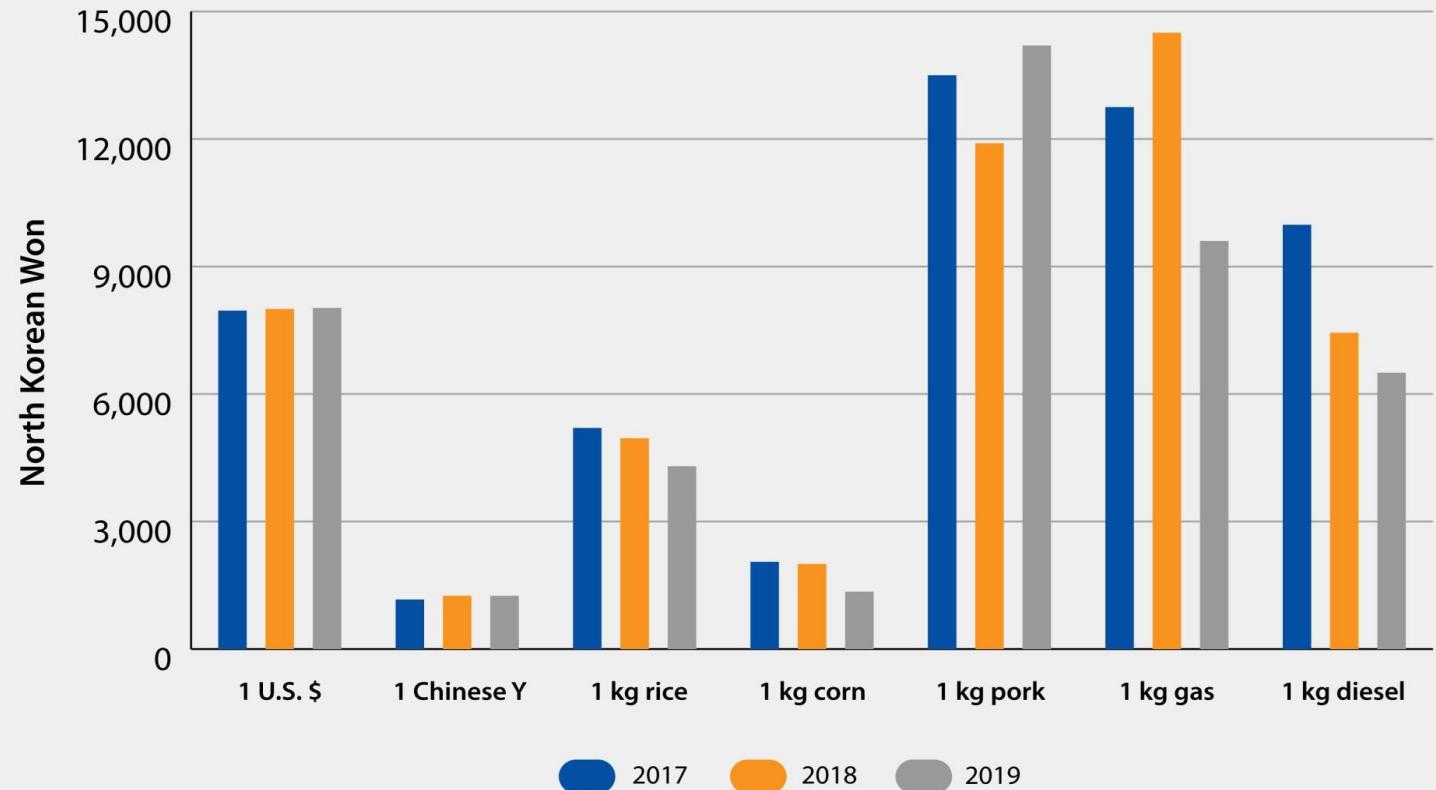
Partner reported trade deficit running about \$200 million/per month, offset perhaps by \$100 million net services, remittances, and unreported or illicit exports.

How can won remain stable with \$100 million a month net outflow?

Theory: Very Tight Monetary, Fiscal Policy

- ▶ Central bank reduces won supply in parallel with loss of dollars.
 - ▶ Little printing of new cash.
 - ▶ Few new net loans to state enterprises and state agencies
 - ▶ State firms allowed to privatize assets to make ends meet.
 - ▶ State agencies raise all kinds of fees to raise funds. (no normal tax system). Allow workers to engage in private income earning work.
- ▶ Impact is good for inflation but devastating to state investment, employment.
- ▶ Cost of stable won is shrinking state sector. State has very large assets so this can last a long time. Like China.
- ▶ Also, by allowing US dollars and RMB to circulate, real savings vehicles are available for the first time, allowing citizens to save. Reduces current demand.

North Korea Prices, May 2017-2019



Reform and Opening

- ▶ Chinese construct. Order is important. Reform then Open.
- ▶ What is meant by Reform
 - ▶ Unify price system
 - ▶ Establish at least some private property rights
 - ▶ Decollectivize agriculture
 - ▶ Create new money and banking system
 - ▶ Shrink huge bureaucracy and military,
 - ▶ Establish tax system and transparent fiscal budget
- ▶ This could put economy on moderate growth track, without foreign opening.

Then comes opening

- ▶ Join WTO, IMF, World Bank
 - ▶ Removes non-market tariff issues, especially with US
 - ▶ Old debt workout
- ▶ Normalization with Japan
 - ▶ Obtain \$10-20 bn in colonial era reparations.
- ▶ Carefully allow inward FDI. Borrow to build domestic firms.
- ▶ Comparative Advantage based exports. (ROK model)

- ▶ Result would like by very rapid long-term growth taking advantage of high human capital, natural resources, and geographic resources.

US - North Korea Economic Issues



Non-Market Economy Issues



Trading with the Enemy Act



Terrorist List



Many Executive Order sanctions



UNSC Sanctions

Readings:

- ▶ [KEIA.org Peninsula Blog, Many Items](#)
- ▶ [NAEIA.org Many items](#)
- ▶ <http://blog.keia.org/2019/01/north-koreas-pegged-won-wiggles-doesnt-break-yet/>
- ▶ https://www.ncnk.org/sites/default/files/NCNK_William_Brown_NK_Shackled_Economy_Report.pdf
- ▶ <http://www.theasanforum.org/sanctions-and-nuclear-weapons-are-changing-north-korea/>