



## Kim Jong Un's Christmas Present: More About Dollars Than Sense

Bill Brown, 1 February 2020 <sup>1</sup>

Remember Kim Jong Un's promise of a Christmas present, or a New Year's surprise, that had Washington pundits shaking in their galoshes just a month ago? It is still not clear what he meant, but the gift now seems to have been to spare the world his normal New Year's Day state-of-the-nation and economy speech, replacing it with a long winded oratory the day before to a Worker's Party conclave. In this more private address, he bemoaned the impact of UNSC sanctions on the country and asks for yet another round of belt tightening from the people, something he promised just a little over a year ago he would never again have to do.<sup>ii</sup> He continued his year-long complaint about weak management of state enterprises culminating in his usual dictum: "work harder, work smarter so we can prevail against a world that is against us." The main difference though, out of line with past performances, was that he said nothing about the country's longer-term economic plan, either the five-year plan that is supposed to end this year or a new one that should be under development. And nothing about the highly touted "new path", proclaimed just a few months ago as a threat to denuclearization negotiations.

This absence of forward thinking is interesting given the economy is still about half planned and run directly by the state, a "command" or socialist style economy, and state factories and agencies need to know what they are supposed to make and how much labor and materials will be allocated to do their jobs. Will they be able to import essential equipment and intermediate inputs? Most importantly, will they get the rations needed to pay their millions of workers or are they going to get a lot more money to pay them real salaries? Power elites in Pyongyang must be wondering if Kim is on the verge of giving up the plan entirely, given the lack of mention. They must know this would cause a further lurch to market mechanisms—using dollar profits to determine investments and increased market pricing of labor and capital in lieu of command economy allocations. But Kim didn't give any indication of that either, sending

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forth a confusing combination of decentralized management, which might be read as more use of market prices and private profits, and stronger central controls which, of course, would be the opposite. All this in an economy where dollars seem to be rapidly replacing the domestic won as the driving force. Even some of the state's electricity fees are said to now be priced in US money.<sup>iii</sup>

Meanwhile, as if to add to the slate of worries on Kim's desk as the new year begins, and amid the corona virus that has caused him to close its border with China, just as he was preparing for the spring opening of a huge new tourist resort at Wonsan, China released its dismal December and full-year 2019 data on trade with his country. Many dispute the data as being politically doctored by Beijing, and it does go against some ground evidence of trade as usual. The voluminous Chinese General Administration of Customs compilation—millions of bits of data on trade in thousands of products with hundreds of countries, and used for everything from bank



invoicing to customs duty collection and even GDP calculation, squares with the government's official sanctions against North Korea - a virtual embargo on imports from that country. In these circumstances, no one is quite sure what is going on but Kim is likely much less happy with President Xi than with President Trump, although he can't say so. He can't complain too loudly lest Xi pull the last plug and stop delivering North Korea's entire crude oil supply, or more



seriously stop the smuggling. Since the Mao era, China has supplied about 500,000 tons of crude oil a year on “friendship” terms, aid that works like a choke collar around North Korea’s neck. My guess is that is why there were no surprise nuclear or ICBM tests this Christmas. Kim has many other, even bigger issues to worry about as well.

Aside from Christmas presents, let’s look at the little we know about Kim’s economic agenda as he begins the year of the rat, ironically in this cycle it is properly called the gold or money rat, and speculate a little. In his half-dollarized economy, I expect Kim and all North Koreans can appreciate that astrological sign. Many caveats are in order since information sources are sparse and we don’t really know for sure what drives Kim and his Worker’s Party.

### **Sanctions and Trade: Kim’s top complaint.**

First on his plate must be dealing with sanctions and amongst these, Chinese sanctions, really imposed only since 2017 at the demand of the UN Security Council with full approval by Beijing. To the extent that China “cheats” on these sanctions it is thus cheating on itself, not unlikely given the complications inherent in any country’s trade policies, and especially with respect to a next-door neighbor. Here we have the benefit of looking at data that Kim himself probably sees since it is produced and published by China, based on its customs collection. It is just the reverse of North Korean data which, presumably, also are collected in some form but never published. Chinese exports to North Korea are North Korean imports, and Chinese imports are North Korean exports. It would be interesting to see how the two compare and I would not be surprised if Kim or his senior advisors ask for that. Our own US customs collection often differs considerably from that of our trade partners, so it is unlikely the two are exactly alike. Most countries collect better import data than exports, since imports often carry tariffs. And we hear quite a lot about smuggling, corruption, and trade that bypasses customs houses such as the vaunted “ship-to-ship” oil and coal transfers. Imagery of Nampo harbor, moreover, seems to indicate shipping is near normal. So, what is happening with trade is complicated and we don’t really know for sure. Kim probably doesn’t either, or Xi Jinping for that matter.

Still, the official data spells out a worrisome story for Kim, to say the least.

- Chinese imports from North Korea were up 11 % from 2018 to reach \$216 million but were still under 10 percent of pre-2017 levels. A “dead cat bounce” as Wall Streeters would say. The rise in Chinese purchases was accounted for by two non-sanctioned products, human hair wigs, and watches assembled from imported timing chips from China. It shows North Koreans are responding in a rational, market-like way, but their efforts are too small to count for much, at least so far. Footwear exports also are on the rise and may be an area to watch given the large size of the market. Expect Kim to visit a shoe factory soon. Anthracite coal, iron ore, and non-ferrous metals registered zero trade, given the sanctions, but coal is widely seen to be exported covertly.

## North Korea Exports to China<sup>iv</sup>

Million US Dollars

	2016	2017	2018	2019
All	2,634	1,653	195	216
Mineral Fuels	1,187	413	11	11
Apparel	724	562	0	0
Ores	225	187	25	22
Iron & steel	44	59	32	34
Wigs etc.	3	9	24	34
Clocks, Watches	0	2	31	49
Footwear	1	2	5	7

Chinese exports, that is North Korean imports rose 17 percent and at \$2,589 million are about 80 percent of pre-sanction levels. More interesting though is the composition of this trade. Consumer goods including foodstuffs, tobacco, textiles and petrochemicals such as plastics and fertilizer are up while sanctioned investment goods that in the past amounted to close to a billion dollars a year, have fallen to zero, including essentially no exports of machinery or transportation equipment, normally high valued products needed by North Korean industry. Interestingly furniture has been a large item in recent months, possibly to refurbish the large tourism projects under construction.

## North Korea Imports from China<sup>v</sup>

Million US Dollars

	2016	2017	2018	2019
All	3,192	3,328	2,218	2,589
Plastics	204	231	222	275
Oilseeds	99	122	156	143
Man-made Fabrics	187	219	138	189
Fertilizer	38	36	85	43
Fruits & Veg	99	67	82	64
Knits	85	101	81	90
Apparel	134	117	74	90
Fish	74	102	71	56
Tobacco	19	33	70	51
Milled Products	4	35	66	77
Clocks & Watches	5	9	46	82
Sugar	4	39	40	44
Cereals	26	33	26	84
Petroleum Prod	114	70	24	29
Furniture	49	60	58	75
Vehicles	255	202	1.9	.4
Electrical Machinery	315	338	8	2.7
Non-Electrical Machinery	269	268	7	.7

- At \$2,373 million for the year, China's goods trade surplus, that is North Korea's deficit, was by far the largest on record. November and December recorded North Korea's largest monthly deficits on record.

By partner, China dominates North Korean trade, both before the sanctions were put in place and currently. Russia is second but records only 1-2 percent as much as the Chinese trade. It sells diesel fuel, which is allowed up to a point by UNSC, and a little bituminous coal, probably used for steel industry coking. Curiously, and possibly a data error, one of North Korea's largest export shipments last year was a passenger ship counted at \$85 million, to Denmark.<sup>vi</sup>

### North Korea's Trade with the World, 2019\*

*Million US dollars*

	Data as of:	NK's Exports to	NK's Imports from
China	Full Year	217.5	2,589
Russia	November	2.3	42.1
Brazil	Full Year	0.1	19.7
Honduras	Full Year	1.4	9.0
EU 28**	October	85.6	5.6
India	October	2.3	8.8
Ghana	November	7.5	NA
Costa Rica	November	4.5	0
Indonesia	November	3.0	.2

\*From foreign customs sources, North Korea perspective (Russian exports are North Korean imports.)

\*\* One passenger ship imported by Denmark, September 2019, Eurostat.

### Foreign Exchange Reserves: The people may have more dollars than the state.

In this year of money, Kim must keep a close eye on his own family's dollar holdings and those of the government. Here we can only guesstimate the levels and the flows. South Korea's government figures North Korea held about \$3 billion in reserves in 2016 and has lost about a billion dollars to the trade deficit in each of 2017 and 2018, suggesting they are getting low. My guess based on the reported trade is that the country is losing about \$200 million a month in recent months. However, other components of its balance of payments likely show North Korean surpluses. These would include net revenue on unreported goods trade, for example exports of military products; revenue earned from foreign, mainly Chinese, tourists; money earned by North Korea's tens of thousands of overseas workers and remitted to North Korea; remittances of overseas Koreans who try to send money back to their families; foreign aid commodities that counts as North Korean imports, much of it purchased in China and thus registered as a Chinese export, but are not paid for by North Koreans; and probably small amounts of foreign investments into North Korea, again probably mostly from Chinese-Koreans who may buy or lease property in North Korea. All of these must be net of North Korean purchases, but they are likely to be small. For example, illicit gasoline imports come at a cost to

North Korea's foreign exchange, but unreported coal sales provide revenue. My back of the envelope guess is that these might net to a \$100 million or so, paying for about half the goods trade deficit. This would mean a net outflow of reserves of about \$100 million a month, but who is to say, for sure.

It's worth conjecturing that perhaps this estimate is far off, and that Pyongyang earns more than we think from say military sales, or that its exports to China are greatly under reported. Then we might question why the country's imports seem so sparse, with almost no apparent investment goods coming in, only needed consumer products. Moreover, UN sanctions increasingly are hit at North Korean services exports as well. As of December 20, all UN member states were required to send their North Korean workers home. Reports indicate that China and Russia have failed to send everyone back, but many have, and remittance and worker income is likely to decline sharply this year. Again, I expect Kim is looking at such data and trying to figure out work arounds, perhaps looking at his favorite foreign service, tourism, putting that up against reported US suggestions of allowing US travel to North Korea and the reopening of South Korean tourist projects. No doubt the closure of the border with China last week, due to the coronavirus, will hurt in the short term but may give him a convenient excuse for failure on that front.

The foreign exchange picture is further complicated by the unusual degree to which North Korea's economy has been dollarized in recent years, the result of domestic distrust of the country's own currency, the won. Hundreds of millions of dollars' value in foreign money, maybe more than a billion, especially US currency and Chinese yuan, circulates or is held as savings by North Korean citizens. This is a godsend for citizens who for generations have had no financial vehicle available for savings. These funds are not easily accessed by central government authorities so are best considered private, not official reserves, but they may be used for consumer imports. Of great concern to Kim must be the thought that the country's elites now hold lots of Benjamins, which I expect he worries they can use to corrupt poorly paid security officials and thwart government objectives. His killing of his aunt's husband some years ago may reflect such fears—rumors were that Uncle Huang had accrued too many dollars from side-line export businesses.

One might think that the strong-armed state could simply force people to turn in their dollars, but their use is so widespread, even among government and party people, this would likely cause panic and chance insurrection. The last time this was tried was in 2009, as Kim was being groomed for power, and the result was rioting in the streets, forcing a rare government apology and the execution of the Party official in charge of finance. Kim likely learned an important lesson and has not tried to force the issue, so dollar use has proliferated. A few weeks ago, Daily NK reported the government issued a call for people to use the won more and dollars less in their commercial transactions and physically clean up the dirty won notes,<sup>vii</sup> to make them more attractive. A "please turn in your dollars and we will give you won" story line. Perhaps

related, the won immediately fell in value a few percentage points in the widespread currency markets.

I expect Kim and his advisors thus pay very close attention to the exchange rate and worry about a speculative collapse in value. Do they have the foreign exchange to directly intervene and buy a collapsing won with an ever-shrinking supply of dollars? Would a Christmas surprise cause such a panic as ordinary people decide foreign retaliation could hurt the won even more, and thus force the issue by trading it in at any price? Maybe Kim decided it's just not worth the chance.

### **Foreign Exchange Rate and Inflation: Success but at What Cost and for How Long?**

If there is one economic success story that Kim can be proud of, surely it is his taming of the inflation and currency depreciation that plagued his father's regime. That this has occurred during a period of extremely tough sanctions on export earnings is even more surprising. One would expect the drop in exports to have reduced the value of won against foreign currencies and thus drive up prices of imported goods, raising the rate of general inflation.

This hasn't happened, at least according to what look to be reliable exchange rate and market price data as reported by two outside groups, one in South Korea, Daily NK, and the other, Asia Press, in Japan. Both are affiliated with defectors from North Korea who have continuing access to people who report to them market prices. The data shows that soon after Kim came into power, the won/dollar rate stabilized at 8,000 won per dollar and is in fact was so stable it looks like the won was pegged at that rate. Meanwhile prices of the several important commodities that are tracked, including the all-important price of rice, stabilized after years of rampant inflation. This stability has been maintained even in the last year as the trade deficit based on partner data widened to record levels. If anything, commodity prices are falling. The won, however, has become somewhat more volatile in the last year, moving up and down against the dollar, moving sharply down over the past month.

Some analysts use this financial stability to say the sanctions are not having a meaningful impact on the economy and strongly suggest China is cheating with its data, in effect cheating on its own sanctions rules. No doubt some of that is occurring, but there is another explanation that can account for financial stability and seems more likely to me. After the bad experiences of his father, Kim may have simply ordered his banking authorities, the Ministry of Finance and the Chosun Central Bank, to hold the line on the exchange rate, forcing them to maintain the 8,000 rate by withholding won credit, or issuance of won notes, whenever it began to depreciate. This would be remarkably like a very liberal Hong Kong type currency board where monetary policy is relegated to second place behind all important exchange stability. It can work well once people are satisfied the rate will hold and thus don't have an incentive to speculate against it, but any wavering can cause a wave of adverse speculation, even panic selling. Hence the tight focus on a peg, or something close to it.

Tight monetary policy also is likely accompanied by stringent government fiscal policy, since budget deficits cannot be financed by printing money lest the increase in money supply devalue the won. North Korea does not have an ordinary tax system, so tax rates don't rise; instead spending drops and all kinds of fees are increased. State owned firms and government agencies cannot borrow as freely as in the past, so to compensate they seem to have increased liquidation or privatization of their assets, selling apartments or leases to their workers, or leasing out equipment to private entrepreneurs, for example, in return for cash. This can be helpful since the privatized assets often are used more productively and thus spur output growth, offsetting some but not likely all the decline in socialist output.

While good for financial stability, a tight monetary and fiscal policy - that is no increase in credit or currency or deficit spending - has a big economic cost, often pushing the economy into recession since companies and individuals can't borrow to invest, and investment spending crumbles. Prices, rather than rising, fall, adding to trouble in the producing sector. This to me is what Kim's economy now looks like; not an inflationary bubble but a recessionary spiral. And the recession is caused by absence of investment, not consumption, which in North Korea is always near a subsistence level. So, this is not such a good environment for speaking of five-year plans, something Kim probably figured out himself.

### **Dual Price and Wage System: Inefficient and Unfair**

Most economists love the idea of a single price, even stating it as one of the few "laws" in the discipline, "the law of one price." In a competitive market economy where everyone seeks to make some profit, arbitrage, buying low and selling high, should eliminate price disparities. When prices differ for the same good or service in the same economy, say for prescription drugs, airline seats, or college tuition, something is broken. Usually some regulation or monopoly power has gotten in the way. The single price forces efficiency in production and fairness in distribution, subject to the important condition of competitive markets.

North Korea, in contrast, might be called the land of many prices. Or at least two - the market price and the command or rationed price. Amazingly, they differ by a factor of 50 to 100 or even more. That is 50 times not 50 percent more. This begins with the exchange rate. The official rate for won is about 150 to the dollar. The widely prevalent market rate is 8400 won per dollar. The price of a kilogram of rice under the ration system is almost zero whereas the market price is close to 4,800 won per kilogram. Electricity is essentially free under the ration system, including for industry. In the market, it is simply unavailable except at scalper's rates. But the government may be about to start charging for some use, surely a political sensitive issue. Daily NK reports that Pyongyang residents will be charged \$50 a month, that is fifty US dollars cash not the won equivalent, for use above a certain quota. This would be only a band aid for power problems, but perhaps a step in the right direction. As the market economy has expanded over the past twenty years, more and more goods and services are based on market prices and the rations are fast disappearing. This has enabled a big increase in productivity, at least in distribution, and makes famine, as occurred in the mid-1990s, much less likely. And, for what it is worth, Kim said in his



seven-hour oration that the country had a good harvest last year, despite alarms rung by the World Food Program and the Food and Agricultural Organization in mid-summer that bad weather was causing a big need for food aid.

At the top of Kim's worries, however, must be the badly distorted and potentially dangerous dual wage system. The official wage chart for government workers of all kinds allows wages of between 3,000 and 5,000 won per month, say for a schoolteacher, policeman, nurse, or doctor. It seems to be slightly higher in state enterprises for production workers, but not much. This level of pay is sustainable in the ration economy, where necessities are cheap, even free if they are available, but it doesn't even buy a cup of coffee in the market economy, where wages are about 100 times higher. How can a teacher possibly afford a \$100 cell phone when her official pay nets about 50 cents a month? She can, and does, by offering private lessons to students whose parents are in the market side of the economy, collecting maybe a few dollars a day, neglecting her normal class in the process. The same thing is occurring across the country's huge state workforce, corrupting state services at a prodigious rate. Daily NK reported a few weeks ago that at least for a short while, the country's big ammonia fertilizer plant at Hungnam had shut down, not due to a lack of imported oil, as the plant probably wisely converted to coal a few years ago, but because the workers were not coming in since they were not being paid and instead they were off working in the markets.<sup>viii</sup> This kind of stoppage may not yet be prevalent, and there is no organized labor of the sort that sparked a revolution in Poland, but state enterprises must be torn. Do they produce accordingly to the increasingly invisible central plan or do they allow their workers to produce for themselves, letting go of something as important as fertilizer?

Kim needs, and may be, considering a big pay increase for state workers, even "matching to market" while pushing many into private firms, reducing their burden on the state. Coal miners in state mines are said to receive many times the state wage, for example, and the mines, if they can export, can easily support higher wages. But given the tight budget constraints, an overall wage boost would require a big increase in money supply, and inflation and exchange rate depreciation would likely follow. Not an easy choice. Either let the state continue to massively corrupt itself, risking unhappy state employees, or cut back state employment and let the enterprises go private, giving up on the country's socialist experiment. And then there is the military and its one million troops, all on the pitifully poor ration economy, not the more productive and growing market economy.

Even more than President Xi's choke collar, potentially disgruntled soldiers, schoolteachers, nurses and steelworkers all being asked to tighten their belts, while watching as foreign tourists don't show up for expensive new tourist resorts, may be the real reason for Kim's big no-surprise Christmas present for President Trump. Happy Year of the Money Rat.

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<sup>i</sup> <https://www.apmex.com/product/198307/2020-great-britain-1-oz-gold-year-of-the-rat-proof-box-coa>

<sup>ii</sup> Jonathan Cha, Daily NK. <https://www.dailynk.com/english/kim-jong-un-does-unexpected-yet-again/>

<sup>iii</sup> <https://www.dailynk.com/english/pyongyang-boosts-state-collection-electricity-fees/>

<sup>iv</sup> China General Administration of Customs, Jan 2020

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<sup>v</sup> China General Administration of Customs, Jan 2020

<sup>vi</sup> Eurostat via Global Trade Atlas, 31 January 2019. But sometimes North Korea is mistaken for South Korea and South Korea is the world's largest exporter of such ships.

<sup>vii</sup> <https://www.dailynk.com/english/north-koreans-turn-to-local-currency-due-to-foreign-currency-shortages/>

<sup>viii</sup> <https://www.dailynk.com/english/north-korea-largest-fertilizer-plant-no-longer-operational/>