

BY STEPHAN HAGGARD AND MARCUS NOLAND

North Korea

watchers are getting accustomed to double-takes. Three months after the death of the nation's leader, Kim Jong-il, in December 2011, his third son and chosen successor, Kim Jong-un, gave a televised speech. (Kim Jong-il, for his part, had not recorded so much as a radio broadcast in his entire 17-year reign.)

A month later, the young monarch turned up at a decrepit amusement park to berate officials over broken equipment, peeling paint and uncut grass. He was later shown in footage on the *Today* show, his portly frame strapped into a roller coaster, careering through a full loop. In July, Kim was accompanied by Ri Sol-ju, his new wife, to a pop concert complete with Disney characters and miniskirted dancers.

This is certainly not your grandfather's North Korea. Or is it? Guessing the size of the North Korean economy is a mug's game. But the conventional wisdom is that average North Koreans are no better off now than they were in the mid-1970s – and remain worse off than they were in 1990, when the country's Soviet patron collapsed and the nation



Kim Jong-un and his late father Kim Jong-il.

descended into full-blown famine.

But averages can obscure a lot. The gap between the privileged capital city, with its Dolphinarium and miniature-golf courses, and the increasingly destitute hinterlands is widening. The country suffers from chronic food and energy shortages, a decaying health care

STEPHAN HAGGARD, currently a visiting fellow at the Peterson Institute for International Economics, is the Lawrence and Sallye Krause Professor of Korea-Pacific Studies at the Graduate School of International Relations and Pacific Studies, University of California, San Diego. **MARCUS NOLAND** is deputy director and senior fellow at the Peterson Institute and a senior fellow at the East-West Center in Washington.



PETE KRILL

system, corruption and extraordinary repression of basic human freedoms. Life expectancy is a full decade less than in South Korea.

Macroeconomic instability has returned as well. Inflation is in triple digits. Korean workers in Chinese joint ventures request payment in Chinese renminbi, and at the Kaesong Industrial Complex, Choco Pies (South Korea's answer to the Moon Pie) circulate as a parallel currency. The price of rice is skyrocketing and all signs point to worsening food shortages over the next year.

THE BACK STORY

North Korea's travails are particularly striking considering its neighborhood. The North and South Korean economies constitute a natural experiment. When the Korean peninsula was divided after World War II, the North held substantial advantages: higher productivity, more energy, more industry and a better-educated population. But North Korea did not follow the Soviet Union and Eastern Europe in gradual de-Stalinizations in the 1950s. To the contrary, the cult of personality around Kim Il-

Inflation is in triple digits. Korean workers in Chinese joint ventures request payment in Chinese renminbi, and at the Kaesong Industrial Complex, Choco Pies (South Korea's answer to the Moon Pie) circulate as a parallel currency.

With new leadership in place and the economy facing new stresses, is this North Korea's reformist moment? Rumors of secret directives to the party outlining experimental reforms have been leaking out of the country for months now, given play by those hopeful that reform is imminent. And in light of the country's location in one of the most dynamic regions in the world, the upside potential is enormous. The economy could respond dramatically to even modest reforms, provided they were launched with conviction.

Yet previous regimes have proven tentative and ambivalent about the market, clearly fearful of risking a North Korean version of Tahrir Square. Whether the current leadership – with its deep dependence on the military – has the vision or capacity to initiate a sustained reform is far from obvious. To put it another way: we don't have much idea whether Ri Sol-ju will end up as North Korea's Jackie Kennedy or its Marie Antoinette.

and his son, Kim Jong-il, only grew over time. The economic trajectories of the North and South diverged radically; today, South Korean incomes (in terms of purchasing power) are 20 to 30 times higher those in the North.

Even as the Cold War ended, the North Korean regime stuck to its inward-looking policies. Unlike Vietnam, which faced nearly identical international circumstances and embraced limited Chinese-style reform, North Korea doubled down with a particularly confrontational and repressive military-first policy. This strategy came complete with recurrent international crises around the country's nuclear ambitions – clearly a deterrent to an effective economic opening.

The failure to respond to changed circumstance was not just a missed opportunity; it produced a national tragedy. By the mid-1990s, North Korea had descended into a famine that killed as many as one million people, 5 percent of the population. The only silver

TRENDS

lining to the hunger was that the North Korean economy began to marketize – not as a result of policy changes from the top, but from survival strategies of households and work units. Even local government, party offices and military units were forced into commercial activity. Farmers' markets emerged in the countryside, while rice was traded in the cities; state-owned enterprises engaged in barter and cash transactions in order to stay afloat.

The regime was never comfortable with spontaneous capitalism. Reform held forth the promise of growth, but also the prospect of avenues to wealth, status and power beyond direct state control. In the decade and a half since the end of the famine, economic policy has reflected the tension between the inability of the state to meet basic human needs through its hoary Socialist model and the reluctance of the leadership to give up crucial instruments of power. If anything, the succession of Kim Jong-un has led to ever more erratic swings between tolerance of market activity and efforts to suppress it.

This ambivalence extended to the foreign sector. One upshot of the famine was an expansion of decentralized, cross-border trade with China.

The onset of the first nuclear crisis in 2002 in which North Korea abandoned the pretense of cooperation on non-proliferation tightened the regime's dependence on China and its booming economy. Multilateral sanctions, an effective Japanese embargo, U.S. financial sanctions, and declining support for engagement in the South all had the unintended effect of pushing North Korea into the orbit of China, its giant neighbor to the northwest. By 2011, China accounted for more than half of North Korea's total trade, and dominated foreign direct investment as well.

But the government clearly regards trade

with China – let alone other potential partners – as a Trojan horse. The supply chains that bring Chinese consumer goods to the markets of Pyongyang also carry information about the outside world, both in the form of cultural products like smuggled DVDs and in the stark comparisons between the quality of Chinese goods and North Korean ones. Fearing expropriation without legal recourse, Chinese traders normally require their North Korean counterparts to visit China to make payments and take delivery. Market participants have thus either been to China or know someone who has.

For years, brave North Koreans risked going to jail by secretly listening to foreign radio broadcasts. The opening of trade to China means that the suppression of information is far more difficult. Recent interviews with refugees and travelers reveal that foreign news and entertainment media are now being consumed communally – an extraordinary development in a society in which every neighbor is a potential informant.

A watcher of North Korean state television could be forgiven for believing that Hosni Mubarak is still president of Egypt. Traders know otherwise. The growing number of cell-phones (even if mostly in the hands of the party faithful) provide the mechanism for the dissemination of news, which has constrained the government in unexpected ways. When a missile launch failed in February 2012, the government was forced to admit it within hours. This turn of events would have been inconceivable a decade earlier, when the propaganda machinery could rely on the government's virtual monopoly over information.

Pyongyang's cat-and-mouse game with the market has led to pervasive corruption. In the most recent Transparency International survey, North Korea placed dead last on that score, tied with Somalia in 182nd place. The



Kim Jong-un poses with residents while visiting a military unit on an island southwest of Pyongyang.

TRENDS

government's efforts to attract more foreign investment, even as it sends anti-capitalist shock teams to the border, have sent decidedly mixed signals.

But when the economic incentives are overwhelming, even the most patriotic secret police fall prey to corruption.

Chinese investors and North Korean refugees confirm the stories of predatory behavior. Rampant corruption not only represents a drag on growth, but also impairs the government's capacity to govern as the parochial interests of corrupt officials diverge from the policy preferences of Pyongyang.

Perhaps the most pressing incentive for reform is the high, chronic inflation set in motion by a botched currency "reform" in November 2009. The regime sought to expropriate private wealth held in the form of domestic currency by placing limits on the amount households could convert into new won. (Leftover old won became worthless.) One enduring result of this initiative is an ever-widening gap between the official and black market exchange rates, as domestic traders and even households eschew the domestic currency. The state-run Chosun Trade Bank reputedly has offered the carrot of better-than-official rates in order to obtain foreign currency deposits.

But at the same time, the government brandishes the stick of special inspections of enterprises suspected of hoarding foreign exchange. Given past history, the reluctance of foreign-exchange earners to convert their money into North Korean won at the official rate is completely rational. One response by enterprise managers has been to stash foreign exchange in local trade banks (where bank officials are bribed to disguise the magnitude of the deposits), and to maintain access to foreign-exchange loans.

It's not just bankers and managers who are affected by macroeconomic disequilibrium. Anyone who must live on a won-denominated salary – public school teachers, for example – is experiencing a steady erosion of real income. Inequality is rising as the gap widens between officials and their cronies (who are at least partly sheltered from the ravages of inflation by access to foreign exchange and corruption) and the masses living on North Korean won incomes.

POLICY MACHINATIONS

So what are the reforms, allegedly signaled in a secret speech by Kim Jong-un to the party leadership on June 28? In the runup to a recent session of the Supreme People's Assembly, the country's rubber-stamp legislature, stories circulated of coming changes in the agricultural, mining and industrial sectors. In agriculture, the government appears to be taking its cue from the first phase of the Chinese reform experience, reducing the size of work teams on state-run farms from 10-25 people to only 4-6.

Reports have also suggested that the government will fix the state's take of the harvest. In effect, this could grant farmers fixed-rent tenancy, under which they would have full ownership rights on production exceeding their quotas. Similar reforms, promulgated by Deng Xiaoping in the early 1980s, had powerful effects on both productivity and living standards in the Chinese countryside, triggering decades of double-digit growth. But will the government have the patience to see the reforms to fruition? When urban food shortages emerged in the past, the government sent the army to seize grain, whatever the nominal rules.

In industry, measures reportedly discussed in June would allow state-owned enterprises to retain 30 percent of their earnings – again,





Posters of Kim Jong-il and his son Kim Jong-un at a protest rally in Seoul, June, 2011.

a crucial reform of incentives. The government might also permit private investments in joint ventures with state entities, as long as they are appropriately registered.

In this regard, the June 28 measures resemble North Korean reforms undertaken a decade earlier, which did little more than codify the reality that the market had come to play a more central role in the economy than the leadership wanted to admit. At the time of

the 2009 currency gambit, households had come to rely on the market for both income and goods. When cash holdings were effectively confiscated, those markets collapsed.

Even some of the showcase construction projects planned for the centennial of Kim Il-sung's birth were slowed. Although construction of new apartment buildings was nominally being carried out by state enterprises, some of the cement came from markets that

TRENDS

vanished when the value of the won as a store of wealth was destroyed.

The new regulations effectively sanction the roles not only of small-scale retail markets but also of rich traders and go-betweens who were allowed to invest in real estate. These investors are apparently now granted a share of their apartments, which they can

ment.” A Japanese newspaper published a document, reported to be from the Ministry of People’s Safety, that proclaimed it “unacceptable to extract or trade in any natural resources for profit without the approval of the state. . . . Natural resources should not be sold to other countries at will. . . . Serious infringements will be punishable by death.”

Audits followed. These could be inter-

Without adequate commitment at the top, reforms are not credible. As a result, they don’t work, thereby justifying their reversal and a return to Stalinism-as-usual.

then sell. Property flipping has come to Chongjin (North Korea’s third-largest city).

The fluidity of property rights extends to the mining sector. With the North Korean currency essentially worthless, what matters is the ability to command foreign exchange. And what – apart from missiles – does North Korea produce that could generate foreign exchange? Minerals. Western financial firms have estimated that North Korea has \$6 trillion in underground resources, while a research organization in Seoul recently put the figure at \$10 trillion. The country is thought to have significant deposits of rare earths that are much prized in high-tech manufacturing, though it lacks any capacity to process them. At least not yet.

It is no surprise that control over mineral assets – which yield pure economic surplus to North Korean enterprises that contribute neither capital nor expertise to foreign partners – is hotly contested at the moment. Kim Jong-un recently gave a speech in which he called for rationalization of mining contracts with Chinese firms, bemoaning the prospect of “developing underground resources at random or creating disorder in their develop-

ment.” A Japanese newspaper published a document, reported to be from the Ministry of People’s Safety, that proclaimed it “unacceptable to extract or trade in any natural resources for profit without the approval of the state. . . . Natural resources should not be sold to other countries at will. . . . Serious infringements will be punishable by death.”

Such conflict surfaced this year when a private Chinese mining company, the Xiyang Group, had the temerity to go public with a contract dispute that involved what amounted to expropriation by North Korean authorities. In a departure, the Chinese government did nothing to stifle the dispute and even dressed down a high-ranking North Korean delegation for failure to provide adequate protection of property rights.

But despite reforms of the foreign investment code and rumors of experimental reforms in agriculture and industry, we have yet to hear a clear signal from the leadership that it is committed to a new course. This is not altogether surprising. We would expect initial reforms to be experimental and incremental, as they were in China. Moreover, the shift in direction requires an even more fun-

damental ideological makeover than the one imposed by Deng, given the rigidity of the leadership's commitment to state socialism and self-reliance.

Hopes for a major reform announcement, raised before the Supreme People's Assembly in September 2012, proved premature. Instead of committing to any of the rumored reforms, the Assembly did little more than tweak an increasingly anachronistic educational system that is devoted first and foremost to political indoctrination.

UMPTENTH TIME THE CHARM?

For two decades, North Korea has confounded analysts who predicted its collapse. The government is still intact and rumors of its imminent demise (to paraphrase Mark Twain) are exaggerated. Yet the optimists have not been proved right; the North has never decisively embraced reform. Nor has it even allowed promising experiments to play out. Rather, the regime has typically reversed measures that gave greater scope to the market and private incentives, generating a self-fulfilling policy pathology. Without adequate commitment at the top, reforms are not credible. As a result, they don't work, thereby justifying their reversal and a return to Stalinism-as-usual.

Clearly, the theatrical aspects of politics have changed with the arrival of Kim Jong-un. But will meaningful policy change follow? There are three reasons to believe it might.

The first is Kim Jong-un himself. Whether he is more cosmopolitan – he spent some time in Switzerland – or simply more desperate, Kim *filis* may be less reluctant to grasp the nettle of reform than his father was. Moreover, the mere fact of turnover in leadership provides an opportunity to signal a new course without seeming weak or inconstant.

Second, there are signals of major struggles within the government that could reflect

an effort to reassert civilian control. The military-first policy is typically interpreted through a foreign policy lens, and through North Korea's longstanding nuclear and missile ambitions in particular. But military-first has an important domestic correlate in the steadily growing power of the armed forces within the economy. Not only does the military absorb a crippling share of the budget, but military units also monopolize lucrative trading companies and are engaged in corrupt financial activities that evade central government control.

Following Kim Jong-un's ascent, key military officials were purged and officials associated with the last reform push, undertaken in 2002, were quietly rehabilitated. Normally, one would not interpret past failure as an indicator of future success, and it may well be that the current crop of North Korean policymakers is simply not up to the task. But, at a minimum, those who went through the 2002 reform cycle have experience with failure, and are better positioned to learn from those mistakes. In a speech earlier in 2012, Kim Jong-un called for greater cabinet responsibility, which, in effect, was a call to circumscribe the scope of the military's role in policymaking.

Finally, the external environment may be conducive to reform, as China and South Korea limit handouts but stand ready to engage on a commercial basis. While China still spouts the ideological pap that it is as close to North Korea as "lips and teeth," it is clearly growing impatient with the bilateral relationship. Beijing has proven unable to rein in North Korea's nuclear ambitions, which damage to China's strategic position in northeast Asia by strengthening the U.S.-South Korea alliance, pushing Japan toward a more forward defense posture and setting the stage for enhanced American naval deployments on China's doorstep.

TRENDS

Evidence is mounting that China is nearing the end of its willingness to indulge the North Korean government. Our surveys of Chinese firms doing business in North Korea suggest that they now largely operate on a commercial basis – many are private – and expect little backing from the Chinese government. In effect, the Chinese leadership is delivering the message that if Pyongyang wants material support from China, it will need to change in ways that allow Chinese businesses to profit from their investments.

South Korea, North Korea's second-largest trading partner, has also undergone a sea change in attitude. For over a decade under presidents Kim Dae-jung and Roh Tae-woo, South Korea sought to engage with North Korea. The effort was largely unrequited, as the North Korean leadership spurned deeper cooperation, continued with its nuclear weapons efforts, and rattled sabers along the border.

In 2007, South Koreans tired of the game and elected a conservative president, Lee Myung-bak, who had little faith in the engagement strategy. The Lee administration maintained the experiment at the Kaesong Industrial Park on the other side of the border (where South Korean companies have run manufacturing facilities since 2004), but drastically cut aid and imposed new sanctions on trade outside Kaesong in the aftermath of military provocations in 2010.

However, North-South relations are likely to improve when a new South Korean president takes office in February 2013. As with China, North Korea is perfectly situated to exploit commercial relations, provided it has the nerve to bear the risk of policy reversal.

The most likely scenario is one in which reform will be timid. Some of the gains will undoubtedly be captured by the interlocking

elite comprised of the Kim family, the state (including the military) and the party. But partial reform is better than none, and experiments that yield fruit could reverse the policy pathology described above, with successful experiments giving the leadership the confidence to take the next step.

And what if Kim Jong-un does not make the leap? The most likely outcome is recurrent crises and continued economic stagnation that do not lead to regime change.

Still, there are murmurs of discontent that could someday yield radical change. Surveys of refugees indicate that those who were involved in the market are more likely than others to cite political differences as the motive for their departure. Those refugees have even more negative assessments of the government than the typical refugee, and most critically, are more likely to have expressed these dissenting views while in North Korea. The market is apparently emerging as a semi-autonomous zone of communication with the potential for altering the political culture, as well as the economic. Thus the government is right to fear it.

Given the depth of the economic problems now facing Pyongyang, we cannot altogether eliminate the possibility of a political crisis, one triggered by divisions within the leadership but potentially extending beyond it. The non-violent collapse of East Germany defines the best-case scenario for North Korea. A German-style absorption of North Korea would cost South Korea well over \$1 trillion across a decade, or the equivalent of one whole year of output. No wonder South Koreans demonstrate waning interest in unification.

Meanwhile, back at the Dolphinarium, the 30-mile pipeline to provide fresh seawater has been completed and the dolphins dance for crowds of apparatchiks. How does one say “bread and circuses” in Korean? **M**