

The Future of North Korea is South Korea

(Or hope springs eternal)

Marcus Noland

The Korean peninsula presents a remarkable “natural experiment” for social scientists. Under Japanese occupation, some of the most advanced industrial facilities in Asia were developed in the northern part of the Korean peninsula; the south was the breadbasket. At the time of the partition in 1945 into zones of Soviet and American military occupation, in the north and south, respectively, levels of per capita income and human capital in the north exceeded those attained in the south.

In 1950, North Korea attacked South Korea in a bid to forcibly unify the peninsula, drawing the US and China into the conflict. Most of the capital stock was destroyed as armies from both sides twice traversed nearly the entire length of the peninsula. There was considerable population movement as well, mostly from the North to the South, and it is impossible to ascertain with any degree of certainty the capacities of the two countries when hostilities ended in 1953 with the original borders more or less re-established.

The two Korean states subsequently not only pursued divergent development strategies but also pushed those strategies to extremes. South Korea not only adopted a capitalist system but also went on to pioneer an outward-oriented development strategy, emphasizing international trade as a catalyst. North Korea, in contrast, not only chose central planning but also intentionally time-phased its plans to frustrate linkages with those of other fraternally allied socialist states and in doing so created the world’s most autarkic economy, notable in the degree to which markets were repressed.

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Over the past five decades, economic performance in South Korea has been nothing short of spectacular. Between 1963 when a wide-ranging economic reform program was initiated and 1997 when the country experienced a financial crisis, real per capita income growth averaged more than six percent annually in purchasing power adjusted terms. At the start of that period the country's income level was lower than that of Bolivia and Mozambique; by the end it was higher than that of Greece and Portugal.

As astonishing as South Korea's economic performance has been, its political development has been as impressive, if not more so: In the space of a single decade between 1987 and 1997, leadership of the South Korean government went from an authoritarian strongman (General Chun Doo-hwan) to his elected but hand-picked successor (General Roh Tae-woo) to an elected centrist civilian politician (Kim Young-sam) to a former dissident (Kim Dae-jung). South Korea is arguably *the* premier global success story of the past half century.

In stark contrast, North Korea experienced a famine during the 1990s that killed perhaps 600,000 to 1 million people out of a pre-famine population of roughly 22 million, making it one of the 20th century's worst. This disaster was very much the product of the country's political system, an anachronistic Stalinist dynasty that has systematically denied its populace the most elemental human, civil, and political rights.

The failure of the state to fulfill its obligations necessitated entrepreneurial coping responses by small-scale social organizations—households, enterprises, local party organs, military units—and contributed to a grassroots marketization of the economy. North Korea's transition over the past decade can best be understood not as a top-down attempt by the governing authorities to marketize or improve efficiency, as usually characterized, but rather as a bottom-up marketization arising from coping responses to the trauma of famine, which the government has sought to both ratify but also control, and even reverse, *ex post*. Policy reversals in the fall of 2005 including the banning of private trade in grain, the means through which most North Korean households obtain food, both revealed policymakers' discomfort with this process and put the populace at risk.

Such retrograde moves together with renewed floods in August 2007 have raised fears of a recurrence of the famine conditions of the 1990s. But North Korea's economy and its external relations have changed significantly in the intervening decade, reducing the likelihood of such an outcome. A consensus has emerged in South Korea about the desirability of economic engagement with the North. Indeed, controversies over the historical border between China and Korea, and the deepening economic integration between China and North Korea have stoked South Korean fears that China is economically colonizing the North, and helped drive a policy of relatively open-ended and unconditional official transfers and subsidies. The upshot is that North Korea's economic integration with China, which occurs increasingly on market-conforming terms, may have a greater transformational effect than its more narrowly circumscribed and state-centered interaction with the South.

Historical context

Under Soviet tutelage, the North set about establishing a thoroughly orthodox centrally planned economy. In 1955, founding leader Kim

Il-sung proclaimed *juche*, normally translated as “self-reliance,” the national ideology. Under relatively autarkic conditions, North Korean industrial development was characterized by excessively diverse, sub-scale, high-cost production. Agriculture was collectivized, quantitative planning in production was introduced, state marketing and distribution of grain was established, and private production and trade were prohibited. North Korea made a fateful decision to pursue the goal of national food security through a misguided strategy of self-sufficiency. To compensate for inauspicious natural conditions, a highly industrial input-intensive system of agricultural production was developed to maximize yields, involving, for example, the heavy application of chemical fertilizers and the extensive use of electrically driven irrigation—both of which were dependent on imported oil.

The present crisis has its origins in a multifaceted set of developments in the late-1980s, though the precise causal relationships are unclear. In 1987, frustrated by North Korean unwillingness to repay accumulated debts, the Soviets withdrew support. (Despite its *juche*-inspired declarations of self reliance, North Korea has been dependent on outside assistance throughout its entire history, with first the Soviet Union, later China, and most recently South Korea, in the role of chief benefactor.) That same year the North Koreans initiated policy changes in the agricultural sector, including the expansion of grain-sown areas, transformation of crop composition in favor of high-yield items, maximization of industrial inputs subject to availability, and the intensification of double-cropping and dense planting. Continuous cropping led to soil depletion, and the over-use of chemical fertilizers contributed to acidification of the soil and eventually a reduction in yields.

The economy was hit by massive trade shocks beginning in 1990, as the Eastern bloc disintegrated. Trade with the Soviet Union had accounted for more than half of North Korean two-way trade, including most of its fuel imports. For reasons that remain a mystery, the North Korean leadership appears not to have grasped the epochal nature of the changes occurring around them. Unlike Vietnam, which suffered a similar pattern of shocks, North Korea proved incapable of reorienting its commercial relations, and its industrial economy imploded. Deprived of industrial inputs—most importantly imported oil, used not only to power irrigation systems and agricultural machinery, but as the feedstock for the production of

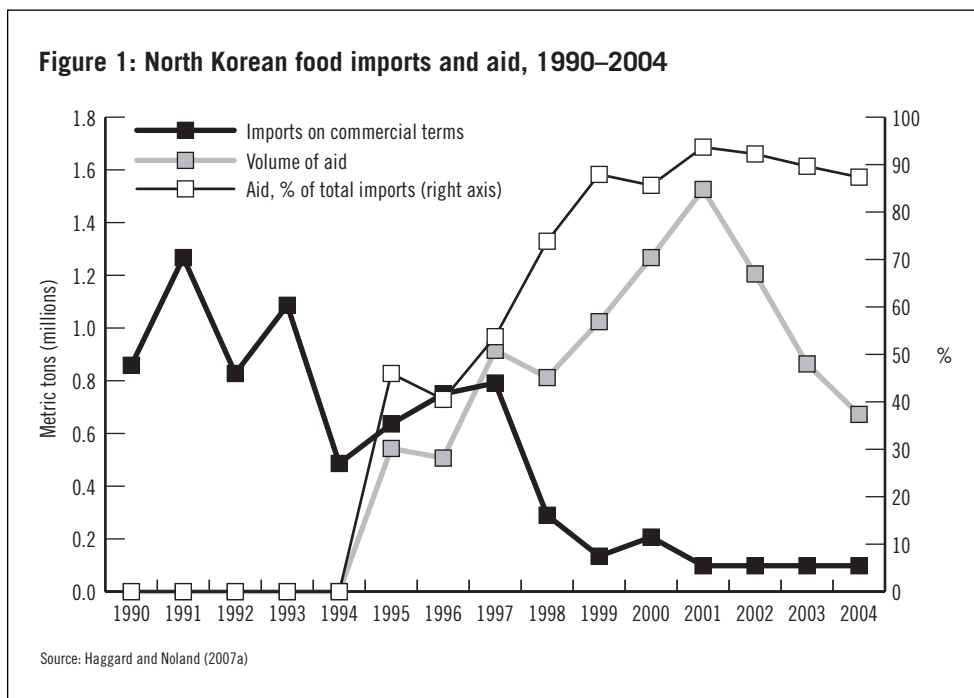
chemical fertilizers—agricultural yields and output fell, and remain below 1990 levels.

As yields declined, hillsides were denuded to bring more and more marginal land into production. This contributed to soil erosion, silting of rivers, reservoirs, and canals, and ultimately, recurrent flooding. China initially stepped into the breach, offsetting some of the fall in trade with the Soviet Union and emerging as North Korea's primary supplier of imported food, most of it reportedly on concessional terms. But in 1994 and 1995, a disillusioned China reduced its exports to North Korea. If there was a single proximate trigger to the North Korean famine, this was it.

At this juncture the government could have relieved emerging shortages by relaxing the supply constraint, either by increasing exports to finance imports or appealing for aid. (Borrowing was not an option: sovereign defaults in the 1970s—the only communist country to do so—left it effectively excluded from international capital markets.) Instead, it chose to suppress consumption, initiating a “let's eat two meals a day” campaign and cutting rations delivered by the public distribution system (PDS), the quantity rationing system from which urban residents, roughly two-thirds of the country, obtained their food.

It was not until the spring of 1995 with a famine under way that North Korea appealed for external assistance, initially approaching Japan, its former colonial master, whose contributions could be portrayed as a kind of reparation, later requesting assistance from rival South Korea, and ultimately, the United Nations system. Floods that summer (and the following summer as well) played an important political role insofar as they facilitated the depiction of the famine as the product of natural disasters. The North Korean government even went so far as to rename the unit charged with managing the aid relationships as the Flood Damage Rehabilitation Committee.

Aid was forthcoming, but the government impeded the normal assessment, monitoring, and evaluation functions of the relief organizations—for example, prohibiting the use of Korean speakers and banning access and relief to certain geographic areas, including ones suspected to be the worst affected. Critically, with assistance ramping up, the government cut commercial grain imports, in essence using humanitarian aid as a form of balance of payments support (Figure 1). While it is true that aid often crowds out commercial grain imports in famines, it is important to underscore that



in the North Korean context the outcomes depicted in Figure 1 are the product of policy, not decentralized decision-makers responding to price signals.

Given the secrecy of the North Korean regime, it is unsurprising that the timing and impact of the resulting famine are still not well understood. Contemporaneous estimates of the excess death toll vary enormously, ranging from 220,000 to 3.5 million, but the most sophisticated attempts to measure excess deaths put them in a range of roughly 600,000 to 1 million, or approximately 3 to 5 percent of the pre-crisis population. The famine had a strong distributional element, and it would be a mistake to characterize the North Korean experience as a pure food availability decline famine. Certain groups and geographical areas were disproportionately affected, generating the highly non-uniform incidence of elevated mortality and malnutrition that persist to this day.

And to be clear, while the North Korean government was unwilling or unable to fulfill its core responsibilities vis-à-vis the citizenry, catastrophic failure did not extend to the political regime itself. Although there appears to have been a rise in the influence of the armed forces relative to the

party, neither the political regime nor the state collapsed or underwent fundamental change. Collapse was limited to the economic sphere.

Post-famine transition

From 1995 on, the state-administered PDS did not deliver minimum human needs, even on paper, and with the state unable to play its traditional role as a provider of food, households came to increasingly rely on the market to obtain sustenance. Left to fend for themselves, small-scale social units began to exhibit a variety of coping behaviors including foraging and other forms of prohibited movement, using barter and eventually monetized trade, including transactions with Chinese counterparties, to secure food. The authorities responded by tolerating to a greater or lesser degree unauthorized internal movement and the development (and/or expansion) of informal markets, including the revival of traditional farmer's markets. A variety of evidence documents the increasing prominence of the market as a mechanism for accessing food, including the results obtained from household focus group interviews conducted by the World Food Programme (WFP) in North Korea, as well as a balance sheet exercise undertaken by Haggard and Noland (2007a). The general conclusion of this work is that at least for the non-privileged classes, the market has become the primary institutional mechanism for obtaining food.

The marketization that began with food gradually encompassed a broader range of household goods, in part building upon officially sanctioned cottage industries for consumer goods that began in 1984 ("the August 3 campaign for people's goods"), as well as forced sales of household items by liquidity-constrained households to secure food and increasingly gray-area activities by local government and party officials and enterprise managers.

Entrepreneurs affiliated with SOEs or other institutions (including government agencies) to obtain political protection in a system with few private property rights or recourse to dispute adjudication. In return, these institutional patrons received a share of the profits generated by what were effectively private initiatives. In at least some cases, entrepreneurs who affiliated with government offices received preferential tax treatment. Workers also bought their way out of their obligations at the SOE by

simply paying a daily fee to be reclassified as an “August 3” cottage industry worker, and were thus freed to engage in entrepreneurial activity.

One result of these crisis-driven adaptations was a considerable decentralization of the industrial economy. The loosening of the central distribution mechanism was manifested in an increase in direct sales outlets where these ventures sold directly to the public at non-controlled prices as well as an increase in department stores selling Chinese goods at non-controlled prices, paralleling the shift from the PDS to the market in the case of food. One Western consultancy operating in North Korea during the 1990s estimated that by 1994 the growing “unofficial” economy already accounted for nearly one fifth of output (Michell 1998). The extent to which the system was fraying was sufficiently large that the state established an ad hoc penal system to handle the surge in criminalized coping behaviors including internal movement for foraging and trade, as well as exit from the country.

The markets which emerged out of these stresses, while geographically fragmented, do function. Prices respond to supply shocks; for example, announcements of large aid donations or the suspension of imports from China during the SARS crisis of 2004. Prices also display considerable geographic dispersion, suggesting that markets remain fragmented, presumably due to physical transportation difficulties as well as the still underdeveloped state of market institutions such as middlemen. High food prices in the rustbelt areas of the northeast imply continuing relative scarcity.

Aid played an ambiguous role in this process. On the one hand it was largely distributed through the central government, reinforcing state power. In recent years, as the state has been increasingly unable to procure domestic production, the PDS has become largely a mechanism for distributing aid. Yet aid also encouraged the development of markets, by creating the possibility of capturing astronomical rents through diversion—which could be realized only if markets existed—and providing enormous incentives to create those markets, through entrepreneurial behavior (legal or illegal) to establish the institutional infrastructure of markets, such as entities offering transportation or hauling services.

Estimates of diversion, ranging from 10 to 50 percent have been constructed through a variety of methods, including a balance sheet calculation reported in Haggard and Noland (2007a). Responses obtained from

WFP focus groups are consistent with the upper end of that range. The analytical work has received support from a small but revealing body of documentary evidence of diversion in the form of surreptitiously shot video footage, much of it produced by a Japanese NGO, Rescue the North Korean People Urgent Action Network (RENK). With aid feeding roughly one-quarter to one-third of the population over the past decade, these estimates, if correct, imply diversion of aid sufficient to feed roughly 3 to 15 percent of the North Korean people.



Sunam Market in Chongjin, North Korea's third largest city, in North Hamgyung province in the northeast of the country



Aid on sale in Sunam Market, Chongjin, July 2004. The bag is inscribed with the words "Gift from the United States."

The welfare effects of diversion are subtle and depend importantly on specific assumptions. Diversion directly moves food away from intended beneficiaries, who depending on their personal, familial, and social network circumstances, may or may not be able to compensate for this loss through other sources of supply, including the market. Conversely, food is fungible, at least to a degree, and to the extent that recipients of diverted aid substitute it for food that they would have otherwise purchased, diversion tends to depress prices in the market—where many of the beneficiaries or their families are, in reality, obtaining their food.

The availability of supplies outside state control—siphoned off from cooperative farm output, diverted from aid, and obtained through trade with China—was both encouraged by and contributed to the development of the institutional infrastructure of a market, such as traders, transporters, etc. There is evidence that the military has been deeply involved in this process, though not for their own consumption—they have first draw on the North Korean harvest—but rather because in the absence of well-defined property rights or dispute resolution mechanisms, their existing

organization, as well as resources in the form of men, trucks, fuel, and, it should be said, guns, make them ideally situated to perform the role of middlemen distributors. Military and police organizations are also prominent participants in informal money lending businesses, presumably owing to their unique ability to collect debts.

July 2002 reforms

South Korean government statistics indicate that North Korea experienced a cumulative decline of 33 percent in real per capita income from its peak in 1990. Careful reconstruction of balance of payments statistics suggests that the economy bottomed out in 1998, and began a slow process of recovery from 1999 on (Haggard and Noland 2007b). In July 2002, with the planning mechanism mortally wounded, the payments system collapsed, and the economy marketizing beyond state control, the government initiated a number of policy changes that decriminalized some of the coping practices that had developed in the previous decade. The economic policy changes had four components: microeconomic policy changes, including alteration of administered prices and wages; macroeconomic policy changes, including the introduction of direct taxes; the establishment of special economic zones; and aid-seeking.

Three analytically distinct price changes occurred, each with their own political economy implications: changes in relative prices and wages, which could be interpreted as an attempt to increase the role of material incentives; a 10-fold increase in the price level, which could be interpreted as an attempt to deal with monetary overhang; and ongoing inflation (perhaps 130 to 140 percent annually between 2002–2005), which was the product of the collapse of fiscal revenue, exacerbated by the maintenance of a bloated military—over 1 million troops in a country of perhaps 22 million people.

There is little consensus about what the North Koreans were trying to accomplish. There is some thought that in the industrial sphere the government was attempting to adopt a dual-price strategy similar to what the Chinese had implemented. The Chinese instructed their state-owned enterprises to continue to fulfill the plan, but once planned production obligations were fulfilled, enterprises were free to hire factors and produce products for sale on the open market. In other words, the plan was frozen

in time, and marginal growth occurred according to market dictates. Yet the deterioration of the North Korean planning apparatus was sufficiently acute that such approach was probably no longer viable.

North Korean enterprises were instructed that they were responsible for covering their own costs—that is, they would no longer receive state subsidies. But at the same time, the state administratively raised wage levels, with certain favored groups such as military personnel, party officials, scientists, and coal miners receiving supernormal increases. Likewise, the state continued to maintain an administered price structure, which tended to badly lag the inflation in market prices. Enterprise managers were told to meet hard budget constraints, but at least initially, were given little scope to manage.

Furthermore, in the absence of any formal bankruptcy or other “exit” mechanism, there was no prescribed method for enterprises that could not cover costs to cease operations, nor, in the absence of a social safety net, for aiding unemployed workers. One common response was for enterprises to remain in operation at extremely low levels of capacity utilization supported by implicit subsidies, either through national or local government budgets or Central Bank loans.

In the agricultural sector, the government implemented a policy of increasing both the procurement prices of grains to increase the volume of food entering the public distribution system (PDS) along with a dramatic increase in PDS prices to consumers, with the retail prices of grains rising roughly 40,000 percent or more in the space of six months. The increase in the procurement price for grain was motivated, in part, to counter the supply response of the farmers, who, in the face of derisory procurement prices, were diverting acreage away from grain to tobacco, and using grain to produce liquor for sale. However, procurement prices did not keep pace with rising market prices, and anecdotal accounts suggest that the policy was not successful in coaxing local harvests back into the PDS system.

When China began its reforms in 1979, more than 70 percent of the population was in the agricultural sector, as was also the case in Vietnam when it initiated reforms the following decade (Noland 2000, table 3.7). De-bureaucratization of agriculture under these conditions permitted rapid increases in productivity and the release of labor into the nascent non-state-owned manufacturing sector. The key in this situation is that change is likely to produce few losers: farmers’ incomes go up as marginal

and average value products in the agricultural sector increase; the incomes of those leaving the farms rise as they receive higher wage jobs in the manufacturing sector; and urban workers in the state-owned heavy industry sector benefit as their real wages rise as a result of lower food prices associated with expanded supply. The efficiency gains in agriculture essentially finance an economy-wide Pareto-improvement. This dynamic was understood by Chinese policy-makers, who used a combination of the dual-price system (allowing the market to surround the plan, to use a Maoist metaphor) and side payments to state-owned enterprises, their associated government ministries, and allied local politicians, to suppress political opposition to the reforms. The existence of a large, labor-intensive agricultural sector is one of the few robust explanations of relative success in the transition from central planning to the market (Åslund, Boone, and Johnson 1996).

In contrast, North Korea has perhaps half that share employed in agriculture. As a consequence, the absolute magnitude of the supply response is likely to be smaller and the population share directly benefiting from the increase in producer prices for agricultural goods is roughly half as large as in China and Vietnam. This means that reform in North Korea is less likely to be Pareto-improving than in the cases of China or Vietnam. Instead, reform in North Korea is more likely to create losers and with them the possibility of unrest, though it may be the case that the formerly favored workers of the industrial proletariat are so beaten down that they do not constitute a serious opposition to reform and indeed might welcome almost any sort of change.

Although one can develop economic explanations for each of these policy changes, the simplest appears to be that they were designed to reward friends and punish enemies. Favored groups such as the military received supernormal wage increases, while the enormous jump in the price level, unnecessary to generate the change in relative prices, could be interpreted as a blow aimed at wiping out the working capital of the class of traders and black marketers that sprung up over the previous decade.

At the same time that the government was undertaking microeconomic reforms, its inability to secure resources forced it to undertake a fundamental fiscal and financial reform. With the central plan crumbling, the government was no longer able to raise significant revenue through a “transactions tax” administered by the central planning authorities. Lim

(2005) quotes a purported internal North Korean document from October 2001 in which Kim Jong-il, who took power following his father Kim Il-sung's death in 1994, bemoans the loss of state control over the economy and concludes, "Frankly the state has no money, but individuals have two years budget worth" (Lim 2005:7).

Unable to tax effectively, and in desperate need of revenue, in March 2003 the government initiated a campaign to sell "People's Life Bonds," an instrument more closely resembling a lottery ticket than a bond as conventionally understood, and promoting their purchase as a patriotic deed.

The government then attempted to address its underlying fiscal crisis by moving from an indirect system of raising state revenue through "transaction taxes" levied through the central plan to direct taxation of enterprises based on profits, as one would observe in a market economy. This proved highly problematic. The enterprises did not have the accounting systems to make this shift feasible nor for that matter did the state. For fifty years the economy had run on the basis of centrally orchestrated quantity planning, not financial profits and losses. Not until March 2003 was accounting legislation enacted, and not until September 2003 was the Tax Collection Agency even organized! Amid this chaos, one tack was to push responsibility for tax collection down to local governments that were then supposed to share collections with the center. Not surprisingly, it appears that the local authorities were unwilling and/or unable to carry out these responsibilities. The result has been a chronic gap between what the state spends and what it takes in; the response has been a resort to the printing press, fueling the inflationary process. There is some evidence that inflation has begun to attenuate of late.

Foreign currency is a hedge against inflation, and those with access to foreign exchange, such as senior party officials, will be relatively insulated from inflation's effects. (One defector, referring to the portraits adorning US and North Korean paper currency observed that "[George] Washington is better than Kim Il-sung.") Agricultural workers may benefit from "automatic" pay increases as grain prices rise, but the real incomes of salaried workers without access to foreign exchange erode. Some observers even speculate that the alleged counterfeiting of US dollars was undertaken to capture seignorage internally.

What began as a socialist famine in which access to food was determined by one's relationship to the state has evolved into a chronic food emergency

in which access to food is largely determined by the ability to command resources in the market. This process created a new set of cleavages and stratifications within North Korean society: The formerly favored industrial proletariat employed in state-owned enterprises has been impoverished. Ethnic minorities and others with familial ties outside North Korea who had faced discrimination were advantageously positioned to access external resources and trading opportunities and have seen their fortunes rise. And perhaps most fundamentally, in 1998, *songun* or “military-first” politics was declared, formally elevating the armed forces above the party and the proletariat. The upshot is that contemporary vulnerability is concentrated among urban non-elite, some of whom spend as much as 80 percent of household income on food.

The third component of the North Korean economic policy change is the formation of various special economic zones.¹ In September 2002, the North Korean government announced the establishment of a special administrative region (SAR) at Sinuiju which would exist completely outside North Korea’s usual legal structures, have its own flag and issue its own passports, and contain land that could be leased for fifty years. To cap it all off, the zone was to be run by a Chinese-born entrepreneur with Dutch citizenship named Yang Bin. He was promptly arrested by the Chinese authorities for tax evasion and subsequently convicted. Press reports over the next two years serially touted a Hong Kong businessman-philanthropist, Kim Jong-il’s brother-in-law, and a female ethnic Korean Republican mayor of a small town in California (!) as slated to succeed Yang. The project was subsequently abandoned, though reports emerged in 2007 that a more limited special economic zone would be established on some nearby islands in the Korea Bay.

The industrial complex at Kaesong, oriented toward South Korea, appears more promising. South Korean small- and medium-sized enterprises (SMEs) are a natural source of investment and transfer of appropriate technology to the North, but they are unlikely to invest appreciable resources in the absence of physical or legal infrastructure. The construction of the park, which addresses the physical infrastructure concerns and now houses enterprises employing roughly 10,000 workers, was accompanied

¹ The first such zone was established in the Rajin-Sonbong region in the extreme northeast of the country in 1991. It has proved to be a failure for a variety of reasons including its geographic isolation, poor infrastructure, onerous rules, and interference in enterprise management by party officials.

by the signing of four economic cooperation agreements between the North and South on issues such as taxation and foreign exchange transactions, and could be regarded as providing the legal infrastructure for economic activity by the SMEs of negligible political influence.

The park has encountered teething problems: North Korea delayed the establishment of transport links, and insists that foreign-invested enterprises pay wages in hard currencies (at wage rates that exceed those of China and Vietnam). Workers are not hired directly but through a government labor agency which retains much of the hard currency earnings; when the South Korean government requested in free trade negotiations with the United States that goods produced in Kaesong be granted duty-free treatment, labor practices in the zone became a source of contention. There is some evidence that the favorable treatment of investment in the complex has created a market for lemons, attracting failing South Korean SMEs hoping to use implicit subsidies and guarantees to gamble for resurrection. Nevertheless, the South Korean authorities appear to regard the Kaesong industrial complex a model for future replication.

The fourth component of the economic plan consists of passing the hat. In September 2002, during the first-ever meeting between the heads of government of Japan and North Korea, despite the shaky state of Japanese public finances, Chairman Kim Jong-il managed to extract from Prime Minister Junichiro Koizumi a commitment to provide a large financial transfer, in some accounts valued at roughly \$10 billion, to North Korea as part of the diplomatic normalization process to settle post-colonial claims. However, Kim's admission that North Korean agents had indeed kidnapped 12 Japanese citizens, and that most of the abductees were dead, set off a political firestorm in Japan. Subsequent events including the 2003 claim that North Korea possessed a "nuclear deterrent capability," and later missile and nuclear tests in 2006, contributed to a hardening of attitudes in Japan and elsewhere, leading to a tightening of sanctions, as well as lessening the already dim prospects for North Korea's admission to international financial institutions such as the World Bank and Asian Development Bank.

In sum, rather than "leading" the transition, the reforms were responses to a *de facto* process of marketization. An open issue is the degree to which marketization accelerated after the 2002 policy changes decriminalized much of the entrepreneurial coping activity—or may have been reversed

as the state, made more confident by improving conditions, has introduced new controls. Surveys done of North Korean refugees in South Korea and China report a decline of “criminal” activities in the post-reform period, but they do not document an increase in marketization (Lee 2007; Chang, Haggard, and Noland 2007). Indeed, the refugees report a slight *decrease* in marketization in the post-reform period, though with the caveat that the decline would be within what public opinion pollsters refer to as the margin of error. The responses are consistent with a view, however, that the 2002 policy changes largely ratified processes that were already well-advanced, rather than deepening marketization in a profound way.

Credibility and time consistency

During the 2005 harvest, reports began filtering out of North Korea of the government engaging in confiscatory grain seizures and renegeing on commitments to the farmers regarding the shares of output that would be retained by the cultivators for free disposal. Then in September, buoyed by a good harvest and enhanced bilateral assistance from South Korea and China, the government announced that it was banning private trade in grain, resuscitating the PDS, and expelling the WFP and NGOs engaged in humanitarian assistance. In March 2006, the WFP’s Executive Board approved a proposal for a greatly downsized assistance program, acquiescing in North Korean demands for an enormous reduction in in-country staff and their confinement to Pyongyang, making monitoring and assessment virtually impossible. It appears that the government has been unable to make the de-marketization moves stick, however.

Having renegeed on its commitments to the farmers, it was predictable that cultivators might revert to famine-era coping behavior such as preharvesting, hoarding, and diversion of effort to tending secret private plots to the detriment of observable cooperative farms, thereby setting the stage for an intensification of distress in the following year.

As an illustration, consider the 1995–96 corn experience. Traditionally, farmers were fed through an annual allotment retained in-kind. In 1995, after the procurement exercise, the authorities realized that they had obtained too little food to operate the PDS and returned to the cooperative farms to extract additional grain that had already been committed to on-farm consumption over the coming year. The following year, half of the

maize crop of 2.3 million metric tons, or enough to feed the whole country for three months, was “lost.” The government’s behavior in 2005 does not appear to be nearly as traumatic as the *ex post* attempt to compress farm rations a decade earlier, and one would not expect the farmers to “lose” half the corn harvest in response. Yet it is reasonable to expect that that earlier experience constitutes an important component of the collective memory that conditions their reaction to the government’s recent moves.

In the event, North Korean and WFP officials announced in March 2007 that the country was 1 million metric tons of grain short and faced calamity. However, market prices, fragmentary and imperfectly observed, did not skyrocket as might be expected in response to acute shortages. One possibility was that North Korea was not actually facing a shortage, and that the government was just trying to exploit goodwill arising from progress in multilateral nuclear talks the previous month to extract more aid, or that there was only a measured, paper, or official shortage: grain had been hoarded by farmers and was being sold into the market.

Another interpretation, but one with very different implications, was that there was indeed a shortage, but prices had not moved because, in anticipation of enhanced aid following the February nuclear talks, the government and/or private traders (sometimes there is no difference) had released accumulated stocks, temporarily depressing prices, disrupting the normal seasonality in prices.

Unfortunately, North Korea balked at undertaking commitments under the February agreement in response to a dispute with the United States over enforcement actions against Banco Delta Asia (BDA), a small Macau bank alleged to be involved in North Korean money laundering and counterfeiting activities, and as a consequence, large amounts of additional aid were not forthcoming. Destruction caused by severe flooding in August intensified whatever shortages might have been emerging during the pre-harvest months of the summer.

Why take such high stake risks? The most charitable explanation was that the 2005 reintroduction of rationing was an attempt to restore the social safety net. This is doubtful, however: rather than being allocated on the basis of need, workers at SOEs were given preferential access. There are at least three other nonmutually exclusive interpretations, all speculative in nature. The first is that the authorities are uncomfortable with the bottom-up marketization of the economy, and the attempt to ban the

market for food is the first step in a broader attempt to roll back the institutional changes that have occurred over the past decade. This explanation is possible, but apart from food, if anything the authorities appear to be acquiescing in a gradual liberalization of the economy, so that other aspects of state behavior do not appear to be consistent with this hypothesis. The second interpretation is that the move to reassert state management over the distribution of food is an attempt to strengthen political control over the population and by resuscitating the PDS, and reconstitute a network of local political officials loyal to the center—i.e., it is an attempt to strengthen political control, not roll back economic change. The final interpretation is that the government's recent moves are an attempted anti-inflation policy: The authorities are spooked by the ongoing inflation, have no effective ability to control the prices on consumer goods entering the country from China, but do believe that they can control the price of grain, which looms large in the consumption basket and is largely produced domestically or obtained through aid flows—two channels subject to some state control. Although this final interpretation might not appeal to the sensibilities of some readers of this journal, it does have a kind of Stalinist command-and-control ring of truth to it. What these three interpretations share in common is a discomfort with the changes of the previous decade and a desire by the authorities to reassert control—a motivation that also emerges from the refugee surveys.

The external dimension

Given North Korea's relatively small size and dependence on essential imports, external relations play a key role. Despite its protestations of self-reliance, North Korea has always depended on patrons, since the disintegration of the Soviet Union relying on a complex and dynamically shifting network of support derived from its geopolitical role.

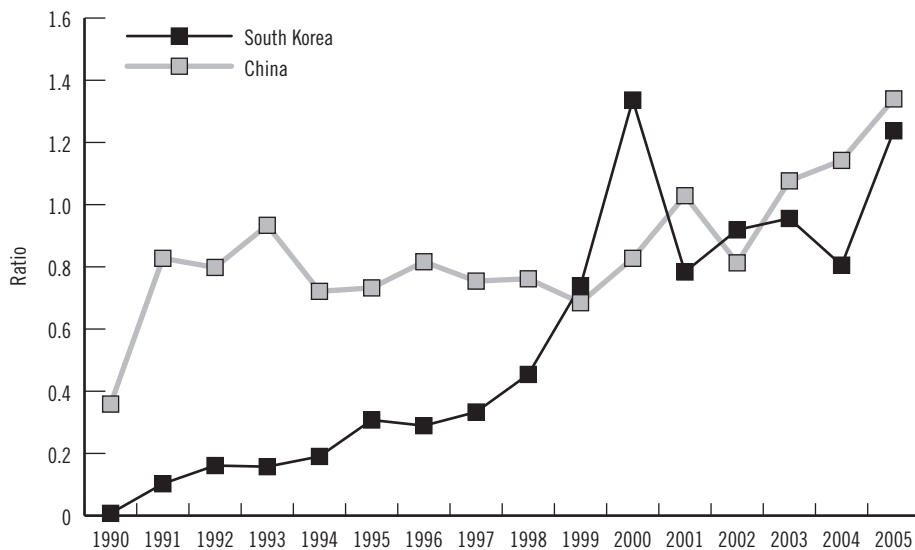
China initially filled the breach created by the Soviet Union, but cut back its support in the mid-1990s, contributing to the emergence of the famine. In parallel, North Korea became embroiled in a diplomatic confrontation with the United States over its nuclear weapons program. If famine relief is one leg of North Korea's tripartite engagement with the outside world, its nuclear weapons program is another. North Korea adroitly used concerns over its nuclear program to extract more than \$1 billion

in support from the United States, making it, in the late 1990s, the largest recipient of US aid in Asia. And while aid from the United States, Japan, and other countries remains linked to the nuclear issue, support from South Korea and China appears less closely bound.

The third component of North Korea's engagement with the outside world has been the emergence of a political consensus in South Korea in support of economic engagement with the North, ratified by Kim Dae-jung's 1997 election as president. The first major project, in effect a kind of loss-leader or confidence building exercise, was the Mt. Kumgang tourism project. From a North Korean standpoint, the project had a number of features to recommend it: The mountain is located along the border and so would not involve incursions of South Koreans deep into North Korea, and as a tourist attraction it could be fenced off, both literally and figuratively, from the rest of the North Korean economy. On the South Korean side, the project was nominally private, undertaken by the Hyundai corporation though in reality it has involved considerable direct and indirect public subsidies as recounted elsewhere (Noland 2000; Haggard and Noland 2007b). Similarly, the second focal point of South Korea's engagement with the North, the Kaesong Industrial Complex, also has its origins in Hyundai's deal with the North Korean government. Like the Mt. Kumgang project, the complex is an enclave relatively close to the border operating on a mix of public and private financing.

To get a sense of North Korea's interaction with its principal partners, and of the possible "socializing effects" associated with engagement with the two countries, the density of North Korea's economic interaction in all forms—trade, aid, and investment—with South Korea and China are expressed as a function of licit merchandise exports in Figure 2. The picture of deepening economic integration with both partners changes, however, if transactions on commercial terms and those embodying a concessional or grant element are disaggregated as shown in Table 1 which reports the partner composition of commercial trade. What is striking is the difference between the deepening integration between North and South Korea depicted in Figure 2, and the relative stagnation of South Korea's role in commercial trade. This point is reinforced in Figure 3: the magnitude of Chinese aid, while uncertain and associated with wide confidence intervals, appears to be fairly constant, and since 1999 has been outstripped by South Korea's rising transfers. The ironic message is that

Figure 2: Ratio of balance of payments transactions to licit merchandise exports



Source: Haggard and Noland (2007b)

Table 1: Partner country share of North Korean commercial trade

Partner	Exports				Imports				Total trade			
	2001	2002	2003	2004	2001	2002	2003	2004	2001	2002	2003	2004
China	19.3	25.4	34.8	41.5	28.4	23.3	28.1	32.3	25.4	24.1	30.7	36.0
Korea	20.1	25.3	25.5	18.3	3.7	4.3	6.6	4.2	9.2	12.4	13.8	9.8
Japan	26.1	22.0	15.3	11.6	14.5	7.9	5.0	4.2	18.4	13.4	9.0	7.1
Thailand	2.8	4.2	4.5	6.4	6.2	10.1	11.2	11.2	5.0	7.8	8.6	9.3
Russia	0.5	0.3	0.2	0.5	3.7	4.5	6.3	9.7	2.6	2.9	4.0	6.0
European Union	10.4	7.5	5.7	4.3	9.4	13.6	15.5	12.1	9.7	11.3	11.7	9.0
MENA	4.1	4.0	4.6	7.6	7.1	9.3	10.1	13.4	6.1	7.3	8.0	11.1
Other countries	16.7	11.2	9.3	9.9	27.0	26.9	17.2	12.9	23.6	20.9	14.2	11.7

Source: Haggard and Noland (2007b)

Note: MENA = Middle East and Northern Africa

North Korea's deepening economic integration with China is largely market-based, while exchange with South Korea has a growing official component.



Implications for political stability

There is no simple mapping between economic distress and political change. Although one implication of the formal analysis of political regime stability in Noland (2004) is that economic performance critically influences political stability, the considerable degree of economic distress experienced in North Korea is not historically unique (Noland 2004, table 2.11). The North's external relations are crucial: the amount of external support necessary to keep North Korea on "survival rations" was (and remains) relatively small (perhaps \$2 billion annually), easily within the scope of its neighbors, each of whom would prefer to forestall political collapse, to finance.

The central issue for the current regime is whether it can continue to navigate internal change successfully, confronting the implicit legitimization challenge posed on one hand by its growing interaction with prosperous, democratic South Korea, while managing diplomatic tensions with countries such as the United States and Japan emanating from its nuclear

weapons program on the other. Under such circumstances, deepening integration with China presents an attractive though potentially dangerous option. The “China card” can also be used to extract more advantageous treatment from South Korea.

Internal changes over the past decade may have set in motion forces that will ultimately prove politically destabilizing. Recent developments have necessitated an ideological reinterpretation of the national ideology of *juche*, to legitimate the policy changes and justify the departure from the country’s socialist tradition. The response has been to intensify the *songun* (“military-first”) campaign. This development, which at first blush would appear to signal the ascendance of the most reactionary element of the polity, may actually be the mechanism through which a broad-ranging top-down modernization of a society subject to external threat is ideologically justified. By elevating the military to the vanguard, the “military-first” ideology justifies all manner of reforms—including the jettisoning of socialism in practice if not as a teleological ideal.

The regime can also draw upon two generations of unparalleled political indoctrination, a complete monopoly on social organization, and a massive apparatus for internal social control that it deploys ruthlessly. With the possible exception of the Korean People’s Army, there is a complete absence of institutions capable of channeling mass discontent into effective political action. There is no Solidarity trade union as in Poland, or Civic Forum as in Czechoslovakia. Indeed, there are not even alternative sources of moral authority capable of legitimating dissent such as that played by the Roman Catholic Church in the uprising against the martial law regime in Poland or the “People’s Power” revolt against the dictatorship of Ferdinand Marcos in the Philippines.

Externally, North Korea’s neighbors have not provided sanctuary to anti-Kim political forces. There is little or no evidence of anti-Kim political organizing among the refugees in the Chinese border region, and there are no marauding guerrilla insurgencies on North Korea’s borders. If anything, North Korea’s neighbors might be expected to actively cooperate with North Korean security services to crack down on such activity if it were to develop.

There is historical precedent for this political trajectory: during the Meiji Restoration and the founding of modern Turkey under Mustafa

Kemal, revolutionary changes were justified as responses to external threats and legitimated in terms of restoring past historical glory. Indeed, contemporary North Korean political slogans bear remarkable resemblance to those of the Meiji Restoration. Yet in this North Korean production, Kim Jong-il would be playing the roles of both the Tokugawa Shogun and the Emperor Meiji.

Moreover, the problem of social control is surely aggravated by the divided nature of the Korean peninsula, and the cognitive dissonance created by a prosperous and democratic South Korea. Ironically, this problem is intensifying as the reforms are having the presumably unintended effect of exposing the isolated North Korean populace to an increasing amount of information originating beyond the borders. Vietnam was a unified country when it undertook reforms in the late 1980s, and while China had to contend with Taiwan, few would argue that Taipei posed a profound ideological challenge to the formulation of reform in Beijing. Prospective North Korean reformers face a more difficult political terrain.

There is no guarantee that Kim Jong-il will successfully turn the trick and one can question the fundamental viability of a post-Kim Jong-il North Korean state, dynastic or otherwise. And while in a positive, as distinct from normative, sense, top-down military centered modernization may be a successful political development strategy, there is no guarantee that a successor military modernizer would be the Park Chung-hee or Augusto Pinochet of North Korea, and not its Alexander Kerensky or Lothar de Maizière, or that the collective leadership that could well emerge after Kim's death might not eventually implode as Tito's successors did in Yugoslavia. The legitimization challenges for a post-*juche* North Korea could be profound, and there is no certainty of success—even if the regime were supported by a South Korea apprehensive of both the costs of abrupt unification and growing Chinese influence in the North. Ironically, one can imagine a situation in which the most radical forces in North Korea would be revolutionary nationalist unifiers, who might well be opposed by a South Korean government which, fearing a collapse and absorption scenario, might try to prop up any incumbent leading the North Korean state.

Epilogue: The floods and the Summit

On 8 August 2007, North and South Korea announced a summit scheduled for 28–30 August. The following week North Korea was hit with severe floods and the summit was postponed until 2–3 October. The two events are inextricably linked.

Heading into the summit, observers expressed considerable skepticism about the motives of the two leaders: Roh Moo-hyun was a highly unpopular leader nearing the end of his term with little of a substantive legacy. His would-be successors in the “progressive camp” trailed badly in public opinion polls in the run-up to December presidential elections. A second summit might provide Roh an opportunity to leave a lasting mark and give his side a boost at the polls. His agreement to go to Pyongyang rather than Kim Jong-il make the expected reciprocal visit to South Korea (the first summit in 2000 had been held in the North) was interpreted by some as a sign of desperation or supplication. For his part, Kim Jong-il could expect the South Korean president to bring money (though perhaps not the hundreds of millions of dollars in secret payments that the Kim Dae-jung had sent north before the earlier summit) and he might reasonably expect to get a better deal out of Roh (and any possible progressive successor) than he would from a conservative. His interest would be to pocket concessions and aid the electoral prospects of the South Korean progressives.

Moreover, while from all accounts the flooding in the North has been severe, North Korea has a history of exaggerating the impact of natural disasters to boost aid receipts. At the time of the 1995 floods, North Korea reported that 5.4 million people (a quarter of the population) had been made homeless; a subsequent UN survey put the number at 500,000—a terrible figure, but less than one-tenth of what was claimed. The following year the government claimed that half the corn harvest was lost due to flooding, but it appears that the flooded areas accounted for well under half of corn production. Even in the current case, North Korea has refused to allow representatives from the UN agencies to visit certain regions—areas where they have never been granted access—despite North Korean claims that these are significantly flood-affected areas requiring humanitarian assistance.

The dilemma that the world community now faces—and it is a long-standing one—is how to respond in a situation which is undoubtedly tragic

but where the local government plays politics and frustrates relief efforts. South Koreans feel a special affinity for North Koreans and it is completely understandable that they would give aid. Yet it should be recognized that the floods have probably created a political environment that may generate much larger transfers than might have otherwise been politically acceptable in South Korea. That is to say, a genuine disaster will probably be used to advance a particular political agenda.

Unfortunately, the South Korean aid program does not meet commonly accepted international standards (Haggard and Noland 2007a), and as a consequence, there are fears that a greatly expanded South Korean program will undercut the now tenuous program run by the WFP, and in the extreme, encourage intransigence by the North in the ongoing nuclear talks.

Kim Dae-jung's "Sunshine Policy" derived its name from Aesop's fable of the North Wind and the Sun in which the Sun and Wind compete to see which can strip the coat off a traveler. While the Wind fruitlessly attempts to blow the coat off, the Sun uses its warmth to induce the traveler to disrobe. Analogously, engagement was originally conceived as an instrument: the point was to encourage sufficient systemic evolution within North Korea to establish a meaningful basis for reconciliation and, ultimately, national unification. An alternative view, into which the government of Roh Moo-hyun seems to have drifted, regards engagement less as a tactic to achieve a transformative goal, than as a goal in and of itself. The issue of which of these conceptions of engagement—as a means or as an end—prevails in the coming years could have a profound impact on not only the nature of North–South relations, but on North Korea itself.

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