The North Korean Economy After the 2009 Currency Reform: Problems and Prospects

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Abstract

North Korea's 2009 currency reform and ensuing actions may have been a turning point for the DPRK economy. The country now has little choice but to adopt a China-type strategy of reform and opening beginning with the development of the border area with China. However, North Korea's provocations have caused a tightening of economic sanctions, including a U.S. prohibition on any product of North Korean origin, even if containing in another product from a third country. North Korea is highly reliant on trade with China and South Korea, although it does trade with numerous countries of the world.

Keywords: North Korea, currency reform, China trade, DPRK exports, DPRK imports, Rason, Hwanggumpyong.

The North Korean Economy After the 2009 Currency Reform: Problems and Prospects

As history may conclude, the disastrous currency reform of November-December 2009 could prove to have been a turning point in the convulsive historical path of the hapless DPRK economy. The so-called currency reform amounted to a redistribution and confiscation of wealth along with an attack, both on markets and dollars or euros being used as a domestic medium of exchange. The effort failed. The die was cast.

The botched currency reform and ensuing events should have made it clear to Pyongyang that the time had come for a new strategy. The old policy cycle would no longer work. Rotating through a military provocation, a diplomatic charm offensive with hat in hand, promises of better behavior, food and economic assistance to keep starvation to manageable proportions, followed by a period of calm before a return to military provocations could no longer elicit the desired international response. This time, undertaking deadly military actions and bringing the Korean peninsula to the brink of war in order to gain attention and set the stage for a diplomatic offensive ended up increasing sanctions and further alienating China, the DPRK's last reliable ally. It was time to carry out the policies expressed in the New Year joint editorial and take realistic and more effective measures to achieve the increasingly-unattainable goal that of becoming a "strong and prosperous" nation by the year 2012.

Currency reform could turn out to be the last major attempt by the government to keep the country from embarking on the same path to prosperity taken by South Korea, China, Japan, and most other countries of Asia. Considering the pre-Korean War status of North Korea as the industrial center of the Korean peninsula, what seems more remarkable than its starving people is that the DPRK could remain an island of poverty amid an ocean of prosperity.

The failed currency reform should have served again to remind the governing regime that there are limits to how much it can squeeze from peasants and merchants to make up for misguided economic policies. Since the currency reform effort, DPRK policy has exhibited three divergent and contradictory strategies. First is the path of Chinese reform. The country seems finally to have embarked on a realistic path of modernization and economic self-sufficiency with heavy reliance on Chinese investment and managerial expertise. Second, it has continued with provocations and forays into military adventurism that only serve to torpedo its attempts at reaching the moderate level of economic independence that it so desires. And third, it continues to stiff arm South Korea, a country with deep pockets, expertise, and a direct interest in promoting economic development in the other half of the Korean peninsula.

North Korea's policies toward economic reforms and markets could be likened to a mountain man sliding down a steep bank into a river. A complete dunk in the waters of capitalism and market forces could do much to wash the DPRK economy of its accumulated vestiges of Cold War socialism. Much as the case with China, North Korea could call the mixed socialist-market economy that is developing slowly, "socialism with North Korean characteristics," or "*juche* with Chinese characteristics." The reality is that without sufficient reform, the DPRK economy will remain one of the backwaters of the world.

The lesson of currency reform for Pyongyang should be that resisting the pull of markets by lashing out with decrees and trying to reverse what progress has already been made is both futile and detrimental to other national priorities, including raising the standard of living of the people, maintaining support for the ruling regime, and developing into a recognized nuclear state. This message apparently has not been lost on the Kim Jong Il regime. Kim's apparent successor, Kim Jong Un, has had his name associated with the success of the special economic zones on the northern border with China, and economic development is being pursued as a way to legitimatize his succession to power. One strategy to ensure a smooth dynastic succession is to build economic achievements credited to Kim Jong Un.[2]

In May 2011, North Korea announced that it was the second happiest country in the world after China.[3] The United States and South Korea were at the bottom of the ranking. It perhaps is comforting to know that the tears being shed in the DPRK have not been tears of pain but tears of happiness. A lesson that the DPRK might learn from China is that the happiness of people and concomitant support for the ruling regime depend partly on the level of well-being but primarily on a steady rise in the standard of living. Rapid economic growth combined with moderate repression of nascent opposition elements seems sufficient to maintain support for Beijing. This is a far cry from the apparent DPRK formula of severe repression of even a hint of opposition and criminalizing what is normal market activity in other countries as well as discouraging foreign investment by lethal military adventurism and then trying to convince the people that they are happy.

The Failed Currency Reform

The currency reform was intended to provide a strong boost to the economy, both to grow and to become more self-sufficient. Even though it was followed by attempts to modernize the DPRK commercial base, it amounted to a deliberate attempt to transfer wealth from those engaged in "illegal" market activity and from households that had saved to the political and military elite. It also sought to bring transactions into the state banking system rather than allowing cash transactions based on markets. As early as 2006, papers in the *Kyo'ngje Yo'ngu* journal of economic policy argued that "idle currency in the people's closets must be pulled out into the official currency structure" and that the bank had to play the key role in currency distribution and transactions.[4]

From day one, however, currency reform and ensuing actions caused huge disruptions in what remained of an already distorted economy. It alienated nearly everyone—including the elites in society—and generated huge increases in prices, particularly for those who could least afford them. Ultimately, it laid bare the utter futility of trying to control all aspects of the economy from Pyongyang. It is no wonder that the architect of the plan, Pak Nam-gi, was reportedly executed at a shooting range and his relatives arrested.

The failures of the currency reform included the following:[5]

- confiscating accumulated savings at all strata of society by limiting the amount that could be converted from the old currency to the new;
- creating shortages of basic commodities both in the Public Distribution System and in markets;
- setting unrealistic prices for basic commodities based not on supply and demand but on old controlled price levels that were hopelessly out of date;
- shutting down markets that were necessary for obtaining basic food and household items for much of the non-elite population; and,

- criminalizing the use of foreign currencies, thereby adding an additional risk to market transactions and importing from China.

After less than two months, even government authorities in Pyongyang recognized that the currency reform and ensuing measures were a complete fiasco. They had caused such chaos and hardship that on February 5, Premier Kim Yong-il reportedly read an hour-long statement before village chiefs and other party officials admitting the policy mistake and apologizing for "having caused great pain to the people by recklessly enforcing the latest currency reform without making sufficient preparations or considering the circumstances." He pledged to rectify the mistakes and to stabilize the financial circumstances of the people. He also indicated that North Koreans would be allowed to use foreign currency and that markets would be permitted to reopen.

Provocations and Sanctions

Following the reversal of the currency reform, one would have expected policymakers to move quickly to make up for the damage done. Instead, DPRK policy took a strange turn that worked to worsen the situation. Suddenly, the military-first aspect of the policy establishment came to the fore. Like a two-headed monster, just when the currency reform head was subdued after causing an economic disaster, the military head popped up and began breathing fire, allegedly sinking South Korea's *Cheonan*, a naval vessel, and shelling Yeonpyeong Island. In terms of the impact on the DPRK economy, each was equally detrimental.

The sinking of the *Cheonan* and shelling of Yeonpyeong Island provided a fillip to efforts to enforce United Nations sanctions on the DPRK. On June 12, 2009, the United Nations, Security Council unanimously passed Resolution 1874, in response to North Korea's second nuclear test. The resolution put in place a series of sanctions on North Korea's arms sales, imports of luxury goods, and financial transactions related to its weapons programs. It also called upon states to inspect North Korean vessels suspected of carrying such shipments. In addition, the resolution provided for new economic and financial sanctions on the DPRK. It called on states not to provide grants, assistance, loans, or public financial support for trade if such assistance could contribute to North Korea's proliferation efforts. It also called on states to deny financial services, including freezing assets, where such assets could contribute to prohibited DPRK programs. Explicit exclusions were made for humanitarian and denuclearization aid.

Combined with a shortage of food, fuel, and fertilizer plus an unusually severe winter in 2010-2011, the economic sanctions tended to slow the economy and worsen an already bad situation for the North Korean people. Aid agencies and governments believe the DPRK needs about 5.3 million tons of additional food in 2011 just to feed its population. An assessment by the United Nations in early 2011 found more than six million North Koreans in urgent need of aid, and they were informed that the North's public distribution system would run out of food between May and July 2011.[6] The international community, however, greeted the request for aid with some skepticism.

The U.N. sanctions have been broad and far-reaching, although problems have arisen in implementation, particularly with countries, such as China, which are obliged to recognize the sanctions but which have other interests they consider to be equally compelling. While U.N. Security Council Resolution 1874 was aimed primarily at preventing nuclear and missile proliferation, it was also was designed to deprive the North Korean elite of luxury goods and to make it difficult for the DPRK to finance international transactions, particularly those related to DPRK's nuclear or ballistic missile programs. Since international banks cannot tell who the ultimate beneficiary is for a given transaction, such as a trade credit or export guarantee, many banks simply stopped dealing with the DPRK in order to protect their reputation and avoid U.S. financial sanctions. Visitors to Pyongyang in December 2010 reported that one ship in port could not unload its cargo because of problems with finding an international bank that would handle the transaction. This made international trade in major items more risky and difficult.

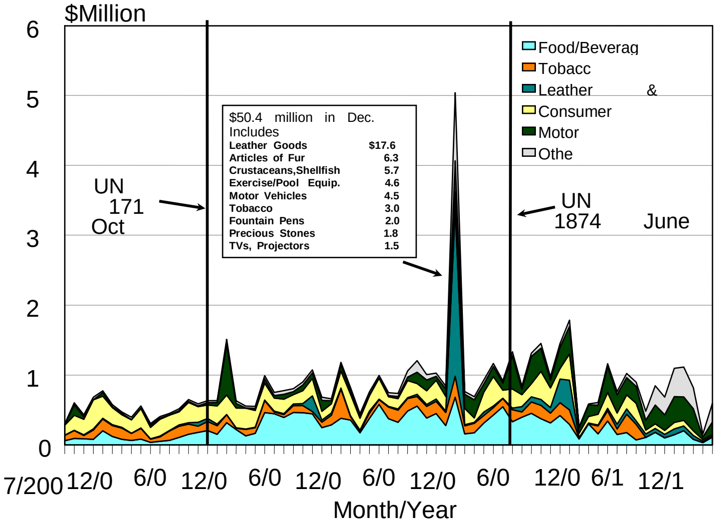
Despite the U.N. sanctions prohibiting the export of luxury items to the DPRK, visitors to Pyongyang in December 2010 reported seeing a variety of such goods from China, Japan, and other countries for sale in markets. Using the U.S. and U.K. definitions in 2009, countries reporting trade to the United Nations exported $212.2 million in luxury items to North Korea. China led the way, with exports of luxury goods of $136.1 million (mostly tobacco, computers and cars). Brazil exported $36 million (mostly tobacco and precious stones), Singapore $29 million (mostly tobacco), and Russia $4 million (mostly cars, some beef and computers but no alcoholic beverages). Clearly, China and other countries have not been enforcing the U.N. sanctions on luxury goods.

The United Nations Panel of Exports in its 2010 final report documented several illicit purchases or attempts to purchase luxury goods by the DPRK.[7] These included two yachts, twelve Mercedes Benz vehicles, electronic items (high-end video recorders and players), musical instruments (37 pianos) and cosmetics. Most of these luxury goods reached or would have reached North Korea after transiting through a neighboring trans-shipment hub.

Luxury goods exported from Japan in 2008 and 2009 were mainly pianos and cosmetics. In 2009, Italy also blocked exports of electronic items, including a projector, some amplifiers and other electronic equipment suitable for a cinema hall, 150 bottles of cognac and 270 bottles of whisky, and in December 2010, a shipment of high-quality tap-dancing shoes.

Figure 1 shows monthly Chinese exports of luxury goods to the DPRK, using a combination of U.S. and U.K. definitions of such goods. Luxury exports from China fluctuated by month but generally increased with a decided downturn in the early months of each year. There is a spike in purchases each December presumably for New Year gifts to be given.

Figure 1. Monthly PRC Exports of Luxury Goods to North Korea



As can be seen in the figure, China continues to ship luxury goods to the DPRK despite the U.N. sanctions. China claims that the ban is not enforceable because the United Nations resolution did not specify what goods are luxury items. The definition of luxury goods does vary by country, but certain items would seem obvious for inclusion. For example, in July 2010, Radio Free Asia reported that Kim Jong-il had provided 160 luxury cars (made in China) to directors of provincial committees of the Korean Workers Party and to municipal committee secretaries (higher level officials already had vehicles).[8] Such cars would be included on a list of luxury goods by most countries.

The United States, Japan, and South Korea also imposed a variety of unilateral sanctions on the DPRK. South Korea terminated all trade with the North except for that through the Kaesong Industrial Complex and humanitarian aid. Japan imposed strict sanctions on trade with North Korea. Prior to 2002, the two countries maintained extensive trade relations. In 2001, for example, Japan exported $1.1 billion in merchandise to the DPRK. From 2006, however, Japan unilaterally imposed sanctions that include a ban on trade with the DPRK, even that via third countries, as well as limits on remittances and travel to Japan by most North Korean citizens.

In the United States, on August 30, 2010, after determining that the DPRK was complicit in the sinking of the *Cheonan*, President Obama invoked national emergency authority to prohibit exports of luxury items to North Korea and to block the assets of targeted individuals and entities engaged in proliferation, money laundering, counterfeiting of goods or currency, bulk cash smuggling, narcotics trafficking, or other illicit economic activity. In addition, on April 18, 2011, Obama issued Executive Order 13570 that prohibited the direct and indirect importation of goods, services, and technology from North Korea. This means that, unless exempt, an import license is required for all products or services entering the United States from North Korea.[9]

The prohibition of both "direct and indirect" imports from North Korea is significant. It implies that parts and components from, for example, the Kaesong Industrial Complex or from Chinese joint ventures in North Korea are not permitted to enter the United States, even if they are substantially transformed and a part of another imported product that is allowed.

The need for Executive Order 13570 stemmed from the debate in Congress over the Korea-U.S. Free Trade Agreement (KORUS FTA) that is awaiting Congressional consideration. In early 2011, many members of Congress raised concerns over whether the agreement could lead to increased imports from North Korea. Although the pending FTA would not cover products from the Kaesong Industrial Complex (KIC), it does contain a provision for future consideration and legislative approval of products from outward processing zones such as the KIC. The FTA also contained rules to determine the origin of products that allowed for components from other countries to be included in products that qualify for the special tariff treatment under the FTA.

Under international trade rules, a finished product made in the KIC or anywhere in North Korea, must be labeled as such and in the United States does not receive most-favored-nation tariff (Normal Trade Relations or NTR) treatment. In the United States, only two countries, North Korea and Cuba, do not have permanent NTR status and must pay the higher pre-World War II rates of duty. However, if a part or component from North Korea is incorporated into a product from South Korea, for example, that has a different tariff classification; it can have a "Made in (South) Korea" label and enter the United States or other countries under the rules for imports from South Korea. In international trade parlance, it is considered to be substantially transformed.

Following the announcement of Executive Order 13570, the Office of Foreign Assets Control (OFAC) in the U.S. Department of the Treasury issued these guidelines:

"Pursuant to E.O. 13570, goods, services, and technology from North Korea may not be imported into the United States, directly or indirectly, without a license from OFAC. This broad prohibition applies to goods, services, and technology from North Korea that are used as components of finished products of, or substantially transformed in, a third country."[10]

Currently, it is not clear how far U.S. Customs and Border Protection (CBP) will go in implementing the executive order's language on prohibiting indirect trade. CBP officials assert that their targeting, verification, and enforcement provisions mitigate the risk of unauthorized products and components from the DPRK entering into the United States. However, CBP relies heavily on the importers, themselves, to comply with existing rules and laws governing imports.

The problem of imports into the United States from the DPRK is not of major consequence now. If North Korea continues to establish joint ventures, industrial complexes, and free trade zones, however, many more North Korean products are likely to enter into global supply chains. This potentially could have a large effect on the willingness of global businesses, particularly those in China, to buy even a small input or service supplied from North Korea. Will, for example, the prohibition include Chinese steel made using coal from North Korea? Will it include bolts, paint, or cloth if they are made in the KIC that could make their way into a car assembled in South Korea? Will it include metals separated in high-temperature furnaces lined with the rare metal magnesite that is found only in North Korea and China? Will it include apparel made by South Korean or Chinese companies but sewn in North Korea? Such processing on commission trade has comprised a large part of the non-KIC trade between North and South Korea.

One implication of Executive Order 13570 is that more data is necessary on trade between North and South Korea. Currently, South Korea does not provide the United Nations or the World Trade Organization with data on trade with the DPRK because South Korea considers it intra-Korean trade. Instead, it reports only totals for broad categories of trade each month. Currently, most imports from North Korea are from the KIC, but if and when the ban on non-KIC trade with the North is lifted, the processing-on-commission trade and exports of minerals from North Korea are likely to resume. As many as 860 South Korean firms, mostly traders, are reported to be operating in North Korea.[11] In the case of Taiwan and Hong Kong, both separate customs areas from the Peoples Republic of China, Beijing reports trade with them in China's national data submitted to international organizations. Perhaps it is time for South Korea to do the same for the DPRK.

The impact of the U.N. and other sanctions on North Korea is reflected in how much the DPRK now relies on trade with China and production in the Kaesong Industrial Complex for their international economic interaction. Except for other rogue regimes, such as Syria, Iran, and Burma, and some government-connected enterprises willing to take political risks (such as Egypt's Orascom Telecom), companies seem to be asking themselves why bother to trade with or invest in North Korea when alternative markets are available.

International Trade

While data on most of the DPRK economy are not available, statistics on much of the country's international trade are reported by trading partners. While such mirror data are incomplete because not all countries report their trade data to the United Nations, they do provide a rough picture of how the DPRK is faring.

Table 1 shows an estimate of North Korean trade, using data as reported by trading partners. These data do not include illicit exports and imports, but they do include some prohibited items, such luxury goods, that go through normal trade channels. In 2010, the total North Korean trade exceeded $7.2 billion with exports of $2.9 billion and imports of $4.3 billion. Considering that the gross national income of North Korea is approximately $28.6 billion, trade accounts for about a quarter of the economy. While this is moderately high for a country so isolated, it reflects more on the poor state of the domestic economy rather than on a robust trading sector.

Table 1. DPRK Trade with the World and with Major Trading Partners ($Million)

Year	2005	2006	2007	2008	2009	2010
North Korean Exports						
World Total	1,787	2,398	2,505	3,228	2,395	2,854
China	499	468	584	760	793	1,188
Share (%)	27.9%	19.5%	23.3%	23.6%	33.1%	1.6%
South Korea	340	520	765	932	934	1,044
Share (%)	19.0%	21.7%	30.5%	28.9%	39.0%	36.6%
Netherlands	4	35	42	19	21	97
Mexico	70	54	44	21	13	46
North Korean Imports						
World Total	3,150	3,486	4,224	5,380	3,623	4,312
China	1,081	1,232	1,392	2,032	1,887	2,277
Share (%)	34.3%	35.3%	33.0%	37.8%	52.1%	52.8%
South Korea	715	519	1,032	888	744	868
Share (%)	22.7%	14.9%	24.4%	16.5%	20.6%	20.1%
India	54	123	639	1,094	311	288
Egypt	0	0	0	0	2	269
Total Trade	4,938	5,884	6,729	8,609	6,019	7,166
Balance	-1,363	-1,089	-1,719	-2,153	-1,228	-1,457

Source: South Korean data from S. Korea, Unification Ministry. World totals are a sum of all data from reporter countries in the U.N. COMTRADE Database. Data, particularly for 2010, not in the U.N. database are from Global Trade Atlas. Data for India for 2006 and 2007 have been adjusted for apparent miscoding. Figures are not adjusted for inflation.

South Korea's KOTRA (Korea Trade-Investment Promotion

Agency) reported that in 2009 North Korea's total trade increased by 22% to $4.17 billion with exports of $1.51 billion and imports of $2.66 billion. As compared with the figures in Table 1, these data are grossly understated. Not only does KOTRA leave out trade between North and South Korea in calculating total DPRK trade, but it also leaves out trade with numerous other countries as well. [12]

Even though the North Korean economy is only loosely connected to the advanced industrialized countries of the world that were the hardest hit by the global financial crisis and ensuing recession of 2008-2009, its exports and imports also were affected by the downturn in world trade. In 2009, DPRK total trade fell by 30% while world trade fell by 22%. In 2010, as the global financial crisis ebbed, DPRK total trade rose by 19% while world trade increased 22%. Actually, DPRK exports to China and South Korea continued to increase during the financial crisis, but DPRK imports fell, particularly from India.

In recent years, North Korea has been incurring an overall annual trade deficit of between $1 billion and $2 billion dollars. In 2010, this deficit was $1.5 billion, of which the bilateral trade deficit with China was $1.1 billion or two-thirds of the overall trade deficit. How the DPRK finances this deficit is unknown, but some hard currency comes from remittances from North Korean labor or relatives overseas and from contract work in other countries. Some imported goods consist of foreign aid, mainly humanitarian assistance that does not require payment, particularly from China, South Korea, and the United Nations. The DPRK also generates hard currency through illicit activities that are not necessarily reported in trade data. This includes exporting arms, sales of nuclear technology, counterfeiting, and illegal drug sales.

Table 1 shows how much the DPRK has come to rely on China and South Korea for both imports and exports. North Korean trade with Japan and the United States is virtually nil because of economic sanctions, except for some humanitarian aid. About half of all North Korean trade is with China. China provides a market for 42% of DPRK exports and 53% of its imports. South Korea's KOTRA (Korea Trade-Investment Promotion Agency) claimed in 2010 that China accounted for more than 80% of North Korea's foreign trade,[13] but as explained above, this figure is vastly overstated because the KOTRA figures for total DPRK trade omit trade with South Korea.

North Korea's trade with South Korea is mainly through the Kaesong Industrial Complex (KIC). Following the provocations by the DPRK in 2010, South Korea terminated all trade with the North, except for that associated with the KIC and basic humanitarian aid. In particular, processing-on-commission imports from North Korea (almost all textiles) dropped by 99.6% from $42.8 million in March 2010 to $179,000 in March 2011.[14] Still, in 2010, DPRK exports to South Korea at $1.04 billion accounted for 37% of all DPRK exports and rivaled the $1.19 billion in DPRK exports to China.

With respect to imports of commodities critical to the North Korea, reliance on China is quite striking. In 2010, out of $64 million in imports of cereals, China provided $60 million or 94%. The remainder came from food shipments from the United States and Canada and what seem to be purchases from countries such as Ukraine and Thailand.

It should be noted, however, that even though China exported $250 million in foodstuffs to the DPRK in 2010, China also imported $79 million in food from the DPRK. These imports consisted primarily of fish and shellfish ($59 million), fruits and nuts ($9 million), and miscellaneous grains ($5 million). At a time when the DPRK is soliciting food aid and the U.N. World Food Program has an emergency operation to help feed people suffering from hunger there, the country is exporting food to China to generate foreign exchange.

In mineral fuel oils, China is the major supplier to North Korea. In 2010, China exported $479 million in mineral fuel, oils, and electricity to North Korea. In order to reduce its reliance on China, however, the DPRK has been seeking other import sources for energy. India is now experiencing a surplus in its domestic supply of refined petroleum and has placed a cap on prices for gasoline that makes exporting more profitable than selling domestically. In 2010, India exported $330 million in mineral fuel oils (refined) to North Korea, up from $262 million in 2009. Egypt also has been deepening its economic ties to the DPRK. In 2010, Egypt reported sales of $265 million in mineral fuel exports to North Korea. Together, Egypt and India now supply about the same amount of mineral fuel to the DPRK as does China.

The energy trade between the PRC and the DPRK is not as one-sided as it is usually characterized. Even though the DPRK imported $479 in mineral fuels from the China in 2010, the DPRK also exported $397 million in mineral fuels to China—almost all coal.

Table 2 shows the top exporting countries to the DPRK with their top export commodity in 2010. It is apparent that while China and South Korea dominate in exports to North Korea, other countries sell significant amounts there. Mineral fuel oil is the top export from China, India, Egypt, Russia, and Italy. Ores are the top export from South Africa,[15] Brazil, Honduras, and Mexico. For Germany the top export is machinery, and for Hong Kong, electrical machinery. Tobacco is the top export from Singapore, while copper is the top export from Chile, and organic chemicals the top export from Taiwan to the DPRK.

Table 2. Top Exporters to the DPRK and Their Top Export Commodity

($million)

Reporting Economy	2008	2009	2010	Top Export	2010 Amount
China	2,032.4	1,887.7	2,277.8	Mineral Fuel Oil	478.8
S. Korea	888.0	744.8	868.3	N.A.	N.A.
India	1,093.6	311.2	288.8	Mineral Fuel Oil	N.A.
Egypt	0.6	2.5	269.9	Mineral Fuel Oil	261.3
South Africa	152.1	103.8	181.7	Iron Ore	180.6
Russia	96.9	41.8	83.6	Mineral Fuel Oil	27.4
Singapore	120.8	54.9	47.8	Tobacco	16.2
Italy	35.0	39.2	42.7	Mineral Fuel Oil	19.5
Thailand	46.1	30.4	29.7	Sugars, Confectionary	9.9
Germany	31.7	43.2	24.6	Machinery, parts	5.8
Brazil	204.7	118.6	21.5	Ores, Slag, Ash	17.1
Honduras	16.9	16.6	20.7	Ores, Slag, Ash	16.4
Hong Kong	8.6	26.3	18.5	Electrical Machinery	13.2
Chile	8.0	8.8	17.5	Copper	17.1
Mexico	3.1	0.9	14.7	Ores, Slag, Ash	10.2
Taiwan	15.6	13.3	13.4	Organic Chemicals	11.8

Source: Data from U.N. COMTRADE Database and Global Trade Atlas.

Table 3 shows the top importers from the DPRK and their top import commodity. After China and South Korea, Brazil, the Netherlands, Egypt, Mexico, and Venezuela each imported more than $40 million from North Korea in 2010. These amounts are dwarfed by the more than $1 billion in imports by both China and South Korea. The top imported products for these countries were coal and oil (not crude) from coal, machinery, electrical machinery, iron and steel, plastics, and apparel.

Table 3. Top Importers from the DPRK and Their Top Import Commodity

($million)

Reporting Economy	2008	2009	2010	Top Import	2010 Amount
China	760.4	793.0	1,187.9	Coal	397.6
South Korea	932.0	934.0	1,043.9	NA	NA
Brazil	176.4	96.0	121.4	Machinery	30.7
Netherlands	19.4	21.5	96.6	Oil (not crude)	74.8
Egypt	33.4	28.6	66.2	Iron and Steel	43.3
Mexico	20.8	12.5	45.9	Electrical Machinery	35.2
Venezuela	227.1	65.1	41.5	Electrical Machinery	17.0
Sri Lanka	0.1	0.4	36.0	Iron and Steel	4.8
Germany	21.6	52.5	31.4	Apparel	19.9
Thailand	28.4	13.9	21.4	Iron and Steel	3.9
Paraguay	35.0	21.9	20.2	Machinery	7.2
India	109.3	6.5	18.0	NA	NA
Russia	13.9	7.8	16.4	Iron and Steel	11.5
Hong Kong	24.5	30.0	12.4	Electrical Machinery	5.9
Colombia	15.9	10.5	11.9	Plastics	4.0
Tanzania	0.3	0.1	8.5	Minerals	6.1
Taiwan	13.2	7.1	7.9	Coal	5.2
Indonesia	8.0	7.6	7.8	Iron and Steel	7.0

Source: Data from U.N. COMTRADE Database and Global Trade Atlas.

The China-Model Strategy (*Juche* with Chinese Characteristics)

North Korea's reliance on China has given Beijing some leverage in inducing Pyongyang to embark on a path of economic development similar to that taken by China. Beijing fully recognizes that unless North Korea reforms its economy, it will continue to face economic hardship and periodically will have to come begging to China for assistance. Over the past decade, China has been urging Pyongyang to follow its own development pattern of reform. The ever suspicious DPRK regime, however, has hesitated to take steps to reform its economy that could lead to a loosening of their grip on society. They even took a detour into

Vietnam, thinking that the Vietnamese experience with reform was more adaptable to North Korea's economic conditions. After several visits to Vietnam and after translating Vietnamese government manuals, Pyongyang apparently concluded that while Vietnam did offer some lessons, relying on the mutual interest, proximity, financial resources, and capability of China was more practical and more likely to find success.

The three trips to China by Kim Jong Il in 2010 and early 2011 seem to indicate how much the DPRK development strategy has come to rely on China. After much cajoling and allowing Kim Jong Il a first-hand view of the results of reform and opening, it appears that China has finally convinced Pyongyang that the best way to achieve its economic goals is to adopt a China-type strategy.

The economic side of the DPRK's traditional ideology of "*juche*" or "spirit of self-reliance" often has implied autarky in trade, but this now seems to be expanded to become "*juche* with Chinese characteristics." North Korea can continue to espouse self reliance and independence, but, in reality, the country can escape from continually living on the precipice of poverty only by adopting more and more of the strategy pursued by the Chinese in developing their economy.

The strategy that has emerged appears to benefit both sides. It is based, first, on using the resources and geography of the DPRK to generate more economic activity and to provide much needed income on both sides of the border. Second, it is to rely on China, not only for financial capital and expertise but to allow Chinese business people to manage certain enterprises and activities, and, third, for the DPRK to put a commercial and transportation infrastructure and government approval process in place, one that is necessary to attract foreign investment, not only from China but also from other countries.

A major thrust of the Chinese economic strategy with respect the DPRK is to create an integrated industrial region focused on China's northeastern Jilin and Liaoning provinces and North Korea's bordering industrial provinces. The plan includes building roads, particularly one connecting the Rajin Port in North Korea, to coal mines and industries in landlocked Jilin province, improving these port facilities, creating a free trade zone on two islands in the border river between Dandong in China and Sinuiju in the DPRK, investing in North Korean industries, and eventually building an industrial complex similar to the Kaesong Industrial Complex.[16]

A major step in this strategy is centered on what has been termed the Rason Special District. The district was named after the two towns of Rajin and Sonbong in North Korea. In 1991, this area was designated to be the DPRK's first free trade zone, but unlike the Kaesong Industrial Complex, never came to fruition. The new Rason project is being developed according to a Chinese plan with Chinese companies managing the investments and operations. Beijing, however, is relying heavily on its local provinces to take the lead rather than funding and orchestrating the process from the central government. The Rason development effort is taking place, according to China's "blueprints," in everything from the planning to investment and management. Local sources have said that China and North Korea have already formed a special joint steering committee for the district with co-chairs from each country.

The Rason development plan calls for building or upgrading roads and port facilities; establishing international freight brokerage, export processing, and financial institutions; and investing in generating electricity, coal mining, oil refineries, manufacturing, and tourism. Initially, electricity is being imported from China. Chinese companies are provided considerable autonomy in their operations. Analysts say North Korea hopes to tout the successful development of Rason as an achievement of Kim Jong Un.[17]

Another area of joint development has been the Sinuiju special economic zone. It was begun in 2002 but has never lived up to its potential. Located in North Korea directly across from Dandong on the Chinese side, the bridge crossing the river is a major artery between China and the DPRK. China has promised to build an additional bridge crossing the river, one that will also handle rail traffic. The current focus is on a free trade zone to be established on the Hwanggumpyong (Huangjinbing in Chinese) and Wihwa islands in the Yalu River, separating the cities of Sinuiju and Dandong. China reportedly has negotiated a 100 year lease on the two islands and initially intended to invest $800 million there for industrial development. With little risk of political "contamination" of North Koreans from visitors to the islands, Chinese citizens are to be allowed visa-free access to the islands. The aim is to build an industrial park on the islands similar to the Kaesong Industrial Complex in North Korea near the border with South Korea.

About 200 Chinese companies operate in the DPRK, of which 86 are listed on China's Ministry of Commerce web site. Of these companies, 35 are in mining, 11 in agriculture/timber, 17 in industrial parts and materials, 7 in apparel, 4 in other consumer goods, 1 in iron and steel, and 1 in automotive vehicles and parts. The other 9 companies are in transportation or trading.[18]

The other aspect of the DPRK development strategy is to build the legal and administrative infrastructure to attract more foreign investment. When Pyongyang announced its "10-Year State Strategy Plan for Economic Development" in January 2011, it said that the plan would help the country achieve its 2012 goal and to put the country among advanced economies by 2020. In order to accomplish this, the DPRK has been trying to streamline the foreign investment approval process and to attract more capital from abroad.

The experience of foreign investors in the DPRK, particularly those from South Korea, has been mixed. A top concern of foreign investors is whether they will be able to repatriate profits and whether their in-country assets will be protected from confiscation. Profit repatriation is yet to be tested on a large scale because most non-KIC investments by South Korean firms in the North have been posting operating losses. The experience of Hyundai Asan in its investment in tourist facilities at Mount Kumgang has not been encouraging. Hyundai Asan had invested $695 million in the resort, but the resort was closed in 2008 after a South Korean vacationer was killed and Pyongyang refused access by investigators from South Korea. Then in 2011, the North Korean government nullified an earlier law that gave Hyundai Asan a 50-year monopoly on cross-border tours to Mount Kumgang and said it was creating a Special Zone for International Tours at the resort area that it would run itself.[19]

Pyongyang has established the Committee of Investment and Joint Ventures to handle investments from China in particular, but also to guide, supervise, and administer investment from abroad. In 2009 and 2010, the Korea Taepung International Investment Group, Pyongyang's state investment agency, and the State Development Bank had been established to perform these functions. Both reportedly continue to operate, but apparently the Committee of Investment and Joint Ventures now carries the most authority.[20]

Prospects

Pyongyang now faces a policy dilemma. The lesson that should be clear to the DPRK is that economics and national security are intimately intertwined. The "military first" doctrine that has been followed has assumed that the economy could be squeezed in order to provide food and other resources for the military. In all countries, however, the economy is both the enabler and the constraint on the military. Every nation, as it begins to industrialize, wants both a rich country and strong army. Japan, China, and South Korea each dealt with the trade-off between the two as they developed. Each found that without economic security for the people, there can hardly be national security for the country.

The three components of the DPRK national strategy include: (1) the China strategy for reform and opening to foreign investments; (2) the provocations *cum* begging for aid strategy; and, (3) a "stiff arm" South Korea strategy. Each of these is intertwined with the other.

As for the "stiff-arm" South Korea strategy, as long as the current South Korean administration is in power, it seems that Pyongyang will continue its hostile policies toward the South. Even though it does so to its own detriment, this is a case in which non-economic issues outweigh the economic. Even though the KIC has been kept operating despite the chilling of relations between the North and South, the prospect of expanding the KIC currently is dim, and the new sanctions on North Korea by the United States may also affect the processing-on-commission trade with the North and other inter-Korean business, should they be revived. The North Korean provocations and ensuing sanctions have ensured that, for the short term, the role that South Korea can play in helping the North industrialize and increase food production will be limited.

The provocation strategy may prove savory to the military, but it can only produce limited shipments of humanitarian aid. Such a strategy works at cross purposes to the goal of attracting foreign investment. North Korea may relish the thought of causing stock markets in South Korea to drop each time it threatens to destroy Seoul, but those same risk factors that give pause to investors with respect to South Korea are magnified several times over when they consider investing in the DPRK. Pyongyang could learn from the China experience with Taiwan. Before foreign investors could feel comfortable building factories in China, Beijing had to tone down its rhetoric and military threats against Taiwan and reduce the probability of open hostilities and possible intervention by the U.S. Seventh Fleet.

That leaves the China strategy, or "*juche* with Chinese characteristics," as the most viable alternative for both the short and long-term development of the economy. This strategy, however, must recognize three current facts of life in the global economy:

- The United States is the largest market in the world; China is second; Japan, third, and South Korea, fifteenth. No country, particularly one in Asia, can industrialize without developing trade and business ties with these economies.

- In order for the DPRK to develop anywhere near that of a mid-level Asian nation, its GDP not only will have to double but double again and continue to grow. As GDP grows, however, the economy becomes so complex that attempting to control all aspects of it through a centralized plan becomes futile. The government can control certain enterprises and set general goals for promoting growth in specific sectors, but trying to manage the economy by fiat and make the myriad market decisions through an autocratic political system creates distortions, breeds dissatisfaction, wastes resources, and ultimately proves impossible to manage. Every country that has industrialized has allowed markets to make more and more of the economic decisions while government has set the framework and defined the parameters of activity through laws and regulations.

- The greater the uncertainty and risk, the more negatively markets and market actors respond. This applies not only to equity and bond markets but to foreign investors and banks. North Korean provocations discourage foreign investment in the DPRK and increase the risk of lending to North Korean traders.

Given the sorry state of the North Korean economy, the China strategy provides the most workable alternative for the DPRK to develop into a mid-level economy and to become self-sufficient in food and other essentials. For China, however, investments in the DPRK economy are not foreign aid. They appear to be based on mutual economic interests and financial viability. The question is whether Pyongyang will be able to keep from interfering in the operations and allow them to generate profits that will then attract other investors into the region. This China strategy is likely to become more and more dominant over the medium term because it now is connected to the dynastic succession of Kim Jong Un.

Notes:

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[1] Opinions expressed in this paper are the author's and not necessarily those of the Congressional Research Service, Library of Congress, or the U.S. Government.

[2] See, for example, Haksoon Paik, Kim Jong Il's Visit to China: Implications for East Asia and the United States, *Foreign Affairs*, June 5, 2011. Posted in 38 North: Informed Analysis of North Korea – http://38north.org. Yonhap, "North Korea Establishes 10-year Economic Development Plan," *North Korea Newsletter*, No. 141, January 20, 2011.

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[4] Tong Yong-su'ng, "Correlation Between North Korea's Economic Policy Changes and *Kyo'ngje Yo'ngu* Papers, Samsung Economic Research Institute, January 13, 2011.

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[9] Executive Order 13551, "Blocking Property of Certain Persons With Respect to North Korea," 75 *Federal Register* 53837, August 30, 2010. Executive Order 13570, "Prohibiting Certain Transactions With Respect to North Korea," 76 *Federal Register* 22291, April 18, 2011.

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[11] Economist Intelligence Unit, *Country Report, North Korea,* May 2011.

[12] For details, see: Mika Marumoto, *DPRK Economic Statistics Report*, DPRK Economic Forum, U.S.-Korea Institute at SAIS, March 2, 2009.

http://uskoreainstitute.org/2009/03/02/project-report-dprk-economic-statistics-project-march-2009/.

[13] Hwangbo Yan, "Over 80 pct of N. Korea's foreign trade with China," *Hankyoreh*, May 28, 2011. For a discussion of problems with KOTRA trade data, see: Stephan Haggard and Marcus Noland, *Engaging North Korea: The Role of Economic Statecraft*, East-West Center, Policy Studies 59, 2011.

[14] Ministry of Unification, "Overview of Exchanges & Cooperation for March 2011."

[15] The data for iron ore from South Africa is suspect. It could be a miscoding of North Korea for South Korea.

[16] For details on Chinese policy and investment in North Korea, see Drew Thompson, *Silent Partners: Chinese Joint Ventures in North Korea*, U.S.-Korea Institute at SAIS Report, February 2011.

[17] Park Min-hee, "N. Korea's Rason Special District could open country to China," *The Hankyoreh* (English edition), May 4, 2011.

[18] Open Source Center, *Directory of PRC Enterprises in North Korea*, China -- OSC Report in Chinese, English 19 April 11, Product FEA20110420016995, April 20, 2011.

[19] Evan Ramstad, "NK Says: See the SZIT at Mount Kumgang," *The Wall Street Journal, Korea Real Time*, June 2, 2011.

[20] Yonhap, "N. Korean Government Body Takes All Power for Investment from Abroad," North Korea Newsletter No. 142, January 27, 2011.