North Korean Economy and Its Impact on Neighboring Countries

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Abstract

The North Korean economy has been continuously deteriorating since the 1990s. Although fiscal revenue increased in 2003, that reflected the issuing of public bonds rather than an actual economic recovery. Under the circumstances, how should neighboring countries deal with North Korea? What can they do to help North Korea achieve a soft landing? The imposition economic sanctions against North Korea would probably force her into a hard landing. The massive outflow of refugees from North Korea, like the European Picnic, would increase costs for China and South Korea. Since North Korea is confronted with South Korea, it would be difficult for her accept the Libyan model. However, for neighboring countries to minimize their own negative impacts, North Korea must accept the Libyan model from economic aid to North Korea from neighboring countries paves the road to the self-sufficiency of the North Korean economy itself.

Keywords: North Korea, Chinese aid, soft landing Libyan model, unification

1. Present Condition of the North Korean Economy

North Korea could be referred to as a major recipient of foreign aid because she achieved economic development by aid from China and the Soviet Union, especially from the latter immediately after the establishment of the country. Because of drastic decreases in Soviet/Russian aid after its collapse, North Korea was unable to carry out proper economic management. China, which had been the other major aid donor to North Korea, was also decreasing aid after 1990s. Since the end of the Sino-Soviet conflict in 1989 prior to the Soviet breakup China no longer had any reason to compete with the Soviet Union for greater influence over North Korea.

A massive decrease in foreign aid was not the only reason for the worsening of the North Korean economy. The country’s economic plans themselves had many problems. In the course of long term planning periods, North Korea often drastically changed plan or disrupted the distribution of resources by accelerating target date or rearranging target figures. When production failed to progress as expected, resources or raw materials were often redirected by the order of the president or other officials, disrupting plan1.

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1 Yang (pp.167-181) refers to a special budget of “President Fonds”.
In addition to circumstance where economic management was not properly carried out, North Korea encountered additional shocking events in the 1990s. China and the Soviet Union successively established diplomatic relations with South Korea, and in 1994 Kim Il Song died. In the mid-1990s, major floods and other natural disasters drastically decreased food production while industry was unable to meet normal production due to shortages of energy and raw material. North Korea had fallen into a situation where it had to endure the “March of Agony.”

What is the current situation of the North Korean economy? Figure 1 shows the trends of North Korean fiscal revenue such statistics are rarely officially published. In 1995 and 1996, the North Korean economy deteriorated to such an extent that state revenues were not announced. These were the years when the “March of Agony” was carried out because of the death of Kim Il Song in 1994 and massive flooding in 1995 and 1996. The fiscal revenue of 1997, which passed the Supreme People’s Assembly, was not even half that of 1994, which was not a very good year for the North Korean economy.

In 2003, fiscal revenues increased 13.6 percent while expenditures increased 14.4 percent, the first double digit increases since 1979. From 2003, North Korea only published the rate of increase and not the actual amount of revenues and expenditures. At first sight, these double digit increases appear to indicate positive economic development as a successful result of the “7.1 Economic Management Improvement Measure” of July 2002. However, in 2002 the most important state revenue sources increased substantially less than state revenue. For example, in 2002 revenue from state enterprises increased 5 percent, the profit of cooperative enterprises increased 3.3 percent, the increase in social insurance revenue was 6.7 percent, and revenue from land use fee increased 3.7 percent.

State revenue increased in 2003 because the state began to issue the “People’s Living Bonds”, (hereafter referred to as the bonds). The bond is a form of government bond whose repayment is guaranteed by the state. It has a maturation period of ten years from May 2003 to April 2013 and was issued in 500, 1,000, and 5,000 won denominations. Lotteries will be carried out 11 times, and winners will be awarded extra lottery prize money, those who do not win the lottery will be paid the full amount by the maturity date starting in December of 2008(Radio Press 2003 No.5 pp.4-5). The fixed repayment amount will depend on the revenue situation of each year. The amount of the lottery prize has not been announced, and it is still unclear what interest rate will be applied. However, it has been explained that the principal is guaranteed even if no one ever wins the lottery.

The amount or the scale of the bonds to be issued is also not clear. Although the exact figures of revenues for 2003 were not published, they can be estimated from the rate of revenue increase, approximately 25.3 billion won at 2001 prices. In case bonds are not issued, i.e., the revenue is only from the profits of state and cooperative enterprises and so on, revenue can be estimated about 22.9 to 23.4 billion won in 2003, based on the rate of increase in the profit of state enterprises, the
primary source of state revenue, of about 3 to 5 percent per year. In other words, the amount of bonds issued will be approximately 1.9 to 2.4 billion won, or about 7.6 to 9.36 percent of the total revenue. However, it is possible that less state profit will be collected, due to the failure of the “7.1 Economic Management Improvement Measure.” In that case, there is a greater temptation to issue more bond.

In fact, such figures as 1.9 or 2.4 billion won have no real meaning because in 2002 the North Korean currency was devaluated as a result of price reform. The extent of devaluation is difficult to estimate from the actual implementation of the reform. For example, the price of rice increased 550 fold, electricity 60 fold, and wages for mine workers increased 30 fold and for government workers 17 to 20 fold. It is difficult to know to the standard of price change upon which the devaluation was based. Furthermore, it is not known how the budget plan was made, and whether the government managed the fiscal plan in an ordinary manner.

According to a study of South Korea, 40 to 50 billion won worth of public bonds were issued, estimated to be around 10 percent of the budget (Zhang and Wang p.53). According to that study, a nominal budget is 400 to 500 billion won, compared to a value of 25.3 billion won and estimated on the basis of the rate of increase in the budget, the inflation rate has been about 1800 percent since the reform were implemented.

Problems remains the bonds will be sold out or not? Are payments to bond holders guaranteed? As to who will purchase the bonds, a cabinet advertisement concerning the issue of Peoples Living Bonds, said that bonds will be sold “based on people’s high patriotism and civil awareness” (Radio Press 2003 No.5 p.21). In view of this statement, the government may force the people to purchase bonds in the name of patriotism. Under hyperinflation, those making money on the black market or those in the privileged classes may not have any problems purchasing bonds. On the other hand, those who never had much savings to begin with and are barely subsisting under hyperinflation will be forced to give up any minimal cash reserves. Inflation has already shrunk the value of their meager cash holding, but if they don’t buy the bonds they will fall prey to suspicion of being unpatriotic and possibly face further problem.

Under the current situation where hyperinflation is left alone because it can not be controlled even if the bonds are reimbursed in five years, the nominal value of the money will be little more than trash paper. With a large debt to its own people, the regime may feel justified in creating an inflationary economic state.

If revenue from the bonds is used for economic development, an optimistic view might argue that revenue from state enterprises will increase, making it possible to reimburse the bond holders. On the contrary, if the bond issue is used to increase the state deficit or for the military, bond reimbursement itself will become dangerously difficult. Realizing the advantage of forcing people to
purchase bonds, the government may be tempted to issue bonds every year, and in five years when reimbursement time approaches, the government may be tempted to issue additional bonds simply to finance reimbursement.

(Figure 1) North Korean Fiscal Revenue
(million of won)

Notes:
1. No official announcement in 1995 and 1996. Only the rate of increase was published from 2002 to 2004.
2. North Korea announced only rate of increase in 2003 and 2004, thus the budget figures were 2001 price. Because of the severe inflation as a result of price reform in 2002, the nominal budget scale in 2003 must be much larger than that indicated by the rate of increase.

2. Economic Relations between North Korea and Its Neighbors

Economic exchanges between North Korea and neighbors will be examined. Trade conditions are indicated in Figure 2. The Soviet Union used to be her primary trade partner, after the its breakup, China became her primary trade partner, followed by Japan and South Korea.

At the end of 2002 because of the suspicion of North Korean nuclear activity, crude oil supplies from KEDO were suspended. Since then, China has provided more than 90 percent of North Korean energy needs. However, in 2003 Russia exported 413 thousand tons of oil products to North Korea. Since its breakup, Russia had only exported about 100 thousand tons of oil product to North Korea. If the six parties talks is successful, it is conceivable that with Japanese and South Korean fund, Russian crude oil will be exported to North Korea.

In 2003, increases in Chinese exports to North Korea largely reflect in price to increase of crude oil. Quantity also increased by 21.5 percent (573 thousand tons), but nominal value increased 58.2

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2. Calculate by author(Source: Radio Press “Kitachousen Seisaku Dokou”2004 No.8 p.12)
percent. In terms of price per ton, it means an increase of 31.3 percent. As a result of world crude oil price increases, the average increase of China’s crude oil export price was 20.7 percent. In the same year, China exported 349 thousand tons (worth $49.95 million) of grain and $63.62 million worth of meat products to North Korea.

North Korean trade with South Korea has two types: a normal trade of exchange types (South Korea treats trade with North as domestic exchange), and a non-exchange type dealing with materials related to KEDO. Contractual processing amounted to no more than $800 thousand in 1992, but increased to $185 million in 2003 comprising a quarter of the total exchange value. Until 1998, more goods went to the South from the North, but because of increases in non-exchange types of materials, the movement of goods from the South to the North increased, and by 2003 the South had a surplus of $145 million.

North Korean trade with Japan has decreased substantially, especially Japanese exports to North Korea, because Japan enforced “catch-all regulation” that meticulously inspect export goods suspected of potentially being used for weapons of mass destruction. That export of any suspicious goods was discouraged.

In trade between Russia and North Korea, the increase in Russian oil exports in 2003 was described above. Prior to 2002, the main Russian export items were steel products and other manufactured goods, not oil. However, since 1991 trade with Russia, with only a few items being traded, did not play any significant role in the North Korean economy. Trade with the Russian Far East is at minimal level, although it appears that North Korea still exports labor forces to that region.

Sources: Custom statistics of each country.
China’s aid to North Korea in the latter half of 1990 is shown in Table 1.

Table 1. China’s Aid to North Korea

<table>
<thead>
<tr>
<th>Year</th>
<th>Description</th>
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<tbody>
<tr>
<td>1990</td>
<td>Jiang Zemin promised annual aid of 500 thousand tons of grain, 1.3 million tons of crude oil and 2.5 million tons of coal.</td>
</tr>
<tr>
<td>1995</td>
<td>Aid of 3 million yuan (100 thousand tons of corn)</td>
</tr>
<tr>
<td>1996</td>
<td>May: at time of Hong Seng Nam’s visit, 20 thousand tons of food aid. August: at Huang Jang Yop’s visit, 100 thousand tons of food aid.</td>
</tr>
<tr>
<td>1998</td>
<td>April: 100 thousand tons of food and 20 thousand tons of chemical fertilizer. October: 80 thousand tons of crude oil.</td>
</tr>
<tr>
<td>1999</td>
<td>June: at Kim Yong Nam’s visit, 150 thousand tons of food and 400 thousand tons of coking coal.</td>
</tr>
<tr>
<td>2000</td>
<td>May: Kim Jong Il’s unofficial visit, food and other goods.</td>
</tr>
<tr>
<td>2001</td>
<td>January: Kim Jong Il’s visit, China announced aid of 200 thousand tons of food, 300 thousand tons of diesel fuel.*1 March: Aid at time of Ceng Qingguo’s visit to North Korea.</td>
</tr>
<tr>
<td>2002</td>
<td>April: 50 million yuan worth of goods (90th anniversary of Kim Il Sung’s birth)*2</td>
</tr>
<tr>
<td>2003</td>
<td>October: Aid at Wu Bang Guo’s visit to North Korea.*3</td>
</tr>
</tbody>
</table>

Sources:
1990: Information from a source at the research institute under the Foreign Ministry.
1995: Information from a source at the research institute under the Ministry of Foreign Economic Relations and Trade.
1996 to 2001: Reconstructed from Chinese Academy of Social Science, Chaoxian Bandao Ziliao Shujuku, (CD Rom)

*1. These numbers were repeated when Jiang Zemin visited North Korea in September but only the North Korean side announced them. It is possible that North Korea may have announced them to show its displeasure for not implementing what was promised in January.

*2. In September of 2002 and July 2003, 20 thousand tons and 10 thousand tons of diesel fuel were imported respectively (Asahi Shimbun, July 17, 2003).

*3. A researcher in Jilin Province stated that the amount was 200 million yuan. (No official confirmation)

Concerning the import of foreign capital and investments, another pillar of the open door policy, North Korea implemented the Joint Venture Law in 1984. However, in reality, it did not develop in North Korea because North Korea was afraid that foreign capital would also bring in outside information as well, and therefore, at the time was reluctant to accept foreign capital. However, other than firms owned by Korean residents in Japan, some Chinese and South Korea companies also invested in North Korea.

North Korea created the Economic and Trade Zones targeting China and South Korea as potential clients. Those for South Korea were industrial zone set up in Kaesong near the 38th parallel and in the Kum Kang San tourist zone. There was also a plan to set up Special Administrative Zone in Shinuiju near the China and North Korean border.
Kaesong is a North Korean city located near Panmunjom on the 38th parallel that divides North and South Korea. Following the North and South summit of June 2000, in August of the same year Kim Jong Il and Chung Mong Hun, Chairman of the Hyundai Asan Company agreed to construct an industrial zone in Kaesong.

On November 20, 2002 North Korea adopted the Law of the Kaesong Industrial Zone. The Law consisted of 5 chapters and 46 articles (with 3 attached articles). Article 3 limited investors in the zone South Koreans, Korean residents in foreign countries and resident aliens and economic organizations. The law also guaranteed favorable economic activity in the sectors of employment, land use, and taxation. Land lease period is for 50 years (article 12). South Koreans, Korean residents abroad, and foreigners and their means of transportation were allowed to enter the zone from the South Korean side at designated entrance without visa but with entrance and exit permission issued by the Industrial Zone Administrative Organization. (Any other entrance will be determined) (article 28).

The enterprise income tax rate is set at a lower rate than in the general regions. It is set at 14 percent of profit, while the rate is 10 percent for infrastructure, light industry, and advanced science and technology areas. (article 43). Article 44 determined that foreign currency can be freely brought into or taken out of the zone and that profits or other income earned from economic activities can be remitted or taken to South Korea or to foreign countries without being taxed.

After the passage of the law in late 2002, an initial groundbreaking ceremony for construction of the zone was held in June 2003, at a time when suspicion of North Korean nuclear activity was once again swirling. First stage construction of the zone was completed by the end of June 2004. Although plans hoped to attract about 300 companies by 2007 in such field as textiles, shoe making, leather, and clothing industries, by 2004 only 15 companies had decided to move in (Asahi shimbun, July 1, 2004).

Kum Kang San is a famous tourist spot on the Korean peninsula. When Chung Ju Young, then the honorary Chairman of the Hyundai Group, visited North Korea in 1992 he announced plan to develop Kum Kang San. In October 1998, an agreement concerning Kun Kang San tours was signed, and the following November the ship “Hyndai Kum Kang” set sail with 1356 tourists for 4 nights and 5 days to North Korea. The tour was carried out under strict controls to prevent any contact between the tourists and North Korean residents. In January 1999, Huyndai Group and North Korea held negotiation meetings on comprehensive Kum Kang San development projects. According to the plan at the negotiation, the Hyundai group was to develop land, construct golf courses, ski resorts, marine museums and hotels in three phases: a giant project with investment of 1 trillion 566.5 billion won ($1.35 billion).

However, because of the Hyundai Group’s management problems since the Asian economic crisis of 1997, Hyundai’s North Korean development projects suffered a setback. Nevertheless, in 2002 North Korea announced the Supreme People’s Congress’s bill on the establishment of the “Kum Kang San Tour Zone” (October 23) and another bill by the same Congress called the “Kum Kang San Tour Zone Law” (November 13). According to the law which consists of 29 articles, tour or tourist business can be undertaken by South Koreans, Korean residents abroad as well as foreigners.

Lists of warnings included prohibitions on photography and communication devices not related to the tours, and so on. From the South Korean side, South Koreans, Korean residents abroad, and foreigners could enter or exit from the tour zone from designated routes without visa but with permits issued by the South Korean Zone Administration Organization.

In September 2002, North Korea established the Special Administrative Zone in Shinuiju near the Chinese border and appointed Yang Bin, the second richest man in China, and who also held Dutch citizenship governor of the special zone. Chinese police authorities, however, put Yang under house arrest for suspicion of tax evasion and other offenses (Asahi Simbun October 4 2004, evening edition). Question remain: why was a person such as Yang appointed to the governor. Why was Shiuiju designated a Special “Administrative” area but not an “Economic” zone.

On September 23 of the same year, at a news conference Yang Bin explained his ideas about the structure of the Special Administrative Zone: 1) settle 200 thousand young Chinese and North Korean technicians and laborers in the zone; 2) employ a European as the Minister of Justice; 3) more than half of the 15 members of the legislature will be foreigners; 4) no visa requirement for foreigners; 5) no custom duties for imports and exports and an income tax rate of 14 percent; 6) the official languages will be Korean, Chinese, and English, and official currencies will be either dollars or Chinese yuan. Yang further announced a few days later on September 27 that electricity will be purchased from the Northeast region of China who enjoyed a surplus; and for infrastructure construction the Zone government will call for foreign companies to participate in international bidding (Nihon Keizai Shinbun September 25, 26, 28 2003).

North Korea expressed displeasure at Yang’s idea that foreigners can enter North Korea without visa claiming that Yang has just announced his personal views without prior consultation with the appropriate authorities. Perhaps North Korea had some legitimate disagreement with Yang’s policies. However, the “Basic Law of the Shinuiju Special Administrative Zone” adopted in September 2002 clearly stated in article 2 that the central government cede legislative, administrative, and judicial rights of the zone and article 3 stated that the law will not change for fifty years. Article 3 allows foreign currencies to be taken into and out of the zone without any restrictions. Clearly, these articles are quite different from those applied to other special economic zones.
Why was Shinuiju designated a Special Administrative Zone? Hong Kong is an example of a Special Administrative Zone. In the case of Hong Kong, China created it to retain capitalism there for fifty years until 1997 when Great Britain was to return Hong Kong to socialist China. It was a system established to retain the advantages of capitalistic Hong Kong as a financial city and a base for transit trade. The plan also eliminated any fears harbored by Western countries by guaranteeing free economic activities there. For these reasons, China gave Hong Kong the right for self rule except in areas of foreign relations and defense.

In view of the Hong Kong situation, questions remain: Why should Shinuiju, a region within the North Korean border, be a Special Administrative Zone with legislative and judicial rights? Why did not the special economic zone do so?

If the goal is to attract foreign investment and earn foreign currency through assembly industries, then the coastal regions or areas close to South Korea are more attractive (As stated above, the Kaesong industrial zone has been established). For such purposes, the most important thing is to create a ‘special zone’ in a place where assembly industries can be easily implemented. Surely, if a special zone is established near the Chinese border, it will be possible to procure investment from China and to utilize Chinese electricity, but whether it will be easy to earn hard currency is not clear.

Rumors speculated that China arrested Yang Bin because he was planning to create casinos in the zone, which China wanted to prevent. Earning foreign currency will benefit North Korean economic development, must also be advantageous for China as well. China was forced to object to Yang’s methods.

As for using China’s electricity, difficult problems still remain. For example, electricity from the Shuifeng dam was going to be used by both China and North Korea, but there have been some problems because North Korea failed to pay. An additional use of China’s electricity seems difficult unless North Korea can guarantee payment.

Yang Bin was sentenced to 18 years in prison by the Intermediate People’s Court of Shenyang City in July 2003. Ke Sung Hae, the First Chairman of the North Korean External Economic Cooperation Promotion Committee, was appointed the new governor of the Special Administrative Zone (Radio Press No.9 July 31, 2003).

In 1991, an Economic and Trade Zone was created in the Rajin and Sonbong region near the Tumen River in North Korea. The area was initially called the Free Economic and Trade Zone, but Free was erased in 1998, and concern has been raised for the increased difficulties of the foreign enterprises there.

These four special zones are far from the center of North Korea and have been established at the “four corners” of the country. Despite its desire to foreign investment, one can observe North
Korea’s painful attempts to minimize contact between her people and “outsiders.”

3. Impacts to Avoid

As “deserters” from North Korea increase, some expect that this may lead to a North Korean soft landing, a phenomenon similar to the “European Picnic” of 1989 where a massive exodus of East Germans from Hungary into Austria took place. Is that possible in North Korea? North Korea allows no freedom of movement within the country, and it is difficult to move near the border. One must not forget that the countries that share a land border with North Korea are China, Russia, and South Korea. Barbed wires exist along the 38th parallel border with South Korea. Although South Korea has removed landmines on its side, the North still retains a buried minefield, a huge deterrent to crossing the border. Deserters crossing the border into Russia will find it very difficult to obtain temporary hiding places until they reach South Korea, explaining why most deserters go to China first and then aim for the South Korea. That is also why many deserters are from the North Korean region near the Chinese border. Even if some are able to move closer to the Chinese border, actual desertion is still difficult. Therefore deserters inevitably head for Tumen River that shares a border with the Jilin Province and the Yalu River with the Shenyang Province of China. For these reasons, many deserters go toward the three provinces of Northeastern China where ethnic Koreans live, especially Jilin Province. From July 2004, Chinese border patrol duties were transferred from Police Border Guard to the People’s Army Border Guard.4 Perhaps China needed to show North Korea that it is strengthening its border patrol.

China’s policy toward its ethnic minorities, unlike the former Soviet Union, has generally been regarded as good because her minority groups comprise 7 percent of her total population. Nonetheless, there are still 1.92 million ethnic Koreans in China (2000 census), and in Jilin Province the share of minority population totals 34.75 percent (China Statistical Yearbook 2003, p.43). There also exists a subtle feeling of distrust between the Chinese and Korean. If a large number of North Korean escape Jilin, feeling of distrust may come into the open. Besides, at present, because of the current state of relations with North Korea, China must discourage the deserters.

Even the desertion of a large number of North Koreans will have little impact on the “Kim Jong Il Regime.” North Korea as a state or the North Korean people in general, and the “Kim Jong Il Regime” are separate entities, which is a definite difference from East Germany.

In North Korea, such a massive population movement as the “European Picnic” would be difficult. If North Korea collapse (even though author does not agree with such an idea), the question is where the people can be accepted. Of course, not all of the present North Koreans will go abroad.

However, if domestic economic activities stop and the current severe system of controls disappear, it is conceivable that about half of the population may seek food and shelter abroad. In that event, since the general population has no money they may have no choice but to go to neighboring countries connected by land. For example, Liaoning and Jilin Province have populations of 42.03 and 26.99 million respectively. If half of the North Koreans, 11 million, go into these two provinces, their population will increase by 15 percent. Moreover, in both provinces the actual rate of unemployment and the sum of city registered plus temporary laid off xiangang workers are at a record rate of about 15 to 18 percent. The region suffers from a continuous economic recession known as the “Northeast Phenomenon.” For such reasons, they would have extreme difficult taking care of refugees.

A similar situation exists in South Korea. A massive influx of immigrants from the North would be a heavy burden on its population of 47.64 million. If part of North Korean would go to South Korea, new increases in population of 20 to 30 percent would inevitably decrease the living standards of South Koreans by 20 to 30 percent or even more for some time. North Korean deserters to South Korea would at first be temporary settled in assistant centers to familiarize them with South Korean life before being sent out into actual society. Inevitably some of them would never get adjusted to life in South Korea and, doomed to spend, frustrated life of resignation. Observing the case of Germany, one realizes that merging a capitalist with socialist society is extremely difficult.

For the impacts on neighboring countries and regions of North Korea, some movements favor economic sanctions against North Korea. Japan prepared for possible economic sanctions by reforming foreign exchange laws. Her Diet passed laws to embargo specially designated ships, although the prime minister stated that he is not going to implement them at the present time. In 2003, a “catch-all regulation” was enforced that prevented the exportation of materials suspected of being used for military purposes. As a result, the export of large trailer used as launching pads for mobile missiles was controlled, and exporters themselves increased self-restraints on exports of suspicious materials. Consequently, in 2003 Japanese exports to North Korea decreased by 25.9 percent from the year before.

For effective economic sanctions China and South Korea, who are the largest and second largest trade and investment partners of North Korea, must participate with Japan in economic sanctions. The embargo on specially designated ships will cause adverse impacts on Korean citizens in Japan who repatriated to North Korea after the 1960s. They went to North Korea because they believed in a “paradise on earth.” But what greeted them was suspicions about their opinions because they came from Japan, they endured economic hardships because they were unable to find jobs using their ability and qualifications. The only thing that supported them was money and goods from relatives who remained in Japan. Money brought into North Korea by relatives visiting from Japan and given to the repatriates was not seized by the government, although remittance through banks must be submitted to the government. If North Korean ships are placed under an embargo, the
adverse impacts on repatriates will be great because most such visiting relatives from Japan use the ships to visit their relatives in North Korea..

Is there a possibility that China and South Korea will implement economic sanctions? For instance, if China carries out economic sanctions, there will be enormous negative impacts on North Korea the flow of energy from abroad will trickle to almost nothing. If China makes a “threat”, by dropping a hint of economic sanction at six party talks, it may have enough leverage to steer North Korea into a direction she wants. Until the third six party talks, there was no evidence that China planned to make any such attempt. Perhaps China wishes to avoid influence on the American presidential election or just hopes to monitor the situation to encourage a change from the American side first. If China uses that most potent weapon called economic sanctions, it will be apparent that China is lending a helping hand to North Korea’s collapse. China may be hoping for a Libyan solution to the North Korean problem. However, China may encounter a situation where it has to convince North Korea A researcher in China at the end of 2003, told the author that China, without announcing to the world, may possibly impose economic sanctions against North Korea. Moreover, China may not be able to use its ultimate weapon or “last resort” against North Korea without definitive evidence that North Korea has nuclear weapons.

South Korea at present is not able to impose economic sanction against North Korea. For South Korea, the breakup of the North by economic sanctions would have great negative impacts that would bring economic confusion to in the South.

4. Possibility of Improvement

Can there be changes in North Korea? An indication of possible changes was the 7.1 Economic Management Improvement Measures adopted in July 2002. The measure changed wage policy from a system that used to pay “equally to those who work and who do not work” to payment of wages “based on the extent of work and the extent of earning.”(Sekai p.249 November 2004). It also raised the almost free rent or free transportation fees to rates comparable to the wage increases. Wages were increased 30 fold for mining workers and 17 to 20 fold for government workers. In other words, the rate of wage increases for workers in hard labor was greater than those in other fields. In the case of rice, the government used to purchase it at 0.6 won per kilogram and sell at 0.08 won, subsidizing it at a loss, but it shifted to a purchase price of 40 won and a selling price of 44 won. The rampant black markets that existed because of shortages were shutdown, and goods were distributed through state-owned stores.

Although wages were raised, workers were still unable to find work, and enterprises were unable to pay wages because of the basic problem of energy and materials shortages that were never been solved. Prior to the improvement measure being put into practice, workers in general used to be engage in various side jobs to supplement their incomes. After adoption of the measures, however
the lives of workers became more difficult because they had to stay in the factories all day because of the increased wages. Despite increased prices “electricity was supplied to factories only four days a week and for only about two hours” (Yomiuri Shinbun, August 23, 2003), a quotation that vividly describes the shortages of electricity and raw materials. Eventually, the implementation of price reforms under severe shortages only invited hyperinflation.

Although black markets have been shutdown, there never was any change in the availability of goods and, therefore, any available goods were driven further underground. For these reasons, black markets were inevitably resurrected into officially sanctioned “comprehensive markets.” Under the new environment, those with some sort of connection to China or access to foreign currency had increased opportunities to make money by smuggling, and thus after the reforms differences in income levels became even greater.

Some say that the Economic Management Improvement Measure, adopted in July 2002, was adopted with the expectation of economic aid from Japan subsequent to visit of Japanese Prime Minister Koizumi to North Korea in September 2002. Undoubtedly, Japanese economic aid would have resulted in the construction of infrastructure. But, price reforms would not have expected results because the production of consumer goods and food output were not likely to recover immediately or even in a short period. Finally, despite some efforts through the “7.1 measures” to bring about some reforms and plans to improve the economy, reforms ignored the proper sequence and simply ended up causing large side effects.

North Korean acceptance of six parties talks is another positive indication that gives a feeling of changes. Meetings were held in August 2003 and in February and June of 2004. There exists a huge gap between the US, who demands verifiable, complete, and irreversible relinquishment of nuclear activity by North Korea, and North Korea who demands the right to maintain peaceful nuclear activity and a firm promise for the guarantee of the regime. At the June 2004 meeting, the US proposed the following: 1) General Secretary Kim Jong Il’s announcement of nuclear denouncement; 2) energy aid from Japan, South Korea, China, and Russia and US guarantees of the provisional safety of North Korea; 3) the dismantling and removal from the country of all nuclear establishments and equipments; and 4) negotiation to normalize US and North Korea relations (Asahi Shimbun June 25, 2004).

From the North Korean side, someone at the US-North Korean bilateral meetings stated that “a powerful section of North Korea is controlling nuclear activity…and the longer the negotiations drag on, the greater the possibility of displaying nuclear capability by experiment (Asahi Shimbun June 26, 2004(evening edition)).” Some changes in North Korea can be felt from such statements, it is not “the nation” but only “a section” that is interested in nuclear experiments, and that they are willing to take the US proposal home for further reevaluation.
The Libyan policy, which renounced nuclear ambitions to achieve the diplomatic relations with the US, may provide hope for the North Korea that desires the maintenance of the “Kim Jong Il Regime.” North Korea may have found a different path from Iraq, who was attacked despite its disarmament. If retaining the “Kim Jong Il Regime” and energy aid can be achieved, North Korea may find that it is easy to accept a comprehensive renunciation of nuclear ambition. However, the Libyan model may be difficult to apply if North Korea does not think that US will be attack North Korea, as she did against Iraq, because of the geo-political characteristics of North Korea, surrounded by China, Russia, and South Korea.

Perhaps what neighboring countries fear most is the “hard landing” of North Korea. A massive influx of refugees will create huge confusion, with exception of Far East Russia where labor is in short supply. It would be difficult to take over an economically devastated North Korea. Infrastructure, for example, is insufficient to construct electric generating stations because of highly inefficient power grids with heavy leakage of electricity. In other words, the construction of power generating stations alone will not be useful, unless an entire power grid is reconstructed. North Korean can produce industrial output if the supply of energy and raw materials can be met. Agricultural production can also reach adequate levels if seed grain, fertilizer, and agricultural pesticides are available, and thus the economy will be able to map a scenario for self sufficiency for the first time in many years.

For the costs of unification, discussions started in the mid-1990s when the results of East and West German unification became clear. Although East Germany was a wealthy and industrialized country in Eastern Europe, the economic costs to West Germany were substantial. Avoiding a large migration of East Germans to West, the exchange rate between East and West marks was made favorable to individuals in East Germany, different exchange rates were set for debts and savings.

There also were costs for the privatization of East German state enterprises. Since East German enterprises were very inefficient and burdened by an inherited welfare system and surplus employees, no foreign companies were interested in them and, therefore, no foreign investment was forthcoming to East Germany. Ultimately, the financial burden on the former West German government increased. In the privatization process, as a result of rationalization, a large increase in unemployment took place, which necessitated increases in social insurance costs.

The costs of unification were initially estimated to be about 30 to 40 billion marks per year, but at times reaching 150 billion marks which comprised 10.5 to 31.4 percent of the annual budget of the former West Germany. It also had to bear the burden of assisting the Soviet Union to recognize German unification. Despite a large burden of the former West Germany, the dissatisfaction of the former East German citizens grew because of increased unemployment and income gap between the

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5 The research was done by Ministry of Foreign Affairs of Japan (not published)
two sides. For those used to a life of unlimited government subsidies, the adjustment to a competitive and capitalist society was extremely difficult.

In view of the realities of German unification, South Korean began to realize the difficulty of unification with North Korea. In particular, the North Korean economy is in a substantially more desperate situation compared to East Germany at the time of unification, and so it may require huge expenditure for reconstruction of infrastructure, restoration of agricultural output, and maintenance of employment levels. A 1995 study estimated the cost of Korean unification to be about 448 billion to one trillion 800 billion dollars (28 to 56 percent of annual South Korean budget). Differences in estimates reflect different goals of unification; that is, whether expenditure lasts until the North Korean economy becomes self-sufficient, or until per capita income in North is half that of South, or until incomes reach the same level on both sides. Cost estimates also depend on the estimated length of time required for unification as well.

For the South Korean economy to avoid ruin and the simultaneous collapse of North Korea, somehow it must help North Korea extract herself from the “lower depths.” Only though such assistant from the South will, in real sense, North Korea lead to a soft landing. One must not forget that, unless North Korean economy is restored, attaining any kind of stability in neighboring countries will be difficult.

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