KET Issue Report

North Korea's Economy and North-South Exchange

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I. Price Reform

Price reforms brought needed change, but they were not necessarily successful

In a dramatic move on 1 July 2002, a sweeping price reform was introduced in North Korea. Since then, the North Korean regime has added merits of the market economy to its planned economic system.

North Koreans strive to adapt to the policy change, accepting a new economic mindset. In the past, they used to get daily necessities and housing at lower prices under government subsidy. With the price reform, however, they now must buy all their necessities with their salary; and they must increase productivity in order to get more incentives for their production.

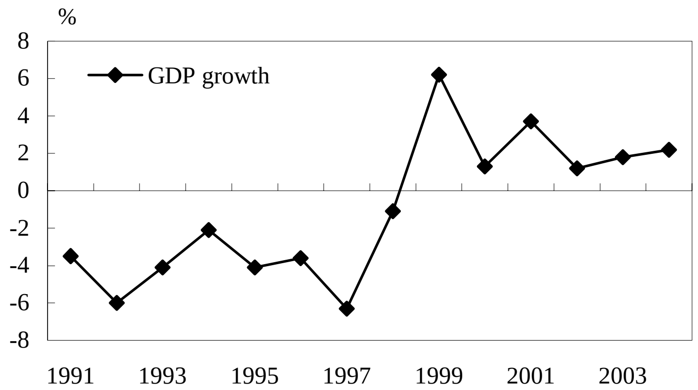
Even Internet users have appeared in the North Korean capital of Pyongyang. Young college students have taken to exchanging information and opinions through the Internet. Not only that but also Pyongyang Sinmun, a local Internet news site, runs commercial advertisements on its website.

North Korea's state-owned companies struggle to improve productivity and boost sales. Aware that increased sales lead to higher incentives, companies compete to outdo their rivals. For example, Pyongyang Cosmetics Factory is even imitating Sinuiju Cosmetics Factory, which has produced a popular brand called “Bomhyanggi” (Spring Scent). Today, around 500 restaurants operating in Pyongyang compete with each other through distinct culinary fare, improving menus and lowering prices.

Investment patterns have also changed. Despite low demand, the March 26 Factory, a cable manufacturer, has invested in facilities to meet future demand. In the process of pursuing joint-venture projects with Chinese companies, some North Korean companies regard themselves as private companies at the stage of nascent development.

Despite these reform steps, the North Korean economy shows a meager 1 to 2% growth rate. In real terms, the economy may have even contracted due to high inflation and its small annual GDP estimated at about US$23.8 billion. The situation runs counter to the regime’s argument that its economy has grown following the announcement of the 2002 reforms.

North Korea's GDP Growth



Source: Bank of Korea

The regime's efforts to boost food production have been ineffective. Despite placing priority on the agricultural sector, a drop in the food aid from the international community has resulted in a severe food shortage. Under the newly adopted economic system, people have to buy food on the open market, unlike high-profile politicians and the armed forces who receive food rations from the regime.

The reform was intended to allow "official" price levels to reflect prices on the black market. However, the price of rice has risen to pre-reform black market price levels. Furthermore, state-owned stores are unable to provide necessary goods, causing consumers to flock to the free market (formerly called the farmers' market), and triggering inflation. North Korea can no longer meet the rising demand of consumers with its limited resources, which means that the reform policy has failed to improve the quality of life for North Koreans

II. Slow Exchanges

South Korean companies are sitting on funds that could potentially be put to good use as investments in North Korea

South Korea's foreign direct investment (FDI), the growth of which had slowed since 1997, has risen dramatically since 2003. In 2004, it increased 50% from the previous year, to a record high of US$5.8 billion. The largest chunk of investment has gone to the manufacturing sector in China. South Korean corporate FDI in China has rapidly increased from 27.4% in 2002 to 37.9% in 2004. And, investment in China's manufacturing sector has similarly jumped from 47.3% in 2002 to 59% in 2004. South Korean companies are increasingly moving their manufacturing facilities overseas because of the unfavorable business environment in their own country.

Goods made in China are rapidly making inroads into the South Korean markets. China accounted for 13.2% in South Korea's total imports in 2004, up from 8% in 2000. In value terms, South Korea's imports of Chinese goods more than doubled from US$12.8 billion in 2000 to US$29.6 billion in 2004. Goods made in China have rapidly replaced Korean merchandise in the mid to low-end markets.

In view of the fact that South Korean companies, especially small and medium-sized enterprises (SMEs), have lost market share in their own country, their idle production capacity and resources can be diverted to North Korea. In 2004, South Korean SMEs made FDI worth US$2.2 billion across 1,695 projects. Of these, 1,099 projects worth US$1.2 billion went to China. A considerable portion of these resources directed towards China and other countries could be redirected towards North Korea. South Korean companies investing in the North could threaten Chinese companies' market share in the South, which amounts to US$30 billion.

For all that, the North-South economic exchange has yet to turn such rosy prospects into reality. The North-South summit talks of 15 June 2000 have led to re-linking of railways and land roads, and opening of an industrial park outside the border city of Kaesong. Even so, private sector investment by the South remains insignificant. Since 1995, 57 companies in the South have received licenses to do business with their North Korean counterparts. But few companies, outside 15 companies that have already applied for operations inside Kaesong industrial park, have actually invested in the North.

Making matters worse, the North-South political dialogue has remained suspended since July 2003, prompting companies in the South to reduce their investment in the North. Only humanitarian aid continues. Apart from the negative effects from suspension of bilateral talks, South Korean companies' interest in the North has gradually waned. As an example of this trend, even the volume of commission-based processing trade – the North sending to the South garments made from fabrics supplied by the South and finished on South Korean sewing machines – has decreased.

Uncertainty still lingers over the operation of the Kaesong industrial park, a model project of what bilateral economic cooperation could achieve by combining the South's capital and technology with the North's land and labor. The US bans imports of goods made in Kaesong while it also bans export of strategic material to the North. South Korean employees gain access to the North Korean industrial park only with official permission from the military authorities from both the North and South.

The biggest obstacle to the North-South economic exchange is the sanctions imposed by the US. Since the US does not recognize normal trade relationships with the North, products made there are subject to the so-called Column 2 tariff rates which amounts to 80% of the value, or 10 times higher than the general tariff rates. Accordingly, products made in the North can only be exported to the South, China, or Russia without any disadvantage.

In addition to the prohibition against the export of strategic materials to North Korea, the Export Administration Regulation (EAR) of the US Department of Commerce makes it difficult for South Korean companies establishing manufacturing facilities in North Korea. The EAR has put a brake on South Korean companies' efforts to pursue joint projects with the North. For example, the 15 South Korean companies operating inside the Kaesong industrial park had to wait three months to find out whether their business violated EAR regulations.

III. Outlook

An open economy and good relations with the US are critical to North Korea's economic reform process

No country can successfully pursue economic reform without market-opening, and North Korea is no exception. Immediately following the introduction of price reforms, the North Korean regime designated Sinuiju, Kaesong, and Keumgangsan (Diamond Mountain) as special economic zones as part of efforts to open its economy, even though in a limited way. These efforts have not born fruit due to the North's nuclear confrontation with the US that unfolded in October 2002. In keen need of external help, the North has appealed to the South Korea for aid. Despite limited support from the South, and its own all-out efforts, the North does not appear to be having much success in achieving its goals.

It needs to put more effort into attracting foreign capital to improve its outdated manufacturing facilities, supply more raw materials to the manufacturing sector, and improve its infrastructure. The North's own distorted economic structure may pose a bigger threat to its fate than the economic sanctions imposed by the international community in the midst of a nuclear standoff. Since the North implemented the price reforms three years ago in preparation for the market opening, its hesitation to fully open its economy will further distort its economic structure. Unless more sincere efforts are brought to bear, the North could go the way of Russia, which tried unsuccessfully to reform its economy without first opening the market in the early 1990s, only to fail.

North Korea's successful economic reform depends on relations with the US. An improved relationship with the US can contribute to maximal effects of the market opening. The US role in the international community should never be ignored. It has provided financial resources to help developing countries to grow. The US market, which controls a quarter of the global economy, remains a major export destination for developing countries. It is the biggest export market for China.

Normalization of US-North Korea relations would open up the opportunity for the North to obtain foreign loans from the international financial institutions, other western countries, and South Korea. Such financial aid will enable it to improve the market environment and secure stable export markets. North Korea should have learned lessons from China and Vietnam that have successfully reformed and opened their economies after repairing relations with the US.

In the final analysis, the two Koreas need to cooperate closely to optimize mutual benefits. The South, for its part, is searching for new foreign investment opportunities. In the face of rising production costs, South Korea invests several billion dollars a year in China and other East Asian countries. Even though the North has the potential for becoming a profitable investment destination, it has been of little interest to South Korean companies because of political and military concerns. Stronger economic cooperation between the two Koreas will provide the South with a new overseas manufacturing base.

North Korean factories are struggling to survive a management crisis stemming from resource shortages. Once they have access to immediate and useful financial resources from the South, they can further pursue market reform and resolve economic problems.

China's collaboration with Hong Kong can be a good example for the two Koreas. In the early stage of market opening, China designated Shenzhen, adjacent to Hong Kong, as a special economic zone to draw capital from Hong Kong and overseas Chinese businessmen. Between 1979 and 1989, Hong Kong accounted for 57.4% of total FDI in China. On June 29, 2003, the two sides signed a Closer Economic Partnership Arrangement (CEPA) through which they acknowledged each other's role and maximized the synergies of economic exchange. Since the CEPA closely resembles a free trade agreement (FTA), it has led to the recovery of Hong Kong's economy that had suffered from foreign capital flight following its reversion to mainland China. This model of mutually beneficial economic cooperation between Hong Kong and China shows the way for the two Koreas to take.

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