

## North Korean Economic Reform Comparison with China and Vietnam<sup>1</sup>

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### Abstract

In July 2002, North Korea announced to implement a series of economic reform. This paper compares economic reforms of North Korea, China and Vietnam. Economic reforms in China and in Vietnam were put into action after major changes in political regimes had taken place, while North Korea has no real change in the political regimes and, therefore, it is inevitable that the reform is not going to be very comprehensive. In any reform, a proper “sequence” is important. In China, reform started in agriculture first and, after successfully solving the problem of “food”, reforms in other areas were carried out. North Korea is suffering from a rising inflation because price reform was implemented despite an acute shortage of goods supplied. In other words, North Korea ignored a proper sequence of reform. Vietnam was successful in controlling hyperinflation because of external pressure from IMF, whereas, there is no such outside pressure in North Korea. Both China and Vietnam implemented economic reforms simultaneously with the policy to attract foreign capital and solved the problem of capital shortage. In North Korea, although joint venture investment law had been announced in 1984, there is no progress in import of foreign capital and foreign technology. Inflation is rising in North Korea because it also failed to carry out a basic and a more comprehensive reform.

**Keyword:** North Korea, economic reform, hyper-inflation, sequence, adjustment policy, comparison with China and Vietnam

### 1. Reasons for Reform.

In July of 2002 it was reported that North Korea will carry out economic reform measures including price reform and depreciation of exchange rate. This paper attempts to compare North Korean reform with those of China and Vietnam to search the “meaning” of North Korean reform. It appears that North Korea calls series of reform as “measures to improve economic management”

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<sup>1</sup> Since author is not specializing in research on Vietnamese economy those source materials listed in the bibliography were used as primary references. It must be pointed out that the author, although did not cite in footnotes unless directly quoted, relied on these sources for thought process and information on Vietnam

and does not use the word “economic reform.” Nonetheless, this paper will refer as North Korean economic reform or reform in order to compare with economic reform measures of China and Vietnam.

The Table 1 below summarizes the main points of economic reform of North Korea, China and Vietnam. As to the “method of reform” some agricultural sectors had been carried out very rapidly even in China. “The sequence or order of reform” should be regarded as listing of approximate time of initial reform implementation, because the reforms in the state enterprises of China have not been succeeded as yet, and reform efforts in industrial sector have been overlapped with those of financial sector. It has been more than a quarter of century since the beginning of China’s reform and more than fifteen years have passed since the start of Vietnam’s Doimoi. In other words, reforms in China and Vietnam have been deeply committed and very much advanced. Attempts have been made, therefore, to compare present North Korean reforms with those of China’s at an initial stage, but depending upon the nature of North Korean reform, comparisons were also made with those of very advanced stages in China and Vietnam.

Table1. Comparison of North Korean Economic Reform with Those of China and Vietnam

	North Korea	China	Vietnam
Prior Condition	Decline of Sino-Soviet aids. Economic deterioration. Establishment of Kim Jong Il System(?).	End of Cultural Revolution. Re-emergence of Deng Xiaoping.	Slowdown of Rapid Socialization of South-Change onto Market Economy –Resistance of Conservatives.
Procedure	Not known	Gradual	Gradual. Shock Treatment in 1989.
Sequence	Price Reform First.	Agriculture→Industry→Finance→Labor	Agriculture and Industry→Change to Market Economy. (Price Reform, etc.)
Agriculture	Team system in 1997	Contract System, Raising Purchase Price	New Contract System in 1981, but Collectivization in South-Output Stagnation. Contract System in 1988 (including Private Farms)
Industry	Central Control(?)	Partial De- centralization in 1985.	Expansion of Output Plan and Finance Autonomy in 1987.
FDI	Joint Venture Law in 1984	Joint Venture Law in 1979.	Foreign Investment Law in 1977.
Foreign Trade	Devaluation against Dollar in 2002	Permit the Use of Foreign Exchange By Some Local and Other Authority	Unifying Foreign Exchange Rate in 1989.
Money and Finance	Unknown	Tax Replacing Profit, and Bank Loan in 1985. Divided Tax System in 1994.	Tax Reform in 1991.

Source) Author made, on Vietnam, refer Keiichiro Ohizumi "Vietnam" in Yonosuke Hara, ed. *Asia Keizai*, pp.275-294

In case of China, a successful reform of the existing system in agricultural sector has been carried out by an introduction of contract system and disbanding people's communes. The rapid rate of growth in China's industrial sector had been achieved by adding a "new territory" called township and village industry and foreign investment enterprises rather than a successful reform in state-owned enterprises, which occupied an absolutely dominant position prior to China's reform. To begin with, it should be made clear also that Chinese success has been in different segments of economy than those of North Korea and Vietnam.

## **2. Content of North Korean Reform**

According to Radio Press, the contents of North Korean reform supposedly implemented in 2002 are as following. "Measure to Improve Economic Management" was instructed by Kim Jong Il in October 2001 and includes the following contents<sup>3</sup>. 1. To boldly improve economic management and, with regards to planning, State Planning Commission should plan important objectives of strategic and national nature, while monthly plan and detailed plan should be done by local planning sections. 2. The price should be set by enterprises themselves under the supervision of superior agency. With regard to materials supply, socialist materials exchange markets should be organized and implemented. 3. Until now the cadres of economic sectors carried out management system with only objectives of production and construction without concern for waste in labor, materials and capital. From now on, one must be able to grasp the extent of real gain of output over inputs of capital, materials and labor. The methods and computation system of fiscal plan must be set up correctly and when there is a pressure on fiscal system, monetary control using won should be strengthened to encourage production activities. The measures include 4, elimination of egalitarian distribution; 5, improvement of wages and free assistance; and 6, development of sciences and technology and information industry.

As to the details, the following changes have been taking place since July of 2002. There had been some rumor that, as a part of price reform, rationing system was terminated. Because of extreme shortage, rationing in food grain is impossible to discontinue and, therefore, price of food grains has been raised while maintaining the rationing. Until the reform, state purchased rice from farmers at 0.6 won per kilogram and sold at 0.08 won thus suffering a great loss. But after the reform, purchase price of rice increased to 40 won per kilogram and selling price to 43 won per kilogram. Even when the official selling price of rice was 0.08 won per kilogram, black market price of rice had been at about 50 won per kilogram. Thus, the new reform in effect served to bring the previous black market price into an open stage. In other words, current price reform is to raise the official prices, which never had any real meaning because of prevalent black market prices, and make them more comparable to real market prices. The pork had been sold at black market called "farmer's

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<sup>3</sup> Radio Press *Kitachosen seisaku doko*, vol.10, August 31, 2002, pp 4-6.

market” at price of 60 to 80 won per kilogram but new government purchase price has been raised to 110 won per kilogram. The aim of such measure is to close down “farmer’s market” and to normalize distribution channels at the state stores.

Prices for important industrial products and imported goods were set at a much higher rate of increase. The price of coal was 1500 won per ton before but was increased to 44 fold, while price of electricity was raised to 60 fold from 2100 won per 1,000 kwh<sup>4</sup>.

The wages have been raised to be comparable to the new price level. As to the wage increase, coal miners have received 30 fold increases, whereas government workers seemed to have received 17 to 20 fold increase. In other words, wage increase was much higher for workers in heavy physical labor than those in non-productive sectors.

In accordance with wage increase, workers now must pay some amount for such basic living expenses as housing and water which used to be either free or almost free. For example, city bus fare increased 20 fold to 2 won, rent for 60 cubic meter rooms to 78 won per month and heating cost for the same size to 175 won.

The reason for introducing new performance based wage system was to remedy some of the ills of old free and egalitarian system. Until now “there were too many free things, and when egalitarian system was tried...it damaged worker’s zeal for labor” and, therefore, “wage for living should be calculated exactly to reflect the amount of work performed and the amount the worker has earned.” With regards to increase in price of food grain, North Korea emphasizes that food cost occupies no more than 3.5 percent of wage. On the other hand, it was pointed out that “in recent several years, when the state was not able to adequately ration food grains, many people abandoned their initial occupation and ran around to support their individual benefits by engaging in commercial activities.”<sup>5</sup> Thus, the officials recognized real existing problems and stated the reasons for necessity of price and wage reform.

Starting August 1 of 2002, exchange rate of won versus dollars was depreciated from 2.15 won per dollar to 150 won per dollar and foreign exchange currency was eliminated. In view of the fact that a dollar was exchanged at 200 won at black market before July of the same year<sup>6</sup>, a further depreciation of won may be called for in order to adjust to the real rate of exchange.

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<sup>4</sup> <http://www.bekkoame.ne.jp/ro/renk/kaidai.htm>. (It was allegedly pointed out by Kim Jong Il, in July 2002, in a lecture titled “Let us know well the national measures to totally improve price and living expenses, and strongly begin construction of prosperous great nation.”)

<sup>5</sup> Ibid.

<sup>6</sup> Asahi Shimbun, August 16, 2002

In the following sections, North Korean reform stated above will be compared with those of China and Vietnam, and attempts will be made to evaluate adequacy and validity of North Korean economic reform.

### **3. Precondition and Sequence of Reform.**

The reason for implementing economic reform in North Korea at this time is because the economic condition is extremely deteriorated. North Korea, claiming external causes, candidly admitted economic deterioration in 1990s. In reality, however, North Korean economy had suffered a series of setbacks prior to 1990s. From the beginning, North Korea heavily relied on aids from former Soviet Union and China for its economic construction. During the period of Sino-Soviet conflict, when Soviet aid decreased, North Korea had no choice but to postpone its long-term economic planning. Unreasonable speed-up movements of achieving plan targets frequently ignored economic rationale.

The question here is whether the present system of Kim Jong Il is a mere extension of Kim Il Song system or Kim Jong Il established his own autonomous system. It has been said that even during the period of Kim Il Song, Kim Jong Il had been in charge of economic management. Present policy of giving top priority to military does not appear to be much different from that of Kim Il Song period. Although Kim Jong Il allegedly had control of military since 1997, it is unclear as to whether or not Kim Jong Il was able to set up his own autonomous system of leadership. If Kim Jong Il system is only an extension of Kim Il Song system, the any future reform measures will not dare to refute the unique Kim Il Song style of socialism. Instead, the reform efforts will most likely to remain as no more than cosmetic changes.

When Kim Jong Il visited China in 2000, China reported that Kim praised China's reform and open door policy. In North Korea, however, it was reported that "the reform and open door policy is a 'Trojan Horse' that threatens stability of socialism."<sup>7</sup> As one can observe from the fact that North Korean officials never use the word "reform" to describe series of their measures of attempted changes, it is apparent that they are quite timid or less than full fledged in their efforts to really reform.

In case of China, after the end of Cultural Revolution and arrest of the Gang of Four, a change in policy of merely refuting Cultural Revolution to a new policy of reform and open door and to a new period of Deng Xiaoping leadership. The people, who were exhausted by ten years of political struggles, enthusiastically supported the reform measures that promise an economic improvement.

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<sup>7</sup> Marcus Noland, "Economic Integration and Cooperation on Korean Peninsula" (<http://www.iie.com/publications>) October 2000

Moreover, in China reform started in agricultural sector and, as production of food grains substantially increased and supply of food became abundant, the life of plenty that the people themselves can feel was guaranteed.

In Vietnam, after the unification of North and South in 1975, economy began to stagnate. The reasons for the stagnations are: too hasty socialization of South; Vietnamese military invasion into Cambodia in 1978 causing a freeze in economic aid from Western countries: and termination of aid from China who supported Pol Pot Party. In 1980, The New Economic Policy (NEP) was initiated but was met by a fierce opposition from the conservatives. However, Soviet aid, which had been the main source of fund and comprised a half of Vietnam budget, was drastically reduced after rise of Gorbachev into power and his review of Soviet aid policy. As a result, Vietnam was forced to adopt a new policy in order to be self-supporting in its national fiscal matters. At the same time, old political veterans, who led the national independent movement, retired from front line leadership positions and thus attempts are made to replace them with the leadership of younger generation.

As precondition of reform, both China and Vietnam had changes in political regime and started with refutation of previously existed situation. On the contrary, in North Korea Kim Jong Il regime not only refuses to refute previous regime, but instead treats it as the object of worship. For this reason, it is highly unlikely that a comprehensive reform, to the extent to refute errors of previous regime, will be ever implemented in North Korea. Instead, it may be inevitable to end up with less than comprehensive policy changes.

When carrying out reform, regardless of market economy or socialist economy, sequence of reform is the key to success or failure of the reform. With regard to sequence of reform, it is not an accidental coincident that both China and Vietnam started reform in agriculture first. It is because solving the "problem of food" for people is the most important starting point. At the same time, for less developed countries like China and Vietnam, industrialization must start with production of consumer products and export products that are competitive in the world market. In these cases, light industries that use agricultural raw materials occupied predominant position and, therefore, development of agricultural sector had been essential to industrialization in these countries.

Both China and Vietnam, during planned economy period, top priority had been given to heavy industries and light industries had been ignored for national prestige. Under reform policy, emphasis shifted to light industries producing mainly consumer goods. The primary reason for the shift is to produce more consumer goods in order to improve people's living standard and, therefore, it was inevitable to shift away from earlier policy of heavy industry emphasis. Another reason is that in both countries there existed development of small scale industries, that do not possess large capital to run heavy industry. In China, these are development of local and village industry and in Vietnam they are private sector industry.

In North Korea, agricultural sector had deteriorated to the extent that food rationing system cannot be touched. If price reform that sharply increase price level is implemented without restoration of outputs in agriculture and in industry, people will have no real feel for an improved living standard and realize only an increase in price level, thus most likely to induce a hyperinflation. The policy of priority in military industry is still in progress and there exists not a hint of restoring production of consumer goods. In other words, North Korea is attempting a reform that disregards a proper “sequence” by implementing price reform without planning to restore outputs either in agriculture or in consumer industry.

#### **4. Price Reform**

In socialist countries, because of official price control, apparent inflation does not take place often. However, under supply shortage, it is natural to have a “hidden inflation.” The shortage of goods is often source of creating an underground economy and is the main reason for many long waiting lines in front of stores. The shortage under price control also brought about fiscal deficits in these countries because of government fiscal subsidies to maintain the price control. In China and Vietnam, as they partially introduced market economy and as they increased open relation with the world economy, they were forced to change their existing pricing system.

In China, only small changes in price had taken place since 1950s. Only time when a large increase in retail price took place was 16.2 percent increase in 1961 after the disaster of the Great Leap Forward policy, and between 1963 and 1972, with exception of 1968, official price had decreased. Since then, magnitude of any increase in price had been less than one percent until the time of the reform and open door policy started. Of course, there existed actual shortage of goods supplied during that period. Because of continuous distorted price structure, it was inevitable to have a price reform by middle of 1980s. Immediately after the reform, a large scale increase in price of agricultural products by government brought about an increase in output of grains. The price incentive was much greater than expected, creating a substantial increase in agricultural output, and thus resulted in an increase in fiscal burden because of agricultural price subsidies. By then, the food grain, which is the basic necessity of everyday life, was permitted to be sold at the open market and it actually meant that price control had been relaxed in part.

In China the reform of industrial sector was formerly launched in 1984. However, because of distorted price structures, the reform did not bring about dramatic results as in agriculture. In industry, in order to convert traditional system of contributing profit to a new system of paying taxes instead, it was unavoidable to go through the path of price reform. In particular, problems are as the following: 1, relative price between the commodities was irrational and especially the prices of raw materials and energy were set too low; 2, differences in the quality of commodities are not reflected

in price; and 3, the payment of tertiary sector was too cheap<sup>8</sup>. Another reason for the inevitable price reform was the increase in fiscal subsidies, which is caused by an increase in government purchase price of agricultural products that created a greater gap between government purchase and selling prices. The price reform proceeded in industry by gradually decreasing number of products whose production level had been directed by government, and by permitting firms to freely set price, within limit of 20 percent above or below the fixed price, on commodities produced in excess of contracted amount. In the process, however, China recorded double digit price increases in 1987 and 1988. As the prices rise to double digit level and supply of commodities become short, there appeared bureaucratic brokers who made money by taking advantage of price differences. People's dissatisfaction toward these bureaucrats was one of contributing reasons for Tiananmen incidence in 1989. For that reason, price reform was discontinued for a while, but had been smoothly put into effect since 1990. In 1992, along with failure of monetary policy, inflationary pressure increased (consumer price increased 14.7 percent in 1993 and 24.1 percent in 1994), but since mid-1993 because of a gradual raise in official rate of interest and recalls of illegal loans, the policy of price reform finally succeeded to lower the rate of inflation to single digit of 8.3 percent in 1996.<sup>9</sup> However, because of continued tight money policy, there continued a deflationary tendency since 1998.

In Vietnam, at the beginning of 1980s, materials and commodities in state sector were sold at much lower price than in free market, and, therefore, the state subsidies continued to increase and budget deficit kept increasing.<sup>10</sup> This system of double pricing became a hotbed of underground economy and created merchants in black market.

On the other hand, as the Vietnam's trade partners shifted from primarily members of COMECON to Western countries starting in 1981, the domestic price was linked to the world market price and the price subsidies became discontinued. A number of adjustments in price and wages since 1981, and 5 to 7 fold increase in price in 1984, caused a situation where market price increased sharply while lowering the real value. Because of this, a policy of price and wage freeze was determined in June of 1985. Inflation continued, however, because no freeze on currency issue was implemented and money supply kept increasing. Because banks provided loans to enterprises at much lower rate of interest than inflation rate, the enterprises earned large profits just by taking out loans from banks and accumulating materials and commodities purchased with the bank loan.

Under the circumstances, inflation continued in Vietnam, and the rate of price increase at the end of 1985 was 91.6 percent, at the end of 1986 was really high level of 487.6 percent, and reached 310.9 percent at the end of 1987. Because of these phenomena, in 1989, on the basis of advice from

<sup>8</sup> Kyouichi Ishihara, "Kakaku kaikaku" in Reiitsu Kojima, ed, *Chugoku no Keizai Kaikaku*, (Keisoshobo, 1988), p.165.

<sup>9</sup> *Tongji ziliao huibian xin zhongguo wushinian*, p.21

<sup>10</sup> On Vietnamese inflation referred, Nguyen Thanh Bang, "Vietnam no Keizai Kakaku --Process, Naiyou to Hyouka" in Sueo Sekiguchi, and Tran Van Tho, ed. *Gendai Vietnam Keizai*, (Keisoshobo, 1992)

IMF and World Bank, complete elimination of price control, single exchange rate, reducing subsidies and introduction of high rate of interest were implemented. These measures of radically converting economy into a market system can be called a “shock treatment.”<sup>11</sup> These measures resulted in a dramatic effects and the rate of inflation decreased to 35 percent in 1989 and to mere 2.9 percent in January of 1990.

There is the similarity between recent North Korean “reform” and Vietnamese policy of bringing black market price, that caused a hyperinflation, into an open and make it official price, and to raise wages to accompany the price increase. The difference is that Vietnam was able to control inflation under strict management, mixed with diplomatic pressure, of IMF and the World Bank. A greater difference with North Korea is that in Vietnam, although the country was poor and goods in general were in short supply, output of grain (rice) was self-sufficient level (becoming rice exporting country from 1989) and, was never in a desperate situation where subsistence itself became a problem because of lack of food. In North Korea, where the state can continue to print money if it wishes (under no outsider’s control) and where the level of poverty reached a point of starvation, there is neither a guarantee that there will not be any hyperinflation, nor any measures to contain the inflation if it takes place.

## **5. Reform in Agriculture.**

In China, reform in agriculture started by converting collective agriculture of people’s communes to a form of production by family contract and responsibility system. This new system started in Sichuan and Anhui provinces in 1977 and instantly spread to entire country. Until then, government purchase price of agricultural goods was very low, but was raised in order to stimulate farmers’ incentive after the reform. The purchase price of grain, for example, was increased 20 percent on average, and on output in excess of planned purchase, the price was raised additional 50 percent on top of the 20 percent increase. In order to avoid a rapid increase in government selling price, the state had to subsidize the price difference and caused an increase in budget expenditure. At around 1983, average purchase price of six different grains including rice and barley was 23.57 yuan per 50 kilogram, while selling price was 14.43 yuan.<sup>12</sup>

Return of agriculture from collective agriculture to an individual or family based cultivation, along with the new pricing policy, was widely supported by farmers and the people’s commune was entirely disbanded by 1982. The total grain output, which remained at 300 million tons during the period of the Cultural Revolution, exceeded 400 million tons by 1984. On per capita basis, agricultural output in 1966 when the Cultural Revolution began was 287 kilogram. By 1977, the

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<sup>11</sup> Keiichiro Ohizumi, “Vietnam” in Yousuke Hara, ed. *Asia Keizairon*. (NTT Shuppansha, 1999), p.283.

<sup>12</sup> *Iwanami gendai Chuugoku Jiten* p.543.

year after the end of the Cultural Revolution, with an increase in population, the per capita output increased to mere 297 kilogram during the more than ten year period. However, after the reform the output increased to 390 kilogram per head by 1984.<sup>13</sup> Although the introduction of family contract responsibility system and increased government purchase price thus had a great positive impact on agriculture, government fiscal burden had increase because of the loss caused by the subsidy system. As food grains were sold in free market starting in 1985 as a result of a rapid increase in grain production, the farmers lost the benefit of additional state purchase price for the portion of output in excess of planned purchase, and price structure became disadvantageous to farmers. For several years after that, agricultural output did not show any visible change and was in a difficult situation to expand output. The period of contract between the government and farmer initially was 3 years but, because of fear for converting to cash crop farm if the period is too short, the contract was extended to 15 years in 1984 and then up to 30 years in 1993.

In Vietnam, reform in agricultural sector started in 1979 before the policy of Doimoi was adopted. Contract system was introduced, norm of grain contribution was frozen for five years and a large scale increase in government purchase price of agricultural goods was decided in 1981.<sup>14</sup>

North Korean food production encountered a totally destructive damage by flood of 1990s. However, even before the flood, beginning in 1970s, food supply worsened to the extent that they already had to launch a campaign of “two meals a day.” The reasons for food shortages are as the following. 1. Unreasonably intensive planting deteriorated soil quality. 2. Soil had no ability to retain moisture because trees were cut down to convert sloped land into arable land whole country. 3. Lack of energy supply prevented production or use of agricultural machinery. 4. Fertilizer could not be properly applied to agriculture because no chemical fertilizer had been produced due to a substantial decrease in factory utilization rate. 5. Attempted land reclamation in 1970s to recover agricultural production ended up in a failure because of excessive salt content in the soil of reclaimed land.

In order to overcome these problems North Korea in 1980s experimented with “family farm” system similar to China’s family contract and responsibility system. The experiment did not go well, so North Korea is trying to make the production units smaller at present. In 1996, “Measure to Improve Implementation of Management System of Team in Joint Production Farm” was announced and was put into practice in 1997. This, however, was not practiced in entire country and China’s family responsibility system was never settled in North Korea.<sup>15</sup>

In North Korea it is difficult to have a “successful result of reform” regardless of large or small production units because of a number of remaining barriers. These are; bad weather, lack of high

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<sup>13</sup> Calculated from *Tongji Ziliao Huiban Xin Zhongguo Wushinian*, p.1 and p.33

<sup>14</sup> Fumi Idei “Vietnam Nogyo no Kaikaku to Hatten Senryaku,” Sueo Sekiguchi and Tran Van Tho, ed. *op. cit.* p. 62

<sup>15</sup> Lin Jinshu, *Chaoxian Jingji*, (Jilin Renmin Chubanshe, 2000), p.131.

quality seed grain, lack of chemical fertilizer and agricultural machinery, and absence of material incentive to farmers.

## **6. Reform in Industry**

In China, prior to start of reform and open door policy in 1978, state-owned enterprises produced 77.6 percent of China's gross industrial output value. Therefore, reform in industry, in fact, means a reform in state enterprises.

Because of distorted price structure stated earlier, productive efforts of Chinese enterprises often did not show any positive results. For example, in coal mining industry, the more you extract coal the more deficits you ended up with.

Under the pretext that there is no unemployment in socialist country, state-owned enterprises served as receptacle of labor and held onto a large number of surplus workers. Moreover, since any deficit in enterprises was subsidized by the state, the operational efficiency in the enterprise was extremely poor. Traditionally, enterprises contribute its entire profit to the state, while the state provided all necessary capital to enterprises. In 1985, China converted into a system whereby the enterprises submit income tax, instead of profit, to state and enterprises finance necessary capital by bank loans. However, the banks at that time was more like a keeper of money for the government, and provided loans to enterprises as directed by the government without having any ability to evaluate enterprises and to make its own decision for the loans. On the other hand, the enterprises never had any idea that the bank loans must be paid back and, therefore, became the reason for "bad loans" that the banking system had been accumulating up to present time.

Starting in mid-1980s, as a measure to deal with the problem of surplus labor, a system of "contract workers" was introduced instead of employment for life. As partial measures of social safety network, annuity, unemployment and health insurances also had been introduced. In such traditionally industrial region as in Northeastern provinces, with a higher ratio of old and retired workers than other regions, contribution to old age insurance annuity alone reached 31.5 percent of total basic wages<sup>16</sup> and exerted additional pressure on enterprise management which already were suffering from a numerous problems. Incidentally, agricultural sector, with huge population, is not covered by any of these social safety nets.

In order to carry out reform and to attempt to improve efficiency in state enterprises, the surplus labor must be eliminated, and this in turn will create a massive unemployment and increase social instability. As a matter of fact, there are frequent demonstrations of workers demanding more jobs in Northeastern region. China is in a dilemma where, as reform in state enterprises proceeds and stock

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<sup>16</sup> *Zhongguo Xinxibao*, November 22, 2001

issuing companies and non-state enterprises increase in number, unemployment also increase. Nonetheless, it is the fact that, as a member of WTO and in an age of “global competition,” China must carry out the reform in state enterprises without delay.

Although reform in state enterprises has not been progressing as anticipated, China’s industrial output has continuously been increasing because of important roles played by local and village enterprises and by foreign investment enterprises in industrial production. Nominal value of gross industrial output had increased from 423.7 billion yuan in 1978 to 11.9048 trillion yuan in 1998. Due to newly added elements, the share of gross industrial output value by state-owned enterprises became less than 30 percent of total gross industrial output value in 1998.

The township and village enterprises by definition are not “privately owned” but are group or community owned. These enterprises are set up by funds provided by lower administrative organization of village or local governments or by group of farmers, and therefore, owned jointly by them (There are some village enterprises owned by individual farmer). In reality, there are other problems that the ownership of village enterprises is falling into ownership of some individuals. There are many new creation as well as many bankruptcies and closures of local and village enterprise, because these enterprises are not getting any assistance in funds from public sector and managed by private individual initiatives alone. In that sense, local and village enterprises are virtually the same as privately managed enterprises.

Industry sector of North Korea indicates a movement toward an opposite direction of privatization or civilian management. According to Suzuki (2000), North Korea, starting at the end of 1999, began a movement to change the names of large scale factory and enterprises from “integrated enterprises” and “general or comprehensive enterprises” into “factory” or “steel mill,” and “General Bureau” which was directly under State Council into “Bureau of Management.” Suzuki suspects that the reason for downgrading integrated enterprises into simple “enterprises” may be to discourage and control the notion of an independent kingdom that integrated enterprises may had and facilitate central management and control of these enterprises.

Furthermore, the main barriers to North Korean industrial reform are not the fact that the enterprise autonomy is not recognized or providing material incentives to workers are not permitted, and so on. There is no question that development of consumer sector industry will be severely hampered under the current situation where top priority is given to military industry for supply of funds, raw materials and energy. The officially announced military budget alone reached about 10 to 15 percent of total budget, but if items hidden in other sections of the budget are included, the total military budget is estimated to be about 30 percent. It is easy to imagine that the bloated military expenses will exert an adverse pressure on other sectors of economy, and thus a picture of distorted North Korean economy can be clearly observed.

## **7. Foreign Economic Relations-Open Door Policy**

Of the three countries, Vietnam was the first one to establish a foreign investment law to attract foreign capital.<sup>17</sup> It was in 1977, only two years after the end of Vietnam War. It appears that in the background of establishing this law was the fact that foreign capital and technology were essential requirements in order to develop oil depositing in Vietnamese offshore. To earn foreign exchange, an urgent task was to develop export industry which also requires foreign capital and technology. One can observe, however, that the Vietnam was somewhat timid in its efforts to attract foreign capital in general. The followings are examples. 1. Income tax was set up at very high level; 30 percent in export industry, 40 percent for industry in advanced technology and large scale investment, and 50 percent in other sector of investment. 2. The period of joint venture was set for 10 to 15 years. 3. There were articles in the law that may hint a possible nationalization of foreign investment firm. 4. Unlike China and North Korea, Vietnam limited the share of foreign investment to more than 30 percent and less than 49 percent of total investment. (It was a pattern one can observe in many developing countries in those days in order to avoid a majority ownership by foreign investment side). The law was very simple and actual implementation of the law was often left to the judgment of administrators. For these reasons, Vietnam set up a new foreign investment law in December of 1987 making it effective January 1988, and in September of 1988 detailed articles for actual implementation of the law were announced. (In year 2000, the foreign investment law was revised again). Earlier Vietnamese law is quite similar to Chinese joint venture law announced in 1979, which also was very simple one with only 15 articles, and often changes in conditions were demanded by opposite sides of joint venture or permission was denied sometimes. The fact that Chinese joint venture law at that time also had 15 year period is very similar to Vietnamese law.

In 1984 North Korea announced a law concerning introduce of foreign direct investment. It was a year before the Plaza Accord and, although timing was excellent, it never reached a point where foreign capital played any significant role on North Korean economy.

Of course, even in China, immediately after the joint venture law was announced in 1979, there was a concern whether capitalist system can really be accepted by the socialist system at the time, and foreign investment was not taking place much, contrary to expectation of China. It was after announcing Regulation for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment in 1984 and Plaza Accord of 1985 that inflow of foreign capital to China began to take place in earnest.

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<sup>17</sup> On Vietnam author referred Masahiko Ebashi and Yasuhiro Yamada, *Shinsei Vietnam no Keizai*, (JETRO, 1978), Chapter 5.

Prior to 1985, when enterprises in Western countries were reluctant to make capital investment in China, overseas Chinese and Chinese capital in Hong Kong and Southeast Asia invested in China, and China also had opportunities to learn about the Western business practices. In the first half of 1980's Hong Kong's share of all of Chinese introducing foreign direct investment contracts was around eighty percent<sup>18</sup>. Among those overseas Chinese or Chinese capital in Hong Kong and Southeast Asia were the major capitalists and owners of major enterprises in Southeast Asia, and in reality they made important contributions to Chinese economic development. There were many Chinese and Chinese enterprises in Hong Kong and Southeast Asia who had relatives in China or other local connections within China. Western capital, when invested in China jointly with these overseas Chinese or enterprises, negotiation often went smoothly without any problems. In other words, Hong Kong and overseas Chinese and Chinese capital, directly or indirectly, contributed in improving environment for foreign capital investment in China.

Vietnamese foreign investment law revised in 1987 set income tax rate at 15 to 25 percent of profit, a substantially lower rate than 1977 law, but the rate was set higher for such valuable resources as oil. In the law revised in year 2000, the tax rate was set at 20 percent for general investment, a lower than the rate in North Korea. In Vietnam, the rate is 15 percent in case of investment when more than 50 percent of its products were exported or invested in region with difficulty. The tax rate is 10 percent for investment in infrastructure and this preferred treatment for investment in infrastructure is the same as in North Korea.

What is needed for North Korea is foreign exchange, but with lack of any raw materials supply in North Korea, urgent need is to earn foreign exchange by trading of goods processed by contract with foreign capital. For that reason, perhaps the most important thing was to set up a "special zone" in a region where it is easy to carry out contract processing. No doubt if the special zone was set up in a region close to Chinese border, there may be investment from China and may also be able to use China's electricity. But it is difficult to know whether hard currency be will be earned or not. Speaking of use of China's electricity, electricity from Shuifeng (Supung) dam was to be jointly used by China and North Korea, but because of North Korean nonpayment of electricity use fee there is an unresolved dispute with China at present. Even if North Korea wishes to use China's electricity, it appears to be difficult to achieve it unless there is a guarantee that the use of electricity will be compensated.

Both China and North Korea, when the foreign investment laws were first announced they imposed foreign investment company to export its products, and that the primary goal was to earn foreign exchange. In other words, kinds of foreign investment were mainly those which engaged in contract processing by using domestic labor force. In China, however, as income level improved and

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<sup>18</sup> On the role played by the overseas Chinese and their capital in Hong Kong and Southeast Asia on Chinese economy, refer Toshio Watanabe in "Aija Keizai no Kouzu wo Yommu"(NHK Library 1998), Hideo Ohhashi "Gendai Chuugoku Keizai -Keizai no Kokuzaika"(Nagoya Daigaku Shuppankai 2003), and others previous research.

the way to acquire foreign exchange by the foreign exchange control center became certain, gradually foreign direct investment targeting domestic markets have taken place. This tendency will further accelerate after China's membership in WTO because opening up of service sector industry such as distribution and finance will also become a reality. "The 1.3 billion people market" may just be a rosy fantasy, but if only 5 percent of 1.3 billion people spend money, it is a big market comparable to population of any one country in Europe.

In this respect, both North Korea and Vietnam, with not very large domestic markets, are likely to have mainly contract processing types of foreign investment. In particular in North Korea, because of small population size and very low disposable income level, it is entirely unreasonable to expect that foreign investment targeting domestic market will be forthcoming.

As capitals from Japan, Europe and U.S. are mainly concentrated into China, foreign investment into Vietnam was traditionally from NIES and small scale enterprises. For that reason, investment to Vietnam has been decreasing since Asian economic crisis. North Korean foreign investments were largely from enterprises related to Koreans in Japan and from South Korean enterprises, including its large conglomerates known as *jaebol*. Foreign investment to North Korea also suffered since the Asian economic crisis because some South Korean *jaebols* encountered management crisis of their own and were reluctant to continue investment into North Korea and because some of investment projects were not going well. Payments to North Korean side by Hyundai Asan for Kumkangsan (Diamond Mountain) tour project had to be decreased because the project suffered from an absence of increases in number of tourists and because of worsening management problems of Hyundai Asan itself. In other words, both North Korea and Vietnam were unable to escape from the adverse impact of Asian economic crisis.

The primary difference in North Korean system of importing foreign investment with those of China and Vietnam is not in the policy itself, but the difference is more likely in the posture toward importing of foreign investment. Deng Xiaoping allegedly has said that "if you open windows, fresh air as well as flies may come in, but it does not matter." In other words, China very much welcomed an inflow of fresh air (foreign capital). On the other hand, North Korea seems to be afraid of a single fly flying in. Perhaps, North Korea, which has a strict control on information flow, may not have immunity to control a single fly (Western information).

China achieved a great of success by simultaneously implementing economic reform and open door policy. If China carried out economic reform alone without open door policy, China may have ended up in a state of capital shortage as many other developing countries often fall into. If China did not have a series of economic reform, China's attractiveness to foreign capital might have been less than a half of what it has been. It is because, without the reform, foreign capital would not have had any freedom to hire employee and to acquire raw materials, right to trade, and freedom to set price or any access to domestic market at all.

Prior to reform, foreign trade was exclusively conducted by the government in all three countries of China, North Korea and Vietnam. In China, immediately after the reform, local areas in general were given right to use 25 to 30 percent of foreign exchange they earned. However Guangdong and Fujian Provinces acquired right to keep 100 percent of foreign exchange earned. Moreover, other areas in general were able to keep 70 to 75 percent of foreign exchange earned above the planned amount. Large enterprises were given the right to conduct foreign trade as well. In the process, however, because of strong desire to earn foreign exchange, there often had been such adverse impacts as decreased export prices due to excessive competition among exporters, or duplicated imports of the identical plants in the same Province. For these reasons, a system of export permit was adopted in 1980.

The rate of exchange at the time was set officially at 1.5 yuan per dollar, a level overvaluing yuan. Because the overvalued rate is disadvantageous to China's exporters, an internal rate to settle foreign trade balance was set at 2.8 yuan per dollar in 1981. Criticism had been raised that this system of two rates is tantamount to export subsidy, and Chinese government decided to depreciate the official exchange rate and unified into a single rate of 2.8 yuan per dollar. Even after that when the trade deficit increases Chinese government discounted foreign exchange certificates. Starting in 1980s, China issued two kinds of currencies, Foreign Exchange Certificate and Renminbi. Initially, these two currencies were supposedly to have the same value, but the difference in value between the two currencies gradually became large. Since such difference caused problems in economic activities and in view of joining WTO, the Foreign Exchange Certificate was eliminated and the currency was unified to Renminbi in 1994.

In Vietnam, all international trade was conducted by the Ministry of Foreign Trade until 1980. There were two changes starting in 1981. First, each and every foreign trading corporation (FTC) which was a part of The Ministry of Foreign Trade now became a part of government branch under which the production enterprises belong. For example, The Ministry of Agriculture and Forestry now control both the production and foreign trade of agricultural products. The Ministry of Foreign Trade will be primarily managing quota and issues all kinds of import and export permits. However, what to trade and how much to trade was still decided by directives of State Planning Commission. Second, local governments were able to directly engage in international trade. Starting in 1985, the number of state import and exports companies directly under local government control has continuously increased, and reached to about 500 of these in entire country by 1990.

As compared to China which became fifth largest trading nation of goods in the world in 2002, North Korea only has very limited number of trading partners. In case of North Korea, prior to exposure about problems of missile trade, trade volume with Western countries had been extremely small. Immediately after the country was established, most of trade had been with old socialist block countries, in particular, with China and Soviet Union. However, starting in mid-1970s, North Korea began to import plants from Western countries. Unfortunately, it coincided with oil crisis period, and

as price of plants was rising rapidly, the price of nonferrous metals, the main source of earning foreign exchange for North Korea, fell sharply during the same time, thus forcing North Korea to default the payment of imported plants price. Although delay of payments with group of banks in Japan and Western countries was negotiated, North Korea was unable to keep their promise to pay off the debt. For these reasons, starting in 1980s a string of Japanese firms began to take trade insurances, and since then Japanese exporters were not able to get insurance for North Korean trade. Under the circumstance, it became extremely difficult to participate in trade with North Korea for Japanese companies in general. Although North Korea's trade with Western Europe increased at times, the trend remained at a very low level because of limited domestic market and, therefore, lack of attractiveness as export market.

The U.S. did not exclude North Korea from the designation of "terrorists aiding countries" and carefully watches exports of strategic and high-tech materials to the country requiring permit from the U.S. Treasury for any export to North Korea. In practice, any export from U.S. to North Korea has been humanitarian aid materials only.

In order to expand foreign trade, starting in 1984 North Korea increased the number of trading ports and permitted border trade. In 1988 State Commission for External Economic Relation was set up, and Ministry of International Trade and a new Ministry of Joint Venture Industry were established under the Commission. At the same time, local right for international trade was also expanded.

Due to changes taking place in Soviet Union, Eastern Europe and China in 1990s, North Korea was forced to settle international trade balance by hard currency instead of traditional barter trade. The trade with former Soviet Union, which had been the number one trade partner of North Korea, the volume of trade shrank to about 10 percent of what used to be after the breakdown of the country. It was inevitable for North Korea to change trade partners from Socialist countries to countries in northeast and southeast Asia. In 1992, North Korea advocated "trade first principle" (simultaneously with agriculture first principle and light industry first principle) and called for utilizing processing trade and transitional trade. Total number of international trading corporations had increased from 39 in 1980s to more than 100 in 1990s. Other than international trade corporations immediately under the State Council, permission was given to Ministry of Social Security, Ministry of Health, Ministry of State Security and Ministry of Defense to have their own international trade corporations. Moreover, each province, each municipal administrative committee and each people's committee also set up its own international trade corporation.<sup>19</sup>

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<sup>19</sup> On Vietnam referred Tran Van Tho "Vietnam no Taigaiboeki to Gaishidonyu" in Sueo Sekiguchi and Tran Van Tho, ed. op. cit.

It appears that North Korea was going through the same route as China and Vietnam as far as the yielding of trading rights to local areas or diversifying trading rights are concerned. The crucial difference, however, is the fact that North Korea is not producing enough goods to export. Under the circumstance, a large number of trading corporations may explore a greater opportunity to export, but they may also vie each other for right to export scarce exportable goods, or some trade corporations may put selfish local interest ahead that of nation as a whole. It is also possible that State will have a difficulty to effectively manage foreign exchange acquired by so many different trade corporations.

North Korea is unable to produce exportable goods because of stagnated domestic economy and in part because it is confronted with trade restrictions from trade partners. The problems of North Korean foreign trade, therefore, are more basic problems that a reform of foreign trade system alone will not be able to solve.

## **8. Future Direction of North Korean Reform**

Will North Korea continue to proceed with reform in the future? At present the whole process is no more than in a very haphazard state, and may invite a worsening of economy rather than an economic recovery. Although black markets were officially closed and system of sales at state stores were restored, it is more likely that scarce goods will be pushed deeper into black market because there are no products available for sale at state stores, and thus making daily life of people in general much more painful than before.

In accordance with official price increases, wages were raised substantially, which will likely to mean that workers will be more tied up to workplace during the regular work hours with or without any actual works to perform. Thus, those workers who barely supported their subsistence by engaging in side jobs (outside of their regular work) will not be able to continue such side jobs anymore.<sup>20</sup> What is needed most in North Korea now is production of goods, especially restoration of food production.

What should North Korea do? Of course, if Japan and North Korea establish diplomatic relation and Japanese economic aids flow into North Korea, construction of infrastructure may take place and the pace of economic development will change. However, there are a number of problems. Although five of kidnapped people have been returned to Japan, questions of their family's return to Japan and other kidnapped people have not been resolved yet. Some of North Korean activities which came into light from the end of 2002 to early 2003, namely, nullifying nuclear freeze

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<sup>20</sup> Lin Jinshu, *op.cit.*, pp. 253-254

agreement, expelling IAEA inspectors, and announcement to withdraw from NPT, would further prevent any early progress in negotiations between the two countries for normalization.

For these reasons, North Korea at present must tackle the problem of economic reconstruction without large scale economic aids from Western countries. Existing serious state of starvation is getting worse and is no longer tolerable anymore. For solving the problem of starvation, North Korea must carry out a concentrated effort to increase food production. It is essential for North Korea to carry out “adjustment policy” that China adopted in 1960s after a dismal failure of the Great Leap Forward policy.

In China, as a disastrous result of the Great Leap Forward policy, a policy to accelerate socialization process, about 30 million people were starved to death. The policy taken up at that time by Liu Shaoqi and Deng Xiaoping is the “adjustment policy.” In order to solve the problem of food first, the policy was to permit “three Ps”, namely, private plot, private market, and private and individual responsibility for profit and loss. Also permitted was the contract production system for farmers. In industrial sector, priority was given to industries that support agriculture, with purpose to restore outputs of chemical fertilizer and agricultural machinery.

North Korea also needs to first implement a policy like China’s “Adjustment Policy” in order to maintain enough supply of “Food”. Farmers’ right to make their own decision must be increased as well either by expanding private plot or by adopting agricultural production responsibility system. At present, it may be necessary to import better quality seed grain by spending scarce foreign exchange. In order to restore agricultural output, a top priority in industry sector must be given to an increase the production of chemical fertilizer and agricultural pesticides that are necessary for an increase in agricultural output.

In case a proper agricultural management system is adopted, North Korea will be able to restore agricultural output despite inclement climate and limited arable land. For example, the yield of Jilin Province of China, North Korea’s northern neighbor, was 5970 kilogram of corn per hectare of field and 5554.7 kilogram of rice per hectare of rice paddy in 2002. At present North Korea’s arable land is consisted of 1,992 thousand hectares of field and 585 thousand hectares of rice paddy. If North Korea is able to produce the level of output comparable to that of Jilin Province, it means that North Korean will be able to harvest 8.4 million tons of corn and 3.25 million tons of rice. It is likely that the quality of land in North Korea has deteriorated due largely to past movements of excessive intensive planting and, therefore, it will not be possible to produce agricultural output comparable to the level of Jilin Province. If North Korea is able to produce only a half yield of Jilin Province produced by stopping its practice of intensive planting and by implementing a more rational water management system and fertilizer application, then North Korea will be able to harvest total of 5.82 million tons of grain.

When agricultural output is restored to some extent, it may be necessary for North Korea to extract more lime and coking coal and convert them for civilian use and for export purpose. North Korea has mineral resources as has been noted as “agriculture in the south and industry in the north.” It is especially urgent for North Korea to increase energy output. At the same time, North Korea must promote such export industry as clothing manufacturing that is labor intensive and requires relatively small capital investment.

Under a normal circumstance, foreign capital must be introduced in order to supplement scarce supply of domestic capital. However, for present North Korean regime may regard that the side effect of such foreign capital introduction, namely, an unchecked inflow of information may be too strenuous. When there is a political instability in a country, it is difficult to expect an active interest of any foreign investor to invest in that country. Introducing foreign capital, however, is the only way to supplement scarce domestic capital.

Present North Korean reform efforts that ignore the proper sequences of reform will only invite a hyperinflation and it is necessary to attempt to restore production of real goods.

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