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**THESIS**

**NORTH KOREA'S 7.1 POLICY**

by

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December 2013

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**NORTH KOREA'S 7.1 POLICY**

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## **ABSTRACT**

This thesis evaluates North Korea's July 2002 economic reforms. It does so by analyzing the content of the reforms, their economic impact on North Korean people, and the problem areas of the reforms. This thesis makes five arguments. First, the July 2002 economic reforms were not intended to reform North Korea's economic system but to provide temporary relief for the regime's survival. Second, unless the problems in monetization and decentralization in the industrial and agricultural sectors are eliminated, the economic development effort is doomed to fail. Furthermore, if Pyongyang solves international, administrative and infrastructural problems within Special Economic Zones, it can spur economic development in the country. Third, the growing economic interdependence may help to leverage upon North Korea. Fourth, North Korea's current political system forms the biggest obstacle for present and future reforms. Finally, for the U.S. and international sanctions to have more effective impact, there should be a consensus on them and the subsidizing effect of other countries should be avoided. In conclusion, the thesis makes policy recommendations and extracts overall lessons for international policy makers, economic leaders, and diplomats that can be applied to this and other cases.

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## **LIST OF ACRONYMS AND ABBREVIATIONS**

DPRK	Democratic People's Republic of Korea
GDP	Gross Domestic Product
KIC	Kaesong Industrial Complex
PDS	Public Distribution System
PSI	Proliferation Security Initiative
SAR	Special Administrative Region
SEZ	Special Economic Zone
UN	United Nations
UNSC	United Nations Security Council
WMD	Weapons of mass destruction

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## **I. INTRODUCTION**

### **A. PURPOSE**

The main purpose of this thesis is to assess the North Korean 7.1 policy and its ramifications and to determine what kind of problems obstructed its success. Northeast Asia's security environment has been volatile, and many incidents have occurred between North Korea and neighboring countries. These tensions mostly have been due to military conflicts such as naval skirmishes and the nuclear crisis. When someone looks at the timing of these tensions, he or she sees that they occur mostly during the most fragile moments of the North Korean economy and that North Korea uses these conflicts as a tool for bargaining. Therefore, a better understanding of the North Korean economy will contribute to estimating future actions and the possible timing of North Korean provocations.

### **B. IMPORTANCE**

Although a cease fire was declared in 1953, North Korea and South Korea still do not have a peace agreement. The tension between these two countries affects fundamental interests of the region's four leading countries—People's Republic of China, Japan, Republic of Korea, and Russia. As a result, developments in the North Korea affect not only the surrounding countries but also the whole world.

The more we understand North Korea, the more we can estimate the future security environment in Northeast Asia. As the security situation in the Northeast Asia affects the balance of power, the future situation in North Korea will have a big effect on shaping the future of the world. Therefore, understanding North Korea better will give us a better assessment of the world's future security environment.

In terms of economics, the most recent series of changes in the North Korean economy began with the July 2002 reforms, which have since been called the "7.1 policy." The reforms are regarded as having failed overall as there has been no significant change in the North Korean economy that can be observed. Moreover, as North Korea is an isolated country, available data are scarce about the results of these reforms.

Under its new leader Kim Jong-un, North Korea is attempting new ventures in economic reform and development, such as establishing new special economic zones (SEZ). Whether these new reforms in the economy will be successful is unclear. On the other hand, there are contemporary sources of information about the results of 7.1 policy and the economic changes that occurred after 2002, especially in the SEZs. To lay out the results of the 7.1 policy and the factors that hindered its success will help us to better understand whether the recent attempts of Pyongyang have a chance to succeed. Consequently, to better judge the 7.1 policy and its results will contribute to a better understanding of the further actions of North Korea.

### C. LITERATURE REVIEW

Bernhard Seliger's article "The July 2002 Reforms in North Korea: Liberman Style Reforms Or Road to Transformation?" discusses the nature of the July 2002 reforms and asserts that the July 2002 reforms were rather Liberman-style reforms and were not totally radical or intended to change the whole economic system.<sup>1</sup> Ihk pyo Hong also evaluates the nature of the reforms in his article, "A Shift Toward Capitalism? Recent Economic Reforms in North Korea," as not being intended as a tool of transformation.<sup>2</sup>

In "North Korean Reform and Opening: Dual Strategy and 'Silli (Practical) Socialism,'"<sup>3</sup> Young Chul Chung supports the argument of these two writers; however, he mostly dwells on the hidden ideology of the reforms. Therefore, Chung's work does not offer insight into the content of the reforms, and he rather introduces the ideological framework of them. His overall assessments about the ideology of the reforms are hard to prove as they are not based on direct confessions of the North Korean leaders.

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<sup>1</sup> Bernhard Seliger, "The July 2002 Reforms in North Korea: Liberman-Style Reforms or Road to Transformation?" *North Korean Review* 2 (April 2006), 22.

<sup>2</sup> Ihk pyo Hong, "A Shift toward Capitalism? Recent Economic Reforms in North Korea," *East Asian Review* 14, no. 4 (Winter 2002), 93.

<sup>3</sup> Y. C. Chung, "North Korean Reform and Opening: Dual Strategy and 'Silli (Practical) Socialism,'" *Pacific Affairs* 77, no. 2 (Summer 2004), 283.

Overall, these sources discuss the pros and cons of the reforms, and all come to the same conclusion that these reforms were indeed not intended to create a significant change in the current system. These reforms merely create short term solutions to the food and currency shortages.

Ihk pyo Hong also gives insight into the content of the North Korean 2002 reforms; however, he does not look into all aspects of this content. He only mentions the monetization and decentralization aspects of the reforms and does not mention efforts on foreign capital acquisition.<sup>4</sup> In his article, “Evaluation of the North Korean July 2002 Economic Reform,” Sung wook Nam gives information about the content of the reform; however, he mostly mentions the achievements of the reform and focuses on the changes in the monetization, as well as reforms in the agrarian and industrial sector. He does not mention the problem areas of these changes in the economy or offer any solutions. Moreover, he does not mention the foreign currency acquisition attempts of North Korean government as it was not an achievement at the end.<sup>5</sup>

Christopher D. Hale, a leading writer on this topic, takes a comprehensive view of all the trends of the reforms. He takes the third aspect of the reforms—foreign capital acquisition—into account. In “Real Reform in North Korea? The Aftermath of the July 2002 Economic Measures,”<sup>6</sup> he combines all aspects of the reform together in an academic approach; however, as it was written in 2005, it is far from current. Christopher D. Hale offers little analysis of problem areas and or recommendations for further improving the North Korean reform attempts.

Among the writers who examine the third dimension of the reform—foreign capital acquisition—are Sung Hoon Lim and Kang Taeg Lim. They give insight into the most important part of the foreign capital acquisition trend—special economic zones of

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<sup>4</sup> Hong, “A Shift Towards Capitalism?” 97.

<sup>5</sup> Sung-wook Nam, “Evaluation of the North Korean July 2002 Economic Reform,” *North Korean Review* 3, no. 1 (April 2007), 37.

<sup>6</sup> C. D. Hale, “Real Reform in North Korea? The Aftermath of the July 2002 Economic Measures,” *Asian Survey* 45, no. 6 (November–December 2005), 823T.

North Korea. They explain the logic behind the development of SEZs in North Korea and also offer strategies to develop them in their article “Special Economic Zones as Survival Strategy of North Korea.”<sup>7</sup>

Stephan Haggard and Marcus Noland are the most well-known writers on North Korea. In their book *Witness to Transformation: Refugee Insights into North Korea*, they use the results of the surveys applied in China and South Korea to refugees that fled from North Korea. The refugees that they surveyed belong to different levels of society. As these refugees fled in different periods of time before and after the 2002 reforms, they are a good source to compare the pre and post reform era.

In their book, Haggard and Noland give detailed information about the results of the 2002 reforms. They investigate whether the policy provided more food and whether the North Korean people were better off. They compare the answers to these questions at each level of society, including farmers, workers at state-owned enterprises, and government and political officers, which gives us objective results by which to assess the overall implications. They also measure the reforms’ effects on the business environment and private farming.

The book offers us unprecedented information on the results of the 2002 reforms given the isolated nature of North Korea. As the writers admit, the results of the survey are proportional to the overall North Korean population and might not reflect the effects of the reforms accurately in some aspects. In addition, the participants of the China Survey are mostly refugees from the northeast part of the country; thus, this might negatively skew the results of the polls as this group was discriminated against in initial relief efforts.<sup>8</sup> Still, the survey results are uniquely the most reliable source of information for understanding the “Red Box;” however, the book mostly refers to the overall results of the reforms and does not judge each aspect of the reforms separately, except for the agricultural ones.

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<sup>7</sup> Sung-Hoon Lim and Kang-Taeg Lim, “Special Economic Zones as Survival Strategy of North Korea,” *North Korean Review* 2, no. 2 (October 2006), 50–52.

<sup>8</sup> Stephan Haggard and Marcus Noland, *Witness to Transformation: Refugee Insights into North Korea* (Washington, DC: Peterson Institute for International Economics, 2011), 57.

There are scarce sources about the problem areas of the reforms. The literature available is mostly about the reasons or results of the reforms. One of the writers who mentions the problem areas in monetization and decentralization is Sung Wook Nam. In his article, "Evaluation of the North Korean July 2002 Economic Reform," however, he only mentions the problems in monetization.<sup>9</sup> Moreover, Ihk Pyo Hong also considers the problems in all aspects of reforms; however, he mentions them only superficially.<sup>10</sup>

Among the writers mentioned earlier, Sung Hoon Lim and Kang Taeg Lim examine the problem areas in the foreign capital acquisition aspect of the reforms. In their article, they explain the developmental path of North Korean SEZs. They also mention the economic and political effects of the SEZs that are not mentioned in other sources.<sup>11</sup>

In addition to identifying the problem areas, they also offer recommendations for future development of the special economic zones, and thus for the success of foreign capital acquisition.<sup>12</sup> Sung Hoon Lim offers additional solutions for the success of North Korean SEZs in his article, "Seven Business Models for Success of North Korea's Economic Reform." He suggests seven business models for four North Korean SEZs, including the Rajin-Sunbong SEZ, which was established before the 2002 reforms.<sup>13</sup>

Robert E. Looney's article, "Trends: North Korea," is another useful source to understand North Korean economy, the 2002 reforms and the problems behind them. He explains the reasons behind the reforms and their similarity with the Chinese model. Then he underscores the problems that hindered the further development of 2002 reforms, such as the regime's response to the reforms in 2005 and the *currency reform* in 2009. He also mentions the importance of SEZs as a way of bolstering foreign capital without exposing

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<sup>9</sup> Nam, "Evaluation of the Reform," 40.

<sup>10</sup> Hong, "A Shift Towards Capitalism?" 104–106.

<sup>11</sup> Lim, "Special Economic Zones as Survival Strategy of North Korea," 49.

<sup>12</sup> *Ibid.*, 58–59.

<sup>13</sup> Sung-Hoon Lim, "Seven Business Models for Success of North Korea's Economic Reform," *North Korean Review* 6, no. 2 (Fall 2010), 86–98.

its people to Western influences. Namely, he provides an overall understanding of the North Korean economy's past and sheds light on its likely future trends.<sup>14</sup>

Hongyi Harry Lai is another writer who contributes to finding solutions for special economic zones by comparing the North Korean model with the Chinese experience. After laying down the criteria behind the success of Chinese SEZs, he especially points out to the administrative problems of the North Korean counterparts and takes lessons from the Chinese ones that should be applied to North Korea.<sup>15</sup>

Harpal Sandhu is another writer who examines North Korea's attempts at special economic zones, their importance, and their effects on Chinese-North Korea relations. He especially mentions the response of the Chinese government to the Sinuiju SEZ and its lack of support; thus, he mentions one of the problem areas of North Korean SEZs.<sup>16</sup>

Suk Hi Kim and Eul Chul Lim focus on the Kaesong SEZ and offer insight into its rather successful story among North Korean SEZs; however, they point to its uncertain future and mention the possible friction points that hinder the development of the Kaesong SEZ.<sup>17</sup> He concludes by suggesting reasons for a positive development in inter-Korean relations; however, as the article was written in 2009, some of the prospects that he suggested did not come to pass as we have seen recent developments in inter-Korean relations.

Darren Z. Cook's article "Reforming North Korea: Law, Politics, and the Market Economy," is one of the contemporary sources on North Korean special economic zones. He gives overall information about all SEZs in North Korea and points out the problem areas within them. He also recommends solutions for the future prosperity and development of these zones. He especially focuses on the judicial aspect of the problems

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<sup>14</sup> Robert E. Looney, "Trends: North Korea," *The Milken Institute Review* (Fourth Quarter 2010), 5–13.

<sup>15</sup> Hongyi Harry Lai, "SEZs and Foreign Investment in China: Experience and Lessons for North Korean Development," *Asian Perspective* 30, no. 3 (2006), 70–96.

<sup>16</sup> Harpal Sandhu, "A Doomed Reform," *Harvard International Review* 25, no. 1 (Spring 2003), 36–39.

<sup>17</sup> Suk Hi Kim and Eul-Chul Lim, "The Kaesong Inter-Korean Industrial Complex Perspectives and Prospects," *North Korean Review* 5, no. 2 (Fall 2009), 81–91.

and lays out the difficulties of the economic environment in the SEZs in the absence of legal guarantees.<sup>18</sup>

In accordance with the political problems that hindered foreign capital acquisition, Jon M. Van Dyke's article explains the naval skirmishes between North and South Korea in his article, "The North/South Korea Boundary Dispute in the Yellow (West) Sea."<sup>19</sup> Moreover, Yu Hwan Koh gives a chronological summary of the North Korean nuclear crisis and the response of South Korea in his article, "Roh Moo-Hyun Administration's North Korea Policy and Nuclear Crisis Management."<sup>20</sup> These two articles, of course, are not enough to cover all the political problems and their impacts on foreign capital acquisition.

Robert I. Rotberg's *When States Fail: Causes and Consequences* is one of the leading books about the lessons to be learned from the past experiences of nation states.<sup>21</sup> He offers overall lessons that can also be considered for the North Korean case. James Dobbins' book *The Beginner's Guide to Nation-Building* is another source that introduces lessons that can be applied to the North Korean economy. His book is also useful to derive lessons from other countries' experiences in economic reform.<sup>22</sup>

Daron Acemoglu and James A. Robinson's *Why Nations Fail: The Origins of Power, Prosperity and Poverty* is another source that offers advice on how North Korean economic institutions should look. They compare poor and rich countries and examine the differences between them; thus, they draw lessons for North Korea if it wants to prosper.<sup>23</sup> Thomas L. Friedman's *The World is Flat: A Brief History of the Twenty-First*

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<sup>18</sup> Darren C. Zook, "Reforming North Korea: Law, Politics, and the Market Economy," *Stanford Journal of International Law* 48, no. 1 (Winter 2012), 1–25.

<sup>19</sup> Jon M. Van Dyke and others, "The North/South Korea Boundary Dispute in the Yellow (West) Sea," *Marine Policy* 27, no. 2 (2003), 143.

<sup>20</sup> Yu-hwan Koh, "Roh Moo-Hyun Administration's North Korea Policy and Nuclear Crisis Management," *Korea and World Affairs* 30, no. 1 (2006), 5.

<sup>21</sup> Robert I. Rotberg, *When States Fail: Causes and Consequences* (Princeton, NJ: Princeton University Press, 2004).

<sup>22</sup> James Dobbins, *The Beginner's Guide to Nation-Building* (Santa Monica, CA: RAND National Security Research Division, 2007).

<sup>23</sup> Daron Acemoglu and James A. Robinson, *Why Nations Fail: The Origins of Power, Prosperity and Poverty*, 1st ed. (New York: Crown Publishers, 2012), 420.

*Century* is a good source to understand why the presence of foreign investment in North Korea would contribute to the world peace. His book underscores the importance of North Korea's foreign capital acquisition effort and the interdependent relationship it would create, which might be a future deterrent for North Korea in its international relations.<sup>24</sup>

#### **D. MAJOR QUESTIONS**

This thesis intends to answer four main questions. First, what are the trends of the July 2002 reforms? Second, what are the economic impacts of these reforms on North Korean people? Third, what are the problems that affected these reforms? Fourth, what are the impacts of politics on the reforms?

#### **E. MAJOR ARGUMENTS**

The writer argues that the 7.1 policy was not intended to reform the whole economy, but to offer temporary recovery for the North Korean situation. Unless the problems in monetization and decentralization in industrial and agricultural sectors are eliminated, the economic measures are doomed to fail. Furthermore, there is little chance for foreign capital acquisition of special economic zones unless international, administrative and infrastructural problems are solved. On the other hand, the growing economic interdependence of North and South Korea may offer some leverage in diplomatic negotiations; however, North Korea's current political system forms the biggest obstacle for present and future reforms. Finally, for international sanctions to have more impact, there should be a consensus on them within the international community and participating nations must continue to uphold these sanctions vigorously. In conclusion, the thesis makes policy recommendations and extracts overall lessons that can be applied to other cases.

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<sup>24</sup> Thomas L. Friedman, *The World Is Flat: A Brief History of the Twenty-First Century*, 1st Picador, Further updated and expanded, Pbk. ed. (New York: Picador/Farrar, Straus and Giroux, 2007), 660.

## **F. METHODOLOGY**

The basic analytical method used in this thesis is a case study approach. The writer uses North Korea's economy as the main focus. At the end of the thesis, the writer includes the lessons learned that can be extracted from such a case study and that can be applied for other case studies.

In some parts of the thesis, the writer refers to the Chinese economy and its development process as North Korean ventures were affected by its biggest comrade. Those parts of the thesis offer a comparative study. This comparison focuses on the special economic zones of North Korea. Here, the writer wants to find out why Chinese SEZs matured whereas North Korean ones are still under developed.

The thesis performs no statistical analysis, but nevertheless uses statistical data to show the effects of the economic reforms. Here, the writer uses recently revealed sources about the development of the reforms. The writer also uses the previously mentioned refugee surveys and their assessments about the reform movements.

The thesis also includes historical study to look into the political aspect of the reforms and find out the political events that effected North Korean economic reforms. The writer briefly looks into the political effects of these historical events. These incidents are mostly the well-known conflicts, such as naval skirmishes and the nuclear crises between North Korea and other countries.

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## II. THE TRENDS OF THE 7.1 POLICY

### A. BACKGROUND

North Korea is one of the few countries having both exclusive political institutions and exclusive economic institutions at the same time, similar to China before economic reforms.<sup>25</sup> After the suspension of energy delivery by the Soviet Union after its collapse in 1991, North Korea was deprived of one of its comrades.<sup>26</sup> The subsequent severe famine in the 1990s which resulted in the deaths of several million people out of 22 million was the best indicator that the already crippled economy had hit bottom.<sup>27</sup> That was when Pyongyang introduced the 7.1 policy.

On July 1, 2002, North Korea introduced the 7.1 policy. Pyongyang named the policy the “economic adjustment package.”<sup>28</sup> The aim was to improve economic conditions, not to transform North Korea into a market economy. North Korean officials described the approach as “silli (practical) socialism”<sup>29</sup> which allowed more incentives for an improved economy within the current ideological system. This kind of approach resembled the Chinese reforms implemented in 1978; however, Pyongyang’s intention was to focus on the inefficiencies within the system and eliminate them.

These measures can be classified into three trends: monetization, decentralization, and foreign capital acquisition. Monetization and decentralization are domestic reforms aiming to stimulate the food supply, transition control over economic sectors from black markets to the state, and channel state’s spending to other areas by abolishing state subsidization in certain areas. Foreign capital acquisition followed two trends and was

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<sup>25</sup> Acemoglu and Robinson, *Why Nations Fail: The Origins of Power, Prosperity and Poverty*, 420.

<sup>26</sup> Seliger, “The July 2002 Reforms in North Korea: Liberman-Style Reforms or Road to Transformation?” 22.

<sup>27</sup> Marcus Noland, “Famine and Reform in North Korea,” *Asian Economic Papers* 3, no. 2 (Spring/Summer 2004), 20.

<sup>28</sup> Hong, “A Shift toward Capitalism? Recent Economic Reforms in North Korea,” 93.

<sup>29</sup> Chung, “North Korean Reform and Opening: Dual Strategy and ‘Silli (Practical) Socialism,’” 283.

intended to cover the severe capital shortage necessary for domestic market and industrial development such as building infrastructure.<sup>30</sup> These trends are examined in more detail in the following sections.

## **B. MONETIZATION**

### **1. Price Increases**

The most significant aspect of the July 2002 reforms was the monetization trend. This trend was composed of price reforms and marketization. Before July 2002 money was not able to perform its crucial role in the monetary system. The public distribution system (PDS) was in practice; therefore, even when a citizen had money, he or she could not buy a desired quantity of goods. Besides, the prices were not formed according to the real cost of production, but according to the cost of raw materials used in production.<sup>31</sup>

To balance the price gap between general markets and national stores and to reflect the actual production costs, Pyongyang increased the official sale prices of rice. As shown in Table 1, the sale price of one kilogram of rice increased from 0.08 won to 44 won.<sup>32</sup>

On the basis of rice prices, Pyongyang also set new prices for other goods, such as corn, diesel oil, electricity, streetcar fares, subway fares, train fares, entrance fees and rents; however, these new prices were not proportional with the increase in the cost of rice as shown in Table 2.<sup>33</sup> While health care and education remained free, Pyongyang stopped supplying subsidies for housing.<sup>34</sup> So, as the price of electricity went up, the people were supposed to pay for it along with their housing costs that were no longer subsidized.

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<sup>30</sup> Hale, "Real Reform in North Korea? The Aftermath of the July 2002 Economic Measures," 823.

<sup>31</sup> *Ibid.*, 824–5.

<sup>32</sup> Seliger, "The July 2002 Reforms," 29.

<sup>33</sup> Hong, "A Shift Towards Capitalism?" 95.

<sup>34</sup> Hale, "Real Reform in North Korea?," 825

Table 1. North Korean Grain Prices and Implicit Exchange Rates (from Seliger, 29).

Product	Price (won/kg)			Price (US\$/kg)		Implicit won/US\$ exchange rate	
	Before	January–June	After June	Retail	Wholesale	Retail	Wholesale
	January 2002	2002	2002				
Rice	0.08	0.98 (0.88)	44 (40)	1.01	0.86	43.6	46.5
Wheat	0.06	0.71	28	—	—	—	—
Barley	0.06	0.71	26	—	—	—	—
Corn	0.04	0.60 (0.49)	24 (20)	0.10	0.07	240.0	285.7

## 2. Wage Increases

While increasing the prices, Pyongyang also increased wages. Monthly wages rose around 20 fold from 110 won to 2000 won. The bulk of the increase in wages was for soldiers and farmers. Wage increases for military personnel were due to the *seongun* (Military first) policy of North Korea. The procurement price for agricultural products was also increased by the government to make farmers produce more for the PDS. Before the reform, the government was paying 0.8 won for rice and selling it for 0.08 won. Thus, the government was taking a loss by this trade. After the reform, the government procured rice for 40 won and sold it to the people for 44 won. Different from the previous practice before reform, the government aimed to make profit out of it.<sup>35</sup>

<sup>35</sup> Nam, "Evaluation of the North Korean July 2002 Economic Reform," 37.

Table 2. Major Prices Before and After the Reforms (from Hong, 96).

(Unit: North Korean Won)

Classification	Item/Stratum	Unit	Prices set by North Korean government		
			Before Reform (A)	After Reform (B)	Price Increase (B/A, Times)
Price	Rice	1kg	0.08	44	550
	Corn	1kg	0.07	33	471
	Diesel Oil	1kl	1	38	38
	Electricity	1kWh	0.035	2.1	60
	Streetcar Fare	one way	0.1	1	10
	Subway Fare	per sector	0.1	2	20
	Train Fare (Sleeping Car)	Pyongsong(North Pyongan Province)-Namyang(North Hamgyong Province)	50	3,000	60
	Entrance Fee	Beach of Song-do	3	50	17
Wage	Rent	Pyongyang area	0.03% of income	Monthly 2 NKW/lm <sup>2</sup>	—
	Laborer	Monthly	110	2,000	18
	Miner	Monthly	—	6,000	—
	Manager of Trading Company	Monthly	150	3,000	20
Exchange rate		NKW/dollar	2.15	150	—

### 3. Devaluation of the Won

Beside price and wage increases, Pyongyang introduced another aspect of price reform: devaluation of the won. One U.S. dollar was worth to 2.15 won before reform; the government readjusted its exchange value rose to 150 won per dollar. Later, the official rate went up to 900 won per dollar.<sup>36</sup>

<sup>36</sup> Ibid., 41.

## C. DECENTRALIZATION

The second aspect of 7.1 policy was decentralization. Decentralization happened in two sectors: industrial and agricultural.

### 1. Industrial Decentralization

The first phase of industrial decentralization included the closure of all nonprofit factories, one of which was a major glass factory. In this phase, the government was trying to improve efficiency within the system.<sup>37</sup> The goal of the second phase was to reduce unnecessary administrative layers, such as party members, from factories. The only party representative that remained at the factories was the party secretary.<sup>38</sup> The most significant difference after July 2002 was that factories were held responsible for covering their costs. The government ceased providing subsidies to factories, so factories were supposed to pay the wages of their employees. This system was called the self-support accounting system.<sup>39</sup> According to the self-support accounting system, managers were also supposed to purchase their own raw material.<sup>40</sup>

To raise capital for the infrastructure of factories, the government issued "People's Life Bonds." Net amount of gain was not determined by the government, and full trust to government was expected. According to the state newspaper *Rodong Shinmun* (Workers' Newspaper), the government built eight power plants with the money raised by bonds.<sup>41</sup>

The government also freed enterprises to invest as they wanted. In addition, factories were allowed to hire and fire workers. Managers were also free to give bonuses to the workers they wanted. With this incentive, the government aimed at performance-based distribution.<sup>42</sup> The motive was to push factories to come up with new strategies to

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<sup>37</sup> Ibid., 38.

<sup>38</sup> Hale, "Real Reform in North Korea?" 833.

<sup>39</sup> Nam, "Evaluation of the North Korean July 2002 Reform," 38.

<sup>40</sup> Hale, "Real Reform in North Korea?" 833.

<sup>41</sup> Ibid., 835.

<sup>42</sup> Nam, "Evaluation of the North Korean July 2002 Reform," 34.

enable more production and to foster the invention of new tactics to make a profit.<sup>43</sup> As Deng Xiaoping asserted, "It doesn't matter whether it's a white cat or a black, I think; a cat that catches mice is a good cat."<sup>44</sup> Pyongyang thought the same.

## 2. Agricultural Decentralization

The other aspect of decentralization happened in agriculture. After July 2002, instead of giving food subsidies to everybody, the government provided only a basic supply of grain as needed by issuing ration coupons. After the end of the drought, grain production increased by 8 %.<sup>45</sup> This created over confidence in Pyongyang that the PDS system could be sustained and even get more reinforced. This kind of approach needed more grain for the PDS system. By raising procurement prices, Pyongyang expected to create an incentive for farmers to produce and supply more grain to the PDS system.<sup>46</sup>

Another aspect of agricultural reforms was a pilot land-lease program in Heoryong and Musan located in Hamgyeong province. People are allowed to perform private farming in this part of the country by using the leased land that had been previously used for collective farming. These areas were established before 2002; the plots were limited to 30 pyong (118 square yards).<sup>47</sup> After the July 2002 reforms, the government increased it to 400 pyong (1579 square yards). Farmers also received capital for fertilizer and farming tools.<sup>48</sup> The government also allowed them to take all of the output and sell it on the market. This incentive led to three-fold higher production than in the state-owned farms.<sup>49</sup>

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<sup>43</sup> Hong, "A Shift Towards Capitalism?" 97.

<sup>44</sup> C. D. Stoltenberg, "China's Special Economic Zones - their Development and Prospects," *Asian Survey* 24, no. 6 (1984), 637.

<sup>45</sup> Nam, "Evaluation of the North Korean July 2002 Reform," 36.

<sup>46</sup> Hong, "A Shift Towards Capitalism?" 100.

<sup>47</sup> Nam, "Evaluation of the North Korean July 2002 Reform," 39.

<sup>48</sup> Hale, "Real Reform in North Korea?" 837.

<sup>49</sup> Nam, "Evaluation of the North Korean July 2002 Reform," 39.

#### D. FOREIGN CAPITAL ACQUISITION

The third aspect of the 7.1 policy and the most important venture of the government was foreign capital acquisition. The first phase of this venture was the devaluation of dollar as mentioned earlier. The government's next incentive for foreign investment was "scrapping the use of foreign exchange coupons for foreigners, allowing foreign nationals to use the same currency as North Korean nationals."<sup>50</sup> As shown in Figure 1, the next and most significant incentive was the establishment of "special open-door areas."<sup>51</sup> These areas are mostly referred to as special economic zones (SEZ). In addition to the Rason special economic zone established before 2002, the government founded the Sinuiju Special Administrative Region (SAR), the Mount (Mt.) Kumgang Tourism Zone, and the Kaesong Industrial Park.<sup>52</sup> The Sinuiju SAR, which was established in September 2002, is on the Chinese border. This SEZ was aimed to focus on trade with countries on the Yellow Sea.<sup>53</sup> Mt. Kumgang SEZ was established in November 2002 on the east coast of North Korea.<sup>54</sup> It was planned as an international touristic attraction, especially for the Republic of Korea (South Korea) and Japan.<sup>55</sup> The Kaesong SEZ was established by a joint venture between North Korea and South Korean Hyundai Assan on June 2003, one year after the reforms.<sup>56</sup> It was established in the city of Kaesong in North Korea, which is only 60 kilometers away from Seoul, the capital of South Korea.<sup>57</sup>

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<sup>50</sup> Hale, "Real Reform in North Korea?" 838.

<sup>51</sup> Chung, "Dual Strategy and 'Silli (Practical) Socialism,'" 300.

<sup>52</sup> Lim and Lim, "Special Economic Zones as Survival Strategy of North Korea," 48.

<sup>53</sup> Ibid.

<sup>54</sup> Chung, "Dual Strategy and 'Silli (Practical) Socialism,'" 301.

<sup>55</sup> Lim and Lim, "Special Economic Zones as Survival Strategy of North Korea," 48.

<sup>56</sup> Hale, "Real Reform in North Korea?" 839.

<sup>57</sup> Lim and Lim, "Special Economic Zones as Survival Strategy of North Korea," 48-49.



Figure 1. North Korean Special Economic Zones (from Lim, 49).

### III. THE ECONOMIC IMPACT OF 7.1 POLICY

#### A. BACKGROUND

North Korea represents a highly information-constrained environment. Thus, the most important way to get information in societies such as North Korea is through surveys. This method has also been applied in closed societies such as the Soviet Union and China. Here, also, the most reliable information about the impacts of the 7.1 policy can be found in the surveys of North Korean refugees fleeing to other countries. There are two major surveys that have been conducted until now: China and South Korea surveys. The primary goal of these surveys was to evaluate the overall impact of reforms.<sup>58</sup> The first question on these surveys was: “Has food availability improved in North Korea?”<sup>59</sup>

The results were surprising; despite the reforms, as shown in Figure 2, almost 75 percent of the refugees expressed that they disagreed or totally disagreed that the food availability had increased. They suggested that the reforms had not provided a better supply of goods.<sup>60</sup>

The next major question was: “Did you become better off?”<sup>61</sup>

As shown in Figure 3, few thought that the situation got better, whereas a majority of the refugees disagreed or totally disagreed that they got better off. The percentage that agreed that they were better off was mostly ex-party officials or farmers.

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<sup>58</sup> Haggard and Noland, *Witness to Transformation: Refugee Insights into North Korea*, 15–17.

<sup>59</sup> *Ibid.*, 66.

<sup>60</sup> *Ibid.*

<sup>61</sup> *Ibid.*, 69.

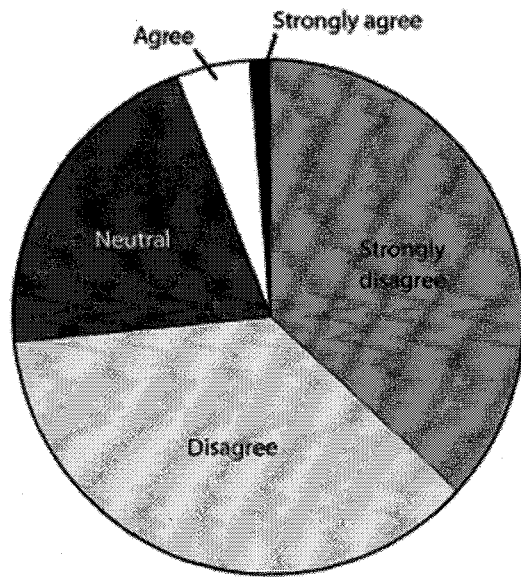


Figure 2. China Survey Response to “Has food availability improved in North Korea?” (from Haggard and Noland, 66).

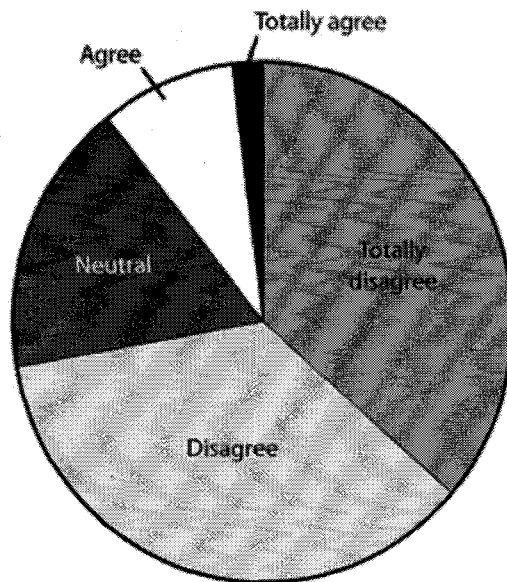


Figure 3. China Survey response to “Did you become better off?” (from Haggard and Noland, 70).

## B. THE EFFECTS ON AGRICULTURE

When asked whether the agricultural policies had any effect, the answer differed among refugees who were farmers, workers and party officers.

Table 3. Pre- and Post-reform Perceptions of Agricultural Policies: South Korea Survey (from Haggard and Noland, 69).

Relative to conditions 10 years earlier, at the time of your departure:	Prereform (before 2002)				Postreform (2003 and after)			
	Totally agree/agree	Neutral	Totally disagree/disagree	Unclear/don't know	Totally agree/agree	Neutral	Totally disagree/disagree	Unclear/don't know
The cooperative or farm had more control over planting decisions	18.5	21.5	46.2	13.9	29.4	17.7	42.7	10.3
There was greater availability of inputs such as fertilizer	6.2	35.4	52.3	6.2	11.8	26.5	54.4	7.4
The government or cooperative managers seemed to take more and more grain from the cooperative each year	52.3	26.2	12.3	9.2	61.8	25.0	11.8	1.5
You had more access to land to grow what you wanted	18.5	26.2	49.2	6.2	29.4	16.2	50	4.4
You had more opportunity to trade farm products on the market	41.5	29.2	27.7	1.5	52.9	27.9	17.7	1.5
The government changed the rules more often	40	21.5	9.2	29.2	64.7	22.1	2.9	10.3
You became better off	4.7	20.2	71.9	3.1	17.7	16.2	66.2	0

As seen in the Table 3, 17.7% of farmer refugees admitted that they had “more opportunity to trade farm products on the market after reform,”<sup>62</sup> which is higher than 4.7% for the pre-reform era.<sup>63</sup> This increase is due to the “shift in the terms of trade in favor of agriculture.”<sup>64</sup>

According to the results, the cooperative or farm had more control over planting decisions, and there was greater availability of inputs, such as fertilizer. Moreover, the farmers had more access to land to grow what they wanted. Furthermore, they had more opportunity to trade farm products on the market. However, the government or cooperative managers seemed to take more and more grain from the cooperative each

<sup>62</sup> Yoonok Chang, Stephan Haggard and Marcus Noland, “Exit Polls: Refugee Assessments of North Korea’s Transition,” *Journal of Comparative Economics* 37, no. 1 (March 2009), 145.

<sup>63</sup> Haggard and Noland, *Witness to Transformation*, 69.

<sup>64</sup> *Ibid.*, 68.

year. Also, the other problem was the unsustainability of the government. The bulk of the people surveyed admitted that the government changed the rules more often. The percentage of the people who thought like this went up to 64.7 percent for the post-reform era, whereas the number was 40 percent for the pre-reform era.<sup>65</sup> Therefore, there is a small but positive change in terms of agriculture. This is one of the rare positive results of the 2002 reforms. In terms of providing space for trading products, the July 2002 reforms made a contribution to the farmers.

### **C. THE EFFECTS ON STATE-OWNED ENTERPRISES**

As shown in Table 4, dissatisfaction increases to 79.2 % for post-reform era, which was 76.1 percent for the pre-reform era among the other refugees such as workers in rural areas and state-owned enterprises (SOE). Different from the results of the poll on agricultural reforms, even the workers in rural areas and state-owned enterprises, who enjoyed a privileged position in North Korea, were not satisfied with the reforms, and eight workers out of ten denied that they were better off.<sup>66</sup>

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<sup>65</sup> Ibid., 69.

<sup>66</sup> Ibid., 70.

Table 4. Pre- and Post-reform Perceptions of State-owned Enterprise Reforms: South Korea Survey (from Haggard and Noland, 71).

Relative to conditions 10 years earlier, at the time of your departure:	Prereform (before 2002)				Postreform (2003 and after)			
	Totally agree/agree	Neutral	Totally disagree/disagree	Unclear/don't know	Totally agree/agree	Neutral	Totally disagree/disagree	Unclear/don't know
More of your enterprise's output was sold on the market	58.7	6.5	30.4	4.4	43.8	25	25	6.3
More of your work was done outside the enterprise	69.6	10.9	15.2	4.4	72.9	10.4	14.6	2.1
People did not seem to work as hard for the work unit as in the past	73.9	17.4	8.7	0	77.1	10.4	10.4	2.1
Your factory was involved in market activities outside the plan	58.7	15.2	21.7	4.4	47.9	31.3	12.5	8.3
The quality of social services at your work unit declined	76.1	13	6.5	4.4	82.5	10.4	2.1	0
The government changed the rules more often	65.3	8.7	6.5	19.6	58.3	27.1	0	14.6
You became better off	2.2	17.4	76.1	4.4	8.3	10.4	79.2	2.1

The participants stated that less of their enterprise's output was sold on the market, and more of their work was done outside the enterprise in the post-reform era. They also claimed that people did not seem to work as hard for the work unit as in the past. On the other side, participants declared that their factory was involved in market activities outside the plan less than before. Compared with the pre reform era, an increasing number of participants confirmed that the quality of social services at their work unit declined.<sup>67</sup>

#### D. THE EFFECTS ON GOVERNMENT AND PARTY OFFICERS

According to the results of the poll applied to the government and party officer refugees shown in Table 5, 19.2 % of party officer refugees suggested that they were better off after reforms, which is a higher percentage compared with the 16.7 % rate before reforms.<sup>68</sup>

<sup>67</sup> Ibid., 71.

<sup>68</sup> Chang, Haggard and Noland, *Exit Polls: Refugee Assessments of North Korea's Transition*, 145–147; Haggard and Noland, *Witness to Transformation: Refugee Insights into North Korea*, 70–72.

Table 5. Government and Party Officers' Perceptions of Reform Trends: South Korea Survey (from Haggard and Noland, 72).

Relative to conditions 10 years earlier, at the time of your departure:	Prereform (before 2002)				Postreform (2003 and after)			
	Totally agree/agree	Neutral	Totally disagree/disagree	Unclear/don't know	Totally agree/agree	Neutral	Totally disagree/disagree	Unclear/don't know
Over time, more effort was spent on ideological and propaganda work in your office	54.2	16.7	25.0	4.2	50.0	30.8	7.7	11.5
Over time, corruption among public officials and high-ranking officers increased	87.5	8.3	4.2	0	76.9	7.7	3.9	11.5
Over time, your office/unit devoted more time to money-making activities not directly related to your official or traditional responsibilities	66.7	12.5	12.5	8.3	73.1	15.4	3.9	7.7
Your office competed against other government/party/military organizations in money-making activities	45.8	29.2	12.5	12.5	26.9	42.3	15.4	15.4
The government changed the rules more often	41.7	25.0	12.5	20.8	53.9	34.6	3.9	7.7
You became better off	16.7	12.5	62.5	8.3	19.2	23.1	53.9	3.9

Fewer people agreed that more effort was devoted to ideological and propaganda work and they also did not agree that corruption among public officials increased. On the other hand, they agreed that their office devoted more time to money-making activities not directly related to their official or traditional responsibilities; however, they did not agree that their office competed against other government/party organizations in money-making activities. They concluded by admitting that the government changed the rules more often.<sup>69</sup>

#### E. THE EFFECTS ON BUSINESS ENVIRONMENT AND PRIVATE TRADING

According to the surveys (see Figure 4) applied to North Korean refugees who fled country at least one year after the reform, 30% of respondents claimed that the government controlled the prices in the reform era, whereas the percentage dropped to around 15% in the post-reform era.

<sup>69</sup> Ibid.

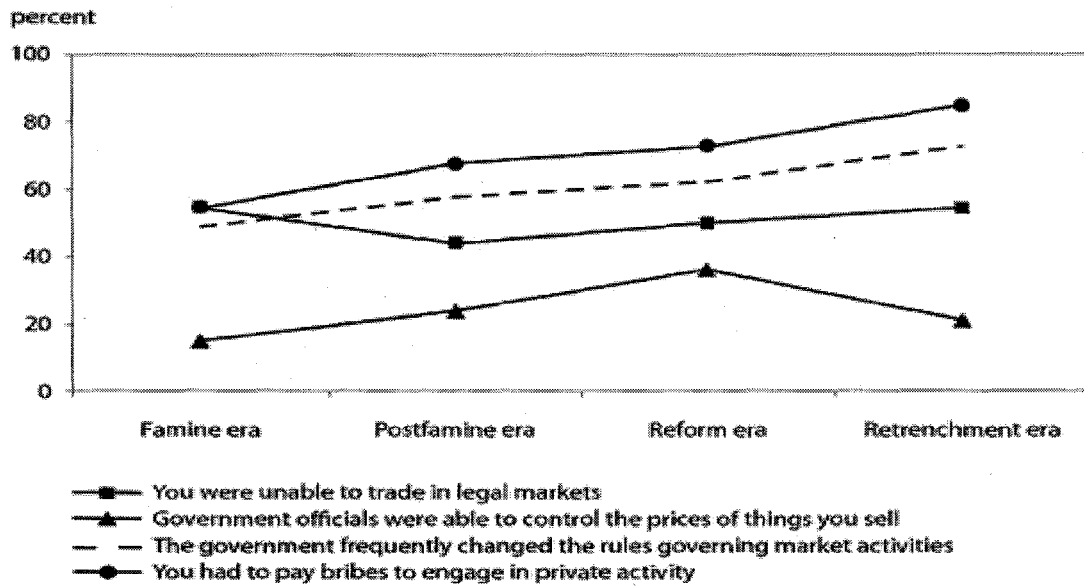


Figure 4. Perceptions of the Business Environment for Market and Private Activities: South Korea Survey (from Haggard and Noland, 67).

There was also an increasing percentage in respondents stating that they were unable to trade in legal (general) markets. Figure 4 indicates a significant increase in black market activities.

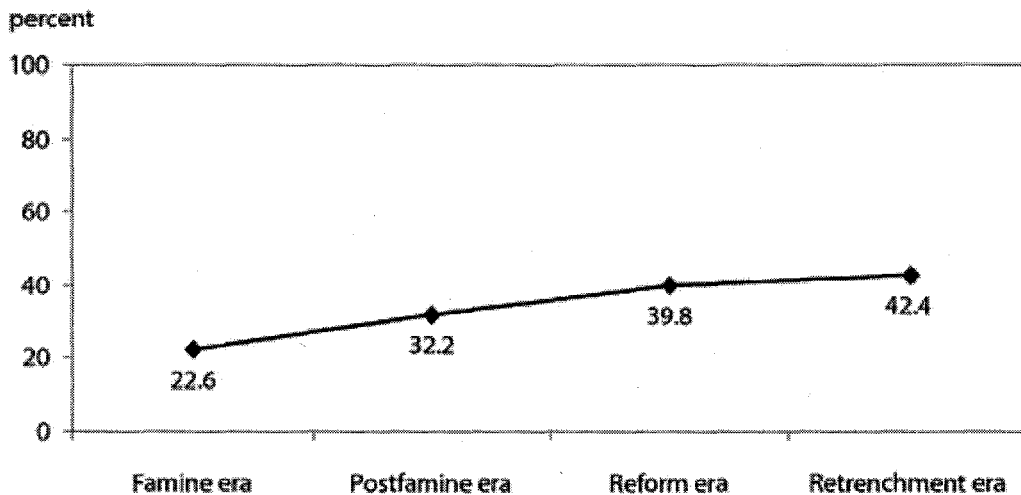


Figure 5. Ease of Engaging in Private Trading in North Korea: South Korea Survey (from Haggard and Noland, 67).

According to the respondents as shown in Figure 5, the ease in private trading for the post-reform period went up to 39.8 % from the rate of 32.2 for the pre-reform era; however, 80% of respondents, which was 65 % in the pre-reform era—Figure 4—admitted that they had to pay bribes to engage in private activity.<sup>70</sup> The survey results among the refugees from Hamgyeong province, where North Korean authorities initiated a pilot private farming program, had more positive assessments about the post-reform era than the others. They evaluated that there was an improvement in well-being and that the emergence of the markets has functioned as a “safety valve.”<sup>71</sup>

According to the results of the South Korea survey, most of the refugees concluded that “merit was not awarded and working hard at your assigned job didn’t yield fruit.”<sup>72</sup> As shown in Figure 6, working at an assigned job was not thought to be the ideal way to behave after the reforms. Moreover, the percentage seeing the market activities as an easy way to earn money also dropped after the reforms. On the other hand, more people thought that engaging in corrupt or criminal activities was an easier way to earn money.<sup>73</sup>

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<sup>70</sup> Haggard and Noland, *Witness to Transformation*, 66–67.

<sup>71</sup> *Ibid.*, 74.

<sup>72</sup> *Ibid.*, 77.

<sup>73</sup> *Ibid.*, 76.

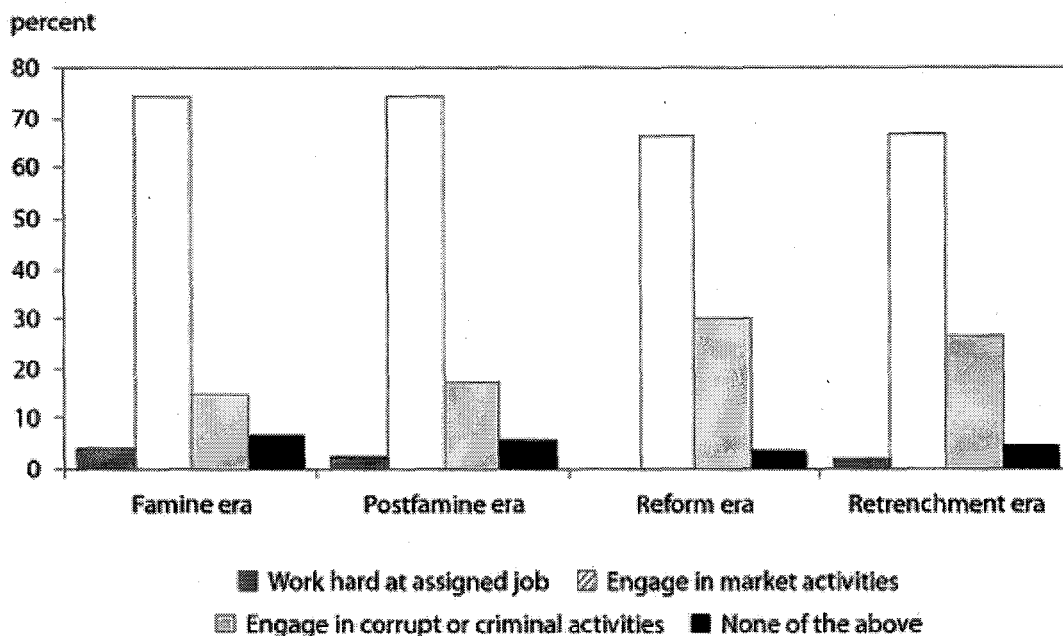


Figure 6. Easiest Way to Make Money in North Korea: South Korea Survey (from Haggard and Noland, 67).

Most of them believed that reforms supported marketization; however, almost all of the refugees emphasized growth in inequality (84%), materialism (92%), and corruption (89%).<sup>74</sup> The survey indicates that the monetization reforms did not actually improve the lives of North Koreans. Only the party officers were more satisfied with the results of the reforms. At first glance, this can be attributed to the 7.1 policy; however, increase in corruption suggests that the satisfaction of party officers may not only be due to the 7.1 policy.

The decentralization in the industrial sector does not seem to have any effect. As the survey suggests, the only perceived improvement is the opportunity to trade farm products on the market. That can be attributed to the 7.1 policy; however the increase in gains of farmers is not only due to general markets but also due to the expansion of the black market. So, the only direct impact of the 7.1 policy on the agricultural sector can be attributed to the Hamgyeong private farming venture. The overall satisfaction among

<sup>74</sup> Ibid., 77.

farmer refugees from Hamgyeong suggests that it was successful. The third aspect of the reforms, foreign capital acquisition, does not seem to have any direct effect on the North Korean economy either.

## **IV. PROBLEMS THAT AFFECTED THE 7.1 POLICY**

### **A. PROBLEMS IN MONETIZATION**

The North Korean government's monetization measures did not yield the expected results. For example, the government could not achieve a profit from the procurement and sale of rice as there was a high motivation for corruption among government officials. Rice prices went up to 250 won on the black market, which was higher than the official procurement price of 40 won. Thus, selling it on the black market instead provided more profit for the farmers. The price increases which formed the first phase of the reform were similar to the start of the Chinese reforms in 1979. The key difference, however, was that in North Korea price rationalization was under national control.<sup>75</sup>

The main reason that monetization could not succeed, though, was that the food and commodity production could not catch up with the demand. Lack of supply, too many won bills, and ongoing demand all contributed to the resulting hyperinflation.<sup>76</sup> As the state did not respond quickly by designating new procurement and sale prices, a large gap between official and black market prices reappeared. The victims hardest hit by hyperinflation were people receiving wages from state or industrial enterprises. They went on receiving the same basic salary, which was 2000 per month.<sup>77</sup> Even so, the government could not pay the full amount of wages. To sustain their lives, these workers had to do additional jobs.<sup>78</sup>

### **B. PROBLEMS IN DECENTRALIZATION**

#### **1. Problems in Industrial Decentralization**

The 7.1 policy's industrial incentives were proper; however there were other problems. There was a severe lack of raw materials. Even steel factories were in quest of

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<sup>75</sup> Hale, "Real Reform in North Korea?" 825–6.

<sup>76</sup> Nam, "Evaluation of the North Korea July 2002 Reform," 41.

<sup>77</sup> Hale, "Real Reform in North Korea?" 825.

<sup>78</sup> *Ibid.*, 837.

scrap iron; therefore, managers who were supposed to procure their own raw material were helpless. Combined with the energy shortages caused by the lack of energy infrastructure, factories ended up with a 30% operational efficiency rate on average.<sup>79</sup> As a result, although the enterprises were allowed to invest freely, they were out of capital to do so.

## **2. Problems in Agricultural Decentralization**

The incentives in agriculture also did not lead to the fully anticipated growth level. One of the reasons for this shortfall was that the government did not adapt the grain procurement prices according to the rate of inflation. While grain prices were going up on the black market, state procurement prices stayed the same. The government could not compensate for the increasing procurement prices for grain, because it lacked the capital for it. As farmers were free to keep a certain amount of their harvest after meeting production targets and to sell the production surplus, they preferred to sell their surplus of production on the black market.<sup>80</sup>

## **C. PROBLEMS IN FOREIGN CAPITAL ACQUISITION**

Foreign capital acquisition by SEZs did not work out for North Korea either. The special economic zones could not provide Pyongyang the necessary capital for its investments. The problems in SEZs can be categorized into three groups: international, administrative, and infrastructural.

### **1. International Problems**

The most significant international problem was customs clearance.<sup>81</sup> The first aspect of customs clearance is strict control over production and export of weapons. Most of the industrial production, which was 18% of whole GDP, was military production.<sup>82</sup> The control on weapons production hampered military exports. The second customs

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<sup>79</sup> Hale, "Real Reform in North Korea?" 834.

<sup>80</sup> Hong, "A Shift Towards Capitalism?" 100.

<sup>81</sup> Kim and Lim, "The Kaesong Inter-Korean Industrial Complex Perspectives and Prospects," 91.

<sup>82</sup> Seliger, "The July 2002 Reforms," 24.

clearance problem was international competition. The products from Kaesong have "Made in Kaesong" or "Made in DPRK" labels on them. This label does not attract customers in terms of origin. Also, the tariff rate was very high for North Korean products. While the tariff rate for Chinese products was between 4.2 and 27.8 percent, the tariff rate for North Korean products was between 45 and 90 percent. High tariff rates did not allow competitiveness for North Korean products in international markets.<sup>83</sup>

Another international problem that hindered the development of SEZs was the Chinese government's lack of support. North Korea did not acknowledge the Chinese government about its special economic zone venture. China was especially uneasy about the Sinuiju special economic zone. As Dandong City is located across from Sinuiju City and connected to it by a bridge, the Chinese government worried that the residents would rush Sinuiju to gamble.<sup>84</sup>

## 2. Administrative Problems

The second part of disappointing results of the reforms was administrative problems. Pyongyang assigned Yang Bin, who was being investigated for commercial fraud by China, as the chief executive of the SEZ. The Chinese government later arrested him leaving the SEZ without an authority.<sup>85</sup> The subsequent authorities who replaced him were not open-minded and innovative. In China, during the initial establishment of the SEZ, Liang Xiang became the Mayor of the Shenzhen SEZ. He fought with corruption and recruited the most talented people in the region using head hunters.<sup>86</sup> North Korean SEZs never had such a leader. The administration also lacked the full authority to establish authority free from Pyongyang. Basic law clearly stated that SEZs were "under the central authority of the State." The SEZs did not have a special body like the Special Economic Zones Affairs Office as in China to communicate directly between

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<sup>83</sup> Lim, "Seven Business Models for Success of North Korea's Economic Reform," 92.

<sup>84</sup> Sandhu, "A Doomed Reform," 39.

<sup>85</sup> Lai, "SEZs and Foreign Investment in China," 90.

<sup>86</sup> *Ibid.*, 78-81.

the SEZ authority and the government, and to streamline the administrative approval procedures for foreign investments.

Another aspect of the administrative problems was the fragility of legal guarantees.<sup>87</sup> Legal guarantees were too fragile to build a secure environment for investment. According to the law, Pyongyang reserved the right to station military personnel in the SEZs. Depending on the international political tensions, trade procedures changed all the time. Judicial processes were the same for SEZs as they were in the other regions of North Korea. Thus, the SEZs lacked an economic law.<sup>88</sup>

### 3. Infrastructural Problems

Infrastructural problems were the third part of the problem for SEZs. The main hindrance with infrastructure was lack of investment. Comparing North Korean SEZs with their role model, China, Shenzhen has spent 4500 million Renminbi (RMB) for its infrastructure.<sup>89</sup> There are no available data on how much money North Korea has spent on infrastructure; however, industries producing too much wastewater and consuming too much electricity were not allowed in North Korean SEZs, which means infrastructure was not adequate.<sup>90</sup>

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<sup>87</sup> Zook, "Reforming North Korea," 25.

<sup>88</sup> *Ibid.*, 17-25.

<sup>89</sup> K. Y. Wong, "China's Special Economic Zone Experiment - an Appraisal," *Geografiska Annaler Series B-Human Geography* 69, no. 1 (1987), 38.

<sup>90</sup> Lim, "Seven Business Models," 92-93.

## V. THE POLITICAL ECONOMY OF THE REFORMS

After the July 2002 reforms, there were important political events that affected the implementation of the reforms. The first one was the 2002 nuclear crisis, which took place only four months after the policy was introduced. Four years later, the 2006 nuclear and missile crisis followed. Also, the Cheonan and Yeongpyeong incidents took place after the failed 2009 currency reform attempts. The last of these incidents, the nuclear crisis, occurred in 2013. While these incidents were happening, there was also domestic politics going on. This chapter is dedicated to finding out the effects of each of these factors on the 7.1 policy.

### A. 2002 NUCLEAR CRISIS

In October 2002—four months after the establishment of the 7.1 policy—North Korea acknowledged that it had been conducting a nuclear program. In doing so, North Korea nullified its 1994 agreement with the United States. Following this open admittance of a nuclear program, North Korea started to harvest plutonium from the Yongbyon nuclear complex. These incidents created a nuclear crisis between North Korea and the international community.

The crisis had no effect on the monetization and decentralization trends of the July 2002 economic reforms. It partially affected the foreign capital acquisition trend of 2002 reforms. This negative effect mostly originated from the sharp decline in trade with Japan.<sup>91</sup> Moreover, Japan's North Korea policy shifted from default engagement to default containment. As a result, Japan started to implement sanctions on North Korea. By February 2004, these sanctions first started with the tightening of procedures for the reporting of remittances and continued as total cessation of trade and stoppage of food aid

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<sup>91</sup> Stephan Haggard and Marcus Noland, "Sanctioning North Korea: The Political Economy of Denuclearization and Proliferation," *Asian Survey* 50, no.3 (2010), 554.

by the end of the year.<sup>92</sup> These sanctions affected the foreign capital acquisition trend of the 7.1 policy as pro-North Korean residents in Japan are one of the major sources of hard currency for North Korea.<sup>93</sup>

Another side effect of the nuclear crisis was U.S. sanctions. In 2003, President George W. Bush announced the Proliferation Security Initiative (PSI). Nonetheless, this was only a weak call for cooperation to monitor possible WMD (weapons of mass destruction) carrying ships.<sup>94</sup> More important than that were fiscal measures taken by the U.S. Treasury Department. It threatened to stop business with any banks helping North Korea's transactions. And it did so. On September 15, 2005 the U.S. Treasury announced that Macao-based Banco Delta Asia had suspicious ties with Kim Jong-il. Following this, Banco Delta froze \$25 million of North Korean funds. Other banks around the world also cut their ties with North Korea "for fears that the United States might retaliate." This affected North Korea's foreign bank accounts; however, they were not significant in the long term.<sup>95</sup> Another target of the U.S. Treasury was foreign firms cooperating with North Korea. Swiss Kohas AS was one of them. The U.S. Treasury imposed sanctions against it suspecting it of being a "technology broker" for the North Korean military by proliferating "goods with weapons-related applications."<sup>96</sup>

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<sup>92</sup> Christopher W. Hughes, "The Political Economy of Japanese Sanctions towards North Korea: Domestic Coalitions and International Systemic Pressures," *Pacific Affairs* 79 (Fall 2006), 464-466.

<sup>93</sup> Ruediger Frank, "The Political Economy of Sanctions against North Korea," *Asian Perspective* 30, no.3 (2006), 26.

<sup>94</sup> Haggard and Noland, "Sanctioning North Korea," 563.

<sup>95</sup> Frank, "The Political Economy of Sanctions," 27.

<sup>96</sup> *Ibid.*, 29.

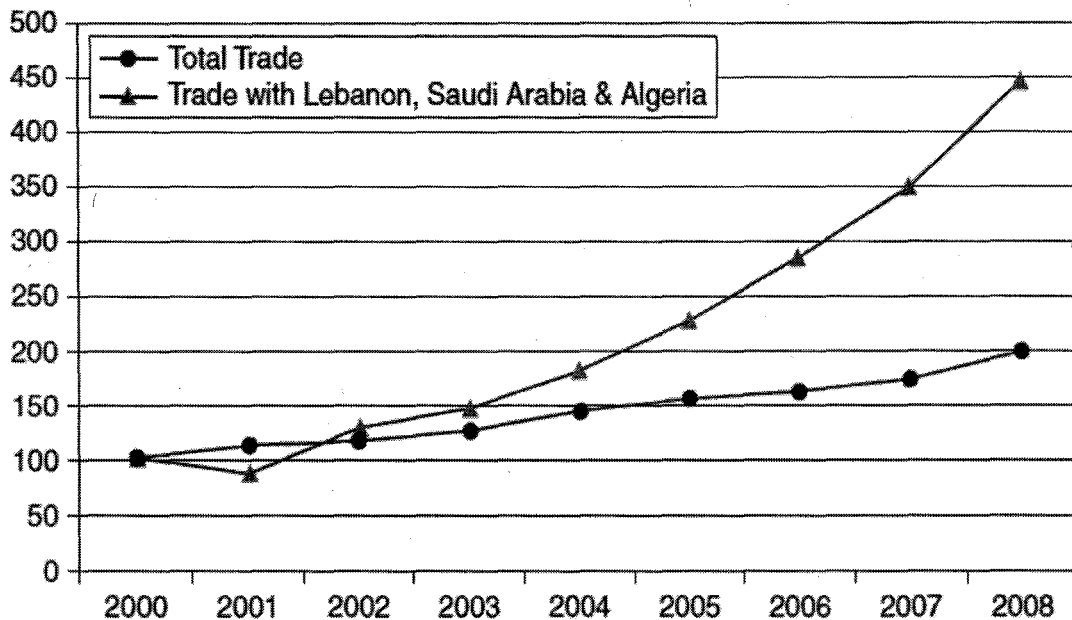


Figure 7. North Korean Trade with the World vs. the Middle East (from Haggard and Noland, 554).

U.S. sanctions also affected the infrastructural development of the Kaesong SEZ. It did not allow the installation of a direct telecommunications connection between North and South until November 2005 due to concerns over dual-use technologies. This prevented direct calls from North to South and disabled Internet connection for a while; however, this sanction did not affect North Koreans directly. Rather, it impacted the South Koreans who were trying to do business with North Korea. This period of isolation even helped North Korea to control the flow of information in and out of the Kaesong SEZ easier.<sup>97</sup>

U.S. sanctions to bring down the regime had short-term effects but not long-term results. They were rare and targeted only specific goods. It had a limited effect that resulted with North Korea's diverting of its economic activities rather than suspending its total trade. As U.S. sanctions were unilateral, they were replaced by other U.S. rival suppliers.<sup>98</sup> China was a major supplier, but it had its own reasons. First, it wanted to

<sup>97</sup> Frank, "The Political Economy of Sanctions," 28.

<sup>98</sup> *Ibid.*, 30.

increase its influence on North Korea and gain leverage against the United States. Second, it wanted to open up new markets in which to direct its production surpluses. Third, the improved economic conditions backed up by the Chinese government's guarantee attracted Chinese entrepreneurs. Low labor costs in North Korea SEZs were another factor for this attraction.<sup>99</sup>

In addition to China, there were other countries benefiting from a growing trade with North Korea. These were developing Middle East countries—Algeria, Saudi Arabia, and Lebanon, as shown in Figure 7. “Trade with Algeria, Saudi Arabia, and Lebanon has grown twice as fast as North Korea’s trade with the rest of the world.” Furthermore, North Korea exported to Thailand, Brazil, Qatar, Myanmar, France, Germany, and Nigeria as shown in Figure 8. On the other hand, North Korean received imports from Thailand, Russia, Brazil, India, Netherlands, and Congo.<sup>100</sup>

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<sup>99</sup> Jae Cheol Kim, “The Political Economy of Chinese Investment in North Korea: A Preliminary Assessment,” *Asian Survey* 46, no. 6 (November-December 2006), 909–912.

<sup>100</sup> Haggard, “Sanctioning North Korea,” 553.

<i>North Korean Imports</i>							
	<i>2004</i>		<i>2005</i>		<i>2006</i>		<i>2007</i>
1. China	26.6	China	31.7	China	32.8	China	32.9
2. South Korea	14.6	South Korea	21.0	South Korea	22.1	South Korea	24.4
3. Thailand	8.0	Algeria	8.1	Algeria	9.3	Algeria	9.9
4. Russia	6.9	Thailand	6.6	Thailand	6.0	Thailand	4.6
5. Algeria	6.8	Russia	6.6	Russia	5.1	South Africa	3.6
6. Brazil	6.2	Congo	2.6	Congo	2.9	Congo	3.2
7. India	4.5	India	2.3	India	2.6	Brazil	3.2
8. Netherlands	4.4	Singapore	2.2	South Africa	2.3	Russia	3.0
9. Japan	3.0	Brazil	2.1	Brazil	1.9	India	2.8
10. Congo	2.6	Japan	1.8	Singapore	1.6	Saudi Arabia	1.6

<i>North Korean Exports</i>							
	<i>2004</i>		<i>2005</i>		<i>2006</i>		<i>2007</i>
1. China	41.2	China	32.2	South Korea	30.0	South Korea	36.8
2. South Korea	18.2	South Korea	21.9	China	27.0	China	27.9
3. Japan	11.5	Japan	8.4	Thailand	8.5	Venezuela	9.3
4. Thailand	6.4	Thailand	8.0	Brazil	4.8	Brazil	4.8
5. Brazil	4.5	Brazil	4.2	Japan	4.5	India	4.4
6. Qatar	2.4	India	2.6	Greece	4.5	Myanmar	2.3
7. Myanmar	1.9	Saudi Arabia	2.1	India	4.2	Netherlands	1.8
8. France	1.9	Myanmar	2.0	Myanmar	2.2	Thailand	1.7
9. Germany	1.6	Germany	2.0	Saudi Arabia	1.6	Russia	1.6
10. Nigeria	1.2	France	1.9	Paraguay	1.3	Saudi Arabia	1.4

Figure 8. North Korea's Top Ten Trading Partners, 2004–2007 (%) (from Haggard and Noland, 553).

Overall, the 2002 nuclear crisis did not directly affect the monetization and decentralization trends of the July 2002 reforms, but it did have some partial effects on the foreign acquisition trend of the reforms. The most important effect of the sanctions by the United States was on North Korea's future prospect for trade and the future of the Kaesong Industrial Complex.<sup>101</sup> If the Japanese embargo and U.S. sanctions were not unilateral and the trade gap had not been subsidized by other countries, this would have

<sup>101</sup> Chung Young Chul, "Political Economy of the U.S. Economic Sanctions against North Korea: Past, Present and Future," *Development and Society* 34, no.2 (2005), 227.

had a more significant effect on North Korean SEZs and foreign capital acquisition in the end. It is also why North Korea reaffirmed its commitment to developing weapons of mass destruction after the crisis and even during the Six-Party Talks.<sup>102</sup>

## **B. 2006 MISSILE AND NUCLEAR CRISIS**

On July 5, 2006, North Korea fired seven missiles over the East Sea. The Taepodong-2 model missiles exploded soon after they were launched. On October 8, 2006, it made its first nuclear test exploding a sub-kiloton bomb. There were new sanctions following the incident. To start with, Japan introduced sanctions on *Chosen Soren*—the General Association of Korean Residents in Japan. It removed tax exemptions for the association, which meant lesser hard currency revenue for North Korea.<sup>103</sup> While Japan accounted for 3% of North Korea's imports and 11% of its exports, trade dropped to a trickle by 2007.<sup>104</sup>

At the same time, the United Nations Security Council (UNSC) implemented trade sanctions on major weapons systems and luxury goods. Another resolution (UNSCR 1874) on June 12, 2009 extended the scope of the sanctions adding all arms-related trade and all training or assistance to it. The latter resolution helped to prevent the collaboration among North Korea, Iran, and Syria on missile and nuclear technologies; however, these resolutions did not include a trade embargo, and it excluded nonmilitary commercial trade. On the other hand, humanitarian assistance and support for denuclearization went on after the sanctions. The United States went on introducing trade sanctions; however, these modest restrictions (reconfirmed in June 2009, by the Obama administration) did not have that much of an effect as the trade with North Korea was so small.<sup>105</sup>

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<sup>102</sup> Nicholas Eberstadt, "The Missing Link for North Korea's Economic Revival?" in *North Korea in Transition : Politics, Economy, and Society*, ed. Kyung-ae Park and Scott Snyder et al. (United Kingdom: Rowman & Littlefield Publishers, Inc., 2013), 147.

<sup>103</sup> Hughes, "The Political Economy of Japanese Sanctions," 465.

<sup>104</sup> Haggard, "Sanctioning North Korea," 554.

<sup>105</sup> *Ibid.*, 562–565.

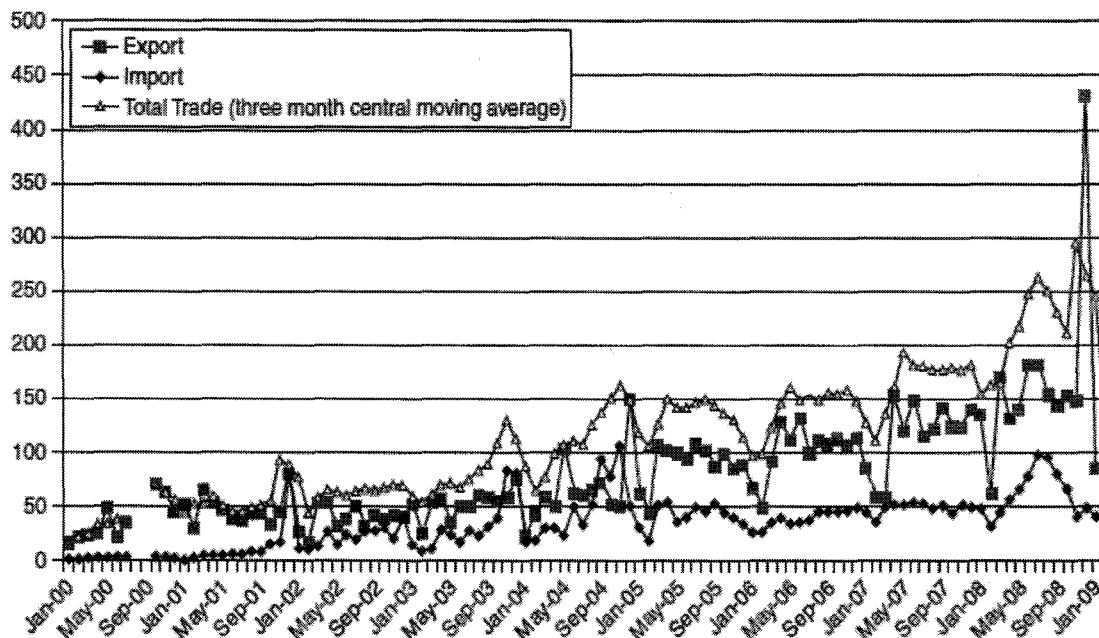


Figure 9. China's Trade with North Korea (from Haggard and Noland, 556).

The effective part of UN and U.S. sanctions was their financial side. The UNSC explicitly provided legal ground for implementing financial means to block WMD-related trade. This constituted blocking of transfers and freezing of the assets related to North Korea's weapons activities and even included nonweapons-related activities depending on the interpretation of the resolution. Likewise, the U.S. Treasury's firm stance against any institutions flirting with North Korea continued and provided a useful leverage for the United States during Six Party Talks.<sup>106</sup>

The sanctions after the 2006 nuclear crisis increased North Korea's dependence on China as shown in Figure 9. Despite an interruption in trade after the missile crisis, there is a sharp increase in North Korea's export to China after the nuclear crisis due to pressure on North Korea for foreign capital acquisition that was needed for imports. By 2007, North Korea's export to China accounted for 27.9% of total exports, whereas North Korea's import from China was 32.9% among all imports. The acceptance of the UN

<sup>106</sup> Ibid.

resolution was a clear sign of China's disaffection with North Korea's behavior. Moreover, the periodic decrease between January 2007 and March 2007 is another sign of dissatisfaction.

Nonetheless, this did not mean the abandoning of China's goals mentioned above. That was also why China showed reluctance to implement more aggressive actions against North Korea. In fact, Premier Wen Jiabao promised more economic support to North Korea. Overall, China had its own reasons to follow economic engagement with North Korea.<sup>107</sup>

In addition to trade with China, the subsidizing effect of trade with other countries went on. These were again developing Middle East countries—Algeria, Saudi Arabia, and Lebanon. Besides, North Korea exported to Thailand, Brazil, Myanmar, Venezuela, India, and Netherlands. On the other hand, North Korean imports were from Thailand, Russia, Brazil, India, Congo, and South Africa. Furthermore, a remarkable contribution was made by the Egyptian telecommunication company Orascom with a \$500 million investment in North Korea.<sup>108</sup>

The UN sanctions in 2006 had little impact on inter-Korean engagement until 2009 as shown in Figure 10. The inter-Korean economic relation was disrupted by the missile and nuclear crisis; however, it continued as it was intended for political and humanitarian interests. Total trade in 2008 reached \$1.8 billion. The overall revenue from the Kaesong and Mount Kumgang initiatives between 2005—the actual date that Kaesong Industrial Complex (KIC) started exports—and 2008 reached a total of \$1.7 billion.<sup>109</sup>

The interruption in trade took place from 2006 until the Six Party Talks in 2007 despite the Roh administration's sympathy for engagement. Starting from the October 2007 summit, the two Koreas embarked on new economic cooperation projects; however,

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<sup>107</sup> Bradley Babson, "Future Strategies for Economic Engagement with North Korea" in *North Korea in Transition: Politics, Economy, and Society*, ed. Kyung-ae Park and Scott Snyder et al. (United Kingdom: Rowman & Littlefield Publishers, Inc., 2013), 163.

<sup>108</sup> Haggard, "Sanctioning North Korea," 552.

<sup>109</sup> Babson, "Future Strategies for Economic Engagement with North Korea," 161.

after the election of Lee Myung-bak, there was a rather conditional approach. He spared \$1.2 billion for economic cooperation for 2009 but did not spend the money because of the worsening relations. As the Mt. Kungang Tourism zone and KIC had substantial noncommercial government subsidies in addition to those from private companies, these noncommercial subsidies were subject to political changes. Under the Lee administration, the share of the noncommercial firms has decreased given the conditional concept of engagement.

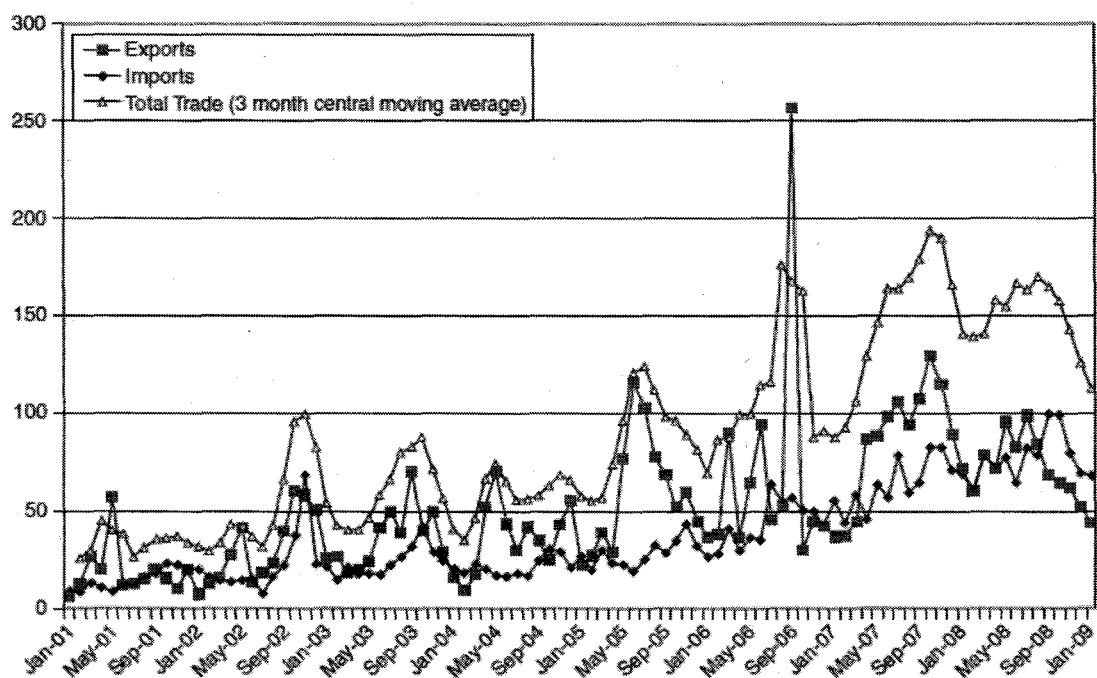


Figure 10. South Korea's Trade with North Korea (from Haggard and Noland, 559).

During the Kim Dae-jung and Roh Moo-hyun administrations, economic engagement was seen as a tool to direct North Korea into reform. The confined nature of the activity to specific regions was the proof of its political face. Therefore, the Roh administration held this *test* separate from international politics. The Lee administration's policies followed the same path with a difference of their conditional nature.<sup>110</sup>

<sup>110</sup> Stephan Haggard and Marcus Noland, "North Korea's Foreign Economic Relations," *International Relations of the Asia-Pacific* 8, no. 2 (2008), 242.

To sum up, the 2006 missile and nuclear crises had effects on North Korean economic changes after the 2002 reforms. The direct effects were on foreign capital acquisition rather than on monetization and decentralization. The changes in monetization and decentralization trends were due to internal dynamics that will be mentioned in the next section in detail; they were not directly related to international environment. The effects of UN and U.S. financial sanctions on the foreign capital acquisition trend were more than the trade sanctions; however, the subsidizing trade with other countries ameliorated their severity. Except for their interruption after the missile and nuclear crises, North Korea's economic engagement with South Korea and China continued. It was by the Lee administration's conditional approach that there was a decrease in investment in the KIC and Mt. Kumgang initiative.

### **C. 2009 CURRENCY REFORM**

As another attempt to recentralize the economy and clear away the negative effects of the July 2002 monetization reforms, the North Korean regime announced currency reforms on November 30, 2009. The reasons for the reform was to curb inflation by decreasing the amount of currency, prevent any further workers abandoning their jobs to participate in private market activities, and stop individuals and companies from hoarding the foreign currency they had acquired. The aim was to diminish the excess money that was causing inflation, to increase the work force, and to increase the state budget to enable more imports to meet the demand.<sup>111</sup>

This was another attempt to rebuild central authority over the economy.<sup>112</sup> The 2008 New Year's Joint editorial was the sign of measures to bring back the centralized economy:

The socialist economy is a planned economy, which can be rapidly developed only when its superiority is adhered to and unreservedly displayed. For this reason, this year's joint editorial importantly stressed the issue of strengthening the planned discipline in all sectors and all units

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<sup>111</sup> Soo-Ho Lim, "North Korea's Currency Reform a Failure?" *SERI Quarterly* 3, no. 2 (April 2010), 115.

<sup>112</sup> Marcus Noland, *Pyongyang's Failed Currency Reform*, ed. Marcus Noland, (Zurich: Eidgenossische Technische Hochschule, 2010), 1.

of the people's economy. In order to brilliantly realize the grand goal of building an economically powerful state presented by the party, all functionaries and working people must cherish the superiority of the socialist planned economy as their firm faith and put great strength into displaying it highly.<sup>113</sup>

Currency reforms are applied all over the world; however, Pyongyang's currency reform was different from the conventional case.<sup>114</sup> There were three elements of the reform:

1. Exchanging currency bills for new ones at the rate of 100 to one with a limit of 100,000 North Korean Won in old bills per household,
2. For workers, maintaining salaries at old currency levels and thus producing a 100-fold raise in income,
3. Completely banning transactions done in foreign currency.<sup>115</sup>

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<sup>113</sup> Patrick McEachern, *Inside the Red Box: North Korea's Post-totalitarian Politics*, (New York: Columbia University Press, 2010), 212.

<sup>114</sup> Noland, *Pyongyang's Failed Currency Reform*, 1.

<sup>115</sup> Lim, "North Korea's Currency Reform a Failure?" 115.

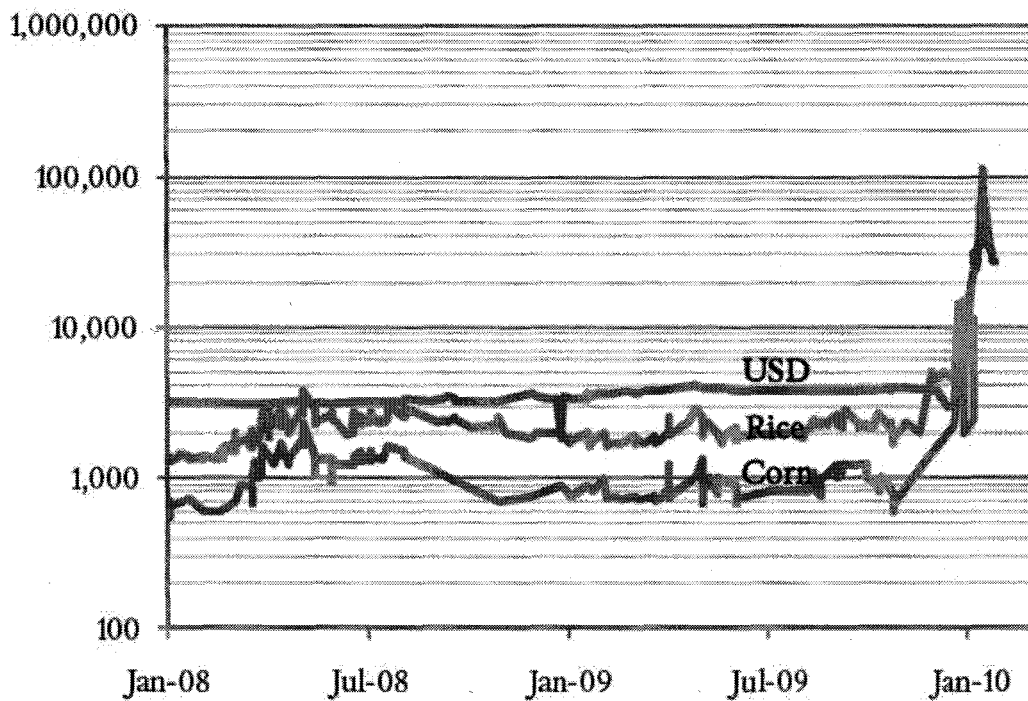


Figure 11. Rising Costs in North Korea (from Noland, 2).

Until that time, the government saw the prices as the fundamental problem, whereas the low food supply was the problem. That was why the government saw the revaluation of *won* as a solution. By the announcement, people started to buy foreign currency on the black market and physical goods to maintain their money's value. This caused the drop of the *won*'s value.<sup>116</sup> The exchange rate climbed higher to 500–600 *won* per dollar.<sup>117</sup> To prevent this, the government banned the use of the foreign currency. This was followed by the announcement of official prices for a variety of goods and limits in the opening hours of the markets. The costs rose dramatically as shown in Figure 11.<sup>118</sup>

As a result of a general dissatisfaction, there was civil upheaval and even physical attacks on security forces that were trying to implement the reforms. As a result of the

<sup>116</sup> Noland, *Pyongyang's Failed Currency Reform*, 2.

<sup>117</sup> Lim, "North Korea's Currency Reform a Failure?" 117.

<sup>118</sup> Noland, *Pyongyang's Failed Currency Reform*, 2.

aggression, the government took a step back and increased the exchange rate to 150,000 won in cash and 300,000 in bank savings.<sup>119</sup> Moreover, Pyongyang eased the conditions of the reforms by offering wage compensation and allowing the use of foreign currency again.<sup>120</sup> Kim Jong-il also executed Park Nam-ki—Director of Planning and Finance—as a scapegoat for the failed reform attempts.<sup>121</sup>

In terms of the rivalry between the cabinet and the party on the economy, the currency reform failure highlighted the cabinet. The failure was such a disgrace for the regime that the currency reform was not mentioned in the 2010 New Year's Day joint editorial. What was mentioned instead was foreign trade as a way of expanding the supplies of food and goods, because the party had realized that the expansion of foreign capital acquisition was important to be able to *centralize* the economy. According to party's new way of thinking, expanding foreign currency reserves would increase the ability to import more. If the state could increase the food supply by imports and distribute the imported goods via government channels, this would revive the public distribution system.<sup>122</sup>

The government had become aware that if they wanted to strengthen the public distribution system, they should first achieve an adequate inventory of food and goods at their state-run stores. This was also one of the complaints related to currency reform. During the reform, food merchants had stockpiled food instead of selling it, which created a low supply of foods and caused prices to skyrocket.<sup>123</sup>

As a result of the party's eagerness to continue foreign capital acquisition, it did not try to curtail the activities of the special economic zones after 2010; however, Pyongyang's current aim is not to open up to the world again, but to achieve the centralization of the trade and foreign currency management systems. With a dominant

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<sup>119</sup> Andray Abrahamian, "North Korea's 2009 Currency Reform in the Context of National Narrative," *North Korean Review* 7, no. 1 (Spring 2011), 69.

<sup>120</sup> Lim, "North Korea's Currency Reform a Failure?" 117.

<sup>121</sup> Noland, *Pyongyang's Failed Currency Reform*, 2.

<sup>122</sup> Lim, "North Korea's Currency Reform a Failure?" 117–118.

<sup>123</sup> *Ibid.*, 116.

public distribution system, the government expects business activities in the black market to shift to the state-run stores. As a result of centralization, Pyongyang expects a virtual cycle of normalization. Overall, the currency reform failed to centralize the economy; its results acted as an incentive for foreign capital acquisition.<sup>124</sup>

#### D. DOMESTIC POLITICS IMPACTING ECONOMIC REFORMS

North Korea has never had the goal of becoming a “strong and prosperous” nation.<sup>125</sup> It is a monolithic system formed around one individual called *Suryong*. There is a Cabinet and a Party under *Suryong*. These components are supposed to act as one body according to the *Suryong*’s guidelines. As a back-up force for the monolithic system, North Korea adapted the concept of *Juche*. The term means *main body* or *subject* and means *independent stand* and the *spirit of self-reliance*. It first originated from the rejection of the de-Stalinization policy in the mid-1950s. Kim Il-sung outlined its three principles during his speech in 1965: self-defense in national defense (*jawi*), independence in politics (*jajoo*), and self-sustenance in the economy (*jarip*). Namely, the state should be self-sufficient in defense and the economy, and also should present its will in politics freely.<sup>126</sup>

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<sup>124</sup> *Ibid.*, 118.

<sup>125</sup> William B. Brown, *Engaging and Transforming North Korea’s Economy*, ed. William B. Brown, (Korea Economic Institute of America, 2011), 153.

<sup>126</sup> Ralph M. Wrobel, “North Korea after the Nuclear Crisis: The Future of the Economic Reforms,” *Post-Communist Economies* 19, no. 4 (December 2007), 485.

Table 6. Military Spending, Selected Countries (from Seliger, 135).

Country	Military Expenditure	
	(Percentage of GDP)	Budget Period
<u>North Korea</u>	<u>31.3</u>	<u>Estimate</u>
China	4.3	2006
United States	4.3	2005 est.
Russia	3.9	2005
South Korea	2.7	2006
Japan	0.8	2006

In 1992, the regime got rid of the last remnants of Marxism in the *Juche* idea and evolved it into a religious/ethical system. This also strengthened the legitimacy of the hereditary system of power transition. As a result of the *Juche* system, North Korea followed economic strategies to achieve a self-reliant state.<sup>127</sup>

Within this system, the regime saw military activities not as a resource absorber, but as a resource generator. Therefore, Pyongyang gave priority to the national defense (*jawi*) and established a military-first politics (*songun chongchi*).<sup>128</sup> This notion is a slogan for a military state where politics, international relations, and even the economy should be led by the military. The military is treated as the ideal model for the society.<sup>129</sup>

<sup>127</sup> Ibid., 485.

<sup>128</sup> Eberstadt, "The Missing Link for North Korea's Economic Revival?" 140.

<sup>129</sup> Yong-Soo Park, "The Political Economy of Economic Reform in North Korea," *Australian Journal of International Affairs* 63, no. 4 (December 2009), 538.

Table 7. Active-duty Military Personnel, Selected Countries (from Seliger, 136).

Rank (no. of troops)	Nation	No. of active- duty troops	Population of country (billions)	Troops/ population
1	PRC	2,255,000	1.330	0.0016
2	United States	1,474,000	0.303	0.0048
3	India	1,325,000	1.147	0.0011
4	North Korea	1,106,000	0.023	0.0480

Table 8. Military Spending, Selected Countries and World (from Seliger, 136).

Jurisdiction	Military Expenditure (billions of US dollars)	Budget Period
World	1,100.00	2004 est.
United States	623.00	2004 est.
PRC	65.00	2008 budget
Russia	50.00	Est.
South Korea	21.10	2003 est.
North Korea	5.00	FY 2002

As a result, Pyongyang spends roughly 30% of its GDP on the military as shown in Table 6. This amounts to \$5 billion as shown in Table 8. Moreover, North Korea has 1,106,000 active-duty troops, which accounts for 5% of its population, as shown in Table 7.<sup>130</sup> The regime's emphasis on *songun chongchi* can clearly be seen in its own official analysis on March 2003: "During *the Arduous March* in our history, great Comrade Kim Jong-il firmly believed that the destiny of the people and the future of the revolution

<sup>130</sup> Bernhard Seliger, *A Peace Dividend for North Korea? The Political Economy of Military Spending, Conflict Resolution, and Reform*, eds Bernhard Seliger, Werner Pascha, (New York and Heidelberg: Springer, 2011), 135–136.

hinged on the barrel of a gun, and that we could break through the difficulties and lead the revolution to victory *only by depending on the Army*... Once we lay the foundations for a powerful self-sustaining national defense industry, we will be able to rejuvenate all economic fields, to include light industry and agriculture and enhance the quality of the people's lives."<sup>131</sup>

The rise of the *songun chongchi* in 2003 was an explicit sign of regime's strong desire to preserve the existing system, rather than reform it. The other way around would be unthinkable where the economy has consequently been considered secondary. The July reforms were also only short-term measures to cope with the economic crisis, not to change the economic system. The country needed a desperate remedy at that time.<sup>132</sup>

The search for the necessary remedy for the failing economy was the start of the ongoing conflict between the cabinet and the party. The cabinet's assessments during the economic crisis showed that marketization was more beneficial for the country than the party's socialist vision. The cabinet formulated the marketization program and introduced it as *Korean-style socialism*. The party saw the cabinet's proposal as a risk to the socialist system and the state; however, Kim approved the execution of the cabinet's economic policy. Kim's visit to Southern China was the key to his pragmatic approach and approval of the cabinet's proposal because his observations during this trip noted the dreadful difference between two countries that was hard to ignore. The cabinet was the winner of the debate with the party; however, the party was not hiding its disaffection with the economic agenda.<sup>133</sup> The most distinct example could be seen in the party's lecture notes which were published soon after the July 2002 reforms:

Through *economic change* and personnel interchange programs too, the imperialists are pushing the infiltration...The capitalist's ideological and cultural infiltration will never cease, and the struggle against it will continue, as long as the imperialists continue to exist in the world...The great leader, Kim Jong-il, pointed out the following: "Today, the imperialist and reactionaries are tenaciously scheming to blow the wind of

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<sup>131</sup> Eberstadt, "The Missing Link for North Korea's Economic Revival?" 140-141.

<sup>132</sup> Park, "The Political Economy of Economic Reform in North Korea," 538.

<sup>133</sup> Jingyi Jin, "Prospects for Reform in North Korea," *SERI Quarterly* 5, no. 4 (October 2012), 118.

bourgeois liberalism into us.”...People will ideologically degenerate and weaken; cracks will develop in our socialist ideological position; and, in the end, our socialism will helplessly collapse. A case in point is the bitter lesson drawn from the miserable situations of the former Soviet Union and Eastern European countries.<sup>134</sup>

The party’s advocacy to abandon the July 2002 economic conditions went on. Its main objection was about the *decentralization* trend. Therefore, it started to emphasize centralization through its statements: “If a country wants to develop and be strong, it should be politically stable and its society should be united...Unity is a root of socialism, and the power of ideology eventually comes out of the power of unity that firmly solidifies all the people as one under the column of the Party and the leader.”<sup>135</sup> There was also emphasis on the *Juche* idea and military-first politics, which undermined the economic reforms: “All functionaries should display all the more higher the revolutionary trait of unconditionally implementing the party policy to the end...The party line and policy are filled with fighting tasks and methods and strategy and tactics for embodying the *Juche* idea and the military-first idea in all areas of revolution and construction.”<sup>136</sup>

As a result of party’s dissatisfaction with the reform policy, the party assigned Park Nam-ki as economic policy director of the Korean Workers’ Party and tried to revive the policy in 2005 and end the *capitalist fantasy*. To form a centralized economy again, the party tried to revive the public distribution system and prevent private farming. The party tried to balance the demand for and supply of grain. Nonetheless, these efforts to revise the 2002 reforms had limited success.<sup>137</sup>

According to the results of the refugee survey that was conducted in South Korea, there was a growth in ease of engaging in private farming. It rose from 39.8% in the reform era (2002–2005) to 42.4% in the retrenchment era (after 2005); however there was a decrease in the ability to trade in legal markets. It rose from 50% in the reform era to 55% in the retrenchment era. On the other hand, there was a high decrease in the

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<sup>134</sup> Eberstadt, “The Missing Link for North Korea’s Economic Revival?” 139.

<sup>135</sup> McEachern, *Inside the Red Box*, 211.

<sup>136</sup> Ibid.

<sup>137</sup> Haggard and Noland, *Witness to Transformation*, 9–12.

government officials' ability to control the prices. It dropped from 35% in the reform era to 20%. Incidentally, there was an increase in the bribes and the frequency of changing rules in the market activities that correlated with the evolution of these policies. As the results indicate, the party was not successful in bringing back the centralized socialist system. It had nothing to do but to freeze its efforts to quit the 2002 reforms until the wake of the nuclear crisis in 2006.<sup>138</sup>

The 2005 attempts were another proof of the halfhearted nature of the July 2002 reforms.<sup>139</sup> But the 2005 attempts were meant mostly to stop the decentralization trend of the 2002 reforms. The trade in special economic zones continued and reached a total of \$1 billion by the end of 2005. By 2005, KIC exported its first products—stainless steel pots. A total of 4100 North Korean workers from 15 South Korean companies were operating by the end of 2005. Also, Mt. Kumgang was a tourist attraction point with its golf courses, restaurants, and hotels. It hosted half a million tourists by the end of the year.<sup>140</sup>

After the nuclear test, the souring relations with South Korea after the Lee administration and the disaffection of China and temporary interruption of the economic engagement with China once again harmed the cabinet's argument and strengthened the party's hand.<sup>141</sup> Backed up by the 2008 New Year's editorial, the party rejected any further attempts to reform the North Korean economy, whereas the cabinet continued to timidly demonstrate the benefits of cooperation with other countries.<sup>142</sup>

Pyongyang was also discontent with the Lee administration of South Korea's conditional approach: "economic reform maneuvers of the Lee Myung-bak gang for *opening up the North* are an attempt to degenerate our system and to *absorb* our Republic into their *liberal democratic system* and thus will unfailingly bring nothing but North-

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<sup>138</sup> Ibid., 9–67.

<sup>139</sup> Park, "The Political Economy of Economic Reform in North Korea," 538.

<sup>140</sup> Meredith Jung-en Woo, "North Korea in 2005: Maximizing Profit to Save Socialism," *Asian Survey* 46, no. 1 (2006), 51–52.

<sup>141</sup> McEachern, *Inside the Red Box*, 211.

<sup>142</sup> Ibid., 212–213.

South confrontation and war.”<sup>143</sup> As a result of the dissatisfaction with the post-Lee era, North Korea tried to use the KIC and Mt. Kumgang as *reverse leverage*. It stopped train operations to these areas and ceased tourism activities in Mt. Kumgang. Moreover, Pyongyang suspended the activities of an economic cooperation office, and demanded that the South decrease its staff of the KIC Management Committee by half. These actions were followed by North Korea’s harsher environmental standards and fines for violations within the KIC in March 2009. There was even a period of temporary shutdown of the KIC during that month. By May, North Korea announced that the existing contracts were void.<sup>144</sup>

The party’s attitude on KIC and Mt. Kumgang was another clear manifestation of its priority on politics, not on the economy. It preferred to sacrifice economic gains to obtain political power. This attitude was also proven in its decline of the U.S. food aid program negotiated in 2008.<sup>145</sup> Therefore, the party’s dissatisfaction with the cabinet’s policy showed itself in the shape of political actions. The party tried to prevent the decentralization effects of the July 2002 reforms. Although the party could not reverse the changes that came along with the reforms, the party did not allow new marketization efforts of the cabinet either. On the other hand, the cooperation in KIC and Mt. Kumgang took place under closer inspection by Pyongyang and was in a more limited nature compared with the Kim Dae-jung and Roh Moo-hyun administration era.<sup>146</sup>

After the 2009 currency reform, the North Korean regime has been more aware of the importance of the foreign capital acquisition trend of the July 2002 reforms.<sup>147</sup> Politics are still a priority as the *Cheonan* attack on March 26, 2010 and the bombardment of *Yeongpyeong* on November 23, 2010 prove; however, there is more interest in foreign investment in special economic zones.<sup>148</sup> The increasing trade volume

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<sup>143</sup> Ibid., 212.

<sup>144</sup> Haggard, “Sanctioning North Korea,” 562.

<sup>145</sup> Ibid., 565.

<sup>146</sup> McEachern, *Inside the Red Box*, 214.

<sup>147</sup> Lim, “North Korea’s Currency Reform a Failure?” 118.

<sup>148</sup> Leon V. Sigal, “Primer—North Korea, South Korea, and the United States: Reading between the Lines of the Cheonan Attack,” *Bulletin of the Atomic Scientists* 66, no. 5 (September 2010), 35.

after these incidents is clear proof of this interest. In 2011, trade in the Kaesong Industrial Complex rose by 24%. This shows how important foreign investment is for both North and South Korea.<sup>149</sup>

The North Korean regime's growing focus on foreign investment can also be seen in its actions between 2010 and 2011:

- Pyongyang established a State Development Bank in March 2010 to provide investment in major projects and “will have advanced banking rules and system for transactions with international monetary organizations and commercial banks;”<sup>150</sup>
- Pyongyang also established The Joint Venture and Investment Commission in July 2010 to oversee approvals of foreign invested projects;
- The government announced a ten-year economic development plan in early 2011;
- The regime increased education activities for officials who are in charge of foreign investment including an informal tour of the U.S. economy in March 2011—the first time in North Korea's history.<sup>151</sup>

The 2013 nuclear crisis is the last of North Korea's attempts to show that politics are its first priority. What it will bring for North Korea's economy is unclear for now. The inauguration of Park Geun-hye as President of South Korea on February 2013 is another factor impacting the future of inter-Korean economic relations. Her *trustpolitik*—a tough line against North Korea sometimes and a flexible policy open to negotiations at other times—will affect the future of North Korea's strategy.<sup>152</sup> Nonetheless, as trade in the KIC after the *Cheonan* and *Yeongpyeong* incidents shows, Chinese investment in Korea is less vulnerable to crises. The recent economic attempts in North Korea also show its growing interest in foreign investment. Therefore, trade in the KIC looks promising for both sides.

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<sup>149</sup> Babson, “Future Strategies for Economic Engagement with North Korea,” 176.

<sup>150</sup> *Ibid.*, 158.

<sup>151</sup> *Ibid.*, 158–159.

<sup>152</sup> Geun-hye Park, “A New Kind of Korea: Building Trust between Seoul and Pyongyang,” *Foreign Affairs* 90, no. 5 (September-October 2011), 13–18.

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## VI. CONCLUSION

### A. RECOMMENDATIONS ON THE 7.1 POLICY

#### 1. Recommendations on Monetization

In order to enhance monetization trends of the 7.1 policy, North Korea should refrain from trying to change prices and wages according to a schedule. It should recognize market prices and should apply price liberalization as China did.<sup>153</sup> Inflationary movements should be mitigated by banking system. According to the surveys, wage increases as a part of the monetization trend tended to favor soldiers and party officials; therefore, to satisfy the needs of the other workers, the government should have a more balanced approach.

#### 2. Recommendations on Decentralization

##### a. *Recommendations on Industrial Decentralization*

To enhance the industrial sector, the government should modernize infrastructure and provide capital to the factories. That is also the solution for infrastructural problems within the SEZs that will be mentioned in detail in the next section. With the provided capital, factories can procure raw material. In order to raise this capital, Pyongyang must abandon its military-first politics and adopt economy-first politics. The government should decrease the military budget and allocate it for infrastructure and industry.<sup>154</sup>

##### b. *Recommendations on Agricultural Decentralization*

In order to enhance the agricultural sector, the government should recognize market prices for grain. To stimulate efficiency in agriculture, private farming should be continued and encouraged to spread. Furthermore, the current system of

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<sup>153</sup> V. F. S. Sit, "The Special Economic Zones of China—A New Type of Export Processing Zone," *Developing Economies* 23, no. 1 (March 1985), 81.

<sup>154</sup> Seliger, "The July 2002 Reforms," 30.

working squads comprised of 25 people should be transformed into family-based farming to increase efficiency in farming as in the Chinese reform.<sup>155</sup>

*c. Recommendations on Foreign Capital Acquisition*

In order to enable foreign capital acquisition through SEZs, North Korea should leave brinkmanship diplomacy and cease creating international tensions such as the nuclear crisis. This is one of the differences between North Korean and Chinese SEZs. During the economic reforms, China followed peaceful diplomacy. If North Korea follows such a path in its international relations, North Korea's unfavorable image can change, and this change can lead to the decrease in the tariff rates; thus, North Korean and SEZ products can enjoy competitive prices in international markets.<sup>156</sup> New leaders can be an opportunity for both sides to open a new page in international relations.

In order to solve related administrative problems, Pyongyang should designate experienced, liberal, and technocratic leaders to inspire and pioneer the economic change within the SEZs. Furthermore, Pyongyang should form an administrative law that allows an autonomous management for SEZs allowing a secure environment for investment. Also, to enable legal guarantees, to clarify trade procedures, and to resolve jurisdiction problems, a special economic law for SEZs should be established.

**B. SUMMARY OF BROADER LESSONS TO BE LEARNED**

The North Korean 7.1 policy gives invaluable lessons about the ineffective reconstruction of a ruined economy. The most significant lesson of all is the rule of reducing the risk of resumed conflict.<sup>157</sup> The ongoing naval skirmish and nuclear crises have indicated a possibility of a war, thus hampering the economic efforts of the 7.1 policy. Removing or diminishing the risk of resumed conflict is one of the prerequisites.

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<sup>155</sup> Seliger, "The July 2002 Reforms," 30.

<sup>156</sup> Lai, "SEZs and Foreign Investment in China," 96.

<sup>157</sup> Rotberg, *When States Fail: Causes and Consequences*, 335.

The second lesson focuses on the rule of law.<sup>158</sup> The absence of administrative and economic law was one of the biggest problems that obstructed the development of special economic zones and blocked the flow of severely needed capital.<sup>159</sup> As the SEZs could not provide the capital, other reforms were deprived of the essential ingredient of their practice. Thus, countries should establish the rule of law.

The third lesson concerns the elimination of price controls.<sup>160</sup> To create development, a government should create an environment conducive to trade. One of the conditions for such an environment is to remove governmental controls on prices. That is how China managed to achieve an economic reform in the 1980s. Therefore, governments should eliminate price controls to enable economic development.

The fourth lesson focuses on building infrastructure. North Korea did not have the adequate infrastructure for growth. Pyongyang should have created a secure economic environment and channeled some of the funds spent on military into improving infrastructure. Thus, building infrastructure is one of the most important ingredients of development.<sup>161</sup>

The last and most important lesson is that the cookie cutter approaches do not end with the same results. Chinese reforms ended up being a great success story and led China to be the second biggest economy in the world. In China's case, agriculture was the pioneer for reform. 63% of the population was in agriculture in 1980, whereas it is only 20% of the population in North Korea during 7.1 policy.<sup>162</sup> So, the measures did not yield to the same results as in the Chinese example. As China's Foreign Minister once told, "We have followed a path of socialism with Chinese characteristics. Such a road is not necessarily suited to other countries' conditions."<sup>163</sup> Therefore, a cookie-cutter approach may not be the exact solution for other countries.

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<sup>158</sup> Rotberg, *When States Fail: Causes and Consequences*, 182–183.

<sup>159</sup> *Ibid.*, 189–203.

<sup>160</sup> Dobbins, *The Beginner's Guide to Nation-Building*, 284.

<sup>161</sup> *Ibid.*, 238.

<sup>162</sup> Lai, "SEZs and Foreign Investment in China," 90–97.

<sup>163</sup> Sandhu, "A Doomed Reform," 39.

### C. SUMMARY OF JUDGMENTS

Reforms in North Korea do not resemble the kind of reforms in China.<sup>164</sup> In North Korea, reforms are not intended to fundamentally change the economic system, rather only to make a partial improvement of the economic mechanism. There are still unfinished reforms in the monetary, industrial, and agricultural fields. If Pyongyang solves international, administrative, and infrastructural problems within the SEZs, this can lead to an economic development in the country.

As discussed earlier, the 2002 nuclear crisis had an indirect effect on the monetization and decentralization trends of the July 2002 reforms. Its effects were rather in the foreign acquisition trend of the July 2002 reforms. On the other hand, the 2006 missile and nuclear crisis had direct effects on foreign capital acquisition. Except for their interruption after the missile and nuclear crisis, North Korea's economic engagement with South Korea and China continued through the KIC and Mt. Kumgang initiative, but entered a cautious phase after the Lee administration's conditional approach.

The 2009 currency reform was the last blunder to overturn the decentralization effects of the July 2002 reforms. Nonetheless, it helped to make the party realize the importance of the capital acquisition trend of the July 2002 reforms. Therefore, the further cooperation in North Korean special economic zones looks promising for the good of North Korea and stability on the peninsula. Among all these initiatives, the Kaesong Industrial Complex looks the most promising. The continuing economic engagement during and after the *Cheonan* and *Yeongpyeong* incidents is clear sign of the importance of economic engagement for North and South Korea. This is a good example that growing economic interdependence may help to leverage upon North Korea.

As already noted, the July 2002 economic reforms were not intended to reform North Korea's economic system as a whole, but to provide temporary relief for the regime's survival. Even so, the relief that resulted from these reforms has been limited. The July 2002 monetization efforts have not worked so far. The decentralization trends had partial success and helped to promote private farming and markets for trading goods.

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<sup>164</sup> Seliger, "The July 2002 Reforms," 33.

The real problem underlying their limited success was North Korea's domestic politics and the competing views on reforms shared by the party and the cabinet. The emphasis on military-first politics after 2003 was a clear manifestation of the halfhearted nature of the *reforms*. The closure of the KIC on March 2009 and the rejection of U.S. food aid were also explicit indicators of North Korea's priority on politics rather than the economy, let alone reforming the system. Even after the failure of the 2009 currency reform effort, there have been signs of emphasis on economy; however, these attempts are only for bringing back a more centralized economy. Therefore, North Korea's current political system poses the most significant obstacle for present and future reforms. To provide real economic development as in China, North Korea should have leaders who believe in a market economy.

For the sanctions to have more effective implementation impact, they must have a consensus and the subsiding influence of other countries should be avoided. China is the most influential country among all. Given China's core political goals, it was impossible to reach such a consensus; however, China's dissatisfaction after the 2013 nuclear crisis may have a different effect on the future of sanctions' implementation power. Nonetheless, more effective than the sanctions would be increased trade and investment such as in the KIC. These attempts would decrease North Korea's incentives to proliferate.

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