North Korea Currency Reform:
What Happened and What Will Happen To Its Economy?*

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I am beginning this presentation with a confession that I am here under false pretenses. I am not an economist, but I am interested in the North Korean political system, and economics is critical to that system. But in North Korea, politics is command and economics is subsidiary.

I am reminded of a telling quotation from Kim Jong Il's December 1996 policy speech given at Kim Il Sung university at the height of the famine, at which he revealed that his father had advised him to leave economic matters in the hands of the functionaries and to focus on politics. Or perhaps it was simply foreshadowing the fact that the worst economic decisions are likely to occur when they are treated as the necessary means by which to achieve specific political objectives. To the extent that Kim Jong Il himself might be directly tied to the currency revaluation decision, it is clear that rumors of his direct involvement in economic policymaking has become a political liability—precisely because the currency revlatuion effort was so badly mishandled.

I will provide a brief recitation of specific policy measures taken as part of the currency revaluation effort. It is important to recognize that to the extent that the market has replaced the state in North Korea as a primary influence shaping who has political power, this development directly threatens Kim Jong Il's political control. The rise of the markets and the accompanying spread of information from the outside world are mortal political threats to the regime and many North Korean policies of the past two years have been designed to defeat this challenge. The bottom line in my view is that currency revluation, along with the 150-day and 100-day battles and other retrenchment measures undertaken in North Korea in the past two years, are efforts to turn back the clock to the halcyon days of the 1960s, when North Korea reached its apex in terms of economic performance. The currency revaluation was a critical instrument in Kim Jong Il's failed attempt to turn back the clock.

Failure of the State to Replace the Market

On November 30, 2009, North Korea announced that it would exchange new currency for old currency at the rate of 100:1, spurring panic in the North Korean markets. The plan was announced to the public with little advance warning, catching individuals with large amounts of local currency off guard. As a strategy for exposing and impoverishing holders of excess local currency, the initial phase of the strategy was effective. A representative of the Korean Central Bank affirmed that "we are not moving toward market opening, but will further strengthen the principle and order of socialist economic

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management."[1] North Korea's objective in pursuing the revaluation, therefore, was aimed at curbing the markets and reinstituting state control over the markets and over public reliance on the state. But given that objective, it is clear that as the currency revaluation process unfolded, it met with a variety of challenges that in the course of less than two months led to an unprecedented public admission of failure by DPRK Premier Kim Yong-il and the dismissal—and reported execution—of finance chief Pak Nam-gi.[2] North Korea's policy failure occurred at a variety of levels. At the technical level, initial implementation of the currency revaluation was undermined by the inability of the state to have sufficient goods on hand to restore the public distribution system as a replacement to the market. Moreover, the reforms themselves caused the markets to seize up, robbing them of the exchange needed to ensure that they continued to be well supplied with goods from China, leading to the breakdown of distribution of necessities in North Korea. A related failure was the difficulty the state faced in setting prices in the aftermath of the reform. The failure to get prices right also interfered with the functioning of the markets and made normal commerce difficult to conduct, leading to shortages of goods. Second, the state effort to expropriate hoarding of local currency and set the limit for exchange of new currency at impossibly low levels invited public outrage and a rather strong backlash among the people. In fact, the backlash was sufficient that the government was forced to undertake tactical readjustments to the ceiling on the amount of local currency that could be exchanged for new currency within days of the announcement of the initial plan. Each dimension of the failure contributed to exposing the major conceptual miscalculation behind the policy, namely, that it is possible to roll back the markets and return to the old state-centered distribution system of the past.

The *Chosun Sinbo* interview with Central Bank representative Cho Song-hyo'n states clearly the objective of the currency revaluation as follows: "In the future, a great deal of economic activities will be conducted not according to the market but based on the planned supply and circulation system, and it is expected that this will make it possible to further strengthen order in the planned economic management. . . In the past, the utilization of the market was partially allowed because the state was unable to satisfactorily secure the supplies needed for the production activities of enterprises as planned. The market was utilized as a supplementary means based on the principle of socialist economic management. We believe that, as the capability of the state has strengthened, the role of the market—which has performed its function as a supplementary means—will gradually dwindle."[3]

For the state to restore its role as the primary source of distribution within North Korean society, it would be necessary for DPRK central authorities to restore government-led distribution mechanisms to a level that would allow it to replace the markets, along the lines of the way that the Public Distribution System (PDS) had historically worked. In

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[1] Kang I-Ruk, "Currency Exchange Measure, Purpose Is To Protect Working People's Interests, to Stabilieze, Improve their Living—We Hear From Cho So'ng-hyo'n, Senior Staff Member of the Central Bank—Material Ground Laid for Fighting off Inflation, Choso'n Sinbo in Korean, December 4, 2009.
[2] "North Korea's Premier Apologizes Over Chaotic Currency Reform," *Associated Press*, February 10, 2010; "N. Korean technocrat executed for bungled currency reform: sources," *Yonhap*, March 18, 2010, http://english.yonhapnews.co.kr/northkorea/2010/03/18/72/0401000000AEN20100318004400315F.HTML
[3] Kang, op. cit.

order to do this, the state-authorized points of distribution would have to be stocked at levels that would be more reliable than the markets. Distribution of new currency into the hands of the people would strengthen ties of people to their work units and restore loyalty to the state. But the spike in demand for goods resulting from distribution of the new currencies, the impoverishment of those marketeers in North Korea who had used local currency as a medium of exchange to facilitate distribution of goods from China, the lack of small bills available initially in the new currency in the markets, and the failure of state-guided pricing to "stick" at the time of the introduction of the new currency all served to undermine the effort.

Central bank representative Cho states in his *Chosun Sinbo* interview that commodities were set at the price levels that had existed in July of 2002 when previous economic reform measures had occurred, "with the international market price of rice as the standard."[4] But those prices proved to be far from the market price of goods, especially in the new currency under circumstances where demand was outstripping supply. As a result, hyperinflation made it impossible for the state to set effective prices in the markets in early December, further contributing to the breakdown of the market mechanism.

North Korean authorities took a second step against the markets by banning use of foreign currencies on December 28, 2009. The Daily NK reported that the official decree requires businesses to deposit all foreign currencies in banks, to be withdrawn after obtaining approval for use of the foreign currency. This measure was designed to further strengthen political control over foreign exchanges in order to "bring the black market under control."[5] The measure essentially criminalized the unauthorized possession of foreign currency in an edict that endangered anyone conducting foreign trade outside of market channels. Having impoverished individuals most likely to be active in meeting market demand, the foreign currency ban criminalized those same individuals.

The third step was the most drastic: North Korean authorities shut down general markets across the country in order to transition them to farmers' markets. This shutdown exacerbated both inflation and the supply of goods inside North Korea, contributing to the spread of famine conditions in various parts of the country. Good Friends reported deaths by starvation in both North and South Hamgyong and North and South Pyongyang Province and a sharp drop in the value of the new currency in North Korean markets.[6]

Stephan Haggard and Marcus Noland argue in their recent policy brief that North Korea's currency reform was confiscatory in nature, that "currency reform was designed to target groups engaged in market activities that not only generate cash earnings but also require cash balances given the underdevelopment of the North Korean financial system, while at the same time providing compensatory allocations to favored groups closely connected to

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4 Ibid.

5 Jean H. Lee, "N. Korea Bans Foreign Currencies in Market Clampdown," Associated Press, December 31, 2009.

6 Various Good Friends reports and Ven. Pomnyun Sunim, "North Korea After the Currency Revaluation," March 1, 2010, Washington, DC.

the state."[7] In the same policy brief, Haggard and Noland estimate inflation in North Korea to have exceeded 100 percent per year in the years following 2002 and dropped to double or single digit levels in 2007 before accelerating again in 2008-2009.

Following the surprise announcement of the currency reform, North Koreans were given only a week (from November 30 to December 6) to exchange old currency for new and faced strict limits on the amount of currency they were allowed to exchange, although these limits reportedly faced strong opposition from average North Koreans. Interestingly, in the face of protests, North Korean authorities adjusted the original ceiling of 100,000 won per individual to 150,000 won in cash and 300,000 won in bank savings.[8] The most egregious mistake of the reform was a serious underestimation by the authorities of the extent to which market activity—and the resulting need for money—was being used to hedge against political control by the state.

The reopening of the markets was accompanied by a rare public apology in a reported meeting with government officials and local village leaders. Premier Kim Yong-il stated that "regarding the currency reform, I sincerely apologize as we pushed ahead with it without a sufficient preparation so that it caused a big pain to the people" and that the government "will do its best to stabilize people's lives."[9] Media reports have also revealed that the alleged responsible official, Park Nam-ki, was dismissed in January as chief of the planning and finance department of the Workers' Party and reportedly executed in March for his failure to lead the currency exchange successfully.

Political Implications for the North Korean Leadership

The failed currency reform of November 2009 presents two major political implications for the DPRK leadership. First are the domestic political ramifications for Kim Jong-il and his regime related to policy failure. Officials and North Korea experts in South Korea seem to widely believe that the biggest motivation driving the currency reform was Kim Jong'il's intention to counter the forces of the emerging free market which would undermine a smooth succession process to Kim Jong-Eun.[10] Although Park Nam-ki took the fall for the botched currency reform, there are already reports that tie the decision directly to Kim Jong Il. For example, a JoongAng Ilbo report suggests that the currency reform was "designed to restore order within and strengthen the centrally planned economy"and indicates that Kim Jong Il has simultaneously approved a push to attract investment from other countries, including the United States.[11] Given the nature of the North Korean leadership, it is hard not to tie Kim Jong Il directly to the decision to pursue a currency revaluation. Such an overt failure might be particularly divisive within

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[7] Stephan Haggard and Marcus Noland, "The Winter of Their Discontent: Pyongyang Attacks the Market," Peterson Institute of International Economics Policy Brief Number PB10-01, January 2010. Accessed at http://www.piie.com/publications/pb/pb10-01.pdf

[8] Jun Kwanwoo, "North Korea's Shock Currency Revaluation Sparks Anger," Agence France Press, December 2, 2009.

[9] "North Korea's Premier Apologizes Over Chaotic Currency Reform," February 10, 2010.

[10] "N. Korea's Currency Reform 'A Bid to Cement Power,'" *Chosun Ilbo*, December 2, 2009.

[11] Jeong Yong-soo, "North's Kim Moved to End Market Economy," JoongAng Ilbo English edition, December 17, 2009.

North Korea, especially given that many "accomplishments" over the course of the past year ultimately are rumored likely to be attributed to Kim Jong Il's chosen successor, this third son, Kim Jong-Eun. However, to the extent that the policy has failed, that failure could polarize reactions among various parts of North Korean society in ways that are invisible now, but could come to the fore in the context of a leadership succession. According to some observers, the currency reform ultimately failed as the state's attempt to reinforce control over private economic activities, the result of which is a "dangerous loss of the system's legitimacy" in the long term.[12]

Second, the currency revaluation also contradicts apparent North Korean efforts to attract foreign investment from the outside, including the West, China, and South Korea. At the same time that the currency reform was launched, Kim Jong Il visited the Northeastern port of Rajin-Sonbong, a major focus of North Korea's drive for foreign investment.[13] There has been recent confirmation of a deal with North Korea by Jilin provincial authorities to lease the number one pier at Rajin Port for 10 years, suggesting that attracting trade and investment has reemerged as a priority of the central government.

During Kim's December visit to the Rason Daeheung Trade Company, he reportedly stressed the importance of export growth. The Korean Central News Agency reported Kim as saying that "it is very important to abide by the principle of the credit-first policy in foreign trade" and that Kim urged workers to observe, "export discipline and improve the quality of goods."[14] Early this year, the Presidium of the Supreme People's Assembly designated Rason as a "special city," reaffirming the central government's direct interest in Rajin-Sonbong's economic potential.[15] Rajin's provincial leadership has been replaced by a team led by former Minister for Foreign Trade Rim Kyung-man, signaling the central government's interest in successful management of the port.[16] No doubt, the appointment also reflects high expectations regarding the level of capital that can be extracted by opening the port to foreign investment.

North Korea's foreign investment drive, however, appear challenged by the burden of the UN Security Council Resolution 1874 overhang that is likely to prevent Western investment, the possibility that China might tie new investments in North Korea to greater political acquiescence to Chinese strategic imperatives, and the likelihood that only China is truly interested in bringing capital to North Korea in return for access to the Rajin port. Moreover, South Korea has held firm in the face of North Korean threats to pull out of its contract with Hyundai Asan at Mount Keumgang, another action that would send the wrong message in attracting foreign investment from the outside world.

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[12] Rudiger Frank, "Currency Reform and Orthodox Socialism in North Korea," Nautilus Policy Forum Online 09-092A, December 3, 2009.

[13] Scott Snyder, "Rajin-Songbong: North Korea's (New?) Strategy to Attract Foreign Investment," *Asia Unbound*, Council on Foreign Relations, March 11, 2010, http://blogs.cfr.org/asia/2010/03/11/rajin-sonbong-north-korea%E2%80%99s-new-strategy-to-attract-foreign-investment/

[14] As reported in North Korea Newsletter No. 86 (December 24, 2009), Yonhap news agency, December 24, 2009.

[15] Park In Ho, "Rason Needs Big Changes to Succeed," The Daily NK, January 6, 2010.

[16] "N. Korean Trade Minister Now Heads Special Economic Zone," The Chosun Ilbo English Editiion, March 9, 2010. Accessed at http://english.chosun.com/site/data/html_dir/2010/03/09/2010030900764.html.

Concluding Thoughts

Kim Jong Il needs cash, so his son may inherit a bankrupt estate in which one survival strategy is to sell off pieces of land (or access) to keep things running. If this is the case, how long can the Kim family last before dissatisfaction that has coalesced around the currency revaluation begins to percolate in ways that would require new leadership in the North? The currency revaluation has shaken the foundations as North Korea continues to be penetrated by the forces of globalization. But in the near term, the currency revaluation has dealt a temporary blow to Kim Jong Il's most formidable challenger: the market. Although there is no organized alternative power center in North Korean society, the currency revaluation fiasco has surely hastened the day when North Korea begins to move in a direction that requires even greater integration with its neighbors, especially as Kim tries to raise cash by attracting external investment. Bradley Babson argues that Pyongyang faces a key challenge of carrying out internal changes in a way that maintains political control and regime legitimacy, while at the same time improving external relations in ways that enhance North Korea's economy and security.[17] This approach may require a major shift in Pyongyang's current strategy, and in the long-term has potentially dramatic implications for political control as the markets continue to wrest political power from Kim Jong Il and his regime.

[17] Bradley O. Babson, "Reform or retrenchment in North Korea?" East Asia Forum, February 26, 2010, http://www.eastasiaforum.org/2010/02/26/reform-or-retrenchment-in-north-korea/