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Reform without Transition: Economic Situation in North Korea since July 1st Measures

Un-Chul Yang¹

. Poor Economic Performance in North Korea

Despite the persuasion and pressure by the international community, North Korea carried out its 2nd nuclear test on May 25, 2009. The harsh North Korean regime continues to maintain its stranglehold on the people and attempts to exclude political democratization. North Korea propagates a *juche* ideology as the foundation of its legitimacy and uses this to insulate its people from the outside world.² However, self-reliance is far from reality for the country and its people. The fundamental obsession to self-reliant economy brought overall economic inefficiency including low level of technology, devastation of production facility, and decrease of labor productivity. As the resultant economic dilemma accumulated, the North Korean economy tumbled harshly in the 1990s. North Korea is well aware of the serious nature of its backward economy, but denies the fact its economic trouble is ascribable to the accumulated troubles of its inefficient system. Instead, it attributes it to the U.S. hostile policy toward the North, or to its weak external economic relations caused by the collapse of the socialist bloc.

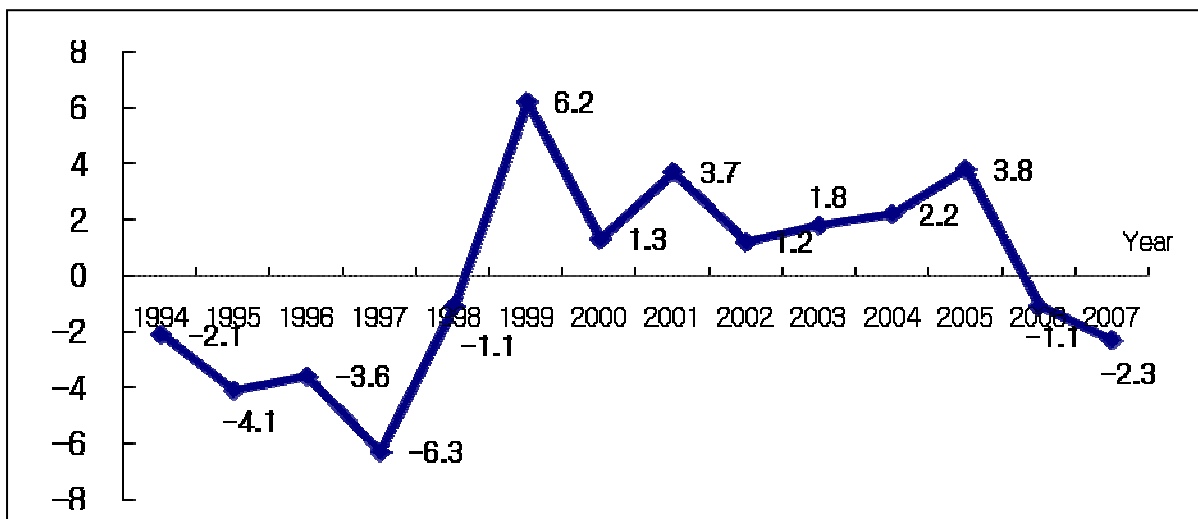
The economy ceased to function during the 1990s, especially as North

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² Although North Korea asserts that "the construction of a self-reliant national economy does not definitely imply with our doors closed," the North is very cautious about opening. *Rodong Sinmun*, Feb. 8, 2001.

Korea faced severe flooding in 1995. After several years of famine and struggle, North Korea announced that the country had overcome its economic hardship through an *arduous march* of sustained effort by Kim Jong Il and the communist party. A positive economic growth in the early 2000s seemed to be possible by foreign subsidies (See <Figure 1>). In general, the North Korean economy is believed to have failed, losing all its potential and ability to overcome the economic deadlock. Even, the North has failed to supply daily necessities and subsistence food to meet the demand of its people (See <Figure 2>).

<Figure 1> Economic Growth of North Korea



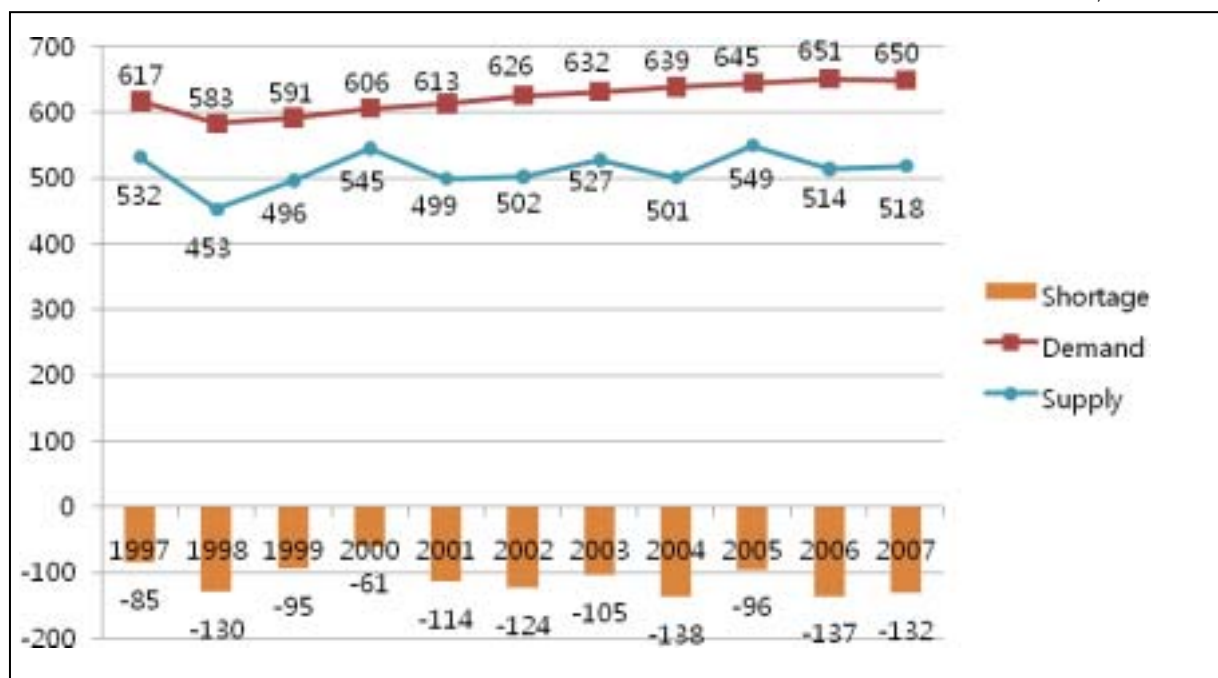
Source: Bank of Korea.

In an effort to ride out the economic hardship, the North introduced bold measures to improve economic management on July 1, 2002 by increasing salaries and prices and providing its state companies with some incentives. The July 1, 2002 measures are viewed as the most progressive among the policy steps taken by North Korea. The measures aimed to cure its economic inefficiency within the framework of the planned economy. Although North Korea is encouraging production more practically than in the past and has pushed ahead with reform-oriented change in the economic sector, it has yet to emerge from decades-old economic difficulties because it has failed to carry out substantial economic reforms. The measures were designed only to smoothly manage the

planned economy, rather than introduce merits of the market economy. Most notable example is North Korea's military industry, which is still on top priority for the development of its economy under its military-first politics.³

<Figure 2> North Korea's Food Supply and Demand since 1997

Unit: 10,000 ton



Source: Ministry of Unification.

Simply, July 1st measures are hostile toward economic reform.⁴ In actuality,

³ Han Kyu-su, "Some problems Regarding the Establishment of Balance between social Production Sectors in a Way to Meet the Demand for the Economic construction in the Military-first Era,"(in Korean) *Economic Studies*, No.1 of 2006, The Publishing House of Science Encyclopedia, Pyongyang, 2006, p. 21, p. 23.

⁴ The core of the July 1, 2002 measures of the North shares various views on its meaning as follows. 1) July 1st measures have an innovative nature, but it is in an initial stage in terms of system transition. Oh Sung-ryul, "A Chances in the North Korean Economy: Theories and Policies,"(in Korean) *Research Papers* 02-19, KINU, 2002. 2) July 1 measures are a brainchild of an insufficient, unsuccessful policy of the North, the measures in principle were aimed at normalizing the malfunctioning command economy by means of introducing a dual commodity price system. Five years after the North took the measures, however, there is no indication the production of food grain and key industrial products increased remarkably. Economic development is running against expectations of the authorities. Yang Un-Chul, *A Comparative Study of the Transition of*

the overall production in North Korea has remained in the doldrums for a considerable period of time. The shortage of capital goods nearly paralyzed production activities in most industrial sectors.

During the initial period of July 1st measures, North Korea faced a severe inflation. The excess increase in wages pushed up the purchasing power of the North Korean people. As time passed, an excess demand caused by high wages, combined with the ever-increasing speculative demand, touched off skyrocketing price increase. This is a typical money illusion, which refers to the tendency of people to think of currency in nominal terms. To stop high inflation, it needs to add up production factors or improve labor productivity. Even now, the inflation prevails in the North, but it is linked with Chinese price level, especially the rice price (See <Table 1>). In actuality, however, it did not happen. According to North Korean refugees at that time, the salaried laborers in the North can hardly buy enough food to feed their families; despite a remarkable increase in their wages, the living standard of the general public remains unchanged or even worse. The labor productivity of North Korean laborer was inevitably low because wages are determined by North Korean authority.⁵ Price distortions are taking place in the entire North Korean economy as the price does not function properly. The North Korean economy lacks a mechanism of voluntary price decision. For example,

the North Korean Economy,(in Korean) Hanul Academy, 2006, The measures are similar to the reform steps taken by the former Soviet Union under the initiative of premier Alexey Kosygin. Nicolas Spulber, *Russia's Economic Transitions: from Late Tsarism to the New Millennium* (Cambridge University Press, 2003). pp. 181-187. 3) North Korea took reform measures as means of survival, just like China and the Soviet Union did. The economic assistance given by South Korea and China to the North can play the role of a launch pad for an economic leap of the North, according to the optimistic view. Citigroup, "Asia Economic Outlook and strategy: North Korea's Reforms," *Asia-pacific Economics/Strategy*, July 24, 2006. 4) July 1st measures resulted in spreading markets in the North. Yang Moon-soo, "The Structural Change of the North Korean Economy in the 2000s,"(in Korean) *KDI Review of the North Korean economy*, May 2007.

⁵ Arbitrary price decision adversely affects the demand and supply of labor, thus decreasing productivity and making people shun labor. Yang Un-Chul, "One Year after North's Implementing the July 1st Measures for Improving the Economic Management," *Current Issues and Policy*, 2003-07, The Sejong Institute, 2003.

North Korea regards the rice price as a kind of price index.⁶

<Table 1> Comparison of Rice Price between North Korea and China

Period	Rice Price in North Korea	Foreign Exchange Rate	North Korean Rice in terms of Yuan	Rice Price in China
	(NK Won/kg)	(Yuan)		(Yuan)
Nov. 2003	200~220	100~110	1.8~2.2	1.5~1.8
May 2004	350	145~150	2.3~2.4	2.4~2.9
May 2005	850~900	315	2.7~2.85	2.4~2.9
Nov. 2005	800	320	2.5	2.4~2.9
May 2006	1,300	375	3.47	2.4~2.9
Jan. 2007	830	425	1.95	2.4~2.9
May 2007	875	350	2.5	2.4~2.9
Jan. 2008	1,350	430	3.14	3.0~3.2
July 2008	2,400	470	5.1	3.2~3.4
Jan. 2009	1,700	520	3.26	3.2~3.4

Data: Open Radio for North Korea. Feb. 2, 2009.

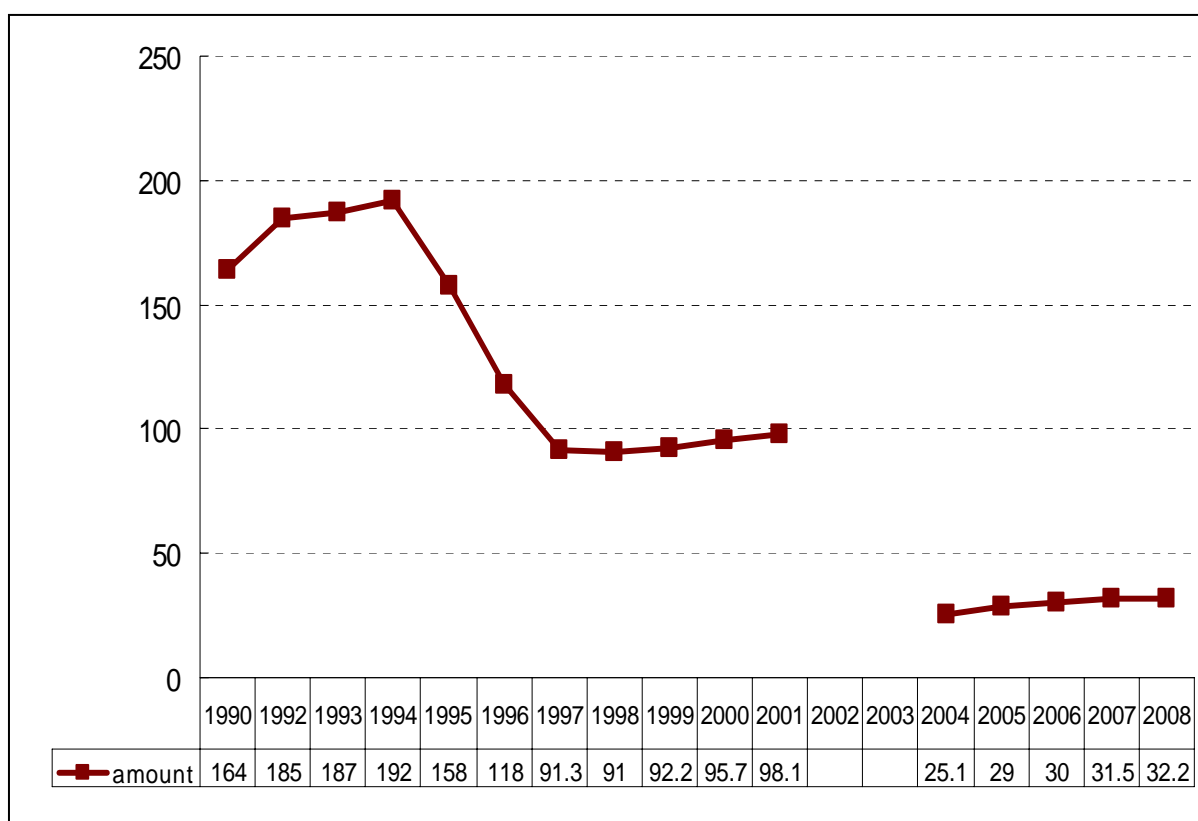
On the contrary to the government expectation, the July 1st measures caused the increase of the portion of private sector and market activation. Reducing government subsidy, most state companies suspended the payments; a growing number of people began to engage in commercial activities in market. The market in North Korea is still under state control despite the nationwide expansion of commercial activities. The setting prices by the government are usually unrealistic. In transaction, commodity prices are determined by the market principle. In addition, shocks to market, such as foreign assistance and natural disasters, have served as factors of price change in the market. In the perspective

⁶ North Korea maintains: "The setting of the rice price as the starting point of pricing consumer goods and as the standard price is the most just measure guaranteeing the objective nature of price." Choe Kyong-hi, "The Starting Point of Pricing Consumer Goods and Services and the Pricing Standard."(in Korean) *Economic Studies*, No. 1 of 2006, The Publishing House of Science Encyclopedia, Pyongyang, 2006, p. 33.

of supplier, many of the state-run enterprises faced a survival game. Thus, they modified their economic behavior to seek maximum profits similar to free competition. The process of determining the prices of goods produced by enterprises changed. Now, enterprises play a bigger role in determining the prices of their products according to market principle.⁷

<Figure 3> North Korea's Finance Expenditure

Unit: \$100 million



Source: Ministry of Unification. The 1st session of the twelfth supreme people's assembly.
(Data of 2002 and 2003 are unavailable. They are expressed in ratios.)

Due to the lack of revenue income, the government has reduced the rationing (See <Figure 3>). The suspension of food rationing and enterprise

⁷ It is common phenomena in Eastern Europe during the initial period of transition. Janos Kornai, *Struggle and Hope: Essays on Stabilization and Reform in a Post-Socialist Economy* (Edward Elgar 1997). pp. 12-13.

operation enlarged the role and scale of the market, and market principles have played a pivotal role in determining commodity prices. A rapid price increase is ascribable to the unprecedentedly remarkable change taking place in the distribution sector. The market, once allowed as a means of supplementing the failure of the planned economy, is taking root as the most important economic arena in North Korea. However, it is still debatable the influence of market in North Korea. One argues that the influence of the private sector continues to increase, although the command economy sector still overwhelms it.⁸

In 2003, North Korea transformed the farmers' market into the general market and allowed trading of not only farm products, but also various consumer goods.⁹ But the gap between prices on the market and the state-run shows was not bridged. This development was similar to that of China.¹⁰ Then, the North allowed the establishment of the *socialist material exchange market* for trading raw materials and intermediate goods between enterprises. Despite these measures to back up the July 1 measures, however, there was no increase in production. Under this situation, the public distribution system did not function. Instead the general market played an important role in easing an imbalance in a supply of goods between regions. But the North has attempted to restrict functions of the market several times over worries about the proliferation of the market. In 2006, for instance, North Korea announced the reinstatement of the PDS, a step against the market. And in 2008, authority prohibited people under age 40 from working, but failed to do so. This implies that the North Korean authority would eventually go back to the Soviet-type planned economy.

⁸ Hong Sung-gook, "An Evaluation of Marketization in North Korea," Sueun Bukhan Kyungje, Summer 2008, The Export-Import Bank of Korea.

⁹ The North Korean Central News Agency, June 10, 2003.

¹⁰ Berry Naughton, *The Chinese Economy: Transition and Growth* (The MIT Press, 2007). p. 92.

. Market Propagation in North Korea

There has been a farmers' market in North Korea since the early days of its socialist regime, despite its Soviet-style command economy.¹¹ North Korea proclaimed a land reform law in March 1945, which was followed by a temporary law to implement the land reform.¹² It authorized the people's market in February 1947 in a "decree on enforcing regulations on the people's market." The people's market was replaced by the farmers' market under Cabinet Decision No. 104 in August for cooperative farms by turning all forms of ownership and public ownership (cooperative ownership).¹³ At the time, the North allowed farmers to produce products in the backyards of their residence to ease the shortage of farm products. Then farmers sold their surplus on the farmers' market. In 1966, the North abolished farmers' payments to the state in kind, and they could sell more of their products on the market. The role of the farmers' market could be ignored in the 1960s, but it began to play an important role for distributing resources in the 1970s, when food and consumer goods were in short supply.¹⁴ The function of the farmers' market turned so brisk in the 1980s that even parts of tractors were traded there when the state often suspended the supply of food and daily necessities. The farmers' market turned into a marketplace where not only farm products, but other various goods, were traded. This development was prevalent when the state suspended food rationing in most areas, and many urban areas suffered from famine.

North Korea made a new attempt to increase production in the agricultural sector in the 1990s, while experiencing an economic crisis. The North

¹¹ Chung Chung-gil, Jeon Chang-gon and Kim Young-hoon, *The Distribution of Farm Products in North Korea And Operation of the Farmers' Market*, The Korea Rural Economic Institute, 1999.

¹² Boo Kyung-saeng et al, *The North Korean Agriculture: Real Aspects and Direction for Development*, Seoul National University Press, 2001, p.35.

¹³ North Korea has used the term *the farmers' market* instead of simply calling *the market* because it views as a symbolic terminology for capitalism.

¹⁴ Matsumoto Jiro, 'The Farmers' Market in North Korea and the Cooperatives Farms' (in Korean) *North Korea*, July, 1987. The Institute of North Korean Studies, Seoul, p 155.

decreased the number of the farming squad from 10-25 to 7-10, with the new squad composed of relatives, allowing their sales of surplus products on the market and emulating Chinese reforms. It also campaigned for projects such as a seed revolution and improving the farming infrastructure. But they produced few results.¹⁵ Under these developments, the role of the farmers' market became more significant. The North Korean people had to buy more daily necessities in the marketplace when the role of the state shops became nominal, because of the shortage of commodities they could sell. Among the commodities traded at the market were not only the goods produced by North Korean citizens privately, but the goods they stole.¹⁶ The massive inflow of Chinese goods into the North vitalized the farmers' market. Also on the market for trade were commodities provided by South Korea and the international community to the North, free of charge on a humanitarian basis. Noteworthy is the fact that the North Korean government recognized the farmers' market as an "official private economic sector." The farmers' market began to ease food shortages and the imbalance of regional material supply, while making up for the state's failure in economic management.¹⁷

North Korea recognized the role of the farmers' market for its people, but has taken steps aimed toward closing down the marketplace or restricting market activities to prevent the growing influence of the private sector. In an effort to prevent the proliferation of the market function, the North reportedly transformed the general market in 2008, and decreed the opening of the market as only once every ten days.¹⁸ However, the measures ended in failure. Most North Korean people are engaged in commercial activities on the market to pay for living expenses. Worried about the proliferation of the market, the North reinforced the functions of state-run shops in a way to make them sell more, various goods at prices cheaper than the market. The North Korean authorities

¹⁵ Boo Kyung-saeng et al, op. cited., p.83.

¹⁶ *The NK Daily*, "Cultivates Fields in the Farm Are Mine," *Keys*, January, 2004.

¹⁷ North Korea has often cracked down on trade in the farmers' market of goods other than those authorized for trade, but their trade has turned brisk soon after the crackdown.

¹⁸ *North Korean News Today*, No. 253, Nov. 18, 2008, Good Friends.

even supplied the shops with goods confiscated from the market. But the market has continued to flourish, despite policy measures against it. After July 1st measures, any North Korean people could rent a stall in the market from the authorities. Even they sold manufactured goods there.¹⁹

It would be easy for the North to abolish the general market because the markets are run by the local governments. But nobody excludes the possibility that some government offices may want to maintain their market, because they collect taxes from its merchants, and senior officials can get illegal income from the market. Generally, the rich people, so-called *the moneyed*, are reportedly expanding the province of their business activities, utilizing the tug of war between the state and senior officials. Foreign goods are also sold on the general market. Moreover, private business in transportation and residential construction is reportedly flourishing, mainly run by *the moneyed*. The production of “August 3 consumer goods” that are sold also on the market is brisk. The work teams are reportedly employing even guards to prevent robberies. But the North took measures in 2007 to restrict the trade of manufactured goods, most of them Chinese, on the general market in Pyongyang, the North’s capital.²⁰

North Korea has attempted to take measures aimed at preventing the proliferation of the market and brisk market activities. For instance, it banned all men and the women under the age of 50 from engaging in commercial activities on the market. A group of women reportedly staged a demonstration against the measure in front of the Party office in Chongjin City, apparently shocking the North Korean government. Undoubtedly, this incident indicates the important role of the market for helping North Korean citizens earn enough money to cover their living expenses. But the North has taken measures to open the general market only one day per month in some areas, or once every ten days in

¹⁹ North Korean government’s recognition of the market as a distribution channel is evidenced by the fact that under the state authorization, North Korean citizens are engaging in commercial activities on the market which is in competition with the state-run shop. For this reason, viewed as natural is a gap between the official prices set by the state and the prices prevalent in the market.

²⁰ Interview with a North Korean woman who ran from Pyongyang to South Korea in July 2008.

others.²¹

As market activities increase, the process of marketization begins in North Korea. It will bring about independent business activities of the North Korean peoples while reducing the government's influence on a long-term basis. But this change has yet to take place in the North because its economic policy regarding the proliferation of the market still remains in the political arena. Viewed from the perspective of system-related doctrine, marketization is expected to take the shape of "dependence on channels" taking place in the evolutionary process of interaction between economic entities. But the degree of marketization will be determined according to changes in the domestic political situation. In other words, North Korea cannot implement any economic policy, even if it is reasonable, when it judges that the policy threatens its leader's authority. The case was similar with Russia and the Eastern European countries. It is hard to expect that change will take place in the near future in North Korea, where Juche idea is equivalent to a religious belief. And it is more so because North Koreans have not experienced a free democratic system.

The possibility of North Korea's reform policy being successful is very low, because it is passive in market operation, which is much different from China. China has been active in the across-the-board reforms regarding the market, cultivated land, and the rationing system, among other things. The North can achieve an economic reform through the market – if not a bold one – with no big problem if the central government deals properly with the market sector. But the North can hardly go ahead with a policy in that direction if the reform is in conflict with the interests of its current leadership.²² Actually, the North came out with policy measures around October 2007, when the second inter-Korean summit was held, to impose an age limit on traders in the market and the kinds of items traded. Reportedly, there was then a Party instruction banning laborers from engaging in commercial activities on the market. The North Korean media was somewhat positive about the market from 2003-2004, but began to stress

²¹ *North Korean News Today*, No. 248, November 6, 2008, Good Friends.

²² *Voice of America*, November 29, 2004.

the principles of the socialist command economy again thereafter.

The North has also attempted to ban the trading of manufactured goods in general market. It aimed at closing the daily market or turning it into a farmers' market where farmers can sell only their surplus farm products.²³ The North recognizes the role of the market only as a supplement to the command economy. With no political reforms, possibilities are low that North Korea will emulate the Chinese reforms based on decentralization. Possibilities are also low that the North will imitate the South Korean development model based on dictatorial leadership, which introduced the market economy while seeking an opening and exploring foreign markets.

Seen from a technical viewpoint, the transition of the socialist command economy is largely based on policies of the government as follows: 1) the stabilization of the macro-economy, 2) a free price system, 3) private ownership, 4) diversion of the munitions industry, 5) an anti-monopoly policy, 6) reforms on the labor market, 7) improvement of the banking system, 8) reforms of the financial market, 9) reforms in the taxation system, 10) improvement of the judicial system, 11) improvement of the social welfare system, 12) reforms of the foreign exchange market, 13) improvement of the foreign trade system, and 14) improvement of the law on foreigners' investment.²⁴ But it is hard to expect North Korea to accomplish these reform-oriented measures in a short period. It also is hard to expect the North to transform its system through marketization because it suffers from a shortage of capital and human resources, worn-out industrial facilities and a lack of capitalist minds, among other things.

North Korea has expanded the market in its own way in an effort to supplement its collapsed command economy. However, it could not overcome the contradictory factors in the command economy, because it failed to allow private ownership, an essential factor for the most fundamental reform: marketization.²⁵

²³ *NK Net*, "Prevalent Are the Rumors on North Korea's Ban on Trading of Manufactures Goods, with Ever Intensified Control of the Market," December, 7, 2007.

²⁴ Yang Un-Chul, *A Comparative Study of the Transition of the North Korean Economic System: From the Command Economy to the market Economy*, Hanul Academy, 2006, p.23.

²⁵ Residences are traded overtly in North Korea, despite the official ban on private ownership. *The*

Despite this development, however, the role of the private economic sector has ever increased while the influence of the state in charge of the command economy has decreased.²⁶ The traditional farmers' market in the North should be oriented toward the market function. This means that North Korea needs to provide a judicial, institutional mechanism, which is necessary for the smooth development of a market economy. An institutional supplement is a prerequisite to establishing a judicial organization or an efficient administrative system, which is necessary for guaranteeing economic freedom. A political process will determine the duration of the period needed for making these preparations. A shorter process of this kind will increase the possibilities of economic development.²⁷

As long as the North Korean government maintains its current ability to control its citizens, it will continually attempt to bring local governments and enterprises under its complete control. For this reason, the autonomy of local governments was limited to the maximum, despite the slumping North Korean economy. It would be proper to say that the unlawful economic activities that have taken place throughout the North were not ascribable to decentralization, but to an administrative vacuum touched off by the bankruptcy of the national economy. Even if decentralization occurs in the North, possibilities are low that it will help improve the living standard of North Korean citizens remarkably. In addition, real decentralization can be achieved in the North only after the country succeeds in achieving political reforms and economic freedom for all of its citizens. The efforts being made by enterprises for their survival are no more than the effect concomitant with marketization. But in case the control power of the central government weakens, both marketization and decentralization will proceed at a rapid pace. New elite will then appear in the North, and they will implement more flexible and refined policy. For this reason, the policy for decentralization occurring in the North will not go beyond the domain of its

Rimjin River, No. 3, August 2008.

²⁶ *The 2003/04 White Paper of the North Korean Economy*, The Korea Institute for International Economic Policy, July 2004, p.263.

²⁷ Of course, there is an acute argument on the merits of radical reforms and gradual ones.

control mechanism.

. The Behavioral Change of State Companies

In North Korea, enterprises are the lowest units in the national economic management system. Enterprises should carry out their production plan approved by the state, just as under the central planning system in former socialist countries. They should also carry out economic activities—such as the securing of raw materials, decision-making on production formula, prices of their products, plus, matters regarding sales of their products—under the instructions and assistance of the state. North Korea has maintained the Taen Work System, which calls for streamlining and detailing economic plans regarding all production-related activities as the official economic management formula.²⁸ The enterprise is not only the production unit, but a political organization, and it serves as social welfare for the common community, which takes care of rationing for its laborers and public property.²⁹ The state gives instructions on production and management to enterprises and supervises them through Party committees in provinces, cities, and counties, and politically controls them through Party organizations in the enterprises.

But the influence of the state instructions and supervision weakened remarkably when the North Korean economy was trapped in an ever-deepening slump in the 1980s, in particular, and during the period of the arduous march in the mid 1990s. With no support given to enterprises by the central government, survival became their most important mission.³⁰ Their passive posture in the past, only getting instructions, became active as they purchased raw materials and sold their products themselves. Their autonomy was also reinforced. In the course of these developments, the plant manager as a technocrat saw his or her authority

²⁸ Lee Sok-ki, "North Korea's Economic Crisis in the 1990s and a Change in the Structure of Enterprise Control," (in Korean) *Comparative Economic Studies*, No. 1 of Vol. , 2004, p. 161.

²⁹ Park Hyung-jung, *North Korea's Economic Management System: Organization and Operation & Reforms and Change*, Haenam, 2002, in particular, p. 127 in Chapter 6.

³⁰ *Rodong sinmun*, January 28, 2007.

reinforce, while the influence of the Party began to wane. In other words, the influence of the Party secretary in the plant, who had been the most powerful since the North established the Taeon Work System in the early 1960s, became weaker than that of the plant manager. In addition, the meaning of many political projects, which were carried out under the initiative of the Party committee in the plant, slowed down.

North Korean enterprises have traditionally provided their laborers with fundamentals for living, such as wages, food rations, and housing. But this does not mean that they were given additional incentives in relation to labor they supplied to the employers, simply because of the characteristics of socialist society. Although laborers working in enterprises are provided with goods, which are non-excludable and non-rival in consumption, along with food rations, the portion of their wages in reward for their labor is comparatively low. There is the view that in North Korea, the state has attempted to solve the question of additional economic supports to laborers with political and moral incentives.³¹ Today in some North Korean enterprises a differential wage system has been put into force.³²

A noteworthy development takes place in the economic management of socialist countries to make up for deficits suffered by state enterprises. When

³¹ Jon Byung-yoo, Lee Il-young, "*The North Korean Labor Market and Ways to Improve Incentives Structure,*" *The North Korean Market, Reforms of Enterprises and the Incentive System for Labor,* The Korean Labor Institute, Seoul, 2004, p. 127.

³² For example, at 26 Electronic Wire Plant in Pyongyang, some laborers are reportedly paid as much as 30,000 won monthly, more than seven times the standard monthly salary. The plant, with about 1,500 employees, has introduced a differential wage system in the course of carrying out a facility modernization program which began in 2002, and which is nearly complete. With its facilities modernized, the plant has succeeded in increasing its production in recent years, resulting in income exceeding the projected yearly target by more than 20 percent on average. To encourage workers, the plant posts the "financial status of the plant, socialist competition table, and achievements on working days," which are indicators of daily production and achievements. Kang Yeon-jin, Kim Youn-chul, Jeoung Yong-soo, Jo Dong-ho, *An In-depth Analysis of Development Regarding Recent Changes in the North Korean Economy,* The Unification Research Institute affiliated with *The JoongAng Ilbo,* Seoul, 2006. pp. 36-40.

enterprises in capitalist economies register deficits, they usually exert various efforts to reduce deficits, or make profits for themselves, by cutting production costs or making structural adjustment. State enterprises in socialist economies, however, excessively pour in factors of production—such as raw materials, energy, labor force and capital—regardless of profitability, because they can receive government subsidies ex-post. This development is ascribable to governments' lax ex-ante handling of specific enterprises' troublesome soft budget constraints. Under the instruction of the government, state companies establish their production plan, make a decision on prices of goods, and sell them regardless of profitability. They get subsidies from the government behavior. The state enterprises face the problems of soft budget constraints.³³

Nowadays most socialist economies are bringing in market functions to promote business efficiency. The state company concerns to increase productivity while reducing the workers.³⁴ Most of North Korean enterprises change their production behaviors as the planned economy performs poorly. However, they are still relying on a distorted management formula. For example, they purchase raw materials with fines paid by laborers for their absence from the workplace rather than promoting management or economic efficiency. In the marketing field, state shops have seen their functions weakened or lost because of an absolute shortage of consumer goods. When the formal economic system collapsed in terms of both production and consumption, enterprises have to procure raw materials and sell their goods with little state intervention, to cover living costs for their employees and submit part of their income to the state. They could

³³ For enterprises, in this case, prices of their products are intrinsic variables because prices of most of their products can be determined under their own authorities, and not under the market mechanism. Moreover, the soft budget constraint does not necessarily imply their ex-ante free choice of factors of production. Janos Kornai, *Corruption and Dilemmas. Studies on the Socialist Economy and Society* (The MIT press, 1986). p. 35, p. 41.

³⁴ One study shows the soft budget constraint does not necessarily always bring about the inefficiency of an economy. The ex-ante soft budget constraint, or government's ex-post supports to state-run enterprises in china, has helped improve business performance and achievements. Sara Yueting Tong, "Soft Budget Constraint and Productivity of Chinese State Enterprises," *Working Paper*, University of Hong Kong, 2002.

hardly attain projected profits or make structural adjustments because of political reasons; they sold their goods cheaper than marginal costs, and depended on government subsidies. Today, North Korea is implementing a policy to give incentives to managers of state enterprises, yet it is still monopolizing factors of production. Under this economic system, there is serious inefficiency caused by the state monopoly. In other words, the few ruling elite misuse their monopoly power to get their own interests, rather than promoting enterprises' profitability and laborers' welfare. As a result, the ruling elite group easily captures the economic rent. The general public, with the suspension of the rationing system, is then faced with having to pay for public welfare programs under the benefit principle—programs formerly provided by the state free of charge. If the low income class cannot adapt to this system, social welfare programs for them will also become nominal. These developments will be followed by unproductive, illegal activities of the low-income class, such as stealing state property.³⁵

As the planning function of the central government weakens in the North, followed by a production reduction in state enterprises, the role of the unofficial economic sector regarding both consumer goods and capital goods is increasing.³⁶ The farmers' market, for instance, was transformed into a general market in 2003, followed by the establishment of a socialist material exchange market and the proliferation of small-scale services. These developments may indicate a change taking place in the economic sector of the North is maintained by itself with no government intervention. The guiding principle of "streaming" and "detailing" in economic planning is still a part of the North's ruling ideology,

³⁵ Yang Un-Chul, "State Monopoly and the Rent Seeking Behavior: The Case of North Korea," *Sejong Policy Research*, Vol. , No.2., 2006. P. 186.

³⁶ The Phrase "market principle" is taboo in North Korea. The North explains the capitalist economic phrase with its own expression: "Along with the command economy sector where production and distribution is made under the state plan and prices, there emerged a sector where economic transactions are made between enterprises under contracts and agreements. An important issue is how to combine this sector and the command economy sector," Yun Jae-chang, "Some Problems Regarding the Development of Economic Management in Our own Way today," *Journals of the academy of Social Sciences*, The publishing House of the Academy of Social Sciences, Pyongyang, No. 1 of 2007. p. 16.

but it has actually become nominal or meaningless because the central government suspended the supply of raw materials to most enterprises. Nowadays many enterprises in the North are securing raw materials essential to their production, and even part of their labor force, outside the province of the command economy. The North, however, is still trumpeting the natural nature of the state-oriented socialist economic management, turning away from reality.³⁷

North Korea has steadily raised the prices of daily necessities produced by state-run enterprises to increase state revenues. But the ordinary people, consumers, can hardly buy commodities - regardless of their prices - because of the state's inability to supply enough goods to meet demand. Instead, they buy Chinese consumer goods as substitutes in general market. However, the goods designated by the government as strategic items have scarcity value; their prices rise continually.

It is desirable for North Korean enterprises to restructure themselves to minimize the managing costs. There are some cases of merger and closure of enterprises in North Korea, but the North can hardly succeed in restructuring state enterprises with a large-scale reduction of manpower. For survival, at the same time, they are required to produce and sell competitive goods selectively in foreign markets. If North Korean enterprises succeed in promoting efficiency through restructuring, the settlement of market functions in the country will be advanced. As a solution in long-term basis, it can consider the privatization of state enterprises. Of course, privatization might not satisfy all people of every class, but it can be the second-best option. North Korean enterprises are reportedly given autonomy to some extent, but they are not ready to be privatized. The prerequisite to substantial privatization is guarantee of an autonomous price setting by enterprises. The establishment of an autonomous price decision mechanism should be preceded by the provision of a legal base and a concrete plan for privatization: the proceeding of commercialization.

As the state-owned economy began to collapse, North Korea started to

³⁷ To say it more correctly, the North asserts state-oriented order. *KDI Review of the North Korean Economy*, July 2007. p. 64.

form domestic working parties to produce and manufacture the so-called August 3rd People's Consumption Products.³⁸ The domestic working parties consisted of full-time housewives, who produced various necessities from food products such as tofu, rice cakes, and noodles, to necessities and handicrafts such as socks and paint, using recycled residuals and scrapped material. The prices of August 3rd Products were slightly more expensive than products sold at state-owned stores, but were considerably cheaper than goods sold at farmers markets. Also, unlike state-owned shops where products required consent from the People's Party to be sold to consumers, these August 3rd Product stores were able to sell all goods without any restrictions. Thus, rational prices and convenience of the August 3rd Products attracted a large crowd of consumers.

Consequently, state-owned commerce became increasingly paralyzed, while domestic working parties flourished. In places such as Pyongyang, small businesses selling August 3rd products owned almost hundreds of employees with numerous sectional workplaces. State authorities, threatened by the rise of capitalism within the nation, began to regulate further growth of domestic businesses. However the August 3rd Products will open up new opportunities for the market economy and help ameliorate consumer conditions of North Korea.

³⁸ Initiated on August 3rd, 1984 after Kim Jong Il visited the national light industry exhibition, simply called August 3rd Products, so to speak, covered the insufficient production of state-run businesses.

. Prospects of the North Korean Economy

North Korea is unable to provide a stepping-stone for sustained economic growth because of shortages in capital, energy, and technology. In a macroeconomic viewpoint, the outdated facilities in the heavy and military industries turned into a heavy burden for the North Korean economy, with an astronomical cost required for their maintenance. An increase in production efficiency first requires the inflows of capital and the dismissal of surplus manpower, among other things. If North Korea makes investments in programs for industrial restructuring, the efficiency of investments, and the marginal productivity of capital will lessen as the adjustment cost becomes huge. Thus, North Korea's GDP will decrease continually if the North continues to maintain its current economic system.³⁹

Since North Korea took measures for improving economic management on July 1, 2002, it has motivated the decentralization of authority and autonomy of state enterprises. At present, the North Korean government does not supply resources to all enterprises, but only the industrial concern which it views as strategically important; they enjoy the privilege to monopolize factors of production. Most North Korean enterprises suffer from an ever-deepening shortage of factors of production. The state-run shops, with their functions paralyzed, cannot supply consumer goods to the public. As the economic transactions for daily life occur in the market as far as consumer goods concerned, the role of market becomes inevitable in North Korea. Although the North Korean government supervises and controls markets and related business activities, the autonomy of merchants and enterprises will be reinforced continually, fanning the proliferation of the market function. The portion of the unofficial sector in the North Korean economy has increased when established enterprises could not perform their function properly. If state enterprises in the

³⁹ Some North Korea watchers are in doubt about the reported sustained growth of the North Korean economy in recent years, plus the growth rate. The growth rate might be exaggerated, or the growth rate, if correct, could be attained most probably thanks to foreign assistance.

North suspend their operations, many laborers will suddenly be jobless. Laborers with weak competitiveness will need to find jobs in the service sector, small-sized manufacturers or self-employed business concerns, but their reemployment has yet to be guaranteed. In Russia, Eastern Europe and China, the emergence of many self-employed small business companies helped solve much of the unemployment problem, but it is too early to expect the emergence in North Korea.

The inefficiency of the North Korean economic system has been fully verified. The North Korean economy has no option but to collapse if it delays measures for substantial economic reforms for too long. North Korea has attempted economic reforms on an experimental basis, but its adherence to the planned economy is suppressing the bud for economic growth. The North has taken policy measures to introduce incentives for laborers, give a freer hand to enterprises, and to induce foreign capitals, but its economic steps are so far against the market economy. The North's economic policy is incompatible with market-oriented reforms. Due to protracted economic difficulties, the North Korean government has tried to find the breakthrough by strengthening its military power.

The proliferation of the market results in increasing the portion of the unofficial sector in the North Korean economy. State-run shops are unable to supply consumer goods because their functions are paralyzed. Most North Korean citizens buy goods mainly in the general market. In other words, marketization has proceeded considerably as far as consumer goods are concerned. Even the market functions for trading capital goods between enterprises. Though North Korean government continues to supervise and control market related economic activities, but the role of market and the autonomy of state enterprises will continue to expand. This will be the starting point of economic transition in North Korea.

What the North really needs is a system transition from the command economy to the market economy. Marketization and decentralization will actually be achieved in North Korea when the North is ready for improving its political system and economic structure through successful reforms and opening. The

needs to make an attempt for radical reforms like Russia and other Eastern European countries or employ a dual track experiencing in China is necessary for North Korean economic transition on a step-by-step basis. Only economic reforms can revive the dying North Korean economy. But it is uncertain what formula of reforms is relevant to North Korea. To find the optimal path is our mission.

**North Korea's Trade and FDI:
Does North Korea Follow Vietnam's Path?**

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North Korea's Trade and FDI: Does North Korea Follow Vietnam's Path?

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North Korea pursued an ideology of *Juche* or self-reliance since the 1950s and isolated itself from the world economy. The *Juche* policy consists of three elements, political independence from all foreign powers, economic self-sufficiency and military self-defense. North Korea has fostered a military-industrial complex with a belief that promotion of heavy industries would make both its economy and military stronger. In its development process, North Korea had avoided foreign direct investment and neglected international trade relations because of its distrust of foreign powers and fear of being exploited by Westerners. Until 1960 actual economic performance exceeded highly set targets owing to mass mobilization and moral incentives. However, in the long run, the outcome of the *Juche* policy under a command economy was disastrous because of lack of economic incentives and sub-optimal decision making process by a few political elite.

North Korea's economic crisis occurred in the 1990s when drought and floods hit the nation already suffering from poor economic performance due to inefficiency of the command economy. North Korea's 1990s were characterized by negative economic growth with an average growth rate of -4% during 1990-1998 as shown in Figure 1. After 50 years of implementation of the *Juche* policy, North Korea ended up with isolation from the globalized world, poor infrastructure, technological obsolescence, uncompetitive industries, and poverty-ridden economy, while other former command economies such as Russia, China and Vietnam, have made economic progress with adoption of a market economy and implementation of their economic reforms.

Confronted with an economic crisis during the 1990s, the North Korean regime began to introduce economic reforms in 2002, increased its trade with other countries and opened free trade zones to induce foreign direct investment. Furthermore, the six-party agreement in February 2007 offered various incentives for North Korea. The short-term benefits that North Korea may receive according to the agreement included provision of fuel most needed by North Korea and removal of North Korea from the US terrorist list. In the long

run, North Korea may have far greater benefits which include normalization of external diplomatic and economic relations, negotiation of bilateral and multilateral trade agreements, lift of the US and Japan economic sanctions and permission of North Korea to join international institutions such as the World Trade Organization (WTO), World Bank, International Monetary Fund (IMF) and Asian Development Bank (ADB).

Recent changes occurring in North Korea remind us of what happened in Vietnam during the 1990s. Vietnam started its economic reforms, so-called *Doi Moi* in 1986 with the openness policy. Since then Vietnam obtained normal trade relations with EU, Japan and many other countries in the late 1990s and successfully negotiated permanent normal trade relation with the US and succeeded in joining the WTO in 2006. After obtaining normal trade relations with advanced countries, Vietnam's trade has accelerated, which has contributed significantly to Vietnam's economic growth.

The purpose of this paper is to review North Korea's economic reforms and their effects on trade and foreign direct investment and to examine whether North Korea can be as successful as Vietnam in its pursuit for economic growth. We will also investigate whether there are any obstacles preventing its advance to economic prosperity. Section 2 reviews North Korea's economic reforms, section 3 analyzes the trend and patterns of North Korea's trade and foreign direct investment. Section 4 introduces Vietnam's *Doi Moi* policy and evaluates its economic effects. Section 5 compares North Korea and Vietnam in their economic conditions, competitive positions and economic reforms. Section 6 analyzes potential stumbling blocks to North Korea's pursuit of emulating Vietnam's success. The last section summarizes this study and draws some conclusions.

North Korea's Economic Reforms

In planning and implementing economic reforms, the North Korean regime adopted a Chinese style approach with economic reforms preceding political reforms as it learned from the Russian failure of the shock therapy approach of concurrent political and economic reforms and heeded the Chinese success of a gradual approach. In more recent years, it seems that North Korea has been more interested in the Vietnamese approach of economic reforms, which is even more gradual than the Chinese approach.

According to Yazhou Zhoukan Weekly on October 27, 2007, North Korean leader Kim Jong-il expressed an intention to benchmark Vietnam's two decades-old reform and openness policy *Doi Moi*. Vietnam has pursued the reform and openness policy since 1986 to introduce a market economy, and to liberalize trade and investment with foreign countries to a certain degree. With 20 years of implementation of the *Doi Moi* policy, Vietnam achieved high economic growth, an average growth rate of 7.5% for the period of 1990 -2007. During the Asian financial crisis of 1997-98, North Korea's output declined by 6.3% while Vietnamese economy achieved economic growth at 8.2% in 1997 and 5.8% in 1998 respectively.

Economic reforms, so-called economic adjustment policy according to the North Korean authority, include a series of measures to introduce market economy elements to the command economy. First, enterprise autonomy in North Korean factories over price setting is allowed to some extent in place of central planning, and the official targets of production are replaced by responsibility contracts, in which factories are allowed to sell extra output exceeding the quotas assigned by the contracts, and profits can be distributed on the basis of individual performance. Second, family-oriented farm operations are encouraged with household responsibility system, in which farmers were allowed to retain extra output after meeting official targets. Nonagricultural activities such as transport and commerce in rural areas by individuals are encouraged. Third, prices and wages are allowed to increase to reflect real market values and rationing system is discontinued for most commodities except for food. Fourth, free markets and farmers markets are legalized and individuals are allowed to make profits through commercial transactions. Finally, economic adjustment policy includes opening its market to international trade and foreign direct investment. Several free trade zones were designated recently in addition to the Rajin-Sonbong area which was established earlier, and the Kaesong Industrial Complex (KIC) has been developed since 2002.

North Korea's Trade and FDI

Although North Korea's data and statistics are notorious with reliability problems, information on trade transactions and FDI data tend to be fairly accurate because trade and investment statistics reported by North Korea can be cross-checked with the statistics reported by its trading partners to international organizations. The Direction of Trade Statistics published by the IMF indicates that North Korea, though isolated, has traded with about 80 countries. Until

2001, Japan was the main export market for North Korea. However, economic sanctions imposed by the Japanese government due to tensions between the two governments arising from both missile tests and the kidnapping incident of Japanese citizens resulted in gradual reduction in Japan's imports from North Korea over last few years to eventually zero in 2007. Now South Korean and Chinese markets together account for about three quarters of North Korea's total exports, with South Korea taking over China for first place since 2006. It is worthwhile to note from Figure 2 that the growth rates of North Korea's exports have been accelerated since it implemented the reform policy in 2002. North Korea's major export items include primary products such fish and animal products and mineral products such as coal and iron ore, although some manufacturing goods such as metals, textiles and machinery are also exported.

China and South Korea are not only North Korea's major export markets, but also major sources of their imports, with their combined share in North Korea's total imports being in excess of two thirds in recent years. Figure 3 shows a surge in North Korea's imports in 2001. However it is misleading because the surge was mainly due to Japan's food aid in a large shipment to North Korea. North Korea's major import items include fuel, food and materials and components for manufacturing. North Korea's trade with the United States, Europe, Japan and even its former ally, Russia, has remained at minimal levels in recent years. North Korea's exports to China or South Korea account for more than one third of North Korea's total exports while North Korea's exports to China or South Korea account for less than 1% of total Chinese or South Korean imports. So, North Korea plays a very minor role for trade of both China and South Korea. North Korea has been plagued with chronic trade deficits as shown by Figure 4, with the trade deficit surging in 2001 when there was a surge in imports.

Since the collapse of the Soviet Union, China has remained North Korea's chief ally and the major trading partner. North Korea heavily depends on China for its petroleum need, about one third of its total import values. North Korea also imports iron and steel, various machinery and vehicles from China. On the other hand, China imports mainly coal, iron ores from North Korea by taking advantage of North Korea's rich mineral resources. China also imports fishery products from North Korea. North Korea's exports to China increased to \$582 million in 2007, up from \$40-50 million during 1998-2000, while its imports from China more than tripled from \$330-450 million during 1998-2000 to \$1392 million in 2007. North Korea's missile and nuclear device tests in 2006 strained diplomatic relations between the two countries,

but did not affect trade much. However, another missile test in 2009 may have negative effects on their trade relations.

South Korea's trade with North Korea increased gradually from 1990 to 2002, and it has accelerated since 2002 under the Sunshine Policy of former South Korean President Kim Dae Jung. North Korea's exports to South Korea more than quadrupled from \$176 million in 2001 to \$765 million in 2007 and its imports from South Korea also more than quadrupled from \$227 million in 2001 to \$1033 in 2007. North Korea's major export items include agricultural, fishery and forestry products, textiles, and some metal products and electronics. However, most of electronics export items were manufactured by South Korean subsidiaries established in the Kaesong Industrial Complex (KIC). North Korea's imports from South Korea include fertilizers, chemicals, machinery, and steel/metal products.

Russia and Japan played an important role for North Korea's trade in the past. Russia was North Korea's most active trading partner during the Cold War. The USSR also provided financial aid and military aid during that time period. North Korea's trade with Russia peaked in 1996 when its exports were \$347 million and its imports were \$525 million, about one fourth of total North Korean exports and imports. However, their economic cooperation cooled as Russia recognized South Korea and opted out of the bilateral defense agreement with North Korea in the 1990s. Russia exported fuel, aircraft and paper to North Korea while importing electrical machinery. Japan maintained significant economic cooperation with North Korea early on, only second to China as North Korea's trading partners in the past. In 2001, Japan was the largest donor of food aid to North Korea. However, North Korea's provocative nuclear and missile tests and North Korea's refusal in resolving the incident of kidnapping Japanese citizens by North Korean agents resulted in imposition of very strict unilateral economics sanctions by the Japanese government in 2006. Since then bilateral trade plummeted to nil. Prior to the sanctions, Japan used to export electrical machinery and vehicles to North Korea while importing seafood, coal and textile.

North Korea' trade with the US has been very limited for several reasons. North Korean products are subject to very high tariffs which came to exist before World War II because there are no normal trade relations. Furthermore, various economic sanctions were imposed by the US government because North Korea is considered to be a threat to national security and also by the United Nations because of North Korea's nuclear test. In recent years,

India and Thailand have emerged as the 3rd and 4th trading partners of North Korea.

In 1984 North Korea enacted the Joint Venture Act in order to induce foreign direct investment, and in 1991 it passed the Foreigner Investment Act and opened the Rajin-Sonbong free trade zone. However, annual FDI flows have been in small amounts and sporadic until 2002 because of weak investment environment. However, FDI flows have been increasing since 2003 as investment environment improves owing to economic reforms. Figure 5 shows annual FDI flows and cumulative FDI stocks according to data compiled by the United Nations Conference on Trade and Development (UNCTAD). Except for two surges of annual FDI flows in 1989 and 1997, the FDI flows were at very low levels from 1987 to 2002, even negative in some years. They have gradually increased since 2003 and North Korea's cumulative FDI stocks were 1, 565 million in 2006.

South Korea and China are two major sources of investment for North Korea as well as two major trade partners. In 2002 North Korea established Sinuiju Special Administrative Region (SAR) on the Northwestern border with China to promote Chinese investment and founded the Kaesong Industrial Complex (KIC), not far from the border with South Korea, to attract South Korean firms. With the completion of the first stage construction of the KIC in 2007, it attracted more than 50 South Korean firms, generated employment for more than 15,000 North Korean residents, and produced more than \$250 million in goods. The products manufactured the KIC include textiles, metals and machinery, electric and electronic products and chemical products. However, the KIC has been stymied after the recent missile test, as tension arose between the two Koreas. While South Korean firms are restricted to invest in certain designated locations, Chinese firms are allowed to invest in various industries as well as various locations. So, considerable amounts of Chinese investment have gone to mineral extraction at various locations.

Vietnam's *Doi Moi* Policy

In order to discuss whether North Korea follows Vietnam in its reforms, it is necessary to know the major elements of Vietnam's economic reforms. In 1986, Vietnam's liberal socialist party leaders concluded that the Vietnamese economy can be stimulated by six major economic policy changes, which was dubbed by the Vietnamese government as *Doi Moi* (reform or renovation). According to Murray (1997) the *Doi Moi* policy consists of: 1) decentralization of

state economic management allowing some autonomy to state industries, 2) replacement of centrally planned economic measures by a market-oriented monetary policy, 3) adoption of an outward-oriented policy in external economic relations while allowing exchange rates and interest rates to respond to the market conditions, 4) agricultural policies that allow long term land use rights and greater freedom of farmers to buy inputs and sell their products, 5) reliance on the private sector as an engine of economic growth, 6) permission to state and privately owned enterprises to deal directly with the foreign firms. Decades of government efforts, entrepreneurial spirit of Vietnamese businessmen, and hard work of Vietnamese people since the launch of *Doi Moi* in 1986 have transformed Vietnam into one of the most dynamic emerging markets in the world.

In agriculture, the effects of *Doi Moi* have been very positive. Return of land to farm households from large state cooperatives, gave rural population with much greater choice on how to best use and manage their land. Another positive effect is the increasing rates of using mechanized equipment such as mechanized ploughs and threshing machines that produce higher yields (Nugent, 1996). Consequently, rice production drastically increased and Vietnam changed its position from a net importer of rice to the world's second largest rice exporter since the mid-1980s. Unlike some other resource-poor emerging economies, Vietnam is endowed with natural resources and agricultural commodities. It has benefited from recent surges in the crude oil price, as it is the third largest oil producer in Asia. Vietnam is also the second largest exporter of coffee in the world. The recent worldwide commodity boom has helped Vietnam to achieve impressive economic growth.

Figure 6 shows Vietnam's exports, imports and trade balance. Both exports and imports increased more than 20 times from 1900 to 2007. Furthermore, the rates of growth have accelerated since 2000. Vietnam is one of the largest recipients of foreign direct investment (FDI) in the world relative to the size of its GDP in recent years. The US, South Korea, Japan and Hong Kong are its largest FDI providers. According to Vietnam's FDI codes, all types of FDI including 100% sole ownership, joint ventures, licensing agreements and turn-key operation, are possible. The availability of low-cost educated labor and favorable government incentives such as provision of infrastructure and tax concessions to attract FDI, have made Vietnam an attractive manufacturing center in the region. Figure 7 shows committed FDI flows and implemented FDI flows in Vietnam from 1990 to 2007. The Asian financial crisis of 1997-1998

slowed the FDI flows into Vietnam for several years. However, these flows increased again in 2006 and 2007. The country's accession into the World Trade Organization (WTO) in 2007 will certainly help the country to increase its exports and to receive more FDI inflows.

Another major change coming from *Doi Moi* is privatization of the state-owned enterprises (SOEs) through equitization. The equity market of the country has experienced a strong rally since 2005 due to the ongoing restructuring and the gradual sell-off of the SOEs. The stated goal is to eventually prepare the SOEs to be privatized through initial public offerings. The privatization of some SOEs since 2005 has attracted strong foreign investors' interests.

Vietnam's economy has grown at the average annual growth rate of 7.5% since 1990, making it the second fastest growing economy in Asia after China. Figure 1 contrast Vietnam's annual economic growth rates to those of North Korea. Prior to *Doi Moi*, average per capita income was about \$170 per year, and over seventy per cent of the population was considered poor. Poverty in recent years amounted to less than 15% of the population by the internationally accepted poverty line standard, and per capita income has increased to \$835 in 2007.

Comparison of North Korea and Vietnam

Even though Vietnam adopted *Doi Moi* policy in 1986, Vietnam had trade mainly with Russia (former Soviet), China and other former communist countries until the early 1990s as North Korea did. However, Vietnam has been very aggressive in opening its market and gaining access to foreign markets during the 1990s. In 1990 it established free trade zones. Vietnam had first major trade agreement with European Union in 1992, and joined the ASEAN in 1995 while beginning the WTO accession talks in the same year. In 1999, it secured the Most Favored Nations (MFN) concession from Japan, and the following year it successfully concluded the most important bilateral trade agreement with the US, which took effect in 2002. In addition to its initial reforms in 1986, Vietnam has continued to undertake many additional economic and legal reforms. Vietnam rewrote its commercial codes and made new laws on competition and investment. The highlight of Vietnam' endeavor to reach the global market was joining the WTO in January 2007. In order to join the WTO, Vietnam completed its bilateral accession agreements with more than 20 countries by 2006. Vietnam's trade status with the US

progressed from trade sanctions until 1994 to normal trade relation in December 2001 to permanent normal trade relation in 2006.

On the other hand, North Korea has been slow in introducing economic reforms, almost twenty years behind Vietnam (North Korea's reforms in 2002 compared to Vietnam's *Doi Moi* in 1986), and it has been very reluctant in transforming its socialistic economic system into a market economy. North Korea has not been as aggressive in opening its market as Vietnam has been. Furthermore, North Korea's missile and nuclear device tests deteriorated not only diplomatic relations but also trade relations with several developed countries. For example, when North Korea launched several missiles and detonated a nuclear device in 2006, Japan imposed very strict unilateral trade sanctions which resulted in no imports from North Korea in 2007. The US government prohibited trade with North Korea until 2000 when the Clinton Administration partially lifted trade sanctions. More recently the Bush administration relaxed some other restrictions. However, missile tests in April 2009, in defiance of the warnings of the US and UN would bring negative effects on further lift of trade sanctions. Many advanced countries including the US, EU and Japan have given Vietnam the benefits of Generalized System of Preferences (GSP) which imposes lower tariff rates to the products coming from developing countries. On the other hand, North Korea do not benefit from such a system. On the contrary, because North Korea does not have normal trade relations with the US and Japan, its products are subject to much higher tariff rates. Only the EU allows application of the MFN clause to North Korea, but the tariff rates under the MFN clause is higher than the tariff rates under the GSP.

Table 1 compares South Korea, North Korea and Vietnam in many different aspects: economy size, income level, degree of freedom, globalization, competitiveness, corruption perception, etc. North Korea's size of economy measured by the purchasing power parity GDP is about ¼ of Vietnam while the magnitude of its exports is only 1/30 of Vietnam's. This fact is clearly reflected in their globalization index ranking; North Korea is in the 168th place while Vietnam is in the 96th place. Vietnam's ranking of the 70th out of 134 countries for the global competitiveness index is also impressive (North Korea is not ranked). North Korea has been at the bottom of the ranking for political freedom and economic freedom. Vietnam was also at the bottom of the ranking too in its early years of reform, but it has made progress in both freedoms over time. Table 2 which breaks down economic freedom into 10 categories indicates that North

Korea's scores in many categories are zero while Vietnam has high scores (60 and above) in several categories such as business freedom, trade freedom, fiscal freedom, government size, monetary freedom and labor freedom.

What Prevents North Korea from Becoming the Next Vietnam?

Many studies have shown that trade is an engine for development and economic growth for small open economies (Balassa, 1989; Baro, 1991; Frankel and Romer, 1999). For capital poor countries lacking natural resource endowments, rapid increase in exports would not be possible without FDI. North Korea is a typical example of capital-poor and resource-poor countries except for some mineral resources such as coal and metal ores. North Korea has geographical advantage in promoting its trade relations because it is surrounded by several big or rich economies, China, Russia, Japan and South Korea. Since North Korea has borders with three countries, China, Russia and South Korea, it can benefit from lower transportation costs through border trade.

Because Vietnam has large reserves of crude oil and produces rice three times in a year, its export amounts are of considerable size, but it has induced FDI to further its exports and development. In spite that North Korea really needs large amounts of FDI for its development and growth more so than Vietnam, North Korea has not responded favorably to external demand for transparent legal protection of investment assets and freedom of business activities in North Korea. Instead North Korea has restricted FDI activities within specific free trade zones. Exception is for some Chinese investment which could be fully integrated into the North Korean industries. By not allowing FDI into existing North Korean enterprises or industries, the North Korean government has not taken advantage of full spread effects of FDI to its economy. North Korean entrepreneurs and workers outside of the free trade zones could not have benefited from new advanced technology, management skills or learning by doing experience.

While Vietnam provided necessary social infrastructure and tax incentives through tax holidays and special tax rates to FDI firms, the North Korean authority has not paid attention to these matters. The North Korean government enacted several acts in regard to trade and FDI, but the bureaucracy in traditional socialistic mentality is not pro-reform minded and has not come up with some creative ways of solving bottlenecks. For example, if North Korea does not have sufficient government funds for construction of needed social infrastructure, an

alternative is to give an exclusive right of use of the facilities to the developers for a limited time period. Some developing countries have used this method for construction of roads, railways, harbors and airports. Tax rates in North Korea tend to be higher than those of other competing FDI recipients.

When we compare Foreign Direct Investment Acts and other related acts of North Korea and Vietnam, more differences than similarities can be found. First, North Korea's FDI codes allow only direct investment while Vietnamese FDI codes allow both direct and indirect investment. North Korea loses many potential investment of diverse forms by insisting on one business type, that is, socialistic enterprise (Jung, 2008) while Vietnam has taken advantage of all possible investment opportunities by allowing sole proprietorship, partnership, limited liability company and corporation.

Second, FDI firms in North Korea do not have freedom or flexibility of hiring workers from labor markets, but have to depend on the labor pool arranged by the government agencies. In the case of Vietnam, employers have choices in hiring. They could hire workers on their own or rely on the group hiring arranged by the government agencies. Group hiring may be simple and easy if the targeted employees are manual un-skilled workers, but it may not be an appropriate method in hiring skilled workers or middle managers. Furthermore, dealing with government agencies as a middleman between employers and employees raises transaction costs. In addition, collection of social insurance and additional fee charged by the North Korean authority increase labor costs too. In Vietnam employers have freedom of hiring and firing its workers, thus getting the best qualified workers from competitive labor markets. This is not the case with North Korea.

Third, compared to North Korea, Vietnam has a simpler procedure of establishing a FDI firm and it also requires less documents. So, it takes less time to complete the process of establish a FDI firm in Vietnam than in North Korea. Jung (2008) reported the total required days for a business approval as 45-55 days in Vietnam and 65 days in North Korea. In North Korea, two levels of governments, the central and local governments are involved in approving an FDI application, and there is no clearly defined distribution or delegation of authority between the central and local governments.

Conclusions

Economic performance of North Korea since introduction of its economic adjustment policy or economic reforms in 2002 has not been as impressive as Chinese or Vietnamese economic performance. It is true that economic reforms in North Korea reversed its decade-long negative economic growth into positive economic growth, but its economic growth rates were usually at the low level of 1-3% or even negative in 2006 and 2007, while Chinese and Vietnamese economies grew at much higher rates. If North Korea really desires to emulate the success of China or Vietnam, it needs more than superficial reforms and lip services. North Korea needs to heed not only the open door policies of China and Vietnam which have led to development and economic growth, but also that the two countries have gone through several economic, social, legal and institutional reforms, sometimes painful reforms, to make their openness policies effective.

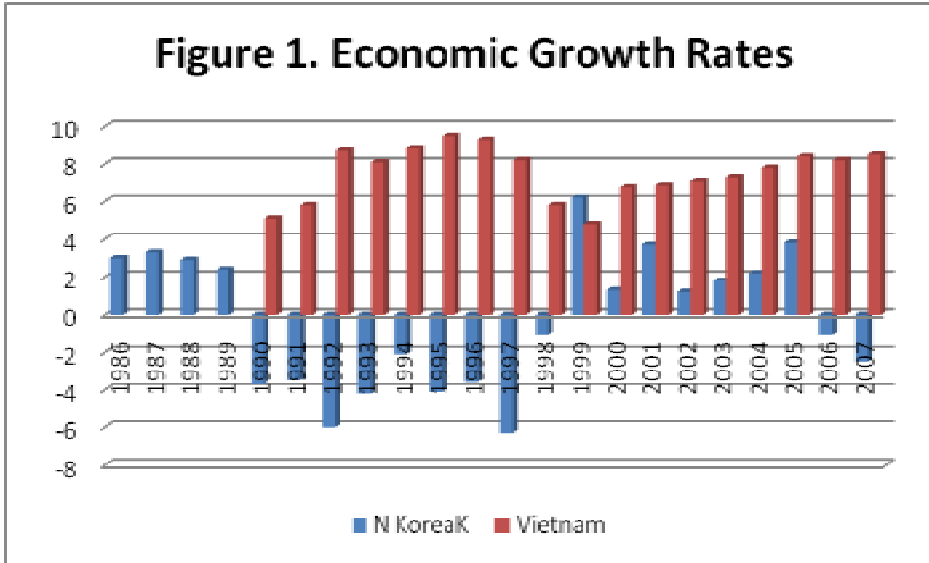
Trade decentralization and trade liberalization is recommended for export promotion and economic efficiency. Trading companies in North Korea are subsidiaries of or affiliated with the North Korean government, military or the communist party. These companies are not guided by profit motive and economic incentives, but controlled by government policy and political motive. Privatization of existing public trading companies or allowing private enterprises to engage in international trade would be desirable. Enterprises in manufacturing and service sectors should also be given autonomy in operation and management of the enterprises and be allowed to involve in international trade directly.

When free trade zones or special administrative zones were established in North Korea, these areas were walled off from ordinary North Korean citizens and businesses for the fear of contaminating effects of capitalism on the North Korean society. This is particularly true with the KIC where many South Korean firms have invested. The North Korean authority would like to embrace increased worker earnings, tax revenue and rent revenue, the benefits generated from production and employment in this isolated trade zone without being influenced by the presence of foreign enterprises in North Korea. In doing so, North Korea is losing far greater potential dynamic benefits coming from technology and knowledge spread effects. China and Vietnam were able to achieve high economic growth because they allowed FDI to be integrated into their

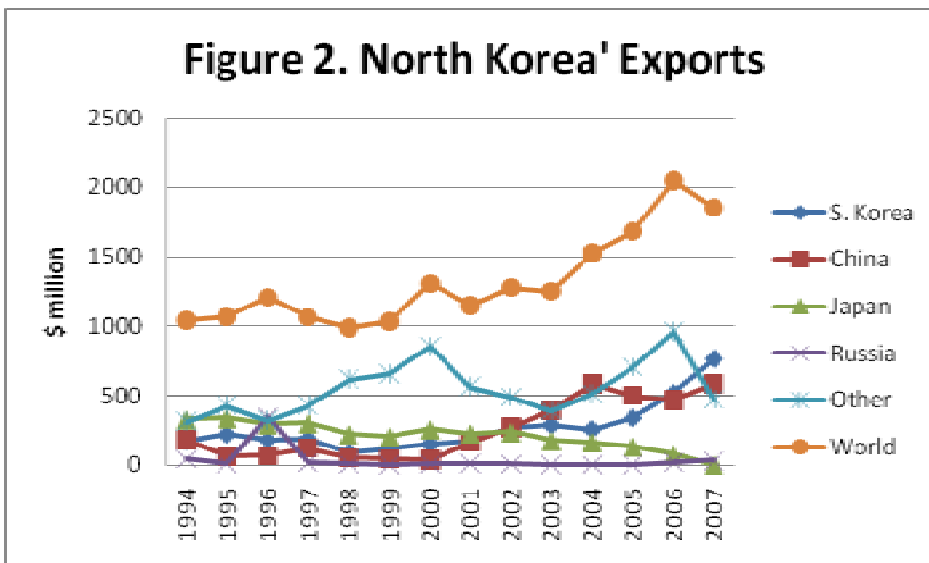
domestic industries and economies. Both countries have allowed various types of FDI including direct investment, indirect investment and portfolio investment as mentioned in the previous section. Allowing North Korean domestic enterprises to supply raw materials or intermediate materials needed for production in the special trade zones would benefit both domestic suppliers and FDI enterprises. When these provisions are permitted, then the special trade zones will truly serve as a driving force of North Korea's modernization of its economic system and globalization.

Appropriate macro-economic policy should accompany economic reforms. North Korea currently experiences rampant inflation. It needs a sound fiscal and monetary policy to curb inflation and maintain stable prices. North Korea is one of a few countries that still maintain dual exchange rate system, official and unofficial exchange rates. Dual exchange rate system impedes international trade and FDI flows. Recently the difference between these two rates widened because of rampant inflation. The official exchange rate was around 140-150 won per dollar in April 2009 while the unofficial rate was as high as 2,000-3,000 won per dollar. A stable exchange rate is essential to promote trade and FDI. China's trade and FDI moved one step ahead when it abandoned the dual exchange rate system early in its economic reform period.

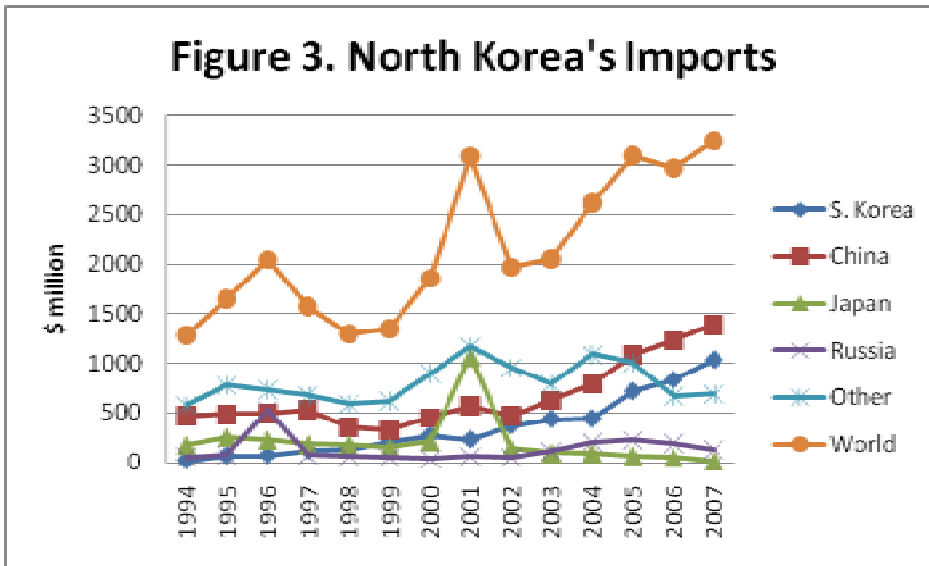
The suggestions or recommendations discussed in this paper for North Korea are what China and Vietnam adopted for their development and economic growth in a socialist-based market economy without sacrificing their socialist political system. Given North Korea's priority of political considerations over economic considerations and given North Korea's current politico-economic situation, the North Korean regime may not be ready to implement such additional reforms. However, there may be no other way to emulate the success of China or Vietnam unless North Korea implements the openness policy as extensive as China and Vietnam did. It is up to the North Korean leadership to stay in isolation from the globalized world and remain in poverty or to follow Vietnam's path for economic prosperity.



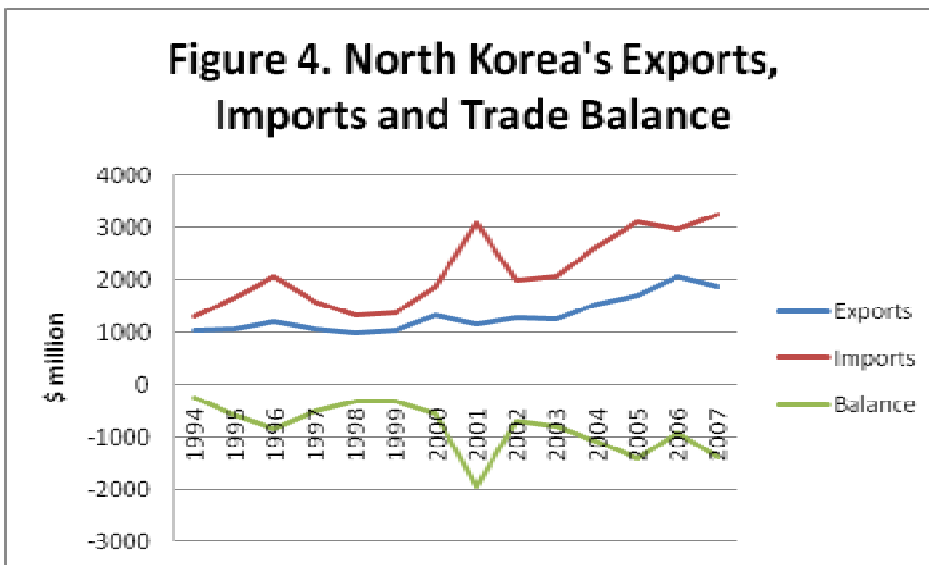
Data Source: Bank of Korea for North Korea and Asian Development Bank for Vietnam



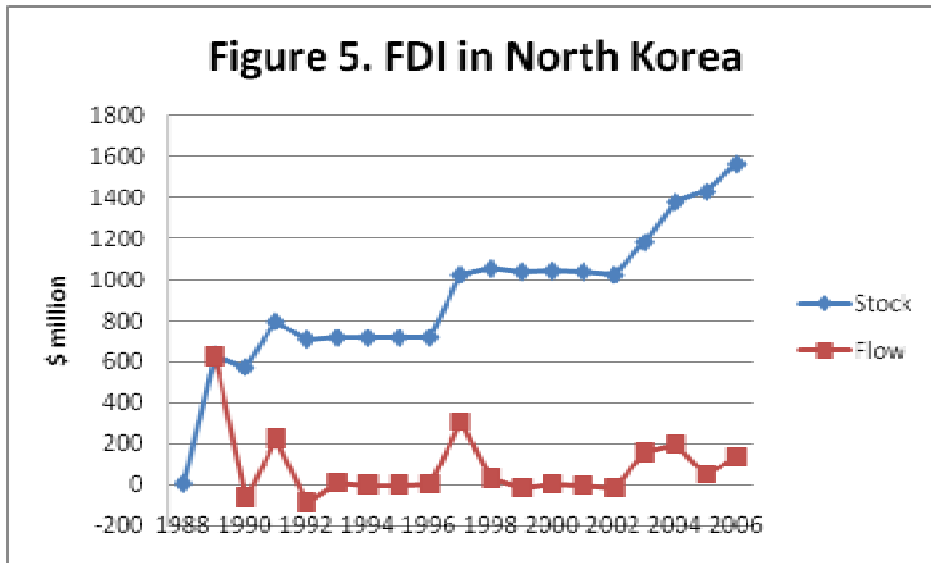
Data Source: UN COMTRADE Database and Unification Ministry of South Korea



Data Source: UN COMTRADE Database and Unification Ministry of South Korea



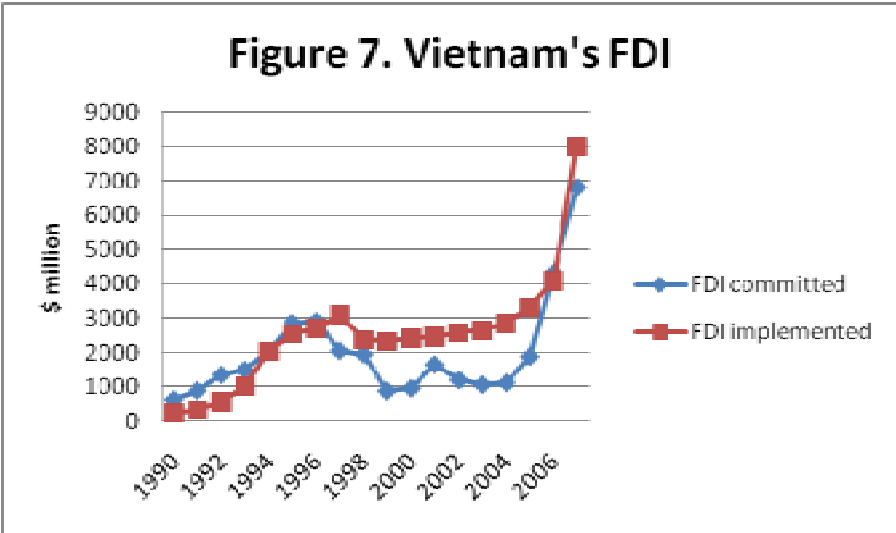
Data Source: UN COMTRADE Database and Unification Ministry of South Korea



Data Source: UNCTAD, Foreign Direct Investment Database



Data Source: Asian Development Bank and General Statistics Office of Vietnam



Data Source: Asian Development Bank and General Statistics Office of Vietnam

Table 1. Comparison of South Korea, North Korea and Vietnam

Variables		South Korea	North Korea	Vietnam
Population		48.5million	22.7 million	86.9 million
2008 GDP (PPP)		\$1278billion	\$40 billion	\$215.8 billion
2008 GDP		\$858billion	\$26 billion	\$91billion
2008 GDP per capita (PPP)		\$26000	\$1700	\$2800
2008 Exports		\$419 billion	\$2.2 billion	\$66.6 billion
2008 Imports		\$435 billion	\$3.1billion	\$79.4 billion
2008 Political Freedom Rating	PR	1	7	7
	CL	2	7	5
2008 Economic Freedom Ranking (2008)		40 (score: 68.1)	179 (score: 2)	145 (score: 51)
Globalization Index Ranking (2008)		87 (score: 59)	168 (no score given)	96 (score: 55.67)
Global Competitiveness Index Ranking (2008)		13 (score: 5.3)	-	70 (score: 4.1)
Corruption Perception Index Ranking (2008)		40 (score: 5.6)	-	121 (score: 2.7)
Human Development Index Ranking (2008)		25 (score: 0.928)	-	114 (score: 0.718)

Table 2. Breakdown of 2008 Economic Freedom

Variables	South Korea	North Korea	Vietnam
Business Freedom Score	90.4	0	61.7
Trade Freedom Score	70.2	0	63.4
Fiscal Freedom Score	70.4	0	74.3
Government Size Score	72.5	0	77.3
Monetary Freedom Score	80	0	67.0
Investment Freedom Score	70	10	30
Financial Freedom Score	60	0	30
Property Rights Score	70	5	10
Freedom from Corruption Score	51	5	26
Labor Freedom Score	46.4	0	70

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Contents

- Overview
- Current Status
- Support of Operation
- Assesments & Challenges
- Prospects of the KIC

Overview

Location



5

Development Proposal by Hyundai in 2000

Development of 66.1km² of land on a phase-by-phase basis: 40% for plants & 60% for supporting area for plants



Phase 1 area: 3.3km² (5%)



Phase 2 area: 8.3km² (12%)



Phase 3 area: 18.2km² (28%)



Kaesong City & the remaining area: 36.3km² (55%)

6

History

- ➡ On Jun. 30 2003, development of the phase 1 area began.
- ➡ On Dec. 15 2004, first product made in the complex was shipped.
- ➡ On Jun. 25 2007, 182 lots were sold in the second round of land sales.
- ➡ On Oct. 16 2007, construction of infrastructure for the phase 1 area was completed.

7

Current Status

8



Current Status

As of May 2009

106 businesses were in operation.

Total output was USD 580 million.

Types of businesses

Textile(63), metal/machinery(22),
electronic/electrical(11),
chemicals(7), food(2)

Overseas Investment

6 factory lots for foreign investors.
Currently, 3 lots are sold.

- ❖ Hiring 40,134 North Korean workers, paying around \$35 million a year
- ❖ About 400 persons, 300 vehicles enter KIC across DMZ per day



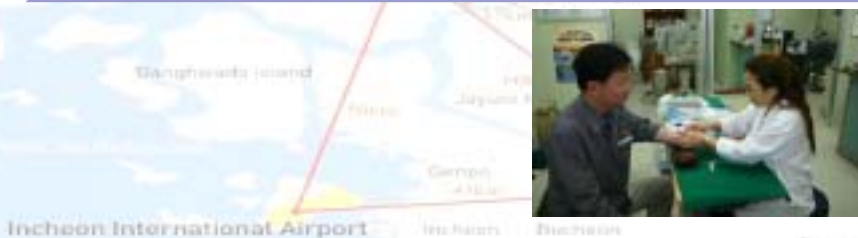
Work Environment

Competitive workforce

- ✓ Low labor cost
- ✓ High educational level of the North Korean workers
- ✓ Same language between South and North Korean workers

Clean & safe work place

- ✓ Cooling and heating facilities / Ensuring industrial safety
- ✓ 48-hour work week, up to the international standard



Work Environment

Amenities & services

- ✓ Snacks & shower facilities
- ✓ Hospital & exercise equipment
- ✓ 190(100) Shuttle bus for commuters

Opportunities for job training

- ✓ Technical Training Center



Figures

Production (Unit: USD 10,000)				
Year	2005~07	2008	2009 (Jan.-Feb.)	Total ('05.1~'09.2)
Amount	27,342	25,142	3,648	56,132

- Average North Korean worker produced about 1,000 US\$ per month in 2008.

Export (Unit: USD 10,000)				
Year	2005~07	2008	'09. 1-2	Total ('05.4~'09.2)
Amount	6,036	3,584	322	9,942

- 18% of production is exported.
- Major destinations are China, Europe, Middle East and Russia.

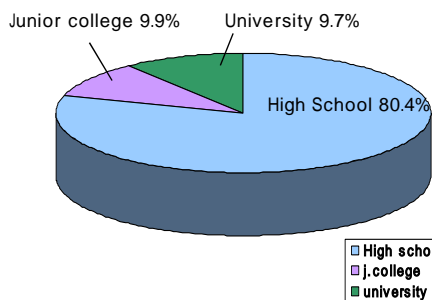
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Employment

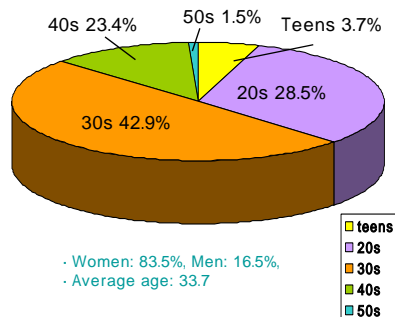
No. of Workers (Feb. 2009)

Area	South Korea	North Korea	Total
Number	1,262	38,323	39,585

Educational Level



Age Distribution



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Workplace

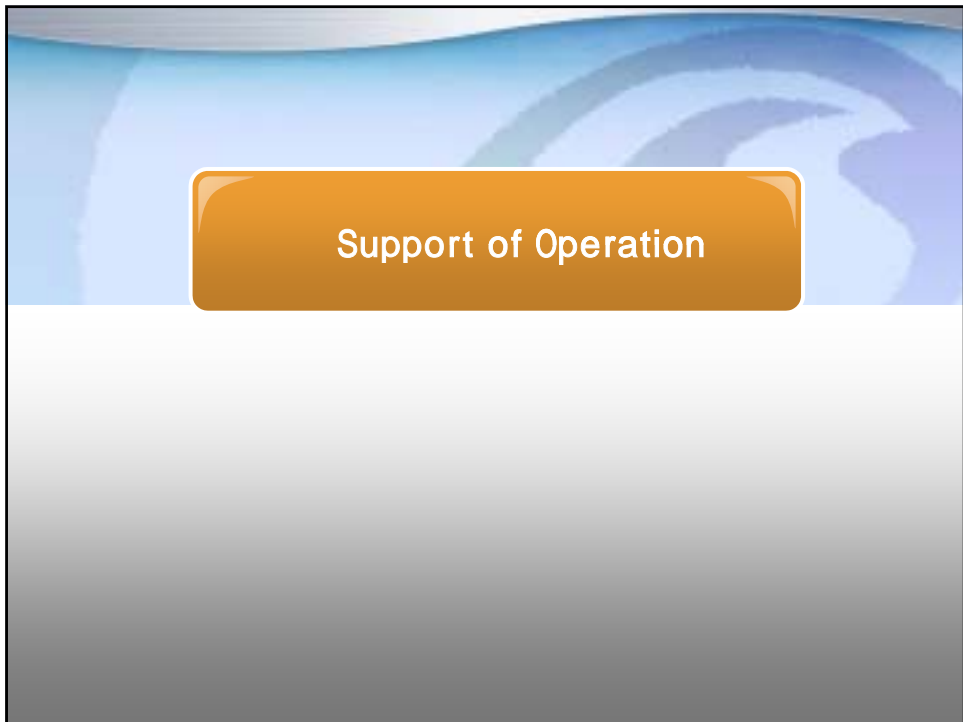
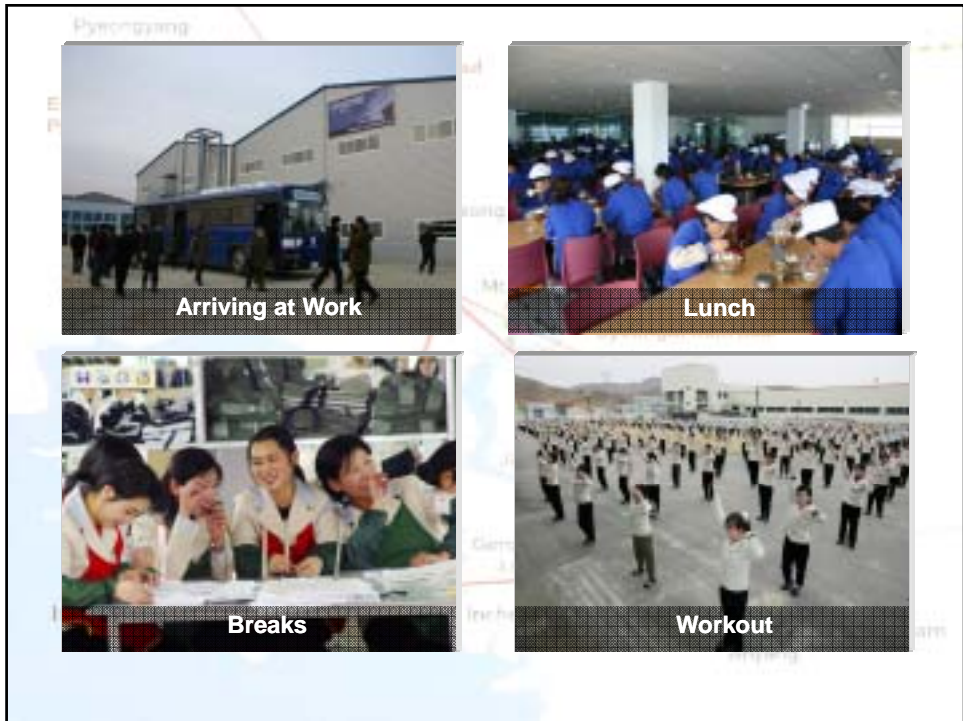


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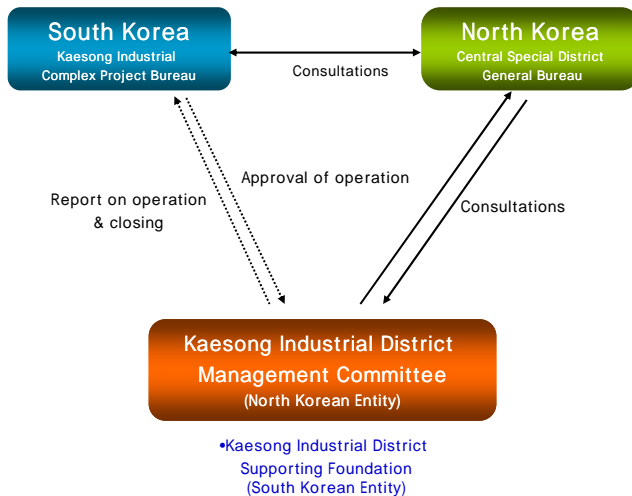
Technical Training



16



Operational Structure



19

Institution

Inter-Korean Agreements

- Agreements on investment protection, prevention of double taxation, commercial dispute, payment clearing & settlement took effect.
 - Agreements on passage, entry, stay, communications, customs clearance & quarantine took effect on Aug 1, 2005
- * Foreign buyers, engineers & investors were allowed in since May 30, 2005

North Korean Rules & Laws

- Law on Kaesong Industrial District Law was established on November 20, 2002.
- 16 sub-clauses, 42 rules & 1 enforcement regulation on taxation and labor were included.

South Korea stipulated " Act on Support of Kaesong Industrial District " on Aug. 26, 2007

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Products of the KIC

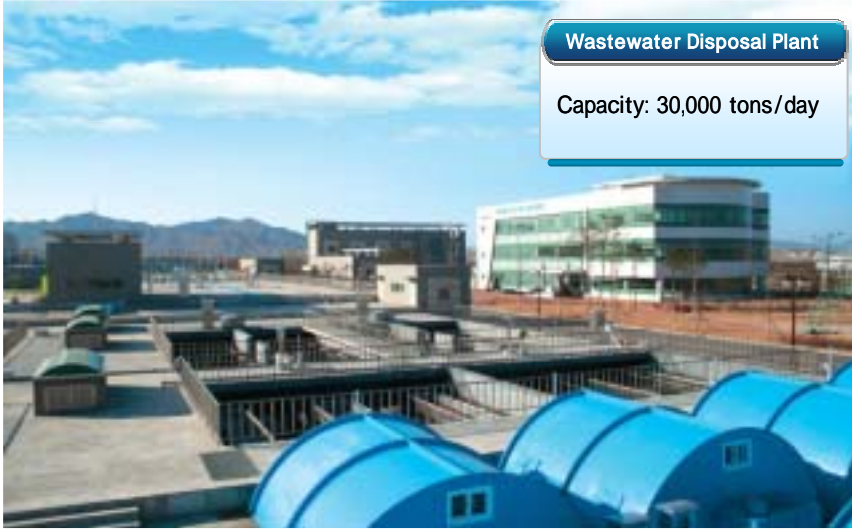


Infrastructure



Water supplying & purifying facility
Capacity: 60,000 tons / day
(Source: Weolgo Reservoir)

Infrastructure



Wastewater Disposal Plant

Capacity: 30,000 tons/day

23

Infrastructure



Electricity

Capacity: 100,000 kW transmitted
From South Korea



24

Infrastructure

Technical Training Center

4,000 trainees / year



25

Products of GIC



Infrastructure

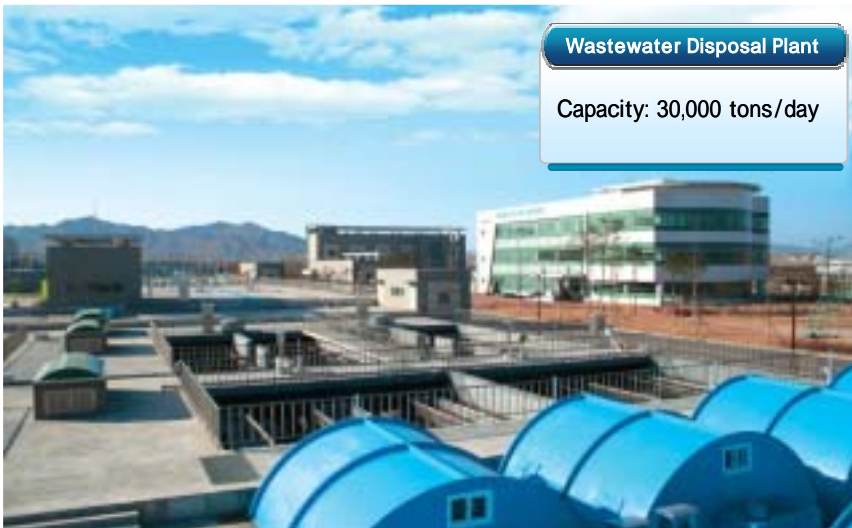


Water supplying & purifying
facility

Capacity: 60,000 tons / day
(Source: Weolgo Reservoir)

27

Infrastructure



Wastewater Disposal Plant

Capacity: 30,000 tons/day

28

Infrastructure



Electricity

Capacity: 100,000 kW transmitted
From South Korea



29

Infrastructure



Technical Training Center

4,000 trainees / year

30

Implications, Assessment, and Challenges

31



Implications

- **Mutually beneficial economic cooperation between South & North Korea**
 - Pragmatic economic cooperation which produces practical results by combining capital and technology of the South and land and labor of the North

- Major project which paves the way for peace and unification of the Korean peninsula

=> And Also, Providing Momentum of Economic Transition



Assessment

Exemplary model for Inter-Korean economic cooperation

- Combining comparative advantages of each side
(Capital & technology of the South and land & labor of the North)
- Creating new opportunities for SMEs, with profits for early investors
- Technical know-how and better-life for N. K. workers
- Looking glass into advanced South Korea

From ' battle field ' into ' peace zone '

- Reducing tension by moving military base near Gaeseong city further to the North (2 division workforce replacing 1 division unit)
- Connecting road and railway across DMZ

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Challenges

Politics rule over Economy

- N.K. cut S. Koreans with residing permit to 880, limited daily entry of persons/vehicles to 750/450 respectively (Dec. 1, 2008)
- N.K. blocked passages of persons and vehicles during joint US-ROK military exercise (March 9~20, 2009)
- N.K. detained a S.Korean worker (March 30, 2009)
- N.K. proposed negotiation to renew existing contracts regarding land lease and wages (April 21, 2009)
- N.K. notified it would nullify laws and contracts regarding land, wage, tax & etc.(May 15)

Nuclear Issue & Inter-Korean Relations

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Prospects for the KIC

35



Future Tasks of KIC

Base for Inter-Korean economic community

- Establishment of transparent legal system
- Pursuing free transfer of labor, material & capital
- Industrial cluster linking Incheon and Nampo (bed town)

Foundation for Peace in North-East Asian Region

- Rehabilitation and development of North Korean economy
- Spill-over of economy to peace
- Investment by neighboring countries

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Future of the KIC

Political Factors

- North Korea ' s Nuclear Issue
- Political Instability of the Korean Peninsula
- North Korea ' s Internal instability

Technical Factors

- Dormitory Construction for NK Laborers
- Free Passage and Customs
- Maintaining Wages and Tax Incentives for SK companies

THE SOCIAL CONSTRUCTION OF NORTH KOREAN WOMEN'S IDENTITY IN SOUTH KOREA: ROMANTICISATION, VICTIMISATION AND VILIFICATION

Mikyoung Kim

ABSTRACT

It has been more than a decade since North Korea was struck by famine and an outflow of refugees began. By 2007 about 10,000 refugees had settled in the South. Sixty percent of the new settlers are women. In face of the increasing visibility of refugees, this article aims to bring the 'people' back into the discourse. The identity of North Korean women has been constructed into a set of complex and contradictory categories: they have become the objects of romanticisation, victimisation and vilification. They are portrayed as the preservers of traditional feminine virtues, asexualised bodies, and sexual objects. The paper concludes by arguing that the unilateral imposition of identity in the South is harmful for the future social integration of the peninsula.

1 INTRODUCTION: WOMEN REFUGEES IN THE SOUTH-SOUTH DIVIDE

The Democratic People's Republic of Korea (DPRK, North Korea) poses many different kinds of challenges in East Asia. The nuclear weapons it is said to possess are viewed as a potent threat to regional security. Widespread famine resulted in many human casualties. The North's refusal to co-operate with the trans-border energy transportation system is an impediment to regional energy security (see Kim Mikyoungh 2009). North Korea's particular approach to human rights stirs concerns over its checkered records. Amid this multiplicity of challenges, the 'people factor' is often missing in the debates. The usual perspectives in international relations (IR) focus mostly on issues of war and order and of power and security, and seem to give scant attention to the cultural interactions of human agents, who may be uncritically assumed to be embedded in the institutions, or are relegated to the margins. In building up on the existing studies on inter-Korean relations, this article attempts to bring people back into the debate.

By 2007, 10,000 North Korean refugees had settled in the Republic of Korea (ROK, South Korea). While the famine of the mid-1990s initially served as the primary push factor for border-crossings, recent arrivals talk more about hopes for a better life and better jobs. As many as 300,000 refugees are estimated to be in hiding, mostly in China

and other adjacent countries, and many of them are believed to be pressing onward towards South Korea. One striking aspect about the group is that women not only make up the majority of the refugees, but their experiences in the North and in transit also shape their gendered identity. When this empirical reality is combined with South Korean dynamics, which are cultural, political and structural in nature, a specific group of disadvantaged people emerges. North Korean women are subject to a perilous construction of social identity from the double workings of power imbalance and patriarchal norms. Concerns for their human rights are not limited to their precarious existence in the North and in China. A parallel situation, lesser in degree but probably similar in nature, is going on in the South as well.

The ‘South–South divide’, an ideological divide within South Korea, makes the refugee settlement process difficult,¹ for there is little room for ideological compromise between the anti-communist conservatives and the conciliatory progressives.² The refugees from the North have to move in divisive political waters, because most aspects pertaining to their Southern existence are open to debate: the causes of the famine (systemic mismanagement versus natural disaster), the utility of food aid (sustaining the North versus famine relief), motivations for escape (betrayal versus survival), their background (socially marginal people versus courageous victims), their trustworthiness (a self-selected group versus an ethnic camaraderie), and their contribution (a drain on welfare versus a labour pool). Human rights are one of the thorniest issues in the divide.

Both silence and articulation show the irony of politicised human rights in the South. Whereas the Kim Dae-jung government remained silent on North Korean human rights abuses, the Lee Myung-bak administration has put it on the agenda as one of its policy priorities. Taking a critical stance towards the DPRK’s human rights policy also entails the danger of imposing universally defined human rights on the particular context

¹ The older generations, with their memories of communist brutality during the Korean War, constitute the core of the conservatives, whereas the younger generations, who witnessed a democratic transformation, support the North as an equal partner. Before the Kim Dae-jung administration’s ‘Sunshine Policy’ of engagement began, the ideological divide was limited to the causes of the Korean War and the presence of US forces in Korea. Since the inter-Korean summit of 2000, the main issue of contention has become the stance towards the North’s regime.

² The situation gives the conservatives a justification not to engage with the North, while the progressives are wary of antagonising the North Korean leadership.

of North Korea (Kukche Chǒngbo Yǒn'guwǒn 2000: 399).³ Human rights are a highly troublesome issue in inter-Korean relations. Under these complex circumstances, the women of North Korea fall between the cracks of ideological divide, academic speculation, and identity construction.

2 NORTHERN WOMEN

The psychological distance between the peoples of North and South Korea has been reduced since the inter-Korean summit of 2000. In the live television coverage, people in the South saw their Northern compatriots in colourful traditional costumes, waving artificial flowers and welcoming their president. The old images of red communists were slowly evaporating in the air of détente. The arrival of refugees also put a human face on the enemies from the Northern regime. The need to explore the routes toward peaceful co-existence registered with people, at least in the South.

Yet a lack of reliable data renders a systematic study of any topic on North Korea virtually impossible. Glimpses into the lives of North Korean women have trickled out through the occasional narratives of visitors and refugees, neither source sufficient to conduct fair research. The former, through the bias in accessibility, does not permit generalisations. The latter embeds the potential fallacies of a self-selected group, since refugees can be more in tune with the interviewers' perceived intentions than engaging in honest recollection. The creation of social identity is a separate matter. That process draws on the subjectivity of the participants in cultural interactions. In the absence of direct experiential reference, the women of the North exist only in the imagination of the Southerners. The cursory observations of the few visitors also create and recreate the images of Northern women. Through iterated representation and imagination, the women of the North have often been reduced to one-dimensional, yet mutually contradictory, categories of beings. The power imbalance reduces them to passive recipients of objectification. The women's lack of means to correct this stereotyping is a reflection of

³ The *Pukhan Chǒngbo Chongram* [North Korea encyclopedia] states that '*The North Korean Dictionary of Political Vocabulary* defines human rights as "a concept that is guaranteed only when all forms of oppression are eliminated, and the people become the owners of a socialist nation." Human rights are also translated into "human rights of our way", granting differential privileges on the basis of different political classes. Human rights are protected only for those who are loyal to the Party and the Great Leader, while exercising dictatorship over those who belong to the enemy classes.'

inter-Korean relations that undermine their capacity for self-representation. Their ontological identity is formulated in the equations of identity construction and representation.

2.1 *Women refugees from the North*

Since the early 2000s, the gender composition of refugees has swung towards a female majority. In the period from 2002 until February 2008, women constituted on average 70 percent of the total refugee population. This is a reversal of the male majority during the period between 1989 and 2001 (Lee Geum-soon 2008: 49-57; Ministry of Unification 2007: 146). The disproportionate gender composition is a result of a variety of causes: food shortages in the North (Chang, Haggard and Noland 2006: 28-9), a high demand for female partners in rural China, and a rising awareness of outside opportunities. Unlike women living in the North, women refugees have to face the Southern stereotyping head-on. Their gendered experiences in North Korea, in the transit country, and in South Korea also transform their gender consciousness.

Against the backdrop of Kim Jong Il's admonition that 'all North Korea experts in the South are phonies',⁴ this paper draws on the primary data of in-depth interviews with refugees and experts, and the secondary sources of statistics, photographs, poems, prose, and Internet commentaries.⁵

3 IDENTITY AND REPRESENTATION

The three major IR paradigms—rationalism, liberalism and constructivism—utilise three core concepts: power, interests and identity. The human rights debates on North Korean women are best served by social constructivism (Anand 2007: 15; Hall 1997a). The debates are ultimately about 'people', thus entailing intangible and hard-to-quantify dynamics. Not only can weapons be deployed to launch assaults on people as war assets,

⁴ Kim Jong Il criticised South Korean experts on North Korea as 'phonies' during a meeting with the delegation of South Korean journalists in Pyongyang in July 2000 (Kim Mikyoung 2000: 4).

⁵ The refugee interviews began in July 2000 and continued until October 2008. The total number of compiled in-depth interviews is 36, and the venues included church, private homes and coffee shops. Over multiple meetings, the duration of interviews also varied from 30 minutes to several hours.

as projected in rationalism, but perceptual tools such as images and words also can violate human dignity. The securitisation of North Korean human rights in US and Japanese political milieus reflects the strategic calculations involved in serving particular domestic interests,⁶ as assumed by liberalism, and yet it fails to address the interactive human dimension as a socio-psychological product. As this article aims to bring the people back into the debate, it focuses on demystification of the South Korean parochialism towards Northern women.

While not undermining the salient variables of power and interests in classifying North Korean women as the Other, the (un-)conscious identity construction is a cultural process under the influence of world views and the prevailing ethos. The cognitive aspect of a culture, its 'world view', is distinguishable from its evaluative, aesthetic and emotional aspects—its 'ethos'. The world view of a people, as suggested by Geertz, 'is their picture of the way things in sheer actuality are, their concept of nature, of self, of society. It contains their most comprehensive ideas of order.' The ethos of a people is, in contrast, 'the tone, character, and quality of their life, its moral and aesthetic style and mood; it is the underlying attitude toward themselves and their world that life reflects' (Geertz 1973: 127). World view rationalises ethos, and ethos instills world view with affect. World view and ethos are inseparable and converge in every cultural realm, including philosophy, religion, ideology, political values and the rights of human beings. South Koreans' (un-)conscious, and yet politicised, daily acts of presenting North Korean women as the Other are a manifestation of world views and ethos. The way in which North Korean women's identity is constructed within the discursive practice of the South raises the need to adopt a post-colonial stance towards the objectified Others (Spivak 1988).

Non-state agencies, such as non-governmental organisations (NGOs), the media, journalists and ordinary people, participate in meaning-giving and meaning-seeking activities in their limited interactions with Northern women. In self-reflecting mode, a reversal of position is necessary to imagine how power is experienced, a departure from the customary efforts to know how power is executed. We get to know who we are by looking at our own selves, and considering what we are looking at. The mirror-image projection is the beginning of a self-reflexive journey. From examining what we see in

⁶ Since the end of the Cold War, and especially since the events of 11 September 2001, regional issues relating to human rights, illegal migration, epidemics and environmental degradation have increasingly come to be viewed as international security issues. The transformation of these formerly peripheral social issues into core security concerns has come to be called securitisation.

Northern women under our gaze, we place our own selves under examination. The following analyses the way in which we categorise and judge Northern women, and how their human rights are violated.

4 ROMANTICISATION, VICTIMISATION AND VILIFICATION

In the absence of direct experiential reference, stereotyping is a primary filtering mechanism. Drawing on statistical discrimination, the pigeon-holing task of classification ensues. As the 1995 famine confirmed the capitalist superiority of the South over the socialist system of the North, at least in material terms, the Northerners evoked images of poverty, hunger and desperation. The 2000 inter-Korean summit turned them into our compatriots, rather than an imminent danger, deserving our fraternal aid. In due process, the Northerners have reached the South with a human face, a face that the Southerners have given them independently of their volition. As stereotyping fixes difference, the Northerners are being reduced to and naturalised into a certain category of being (Hall 1997b: 257-58). In drawing out their essential being, the discussions below demonstrate that Northern women are the most vulnerable group for being both Northern and women.

4.1 *Romanticisation: nostalgia for the traditional female archetype*

In the prelude to the 2000 inter-Korea summit, the North decided to experiment by admitting a selected few from the South and, in the late 1990s, permitted the entry of progressive opinion leaders. The visitors began relaying their impressions of this little-known society, and the curious audiences in the South were ready to listen. No matter how cursory and anecdotal the impressions were, their subjectivity was mediated between an authoritative representation and a curious audience. One of these generally unilateral portrayals is the nostalgic romanticisation of Northern women as the preservers of traditional feminine virtues. The poet Ko Un harboured complex feelings towards the Northern women he encountered (Ko 1998a):⁷

Oh, come on, come hurry on. Hurry to

⁷ Translations of poems, prose passages and website postings are by the author. They have been edited as necessary.

Take a look at me, the Taedong river was whispering to me.
The river was like my own blood and flesh like grandmother, mother and sister.
At the same time, it felt like an unfamiliar and attractive opposite sex
Into whom I was supposed to be drawn.

The Taedong river runs through Pyongyang. It is highly probable that Southern visitors were only permitted to tour the designated show sites of the capital. Under these controlled circumstances, the poet ironically feels an emotional affinity towards the river as a representation of kinship as well as the seductive female. This stretch of the imagination feminises the Northern territory in terms of its seclusion, nostalgia and the lure of the forbidden. In a series of newspaper articles, Ko continued on his nostalgic journey (Ko 1998b):

The soft curves on the hills were like the swollen breasts of a mother. The women's long skirts stretched well below their knees carried an air of courteous coyness. A certain ancient shyness became a distant memory of the person I had left in my hometown. It was actually not what I could remember about my childhood, but was what I saw in today's North Korea. I have found the untainted image of my hometown there.

The Northern territory provokes nostalgia for what the poet has forgotten. The heartache and longing for lost memories are preserved in the hills of the land and the covered knees of the women. The images of fertile mother and coy female exist on the evocative continuum of lost innocence. The shortage of food and the deprivation of Northerners escape the poet's imagination. This portrayal is in sharp divergence from the grave famine of the 1990s (Moon 2009).

The novelist Lee Ho-chul made his own nostalgic journey into North Korea. In a piece carried by *Donga Ilbo* (8 September 1998), Lee wrote that:

During my stay in North Korea, the middle-aged serving ladies left the most memorable impression on my brain. They have so thoroughly preserved the archetypal image of Korean women in the land of Chosun. The South was full of them in the 1940s and 1950s, and many were still lingering on until the 1960s and 1970s. The virtues of genteelness, humility, prudence, politeness, industriousness and resourcefulness make up their impressive calibre. The traditional image of women that the ladies carried on was far from any shallow

falsity. This is it: the desirable path that the North and South have to take lies with the preservation of traditional virtues.

Considering that only a handful of those with a verified class background are selected to have contact with Southern visitors, the virtues that Lee detected in these women were limited to a slice of highly controlled reality.

On the reverse side of nostalgia lies another constructed reality, that of backwardness. Under the South Korean gaze, Northern women come to the fore as a pre-modern category. The popular television commercial for *Red Pen*, a set of supplementary learning materials, exhibited the Southern perceptions of Northern women. The advertisement was targeted at the vast and lucrative private education market in the South. In a scene in the commercial, upon a game show host's call for someone to bring a *Red Pen* on to the stage, a North Korean woman in the traditional costume of the white *chogori* (blouse) and the black *chima* (skirt) runs toward a child's room, grabs a red pen, and rushes to the stage. At the sight of this, all the South Korean women explode into laughter. Everybody else knew what the call for a *Red Pen*⁸ was about, except the Northern woman. She was an epitome of backwardness, who could not catch up with the rapidly changing cultural code of the South. As art imitating life, the television advertisement was a reflection of social perceptions. The North Korean woman was truly an outsider, who did not get the 'education fever'. Her pre-modern persona in the modern game show setting tells a very different story from literary nostalgia.

In contrast to the subaltern representation insisted on in the Southern voice, Northern women within the DPRK have advanced to a high socio-political status since socialist nation-building began in the 1950s. By 1989, for example, women held about 40 percent of professional and technical positions in the occupational hierarchy (Kim Ae-sil 2001: 175-77). With the food shortage worsening, more women are engaging in informal economic activities, growing commodities and selling them in the marketplace. They have proved to be tough providers for the family. North Korean husbands nowadays are called by various unflattering nicknames because of their lack of contribution. In the aftermath of the failure of the public distribution system, men still have to report for work

⁸ *Red Pen* is the name of supplementary learning materials printed by Kyowon Ltd. for preschool toddlers, elementary and middle school students. The materials including workbooks, mock tests, peer magazines and encyclopedia are mailed to subscribers at the membership fee. *Red Pen* teachers, mostly part time housewives, pay weekly visits to the member's house in order to check individual progress and provide consultations. For more details, visit <http://www.redpen.seoul.kr>, accessed on April 30 2009.

even if they do not render actual labour. Such is the daily reality that contradicts the romanticisation of Northern women.

4.2 *Victimisation: asexual beings*

The government of the ROK was the first to respond to the North's call for international assistance in the 1990s, and concerns for North Korean welfare are accordingly on the rise amongst the South Korean public. With the South's provision of 150,000 metric tons of rice in June 1995, many humanitarian NGOs in the South launched nationwide 'Help North Korea' campaigns. As many as 44 organisations were active in the aid campaigns in 1997, though the number was reduced to 25 in 2000. In this mood of détente, the amount of assistance increased dramatically as well. A sum of US\$3.05 million in 1996 rose to US\$26.67 million in 1997 and to US \$28.25 million in 1999. The volume of aid reached its peak in the inter-Korean summit year of 2000 at US \$78.63 million, a 24-fold increase from 1996 (Ministry of Unification 2001).

Humanitarian NGOs, a burgeoning group in civil society in the South, serve as intermediaries between the Southern population and the women refugees.⁹ Out of the four primary fund-raising strategies, most of these NGOs engage in the begging mode of campaign. The concept itself of a campaign is of relatively recent introduction and draws on marketing expertise. The campaign method has the double advantage of cost-effective advertising and the raising of a large sum from one event. A further development is to match different types of donors with customised value systems. 'Begging' mode aims to provoke the donor's pity and sympathy towards the beneficiaries. Demonstrating pain and suffering in the form of physical deformation is one of the most widely used methods. In the North Korean case, it has led to women being objectified as sick, asexual beings.

The obvious aim of the campaign was to motivate donations. Against the background described above, many NGOs adopted begging as their primary fund-raising method. The website of one of the leading organisations, for example, carries photographs of a woman refugee hiding on the DPRK–China border. The accompanying narrative reads as follows: 'On 9 June [1998], we proceeded to the village graveyard as soon as we arrived at the city of Changbaek.¹⁰ We were able to find five refugees, three women and two children, in hiding there. One of the women was lying on the ground and

⁹ The descriptions of NGOs in this paper include non-profit organisations (NPOs).

¹⁰ Changbaek is a city located on the Sino–DPRK border.

looked like a skeleton. The skin of both her hands was peeled and swollen...the sick woman said she was from Hamhŭng, a North Korean border city [*sic*], and was 30 years of age.¹¹ The material is powerful enough to show the destructive effects of hunger on human dignity. At the same time, it reduces the woman's ontology to that of a diseased body. The woman exposing her bare breasts and legs ceases to come across as a female. The fear and fatigue in her eyes define what she is: an asexualised being under the Southern gaze.

A campaign strategy such as the above clearly contravenes the code of ethics set out by the International Federation of Red Cross and Red Crescent Societies (1994: 8), as stated in the following:

In our information, publicity and advertising activities, we shall recognise disaster victims as dignified human beings, not objects of pity: Respect for the disaster victim as an equal partner in action should never be lost. In our public information we shall portray as objective image of the disaster situation where capacities and aspirations of disaster victims are highlighted, and not just their vulnerabilities and fears.

Despite the potential for ethical violation, the strategy succeeds in provoking strong emotions in donors. South Koreans leave their messages on the website board, such as the following: 'I feel so sorry for them. I happened to visit the website to help my children's homework. If my small donation can be of some help, I would be happy';¹² and 'I am very sad...I happened to find this site when searching for information on North Korea. I knew about this from watching TV, but did not know how bad it is...It is particularly sad because my relatives are also living in the North...I hope my little sum of money can be helpful...I am praying for peaceful unification sooner than later.'¹³ South Korean donors pitch in out of sympathy, pity and compatriotism. But this comes at the price of ingraining the 'victim' images in the minds of South Koreans.

The pitfalls of intensified competition in NGOs' fund-raising activities from the mid-1990s have shown themselves in a serious imbalance in human dignity between the giver and the receiver. The begging methods in the Help North Korea boom have resulted in further marginalisation of the Northerners. Structural variables are largely accountable

¹¹ <http://jungto.org/gt/kor>, accessed 25 November 2000.

¹² www.hungerchild.co.kr, accessed 30 October 2000.

¹³ www.hungerchild.co.kr, accessed 16 September 2000.

for the irony of victimising the victim: increasing competition among NGOs, a widening gap between resource-rich NGOs and poorly endowed organisations, lack of expertise in assistance activities, and political determinants of humanitarian work. The South Korean NGOs' adoption of the begging method was a byproduct of a well-intentioned, but poorly executed, strategy. Given their short history, the humanitarian NGOs did not have enough opportunities to consider the code of ethics. As news of the famine arrived suddenly in the South, crisis management was carried out with a hasty *modus operandi*.

Nonetheless, the violation of Northern women's human rights is a matter of concern for the NGOs' marketing strategies. The NGOs have been using bleak images of innocent victims in their campaigns. The fund-raising practices further victimise the victims. The current 'art of giving' is a poignant reflection of the state of affairs between the peoples of the peninsula. Furthermore, the NGOs' campaigns have serious ramifications for future reconciliation and peace-building between the two Koreas. The North Korean settlers, women in particular, have to bear the burden of having been the beneficiaries of Southern relief activities. South Koreans, on the other hand, will continue to remember their North Korean refugees as the helpless victims projected in those campaigns. This particular construction of identity will impede just social integration on the peninsula.

4.3 *Vilification: sexual objects*

The Northern women's identities are those of subjective imagination and mutual contradictions. The Southern visitors found the traditional female virtues preserved in the Northern women, whereas the NGOs saw hunger in the disease-stricken bodies. As for one more representation, the Southerners approach the Northern women as sexualized objects. This imagery is the outcome of unverified fantasy compounded with gender norms of double standards. In this classification, the Northern women are turning into promiscuous and calculating predators.

The so-called Pleasure Unit (*kippŭmjo*) adds to the South Korean fantasy of North Korean women as sexualised beings. The 2000 inter-Korean summit was a watershed event in many regards. It not only transformed North Korea from the enemy into a partner, but the summit also dramatically changed the image of the North Korean leader, Kim Jong Il. Before the meetings, he was usually placed into one or more unflattering categories: alcoholic, perverse, suffering from a personality disorder, sadistic, manic-depressive, a film maniac, and so on. After the summit, Kim reemerged as a

‘shrewd and rational leader’, who had been sustaining his regime despite threats and bluffs from powerful neighbouring countries. Kim Jong Il’s autocratic power has often been associated with unlimited access to entertainment, and the Pleasure Unit is rumoured to fulfill his indulgence. This perception is independent of the existing evidence that the unit is actually an entertainment troop, recruited from schools all over the country. Female students in middle and high schools with singing, dancing and acting talents and with a good class background are selected for Section 5 of the Korean Workers’ Party. This section is in charge of selecting, training and scheduling the performances of the troop. Many regard membership as an honour, and the selection process is known to be very competitive. The Kim Jong Il boom has been associated with the unit, provoking a highly eroticised imagery of Northern women. This damaging evocation linking political power to a group of young women has led to the construction of Northern women as sexualised beings. With the current speculation on the leader’s poor health and the talk about succession, the leader’s several wives and sons are fueling the imagination in this respect. Given that South Korea is not free from human trafficking problems,¹⁴ the social construction of North Korean women’s sexual accessibility demonstrates another perceptual irony.

As more information on the DPRK is relayed to the world, so are the stories of the refugee women’s lived experiences. An increasing number of women are choosing to leave the land of famine to look for better life chances elsewhere. The majority of escapees hiding in China are women, and many of them are known to use sex as a survival tool. It is a pragmatic move for them to secure assistance from the local Chinese by entering into relationships of cohabitation and/or marriage (Lee Sae-rop 2002). After securing financial resources and a human network, they move to the South. This explains why the majority of recent settlers are women in the age cohort from the teens to the 30s. With the few exceptions of married women who escaped in a family unit, the majority of women have spent a substantial amount of time in China under the protection of local Chinese men. This causes problems, legal and perceptual, once they settle in the South.

Some of the women arriving in the South are pregnant, and sometimes cannot prove who the fathers are. Under the South Korean Constitution, a child fathered by a North Korean man qualifies to become a South Korean citizen. But citizenship is denied to a child of a Chinese national. This legal technicality makes highly probable the inheritance of poverty by a succeeding generation of stateless people. An educational specialist for the refugees shared his concerns in the following passage:

¹⁴ <http://www.state.gov/g/tip/rls/tiprpt/2007/82806.htm>, accessed 13 September 2008.

The women students sometimes enter the [special] school [for young settlers] already pregnant. According to the rules, we cannot let them continue with schooling and stay at the dormitory. And yet, they have no other place to go once expelled. I ended up making a plea to the adjacent social welfare facility designated for pregnant foreign workers. The settlers can stay there until they give birth, but then again, there occurs another problem. The current South Korean law does not acknowledge the citizenship of children borne by foreign fathers including Chinese. This automatically disqualifies an infant from receiving the necessary protection such as medical care and compulsory education. The women have to prove in court that the fathers are North Koreans, who are regarded as Korean citizens under the Constitution, so that their children can live as normal citizens in the South.¹⁵

Putting legality aside, the physical histories written on their bodies create a negative social stigma in the South. South Korea still is regarded as a conservative Confucian society. As more refugee women find employment in the informal sector, the social prejudice targeted at them on the basis of their assumed sexual promiscuity leads to the violation of their human dignity. A researcher stated during an interview that:

We have to be very careful in telling how much and what we know about the settler women in South Korean society because of the social stigma. I am afraid that they will be subject to insurmountable stigma once what they went through becomes public knowledge. During the course of my research on the women settlers, I have learned that they had to do many things in the North and in China to get food, shelter and protection, to pass through the border patrols and to save enough money to come to the South. I have to be as vague and general as I can be in sharing my findings.¹⁶

Despite being subjected to social stigmatisation, the women refugees often express their amazement with Southern women. Back in the North, they took the patriarchal norms for granted—it was just the ‘way things are’. But their exposure to middle-class housewives through work and the mass media drives them to question what

¹⁵ Interview, 29 October 2008.

¹⁶ Interview, 30 October 2008.

used to be the 'way things are'. Facing confusion between the old and new norms, the settlers are generally insistent on the old way. A woman refugee described her relationship with her estranged husband during an interview:

We are divorced now, and he is living with a South Korean barmaid. I hear she is a married woman with children. She lost her house because of heavy debts and ran away from her own family. They met at the bar where she was working...I tried to change his mind...I got a divorce only after trying everything under the sun, including visiting the woman's husband. He was living in a shanty with two young children, running a private arithmetic school in a poor neighbourhood. He told me she could not move in with them because of her debts. If she came back to the house, her creditors would take away everything. I got upset and scolded him. 'People come before money,' I said. 'How could a family be broken like this just because of money? Is this how South Korea works?' Her child showed me a letter she had written to her mother. It read, 'I miss you, Mom. I hope I can bring your lunch box to the picnic.' She put the letter on the refrigerator. It made my heart ache.¹⁷

This Northern woman living under the judgmental Southern gaze actually provides a moral critique of South Korean society. Not only is she heartbroken because of her husband's affairs, but she is also angry with the ethical priorities of the new land. Her words deflect Southern superiority, in material terms, even though she is socially marginal. Her critical observations of the South continue as follows:

[After she became impoverished through her former husband's recklessness] I even visited the National Assembly and made a plea. I asked the National Assembly, 'Is this country lawless?' Our police protectors told me, 'This is a free country. We really cannot do anything about a personal problem like yours.' In other words, they didn't care. I told them, 'The family is the basic unit of society. If South Korea is a country where women desert their families, what kind of future does it have?' Until we got here I thought death was the only thing that could put us apart. Who would have known that our family would be torn apart like this here in the South?

¹⁷ Interview, 3 September 2000.

This woman refugee reverses the obvious power dynamic by making a judgment about the South. With the firm conviction that social order can be maintained by keeping the family intact, a teaching from the old land, she commands the subjective moral authority to criticize the Southern state of affairs. North Korean society still carries on the strong Confucian tradition, which occupies a different place from the political rhetoric of egalitarianism.¹⁸ While the former emphasises submissiveness, self-sacrifice and chastity, the latter glorifies independence, industriousness and communalism among women (Lee Young-Hoon 2008). And this juxtaposition of contrasting norms lingers on despite what ideational politics in the South have made of them.

5 CONCLUSION

Different forms of national unification have been advocated by the different South Korean governments. The first president of the ROK, Syngman Rhee, was adamant on unification with the communist North under the capitalist South's terms. The Kim Dae-jung administration, 50 years later, advocated the confederate system of one people – two political systems – two independent governments (*Monthly Chosun*, October 2008: 113). Unless the peninsula is unified following the DPRK's design—the most unlikely scenario—the South will have to bear the burden of facilitating social integration with the North. Since the core of social integration lies with the protection of the politically weak and socially marginal, the advancement of equality will define the crux of the South's moral authority. Northern women are highly likely to occupy the most disadvantageous position among the various socio-economic groups. Patriarchal gender norms compounded with class hierarchy will bind them into doubly disadvantageous circumstances. The social construction of Northern women's identity in the South supports this projection. The experiences of East German women shed useful light on this concern.

Amid the deteriorating gap between the former East and West Germany after the

¹⁸ An interviewee elaborated on gender discrimination in the North Korean socialist system: 'The North Korean workplace can appear to be egalitarian between sexes. But it is customary for the man to be in the managerial position, and the woman in the position of assistant...the head is mostly a man. It is very rare to find a successful woman working in a responsible post...It is true that many women work outside the home because men have to serve in the military for ten years. For the same work, women are not treated the same' (Interview, 13 August 2005).

fall of the Berlin Wall, frustration with a sense of relative deprivation deepened in the East. In the unified Germany, women, young people and children became the biggest victims of the socio-economic restructuring; for example, five years after unification, in 1995, the female unemployment rate in the former East Germany doubled that of 1989. According to opinion surveys conducted by the weekly magazine *Der Spiegel* in 1995, 87 percent of the respondents answered that women's status was higher in East Germany than in unified Germany (Ministry of Unification 1995: 112-13). It is instructive to observe that the socialist system of the former regime provided better protection for women than the democratic capitalist system. The situation for North Korean women is expected to be worse than it is for their East German counterparts, because of the on-going pejorative representation and identity construction they face.

The food shortage is not expected to improve quickly: it is a complicated problem of natural disasters and government failures. According to the 2008 World Food Program report, US \$503 million of aid is necessary for the 23 million people in the North to survive through the spring of 2009 (*Time*, 15 September 2008: 11). The domestic political situation is also precarious. With the top leader in poor health, rivalries between the military and the politburo and between the technocrats and the ideologues are reported to be getting intense. In preparation for the advent of collapse, South Korea's Concept Plan (CONPLAN) is in need of revision to better cope with contingencies such as a sudden influx of refugees or risks from possible weapons of mass destruction.

In examining various scenarios, this article argues that it is the people who will shape the trajectory, speed and process of inter-Korean reconciliation. Northern women are often unilaterally romanticised, victimised and vilified in the Southern imagination, to the detriment of peaceful co-existence between the two peoples. While the subjectified Others cannot command their own voice to refute the unfair stereotyping at the moment, they will some day gain enough voice to fight against this classification. As the ingrained images linger on in the South, grievances continue to grow elsewhere, only to damage mutual interests.

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Time, 15 September 2008

Likely Impact of the U.S. Economic Crisis on Negotiations with North Korea

by

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Biographical Sketch

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Abstract

Negotiations with North Korea since the last six-party talk ended in December 2008 have been stalled to say it mildly, interrupted by North Korea's test-launching of a long-range missile on April 6, 2009 and predictable responses by the U.S., Japan, and other countries. The inactive period, however, coincided with a serious recession in the U.S. and beyond that led the U.S. to spend an unprecedented amount of money for bailouts and economic recovery. Budget deficits for the 2008-09 and 2009-10 fiscal years are projected to exceed one trillion dollars by a significant margin. Facing the serious recession, the U.S. will not be in a position to offer any meaningful economic concessions to North Korea even if negotiations are resumed anytime soon. Further, the removal of North Korea by the U.S. from a list of state sponsors of terrorism in 2008 is symbolic because there are numerous other sanctions still in effect against North Korea. The road map toward successful negotiations at future six-party talks will have to be comprehensive so that both sides, especially North Korea, can see what the ultimate outcome of their concessions is likely to be.

Likely Impact of the U.S. Economic Crisis on Negotiations with North Korea

The last six-party talk in Beijing had ended on December 11, 2008 when negotiators were not able to reach an agreement on the issue of verification over the accuracy of the nuclear inventory given by North Korea in June 2008. The sticking point was North Korea's refusal to let international inspectors take samples from soil and waste at its nuclear facilities, which the United States had maintained was critical to reaching an agreement. Complicating the issue, however, is the rapidly-declining U.S. economy as indicated by the real GDP that fell at an annual rate of 6.3 percent during the fourth quarter of 2008.

This paper reviews the state of the U.S. economy to measure just how serious the economic crisis is and then speculate on how the state of the U.S. economy may affect the future of the negotiations with North Korea. This paper concludes with some suggestions on the direction that North Korea might consider taking in the middle of the U.S. economic crisis.

History of the Credit Crunch of 2008

Although there is no consensus on its exact duration, the beginning of the great moderation is believed to be the early 1980s. The good times of the great moderation are characterized by significant reduction in fluctuations, and improvements in aggregate output, employment, and inflation. Explanations for the great moderation include (a) improved monetary policy, (b) financial innovation, (c) increased global integration, (d) better inventory controls, and (e) good luck in the form of smaller exogenous shocks. As Federal Reserve Chair Bernanke opined during his discussion of the great moderation at the 2004 meetings of the Eastern Economic Association, "Explanations of complicated phenomena are rarely clear cut and simple, and each... probably contains elements of truth." (Davis and Kahn 2008, p. 155) It may be premature to give credit to any or all of these explanations. It is yet to be known whether the latest great moderation is in a temporary halt or is over until the next great moderation appears on the horizon many years later. The end of the great moderation did not begin with sub-prime mortgages. The end started long before the great moderation even began.

Securitizing mortgages in the United States have a long history. In 1968, the Government National Mortgage Association (Ginny Mae) was allowed to securitize FHA/VA mortgages backed by the U.S. government for resale in a secondary market. In 1970, the Federal Home Loan Mortgage Corporation (Freddie Mac) started selling government-backed MBS. "In 1981, the Federal National Mortgage Association (Fannie Mae) began issuing MBS, and soon after new 'private-label' securitized products emerged for prime loans without the backing of the government." (Mizen 2008, p. 537) In 1982, the Alternative Mortgage Transaction Parity Act allowed variable-rate mortgages as an alternative to the fixed-rate mortgages. In 1986, the Tax Reform Act ended tax deduction for interest on loans with the exception of mortgage loans. All these changes played a role in leading to the 2008 crisis. It is important to note that these

changes, standing alone, are nothing wrong, but were abused during the early years leading to the 2008 crisis.

During the great moderation of the 1990s and the early part of 2000s, the rate of inflation was low and the economy grew steadily. During the same period, countries in Asia and the Middle East started to save enormous amount of money. From 1996 to 2007, industrialized countries went from a current account surplus of \$14 billion to a current account deficit of almost \$500 billion. “At the same time, developing countries went from a current account deficit of \$82 billion to a surplus of \$760 billion.” (White House, p. 63) The influx of this capital lowered interest rates. These new wealthy were not satisfied with low interest earnings and searched for high yielding assets. Sub-prime mortgages provided the opportunity.

Role of Sub-prime Mortgages

Sub-prime mortgages have higher application and appraisal fees, higher insurance costs, higher fines for late payment or delinquency, higher probability of termination through prepayment due to refinancing or default, and, of course, higher interest rates that made these loans attractive to wealthy investors.

The rapid growth in residential MBS backed by sub-prime mortgages with a large number of steps between originators and holders of MBS contributed to underestimating the risk associated with these securities that was not properly appraised by bond raters, nor properly understood by final buyers of these securities. Perhaps, wealthy buyers of these securities may have underestimated the risk more willingly than naively. This is how it happened.

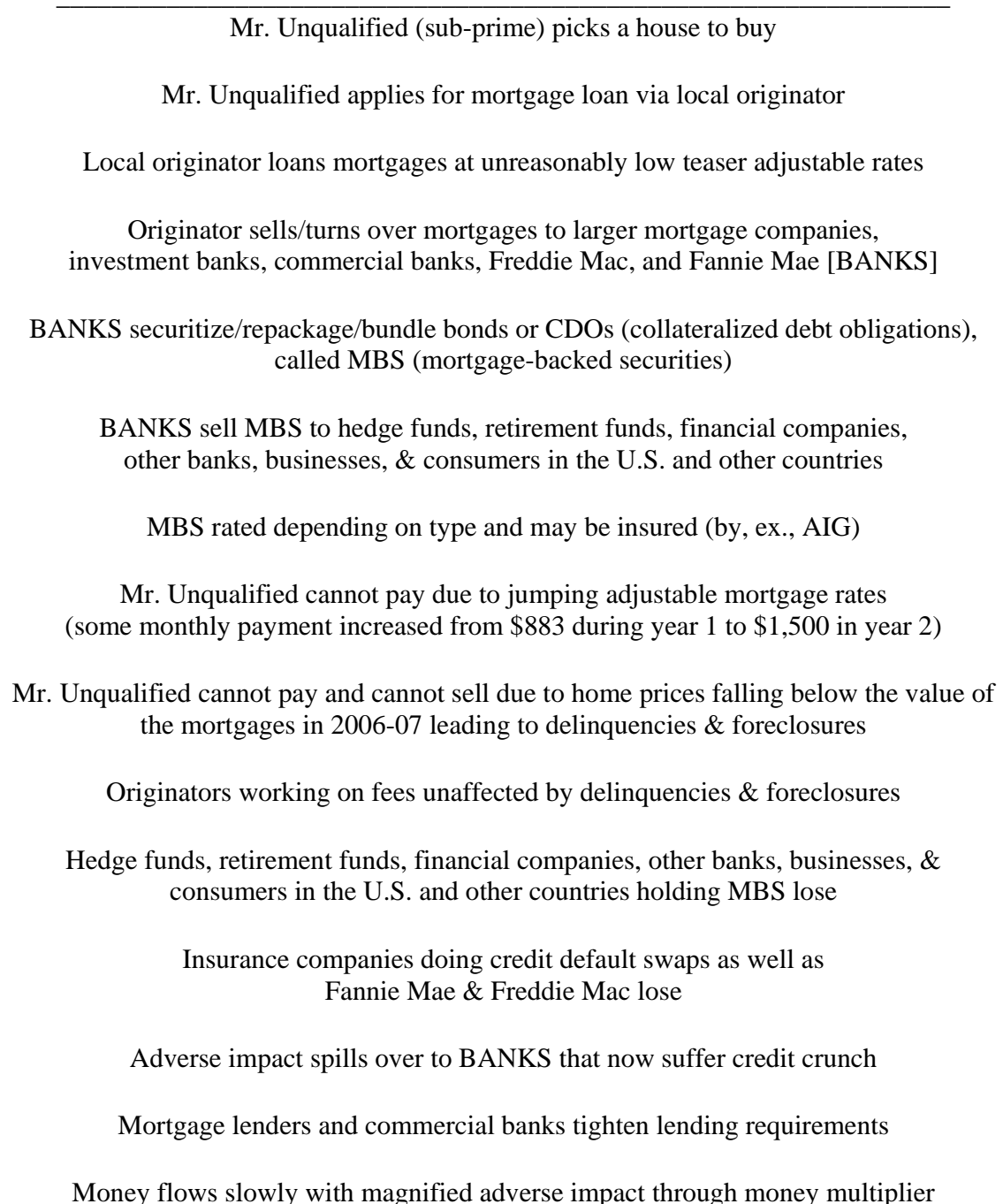
Motivated by up-front fees, originators who are brokers and agents of banks ignored the credit worthiness of borrowers and sold as much sub-prime mortgages as they could. Case stories reported frequently in late 2008 by CNN, CBS, and other media indicate doubling of mortgage rates and monthly payments during the second year when the enticing teaser rate expired. These loans are cynically called NINJA loans because the recipients of these loans had No verified INcome, Job, or Assets. Rating agencies earned up-front fees from rating MBS, and more fees from advising clients on how to improve those ratings. Leaders of large mortgage companies, investment banks, and commercial banks that handled sub-prime mortgages earned bonuses based on the volume of business that increased short-term profits for these lenders. This led to the textbook-type information asymmetry and adverse selection between sellers and final buyers of the MBS. Buyers underestimated risks while ratings became less reliable.

A rapid increase in sub-prime mortgages began in 2002 following the 2001 recession. The increase was fueled by several factors such as (a) an increased use of brokers and agents who worked on commission that led them to care more about quantity than quality, (b) a wide use of teaser rates in adjustable mortgages that were not sustainable, (c) executive compensation system such as bonus for short-term gains that encouraged quantity ignoring risk, and (d) political support under the disguise of helping

low income families to buy homes, which encouraged brokers and agents to ignore credit-worthiness of borrowers.

The immediate cause of the 2008 recession is widely agreed to be the excessive amount of sub-prime loans. The sequence of events that led sub-prime loans to the recession is summarized in Flowchart 1.

Flowchart 1. Sub-Prime as a Trip Wire to the 2008 Recession



Slowing housing market due to strict lending requirements &
marginally-qualified buyers staying out of the market

Lower stock prices & recessionary economy in the U.S. and beyond.

Why Did It Happen

Commercial banks have replaced their traditional “originate and hold” model with the “originate and distribute model”. In the “originate and hold” model, banks borrow funds through short-term deposits and make long-term loans while holding onto claims until they mature. In the “originate and distribute” model, banks make loans and then sell their claims to someone else. The widespread adoption of the “originate and distribute” model may be blamed for causing the crisis. However, securitization of claims that allowed the “originate and distribute” model has been operating at least since 1968 when the Government National Mortgage Association was allowed to securitize FHA/VA mortgages backed by the U.S. government for resale in a secondary market. More likely, the culprit was the rapid growth of MBS backed by sub-prime mortgages. “The change in the past decade has been the growth in residential MBSs backed by subprime mortgages with a larger number of steps between originator and holder and, as a consequence, greater opacity. This has contributed to the mispricing of risk that was not properly appraised. The result is twofold: Investors are far removed from the underlying assets both physically (due to the global market of these assets) and financially (since they often have little idea about the true quality and structure of the underlying assets several links back in the chain).” (Mizen 2008, p. 550)

In the extended “originate and distribute” model of commercial banks, “brokers and agents of banks selling mortgages were motivated by up-front fee income unadjusted for borrower quality. The bonuses rewarded growth of business over a short time scale (typically a yearly cycle) with no penalties if subsequent developments revealed a lack of due care and attention in the origination process or losses to the originator.” (Mizen 2008, p. 550) Further, “originators had no greater incentive to look more carefully than brokers at borrower quality. The incentives for the originators of the loans, faced with the knowledge that the products would be combined in complex ways and sold, were different from those for an originator who intended to hold the assets to maturity.” (Mizen 2008, p. 551) As the quantity of new borrowers declined, “lenders reduced their standards to maintain the volume of loans feeding into the securitization market,” encouraged by politicians who wanted votes from those with little or no qualifications for mortgage loans. (Mizen 2008, p. 551) This may be an understatement. The March 22 version of the Dateline by NBC reported that the income of an applicant who had \$20,000 annual earnings was filled in the application form as \$90,000 without the knowledge of the applicant.

Ratings of bonds are supposed to indicate the likelihood of default of the securities. Given the complexity of the products offered, investors may have relied on ratings provided by ratings agencies. The granting of AAA ratings to asset-backed securities, which was quite common until the middle of 2007, “meant many investors believed they were buying very safe assets, and certain organizations such as pension funds, which face restrictions on the assets they are permitted to purchase, were able to buy these assets. These risks were not properly priced because they did not anticipate the potential for lower house prices or the potential effects house price declines would have on subprime default rates.” (Mizen 2008, p. 554)

Some may ask why it was not possible to stop the sub-prime crisis before it exploded into a full-blown credit crunch. There were early, but probably too late, signs during 2007.

In February 2007, sub-prime mortgage defaults began to increase. In April 2007, New Century Financial, a sub-prime specialist, filed for Chapter 11 bankruptcy. In May 2007, Swiss-owned investment bank UBS closed the Dillon Reed hedge fund after incurring \$125 million in sub-prime mortgage-related losses. All these early warning signs were judged to be isolated events, rather than what turned out to be the beginning of the much-more serious financial crisis. Even when Fitch Ratings, Standard & Poor’s, and Moody’s all downgraded sub-prime related mortgage products from their AAA status in June and July of 2007, few, if any, recognized the seriousness of the problem, at least not publicly. (Mizen 2008, p. 533)

“Within a 9-day period in September 2008, the crisis deepened abruptly with a series of stunning events. On Sunday, September 7, 2008, the Federal Housing Finance Authority (FHFA) placed the ailing mortgage giants Fannie Mae and Freddie Mac into conservatorship on Sunday, September 14, 2008, the investment bank Lehman Brothers filed for bankruptcy, and another bank, Merrill Lynch, negotiated an acquisition by Bank of America. ... on Tuesday, September 16, 2008, the Federal Reserve announced the creation of a credit facility (lending arrangement) in exchange for a majority equity stake in the insurance giant American International Group(AIG).” (White House, p. 74) During the last quarter of 2008, the U.S. real GDP fell by an annual rate of 6.2 percent.

Pre-Obama Bailout Measures

Countermeasures began to fill the public media since early in 2008. At least in the beginning, the countermeasures were unorganized and appeared to be no more than patch work of instant responses, rather than well-thought plans, perhaps indicating that the crisis still was not judged to be serious. Major countermeasures that were announced before the inauguration of the new administration in January 2009 are summarized in Table 1.

In the process of developing financial countermeasures to deal with the credit crunch of 2008, the Federal Reserve made announcements of several tools of monetary policy that were not mentioned in traditional economics or finance textbooks. These

include, but are not limited to: (a) October 6, 2008 decision to buy commercial papers directly from companies to increase credit, (b) October 6, 2007 decision to pay interest on commercial bank reserves at the Federal Reserve Bank, (c) October 21, 2008 decision to buy commercial papers from money market mutual funds, again to increase credit, and (d) December 16, 2008 decision to purchase credit card debts from commercial banks to increase money supply. Commercial papers are the primary tool by which businesses finance their needs for short-term cash flow.

Table 1. Pre-Obama Bailout Measures

Date	Action
March 16, 2008	Federal Reserve makes a loan guarantee of \$29 billion for sale of Bear Stearns to JP Morgan Chase (\$29B).
July 11, 2008	FDIC seizes IndyMac Bank covering \$8.9 billion of losses.
July 14, 2008	Federal Reserve issues a policy statement that prevents mortgages from being sold without verification of income and financial assets to ensure repayment.
Sept. 16, 2008	Federal Reserve guarantees a loan of \$85 billion to AIG. The loan package increased to \$150 billion on November 10, 2008, and to \$180 billion on March 2, 2009.
Sept. 19, 2008	A \$700B bailout plan announced amid warnings of a depression worse than the Great Depression of the 1930s.
October 3, 2008	President George Bush signs the \$700B Emergency Economic Stabilization Act of 2008 into law. The main thrust of the law was to use part of the money to purchase troubled mortgage-backed securities.
October 6, 2008	Federal Reserve decides to buy commercial papers directly from companies to increase credit.
October 6, 2008	Federal Reserve decides to pay interest on commercial bank reserves at the Federal Reserve Bank.
October 21, 2008	Federal Reserve decides to buy commercial papers from money market mutual funds, again to increase credit.
Nov. 14, 2008	News reports state that the U.S. government decided not to buy troubled mortgage-backed securities with the bailout money.
Dec. 9, 2008	The Treasury Department sold \$30 billion in four-week bills at an interest rate of zero percent. “And when investors traded their T-bills with each other, the yield sometimes went negative. That’s how extreme the market anxiety is: Some are willing to give up a little of their money just to park it in a relatively safe place.” (Press-Register, December 10, 2008, p. 7B)
Dec. 16, 2008	Federal Reserve announces its plans to purchase mortgage-backed securities. Federal Reserve decides to also purchase credit card debts from commercial banks to increase money supply.
Dec. 16, 2008	Federal Reserve cuts its bench-mark federal funds rate to zero to 0.25 percent.

Dec. 19, 2008	U.S. Congress approves \$17.4 billion loan package for General Motors and Chrysler. Ford did not ask for loan.
January 15, 2009	Senate voted by 52 to 42 to release the remaining \$350 billion of the \$700 billion bailout funds at the urge by President-elect Obama.

The Emergency Economic Stabilization Act of 2008 was passed by the Congress on October 2, 2008 and signed by the then President Bush on October 3, 2008. Half (\$350 billion) of the total \$700 billion were authorized for spending while Bush was president and the other half were authorized for spending after Obama was elected as president. Funds distributed under this Act are known as TARP (Troubled Asset Relief Program) funds. Initially, this \$700 billion program authorized the U.S. Treasury to buy troubled assets. On Nov. 12, 2008, however, the Treasury announced that it had decided not to purchase troubled assets as contemplated, but would continue to inject capital into financial institutions via purchase of senior preferred shares. It is too early to ask where the send half of TARP funds went, but it is not too early to ask where the first half of TARP funds went.

The credit crunch of 2008 finally spilled over to the main street and led to the recession. There is a disagreement as to when the recession began. In November 2008, the National Bureau of Economic Research announced that the 2008 recession began in December 2007. Although the economy had been slow since 2007, the real GDP actually increased by 2.8 percent during the second quarter of 2008, prompting many economists to claim that the real recession began in May or June of 2008. The U.S. economy rapidly declined at an annual rate of 6.2 percent during the last quarter of 2008 and this decline led to the “stimulus” packages of 2009.

Post-Obama Recovery Measures

On January 28, 2009, the House passed \$819 billion stimulus package. On February 9, 2009, the Senate passed its own version of the stimulus bill of \$827 billion. The compromised final package of \$787 billion was passed by both House and Senate on February 13, 2009. The final 407-page American Recovery and Reinvestment Act of 2009 was signed by President Obama on February 17, 2009. The non-partisan Congressional Budget Office says the bill could increase employment in a range of 800,000 to 2.3 million jobs by the fourth quarter of 2009 and 1.2 million to 3.6 million by the fourth quarter of 2010. (USA Today, February 13, 2009, 3B) Conspicuously absent from the package is the kind of spending that will have an immediate impact such as tax rebate that can only be spent, not saved. Recovery measures under the new Obama administration continue to be announced.

On February 10, 2009, Treasury Secretary Tim Geithner announced the “financial stability plan”. This plan was clarified on March 23, 2009, when the Treasury Department revealed its program to purge bank balance sheets of as much as \$1 trillion in sour assets that are limiting lending and prolonging the recession. The government will

commit \$75 billion to \$100 billion of taxpayer money to launch the "Public-Private Investment Program," seeking to create a market for that bad debt. The government plans to run auctions between the banks looking to unload the bad assets and the investors looking to buy them.

On March 4, the Obama administration announced its mortgage relief plan that is aimed to help as many as 9 million borrowers qualify for more affordable mortgages through refinancing and modified loans. Among the specifics is the refinancing plan that is "limited to borrowers who owe up to 5 percent more than their home's current value," and the "Loan modifications, supported by \$75 billion in federal funding, are unlikely for severely 'underwater borrowers'". (Zibel 2009) On March 5, 2009, the House passed legislation that would give bankruptcy judges new power to make changes on existing loans that include reducing the principal, lowering the mortgage rate to as low as 2 percent, and extending the length of the loan. The Senate has to pass its own bill and the two versions have to be compromised to become a law. On March 16, 2009, President Obama announced a plan to assist small businesses, which includes purchase of up to \$15 billion in securities backed by Small Business Administration (SBA) loans, and increases in the government guarantee on certain SBA loans from up to 85% to as much as 90%. (Petrecca 2009)

On March 18, the Federal Reserve announced plans to pump nearly \$1.2 trillion into the economy. (Kirchhoff and Waggoner 2009) According to the plan, the Fed will buy up to \$300 billion in long-term Treasury securities during the coming six months; buy up to another \$750 billion in MBS issued by Fannie Mae and Freddie Mac in addition to \$500 billion that the Fed has already committed; and buy up to \$100 billion in debt of Fannie Mae and Freddie Mac. On March 19, 2009, Secretary Timothy Geithner of the Treasury Department announced \$5 billion in loans for the auto suppliers in an effort to keep the auto industry running. (Carty 2009) Additional recovery and stimulus measures are expected to continue to be announced by the Obama administration.

The Troup of Twenty, abbreviated to G-20, was organized in 1999, and is made up of the finance ministers and central bank governors of 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States of America, and also the European Union which is represented by the rotating Council presidency and the European Central Bank. The G-20 carried out the preparatory work for the Leaders summit held in London on April 2, 2009. At the end of the April 2 meeting, the Leaders issued the Global Plan for Recovery and Reform. Among the agreements included in the declaration, is a \$1.1 trillion program of support to restore credit, growth and jobs in the world economy. Programs that comprise the \$1.1 trillion program are "to treble resources available to the IMF to \$750 billion, to support a new SDR allocation of \$250 billion, to support at least \$100 billion of additional lending by the MDBs [Multilateral Development Banks], to ensure \$250 billion of support for trade finance, and to use the additional resources from agreed IMF gold sales for concessional finance for the poorest countries." Whether these agreements will have any

measurable impact may be known by the time G-20 meets in Korea which is the chair of the group in 2010.

Uncharted Territory

How will all these bailout, recovery, and stimulus expenditures affect the future of the U.S. as well as the world economy? Since the amount of new expenditures is so huge, the U.S. economy as well as the world economy is clearly entering an uncharted territory. The scope of new expenditures is summarized in Table 1. Note that much of the funds are pledges for aid when needed, and do not represent actual spending, while others are actual expenditures. Further, some of these expenditures may be overlapping. None-the-less, Table 1 does indicate the large scope of total recovery and stimulus expenditures.

Table 1. Scope of U.S. Recovery Funds

Amount	Purpose
Part A	
\$1,800B	FRB's purchase of commercial papers directly
\$600B	FRB purchase of debt & MBS's
\$200B	Support student, auto & credit card loans
\$600B	Fed purchase of commercial papers and CD's from money market
\$1,900B	FDIC guarantees for banks
\$900B	FRB's loans offered to meet financial institutions' year-end cash needs
\$700B	Treasury to buy equity stakes in financial institutions
\$250B	Treasury, FRB & FDIC shouldering Citygroup losses
\$29B	Guaranteeing losses from JP Morgan's buyout of Bear Stearn
\$200B	Treasury purchase of preferred stocks of Fannie Mae and Freddie Mac
\$144B	MBS purchases by Fannie Mae and Freddie Mac
\$300B	FHA to refinance failing mortgages
\$50B	Guarantee principals in money market mutual funds
Unlimited	FRB's loan offer through discount window
Unlimited	FRB's currency swap lines with ECB & central banks in UK, Japan and Switzerland (Under a currency swap, a central bank can draw on the funds of a fellow central bank to provide short-term money)
Part B	
\$787B	Stimulus package signed into law - February 17, 2009
\$75B	Housing stabilization package - March 4, 2009
Unknown	Financial stability plan announced - February 10, 2009
\$1,150B	FRB's plans to purchase MBS and Treasuries - March 18, 2009
\$1 trillion	Action plans of the Feb 10 Financial stability plan - March 23, 2009

Source: Part A - USA Today, Nov. 28, 2008, 6B, and Part B: USA Today, Feb. 13, 2009, 3B, and USA Today, March 19, 2009, 1B.

Adding all figures listed in Table 1, the total is over \$10 trillion plus two unlimited's and one unknown. The cumulative debt of the U.S. government which was \$10.6 trillion as of November 19, 2008. The FY 2009-10 budget proposed by President Obama on February 25, 2008 was \$3.55 trillion. The problem is that the U.S. government has been running a large amount of deficit even before the latest crisis began in 2007: \$317B in FY 2002-03, \$538B in FY 2003-04, \$568 in FY 2004-05, \$493B in FY 2005-06, \$434B in FY 2006-07, and \$343B in FY 2007-08. Budget deficit for the 2008-09 and 2009-10 fiscal years are projected to exceed one trillion dollars by a significant margin. As of April 2009, the Congressional Budget Office projects annual deficits based on President's budget to be \$1,845B for 2009, \$1,379B for 2010, and declines to \$658B in 2012 but bounce back to over one trillion dollars in 2018. Regardless, the only viable option for raising the needed funds is to sell Treasuries.

What happens if U.S. domestic investors and foreign buyers of U.S. Treasuries begin to feel uneasy about the financial solvency of the U.S. government and refuse to buy the Treasuries. To avoid rising interest rates that are then necessary for the U.S. government to sell Treasuries, the Federal Reserve will be forced to buy Treasuries. Note that on March 18, 2009, the Federal Reserve already announced plans to buy up to \$300 billion in long-term Treasury securities during 2009. (Kirchhoff and Waggoner 2009) This leads to a pure increase in money supply, and will generate fears of bad inflation.

Another possible source of inflation is to examine the monetary base since the increase in borrowing and demand deposits that new borrowing induces can be viewed beyond the direct control of the Federal Reserve System. The monetary base is the sum of currency in circulation and bank demand deposits at the Federal Reserve Banks. Bank demand deposits held at the Federal Reserve as reserve balances "grew from \$10.2 billion the week ending January 17, 2007, to \$795.5 billion the week ending January 28, 2009. Of this large amount, \$769.2 billion was held as excess reserves at the Fed." (Gavin, p. 57) These bank reserve deposits are sometimes called federal funds that banks borrow from one another on an overnight basis. Banks are holding these excess reserves earning only 0.25 percent annual interest, and cannot be expected to hold this large amount of excess reserves as the economy recovers. It is scary to assume that the Fed will be able to control inflation as recession ends and the economy expands.

If fears of bad inflation are seeded, "This concern will lead them to start dumping their holdings of U.S. Treasuries. In so doing, they'll drive up interest rates, which will lead the Fed to print money to buy up those bonds. The consequence will be more money creation-exactly what the bond traders will have come to fear. This could lead to spiraling expectations of higher inflation, with the process eventuating in hyperinflation." (Kotlikoff 2006, p. 242) These possibilities are demonstrated in Flowchart 2. Clearly, the U.S. economy is entering an uncharted territory, which may influence the U.S. position in negotiating with North Korea.

Flowchart 2. Possible Impacts of Deficit Financing

Government Sells Treasuries

Although the U.S. officially removed North Korea from its list of state sponsors of terrorism on October 11, 2008, the story goes back to November 29, 1987 when North Korean agents blew up Korean Air Lines 858 with 115 passengers and crew members 45 minutes away from Bangkok. Following the explosion that killed everyone aboard, the then U.S. Secretary of State George Shultz placed North Korea on the list of countries supporting international terrorism under Section 6(i) of the Export Administration Act of 1979. North Korea was added to the list effective January 20, 1988. Placement on the sec. 6(i) list “not only results in the constriction of trade possibilities; placement also may trigger denial of beneficial trade designation (NTR or GSP), unfavorable tax status for investors, new limits on diplomatic relations, opposition in international financial institutions, and stricter licensing requirements for trade with the United States in food and medicine” (Rennack 2003, CRS-7).

The problem is that North Korea refused to fully cooperate in verifying its declaration, stalling the progress of the six-party talk and, more importantly, making the removal of North Korea from the list of state sponsors of terror purely symbolic. The idea of removing North Korea from the list of state sponsors of terror is to move toward taking follow-up actions that will allow most favored nation (MFN) tax rates on North Korea’s exports to the U.S., encourage financing from international financial institutions, and promote private sector investment in North Korea. The removal should have been the very first step, which, standing alone, means little, if any.

Early in 2009, there were news reports indicating that North Korea was preparing test of Taepodong-2 long-range missile, with explanations ranging from sending a message to the Obama Administration of the U.S. for greater leverage in negotiation, pressuring Lee Myung-bak Administration of South Korea for restoration of the sunshine policy, to consolidating power within North Korea. (Paul Wiseman, “N. Korean missile limited ... for now,” USA Today, April 2, 2009, 6A) On April 6, 2009, North Korea did launch the missile from Musudan-ri, a coastal city in the East Sea, called also the Sea of Japan. Although President Obama condemned the action through his many speeches during his visit to Europe and Japan we well as the U.S. requested an emergency session of the United Nations Security Council for possible additional sanctions, the impact of these reactions is likely to be minimal, if any, beyond some delay in resuming the six-party talk. North Korea is not in a position to try aggressive actions of any significance, while additional sanctions are virtually meaningless since North Korea is already isolated enough.

Conclusions

The economic crisis summarized in this paper will clearly make it more difficult for the U.S. and North Korea to make any meaningful negotiations any time soon. The issue, however, may be more complicated.

During the first phase of the 2007 Agreement, North Korea agreed to shut down its reactor and reprocessing plant at Yongbyon, to allow IAEA inspectors, and to provide details of its nuclear programs, in return for 50,000 tons of heavy fuel oil. In the second

phase, North Korea agreed to disable its nuclear facilities under the supervision of U.S. experts and to provide a full list of its nuclear programs, in return for another 900,000 tons of fuel. The only other promise that the U.S. made to North Korea was to remove North Korea from its list of state sponsors of terrorism and end the application of the Trading with the Enemy Act.

The root of the real problem in negotiations with North Korea may well be the mistrust that the U.S. and North Korea have against each other. As discussed in detail by this author (Chang 2006), the U.S. sanctions against North Korea are multi-faceted. There is a good possibility that all the back-channel promises that the U.S. may have made to North Korea could have been misunderstood by North Korea to be as a significant first step toward a full-blown diplomatic relation between the two countries. With so many surprises in the past, on the other hand, the U.S. may have felt a need for a more cautious approach. Clearly, there is a need for the U.S. and North Korea to have a significantly higher level of trust in each other than they had in the past to make future negotiations a success. North Korea needs to be prepared to be more open and sincere in denuclearization of its arsenal. Just as importantly, the U.S. and other partners of the six-party countries need to be ready to reciprocate by offering meaningful and comprehensive concessions that North Korea needs to become a member of the peaceful global community.

The impact of the current economic crisis in the U.S. on negotiations with North Korea is two-fold. One is that it will make it difficult for the U.S. to make any significant concessions in terms of immediate financial assistance. The other, which may be more important, is that the U.S. may not be able to pay the kind of attention that is needed to make future negotiations successful. Leaders in North Korea need to understand that they are not the center of the world, nor have to be the center of the world to have successful negotiations. The road map toward successful negotiations at the six-party talk will have to be thorough and comprehensive so that both sides, especially North Korea, can see and feel what the ultimate outcome of their concessions is likely to be.

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Likely Impact of the U.S. Economic Crisis on Negotiations with North Korea

by
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May 28, 2009

U.S.-North Korean Relations since 2008

- **February 25** Lee Myung-Bak inauguration
 - promised more effective results in NK dealings
 - effectively halted Kim Dae-Jung's sunshine policy
 - North Korea suspended official inter-Korea dialogue
 - **June 26** Bush notifies U.S. Congress of his intent to rescind North Korea's designation as a state sponsor of terror in 45 days.
 - **Sept. 2008** Rapid decline of the U.S. economy
 - **October 11** U.S. officially removed North Korea from list of state sponsors of terrorism.
 - **December 11** Last six-party talk ended.
 - **April 6, 2009** NK launched Taepodong-2.
 - **April 13, 2009** U.N. Security Council unanimously condemns the launch for violating 2006 resolution.
-

State Sponsor of terrorism

- The placement on the list “not only results in the constriction of trade possibilities; placement also may trigger denial of beneficial trade designation (NTR or GSP), unfavorable tax status for investors, new limits on diplomatic relations, opposition in international financial institutions, and stricter licensing requirements for trade with the United States in food and medicine” (Rennack, Dianne E. 2003. *North Korea: Economic Sanctions*, CRS-7, updated January 24, 2003).
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Opposite is not necessarily true!

- The idea of removing North Korea from the list of state sponsors of terror is to move toward taking follow-up actions that will allow most favored nation (MFN) tax rates on North Korea’s exports to the U.S., encourage financing from international financial institutions, and promote private sector investment in North Korea. The removal should have been the very first step, which, standing alone, means little, if any.
-

Sanctions against April 6 Missile Testing

- Impact of additional sanctions, if any, is likely to be minimal.
 - North Korea is not in a position to try aggressive actions of any significance.
 - Additional sanctions are virtually meaningless since North Korea is already isolated enough.
 - It may delay the six-party talk.
 - For all sanctions against North Korea, see:
 - Chang, Semoon, "Should U.S. Economic Sanctions on North Korea Be Lifted?" North Korean Review, 2 (Fall 2006), 36-46.
 - Chang, Semoon, "The Saga of U.S. Economic Sanctions on North Korea" Journal of East Asian Studies, 20 (Fall/Winter 2006), 109-139.
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Now:

- How will the U.S. economic crisis affect negotiations with North Korea?
 - Let us review the extent or severity of the U.S. economic crisis.
-

Trip Wire to the 2008 Recession

- Mr. Unqualified (sub-prime) picks a house to buy
 - Mr. Unqualified applies for mortgage loan via local originator
 - Local originator loans mortgages at unreasonably low teaser adjustable rates
 - Originator sells/turns over mortgages to larger mortgage companies investment banks, commercial banks, Freddie Mac, and Fannie Mae [BANKS]
 - BANKS securitize/repackage/bundle bonds or CDOs (collateralized debt obligations), called MBS (mortgage-backed securities)
 - BANKS sell MBS to hedge funds, retirement funds, financial companies, other banks, businesses, & consumers in the U.S. and other countries
 - MBS rated depending on type and may be insured (by, ex., AIG)
-

Continuing...

- ❑ Mr. Unqualified cannot pay due to jumping adjustable mortgage rates. (some monthly payment increased from \$883 during year 1 to \$1,500 in year 2)
 - ❑ Mr. Unqualified cannot sell due to home prices falling below the value of the mortgages in 2006-07 leading to delinquencies & foreclosures.
 - ❑ Originators working on fees are unaffected by delinquencies & foreclosures.
 - ❑ Hedge funds, retirement funds, financial companies, other banks, businesses, & consumers in the U.S. and other countries holding MBS lose.
 - ❑ Insurance companies doing credit default swaps as well as Fannie Mae & Freddie Mac lose.
-

Continuing...

- ❑ Adverse impact spills over to BANKS that now suffer credit crunch
 - ❑ Mortgage lenders and commercial banks tighten lending requirements
 - ❑ Money flows slowly with magnified adverse impact through money multiplier
 - ❑ Slowing housing market due to strict lending requirements & marginally-qualified buyers staying out of the market
 - ❑ Lower stock prices & recessionary economy in the U.S. and beyond.
-

Why crisis now?

- ❑ The Great Moderation (U.S.) or the Great Stability (U.K.) of the 1990s
 - ❑ Low inflation & steady growth
 - ❑ **Global savings glut** from China, Japan Germany, and oil exporting countries as well as the U.S. & others
 - ❑ Low interest rates
 - ❑ **Increased demand for high interest earnings, and high yielding assets**
-

Sub-prime mortgages

- ❑ Met demand for high-yielding assets by the Great Moderation generation
 - ❑ Sub-prime mortgages
 - Higher application and appraisal fees
 - Higher insurance costs
 - Higher fines for late payment or delinquency
 - **Higher interest rates**
-

All merging together ...

- ❑ Originators (brokers & agents of banks) selling mortgages motivated by up-front fees
 - ❑ Mortgages offered to unqualified at low teaser rates that were not sustainable
 - ❑ “**NINJA**” loans – so called because the recipients had **No** verified **I**ncome, **J**ob, or **A**ssets.
 - ❑ Executive compensation system favoring quantity, ignoring risk
 - ❑ Rating agencies made up-front fees from rating MBS, and more fees from advising clients on how to improve those ratings
 - ❑ Political support under the disguise of helping low income families to buy homes (e.g. Association of Community Organizations for Reform Now)
 - ❑ Classic **information asymmetry** and **adverse selection** between sellers and final buyers of MBS.
-

Toward a disaster ...

- ❑ Rising demand for homes from sub-prime borrowers
 - ❑ Increase in supply of new homes
 - ❑ Falling home price
 - ❑ Mortgage debt greater than value of homes
 - ❑ Fraudulent loans leading to almost “doubling” mortgage payments
 - ❑ Cannot sell homes to pay debt because debt is greater than home value
 - ❑ Cheaper to walk away - foreclosures
-

White House, Economic Report of the President,
Transmitted to the Congress January 2009, p. 74

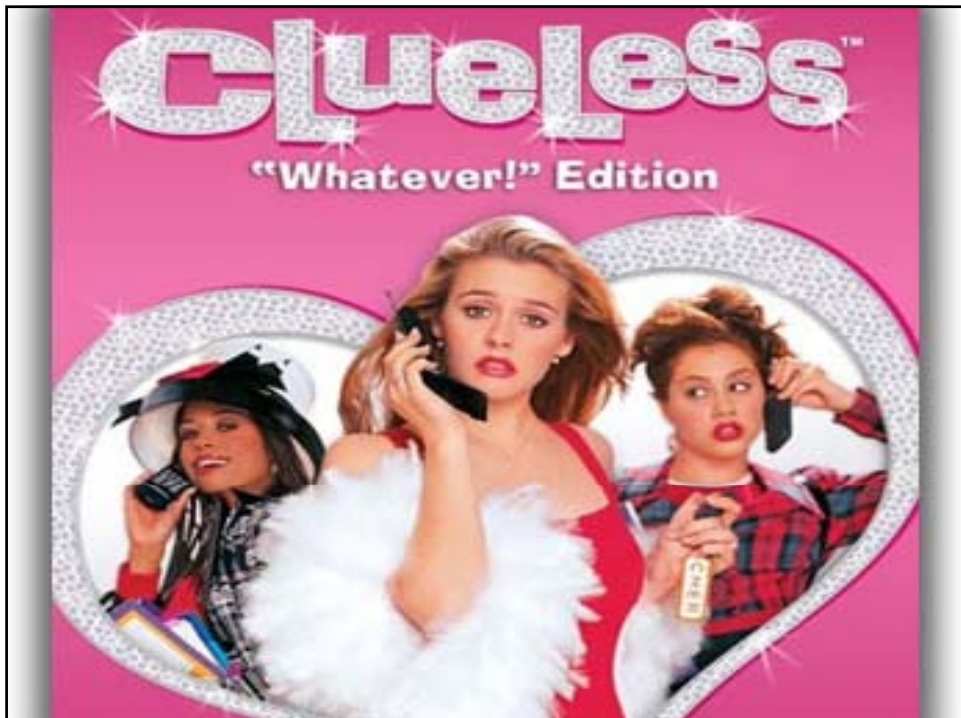
- **“Within a 9-day period in September 2008, the crisis deepened abruptly with a series of stunning events.** On Sunday, September 7, 2008, the Federal Housing Finance Authority (FHFA) placed the ailing mortgage giants Fannie Mae and Freddie Mac into conservatorship on Sunday, September 14, 2008, the investment bank Lehman Brothers filed for bankruptcy, and another bank, Merrill Lynch, negotiated an acquisition by Bank of America. ... on Tuesday, September 16, 2008, the Federal Reserve announced the creation of a credit facility (lending arrangement) in exchange for a majority equity stake in the insurance giant American International Group(AIG).”
 - **GDP declined by 6.3% during the 4th quarter of 2008 and 6.1% during 1st quarter of 2009.**
-

Pre-Obama Counter Measures

- March 16, 2008: FRB loan guarantee of \$29B for sale of Bear Stearns to JP Morgan Chase.
 - July 11, 2008: FDIC seizes IndyMac Bank covering \$8.9B losses.
 - July 14, 2008: FBR prevents mortgages from being sold without verification of income and financial assets to ensure repayment.
 - Sept. 16, 2008: FRB guarantees \$85B loan to AIG. The loan package increased to \$150B on Nov. 10, 2008, and to \$180B on March 2, 2009.
 - Sept. 19, 2008: \$700B bailout plan announced.
-

Continuing ...

- ❑ Oct. 3, 2008: Bush signs \$700B Emergency Economic Stabilization Act into law. **Idea was to use part of money to buy troubled MBS.**
- ❑ Oct. 6, 2008: FRB decides to buy commercial papers directly from companies.
- ❑ Oct. 6, 2008: FRB decides to pay interest on commercial bank reserves at the Fed.
- ❑ Oct. 21, 2008: FRB decides to buy commercial papers from money market mutual funds.
- ❑ Nov. 14, 2008: **Gov't decides not to buy troubled MBSs** with the bailout money (clueless?)



Continuing ...

- ❑ Dec. 9, 2008: U.S. Treasury sold \$30B 4-week bills at zero interest rate. "when investors traded their T-bills with each other, the yield sometimes went negative." (Press-Register, Dec. 10, 2008, p. 7B)
- ❑ Dec. 16, 2008: FRB announces plans to buy MBS & credit card debt from commercial banks.
- ❑ Dec. 16, 2008: FRB cuts federal funds rate to zero to 0.25 percent.
- ❑ Dec. 19, 2008: Congress approves \$17.4B loan package for General Motors and Chrysler.
- ❑ Jan. 15, 2009: Senate releases remaining ~~\$350B of \$700B for Pres-elect Obama.~~

Post-Obama Recovery Measures (All during 2009)

- ❑ Feb. 17: Obama signs the \$787B American Recovery and Reinvestment Act into law.
 - ❑ March 4: Obama announces mortgage relief plan with \$75B for refinancing and modification of existing loans.
 - ❑ March 16: Obama announces a plan to assist small businesses by increasing loan guarantee up to 90%; doubling equipment write-off to \$250,000, & pressuring 21 largest banks getting government financial help to increase small business loans.
 - ❑ March 18: FRB announces plans to inject \$1.15 trillion by buying up to (a) \$300B in long-term Treasury securities during the coming 6x months; (b) another \$750B for purchase of MBS issued by Fannie Mae and Freddie Mac in addition to \$500 billion that the Fed has already committed; and (c) relieving \$100B in debt of Fannie Mae and Freddie Mac.
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Continuing ...

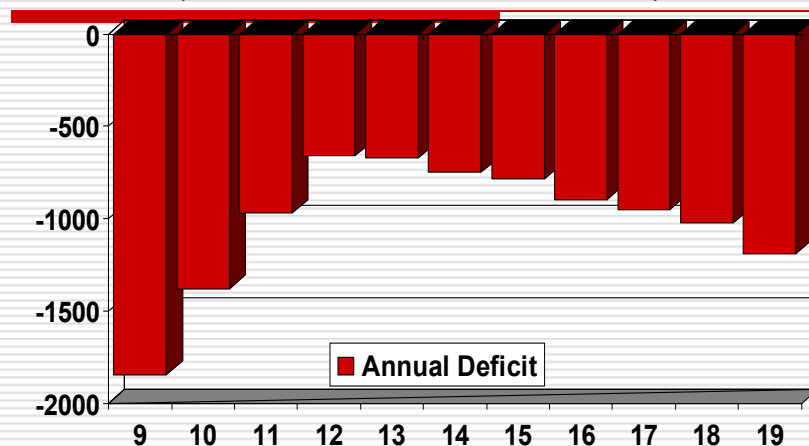
- March 19: Treasury announces \$5 billion in loans for the auto suppliers: "the loans can go only to companies with operations in the U.S. and for parts made or assembled in the U.S."
 - March 23: Treasury announces plans to purge bank balance sheets of as much as \$1 trillion in sour assets by committing \$75B to \$100B to launch the "Public-Private Investment Program."
 - April 2: Leaders of the G-20 countries issues the Global Plan for Recovery and Reform. Among the agreements is the \$1.1 trillion program of support to restore credit, growth and jobs in the world economy: "to treble resources available to the IMF to \$750 billion, to support a new SDR allocation of \$250 billion, to support at least \$100 billion of additional lending by the MDBs [Multilateral Development Banks], to ensure \$250 billion of support for trade finance,"
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Possible Impact of Borrowing under Obama Administration

- How much borrowing
 - Possible scenarios
 - Departing thoughts
-

CBO Estimate of U.S. Budget Deficit
(annual deficit in \$billions)



Source: CBO.gov, April 2009

Root of the Real Problem

- ❑ Mistrust and miscommunication between NK and the U.S.
 - ❑ All the back-channel promises that the U.S. may have made to North Korea could have been misunderstood by North Korea to be as a significant first step toward a full-blown diplomatic relation between the two countries.
 - ❑ With so many surprises in the past, on the other hand, the U.S. may have felt a need for a more cautious approach.
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Likely Impact of the current economic crisis

- ❑ The U.S. finds it **difficult to make any significant concessions** in terms of immediate economic assistance.
 - ❑ The U.S. may not be able to pay the kind of attention that is needed to make future negotiations successful.
 - ❑ Leaders in North Korea need to understand that **they are not the center of the world, nor have to be the center of the world to have successful negotiations.**
-



Road Map toward Successful Negotiations

- ❑ North Korea needs to be prepared to be **more open and sincere in denuclearization** of its arsenal.
 - ❑ Just as importantly,
 - ❑ The U.S. and other partners of the six-party countries need to be ready to reciprocate by offering **meaningful and comprehensive concessions** through which North Korea can clearly see and feel the final results of their concessions.
 - ❑ **THANK YOU, THAT'S ALL!**
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Tools of Monetary Policy (not found in the textbook)

- ❑ Oct. 6, 2008 decision to buy commercial papers directly from companies to increase credit
 - ❑ Oct. 6, 2007 decision to pay interest on commercial bank reserves at the Federal Reserve Bank
 - ❑ Oct. 21, 2008 decision to buy commercial papers from money market mutual funds, again to increase credit
 - ❑ Dec. 16, 2008 decision to purchase credit card debts from commercial banks to increase money supply, & more
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The Emergency Economic Stabilization Act of 2008

- ❑ TARP (Troubled Asset Relief Program)
 - ❑ "A lot of it is, apparently, just sitting in the bank. A Government Accounting Office audit released earlier this month showed the Treasury Department doling out buckets of cash: \$15 billion for Bank of America, \$45 billion for Citigroup, \$3.5 billion to Capital One, nearly \$6.6 billion to U.S. Bancorp. ..."
 - ❑ "By the 2008 election, with Democrats firmly ensconced in control of Congress (and heading for control of the White House), commercial banks had split their \$34 million in campaign contributions almost evenly to both political parties. Investment firms, many of which are converting themselves into commercial banks to grab some Treasury funds, gave far more -- \$141 million this year [2008]"
 - ❑ Source: Madden, Mike, "Dude, where's my \$700 billion?" published on December 17, 2008 and accessed in http://www.salon.com/news/feature/2008/12/17/700_billion/ March 4, 2009.
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Three quotations on Minsky Hypothesis

- “Minsky argued that the relative stability of the post-war period had led to development of Money Manager Capitalism—a much more unstable version of modern capitalism.” (Wray, L. Randall, and Éric Tymoigne, “Macroeconomics Meets Hyman P. Minsky: The Financial Theory of Investment,” The Levy Economics Institute and University of Missouri–Kansas City, Working Paper No. 543, p. 18)
 - “‘Stability breeds instability’ is a famous Minsky slogan, meaning that financial instability and economic turmoil are endogenous phenomena that stem from the over-optimistic sentiments and confidence that overtake the economy during a boom” (Fernandez, Luisa, Fadhel Kaboub, and Zdravka Todorova, “On Democratizing Financial Turmoil: A Minskian Analysis of the Subprime Crisis,” The Levy Economics Institute of Bard College, Working Paper No. 548, p. 2)
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The third quotation ...

- “the financial innovations of the past decade greatly expanded the availability of credit, which then pushed up asset prices. That, in turn, not only encouraged further innovation to take advantage of profit opportunities, but also fueled a debt frenzy and greater leveraging.” (Wray, L. Randall, and Éric Tymoigne, “Macroeconomics Meets Hyman P. Minsky: The Financial Theory of Investment,” The Levy Economics Institute and University of Missouri–Kansas City, Working Paper No. 543, p. 20)
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Financial innovations or Wall Street gimmicks? - examples

- Short selling
 - borrows 100 shares from a broker expecting price to fall
 - sells 100 shares @\$10 market price
 - price falls to \$7; seller buys 100 shares at \$700
 - Seller returns 100 shares; earns \$300 minus fee.
 - Credit Default Swaps (CDSs)
 - insurance-like contracts sold by banks, hedge funds, and insurance co. to cover potential losses on bonds, MBS, etc backed securities.
 - worse yet, investors may buy CDSs on bonds likely to default without owning the bonds – naked swaps.
 - like buying a life insurance on someone who is dying, hoping that he or she dies!
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Moral Hazard

- “The guiding principle of do what is necessary, has been replaced by the recognition — reinforced by actions — of the importance of doing whatever it takes to break the downward spiral in the financial and credit markets that has contaminated the overall economy.” (Rosenblum, Harvey, Danielle DiMartino, Jessica J. Renier, and Richard Alm, “Fed Intervention: Managing Moral Hazard in Financial Crises,” *Economic Letter*, 3 (October 2008), 1-12; p. 2)
 - “The too-big-to-fail (TBTF) now rests at the very top of the ills elected officials, policymakers and bank supervisors must address.” (Stern, Gary H., “Too Big to Fail: The Way Forward,” *The Region*, published quarterly by the Federal Reserve Bank of Minneapolis, 22 (December 2008), 2-6; p. 6).
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Fairness Issue

- “Despite losing hundreds of billions of dollars on risky loans and accepting massive cash injections from taxpayers to stabilize their businesses, Wall Street firms paid out an estimated \$18.4 billion in cash bonuses, says the New York state comptroller.” (Shell, Adam, “Wall Street castigated for paying \$18.4B in bonuses,” USA Today, January 30, 2009, 2B)
 - “New York Attorney General Andrew Cuomo said in a letter to [Rep. Barney] Frank that Merrill Lynch paid bonuses of more than \$1 million each to 696 employees in December, with four of the highest-paid employees getting a total of \$121 million. The bonuses were paid just days before BofA completed its purchase of Merrill.” (Gogoi, Pallavi, “Bank execs taken to task for bonuses,” USA Today, February 12, 2009, 1B)
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Continuing ...

- Under the federal Consolidated Omnibus Budget Reconciliation Act (COBRA), laid-off workers can continue their former employer’s health coverage for up to 18 months, but only if they pay the entire premium plus a 2 percent administration fee. The stimulus package will subsidize 65% of COBRA premiums for employees who were laid off between September 1, 2008, and the end of 2009. The subsidy took effect on March 1, 2009. Employees who were laid off before September 1, 2008, or retired and left voluntarily between September 1, 2008 and the end of 2009 are not eligible. Some employees who wanted to quit shirked in such ways to be fired, rather than resign voluntarily. – by Semoon.
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