

# North Korea's Planned Economy and Marketization

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CHAPTER 1

# CONVENTIONAL PLANNED ECONOMY

1. Framework of a Planned Economy
2. Taaan Work System & Unified and Detailed Planning

# 1

## Framework of a Planned Economy

A socialist economy like that of North Korea, especially a classical socialist economy before opening to the outside world and reform, is characterized by the following three points in comparison with a capitalistic economy like that of South Korea. First, it upholds state ownership, not private ownership. Second, resources are allocated not by the market but according to plans. Third, the rights to make decisions on economic matters are not distributed to individual economic agents like enterprises and households but concentrated in the central government. The second and third characteristics are part and parcel of a centralized planning system.

The key to North Korea's socialist ownership is ownership of the means of production. Most of the means of production are owned by the state; some are owned by socialist cooperatives. According to the North Korean government, its socialist reform of the means of production (nationalization of major industries like manufacturing, mining, railroads, and banking and collectivization of farms) started in 1946 and was completed in 1958.

Planning in a socialist economy like that of North Korea refers to the establishment and execution of plans and monitoring and evaluation of their execution within the scope of a national economy<sup>1</sup>. This planning can be defined as follows:

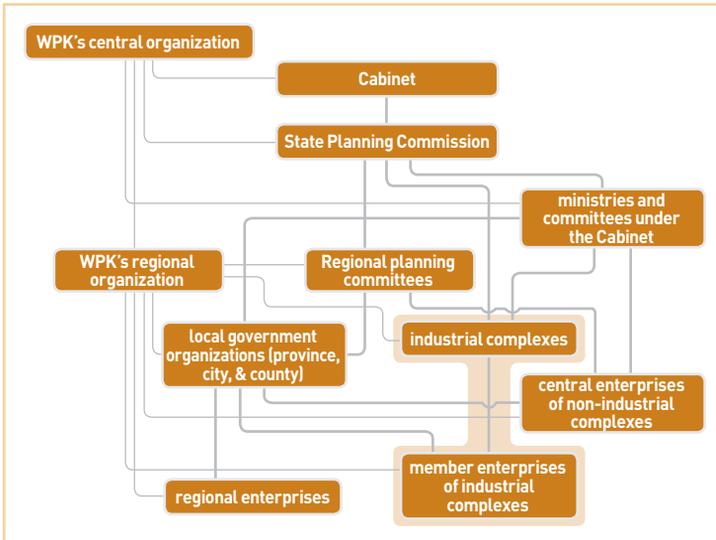
Such planning covers an extensive scope and is very detailed. Except for side businesses at collective farms, it deals with every aspect of the national economy, ranging from the production, logistics, distribution, and consumption of goods, as well as investment, changes in the industrial structures, technical development, training and deployment of workers, and foreign trade. Macroeconomic production, consumption, and investment plans for the whole country are drawn up by the central government. Based on these plans, the central government yields influence on economic activities by individual agents like enterprises and households at a microeconomic level.

Under this planning, the emphasis is on vertical control. Decisions are passed down from top to bottom. Horizontal communication like voluntary and spontaneous contracts or exchange of opinions by actual agents at the bottom is not considered very important.

1. A national economy is the aggregate of economic activities that are closely interconnected in the unit of a nation. As a nation is the basic political unit in today's world, economic laws and systems are managed at the national level in a comprehensive way. Economic activities by economic agents like the government, local government organizations, enterprises, and households are naturally based on such laws and systems and closely interrelated at the national level.

What is important is striking a balance between the supply and demand of goods and services, and this balance is achieved through planning, namely administrative means, not by the market. In a market economy, the supply and demand of specific goods, services, raw materials, etc. is mediated through trade at market prices (prices of goods, interest rates, wages, etc.) to achieve a balance. In a planned economy, the balance is achieved through plans.

**Figure 1** North Korea's planning and management structure



Note: This figure represents a very simplified version of North Korea's planning and management structure. It was established when industrial complexes were fully introduced in 1985, and it remains in place to this day. The thick lines (between the boxes) indicate the hierarchy of administration, and the thin lines denote affiliation with the Workers' Party of Korea (WPK).

Source: Yang Mun-su, North Korean Economy's Structure: Mechanism of Economic Development and Recession (Seoul: Seoul National University Press, 2001), p.86.

One of the salient features of a centralized planned economy like that of North Korea is that its planning and management organizations constitute a hierarchy. As seen in Figure 1, the operational structure of North Korea's economy or its planning and management structure can be simplified into a hierarchy with the planning authorities at the center, ministries related to different industries, and enterprises. At the peak are the central planning authorities that control the entire economy (State Planning Commission), and at the bottom are enterprises, which are production units.

The central authorities, enterprises, and consumers are linked through a vertical decision-making process in which reports are passed up the hierarchy and instructions are handed downwards, with administrative agencies acting as intermediaries. Individual enterprises report their activities to the planning authorities. The authorities come up with a plan based on such information to achieve the state's goals. Then, the authorities assign planned projects (index targets)<sup>2)</sup> to all the enterprises, order their execution, and monitor and supervise the progress in achieving them. The planning authorities also provide enterprises with raw materials,

2. At the bottom are the enterprise plans. They are executed under the ministry plans, and all plans are part of the central plan, namely the national economic plan. Conversely, drilling down from the central plan leads to the ministry plans and then to the enterprise plans at the bottom. The central plan calls for index targets for the ministries and enterprises to achieve. Index targets are the quantified representations of assigned projects to be performed by production units such as ministries, local government organizations, and enterprises.

facilities, and funds needed for production, and they designate where products produced by enterprises will go. Enterprises are merely producers.

Here the ministries and committees play an important role. Each and every enterprise in North Korea (mainly central industries) without exception belongs to a certain ministry and committee. Thereby, they are placed under direct control of a specific management bureau within the ministry and committee. Each ministry and committee supervises individual enterprises. Provincial, municipal, or county people's committees supervise enterprises within their jurisdiction, but the scope of their supervision is relatively limited.

As seen in Figure 1, the WPK and administration work closely together at each step of the planning and management structure. At each step, the administrative agency corresponds to the Party's agency almost on a one-on-one basis. For instance, the Cabinet's Ministry of Light Industry corresponds to the Light Industry Department of the Party's Central Committee. Enterprises are subject to dual supervision (or "guidance" as the North Koreans like to say) by the WPK and administrative agencies. According to the principle that supervision by the WPK takes precedence over administrative supervision, the reality is unitary supervision by the WPK.

For its part, the State Planning Commission, which controls all of North Korea's economy, is subject to guidance by the

WPK's Central Committee. In fact, the basic responsibility of the State Planning Commission is to devise plans to implement Party policies across all economic areas and supervise their execution.

The utmost precedence of Party policy is upheld even at the enterprise level. The 'Tae'an Work System' introduced in 1961 is still the most important mechanism of enterprise management. Unified and detailed planning introduced in 1964 to 1965 are important aspects of planning. The Tae'an Work System and unified and detailed planning will be discussed in the next section.

The physical foundation of this centralized planning and execution process is a centralized materials supply system, one of the components of the Tae'an Work System. The authorities (ministries, management bureaus, etc.) assume the responsibility for supplying all necessary materials 'in-kind' to the production sites (factories, enterprises, etc.).

There is also a single funding system by which the government takes sole responsibility for distributing funds necessary for the operation of agencies and enterprises. All funds required in the execution of government plans are exclusively guaranteed by the state based on a fiscal plan. In fact, most funds for economic operations in North Korea are provided by the state. Funding and fiscal matters are handled in a way that supplements the state budget.

The basic framework of the centralized planning system seen so far was generally established in the 1960s. There has been change to some degree but the framework remains the same to this day.

## Taeon Work System & Unified and Detailed Planning

It is no exaggeration to say that the Taeon Work System and unified and detailed planning are the two pillars of North Korea's planned economy system. The former specifically applies the basic policy of economic management to the management and operation of enterprises while the latter does so to the economic operation system of the state. Namely, the former and latter microscopically and macroscopically deal with North Korea's planned economy, respectively.

Kim Il-sung, the late leader of the DPRK, suggested directions and ways to improve economic guidance and enterprise management in a way that suits the true nature of socialism at the enlarged meeting of the 2nd Plenary Meeting of the 4th Central Committee of the WPK held from late November to early December in 1961. That same December, he stayed for ten days at the Taeon electric power plant, providing on-the-spot "guidance". The Taeon Work System is an industrial management system resulting from such experience. The system has multiple components, and the most important are the following two:

First, the existing one-man management system was replaced by a collective guidance system through a factory's party committee. In the management and operation system of a factory, the factory's party committee is nominally at the top, followed by its manager and party secretary<sup>3)</sup>. In fact, the party secretary is at the top despite the official collective guidance system.

According to the official explanation by the North Korean authorities, the Tae'an Work System is truly an 'industrial system that embodies the ideology of *juche* (self-reliance) and revolutionary policy for the people or an 'economic management format that realizes the revolutionary policy under collective supervision by the party committee. Its true nature or core element is collective supervision by the party committee.

Second is the centralized materials supply system. Such parties as ministries, committees, and management bureaus take responsibility for supplying materials in-kind to factories and enterprises; factories and enterprises in turn take the same responsibility for workplaces; and workplaces do the same for production sites.

This is meant to enable producers to concentrate on production, and economic guidance agencies to actively

3. The factory's party committee chairman in the 1960s.

manage enterprises' production and organization. This system is supposed to facilitate cooperative production and strengthen control on the consumption of materials, allowing for the most effective use of materials.

Unified and detailed planning is the basis of North Korea's planning system. Unified planning is intended to consolidate all planning under the comprehensive supervision of the State Planning Commission. Through unified planning, the state can uniformly control economic activities in all areas of the national economy and solely manage the material and human conditions of production across the nation. Detailed planning seeks to devise concrete plans and legally compel the achievement of all index targets. As pointed out by the North Korean authorities, unified and detailed planning is unique to the North: it is not used by any other socialist nation including China. Kim Il-sung once described it as "the most righteous path to strengthen centralized control in the economic sector."

North Korea introduced unified planning in 1964 and detailed planning in 1965. With regard to unified planning, it reshuffled the national planning structure in 1964. Under the State Planning Commission, two regional planning committees were established in each province to supervise the execution of assigned projects. National planning departments were established for cities and counties, and factories and enterprises. In addition, departments and committees under

the State Administration Council (the present Cabinet) and all the planning units at both the central and local levels were designated as the subordinate entities of the State Planning Commission. They were made subordinate to both their respective superior agency and the State Planning Commission.<sup>4)</sup>

Detailed planning was done alongside unified planning. It literally involved making the most detailed plans possible. This was a means by which the government's planning units directly and closely connect overall economic development with management activities by individual enterprises. This specifically incorporated the details of plans into economic activities at all possible levels from the central government to regions and to enterprises, occurring between areas of the national economy, between enterprises, between regions, and within each entity (area, enterprise, and region). This naturally resulted in sharp increases in index targets as well as the number of target items of planning. Detailed planning also rendered the achievement of index targets by individual economic units into a legal obligation.

4. Unified planning did not mean simplifying the planning and management structure. Recall that it was done together with detailed planning in North Korea. It was, therefore, inevitable in 1965 that the number of planning organizations increased and the overall structure became somewhat complex. Nevertheless, the reshuffle strengthened supervision by the State Planning Commission.

## System for Distribution of Food Rations and Other Necessities

Distribution of food rations in North Korea was partially introduced in 1946 for urban residents engaged in the socialist planned economy due to food shortages that occurred immediately after national liberation. It was gradually expanded to all of the North Korean people starting in the latter half of the 1950s.

North Korea's food ration distribution system combined largely three economic systems, namely, the state's monopolistic food trading system, the national ration distribution system for urban residents, and the ration distribution system for farmers in collective farms.<sup>5)</sup>

The North Korean Cabinet announced in 1957 its decision to "allow the sale of food only by the government," totally prohibiting dealings by individuals in food, which had been permitted up to the time. Urban residents, who did not

5. For more details, refer to: Lee Seok, et al., *Changes in North Korea's Planned Economy and Marketization* (Seoul: Korea Institute for National Unification, 2009), pp.78-79.

produce food, were made fully dependent on the state for food.

A de facto ration distribution was introduced at farms in 1962 when an agriculture guidance system based on the management committees of county collective farms was established. Through this system, the North Korean government seized control of the entire process of production, logistics, and distribution at collective farms.<sup>6)</sup>

According to official announcements by the North Korean authorities, the total crop yield and total cash income of a collective farm minus expenditures (e.g. usage fees of agricultural machinery, costs for fertilizer and fuel, and funds set aside for the future of the farm) are distributed to farm members in-kind and in cash. The annual amount of food distributed remains the same regardless of the variation in the crop yield. What changes yearly is the cash distribution. In-kind distribution is de-facto ration distribution, and farm members receive only the same ration as workers.<sup>7)</sup> Any excess

6. Above all, the agriculture guidance system controlled by the management committees of county collective farms brought about greater change in terms of ownership. It integrated collective ownership and all-people's ownership (state ownership) in the agricultural sector. In fact, it came close to state ownership. The important means of production at collective farms such as tractors and rice planting machines became the property of the state, not that of the farms. Also, the management committees came to supervise collective farms in a corporate way, like enterprises, not administratively.

7. The amounts are fixed, e.g. 700g per day per general laborer or 800g per day per heavy laborer or soldier.

is purchased by the state in its entirety. Unlike cash, farmers cannot freely dispose of grains.

Ration distribution to urban residents is based on this institutional framework. Rations for them include foods forcibly purchased from collective farms and foods imported. Unlike farmers who receive a year's worth of food at one time, urban residents receive rations twice a month or every fifteen days.

North Korea gives out rations only to workers belonging to government agencies or enterprises and their families. Except for few exceptions, no one without a job can receive rations. Urban residents receive ration coupons from their workplace and visit the ration distribution center they belong to purchase food at low prices set by the authorities.

In the early days, most necessities could be bought freely at state-owned stores, except for food and some other necessities. Starting in the late 1970s or early 1980s, when the overall economic situation took a bad turn, a de facto ration distribution system came into being with the appearance of the so-called product supply card.

The product supply card is a kind of ration coupon. It is a right to buy products at state-owned stores. There are two kinds: one for food and another for industrial goods. Members of the general public each receive a set of 12 supply cards once a year. They are to present one each month at a state-owned

store and buy products as prescribed on the card, that is, in amounts determined by the government. For example, the numbers of liters of soy sauce, grams of soybean paste, grams of cooking oil, pairs of shoes and socks, pieces of underwear, cakes of soap, tubes of toothpaste, and toothbrushes one person can buy are all specified.





# PLANNED ECONOMY AFTER THE ECONOMIC CRISIS

1. Contraction and Weakening of the Planned Economy
2. Generalization of Direct Control by the Supreme Leader
3. Collapse of the Ration Distribution System

# 1

## Contraction and Weakening of the Planned Economy

In the aftermath of the collapse of the Communist bloc, North Korea's third seven-year plan (1987~1993) ended in failure. Even the North Korean government itself officially recognized the failure. It designated the following two or three years as a recovery period and set forth a new economic strategy that focused on agriculture, light industry, and trade, which also failed to produce visible results. The years from 1994 to 1997 are recorded as a time when the North Korean economy fell into a bottomless pit that is depicted by a great number of people dying from hunger and the Arduous March. According to assumptions by the ROK Bank of Korea, the North Korean economy contracted for nine consecutive years, from 1990 to 1998 (based on the real growth rate). Its GDP plummeted 30.0% during said period.

This economic crisis shook North Korea's planned economy to its very foundation. Production in almost every industry including energy decreased sharply, resulting in severe shortages of raw materials. The supply of raw materials became extremely unreliable. The centralized materials

supply system, the physical foundation of North Korea's centralized planned economy, was practically destroyed by the economic crisis, sending tremors throughout the entire planned economic system.

Most importantly of all, the Tae'an Work System and unified and detailed planning, the two pillars of North Korea's planning system, were greatly weakened. In fact, the centralized materials supply system, one of the key elements of the Tae'an Work System, had already started to decline before the 1990s, as had unified and detailed planning. The difficulties became even more severe during the economic crisis in the 1990s: the system virtually collapsed. The failure by the central planning authorities to properly provide raw materials to enterprises constituted a non-guarantee of the means to implement plans. If the central planning authorities still demanded that enterprises execute their plans, practical rights to do so would have had to be handed over to enterprises to a considerable degree. The central control over enterprise activities weakened greatly as a result, and unified and detailed planning, "the most righteous path to strengthen centralized control in the economic sector," became an empty slogan.

The scope of central planning also contracted markedly. The official economic system came nearly to a complete halt during the economic crisis in the 1990s. Even after 2000, when industrial production was partially restored, an overall balance through planning was impossible to achieve. An

overall balance was impossible from the start when only a very few enterprises engaged in normal production. It is believed that central planning is being performed for some essential industries to maintain the official economy like electric power generation, metals and machinery, and construction.

It is true that the scope of enterprises that are subject to central planning has considerably narrowed. The State Planning Commission sets production targets for such enterprises and supplies materials for production. Not much is known about such enterprises. It seems certain that regional factories are excluded from central planning. Among central industries, 'special enterprises' are core enterprises that maintain the official economy regardless of their affiliation with the Cabinet, WPK, or military. It seems that central planning works for them to some degree.<sup>8)</sup> As not many of the first and lower grade enterprises still produce, planning must not hold much meaning for them. In short, central planning is employed in a very limited scope: it focuses on strategic areas and, thereby, does not guarantee an overall economic balance at all.

8. North Korea classifies its enterprises into different groups: they are classified as large and medium & small enterprises, and into special, first, second, third, and fourth grades according to their size by several parameters (number of employees, fixed properties, production capacity, etc.) and contribution to the national economy. Economic Dictionary 1 (Pyongyang: Social Science Publishing Company, 1985), p.302.

For its part, the State Planning Commission eventually became obsolete. With the fall of the key industries in the 1990s, the centralized materials supply system practically ceased functioning. Its function was restored in very limited respects after the partial recovery of industrial production in the 2000s. Even after the partial recovery, resources over which the Cabinet could exercise control were—and remain—very limited, and even those parts of the economy controlled by the Cabinet (the “Cabinet economy”) cannot function without resources from what are called “privileged economies” like the WPK and military<sup>9</sup>. Because the Cabinet economy fails to control the overall industrial cycle, the State Planning Commission can no longer perform a central role in planning.

A substantial portion of the resources necessary for the execution of plans must be secured from the WPK and military outside the Cabinet economy. In this process, the State Planning Commission does not matter much. The narrowing of the scope of enterprises subject to central planning also reduced the role of the Commission, as did the imposition of direct control by Kim Jong-il. It no longer coordinates economic matters or guarantees a balance through planning and only makes nominal plans.

Plans must often be changed in the middle of execution

9. Refer to page 45 of this paper for privileged economies.

because of the significant unreliability of supply of materials by the authorities. In the process of using limited resources, priorities often change due to decisions by the supreme leader. Against this backdrop, even the authorities are half-hearted about carrying plans out to the letter. Once a policy, which is the supreme leader's instruction, is determined and issued by the top, projects to implement it takes precedence over any outstanding plans.

In North Korea, economic projects that require a huge volume of resources can be changed anytime as the supreme leader sees fit rather than being implemented according to plans by the authorities. This tendency to not strictly adhere to national economic plans became readily apparent when Kim Jong-il became supreme leader, and it has persisted for quite a long time and even become more pronounced. As a result, national economic plans are being established every year but are only titular<sup>10)</sup> in North Korea.<sup>11)</sup>

10. Park Hyeong-jung offers the very interesting argument that national plans in North Korea are no more top-down instructions but only collections of reports from the bottom. There are no longer any top-down instructions about economic plans: it only appears that the state issues instructions and enterprises carry them out. In fact, the state only collects payments due from enterprises based on their reports. Refer to: Park Hyeong-jung, "North Korean Economy as a Hybrid of the Past and Future: Segmentation of the Economy in Seven Semi-Independent Compartments Based on the Diversification of Surplus Occupation and the Economic Coordination Mechanism," Korean Association of North Korean Studies Journal, Vol.13, No.1 (2009), p.50.

11. For more details, refer to: Lim Kang-taeg, et al., Study of the Status of North Korea's Official Economy for the Estimation of Unification Costs/Benefits (Seoul: Korea Institute for National Unification, 2011), pp.51-59.

## Generalization of Direct Control by the Supreme Leader

With the launch of his regime, Kim Jong-il exercised direct control over the WPK, military, and state. He completely disregarded the prevailing hierarchy among the agencies of the WPK, military, and state and placed them all equally under his direct control.

Since the appearance of Kim Jong-il as heir to the regime, the official policy-making mechanism started to weaken, and it has done so at an accelerating pace since the death of Kim Il-sung. It was replaced by an unofficial policy-making process where the supreme leader himself attended to different sectors through so-called ‘close aide politics (where decisions are facilitated by close aides to the leader)’ and ‘proposal-based politics (report-based or ratification-based politics)’. This unofficial decision making took root as the most fundamental and universal way of establishing and implementing any policy in North Korea.

Under the Kim Jong-il regime, close aide politics was top-down decision making while proposal-based politics

was bottom-up decision making. Under the latter, each agency wrote a report (or proposal) about the area under its jurisdiction, had it authorized by the supreme leader, and implemented it. Proposals approved by Kim Jong-il became the WPK's 'directives' and were issued to the appropriate agencies as the WPK's policies to be implemented without question at any cost.

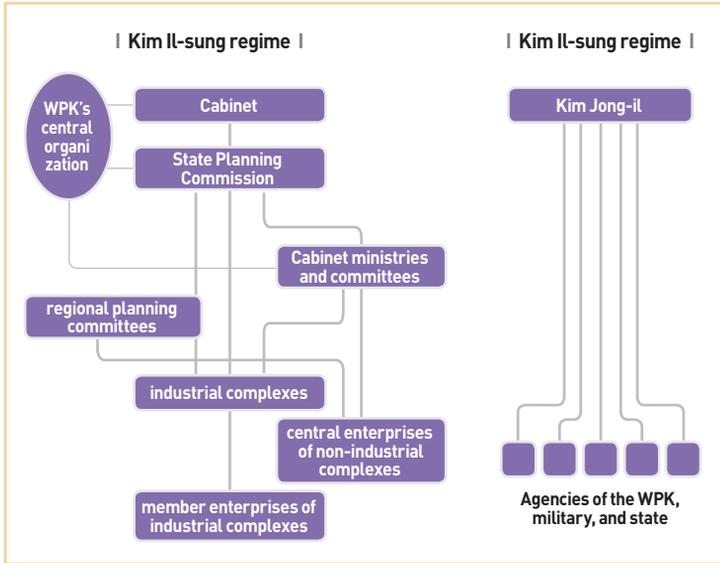
Instructions, orders, and anything uttered by Kim Jong-il at meetings with high-ranking officials, events with close aides, on-the-spot guidance, and any other occasions were regarded as directives and implemented as policies. Even in such cases, they were documented, reported for authorization, and made into official policies for implementation.

These directives took precedence over plans in the management of the official economy. From the perspective of individual units that were to carry out plans, directives that were given to them without warning due to instructions by the supreme leader were higher in priority than plans. Too many directives were passed down, and plans were deprioritized and dealt with only formally. The planned economy system, therefore, became more and more nominal.

The State Planning Commission, which had previously supervised the overall national economy, was noticeably downgraded and its functionality greatly reduced. As seen in Figure 2, under the operating system of North Korea's official

economy of the Kim Jong-il regime, Kim directly controlled the agencies of the WPK, military, and state.

**Figure 2** Change in the operating system of North Korea's official economy



Note: The agencies of the WPK, military, and state refer to the WPK's specialized departments, the Ministry of People's Armed Forces, the Cabinet's ministries and committees, etc.

Source: Lim Kang-taeg, et al., Study of the Status of North Korea's Official Economy for the Estimation of Unification Costs/Benefits (Seoul: Korea Institute for National Unification, 2011), p.153.

Let us look into the national mechanism of using foreign currency under this regime of direct control by the supreme leader. North Korea has a supply and demand plan of foreign currency worked out in advance as an official national plan. It consists of plans for foreign currency income and expenditures, and the foreign currency expenditure plan

includes the input of foreign currency into the official economy. There would be no serious problem if things went as planned but the reality is different.

From the state's perspective, the demand for foreign currency is high but its supply is limited. The different agencies and sectors are inevitably keen to get a hold of foreign currency. Political power and logic have come into play for years and plans have been disregarded and rendered titular.

Instead, the unofficial decision-making process characterized by proposals and directives plays an important role. The foreign currency income of a national plan is managed by the Cabinet, and foreign currency earned through national projects is deposited in accounts at the Foreign Trade Bank of the DPRK. Once deposited, it is not easy to withdraw the money as it is virtually controlled by the state.

The Cabinet's specialized department studies the distribution of foreign currency, and its plenary meeting issues monthly instructions. Nevertheless, as directives given by the supreme leader take precedence, Cabinet decisions are secondary. Foreign currency in the national plan is used for unexpected directives. All of the foreign currency designated in the national plan can disappear from the accounts of the Foreign Trade Bank in an instant once a secret directive is issued. The priorities in using foreign currency depended on

the whims of Kim Jong-il.

Generally speaking, the framework of national use of foreign currency is not exchange but distribution. There are two forms: one is planned distribution and the other is non-planned distribution (due to directives given by the supreme leader). The share of the latter has increased over time.

When used for national purposes, foreign exchange income earned through official plans is mixed with 'revolutionary funds' earned through unofficial and non-planned efforts to express loyalty to the supreme leader. This is only natural for the supreme leader, who virtually monopolizes the rights to distribute resources, especially those to use foreign currency.

Supervision and control over the use of foreign currency by Kim Jong-il was strengthened after the economic crisis. Unlike in the spending of domestic currency, the State Planning Commission could not get involved in that of foreign currency. To spend the foreign currency of the national plan, a directive by Kim Jong-il was required in addition to a ratification by the premier of the Cabinet.

Proposal-based politics means that the supreme leader single-handedly makes all important decisions for national matters. This inevitably creates an excessive burden on him as well as confusion and discord in the decision-making process. Though the scale of the economy, targets of planning, and areas subject to direct control by the supreme leader

contracted greatly during the economic crisis, the essence did not change. It should also be noted that such side effects as the lack of objectivity, rationality, and promptness in the decision-making process are unavoidable.

Different agencies only consider their positions and interests and those of their respective sectors and develop logic that helps justify their perspectives. This interferes with the supreme leader making reasonable and objective decisions at the national level. Moreover, the supreme leader is inundated with reports produced by all kinds of agencies and sectors. There was even a case where opposing proposals on the same matter submitted by two agencies were both ratified.

## Collapse of the Ration Distribution System

The economic crisis affected the North Korean economy in many ways, and the most agonizing to the general public was the collapse of the central ration distribution system of food and other necessities. Delays began to occur in ration distribution in the early 1990s, and the ration amounts soon started to dwindle. The system entirely ceased functioning at all between 1994 and 1995. This is officially known as the “Arduous March”, but it is popularly known as the “no-rations period”.

Amid the ongoing North Korea economic crisis, food shortages are chronic and often severe. The shortages were so bad in the mid-1990s that the North Korean government appealed to the international community for food aid. It had no choice but to bring in grain from outside as bouts of food shortages continued to occur starting in 1992. Nevertheless, even with imports and external assistance, the demand could not be met and North Korea was left short of hundreds of thousands of tons of food every year. Ration distribution was delayed and curtailed, and the people suffered extreme hardship with the collapse of the food ration distribution

system in the mid-1990s.

There was a major famine in the mid- and late 1990s including the 1994 to 1997 Arduous March. Estimates of the death toll range from 200,000 to three million people. There is no way an accurate toll could ever be determined.<sup>12)</sup>

The food situation was indeed horrendous, and it was, needless to say, no better for other necessities. State-owned stores did not get supplies of goods, and their shelves eventually became empty.

Under these circumstances, the central government started to shift the responsibility for resolving food shortages to local authorities and enterprises. The central government used to take responsibility at least for food supply, but the situation changed completely. Starting in around 1992 and 1993, cities and counties were instructed to resolve food shortages on their own, and since 1995 and 1996, the “no-rations period”, factories and enterprises were given the same basic instructions.

12. At a UNICEF conference in Beijing in May 2001, then DPRK Vice Foreign Minister Choe Su-hon disclosed that 220,000 people had died of famine from 1995 to 1998. [Joongang Ilbo, May 16, 2001]. For estimates of fatalities from the North Korean famine by different organizations and academics across the globe and their appraisals, refer to: Jeong Gwang-min, Political Economy of the North Korean Famine: Suryeong (Supreme Leader)-Centered Economy, Self-Rescue, and Famine (Seoul: Zeitgeist, 2005); Lee Seok, Famine in North Korea from 1994 to 2000: Occurrence, Shock and Characteristics (Seoul: Korea Institute for National Unification, 2004).





# DEVELOPMENT OF NORTH KOREA'S MARKETIZATION

1. Conceptual Framework
2. Economic Crisis of the 1990s and the Arduous March
3. After the July 1 Economic Management Improvement Measures
4. Since the Latter Half of the 2000s: Between Restriction and Tolerance of Markets

# 1

## Conceptual Framework

Marketization is a very extensive and comprehensive concept that encompasses various aspects. We often think of a market as a location or space like a department store or conventional market, but that is only a mere part of a market. A market can indeed be a location, but it is more important as a system. Strictly speaking, when we talk about a market, we are referring to the market mechanism.

When marketization is postulated as opposed to planning, this is about the introduction and expansion of the market mechanism. By the market mechanism, prices are determined through the interaction of supply and demand. Signaled by this price information, different decision-making units (economic agents) like households and enterprises take economic actions, and furthermore, resources distribution is adjusted at the macroeconomic level.

Marketization can also be explained by the creation and expansion of marketplaces. Marketplaces are classified as local, external, nationwide, international markets, or others in

terms of geography and function. For a market as a system to develop, local and external markets should be integrated and a nationwide market should be in place.

Markets can be divided into product and factor markets by target of transaction and further into industrial, consumer, capital and financial, and labor markets. In socialist economies, these markets are nearly completely nonexistent, and to the degree that they do exist at all, they are very insignificant. In a socialist economy, enterprises procure (are supplied with or are assigned) inputs (materials, funds, and labor) from government agencies or other enterprises according to central plans. Their products are then delivered (supplied or assigned) to other enterprises or commercial government agencies.

The integration of local and external markets and the formation of a nationwide market even at a rudimentary level correspond to the advance of marketization. Marketization advances further when the four industrial, consumer, capital and financial, and labor markets appear and expand, and enterprises (or cottage industries), the basic unit of production, increasingly procure raw materials, funds, and labor and dispose of products through markets.

From an institutional perspective, a market does not only refer to a pricing mechanism. A market is a combination of institutions called market elements. These elements are

physical locations where goods are available, suppliers, consumers, conventions or laws, and more. In modern society, goods and currency are utterly essential.

The advance of commercialization and monetization or the development of a commodity money economy is closely related with marketization. The former is an important condition of marketization and facilitates its expansion. In turn, the expansion of marketization facilitates commercialization and monetization. The progress and level of commercialization and monetization are two of the criteria to measure the extent of marketization.

Now, from a different perspective (that of different agents), let us look at the general aspects of marketization. This perspective helps better understand the process of a market's formation and development.

First, people appear in a market as suppliers (sellers) and consumers (buyers) for whatever reasons. At first, they may be engaged in simple barter, but over time, currency-based trade gradually develops. The reason for people's engagement in the market is initially non-monetary as, for example, for exchange of goods that they have in surplus or lack. This also gradually becomes monetary, as for profit. This is how a consumer market comes into being.

If suppliers (sellers) and consumers (buyers) cannot meet face-to-face for such reasons as geography, there appear

merchants who broker deals. They can be traveling peddlers or store owners engaged in commerce at fixed locations. Suppliers (sellers) participating in a physical marketplace are original owners of goods like small-scale producers or merchants who assumed goods from original owners, regardless of whether they produced the goods themselves or acquired them in some other way.

Merchants engage either in local commerce (short-distance commerce) or in interregional commerce (long-distance commerce). The trade volume is small for the former and large for the latter.

Market development in turn encourages production. Stable sales channels and their expansion sufficiently motivate producers to increase their production. Market participation by small-scale producers increases, and division of labor occurs and expands. In other words, small-scale producers become to focus on the production of their own specialized items over time. And producers come to affiliate with each other, which leads to the formation and development of an industrial market.

Market development also requires the formation, expansion, and differentiation of merchants. A good example is differentiation between wholesale dealers and retailers. At the initial stage, the same merchants engage in both wholesale and retail sales, and with the development of a

market, they tend to become specialized as either wholesalers or retailers. Another division is between specialized and general merchants who deal with specific and multiple items, respectively. Merchants at first take care of warehousing and transportation, and gradually, merchants specializing in those appear. Namely, warehousing and transportation are separated from wholesale and retail sales.

As a market develops, the need for credit, and furthermore, for finance intensifies. Whether it is a person participating for the first time in the market as a seller or already engaged in commercial activities, he needs operating funds. It is initially often the case that sellers who have surplus funds lend money. Over time, people who accumulate wealth through commercial activities are bound to appear, and some of them convert into professional financiers (private moneylenders or loan sharks). This is the emergence of the financial market.

With the further development of marketization, it is the turn of capitalists and laborers to appear. Merchants who accumulate capital through commerce become capitalists while laborers who offer their labor as a product appear. This is the emergence of the labor market.

## Economic Crisis of the 1990s and the Arduous March

Markets in North Korea did not come from nothing. Small-scale farmers' markets that had legally existed before<sup>13</sup> transformed into large-scale black markets during the economic crisis in the 1990s. This is because the state-run commercial network failed to properly function, shortages of consumer goods were serious, and food rations were slashed. During the Arduous March in the mid-1990s, rations were practically suspended. The collapse of the national ration system was the primary driver of black marketeering.

Because the state failed to properly supply food and other necessities, individuals had to take up commercial activity to survive. As seen in Table 1, individuals participated in many different market activities.

13. There had been black markets within farmers' markets even before the economic crisis. Until the mid- and late 1980s, black-marketeering in agricultural produce was very limited and thereby only peripheral in terms of the overall economy. For the best, most extensive information available on the farmers' markets before the economic crisis, refer to: Gu Gap-u and Choi Bong-dae, "Formation of Farmers' Markets: 1950s to 1980s," Choi Wan-gyu, ed., *Formation and Development of North Korean Cities: Cheongjin, Sinuiju, and Hyesan* (Paju: Hanul, 2004).

Table 1 helps you understand the different forms of market participation. What should be borne in mind is that it is about the situation before 2003 when general markets became legal.<sup>14)</sup> This looks at market activities by different participants based on legality and illegality and disregards the existence of merchants for convenience sake. The assumption is that individuals directly supplied (sold) goods at markets. A distinction should be drawn between whether the process of individuals acquiring goods to supply (sell) to markets was legal or illegal and whether supply of the goods to farmers' markets (black markets) itself was legal or illegal.

It was legal for individuals to supply agro-livestock products from kitchen gardens, etc. to farmers' markets (black markets). Supply of agro-livestock products acquired in all other ways, food and industrial products in particular, was illegal. The act of supplying goods to farmers' markets itself was illegal but there are some cases where the acquisition process was legal, such as imports by official agencies and food produced by collective farms. Naturally, acquisition of food and industrial products stolen and misappropriated from factories and farms and of goods smuggled by individuals and agencies was illegal.

14. After the legalization of general markets in 2003, if a product was legally acquired, its supply to a market was also legal, except for some goods.

**Table 1** Types of goods supplied to farmers' markets (black markets)

Classification	Acquisition process	Goods acquisition	Supply to farmers' markets
Property owned by individuals	Property owned by individuals including clothing, tableware, and furniture	Legal	Illegal
Products produced by individuals	Produce from kitchen gardens	Legal	Legal
	Agro-livestock products produced by individuals on the side	Legal	Legal
	Agro-livestock products produced by collective farms on the side	Legal	Legal
	Groceries and other necessities produced by individuals on the side	Legal	Illegal
	Produce from farmland illegally cultivated by individuals	Illegal	Illegal
Products produced by enterprises (including farms)	Livestock products illegally raised by individuals	Illegal	Illegal
	Food and industrial products produced in the official sector	Legal (enterprises' perspective)	Illegal
Goods brought in from other countries including China	Food, other necessities, and raw materials stolen and misappropriated from the official sector	Illegal (individuals' perspective)	Illegal
	Imports by official agencies	Legal (enterprises' perspective)	Illegal
Aids from international society	Goods smuggled by individuals and agencies	Illegal	Illegal
	Supplies stolen and misappropriated by individuals and agencies	Illegal	Illegal

Note: This is about the situation before 2003 when general markets were legalized.  
 Source: Yang Mun-su, Marketization of the North Korean economy: Form, Nature, Mechanism, and Implications (Paju: Hanul, 2010), p.228.

Let us look at the above from the perspective of participants. The most rudimentary market participation was the disposition of one's own properties. Individuals supplied (sold) clothing, tableware, furniture, and other items they owned to markets. In this case, acquisition was legal and supply to the market was illegal.

The next level was supplying the market with goods that individuals produced. This included producing agro-livestock products, etc. from kitchen gardens, on the side, and in other manners and supplying them to markets. In this case, both acquisition and market supply were legal. Another case was supplying markets with produce from patches illegally cultivated by individuals or livestock products illegally raised by individuals. In this case, both acquisition and market supply were illegal.

Next was supplying markets with goods produced by enterprises (factories and farms). Enterprise supplies of food and industrial products (daily necessities) produced by factories and farms were legal and illegal in terms of acquisition and market supply, respectively. Another form was supplying markets with industrial products (daily necessities), raw materials, and food stolen or misappropriated from factories and farms by individuals. This could happen during the production process at factories or farms or during the distribution process at commercial institutions. In this case, both acquisition and market supply were illegal.

Next was supplying markets with goods brought in from other countries including China. The first form was enterprise-level supplies of official imports by trading companies, etc., and this was legal with regard to acquisition but illegal concerning market supply. Another form was supply of smuggled goods by individuals, agencies, or enterprises, and both respects were illegal in this case. The last was supplying aid goods from Korea and the international community. Individuals or agencies stole and misappropriated such goods, and this was illegal in both respects.

Once the people got involved in markets as suppliers and began earning unofficial cash income in addition to their official wage, they and their families came to participate in markets as consumers with the additional cash. They became able to buy food and other necessities at markets to survive and escape starvation. Those who hesitated to participate in markets at first witnessed others who made a living through commercial activities and followed suit. At first, it was mostly individuals who participated in markets, and over time, participation by enterprises themselves or their members increased.

### Farmers' markets, black markets, general markets, and local markets

These are actually the same markets referred to by different terms through the years and depending on those involved. Farmers' markets were initially legal small-scale consumer markets. Their historical roots run very deep. In 1958, the North Korean government allowed farmers' markets to open every ten days in rural communities and in cities where people could directly sell and buy some agro-livestock products farmers produced in their small private kitchen gardens or on the side. Still, grains like rice and corn and industrial products were banned from trading. Through the course of the economic crisis of the 1990s, these farmers' markets became huge black markets called *jangmadang*. From 2003, North Korea legalized farmers' markets-turned-black markets. These are called "general markets" in South Korea and "local markets" in North Korean literature.

Farmers' markets ended up as huge black markets. Bans on trade items became useless: not to speak of bans on food, daily supplies, and expensive consumer durables. Even some producer goods were traded. Trading was conducted not only within farmers' markets sanctioned by the state but also in other locations like roadsides frequented by people and residential streets. The frequency of opening also changed where markets that were supposed to open every ten days began to open every day. The number of users rapidly increased, and even professional merchants emerged.

The response of the North Korean government toward this rampancy of black markets was a series of crackdowns and connivance, but it was more like connivance. They recognized the proliferation of black markets as unavoidable and useful toward easing the severe shortages of food and other necessities due to the paralysis of the national ration

distribution system and mostly overlooked their proliferation.

Since the economic crisis, trade became much decentralized and trade with China and other parts of the world increased, which greatly facilitated marketization.<sup>15)</sup> Since the late 1970s, decentralization of trade progressed incrementally against the backdrop of economic difficulties and shortages of foreign currency. This largely occurred in two ways: one was the transfer of trade rights to production units and regions within the general economy (Cabinet economy). The other was the increasing independence of privileged economies from the Cabinet economy—the WPK economy (elite economy), and military economy in particular—and such rights were transferred to units of different levels within them.

A full-scale measure for trade decentralization appeared in 1991 under the name of a ‘new trade system.’ It was a system to install trading companies not only under the State External Economic Affairs Commission but also under the Cabinet’s departments (presently ministries) and committees responsible for production as well as in ‘do’ provinces to directly engage in trade with other countries.

15. The North Korean mechanism where trade decentralization led to the activation of trade and resulting expansion of marketization is discussed further in the first section of Chapter 4 of this paper.

The new system allowed producers to directly engage in external trade. It allowed departments (ministries), committees, and provinces to directly sell goods produced in their respective sectors and regions and to directly purchase necessary goods. After its introduction in 1991, almost all agencies belonging not only to the Cabinet economy but also to privileged economies established trading companies to earn foreign currency.<sup>16</sup> Foreign trade became chaotic because of the mushrooming growth of trading companies during the Arduous March period.

What is noteworthy is that this trade decentralization was closely related to 'self-rescue' efforts that North Korea required of its departments (ministries), committees, and provinces. They were required to find sources of exports and earn foreign currency on their own to 'normalize production' or smoothly run their respective agencies. This required all sorts of agencies, enterprises, and local authorities to feed and clothe their people on their own. Though their situation was said to be better than that of the agencies of the Cabinet, those of the WPK and the military were also required of some degree of self-rescue.

16. For details, refer to: Park Hyeong-jung, "Commercial Engagements of the Party-State Agencies and the Expansion of the Market Economy in the 1990s in North Korea," *International Journal of Korean Unification Studies*, Vol.20, No.1 (2011); Choi Jin-I, "Internal Change in North Korea after the Economic Crisis," Lee Dae-u, ed., *North Korean Society Examined Together with Defectors: Dilemmas and Solutions of North Korean Issues* (Seoul: Oreum, 2012).

## North Korea's privileged economies and trading companies

In North Korea, the separation of general and privileged economies started in the mid-1970s. This is when privileged economies broke away from the Cabinet and started to operate as independent economic entities under the direct control of the supreme leader. Privileged economies refer to the WPK and military economies. Each has a complete economic system comprising farms, factories, enterprises, mines, trading companies, and banks.

The WPK economy was launched with the appearance of Daesung Chongguk ('Daesung Trading Company') and Bureau 39 in 1974. In 1978, Daesung Bank was established. A new economic alliance was created from this combination of Room 39 of the WPK, Daesung Chongguk for production and trade, and Daesung Bank for external settlements. They are not under the control of the Cabinet but are subject to the direct control and supervision of the WPK. The WPK economy further expanded with the establishment of additional economic departments in the WPK including Bureau 38.

The military economy separated from the Cabinet in 1979 when the Second Economic Committee was established. The committee was a consolidation of different departments for the production of military supplies under the State Administration Council (Cabinet). It is a system that plans, produces, manages, and supplies munitions on its own and currently even handles arms exports and imports. It is not supervised by the Cabinet but by the Munitions Industry Department of the WPK's Central Committee.

Since the economic crisis, the WPK and military economies assumed control over mines, factories, farms, and more which used to belong to the Cabinet, expanding in size. They also established subordinate trading companies one after another. Like agencies of the Cabinet, those of the WPK and the military were also required of some degree of self-rescue amid the economic difficulties. Especially during the Arduous March period, foreign trade became chaotic as a result of the mushrooming growth of trading companies.

# 3

## After the July 1 Economic Management Improvement Measures

After the official launch of the Kim Jong-il regime in 1998, the North Korean government set to sorting out the mess stemming from the economic crisis, especially the economic and social disorder due to the extensive black markets and overhauling its systems and institutions. Internally, it adopted utilitarianism and practical socialism as major policies in 1998, and externally, it seriously addressed its relations with the outside world. The July 1 Economic Management Improvement Measures (hereinafter July 1 Measures) of 2002 were part of these efforts.

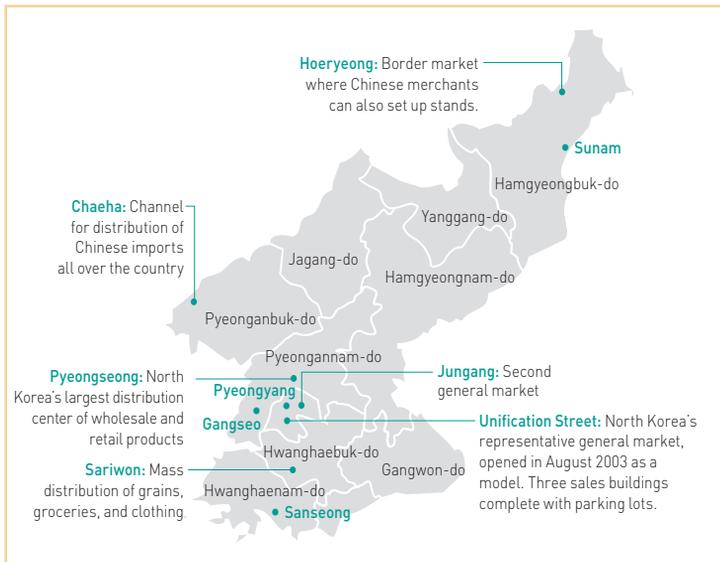
The July 1 Measures entailed different actions and significances, which included the partial introduction of a market economy mechanism. This was partial acceptance of the bottom-up marketization that had already been going on for quite some time.

In 2002, an ‘earned income indicator’ was introduced to evaluate enterprise performance. It was used to allow enterprises’ non-planned production and distribution. This permitted de facto market economic activities by enterprises.

‘Socialist barter markets’ were also introduced, which signaled an official sanction for industrial markets for the first time. This was meant to allow factories and enterprises to exchange raw materials and parts that are in excess on one side and lacking on the other side, and a certain ratio of their products to be used for exchange of materials.

In March 2003, general markets were newly introduced. The term ‘farmers’ market’ was changed to ‘market’, and the scope of items distributed was widened beyond the existing agricultural and local products to include groceries and industrial goods. In other words, consumer markets were officially allowed by legalizing the black markets.

**Figure 3** North Korea’s representative general markets



Source: Institute for Unification Education, Understanding of North Korea (2013), p.172

Some of the state-owned stores were in fact simultaneously converted to markets. Some of them of which functionality was paralyzed due to the collapse of the national ration distribution system were leased to agencies and enterprises including trading companies to sell imports from China, etc. to people. Those state-owned stores hung up signs that said 'Consignment Purchase Store', so de facto market transactions were allowed. Also, individuals with resources were allowed to borrow the titles of agencies and enterprises to run stores and small-size service businesses.

While employing direct policy measures that tolerated marketization, the North Korean government also occasionally took indirect measures. A good example is the advance of commercialization and monetization. Allowing unplanned production by enterprises meant the production of more goods to be sold at the market. Also, charges were imposed on transactions between agencies and enterprises that had previously been free of charge. This indicated the establishment of a system where everything was assigned a price and valued in money. In addition, the de-facto abolition of free provision of consumer goods, the resulting conversion from wages in-kind to cash wages, and allowing enterprises to retain cash all suggested the advance of monetization. The need to survive was a powerful incentive for both enterprises and workers to hoard currency.

With markets legalized, the number of participants sharply

increased. Above all, suppliers and the volume of goods made available increased in general markets, which are consumer markets. Market participation not only by individuals but also by agencies and enterprises shot up.

As mentioned above, trading companies played a very important role in the advance of marketization in North Korea. Trading companies had officially imported goods for their agencies and enterprises for a kind of self-consumption and only illegally imported for sale in the markets. With the permission of general markets and marketization of state-owned stores, trading companies were enabled to officially import goods to sell at markets and thereby sell directly to the public.

**Table 2** July 1 Measures and follow-up measures

Classification	July 1 Measures	Follow-up measures
Price, wage & exchange rate	<ul style="list-style-type: none"> <li>• Increased prices (25 times), wages (18 times) and the exchange rate (70 times)</li> <li>• Abolished the free provision of consumer goods</li> <li>• Curtailed and abolished all kinds of subsidies</li> </ul>	<ul style="list-style-type: none"> <li>• Installed foreign currency exchange counters at general markets, etc. (2003)</li> </ul>
Government fiscal management	<ul style="list-style-type: none"> <li>• Abolished transaction tax, introduced enterprise profits payable to the government</li> <li>• Introduced farm rents</li> </ul>	<ul style="list-style-type: none"> <li>• Introduced usage fees and dues to the government for general markets (2003)</li> <li>• Issued people's livelihood bonds (2003)</li> <li>• Installed jipgeumso, a tax collection agency (2003)</li> <li>• Expanded farm rents into real estate usage fees (2006)</li> <li>• Revised the Central Bank Act (2004)</li> <li>• Established the Commercial Bank Act (2006)</li> </ul>
Agriculture	<ul style="list-style-type: none"> <li>• Increased the purchase prices of grains (50 times) to encourage farmers' incentive to produce</li> <li>• Decreased the purchase amount by the government</li> <li>• Enhanced farms' management autonomy</li> </ul>	<ul style="list-style-type: none"> <li>• Some collective farms carried out a pilot project for vegetable gardens (2004)</li> </ul>

Classification	July 1 Measures	Follow-up measures
Enterprises	<ul style="list-style-type: none"> <li>• Performance evaluation based on the earned income system</li> <li>• Implemented a self-supporting system in earnest</li> <li>• Granted managers more rights</li> <li>• Increased enterprises' management autonomy</li> <li>• Increased worker incentives</li> </ul>	<ul style="list-style-type: none"> <li>• Implemented reform measures at some factories and enterprises to greatly increase management autonomy (2004)</li> </ul>
Commerce, distribution & services		<ul style="list-style-type: none"> <li>• Opened general markets (2003)</li> <li>• Converted some state-owned stores to consignment purchase stores (2003)</li> <li>• Virtually allowed individuals to run restaurants and services (2003)</li> </ul>
Foreign economic relations	<ul style="list-style-type: none"> <li>• Expanded decentralization of trade</li> </ul>	<ul style="list-style-type: none"> <li>• Designated Sinuiju Special Administrative Region (Sept. 2002)</li> <li>• Designated Mount Kumgang Tourist Region (Oct. 2002)</li> <li>• Designated Kaesong Industrial Region (Nov. 2002)</li> </ul>

Source: Kim Yeong-yun and Choi Su-yeong, Trends of North Korea's Economic Reform (Seoul: Korea Institute for National Unification, 2005).

For their part, individuals actively took up market economic activities and in various ways. They invested their capital in state-owned stores to bring in goods from China or within North Korea to sell to the public, paid some of the profits to

the authorities, and received the rest for themselves. As they could not officially rent store space, they had to borrow the titles of agencies and enterprises. This frequently occurred not only for stores but also in service businesses like billiard halls, karaoke bars, and restaurants. At the same, individuals aggressively increased side production (cottage industries) and those who did well increasingly outsourced contract processing to enterprises that had little or no work to do.

With the appearance of socialist barter markets, namely legal industrial markets, enterprises were able to procure raw materials through markets. After the emergence of general markets in particular, it became legal for them to raise funds by selling goods at markets. This connected industrial and consumer markets, and their participants began to influence each other.

Because commercial activity itself had been illegal, a merchant class could not form. The situation changed with the emergence of general markets. Financiers who got involved in business in earnest and made a great deal of money emerged one after another. These financiers made most of their fortunes through private commerce, especially through trade with China. As a step further from the formation of merchants, they become differentiated into different types. A good example is the differentiation between wholesalers and retailers.

As markets are legalized and expand, the need for credit, and furthermore, for financing increases. Of course, there is no official financial market in North Korea. All financing is done through unofficial markets or private financing. It largely involves financial relations between individuals and those between enterprises and individuals. As explained above, the former are overwhelmingly loans for commercial activities. The latter involve borrowing money by enterprises from individuals, but never vice versa. The reason is simple: state-owned enterprises and banks do not have money, but individuals do. The financial transactions between individuals and enterprises broadly involve loans, investments, and outsourcing of contract processing. Money-borrowing enterprises can be factories, stores, or trading companies. The purpose can be for investment or operation.

This is how financial, industrial, and consumer markets became interconnected and their participants came to influence each other in North Korea. It is only natural that increased participation by individuals in the financial market should have led to increased participation by individuals and enterprises in the consumer and industrial markets. Consequently, the expansion of the consumer and industrial markets was inescapable.

Wage labor relations started to appear in rudimentary forms. Opposite the wage earners are the financiers. Employment relations obtained between store owners and employees in

commerce; ship owners and fishermen in fisheries; and illegal landowners and tenant farmers in agriculture. Wage labor relations even appeared in cottage industries between clients and processors. These relations have mostly appeared in unofficial areas, and in some cases, the boundaries between legality and illegality have become ambiguous. As seen so far, individuals' participation in the labor market led to the expansion of market participation by financiers, and as a result, the expansion of the consumer market could not be avoided.

In the end, the four industrial, consumer, financial, and labor markets were formed and became interconnected, creating synergy effects and facilitating each other's expansion.

## Since the Latter Half of the 2000s: Between Restriction and Tolerance of Markets

In North Korea, the reformative line of policy started to recede in 2005, and it seems that in 2007 North Korea began to again restrict markets.<sup>17)</sup> This is believed to be because the economic reforms such as the July 1 Measures were led by the Cabinet, and over the course of the reforms, resistance by the WPK increased and concerns grew over the political and social side-effects of the reforms like social disorder, Mammonism, and the spread of individualism.

The crackdown and control on markets in 2007 were serious in various areas. Merchants with stands in general markets were continually subjected to restrictions in terms of their age, business hours, merchandise, and locations. Restrictions were applied on non-general market activities, too: individuals' investments in service businesses were restricted and trading companies had to undergo restructuring. Financiers and

17. For more details, refer to: Han Gi-beom, "The Organizational Behavior and Bureaucratic Politics in North Korea's Decision-making Process: Expansion and Retreat of the Economic Reform (2000-2009)", a doctoral thesis, Kyungnam University Graduate School (2009), pp.190-215.

party-state officials were subject to punishment through various modes of censorship.

Furthermore, attempts were made starting from 2009 to physically close general markets, or convert them back into farmers' markets. Though implementation was delayed due to resistance by the public and for other reasons, a reorganization was announced for the markets across the nation into farmers' markets starting in January 2009.

In late November of the same year, currency reform was carried out with lightning speed to more aggressively suppress marketization. It was supposed to claw back cash from the segments that retained cash in large quantities like wealthy merchants and brokers through exchange of old and new currencies and imposition of exchange limits, and to thereby greatly curtail the financial basis of market economic activities and inhibit marketization. It was announced in January 2010 that general markets would be converted back into the old farmers' markets.

#### North Korea's currency reform

North Korea carried out currency reform without warning on November 30, 2009, attracting attention from home and abroad. It was the fifth reform in 17 years after the fourth in 1992. During this one-week campaign from November 30 to December 6, redenomination was effected to exchange 100 won in the old currency for 1 won in the new currency with the exchange limit of 100,000 won of old currency per household. As a result, many people had a considerable portion of cash confiscated by the government. The exact reasons for this reform are not known, but it is believed to have been meant to curb inflation, secure fiscal revenues, and restrict marketization for economic purposes.

During the period of market restriction starting in 2007, North Korea's marketization seems to have receded somewhat on the surface in terms of general markets and individual businesses. The business hours of markets, the number of participants, and the types of items traded seemingly diminished somewhat. However, this was only temporary and partial. Markets were maintained in spaces not known to the crackdown teams. In fact, neither the number of participants nor the trade items changed much from before if dealings both inside and outside of the general markets as well as black market dealings are considered. As a saying goes, "When those at the top have measures, we have countermeasures down here," so the public came up with all kinds of ideas to thwart the authorities.

Repeated crackdowns tend to have less and less effect. They were to a great degree nullified by learning effects. Many residents who were caught during crackdowns were able to obtain release for themselves by paying bribes and managed to establish cordial relations with the crackdown teams.

Crackdowns were met with direct resistance by people. They complained, "Why don't they let us do business if they are not going to give us food? If it is not an intent to see us die slowly, then what is it?" or "With no rations or wages, how else are we supposed to make a living? Isn't this a world where only bad people are better off?"

A clear example of the limits of crackdowns on markets is the failure of the attempts to close the general markets. The North Korean government announced a measure to convert the general markets back into the farmers' markets in January 2009, but out of fear over resistance by the public, was compelled to withdraw it.

The currency reform, a stronger market-restricting measure, was not strong enough to contain marketization. Nevertheless, the reform greatly reduced the volume of currency in circulation, and thereby sharply restricted transactions in the markets. However, the upshot to this was sharp hikes in the foreign exchange rate and prices. As the side effects of the currency reform, such as spurts in prices and reductions in availability of goods, became uncontrollable, the authorities started to lighten up its crackdowns on markets in early February 2010. They also began to back away from market restrictions in May the same year. Thus, the North Korean government's efforts starting in 2007 to inhibit marketization through different measures including such extreme ones as the shutdown of markets ultimately came to nothing.

Since May 2010, the markets in North Korea have been restored to their legal status, and this policy line has continued. Of course, there have been direct and indirect crackdowns and controls. For instance, during the 100-day mourning period of Kim Jong-il's death from December 17, 2011 to March 25, 2012, the restrictions on travel by people

and other activities were redoubled. This continued along the borders even after the mourning period. In October 2012, the State Security Department and Defense Security Command of the Korean People's Army together imposed censorship, and even before it was completed, censorship groups belonging to the National Defense Commission began to take control of the effort. Their censorship targeted the 'five rebellious acts that destroy socialism,' which are illegal phones, illegal videos, narcotics, smuggling, and prostitution.

Also overall social control was strengthened. In early September in 2012, each *inminban* ("people's unit"), a sort of neighborhood watch group, began checking upon the movements of its members every day. In late November, the *bunjuso*<sup>18)</sup> heads from across the nation were summoned to Pyongyang to hold a meeting on how to eradicate impure elements in 13 years. In his congratulatory message sent to the meeting, Kim Jong-un emphasized that rebellious elements should be hunted down and "ruthlessly squashed." In early November before the convention, Kim visited the State Security Department to strongly demand punishment of rebellious elements.

These restrictive measures did not directly target markets but were aimed at 'eradicating anti-socialist elements' of

18. *Bunjuso* is a unit at the bottom of the Ministry of People's Security's organization and corresponds to a South Korean police substation.

any kind, whatever they may be. Also the scope and degree of crackdowns were nothing compared to the full-scale crackdowns and control of the markets which started in 2007. Censorship of anti-socialist elements had always been in place. These measures did of course discourage the proliferation of markets to some degree, but they were not meant to directly suppress markets. The crackdowns on markets executed after May 2010 were only temporary, local, and limited.

It should be pointed out that, though the policy line since May 2010 has been tolerant toward marketization, the authorities have not adopted any new measure that could facilitate it. No measures above the level of the July 1 Measures of 2002 have been pursued.

So, why has the North Korean government not recently cracked down on markets, which it regarded as ‘hotbeds of anti-socialism’? One might wonder about the fact that it condoned or kept a loose rein on the markets at the change of regime, which is a politically very sensitive time and requires national unity more than anything else.

The livelihood of the people can provide a plausible answer. The newly launched regime faced the tremendous challenge of how to improve the people’s livelihood, which was characterized by ongoing hardship such as chronic food shortages. The government greatly emphasized the need to improve the quality of life for the people for many years but

failed to achieve concrete results. The fact that the June 28 New Economic Management Measures were considered but have not been implemented reveals that economic reform in earnest is still politically challenging, however. Turning a blind eye to market economic activities by the people for some time may not be the best solution, but is still the second best. It is a kind of desperate countermeasure to minimize the people's complaints.

The North Korean government designated 20 days from December 19, 2011 when the death of Kim Jong-il was officially announced to December 29 as a mourning period and shut down the general markets. Yet, it had to partially allow commercial activities at general markets from December 25 even before the mourning ended due to the people's great discontent about delivering and obtaining supplies of food and other necessities and sharp increases in prices and exchange rates.

A similar situation occurred in December 2012, the first anniversary of Kim Jong-il's death. The government announced on December 5 a mourning period of December 7 to 18 and prohibited use of mobile phones, drinking, gambling, entertainment, and the four ceremonial occasions of coming of age, weddings, funerals, and ancestral rites during said period. Furthermore, it banned imports of Chinese products at the customs office on the North Korean-Chinese border from the 5th. It was to blockade markets

during the mourning period. However, the suspension of Chinese imports immediately caused surges in prices and exchange rates as well as in the public's hardships. Thus, the North Korean government opened the customs office on the 10th, before the end of the mourning, being at a loss about what to do with the markets.





# DEVELOPMENT, STATUS, AND STRUCTURE OF NORTH KOREA'S MARKETIZATION

1. Foreign Dependency of Marketization
2. Rise of Monopolies and Oligopolies & Wealth Disparity due to Collusion Between Government and Businesses
3. Prolonged Marketization and Its Establishment
4. Evaluation of Marketization

# 1

## Foreign Dependency of Marketization

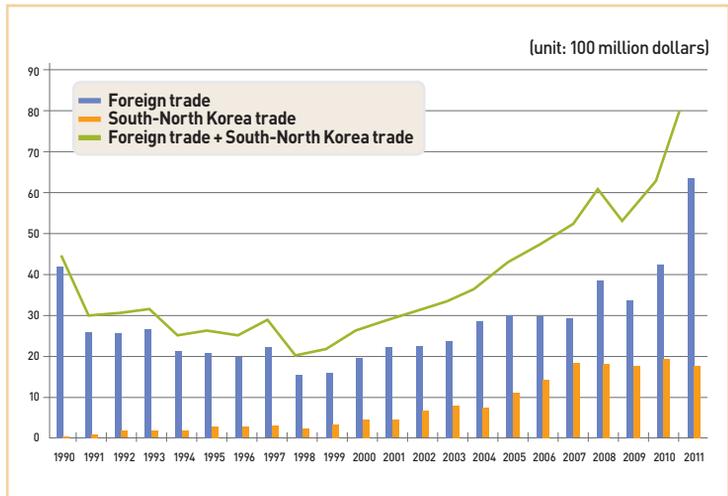
The development of markets in North Korea was due more to the development of distribution, that of foreign trade in particular, rather than that of production. Namely, the development of markets in North Korea was not accompanied by distinct increases in productive capacity. With most internal resources exhausted and the industrial infrastructure almost destroyed, the additional production stemming from expanded marketization is necessarily limited.

Geographically, consumer markets developed primarily in cities, especially border towns and large inland cities. The situation is different in rural areas<sup>19)</sup> and this has caused North Korea's marketization to deepen the nation's foreign dependency.

19. In this regard, the development of markets (consumer markets) in North Korea is clearly unlike that in China. During the early days of the economic reform in China, market development resulted from the development of production rather than that of distribution, and geographically, markets were much more established in rural villages near cities.

As seen in Figure 4, North Korea's foreign trade rose steadily since about 2000. These increases greatly promote the marketization in North Korea.

**Figure 4** Development of foreign trade and South-North Korea trade



Source: ROK Bank of Korea, ROK Ministry of Unification

The North Korean trade system today has undergone change, trade decentralization in particular, and acquired a structural trait that expedites marketization. Opportunities greatly increase where private capital and private economic activities find their way to trading companies. Trading companies compete to hire capable individuals to increase foreign currency income. Individuals are only nominally enrolled at trading companies and freely engage in trade activities under their official titles at trading companies

associated with the WPK or the military. Basically, they earn foreign currency through trade with China and other countries within a few institutional systems like wak<sup>20)</sup> or even beyond their scope, pay some of the earnings to the appropriate agencies (trading companies), and keep the remainder for themselves. Roughly put, it is private trade under the pretext of official trade.

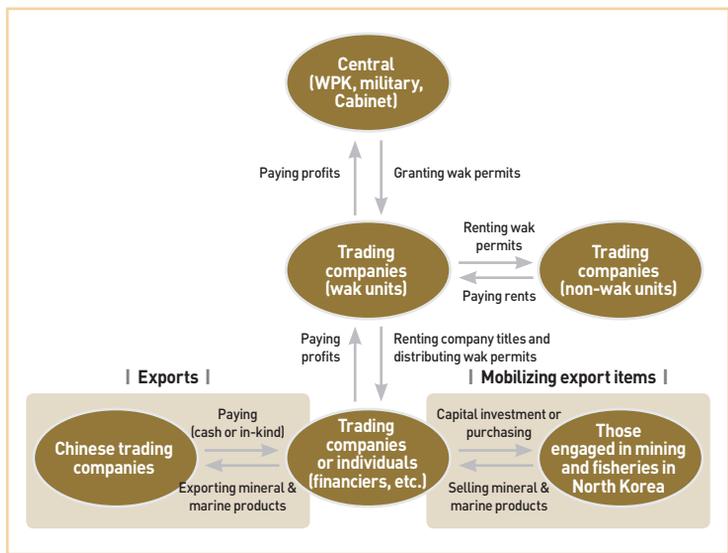
The operation of trading companies itself is now mostly conducted according to market principles. Of course, there are still regulations on trade items and prices, but the North Korean government only requires results from trading companies and does not generally question how they achieved such results. As cash flows take precedence over in-kind indexes at trading companies due to their innate character, the trading companies enjoy quite considerable autonomy. Currently in North Korea, enterprises are engaged in not only planned economic but also market economic areas, and trading companies are no exception. In fact, they interface more with market economic areas.

In Figure 5, most of the actual principal agents of trade are individuals, especially the nouveaux riche financiers. These individuals first borrow a title from a trading company with a wak permit. For instance, they are granted a job title like the

20. A wak is a kind of trade permit. It will be discussed further in the second section of this chapter.

head of A foreign currency-earning company under B trading company. Then, they marshal items to export. In the case of minerals, they visit a mine in North Korea and purchase minerals in cash or in-kind. Payment is made by funds they have or borrowed from others. Obtaining marine products is more complex. It can be a simple purchase or involve investment like farming.

**Figure 5** Correlation between foreign trade and marketization: in case of general trade



Source: Yang Mun-su, Marketization of the North Korean economy: Form, Nature, Mechanism, and Implications (Paju: Hanul, 2010), p.165.

The process where individuals, the actual agents of trade, purchase export products, export them to China and elsewhere, and earn foreign currency mainly takes place in

the realm of a market economy. Purchases of export products by individuals like financiers are unofficially made by applying market principles like market pricing.

Mineral and marine products obtained this way for export are exported to Chinese trading companies. Individuals can directly work with Chinese partners as they can borrow titles of wak-unit trading companies and be granted their own wak. Certainly, they are subject to supervision by wak-unit trading companies, their superior agencies in the export process, but this arrangement is rather nominal. What matters is whether they can submit profits in the amounts required by trading companies. Trading companies use some of these profits received for their operations and other purposes, and give the rest, which is most of their share, to their superior agencies like the central Party, the Ministry of People's Armed Forces, and the Cabinet.

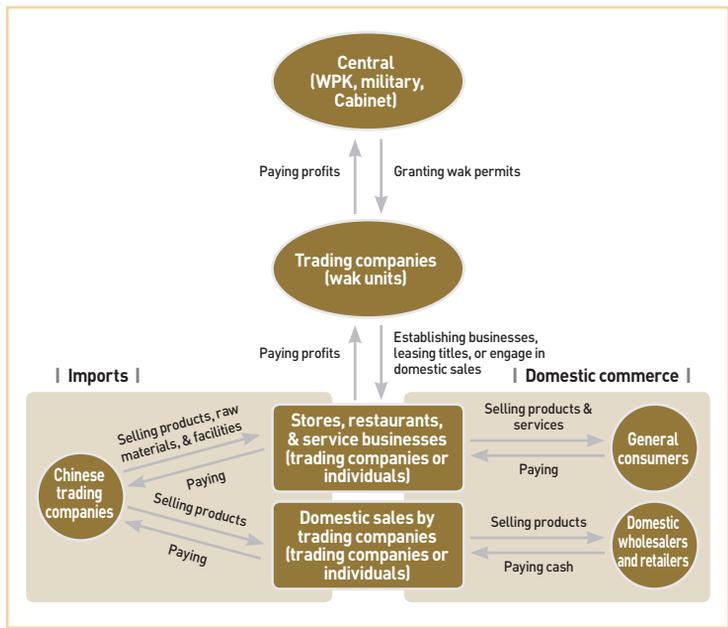
Figure 6 shows how trade is connected with domestic commerce. Trading companies belonging to the central agencies like the WPK, military, and Cabinet import products from China and sell within North Korea. This was allowed by the July 1 Measures.

Trading companies can establish service businesses like stores, restaurants (run based on agreements among interested parties), billiard halls, and Internet cafés. Trading companies can run them themselves or lease titles to individuals with

money. These stores, restaurants, and service businesses import products, raw materials, and facilities mainly from China and sell them to North Korean people. Instead of establishing these businesses, trading companies themselves can directly sell merchandise to wholesalers and retailers within North Korea.

In Figure 6, all domestic commerce falls into the realm of a market economy.

**Figure 6** Correlation between foreign trade and marketization: in case of trade connected with domestic commerce



Source: Same as that of Figure 5

Imports for domestic sale are virtually part of a market economy. Domestic and foreign currency earned this way goes all the way up to the central agencies through wak-unit trading companies. This is how foreign-currency earning in North Korea depends on a market economy.

From the perspective of individual economic agents, trade activities constitute a hierarchical system of the central agencies (WPK, military, and Cabinet), trading companies (wak units), and the lower organizations of trading companies or individuals like financiers from top to bottom. All adhere to the framework of a planned economy. However, the agents at the bottom, who are the actual agents of trade activities, work in the realm of a market economy, whether they are individuals or the lower organizations of trading companies.

When looking at the real operating system of trade activities, the top and bottom are operating as a planned economy and mostly as a market economy, respectively. Strictly speaking, the North Korean economy is officially a planned economy but actually operates as a market economy. Surpluses generated by the market economy of the lower stratum are appropriated by the planned economy of the upper stratum. In other words, the surpluses generated by the real market economy are taken by the nominal planned economy. This situation is essentially the same whether it involves special economies (WPK and military) or general economies (Cabinet).

## Rise of Monopolies and Oligopolies & Wealth Disparity due to Collusion Between Government and Businesses

As a result of the advance of marketization, wealth has naturally been accumulated and become more concentrated in fewer hands, and a rudimentary monopoly and oligopoly structure has emerged around the world. This has also been attended by increasing disparity in wealth. North Korea is no exception. With the tougher crackdown and control of markets starting in 2007, these problems are becoming more serious. The rich are indeed getting richer and the poor poorer due to the redistribution of wealth that has occurred following the 2009 currency reform.

The wak system is the key to North Korea's foreign trade. Wak are trade permits that cover both licenses and quotas.

Trade is based on permits in North Korea, but not all trading companies are granted wak permits. Only agencies regarded as important by the government, especially trading companies under powerful agencies, have wak permits. Wak permits are de facto privileges, and privileged permits inevitably incur rent-seeking behavior.

All trading companies strive to acquire wak permits. The authority that grants wak permits is not institutionally defined, and any decision on a wak is ultimately up to the supreme leader. Acquiring wak permits reportedly required heavy lobbying of those at the top of the power structure in addition to a proposal to Kim Jong-il.

The authority to grant wak permits to individual trading companies is tantamount to that to distribute resources within North Korea. To Kim Jong-il, it was an important means to direct the authorities and their members however he wanted, and to induce competition among the elite to show loyalty. Wak permits are, therefore, granted as rewards for loyalty.

Not everyone succeeds in business. If one borrowed money to start a business, he can go broke if he fails. According to North Korean defectors, many who participated in commerce after the July 1 Measures fell into this predicament. Due to the ongoing increase in so-called non-tax payments that are actually quasi-taxes, the people are plundered of any profits earned through commercial activities by the authorities and people in the middle echelons, which puts a great burden on their livelihoods.

To make things worse, the tougher crackdowns have caused the cost of doing business to rise. People can avoid being targeted in crackdowns by offering bribes, and this

has in turn increased costs and reduced profitability. Some of the people who lost their fortunes in the currency reform were forced out of the market and fell into the lowest rung of society, even becoming day laborers. Not a few of them became the so called kotjebi, a Korean term denoting homeless children, or criminals.

On the other hand, with the advance of marketization, upper-class merchants like financiers came to earn more money. The tougher crackdowns only facilitated wealth concentration and accumulation. In other words, the financiers were beneficiaries of crackdowns in that the crackdowns suppressed their competitors and helped them consolidate their monopolistic and oligopolistic status. The currency reform had the same effect.

The crackdowns also had an effect on the powerful represented by those belonging to the central Party, Ministry of People's Armed Forces, Ministry of People's Security, State Security Department, and Public Prosecutor's Office. Taking a step further being simply bribe-takers, they collude with financiers or enter into business themselves. More accurately, it was not they but their families including spouses, parents, brothers, sisters, and other relatives who entered business. They had been involved in market activities before the crackdowns, which placed them in a prominent position in the markets.

Conducive to the trends toward monopoly and oligopoly and increasing wealth disparity is the existence of home phones (for long-distance calls) and mobile phones. Rich people can afford to have phones installed, and they earn more money with them. Free access to phones is an overwhelming advantage in gaining information on the supply of goods in different regions and differences in their prices. Those with means of transportation in addition to phone access can dominate the market as movement of goods between different locations is no restriction to them. Because the installation of phones is so costly, the better-off who can afford them gain greater advantage and can earn even more money. Those at the authorities have free access to phones while restricting phone use by the general public, so they enjoy a dominant position in the market.

Through the above process, the collusion between those with money and power has escalated. Through the collusion between those in government and business, the rich-get-richer and the poor-get-poorer has increasingly become ossified, for the following three reasons:

Firstly, despite the partial legalization of markets, the overall degree of market institutionalization remains low. Legal and illegal elements are mixed up in market economic activities, and their boundaries are vague. Consequently, the logic of law and institutions does not apply to the interpretation and determination of the illegality of certain market economic

activities: rather, the logic of might makes right prevails instead. Judicial authorities and other powerful entities like the WPK and military can intervene and arbitrarily interpret what constitutes illegality, but no one in North Korea can argue about the legality of acts by the powerful, leaving them free to engage in market economic activities as they please. The ground is ripe for corruption and graft by the powerful.

Secondly, North Korea has suffered a financial crunch. Even the powerful entities like judicial authorities, the WPK, and the military are ready to launch into market economic activities for personal interests under the pretext of pursuing the public interest (raising money for agency operation) when the government cannot properly fund them.

Thirdly, the anti-marketization policy represented by physical crackdowns on the markets has served as an entry barrier to the markets by enabling monopolization of information and physical and financial restrictions on competitors. Ironically, the fruits of this rudimentary monopoly and oligopoly system in the markets are enjoyed by the powerful, who are behind the anti-marketization policy.

# 3

## Prolonged Marketization and Its Establishment

The economic crisis in North Korean has been extremely prolonged, but marketization has slowly taken hold over more than 20 years. The markets have become integral to the operation of the North Korean economy as well as to the livelihoods of the people. It can be said that they have taken root as a system to some degree. With the prolonged marketization, the people had more opportunities to learn about markets and how they operate and are now increasingly adapted to them.

As discussed above, with the advance of marketization, the interrelationship of the consumer, industrial, financial, and labor markets has only intensified, and they facilitate each other's growth through interactions. The advance of marketization interlocks with different conditions of market development. One of particular interest is the advance of commercialization and monetization. North Korea's monetization is characterized by its dependence on

dollarization.<sup>21)</sup> Other conditions for market development in North Korea include the development of transportation and communications and the establishment of laws and institutions.

The advance of marketization in North Korea has also brought about change to ownership, though very limited. Above all, it has caused the expansion of cottage industries. With more opportunities for private capital to advance into service businesses like stores, restaurants, billiard halls, and karaoke bars, small private service businesses are growing, too. At the same time, more and more private capital is being invested into the official sector of factories, trading companies, stores, restaurants, and the like.

As a consequence, the government has become more dependent on the market. All sectors including the WPK, military and Cabinet depend on surpluses from the markets in various ways to make up for budget shortfalls. It is no exaggeration to say that even the government cannot survive without the markets.

21. Dollarization means adopting foreign currencies for domestic circulation. Not only the US dollar but other foreign currencies are used including the euro, but because the US dollar is so widely used and is the world's reserve currency, the use of all kinds of foreign currency is called dollarization. In North Korea, this refers to the people's avoidance of the local currency, the North Korean won, and preference for the US dollar as well as replacement of the local currency with foreign currencies to some degree: Gresham's law holds firmly in North Korea. Dollarization in North Korea involves the US dollar and the Chinese yuan concurrently.

Certainly, this situation has been induced by the North Korean government. It rewrote the mechanism by officially recognizing market activities through the July 1 Measures and enabling the national and planned economies to appropriate the surpluses of the market economy. It absorbs the surpluses as fiscal revenue to meet the shortfalls in fiscal revenues.

What is noteworthy here is that it is not only the government budget that absorbs the surpluses of the market economic areas. The currency earnings of privileged economies such as WPK and military economies fall under this category as well. The surpluses generated through market activities by trading companies in particular are more likely to be appropriated by privileged economies than general economies. Under the North Korean economy, which is currently divided into privileged economies and general economies, the Cabinet economy raises nearly all fiscal revenues and the privileged economies are not directly involved.

The economies of the WPK, military and Cabinet use their earnings from the market economic sectors to sustain the public institutions and state-owned companies under their jurisdictions and the livelihoods of their members. This is a situation where 'the state survives by being parasitic on markets.' This is enabled by a variety of dues to the government and usage fees that have been introduced or revamped since the July 1 Measures, or further, the legalization of general markets. In other words, the North

Korean government meant to secure necessary finances by actively identifying new sources of tax revenue (refer to Table 3).

**Table 3** The government's dependency on markets: Types of taxes connected with markets

Classification	Direct payers of taxes	Actual parties that pay taxes	Connection between taxes and markets
Profits payable to the government by factories & enterprises	Factories & enterprises	Factories, enterprises & consumers	Earned income (unplanned production and distribution)
Usage fees and dues to the government for general markets	Merchants with stands in general market	Merchants, cottage industries, & consumers	Selling goods in general markets
Dues to the government by service businesses	Service businesses like consignment-based purchase stores, agreement-based restaurants, billiard halls, & karaoke bars	Service businesses & consumers	Selling services to the general public
Profits earned by trading companies	Trading companies	Trading companies, agencies, enterprises, domestic distributors, consumers	Domestically purchasing export products and selling imports
Farm rents & real estate usage fees	Agencies, enterprises, cooperatives, & individuals	Agencies, enterprises, cooperatives, & individuals	Various market economic activities that use real estate like land, houses, and buildings

Source: Yang Mun-su, Marketization of the North Korean economy: Form, Nature, Mechanism, and Implications (Paju: Hanul, 2010), p.89.

# 4

## Evaluation of Marketization<sup>22)</sup>

One of the key points surrounding North Korean marketization is the degree of marketization or the scale of markets (or percentage of the market economy to the entire economy). Various academics have made attempts to estimate this, but with an absolute lack of relevant data and information, it is extremely difficult to accurately grasp the degree of North Korean marketization. The below is based on North Korean defectors' personal experience and observations and is clearly limited in that it is a subjective appraisal. Still, it is used to simply consider the degree of North Korean marketization from three perspectives: the degree of market prices applied, that of consigned management to individuals, and that of participation in the market economy.

The first is the appraisal of the degree of market prices

22. The author conducted surveys of North Korean defectors in 2005 and 2009 to find about the degree of North Korean marketization. For the results of quantitative analysis based on those surveys, refer to: Kim Byeong-yeon and Yang Mun-su, *Markets and the Government in the North Korean Economy* (Seoul: Seoul National University Press, 2012), pp.121-130.

applied. Since the economic crisis, it is often the case in North Korea that factories, enterprises, or farms autonomously sell produced goods to other factories or enterprises, markets, or individuals at market prices instead of providing them to their counterparts at government-designated prices according to government plans. The ratio of sales at market prices can shed light on the progress of marketization. According to North Korean defectors, the percentage of sales at market prices fell somewhat as a result of the market crackdowns, but it seems that the share of goods, whether produced in agriculture or industry, being sold at market prices is being steadily maintained above some certain level.

The second is the appraisal of the degree of consigned management to individuals. The number of cases of management consigned to individuals, where factories, enterprises, restaurants, or service businesses<sup>23)</sup> are explicitly leased to individuals or their operation is implicitly consigned to individuals, has greatly increased since 2000. This can be construed as de facto privatization, especially of small-scale entities.<sup>24)</sup> It seems that the percentage of consigned management has increased over time in all the areas including

23. Service businesses include bathhouses, barber shops, beauty parlors, repair shops, karaoke bars, billiard halls, and more.

24. Here privatization denotes de facto privatization rather than de jure privatization, which is legal private ownership. More specifically, it refers to management consigned to individuals. As such, small-scale privatization in North Korea is incomplete and reversible privatization.

regional industries, central industries, stores, restaurants, service businesses, and trading companies. As in any other socialist countries, it seems that in North Korea, too, small-scale privatization is much further along the way in the service industry, which engenders restaurants and stores in a broad sense, than in manufacturing.

The third is the appraisal of the degree of participation in the market economy. Though the overall degree of participation has not increased over time, it seems that the percentage of participants in different market areas has remained steady. It is believed that participation by housewives is particularly high.





# CHARACTERISTICS OF NORTH KOREA'S DUAL ECONOMIC STRUCTURE

1. Dual Economic Structure with Ambiguous Boundaries
2. Coexistence of the Planned and Market Economies
3. Supplementary and Conflicting Relations Between the Planned and Market Economies
4. The North Korean Government's Dilemma

# 1

## Dual Economic Structure with Ambiguous Boundaries

### (1) Strategy for the dual economic structure of the national economy

Since the economic crisis in the 1990s, one of the key elements of North Korea's economic policy has been building a kind of dual structure for its national economy with features of both planned and market economies. On the other hand it is that of privileged economies (WPK economy and military economy) and general economies (Cabinet economy and the people's economy). It is also that of heavy industry (war industry included) and light industry. This dual structure is only conceptual and surely harbors the risk of oversimplification, however. A dual structure does not mean two separate or independent sectors. Rather, they are intertwined and the boundaries between them are vague at many points. This is especially true in the dual structure of planned and market economies.

The national economy in North Korea was practically swept away by the economic crisis in the 1990s. The macroeconomic reproduction and cycle structures were destroyed, and the

national economy failed to maintain its integrity and instead became fragmented and segmented. It is largely divided into planned and market economies, or into four sectors of the WPK, military, Cabinet, and (unofficial) people's economies<sup>25)</sup>.

After 2000, the North Korean government attempted to formalize the dual economic structure. It began to institutionalize the dual structure strategy of the national economy. In other words, the North Korean government readjusted resources distribution based on priorities but practically abandoned its responsibility for the management of much of the national economy. It still takes responsibility for the WPK and military economies and part of the Cabinet economy, but shirks responsibility for the people's economy and some of the Cabinet economy. The former economies are still bound by the planned economy, and the latter are allowed to function as market economic areas. This is a strategy of the North Korean government for surviving a crisis in which national budget revenues were cut in half.

There are largely two ways to respond to drastic cuts in fiscal revenues. One is to equally curtail the budgets for all areas, and the other is to unequally curtail the budgets for

25. Here the people's economy refers to the totality of the economic life of individual North Koreans, which is hardly connected to the national economy. Because the national ration distribution system of food and other necessities became nominal after the economic crisis in the 1990s, people had to engage in economic activities in markets separately and on their own to gain access to such necessities. These activities in the aggregate are referred to as the people's economy.

them. North Korea took the second option. In response to the economic crisis, it reorganized the resources allocation system based on the so-called order of priority. Indeed, these priorities had existed before the economic crisis.

The North Korean government kept key enterprises and industries within the framework of the nation's planned economy, or more precisely, tightened its grip on them by issuing direct instructions and through compulsion in a way that went beyond the framework of a planned economy. Meanwhile, it let go of other enterprises and industries by putting them in the hands of the markets. The former and latter groups of enterprises and industries are clearly distinguished from each other. The former are the nation's key industries represented by the defense and heavy industries and the latter are light industries that produce consumer goods.

At first glance, the market economy seems to be left alone or to self-rescue. Amid the economic crisis since the 1990s, the North Korean government lost considerable control of the national economy and even officially recognized this loss by shifting its responsibility for the livelihoods of the people to local and regional authorities, factories, and farms. This means that regions, factories, and farms are to take care of the livelihoods of their workers and members on their own without materials and funds from the central government, and the government will turn a blind eye if they do so through a market economic mechanism. Even the agencies

of the Cabinet, WPK, and military are required to support themselves to some degree.

On a closer view, the North Korean government did not unconditionally require self-rescue. Whether it was agencies of the WPK, military, and Cabinet or local and regional authorities, factories, and farms, it created new conditions such as much greater access to foreign trade. Namely, it reshuffled the economic structure that opened the door to different economic agents to engage in foreign trade so that they could feed themselves on their own.

The July 1 Measures signaled the formalization of this dual structure strategy. There had been such a dual structure before, but markets were still unofficial.

## **(2) Relations between the official and unofficial economies**

In the classic socialist economy of North Korea before the economic crisis in the 1990s, the official economy practically constituted a planned economy. Surely there had been illegal market economic elements like black-market dealing as well as legal market economic elements like kitchen gardens and farmers' markets, but they were only peripheral.

The North Korean socialist economy was somewhat different from those of the old Soviet Union and Eastern Europe. In the latter, ration distribution was not done for

consumer goods, which were generally available at state-owned stores for purchasing. In North Korea, especially since the 1970s, essential consumer goods including food were generally rationed out and purchases at state-owned stores were supplementary and limited.<sup>26)</sup> The official economy of North Korea was predominantly a planned economy before the economic crisis.

The situation started to change after the economic crisis: the planned economy rapidly contracted and marketization began to spread. Nevertheless, the markets remained illegal until before the July 1 Measures, so the economy was still officially considered a planned economy. The markets gradually expanded in the unofficial economy, and the gaps between the official and unofficial economies and between the official institution and reality steadily widened.

After the markets were partially legalized and formalized through the July 1 Measures, the situation took a completely different turn in the 2000s. Now, the official economy came to encompass both planned and market economies. As markets are only partially legalized, the former actually has greater weight in the official economy than the latter.

The North Korean government was able to narrow the gap

26. The people purchased most necessities except for food at state-owned stores. Still, the prices and quantities of purchases at those stores were prefixed, so that they were far from markets, unlike stores in the Soviet Union and Eastern Europe.

between the official and unofficial economies through the July 1 Measures. Even so, marketization rapidly progressed afterwards, and no more so than in the unofficial economy. It spread widely, far beyond the legalized bounds. For instance, the July 1 Measures legalized only some industrial markets including consumer markets represented by general markets, and socialist barter markets. In fact, financial and labor markets also greatly progressed but remain illegal. Also, small-scale retail businesses like merchants with stands in general markets are legalized, but not large-scale wholesale businesses. This is causing the gap between the official and unofficial economies to widen still further.

The official and unofficial economies partially overlap. This will be looked into in greater depth later. For example, factories and enterprises in the official economy fill orders for contract processing from individuals and receive payments (unofficial economic activities). These payments are used to execute government plans (official economic activities) or satisfy officers' private interests (unofficial economic activities).

There are also many cases where the boundaries between the official and unofficial economies are ambiguous.<sup>27)</sup> In the above example, it is unclear whether, when payments for

27. For more details on the overlaps and vague boundaries between the official and unofficial economies, refer to: Choi Bong-dae, "Implementational Implication of the Activation of North Korea's Unofficial Economy since the Late 1990s," Yun Dae-gyu, ed., *Transition Course of the North Korean Regime and Development Conditions* (Paju: Hanul, 2008).

contract processing are used for the welfare of the employees of factories and enterprises, such economic activities should be classified as belonging to the official or unofficial economy. This is also an issue with August 3rd workers, who are widely deployed at factories and enterprises. August 3rd workers are those who do not regularly go to work and instead freely engage in commercial activities in exchange for monthly cash payments of a certain amount to the factories or enterprises where they belong. Factories and enterprises can use this cash to carry out government plans, for the welfare of workers, or to satisfy officers' private interests. This case clearly shows that the official and unofficial economies can become deeply entangled in many complex ways.

After the July 1 Measures, the overlaps and vague boundaries between the official and unofficial economies became even more extensive. For example, contract processing outsourced to factories and enterprises and the number of August 3 workers considerably increased. The entanglement between the two is more readily apparent at trading companies than at factories and enterprises.

### (3) Theories of segmented and fragmented economies

How can the North Korean economic system be conceptualized after the economic crisis of the 1990s? It should be seen as being in a long, complex transition of a sort where the classic

socialist economy collapsed but its replacement has not yet fully emerged.

The vacuums of the planned economy are being filled by non-planned economic activities of various forms. The cycle of the national economy was destroyed, so individual economic agents are moving forward on their own initiative or in units for survival. Last but not least, the “suryeong (supreme leader)-centered economy” and privileged economies have become even much more bloated compared to their counterparts in other countries.

The academic community at home and abroad has tried to build a conceptual framework to understand the North Korean economic situation, and as a result, has arrived at some degree of agreement, which is that it is characterized by segments, fragments, or zones. The North Korean economy is not a cohesive national economy in a general sense but an economy consisting of relatively independent segments, zones, and blocks. This character became even more pronounced after 2000.

This segment theory is similar to yet different from the theory of coexistence of planned and market economies that appear in the period of reform and opening or transformation of a state mechanism in a socialist economy. Most of the advocates of this segmentation theory emphasize that the North Korean economy after the economic crisis cannot be sufficiently explained by the traditional concepts of planned and market economies and, instead, requires new concepts.

It has been suggested that the North Korean economy is not a dual structure of planned and market economies but that of the official economy and the “court economy” that revolves around the dynastic Kim family; that of the court economy and the people’s economy; and that of the suryeong economy and the official economy. Studies have also been done about more segments: a triple structure has been suggested of the people’s, privileged, and market economies; the WPK, military, and national economies; and revolutionary funds, special units, and the people’s economy.

Also suggested is a quadruple structure of the first (people’s), second (military), third (WPK), and fourth (unofficial) economies; the court, military, civilian, and underground economies; the mobilized economy, privileged planned economy, general planned economy under the Cabinet’s jurisdiction, and market economic activities. There is even a study that suggests seven segments of the Kim Jong-il economy, ‘corporate’ economy of government agencies, Cabinet economy (planned economy), second economy (privileged planned economy), mobilized and supported economy, agricultural cooperative economy, and semi-market (black-market) economy.<sup>28)</sup>

28. The following provides the most information on the theories of segmented and fragmented economies in domestic academia: Park Hyeong-jung, “North Korean Economy as a Hybrid of the Past and Future: Segmentation of the Economy in Seven Semi-Independent Compartments Based on the Diversification of Surplus Occupation and the Economic Coordination Mechanism,” *Korean Association of North Korean Studies Journal*, Vol.13, No.1 (2009)

These concepts of segmentation and fragmentation clearly facilitate a better understanding of the reality of North Korea, which cannot be properly explained by the conventional dual structure of planned and market economies. Still, there is a point to make.

The degree of independence of each segment, especially their relevancy to the market economy, should be considered. For instance, are segments like the privileged, suryeong, court, WPK, and military economies independent from and in conflict with the market economy? Or are they relevant? If so, how relevant?

The major driving forces of the privileged, suryeong, and other such economies are foreign trade and foreign currency. This was so in the 1990s and even more so after 2000. As seen above, the hierarchical structure of foreign trade has markets at the bottom. As such, those economies are not in confrontation with or separate from the market economy. Rather, they are tightly connected with each other.<sup>29)</sup>

29. Hong Min makes a very interesting argument on the relationship between privileged economies and the market economy. According to him, privileged economies are not in conflict with markets but rather consist of 'market forces' that facilitate markets. Privileged economies are helping internalize the market economy, and they are never distinctively separable. He also argues that the existing theories of segmented and fragmented economies may be helpful in explaining this but be detrimental to seeing the overall picture and understanding the true nature. Refer to: Hong Min, "Status Review of Studies of the North Korean Economy: Centering on the Suryeong-Centered Economy and Market Forces," KDI Review of the North Korean Economy, January 2012 issue.

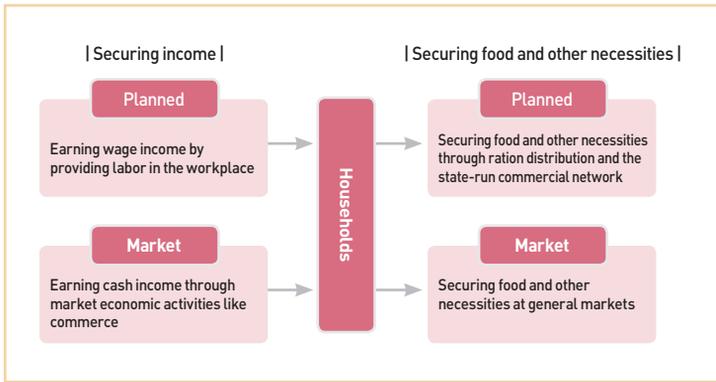
The point here is that when segmented and fragmented economies are used as concepts to understand the North Korean economic system after 2000, their relevancy to the market economy must be considered.

## Coexistence of the Planned and Market Economies

Then in which form do the planned and market economies coexist? They exist in too many forms to all be mentioned in this paper. Only representative forms are described here.

Households are the main agents of consumption, and as seen in Figure 7, they can use the planned and market economies to secure income and food and other necessities. Households can earn wage income by providing labor at their workplaces in the planned economy, or earn cash income through market economic activities like commerce in the market economy. On the other hand, they can secure food and other necessities with the earned income through ration distribution and at state-owned stores of the planned economy, or do the same in general markets of the market economy. The percentages that the planned and market economies account for in the processes of earning income and securing food and other necessities vary across households, but the percentage of the planned economy must be higher in elite households and that of the market economy higher in general households.

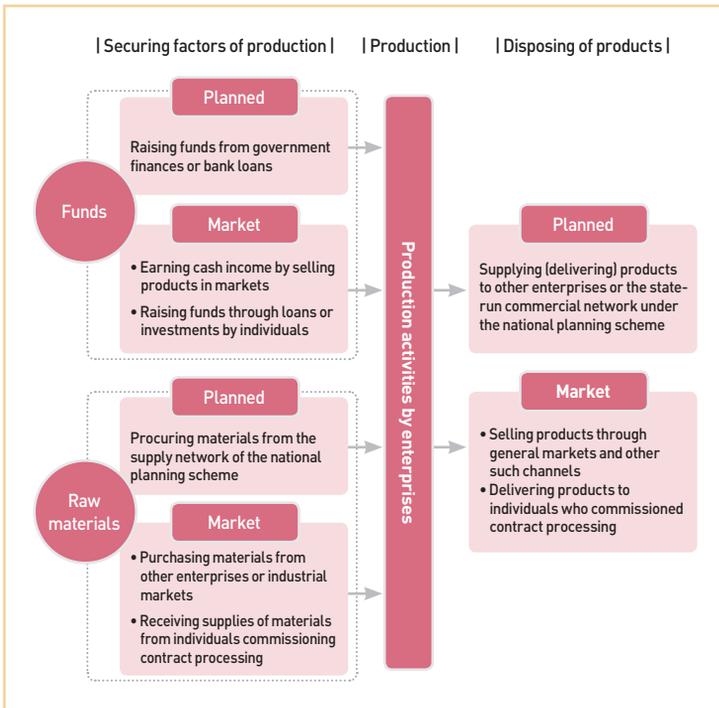
**Figure 7** Coexistence of the planned and market economies: from the perspective of households



Enterprises are the main agents of production, and as seen in Figure 8, they can secure factors of production and dispose of products in both the planned and market economies. Enterprises can raise funds from government finances and banks in the planned economy, or in the market economy, they can earn cash income by selling products in markets or raise funds through loans or investments by individuals like financiers. They can procure materials from the supply network of the national planning scheme in the planned economy, or in the market economy, they can purchase materials from other enterprise or industrial markets or receive supplies of materials from individuals who commission contract processing. They produce products with these funds and materials and deliver such products to other enterprises or the state-run commercial network under the national planning scheme in the planned economy, or

in the market economy, they sell them in general markets or deliver them to individuals who commissioned contract processing. The percentages that the planned and market economies account for in the processes of securing factors of production and disposing of products vary across enterprises. The percentage of the planned economy must be higher at enterprises considered more important and of higher priority to the national economy, and that of the market economy must be higher at those of lower priority.

**Figure 8** Coexistence of the planned and market economies: from the perspective of enterprises



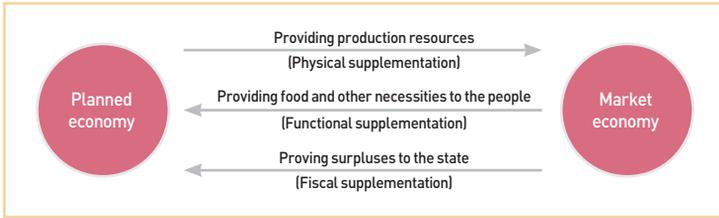
# 3

## Supplementary and Conflicting Relations Between the Planned and Market Economies

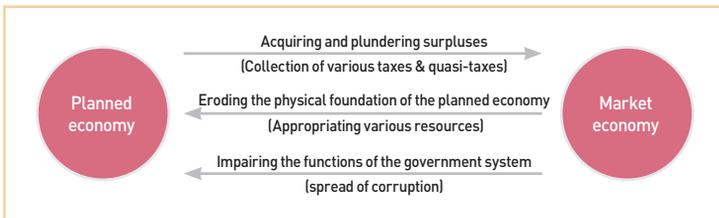
It is very difficult to sum up the relations between the planned and market economies in North Korea. Above all, they overlap with each other and the boundaries are ambiguous. Let us describe their basic relations despite the risk of oversimplification.

Most importantly, they supplement and oppose each other at the same time. They have both supplementary and conflicting (substitutive) aspects (refer to Figures 9 and 10). The market economy depends on the planned economy for a considerable part of its physical foundation. It secures its production basis by appropriating facilities, raw materials, parts, electricity, etc. from the planned economy. Instead, the market economy supplies food and other necessities to the people, a task the planned economy fails to do, and thereby supplements the planned economy. For its part, the planned economy absorbs the surpluses of the market economy as taxes and quasi-taxes to bolster its fiscal condition.

**Figure 9** Relations between the planned and market economies: supplementary aspects



**Figure 10** Relations between the planned and market economies: conflicting aspects



A considerable portion of economic surpluses the market economy generates is plundered by the planned economy, so it naturally has far less wherewithal to further expand. It does not have a structure by which it can accumulate its surpluses.

The planned economy has an even more serious problem: so many different kinds of its resources are appropriated that its physical foundation is encroached upon. One would expect the planned economy to be profitable since it does not provide any resources but only plunders the market economy of its economic surpluses. However, the profits it gains are offset by the encroachment upon its foundation. Surpluses from the market economy are reinvested in the planned economy and

used for productive activities, but they are more likely to be used for consumptive activities. This is more the case when the surplus is leaked from the public domain to the private domain. The planned economy may not be viable after all.

The spread of corruption resulting from the advance of marketization has also had a deleterious effect on the planned economy. It hinders the workings of the overall government system where instructions are handed down top to bottom and carried out, and it has increasingly caused private interests to assume precedence over the public interest, indirectly tearing down the planned economy.

For now, it is difficult to determine which of the complementary forces or conflicting forces of the two economies are greater. Also difficult is to know whether the positive effects of the market economy on the planned economy outweigh its corrosive effects on the latter. When considering not only purely economic aspects but also social and political aspects, however, the two economies conflict more with each other than support each other. More than supporting the planned economy, the market economy is eroding it away. When looking at the qualitative change of the market, not its quantitative expansion, the rising disparity in wealth due to the cozy relations between government and business is likely to exacerbate the political and societal instability. The spread of corruption, and furthermore, the rise in crime, are likely to damage the functions of the government systems. The

situation in the future can be extrapolated to some degree; the only difficulty is knowing how fast the trends and events will unfold.

# 4

## The North Korean Government's Dilemma

The North Korean government has a fundamental dilemma. There is the need to adopt marketization to revive the economy. The foundation of the planned economy broke down and domestic resources are depleted. The state can no longer sustain the livelihoods of the population, so it has no choice but to tap the power of the market economy.<sup>30)</sup>

At the same time, the advance of marketization creates risks of political instability. It poses a formidable challenge and risk to the existing political and social order. It promotes individualism and Mammonism, widens the gap between the rich and the poor, and shakes society to its foundation. Marketization can lead to questions about the prevailing political order. The developments during the few years after the July 1 Measures confirmed the concerns of the North Korean leadership. The criticism by Kim Jong-il that “markets

30. Marketization alone is not enough to restore and rebuild the economy. Marketization is an institutional condition, and physical and fiscal conditions should also be met to the end. In this sense, marketization is only a necessary but insufficient condition for economic recovery and reconstruction.

are hotbeds of anti-socialism” was not an exaggeration. In fact, the North Korean government introduced the July 1 Measures in 2002 to accept marketization, but with the sense of crisis felt by the leadership, reverted to restricting marketization.

As a result, the North Korean government faces a dilemma where it has to both accommodate and restrict marketization. What they aim for is manageable marketization: they allow marketization to a certain degree and restrict it when it goes beyond what they consider acceptable limits. The degree is determined according to political judgments by the North Korean government about the side effects of marketization.

The problem is whether the North Korean government can manage marketization or whether markets can be held back within the manageable scope. For now, this seems to be a daunting task. It began to crack down hard upon the markets in 2007 and even employed the drastic measure of currency reform in late 2009, but this failed to curb them. In May 2010, it went back to allowing markets again.

Now, let us talk about the means by which marketization could be managed. This line of inquiry renders the challenge before the North Korean government especially clear: the government does not have other means of control than physical crackdowns. Physical crackdowns have temporary and partial effects but are not a fundamental solution. This is of tremendous concern to the government, for without

the expansion of the supply capabilities of the planned economy, there is no effective way that it can hope to manage marketization.<sup>31)</sup>

31. From the perspective of political science, which separates the government and the powerful, the beneficiaries of market expansion in North Korea are the powerful, especially trading companies of privileged economies, which makes powerful people the greatest beneficiaries of marketization. For a representative study in this light, refer to: Park Hyeong-jung, "Towards a Political Analysis of Markets in North Korea," Korean Political Science Association Journal, Vol.46, No.5 (2012). The author largely concurs. In consideration of the possibility that the powerful, who outwardly strongly criticize the anti-socialistic aspects of marketization, can be the biggest beneficiaries of marketization, it can be presumed that the North Korean government must achieve a very complex, delicate balancing act in its handling of marketization.





# Future of North Korea's Dual Economic Structure

1. Elements that Spread and Restrain Marketization in North Korea
2. Future Prospects for Marketization in North Korea

# 1

## Elements that Spread and Restrain Marketization in North Korea

To make a reasonable prediction about North Korean marketization, let us briefly look at the elements that spread and restrain it.

First, look at the elements that facilitate marketization. The North Korean government could not hope to reverse it, even if it intended to. It has limited latitude to restrict marketization, primarily because of the collapse of the physical and functional foundation of the planned economy. There are many reasons for the creation and development of markets in North Korea, and the most important one is the de facto collapse of the planned economy. It can be said that the needs left unfilled by the planned economy were naturally met by the market economy. The government made great efforts to curb markets in 2007 and afterwards, but ultimately failed. The government has actually become more and more dependent on markets as marketization has progressed.

Marketization has also been extracted over a period of about 20 years. In North Korea, markets have taken root as

indispensable in the operation of its economy, especially in the daily lives of the people. The markets are not yet completely stable, but the need for them is undeniable. They have taken root as a system to some degree: they are here to stay.

Considering these facts, marketization can be expected to continue, but this constitutes only one aspect of the situation. Elements that prevent the rapid contraction of the planned economy should be considered, too. The government's direct control of certain resources like food and energy alone can prevent the planned economy from contracting below a certain threshold.

Furthermore, North Korean marketization has limits in terms of self-development and expansion. Other socialist countries also experience limits in the expansion of marketization, but the limits are more serious in North Korea. First, North Korean marketization has been progressing under extreme political instability at home and abroad, represented by the three-generation dynasty of leadership and tension in foreign relations, especially with the US. Second, the development of markets in North Korea depends on the development of distribution, especially that of trade when internal resources have dwindled away. Namely, its market development is not accompanied by the noticeable expansion of productive capacity. In addition, surpluses generated in the market economy are plundered heavily by the government or the leadership and middle-ranking officials in the form of

taxes and quasi-taxes. This renders internal accumulation of surpluses difficult, to say the least.

Nevertheless, with the advance of marketization, the physical foundation of the planned economy is further weakening. Resources that can be directly held by the government are also gradually diminishing. This is because marketization has encouraged individuals and enterprises to appropriate state assets, thereby eroding the physical foundation of the planned economy. What is more, the spread of corruption further weakens the planned economy's very ability to function.

## Future Prospects for Marketization in North Korea

The North Korean government has a fundamental dilemma about markets. It needs to incorporate and activate markets within the institutional system for the economy but is concerned that activated markets pose an existential threat to it. Faced with the dilemma to both restrict and allow markets, it chose to allow markets for nearly three years, from May 2010 to 2013. During the time of dynastic power transfer, this was a desperate measure to appease the people and improve their lives.

There is yet another issue. The North Korean government is not sure that it will be able to close markets now even if it intended to. All sorts of attempts to disallow markets from 2007 to 2009 failed. The economic crisis has become protracted, and marketization inexorably persists. Now, the North Korean economy without markets is unimaginable.

There is no guarantee that the current policy of tolerating or keeping a loose rein on the markets will continue indefinitely. Looking back at the last 20 years, it is obvious the North Korean government has continually vacillated in its position

on markets. It has gone back and forth between allowing and restricting markets depending on the circumstances. At some point, the restrictions largely lost their effectiveness, but the North Korean leadership has certainly not shaken off its understanding that markets are ‘hotbeds of anti-socialism.’ Alas, from the leadership’s point of view, they have no other option: they are not likely to suddenly reverse their policy of tolerance or permissiveness that has been in place since May 2010.

Looking at the 20 years’ history after the economic crisis reveals that the market and planned economies have largely coexisted with the former expanding itself and constricting the latter. What does the future hold? Under the current conditions, the possibility of the planned economy being restored to its former glory and the market economy rapidly contracting is virtually zero. It is more likely that, for the time being, the market and planned economies will persist in an uneasy coexistence and that the former will ultimately replace the latter entirely.

What cannot be known is how quickly marketization will proceed. The possibility of the market economy rapidly expanding or the planned economy rapidly contracting is slim. The situation will progress slowly for some time. If the scope of accommodating marketization within the official system increases, marketization may accelerate. In this light, the full-swing implementation of the June 28 New Economic Management Measures is of great interest.



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