

Transformation of the DPRK Socio-Economic System as a Factor in the Peaceful Settlement of the Nuclear Crisis on the Korean Peninsula ¹

The crisis caused by the DPRK's nuclear and missile programs remains one of the most significant global security threats. In this context, the Korean Peninsula was mentioned in the National Security Strategy of the Russian Federation (approved by Presidential Decree No. 683 on December 31, 2015). The common border between Russia and North Korea enhances the importance of this region in comparison with the Middle East and South America, and the real threat of a nuclear war in the Asia-Pacific region requires Moscow's participation in the crisis settlement and prompt reaction to the quickly changing situation.

Historical reference: from 2006 to 2017 North Korea conducted 6 nuclear tests, incorporating a provision on its nuclear status in the Constitution in 2012. After President D.Trump came to power in the United States the tense military and political situation on the Korean Peninsula escalated significantly, putting the region on the brink of war and forcing Russia and China to step up their efforts on finding a peaceful solution.

In response to Pyongyang's missile and nuclear tests, in 2017 the UN Security Council imposed tough sanctions against various sectors of the North Korean economic complex, seriously limiting the possibilities of foreign economic relations. This significantly worsened the conditions for the economic development of the DPRK, forcing the country's leadership to start putting efforts to relieve the sanctions pressure.

In 2018 the situation around the Korean Peninsula improved as the dialogue on resolving the nuclear issue resumed, the Sino-DPRK and ROK-DPRK relations became warmer, and the first US-North Korean summit took place. Russia suggested the UN Security Council to consider relaxing sanctions in response to Pyongyang's first measures on denuclearization. The Republic of Korea opened a liaison office in the DPRK and began preparations for reconnecting inter-Korean railroads, which required specially approved exemptions from the international sanctions regime.

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Expecting a restoration of external economic cooperation, Kim Jong-un announced a change in the country's strategic course. Since 2013, the efforts of North Koreans were officially aimed at "parallel economic construction and building of nuclear armed forces". In April 2018 Kim Jong-un declared successful implementation of the second task and put forward a new strategic line - to concentrate all efforts on economic construction². However, the country's leadership has not yet taken any radical economic decisions, probably hoping to utilize external factors.

Model of the modern DPRK economy

Socialist and capitalist institutions and principles coexist in the modern DPRK economy. The first ones are represented by the remaining social ownership of the means of production, administrative principles of planned production, public distribution system (in a significantly reduced form), non-material incentives (for example, mass mobilization campaigns under ideological slogans). Capitalist elements are widespread in the form of market relations, independent organization of production including attraction of private investment, as well as production processes aimed at extracting profit and including material incentives for workers. At the macro level, the modern DPRK economy can be divided into several key spheres depending on the prevailing management mechanism (central planning or market relations) and the basis for decision-making by business entities (government directives or private initiative based on the search for material gain).

The first sphere includes the military-industrial complex managed by the state and based on socialist principles. The public rationing system has been largely preserved for its employees. Planned targets and production materials are supplied for enterprises by the state. At the same time, according to some data, the decentralization processes have begun in this sphere, for example, with the functioning of commercial firms related to arms export³.

² Korea Today. №5, 2018. P.15

³ Post-socialist world: transformation results. Saint-Petersburg: Aletheia, 2018. Volume 3. Asian reform models. Opportunities and challenges for Russia / ed. by G. Toloraya. P. 123 (in Russian)

The second sphere of this model is the civil economy which combines planning and market principles in its operation. It can be divided into several sectors:

- agriculture (agricultural cooperatives) combining administrative management methods with partial autonomy in economic activity and existence of material incentives;
- large industrial plants and infrastructure facilities, including power plants and large irrigation systems, which are under state management and financing⁴;
- medium-size and small enterprises producing consumer goods. Many private, cooperative and mixed forms of business, often characterized by an independent organization of supply and sales (after the implementation of the plan, if any)⁵;
- services which include public services (education, healthcare, etc.) and commercial services, i.e. wholesale and retail trade, restaurants, commercial transportation, tourism, financial services, etc. The market services sector has been booming in recent years, while, according to South Korean estimates, the share of government services in North Korea's GDP is 2.5 times more than non-state ones⁶.

The third sphere includes special economic zones operating on capitalist principles with the attraction of foreign capital. Among them are Rason, Kumgansan (until 2008) and Kaeson (until 2016), and also potentially - economic development zones which were set up in 2013 throughout the country.

The institutional basis of the DPRK's economic system has not changed much as it retains public ownership of the means of production. More changes have occurred in the management mechanism, as planning is in essence combined with

⁴ Ibid.

⁵ Uneasy neighborhood. Problems of the Korean Peninsula and challenges to Russia: monograph / ed. by G. Toloraya. Moscow: MGIMO-University, 2015. P.62 (In Russian).

⁶ The Bank of Korea. Gross Domestic Product Estimates for North Korea in 2017. Press Release. 20.07.2018

independent (within the limits of available resources or the possibilities of obtaining them) decisions of enterprises and households.

The country's leadership under Kim Jong-un is actively using people's market activity to extract profits and achieve economic growth, essentially encouraging the continued use of capitalist business methods in areas where government resources are scarce. The planned and market sectors are merging and co-existing, sometimes in the form of symbiosis. However, the domestic resources of the DPRK are not enough to provide the necessary investments in the modernization of infrastructure, energy and production facilities, as well as to fully meet the needs of the population. Therefore, the North Korean leadership continues to seek an expansion of foreign economic relations through the development of trade and using the SEZ tool. Thus, the very structure of the modern North Korean economy has the potential to transform it along the path of expanding the market sector, primarily in the production of consumer goods and services, as well as foreign economic cooperation.

Prospects for the transformation of the North Korean socio-economic system

The key factors effecting the evolution of the North Korean socio-economic system in a peaceful environment in the medium and long term are internal (economic policy of the leadership) and external (foreign countries' position on the development of economic relations with the DPRK - sanctions or cooperation). 4 possible scenarios can be constructed depending on the combination of these factors.

In scenario 1 both internal and external factors encourage further market reforms, up to partial privatization. As a result, the structure of the North Korean economy would change due to a rapid increase in the market sector of agriculture, industry and services (with the possibility of partial transition of state-planned sector to the capitalist principles of operation). The role of special economic zones would also significantly increase both quantitatively and qualitatively. At the same time, foreign economic cooperation could speed up the changes (through the

mechanism of the SEZ) with the prospect of integrating the DPRK into regional economic projects.

Internal factor	Encouraging market activity, market reforms	Tightening state control, cracking down on market activity
External factor	Scenario 1	Scenario 2
Reduced sanctions, expanding international economic cooperation, attracting foreign direct investment into the DPRK	Scenario 1	Scenario 2
Increased economic sanctions, economic isolation of the DPRK	Scenario 3	Scenario 4

Given the current level of the UN Security Council sanctions against the DPRK, the development of such a scenario in the near future seems unlikely. However, it is the favorable external conditions that the North Korean leadership needs to carry out market reforms in the country. For several decades experts have been talking about the importance of such reforms, pointing to the example of China (or Vietnam). However, applicability of the Chinese experience for the DPRK is limited. Unlike the PRC, which population at the beginning of “reform and opening up” was mainly occupied in agriculture (83.3% of the labor force⁷), only about 36% of the economically active population is employed in agriculture in North Korea⁸. Therefore, reforms of the economic system in the DPRK cannot start from the agricultural sector to the extent that it was in China. Moreover, the DPRK agriculture significantly depends on industrial inputs, such as fertilizers and electricity for irrigation. Therefore, it is the large industrial sector that would have

⁷ Pivovarova E.P. Socialism with Chinese characteristics. Moscow: Publishing House "FORUM", 2011. P.71 (in Russian)

⁸ DPR Korea 2008 Population Census National Report. Central Bureau of Statistics, Pyongyang, DPR Korea, 2009. P.195

to become the locomotive of the transformation process of the entire economic system pulling up the service sector⁹.

The growth of the DPRK civilian economy in recent years is thought to have been caused not only by budgetary allocations, but also by the activities of North Korean-style “chaebols”, which are diversified conglomerates consisting of enterprises from various spheres (from production to services) connected to government or even military structures. The DPRK leadership could use elements of the South Korean model of catch-up development, which combined state planning with the creation of conditions for the growth of large-scale private business. At the same time, foreign economic cooperation would be crucial to the successful implementation of such reforms.

Scenario 2 is theoretically possible, but in a short period (with the transition to scenario 4). For example, if the DPRK succeeded in getting the sanctions eased and expanding foreign economic cooperation, but to maintain internal stability (preserve the current political system), the leadership would decide to curtail market reforms and strengthen state control over society and the economy. This would quickly lead to new sanctions and an outflow of foreign capital, leaving the DPRK in an economic isolation. The structure of the DPRK economy in this case might lose important market elements of development (for example, in agriculture, collective farmers would be obliged to hand over the entire crop to the state, in industry de-facto private enterprises would be partially nationalized) and limited resources would be redirected to the state distribution channels.

Scenario 3 in a moderate version is currently unfolding. As opportunities for international economic cooperation and attracting foreign investment are limited because of severe external restrictions, the DPRK leadership encourages the development of market relations. The state benefits from them (in the form of different quasi-taxes and fees), and also uses market mechanisms to supply the

⁹ Haggard S., Noland M. *Hard Target: Sanctions, Inducements, and the Case of North Korea*. Stanford, California: Stanford University Press, 2017. P.235

planned sector and achieve economic growth¹⁰. However, with an existing external threat institutional reforms are unlikely to be carried out limiting opportunities for sustainable economic development.

At the same time, North Koreans would be forced to use different schemes (smuggling, using foreign intermediaries, etc.) and foreign trade activities not prohibited by sanctions (cryptocurrency, inbound tourism, etc.) to earn foreign currency and provide the economy with necessary goods and materials. In this scenario, the structure of the DPRK economy would not undergo significant changes in the foreseeable future. A shortage of electricity and raw materials, as well as worn-out infrastructure would still be serious obstacles to achieving sustainable economic growth¹¹.

Scenario 4 could theoretically become real as a continuation of the second or third scenario, if the DPRK leadership, having an external threat, began to perceive the growing market sector as an internal threat to the regime stability. The DPRK government has already tried to crack down on the market sector. The most radical of these attempts was the monetary reform of 2009, which effectively devalued the savings of citizens in national currency¹². Its unintended result was the increased use of foreign currencies in the informal sector of the economy and the further spread of private financial services.

At the moment, scenario 4 looks unlikely, since in unfavorable external conditions it is the market mechanisms that allow the DPRK leadership to ensure the functioning of the economy. Kim Jong-un's strategy is to balance slow economic liberalization with tightening the screws in the domestic political sphere, which allows restraining even hints of discontent from the population and the elite. The results of foreign studies show that so far the leadership of the DPRK has

¹⁰ Hong Jae Hwan. North Korean Economy in the Kim Jong-un Regime. Korea Institute for National Unification. Study Series 18-03. August 2018. P.37

¹¹ Increasing autonomy for North Korean enterprises. // Daily NK. 10.09.2018. URL: <https://www.dailynk.com/english/increasing-autonomy-for-north-korean-enterprises/> (accessed: 14.01.2019)

¹² Lankov A. The Real North Korea: Life and Politics in the Failed Stalinist Utopia. New York: Oxford University Press. 2013. P.126-129

succeeded in preventing any undesirable political consequences of the development of the market sector¹³.

To sum up, we can identify several key trends in the functioning of the DPRK economy at the present stage. On the one hand, given the state's inability to provide all the necessary resources for planned development in all sectors, the private initiative of citizens in organizing production and ensuring consumption grows in the civilian economy and services sector. Under the brand of "our method of economic managing," in which market mechanisms are used as complementary within the framework of a planned economy, North Koreans continue their search for "their own way" in reforming the economic model through careful experiments¹⁴.

The key issue that determines the future prospects for the transformation of the DPRK economy is how to provide an institutional framework for operating of de facto private (or public-private) enterprises and companies when public ownership of the means of production stays in place. A significant part of market relations in the DPRK economy is formally illegal, which leaves for the country's leadership ample opportunities to "curtail the market experiment". However, a large-scale crackdown on private capitalist elements in adverse external conditions is unlikely, as the state-planned sector largely depends on them (especially in terms of supply and domestic investment).

To increase labor productivity and expand import substitution in order to achieve self-sufficiency, the DPRK leadership relies on science and modern technologies¹⁵. However, without large investments in transport infrastructure and energy sector, it is impossible to create conditions for sustainable economic growth. There would not be enough internal resources; financial, material and technological investments from abroad are needed. Therefore, the leadership of the

¹³ Dukalskis A. North Korea's Shadow Economy: A Force for Authoritarian Resilience or Corrosion? // *Europe-Asia Studies*, 2016 68:3. P. 489

¹⁴ *Asian Neighbors of Russia: Cooperation in a Regional Context: monograph* / ed. by Georgy Toloraya; Institute of Economics RAS. Moscow: Publishing and Trading Corporation «Dashkov and Ko», 2016. P.130 (in Russian)

¹⁵ Hong Jae Hwan. *North Korean Economy...* P 24

DPRK will have to continue their efforts to find a way-out from the sanctions isolation to expand foreign economic cooperation.

The role of economic factors in the process of resolving the nuclear crisis on the Korean Peninsula

Despite the fact that the nuclear crisis on the Korean Peninsula was caused primarily by security reasons, from the very beginning, including the period of the first escalation in 1993-1994, the economic component was an integral part of any plan to solve this problem. Since the 1990s, attempts have been made to offer the DPRK economic benefits in exchange for abandoning the development of WMD. After Pyongyang's first nuclear test in 2006, the United Nations Security Council started to impose sanctions against the DPRK, while the regional actors have also been trying to negotiate an agreement with Pyongyang.

In the first 10 years of the UN Security Council sanctions regime, the range of sanctions against the DPRK has been expanded to an unprecedented scale. Restrictions affected the transport, trade, financial, scientific, educational spheres. As a result, by 2018, the DPRK was cut off from the global banking system, since banks in other countries were forbidden to maintain correspondent relations and open accounts with financial organizations of the DPRK. Exceptions were made only for bank accounts of diplomatic missions, as well as channels necessary for the activities of international humanitarian organizations in North Korea.

Transportation of goods between North Korea and other countries is complicated by the possibility of their detention for inspection in any state on the basis of suspicions in the presence of prohibited goods or materials.

As a result of sectoral sanctions of the UN Security Council imposed against the DPRK in 2016-2017 it became impossible to export from North Korea 90% of its export goods, including coal and other types of mineral resources, textiles, seafood and agricultural products. Such restrictions mean a reduction in foreign currency inflows into North Korea, narrowing the country's import and investment opportunities. Until recently, the mineral resources of the DPRK attracted interest

of foreign companies, but after the introduction of the UN Security Council sanctions many of potential projects lost their feasibility (for example, the Russian “Victory” project).

The UN Security Council imposed a ban on the supply to North Korea of aviation fuel (with the exception of refueling civilian aircraft outside the DPRK) and "luxury goods", which are considered to be consumed by the elite. But a more sensitive for the North Korean economy is a ban on the supply of industrial equipment and vehicles, as well as quite stringent restrictions on the import of crude oil and refined petroleum products, introduced in 2017.

North Korea itself does not recognize the economic sanctions of the UN Security Council and calls them illegitimate, aimed at the economic suffocation of the population. Pyongyang tries to circumvent the restrictions by all possible means, using an extensive network of intermediaries in third countries (primarily in China). At the same time, it should be emphasized that the North Korean situation of the 2000s is different from what we are seeing now. For the DPRK leadership, the example of Libya, whose leader agreed to exchange a nuclear program for the economic benefits offered by Western countries, was instructive. Before the Libyan crisis of 2011, North Korea was often offered to follow the example of this Arab country. Koreans learned the lesson and, with tripled force, pushed for the development of nuclear and missile weapons as a means of self-defense.

The country's nuclear status is enshrined in the DPRK Constitution, and it is highly unlikely that North Korea would agree to completely abandon it in exchange for economic benefits. At the current stage Pyongyang is ready to negotiate the denuclearization of the Korean Peninsula, by which the DPRK understands primarily the elimination of all threats to its security. At the same time, economic issues will inevitably be an important part of potential negotiations with the DPRK, since without the lifting of international sanctions and active participation in international cooperation, the economic development of North Korea will be hampered. Moreover, raising the population living standard

inevitably becomes an important condition for the stability of the North Korean regime, while the ongoing transformation of the DPRK socio-economic system which increasingly relies on market mechanisms is a significant factor in the peaceful resolution of the nuclear crisis.

In the autumn of 2018, it became obvious that the key issue for the DPRK in negotiations with the United States on denuclearization is lifting of economic sanctions¹⁶. However, Washington insists on maintaining sanctions until the complete nuclear disarmament of Pyongyang, which seems unlikely in the near future. At the second American-North Korean summit, held at the end of February 2019 in Hanoi, Kim Jong-un failed to achieve a quick easing of the sanctions regime.

The North Korean nuclear program historically has 3 main functions: to ensure the security of the current regime, to play the role of a “bargaining chip” at denuclearization talks, to provide an independent source of much-needed electricity to the economy using the uranium deposits in the DPRK. So, to abandon nukes North Korea would need alternative security guarantees, an alternative source of assistance and an alternative source of energy¹⁷. Multilateral economic engagement could perform all of these functions. In particular, the implementation of large regional projects (in infrastructure, energy, tourism, etc.), in which neighboring countries would have a material interest (first of all, South Korea, Russia and China) could contribute to the creation of a multilateral system of security guarantees to the DPRK.

In the past, some foreign experts often called "extreme autarky and the hostility of the North Korean state to private economic activity" as an obstacle to the country's integration into the world economy¹⁸. It seems that in recent years the

¹⁶ North Korea threatens to restart nuclear program unless U.S. lifts sanctions. // Washington Post. 03.11.2018

¹⁷ Frank R. The Political Economy of Sanctions against North Korea. // Asian Perspective. Vol. 30. No. 3, 2006. P.23

¹⁸ Charles Wolf, Norman Levin. Modernizing the North Korean System. RAND Corporation, 2008. P.7

situation has changed significantly. The new socio-economic realities in the DPRK demonstrate a change in the approaches of the republic's leadership to the methods of doing business. External economic activities of North Korean enterprises, though still often controlled by the state, are more and more based on market principles and aimed at the development of relations with foreign partners. One of the priority directions for them is the Russian Federation. A clear manifestation of this was the desire of the DPRK leader to hold a summit with the Russian president after the “unsuccessful” summit with D. Trump in Hanoi.

The benefits that Pyongyang would receive from international cooperation, primarily for modernization of infrastructure and industry, as well as development of the energy sector, could stimulate North Korea to more peaceful and consistent behavior in the international arena. An important task would be not to allow Pyongyang to follow the path of decades-used tactics of receiving free aid from foreign donors in exchange for ephemeral concessions. It is necessary to develop cooperation that would create conditions for the sustainable development of the North Korean economy and improving of people’s living conditions. At the same time, given the immanent inefficiency of the DPRK socialist economy, the country's leadership would need to continue to take measures to reform it. Thus, the prospects and long-term effectiveness of Pyongyang’s economic engagement depends on both external (lifting sanctions and the position of key actors) and internal (DPRK’s readiness to make concessions on the nuclear issue, gradual economic reforms) factors.

Since 2018, favorable conditions have been created for the international engagement of the DPRK. The approach is supported by the leaders of South Korea, China and Russia. US President D. Trump does not rule out the possibility of economic assistance to Pyongyang. However, as in the case of resolving the first nuclear crisis on the Korean Peninsula in the 1990s, Washington would seek to shift the material burden of potential economic obligations to other countries.

As for the internal factors that could contribute to the success of Pyongyang’s economic engagement, under Kim Jong-un the development of the DPRK

economy continues featuring the expansion of market relations and production chains which are often linked to the external market. And although these changes are not recognized by the country's law, the current leadership of North Korea treats the private initiative of citizens quite favorably¹⁹, because it sees its effectiveness in overcoming economic difficulties²⁰. Such a continuous involvement of the DPRK citizens and state enterprises in market relations lays the foundation for more constructive business interaction with them if international cooperation projects with North Korea are implemented in future. At the same time, serious economic reforms can only be pursued by Pyongyang if a favorable international environment is created.

¹⁹ Lankov A. The Resurgence of a Market Economy in North Korea. Carnegie Moscow Center. URL: <http://carnegie.ru/2016/02/03/resurgence-of-market-economy-in-north-korea-pub-62647> (accessed: 26.01.2018)

²⁰ Silberstein B. Explaining North Korea? // Orbis. Volume 62. Issue 2. 2018. P.338