

Economic and Financial Reform: Alternatives for North Korea

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Biographical Statement

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Abstract

We consider recent reforms in North Korea as a signal that its authorities now recognize that its long-term survival may depend on returning to sustained economic growth. The paper sidesteps the political implications of a commitment to reform and accepts that meaningful economic reform can take place in the absence of political reforms for the present. We consider the recent history of financial liberalization in Asian market economies (South Korea and Japan) and the various paths of reform followed by socialist economies of China and Europe to identify the best model for North Korea. The paper ends with some suggestions for North Korean reforms.

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Introduction

More than 50 years after the signing of the cease-fire at Panmunjon, North Korea stands virtually alone as one of the last of the classical command economies. Like its other centrally managed counterparts, the North Korean economy was able to achieve reasonably rapid rates of growth through forced savings and high rates of investment, at least through the 1970s. By the 1980s, however, the economy began to stagnate and during the 1990s, as the political legitimacy of other command economies collapsed and trade relations deteriorated, the North Korean economy began a sustained decline exacerbated by bad weather and critical shortages of energy. According to estimates from the Bank of Korea (BoK, 2004), North Korea's per capita income in 1998 was only half of what it was in 1990.

Reforms initiated in 2002, combined with some signs of interest in further reform from leaders in Pyongyang, have given a number of outside observers hope that North Korea is now seriously pondering more radical reforms that may finally lead to a significant and sustainable improvement in the standard of living for its 22 million citizens. There are many issues to be decided should North Korea embark on a reform process; however, reforms directed toward the financial system are fundamental to both extensive and intensive growth. Rapid extensive growth results from the combination of generating a high savings rate and investing these savings in projects with higher social returns. Classical socialist (i.e., command or centrally planned) economies are usually able to accomplish the former through administrative control over prices and limited production of consumer goods. The state is able to control how these savings are allocated through the state bank's monopoly over the financial sector; however, the institutions of the centrally planned economy have difficulty ranking projects according to their social return. Intensive growth requires continued improvements in labor productivity, and though command economies can be successful at increasing the availability of education, they perform poorly at providing the incentives for such sustained improvement in productivity. In particular, a major source of productivity improvement is in the continuous selection of better technologies and production arrangements, a process requiring that inefficient operations be regularly shut down and resources shifted to other, more successful ventures.

Financial sector reform is fundamental to supporting sustained extensive and intensive development because the financial system institutionalizes the saving and investment process, provides a system to evaluate and monitor credit risk, and imposes penalties for inefficient uses of capital. How financial reform is pursued in the development process determines the overall path of development.

The rest of the paper is organized as follows. First, we review North Korea's macroeconomic performance and recent reforms to improve efficiency. This review relies heavily on Ahn (2003), Babson (2004), and Dwor-Frecaut (2004). Second, we review the general transformation of economic systems during the past three decades, from state-directed to market-directed regimes, in socialist and non-socialist economies, and note that the financial system is usually the first sector to liberalize.

Third, we discuss the reform process in China as it shifted toward more market-direct structures, and we suggest that China offers the most useful lessons for North Korea; however, we also emphasize the policy errors that China has made with regard to financial sector reform that can potentially limit the outcome of the overall reform process. The specific problems with China reflect a more general problem that even less state-directed financial regimes such as Japan and South Korea have experienced. Fourth, we discuss the role of bankruptcy in the financial regimes of China, Japan, and South Korea. Drawing from the experiences of China and the role of bankruptcy in Asian financial regimes in general, the fifth section concludes the paper with a general development strategy for North Korea. These concluding comments view reform issues from a broad perspective rather than the more specific suggestions offered by Lee (2004).

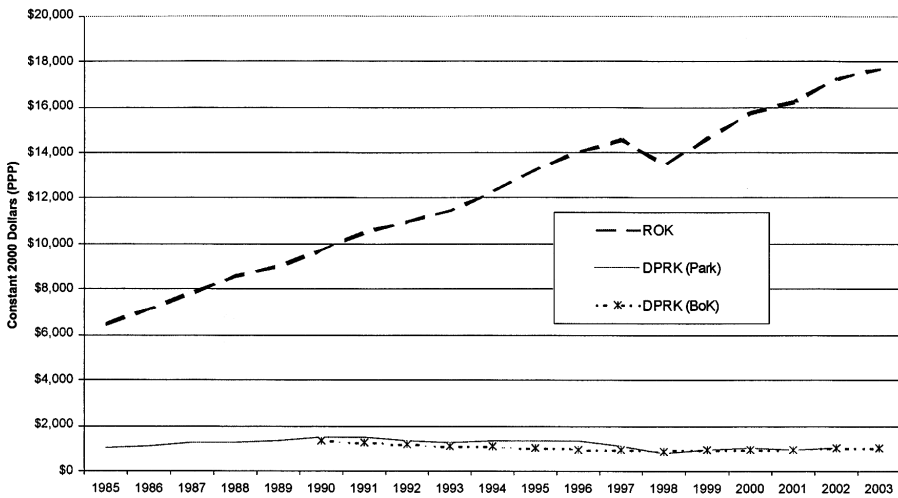
North Korean Macroeconomic Performance and Reforms

North Korea remains one of the most isolated and rigidly controlled economies in the world. By the end of World War II, the north had two-thirds of Korea's industry, while the South had most of the farmers; after Kim Il-Sung took power in 1946, he led with policies of land redistribution in rural areas and nationalization of heavy industry and Japanese-owned firms. After the Korean War, he began to implement virtually all aspects of a Stalinist economy: Both private industry and the financial sector were fully nationalized, agriculture was collectivized, private markets were eliminated, and input-output coordination was centralized. Emphasis was placed on Kim's *Juche* philosophy of self-reliance, and military spending increased to almost a third of national income by the late 1960s, though North Korea continued to rely on outside assistance, alternating primarily between China and the Soviet Union.

Figure 1 compares two measures of North Korea's GDP per capita, in constant 2003 Purchasing-Power-Parity (PPP) Dollars, from Park (2004) and the BoK (2004), against that of South Korea, while Figure 2 shows the annual growth rates of these figures. Though the Park figures are much more volatile than those of the BoK, both series suggest a stagnant and declining economy for North Korea in the first half of the 1990s, with signs of recovery in the second half; relative to South Korea, growth rates were lower (with the possible exception of 1998, after the Asian Financial Crisis) and less consistent.

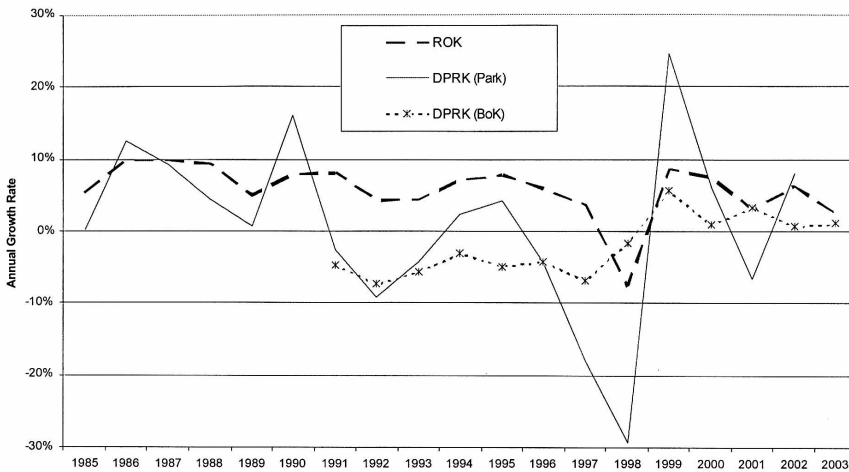
As hinted in Figure 2 by the widely varying growth rates of the two series for North Korean per capita GDP, quantifying North Korean macroeconomic performance is difficult. Few statistics have been officially reported since the 1960s, and much of what information is available is based on anecdotal evidence, educated guesses, and official statistics whose quality is problematic. It is generally accepted that North Korea grew faster than South Korea both before and after the Korean War, and some observers suggest it may have reached growth rates of as high as 12 percent per year. According to Cho (2003, p. 34), North Korean economic growth was positive through

**Figure 1: Gross Domestic Product per Capita:
A Comparison of North (DPRK) and South (ROK) Korea**



Source: ROK numbers are reported in BLS (2004) in 1995 constant dollars. DPRK numbers are reported by Park (2004) and BoK (2004). Series are then adjusted to match 2003 constant dollar (PPP) GDP per capita, as reported by CIA (2004).

**Figure 2: Growth of GDP per Capita:
A Comparison of North (DPRK) and South (ROK) Korea**



Source: These calculations are based on the series in Figure 1.

the mid-1970s. By the 1970s, however, North Korea's economy began to stagnate, and South Korea surpassed the North. While South Korea went on to become one of the fastest growing economies in history, the North's economy then declined for the next two decades, with some return to growth only since 1999. Of course, it is difficult to construct a consistent comparative measure of economic performance.

Maddison's (2001) estimates of per capita GDP, using 1990 International Geary-Khamis Dollars, put South Korean incomes at only three times that of the North in 1990, though this grew to more than 12 times by 2000. However, the U.S. Central Intelligence Agency (CIA, 2004) estimates a ratio of 18:1 by 2003, while the United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP, 2004) reports a ratio as high as 44 in 1995, though these latter statistics do not adjust for PPP.

Cho (2003) attributes North Korean decline in output from the mid-1970s to the late 1990s to both the accumulation of inefficiencies of the command system and the withdrawal of assistance from the Soviet bloc economies as they began to shift from state to market-directed regimes. While North Korea preached self-reliance, it was nonetheless more dependent on trade than observers might expect. In 1990, its trade accounted for 20 percent of GDP, and imports outweighed exports by a 3:2 ratio (Cho, 2003). By 1998, imports had declined by over two-thirds, and though GDP also declined steeply, the trade ratio fell to 11 percent. Food shortages have been chronic, particularly during the famine of 1995–98, and North Korea continues to be unable to feed itself. North Korea has inadequate domestic sources of energy, particularly with the rapid decline in domestic coal production. Shortages of raw materials, particularly metal, steel, cement, and fertilizer, are also widespread since 1990, hampering the full employment of industrial capacity.

In the mid-1990s, there was a growing consensus that North Korea was on the verge of collapse; while this may have been an exaggeration, macroeconomic performance was poor in the 1990s, budget deficits were growing, and reports of famine in rural areas were widespread. At some point, the inefficiencies of the system will accumulate and generate an even more serious crisis, but it appears that North Korea has not yet reached that point. In fact, there is some evidence economic conditions have improved in the last few years. While it is debatable whether the recent increase in output signals sustained recovery, there is a reasonable basis to conclude that reforms introduced in 2002 may be responsible for improvement in economic conditions.

According to Ahn and Ro (2003, p. 21), North Korea commenced a variety of economic reforms in July 2002. These included increased administrative prices and incomes, revisions in the distribution system, enhancing the merit system, decentralizing the planning process, and expanding corporate sector autonomy. The establishment of trust banks was announced in July 2003. There were also announcements that firms would be allowed more control over the disposition of their production, once quotas were met, and this opens up the possibility of a future dual-track system for production within and beyond the plan.

Prices in North Korea are administratively set by the state based on "necessary social labor expenditure," not by relative scarcity in markets. According to Park (2003, p. 384), shortages were exacerbated during the famine of the 1995–98, and prices rose dramatically for commodities and farmers' markets outside of direct state control. Though no official price indices are reported, repressed inflation was finally addressed in the reforms of 2002, when official increases in prices, wages, and the

official exchange rate rose by 2,000 percent to 6,000 percent. Nonetheless, prices continue to be largely controlled by the state.

This effort was not the first time North Korea has attempted reform; past reforms efforts include a joint venture law in 1984 and special economic zones in Rajin-Sonbong in 1991 and, more recently, in Sinuiju City in 2002. Outside of a number of “politically motivated investments in North Korea that lack a basic economic and commercial logic” (Rosenberger and Babson, 2001), few foreign investors have found these economic opportunities to be inviting, and some of these have reported that North Korean officials make them pay discriminately higher wages and input prices.

These recent reforms are in the correct direction but pale in comparison to the reforms needed to establish a foundation for economic recovery and sustained economic development. While North Korea is not on the verge of collapse, it is only a matter of time until a more serious economic and financial crisis occurs, unless the regime makes the commitment to reduce the degree of state direction over real and financial resources.

Paths of Economic Reform and Liberalization

In the past three decades, a range of developed and developing economies began a transition from state-directed to market-directed economies, and this transition process continues. In the 1970s, many nonsocialist economies began a process of liberalization of the financial sector, one of the most state-controlled sectors of many economies. Two decades later, most socialist economies began a much more dramatic phase of liberalization in all areas of their economies, but one in which financial reforms were key. In this section, we review both of these processes in order to understand the economic pressures facing the economy of North Korea.

Trends in Financial Liberalization

Financial liberalization in the nonsocialist economies first manifested itself in the form of market and government innovations in domestic and international financial institutions and structures; for example, the collapse of the Bretton Woods fixed exchange rate system in 1973 was a key turning point in the shift from state-directed to market-directed financial regimes. The transition most frequently emerged in the financial sector with interest rate liberalization, increased asset diversification powers for financial institutions, and development of money and capital markets. The transition then spread to the real sector and is now manifested by a broad liberalization of a broad range of public and private institutions.

Friedman (2000) succinctly characterized the transition as being led by the democratization of technology, finance, and information. The transition has resulted in the economic and financial integration of a large number of economies and a world trading and financial system to a degree not experienced since the decades leading up to the First World War. The transition has not always been smooth nor has every economy participated to the same degree: for example, the African economies and

Middle East economies, with the exception of Israel, have yet to participate except as suppliers of raw materials.

Many of the former Soviet bloc economies and a number of Asian economies have witnessed significant structural change in terms of how far they have shifted from state-directed regimes. Japan and South Korea, for example, have gone from economies that regulated virtually all interest rates, engaged in varying degrees of credit allocation, restricted the inflow and outflow of capital and foreign direct investment, and possessed corporate sectors with no meaningful corporate governance or transparency to economies that permit market forces to play a significant role in real and financial transactions.

China presents an even more dramatic example of change. The Chinese economy was far more rigidly controlled and exhibited more economic and financial distress at the start of the transition than either Japan or South Korea. In addition, China lacks a democratically elected government while Japan and South Korea have functioning democracies. While China continues to be ruled by a Communist government, China's economic and financial institutions are undergoing major reform as market forces are permitted to play increasing roles.

The transformation in most economies has been associated with increased economic growth, increased standard of living, and increased world integration. At the same time, the process has not been smooth, and some economies have experienced financial and economic distress. The Asian Financial Crisis in 1997 and 1998 was associated with currency flight, failures of financial institutions, and declining output in a number of Asian economies. South Korea, for example, experienced a sharp depreciation of the currency, market insolvency of many financial institutions, and decline in output in 1998. South Korea has recovered and now exhibits continued economic growth. Japan was not adversely impacted by the Asian financial crisis but instead had been stagnant since 1991 and only as recently as 2004 has shown signs of meaningful recovery. In contrast, China was largely unaffected by the crisis, though in the early 1990s exhibited high rates of inflation. The United States and many European economies have also exhibited uneven development in the past few decades as the transformation process progresses.

Despite the lack of a smooth process; however, the consensus is that the transformation has significantly increased the production possibilities of the financial and real sectors of most of the economies and that many of the episodes of economic and financial distress can be traced to inappropriate government policies in how the transformation is pursued. That is, the goal or liberalization is not the problem, but rather the approach that government policy has taken to achieve liberalization is the problem.

Economic Liberalization in Formerly Socialist Economies

In the twentieth century, less developed countries that adopted centrally managed socialist systems usually experienced rapid growth, at least initially, as state control over every aspect of the financial sector allowed for forced savings and centralized coordination mobilized economic resources. Once the easy gains were

had, however, growth usually slowed as incentive problems led to a stagnation of labor productivity and the efficiency of resource allocation began to matter more. In particular, the lack of financial mechanisms to impose bankruptcy on inefficient firms, or the lack of a market price structure to meaningfully measure efficiency, made it virtually impossible to reallocate resources away from poor past investments.

Though the legitimacy of the political structure is dependent on the status quo, the possibility of North Korea returning to its early days of rapid growth is virtually nonexistent. Nonetheless, as Kornai (1992, p. 378) points out, the classical socialist economy is viable in the medium run as a coherent, closed system. In the long run, as the economies around it continue to grow more rapidly, North Korean leaders are likely to find it harder and harder to maintain popular support and continue to finance the country's military. Thus, reform is necessary should North Korea want to maintain its economic viability. As we assume that political survival is the first goal of the North Korean regime, this section discusses the development strategies of some of the former Soviet bloc economies, China, South Korea, and Japan, and we suggest that China offers the most appropriate development model for North Korea.

The reforms that North Korea has engaged in so far are largely in the category of what Kornai (1992, p. 397) calls the "perfection' of control." By leaving alone the monopoly of control at the top and the property relations of nationalized firms and collectivized agriculture, the state's efforts to improve incentives and efficiency through bureaucratic reorganization, decentralization, adjustment in official prices, and simplification of planning indicators are only able to provide temporary relief at best. In the Soviet Union, for example, the Kosygin reforms of the mid-1960s failed to address the fundamental problems of the socialist economy, while Gorbachev's initial *uskorenye* (economic acceleration through central planning) reforms led to rising budget deficits and production bottlenecks because of inherent inconsistencies.

While most socialist economies attempted to "perfect" control prior to the eventual collapse of their governments, some engaged in more radical reforms. These reforms ranged from Yugoslavia's implementation of a labor-managed economy and Hungary's New Economic Mechanism to Gorbachev's *perestroika* (party, economic, and societal revitalization through restructuring). These reforms attempted to introduce a significant amount of both private production incentives and market-based prices, but their success was limited. In the case of *perestroika*, for example, the government allowed small private entrepreneurship and replaced state planning targets with negotiated contracts between firms. The result, however, was a diversion of resources away from the state sector and a collapse in state production, a situation made worse by poor macroeconomic management.

For most socialist economies, however, reforms came as a result of political upheaval. Some governments fell due to popular revolts, while others fell after political liberalization attempted to boost their legitimacy through free elections. The new governments found themselves with all the institutions of a centrally managed econ-

omy but without the ideological glue that held it all together. Some, like Poland and the Czech Republic, chose rapid “big bang” transitions, with rapid price liberalization and gradual privatization assisted by their proximity to export markets in Western Europe. Others, like Hungary, chose a more gradual process that avoided the sharp recessions seen elsewhere but failed to create conditions for sustained growth, at least not until more dramatic reforms were implemented. However, the economic and political costs were high, and many governments that led these transitions did not remain in power long.

In Russia and other former Soviet republics, as well as in the former satellite states of central and eastern Europe, many of the fundamental problems of the transition process were in the financial sector. First, the banking sector was slow to commercialize. Its initial portfolio consisted of state-directed loans to state-owned enterprises, and it lacked the means to evaluate creditworthiness and monitor firm performance. As a result, the banking sector relied on the implicit state guarantee to continue to make loans to state firms in order to keep them from shutting down, effectively pouring good money after bad. Second, with perhaps the sole exception of the Czech Republic, governments failed to cope with falling profits from state firms facing increased competition and increased expenditures on subsidies and direct provision of public goods. Because private capital markets were virtually nonexistent because of years of repression, governments turned to central banks to finance their budget deficits, with the result that investment became less uncertain in an inflationary macroeconomic environment.

Of the command socialist economies that began radical reforms, only China and Vietnam did so without a loss of political legitimacy, and Vietnam’s *doi moi* policies essentially followed China’s lead. The continuation of the pre-reform government in China combined with the continuing relationship between North Korea and China and the fact that each shares a border suggests that China offers the most useful lessons for North Korea.

China’s Reform and Liberalization

By the end of the twentieth century, almost all classical socialist economies had abandoned central planning. For the more advanced formerly socialist economies, particularly for those forced by a loss of political legitimacy into a rapid transition, the transition was very difficult. In countries such as Russia, Poland, the Czech Republic and even Hungary, the transition was marked by a dramatic economic decline, and the countries that delayed implementation of radical reforms the longest often found themselves facing even longer waits before positive rates of economic growth returned. Cuba, which still adheres to a rigidly state-controlled economy outside of its successful foreign enclaves, continues to have a per capita GDP less than it had a decade ago, in spite of recent positive rates of economic growth.

One of the major exceptions to this rule is the rapid growth of China since the death of Mao Zedong; China’s superior performance was helped by its particular reform path, by the fact that China was still largely a rural economy, and by the continued political legitimacy of its government. Unlike in Gorbachev’s Soviet Union,

China did not begin reform in the industrial sector, and China did not begin to dismantle the centrally managed economy until it had already become largely irrelevant.

China began instead with decollectivization, the *baogan daohu*, or household responsibility system. While rural collectives continued to have formal ownership of land and maintained many of their local government responsibilities, production management was turned over to individual households. Farmers were allowed to grow what they thought best, in a way they thought best. Once their rents (i.e., production quotas) were paid, farmers were allowed to sell the surplus in rural and urban markets. As a result, agricultural productivity boomed, and living standards improved in rural and urban areas. A surprising result of decollectivization was the release of rural surplus labor to other pursuits, and the Chinese government decided in time to allow rural enterprises entry into sectors once reserved for state-owned monopolies.

Along with a pragmatic approach that eliminated the Maoist policy of “Politics in Command,” China under Deng Xiaoping also began reform with an open door policy. It had the advantage of relatively easy access to the U.S. economy under most-favored nation tariffs, as allowed by the Jackson-Vanik Amendment, access encouraged for Cold War reasons of triangulation vis-à-vis the Soviet Union. Initial foreign sector reforms included the creation of special economic zones in Shenzhen and three other locales for foreign (and eventually domestic) investors, joint venture laws to encourage foreign investment and technology transfer, the decentralization of foreign trade brokers, and incentives such as foreign exchange retention and favorable exchange rates for state enterprises to export. During this first decade of reform, China changed from a closed economy to one in which exports and imports made up a significant portion of economic activity. Still, it was not until China’s second decade of reform that trade and foreign investment exploded.

Economic reforms in China’s state-owned industrial sector did not begin in earnest until a second wave of reform came in the mid-1980s. Initial reforms included increased managerial autonomy, the retention of some fraction of state enterprise profits for bonuses and self-investment, and a two-tier pricing system that gave firms the chance to sell surplus products at higher prices without seeing their state quotas adjusted accordingly. These reforms were successful at improving productivity in many state-owned enterprises, though the increased managerial autonomy also led to inefficient over investment by state-owned firms, and increased competition led to falling profits for the state. The philosophy of the dual price system in particular, though it created opportunities for corruption, also made it possible for China to “grow out of the plan,” as Naughton put it (1995), by allowing firms to benefit by selling on the market without first dismantling the planned economy (as Gorbachev effectively did).

A key element of China’s economic reform during this phase was a restructuring of the financial sector, and this element continues to cause worrisome problems. China took its monobank and separated it into a central bank, four big specialized banks, a trust and investment corporation, and an insurance company. It began to

wean state-owned enterprises off of direct allocations from the government budget to finance their investments, and pushed the enterprises instead toward bank loans. Fortunately, this was made possible in part by a rapid increase in deposits, as Chinese citizens began to save in anticipation of buying desired goods or, in the case of farmers, even building new homes. It was part of a general philosophy of separating state ownership from management, in the hopes that having to repay bank loans would encourage managers to make better investment decisions, but many Chinese firms made the shift to bank borrowing without significant adjustment to the incentives of the soft budget constraint, with the expectation that the government would come to their aid if poor firm performance made it necessary.

China's reform was not without political consequences. Rising price inflation, an increased awareness of official corruption, an uneven process of reform, and hopes that political liberalization being implemented in the Soviet Union and elsewhere could come to China all led to student demonstrations in the late 1980s that got out of control in 1989. After the events in Tian'anmen Square, the Chinese Communist Party was able to reassert control, but efforts to scale back reforms were much less successful.

In the year following Deng Xiaoping's public assertion that Shenzhen's booming economy should serve as a model for the rest of China, the Chinese Communist Party decided to declare a "socialist market economy" as its chief aim and driving economic policy. The new wave of reforms included more efforts to make state enterprises efficient enough to survive, tax reforms to provide the central and provincial governments reliable sources of income in the face of falling profits from state-owned firms, and a devaluation and unification of the exchange rate that brought the official rate in line with the black market rate and made the later move to partial convertibility possible. It also was accompanied by an increased tolerance of wholly owned foreign firms, a growing private sector, stock markets that made it possible for Chinese and foreigners to own minority shares in spinoffs of the more successful state enterprises, and a rapid rise in foreign direct investment.

These reforms also attempted to separate policy and commercial functions of the big state banks in the hope that these banks could better manage the profitability of their portfolios. Unfortunately, this effort contradicted the interest of local officials, who continued to maintain the power to choose bank managers, to minimize urban unemployment by encouraging state banks to keep loaning money to keep failing state enterprises running. By the late 1990s, the resulting rise of non-performing loans essentially made the big banks insolvent, though depositors kept their savings in these banks due to the implicit state guarantee.

Dealing with the problems of unprofitable state firms and bad loans became one of the major economic challenges for China in the decade since the reforms of the socialist market economy began. Deng Xiaoping intended state-owned enterprises to remain the "cornerstone" of the socialist market economy, but their profits, relative labor productivity, and market share continued to decline precipitously during the 1990s. After Deng's death in 1997, the Chinese Communist Party under Jiang Zemin announced a policy of "releasing the small, retaining the large," in which the

largest and most successful firms were to be reorganized into Chaebol-like structures, while other firms were consolidated, privatized, or closed. Bankruptcy laws were first written in the early 1980s, but it was not until 1998 that they began to be enforced in any significant way.

While the disruption of China's economic transformation should not be understated, China was able to avoid even greater unemployment because of the continued expansion of exports, continued government spending on infrastructure, and the encouragement of rapid growth in the non-state sector. Price deflation after 1997 and an undervalued exchange rate have led to rising money demand, which has allowed the financing of surpluses in the international balance of payments without significant inflation (Cargill, Guerrero, and Parker, 2005). Nonetheless, the banking sector continues to lag, and interest rates are tightly regulated to prevent market competition from making it more expensive for state firms to borrow. As a result, there are current concerns that a growing informal curb market could undermine the use of state banks as the primary financial intermediary (Bradsher, 2004).

China's economic reforms have thus led it into a period of sustained economic growth, without the political liberalization that undermined the control of communist parties in other socialist economies. Though challenged once in Tian'anmen Square, there is currently no effective and organized opposition to the Chinese Communist Party, and few doubt that the party can continue to maintain control of China for the foreseeable future. However, China's government has found that the problems of the financial sector, the fundamental issue of state-owned banks supporting unprofitable state-owned firms, continue to haunt it, and pose one of the greatest challenges to economic stability in the future.

Asian and Western Financial Regimes: The Role of Bankruptcy

The continued support of state-owned enterprises and the growing volume of nonperforming loans in China are indicative of a broader problem common to many Asian financial regimes. The resistance to allowing the financial system to impose penalties in the form of bankruptcy for inefficient use of capital interferes with the rational allocation of capital. Not only does the financial system need to have the flexibility to evaluate, monitor, and impose bankruptcy, the financial system, especially, depository institutions also needs to be subject to discipline. That is, "no failure" policies of financial institutions and markets equally interfere with the rational allocation of capital. In the case of the financial system however, bankruptcy needs to be restrained because of the inherent contagion effects of the failure of one of a small number of depository institutions. Government needs to provide a regulatory and supervisory regime that imposes discipline in an orderly manner. In a sense, market-directed regulatory and supervisory regimes need to mimic the market but without exposing the system to instability. The failure of a firm in the real sector is largely contained to the firm and perhaps a few depend-

ent firms; however, the failure of a financial market or depository institutions can have wide-ranging effects.

The shift toward a market-directed financial regime in which bankruptcy plays an important role has been difficult for the nonsocialist Asian economies. The reference to Asian financial regimes implies more homogeneity among different Asian economies and more heterogeneity between Asian economies and Western economies than can be found in practice. However, Asian financial regimes do have a common set of characteristics, with Japan being the foundation model. Japan was the first Asian economy to modernize in the second half of the 19th century. Japan's expansion throughout Asia at the turn of the century through World War II established Japanese economic and financial institutions throughout Asia, and Japan's successful economic development was viewed as dependent on Japanese financial institutions. Hence, the reference to Asian financial regimes is in reality a reference to the Japanese financial regime.

There are many differences between Asian and Western financial regimes. Asian economies regard their financial regimes as instruments of industrial policy to a greater degree than in Western economies. Asian economies prefer bank finance over money and capital markets as the channel to transfer funds from households to the business sector. Government financial intermediation plays a larger role in Asian financial regimes relative to Western regimes, either through government banks and postal savings systems or through direct credit allocation policies imposed on private banks. Asian financial regimes have less transparency than Western regimes. These characteristics are in transition, but continue to differentiate Asian and Western regimes.

These are important differences, but the most significant difference is the role assigned to bankruptcy. Asian financial regimes are designed to be "patient," that is, to limit bankruptcy and provide flexibility for borrowers to remain viable. The "customer relationship" banking systems of Japan and South Korea in the context of company groups are designed to limit bankruptcy. They represent long-term and multidimensional relationships between the bank and the borrower. In contrast, Western regimes are "impatient" and willing to use bankruptcy to ration credit. This difference is fundamental and reflects different assignments of how far market forces are permitted to play a role in the economy.

Cargill and Parker (2002) presented a development model based on two types of financial regimes: state-directed, in which bankruptcy is not permitted, and market-directed, in which bankruptcy is permitted. The model simulations show that the state-directed model performs well relative to the market-directed model because the former is accumulating capital at a faster rate. At some point however, the state-directed model falls behind the market-directed model in terms of economic development performance as the inefficiencies accumulate and slow economic growth. This can be referred to as the "albatross effect" (as in Coleridge's *Rime of the Ancient Mariner*). In addition, the cost of transferring from a state to a market-directed financial regime increases over time.

This simple development model provides insight into the experiences of a num-

ber of Asian development experiences and illustrates how development policies can start as virtuous cycles and develop into vicious cycles.

Lessons for North Korea

North Korea faces difficult choices. Under policies of the status quo, the state can continue to maintain tight control of the economy and society, but even with a continuation of the 2002 reforms economic growth is not likely to be high. As a result, the North Korean economy will continue to be outperformed by its neighbors and weaken North Korea's relative position. Allowing radical economic reforms, however, will require a fundamental change in how state power is exercised. China provides a model of how a socialist centrally managed economy can adopt market reforms without changing the political structure, though serious problems in its banking sector remain. It is debatable as to whether this is sustainable, but China, at least in the first two decades of reform, has been able to maintain a status quo political structure while embarking on meaningful economic reforms and internationalization.

We assume that it is only a matter of time until North Korea's leaders will give priority to achieving economic development goals and begin a process of institutional reform to reduce economic and financial distress and slowly become part of the growing world trade and finance system. Our assumption does not require political liberalization nor require a significant shift toward integration with the world at this time, but we do argue that delay will not make the transition process any easier. The development model presented by Cargill and Parker (2002) clearly illustrates how the transition costs increase the longer an economy relies on a state-directed financial regime designed to limit bankruptcy.

Though far from perfect, China's reform process provides the most appropriate model for North Korea of the available approaches. In this regard, North Korea should begin with rural decollectivization, though North Korea is relatively more industrial than China was at the start of its reform process. North Korea has apparently created hundreds of agricultural markets for selling food directly to industrial workers, a key step in China's rural reforms. A reform such as the Chinese household responsibility system, however, would improve incentives and control for farmers, while allowing the state to maintain nominal ownership of land and continue receiving an adequate agricultural surplus for its industrial needs. It is not clear whether North Korea would have a surplus labor problem if its rural labor were more efficiently used, but if it does then the government should encourage the development of rural firms to employ this labor. A fundamental problem the state would have to deal with is the resistance by local cadres; China dealt with this by allowing them to become some of the first "specialized," or nonagricultural households, so that they profited from economic reforms.

Effective rural reforms would not only increase the real incomes of farmers and workers alike through increased food production, but they could also lead to an

increase in savings to help finance industrial and urban reforms. China's approach to improving production incentives for state-owned enterprises is far superior to the status quo, but these reforms also caused significant problems that reformers need to expect. This approach would allow more managerial autonomy, the retention of profits (subject, of course, to a tax rate) by managers for use by the firm, a dual-track system to sustain fulfillment of the plan while encouraging additional production, and the creation of markets for state-owned firms to sell any surpluses to citizens. However, reformers would need to expect falling state revenues, which would need to be offset somehow. Reformers would also need to expect that managers and cadres would use the two-track system for their own profit and take care to limit access to capital by managers who will not necessarily have the proper incentive to make good investment decisions.

Financial sector reform is critical to achieving sustained economic growth. Park (2003) presents a comprehensive review of the North Korean financial system. The system is based on the same monobank system of the former Soviet Union and Chinese economies in which central bank and noncentral bank functions are controlled by the central bank. In North Korea the central bank is responsible for issuing notes, maintaining the payments system, maintaining the foreign exchange rate system, accepting deposits, making industrial loans, and providing insurance. Monobank systems are based on the supremacy of the production plan in which finance is merely used to bridge gaps between receipts and expenditures and financing is not predicated on credit evaluation or monitoring. Hence, there is no need for institutions separate from the central bank to accept deposits and make loans.

Park emphasizes two problems with North Korea's monobank system: First, the production plan provides no mechanism to evaluate or monitor credit or impose penalty functions and as a result, firms have no incentive to allocate capital efficiently, and second, the economic reforms in agriculture have established a new currency circulation system in which the public is reluctant to deposit funds in the government banks and prefers foreign exchange over domestic currency.

A banking sector separate from the central bank is required to evaluate creditworthiness, monitor performance, and impose financial penalties to achieve a rational allocation of the nation's savings. The banking sector needs to be able to evaluate the creditworthiness not just of individual firms, but of specific projects. The banking sector needs to be able to enforce repayment of loans, not just to give managers incentive to invest wisely but also because this acts as a selection mechanism for better productive arrangements and superior technologies. Unless they are willing to shut down inefficient firms that cannot repay their bank loans without government support, then any reforms will still ultimately lead to the accumulation of inefficient firms and outdated methods of production and rising nonperforming loan problems.

A separate banking sector is also needed immediately to absorb the increasing monetary wealth of the farm sector as reform progresses in the agricultural sector. Park (2003, p. 384) cites statistics that indicate significant increases in cash holdings per household since 1990 and, while prohibited, foreign currency holdings per household are also increasing.

North Korea began tentative financial reform with the July 2003 announcement of a new type of bank to accept deposits referred to as a “trust bank.” This bank appears designed to encourage the public to transfer their cash holdings to the banking system. It is not clear what this signifies and whether North Korea has decided to shift from a monobank to the two-tiered banking system common in market economies and now common throughout Asia and the world.

Opening up the economy to the rest of the world could offer North Korea access to foreign savings, crucial inputs, and export markets, but this can also be problematic for the ruling political institutions in that it would allow North Korean citizens to see how much their economy lags behind the rest of the world. Clearly North Korea needs to find an export market to earn hard currency, particularly because the nation needs outside sources for power generation. Current tensions with the United States are exacerbated by the belief that North Korea’s exports may include military hardware. These tensions may reduce the willingness of outside investors to take advantage of the joint venture law and special economic zones, but the primary obstacles may be the disbelief that the North Korean government is willing to relinquish enough control and provide a stable long-term climate for private investment. In spite of this, North Korea could expand its external market because China and South Korea both have a strong desire to see North Korea’s economy improve, as both are afraid of the consequences of any collapse, so they could serve as more than adequate substitutes for markets of the United States.

North Korea has perhaps bought some time with improved weather and recent reforms, but the failures of the socialist planned economy are long-term in nature, and in time these failures will threaten the life of the North Korean regime. If North Korea is able to resolve its external political conflicts and more meaningfully open up to the rest of the world, it faces an historic opportunity to follow a Chinese-style reform process, to “ride the tiger,” as White (1994) explained it. In addition, as the Chinese lesson helps demonstrate, financial reform and liberalization is an essential component of any liberalization strategy, and it is key to the success of any reform.

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