Policy Forum 10-002: Hard Currency and Socialism: The Ban on Foreign Exchange in North Korea

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Hard Currency and Socialism: The Ban on Foreign Exchange in North Korea

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By Rudiger Frank

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I. Introduction

Rudiger Frank, Professor of East Asian Economy and Society, University of Vienna, writes, "The ban on the use of foreign currencies in North Korea is not only a return to pre-reform orthodoxy, but also to normality as it exists in most countries of the world. It marks one step in the multi-staged strategy of the North Korean state to regain control over its society and economy... In any case, a system of multiple exchange rates will help the North Korean state to follow the developmental path of its neighbors in the hope of becoming part of the East Asian miracle - or, as North Korean media put it, to open the gate to a new era."

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II. Article by Rudiger Frank

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The announcement that the use of foreign currencies will be banned in North Korea beginning in January 2010 has left many observers wondering how this should be interpreted. Based on some basic economics and the experience of pre-reform North Korea and other socialist countries, we can get a fairly good idea of what this is all about.

To begin with, the use of foreign currencies for regular purchases is the exception, not the rule. Try to buy a cone of ice-cream or a car in New York City with Euros or Japanese Yen. The fact that the North Korean government for years did not interfere with the emergence of the Chinese Yuan and the US Dollar as quasi second currencies is the remarkable part, not the return to a currency monopoly as it exists almost anywhere else.

As we witness since 2005 at the latest, North Korea has ended its brief reform period and is returning to orthodox socialism, Korean style. This is visible in ideology with an emphasis on traditional values such as collectivism, in economic policy with a resuscitation of the 1958 Cheollima movement in December 2008, and in foreign policy with the renewed war of words against South Korea and its leaders, not to mention the nuclear and missile tests. The ban on foreign exchange is part of this strategy.

The North Korean state wants to get back control over its society, something that was about to get lost as more and more people discovered that they could advance in society outside of the realms of the state, by trading or engaging in other private economic activities. In a monolithic system such as North Korea, this is a serious threat to moral and structural integrity. As relatively cautious measures such as limiting access to the markets or the nature of tradable goods did not produce the expected results, the state got tougher by initiating a currency reform in December 2009 (see " Currency Reform and Orthodox Socialism in North Korea " and " The Symbolism of the New North Korean Currency ").

It is remarkable, by the way, that it did not send the police or the military to close the markets but rather decided to use macroeconomic measures to do the job. In principle, this is what advanced Western countries would do unless a financial crisis prompts them to be blunter and interventionist. But in lieu of a functioning financial and fiscal system, manipulating the tax or interest rates was not available; so Pyongyang opted for a reform of the domestic currency to get excess liquidity under control. Now, in a second step, it tries to make sure that there are fewer ways to bypass this measure by moving into foreign currencies for economic transactions instead. As a not unwelcome side-effect, the ban on foreign currency use in North Korea will also make corruption more complicated, something that will make corrupt officials unhappy but boost the legitimacy of the state in the eyes of its citizens.

The next step we would have to expect are tougher controls at the border with China, as this is the gate through which most of the traded goods make their ways into North Korea. These goods are needed to keep the population supplied with basic necessities, so we can expect that this trade will not be banned, but rather made more transparent and formal. One place to do so would be in the long-awaited special economic zone between Sineuiju and Dandong in the Northwest, and/or by using the already existing Rajin-Seonbong zone in the Northeast. As KCNA reported (only in the Korean version) on January 4th, Raseon has in early January 2010 been upgraded to the status of Special City (teukbyeolsi), obviously in connection with a Kim Jong-il visit there a few days earlier. North Korea is not against foreign trade, on the contrary, but it wants to be in control.

Returning to foreign currency, the one measure we have so far not seen is the reintroduction of the "woehwawa pakkun don", the Foreign Exchange Certificates (FECs). East Germany had them (called Forum-Scheck), and so did Cuba; China used FECs until as late as 1994 (!). North Korea got rid of its two FECs (one for socialist foreigners, and one for capitalists) in the context of the July 2002 reforms. This currency was originally introduced to enable foreigners or privileged individuals to spend their money inside of the country in special stores while at the same time preventing ordinary citizens from shopping there. It also gave North Koreans with relatives in Japan a chance to convert their Japanese Yen into mostly Japanese goods.

The use of FECs fulfilled a number of functions: It forced foreigners to spend all the money they had exchanged upon immigration, as the FECs were worthless outside of the issuing country; it created hard currency income for the state; and it skimmed off the forex holdings of inlanders. Embezzlement and bribery were not as serious as they would have been if the original currencies were used instead of FECs. On the other hand, even FECs could not prevent the division of society into those with, and the unlucky ones without access to all the benefits available through the possession of some form of hard currency income.

It is hence not yet clear whether North Korea will reintroduce FECs. It might do so if it intends to keep the hard currency stores running and foreign and domestic shoppers separated. On the other hand, the hunger for Western money was one of the factors that led the governments of socialist countries to do embarrassing things that brought in some money but made it loose face dramatically. In East Germany, this included the sale of antiquities and even political prisoners to the West, a not-so-tacit legalization of prostitution in the city of Leipzig during the two annual trade fairs to help Western business men spend their Deutschmarks and Dollars, and letting stunned Dresdeners who for geographical reasons could not receive Western TV get a smell, literally, of the capitalist consumer society in hard currency stores called Intershops.

We have reason to believe that the North Korean leadership has understood the reasons for Eastern European socialism's collapse quite well. We also know that Pyongyang has been very interested in studying the Chinese success, which in many ways is nothing but the continuation of the export-oriented East Asian miracle that had started in the restrictive developmental states of Japan and South Korea. If we interpret the foreign exchange controls initiated by the North Korean government this way, we would have to expect the introduction of multiple exchange rates rather than FECs, so as to promote exporters, make imports of consumer goods more expensive and imports of technology and other strategic goods easier.

The ban on the use of foreign currencies in North Korea is not only a return to pre-reform orthodoxy, but also to normality as it exists in most countries of the world. It marks one step in the multi-staged strategy of the North Korean state to regain control over its society and economy. Restrictions on the semi-official trade with China are likely to be issued, including a relocation of this trade to the better controllable new zone Sineuiju-Dandong. The Foreign Exchange Certificates will not necessarily be reintroduced, although this cannot be excluded. In any case, a system of multiple exchange rates will help the North Korean state to follow the developmental path of its neighbors in the hope of becoming part of the East Asian miracle - or, as North Korean media put it, to open the gate to a new era.

III. Nautilus invites your responses

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