

The Characteristics and Function of North Korea's Second Economy

Hong Tack Chun*

Introduction

Scholars studying the old Soviet-type centrally planned economies long focused on the planning part of the economy, but beginning in the 1970s, they began to have interest in the economic activities outside of the planned economies in the former USSR and East European countries. The planned economies in these socialist countries may be dubbed the "first economies," and the economic activities outside the planned economies can be called the "second economies." The second economies existed from the earliest stages of the Eastern socialist countries, and expanded in such way that official press such as Pravda reported many negative aspects of the second economy as early as in the 1970s.¹

This kind of second economy, which has been mentioned as one of the leading factors that caused the systemic transition of the USSR and Eastern socialist countries, exists in North Korea as well and has expanded rapidly under the mounting economic difficulties. The second economy, which is sometimes called the "black market" or "underground" economy, also exists in the capitalist countries, and in itself is not a particular phenomenon

* Hong Tack Chun is a Research Fellow at the Korea Development Institute(KDI).

¹ Dennis O'Hearn (1980), pp. 218-234.

which is found only in the North. But the expanded second economy in North Korea is quite noteworthy in that it means an increase in the private and autonomous sectors in the socialist planned economy, and also because it was an important factor for system change in the case of the former Soviet Union and Eastern socialist bloc.²

There are a number of views on how to understand the second economy of North Korea. First, some view the expanded second economy as a symptom of collapse in the context of North Korea's extreme economic difficulties. Robert Collins, the officer who is in charge of research on Korean affairs at the Korea-U.S. Combined Forces Command, writes in his "7-step scenario of the collapse of North Korea" that the process of North Korea's collapse would be: "resource exhaustion → giving priority to resource allocation → local autonomy of economy → repression → resistance → division → reconstitution of power."³ He views the black market as playing a role of resource allocation which the state is not capable of doing, and leading to the third phase—that is, the local autonomy of the economy.

Collins argues that at the third phase of economic collapse, autonomous economic activities as well as theft, usurpation, and illegal trade are increasing with the expansion of the black market. The most developed form of autonomous economic activity is independent production and sale without the permission of the authorities. If even the armed forces in the rear areas and security agents also participate in the second economy, Kim Jong-il and his core power group might see this as a serious threat to their authority and launch massive arrests and purges, thereby starting the fourth stage in which repression and control are strengthened. Collins argues that overall, North Korea has entered the second

² See Institute for National Reunification (1993), and Jae-jin Seo (1994), about the argument that expansion of the second economy has a close relationship with the system transition in the USSR and East European countries.

³ "Monthly Chosun", May, 1996, pp. 364-381. Former Vice-Minister of the National Unification Board Young-Dae Song also sees the expanded second economy as being peculiar to the prior stage of collapse of NK system. "Evaluation of the possibility of collapse of NK system", in *National Security of 21st Century: Searching for a New Paradigm*, held by the National Intelligence Training Institute, Dec. 3, 1996.

phase of collapse, and some localities have entered the third or even fourth phase.

In contrast, another view sees the expansion of the second economy as a sign of market-oriented reform. Prof. Hy-Sang Lee, who teaches in the U.S., argues that production of "August 3rd people's consumer goods" and the expansion of "August 3rd direct-sales stalls," which had been encouraged by the North Korea authorities as early as August 1984, means a launching of economic reform.⁴ "August 3rd people's consumer goods" refers to consumer goods produced by the utilization of left-over materials and waste articles in the light industry factories and household work parties. They are directly sold to consumers through the direct sales stalls, not by the state distribution network.

In the 1990's, there have been moves toward the expansion of the second economy such as the daily opening of farmers' market which used be held every 10 days, and increased trade of grains and manufactured goods, which was not allowed as a general rule. This trend has been strengthened in 1996 by the measures that allow free disposition or direct consumption of grains that exceed the assigned quota imposed on the production team. Some see this new trend as a sign of market-oriented reform of the North Korean system.

A third view sees the expansion of the second economy as a survival strategy.⁵ This view points out that the expanded second economy is simply self-help on the part of the North Korean people for survival, which the authorities can do nothing about but to tolerate it.

Differing views on the expanded second economy of North Korea entail different understandings of the North Korean economy and different prospects of North Korea. The expansion of the second economy makes conventional focus on the planned economy insufficient for a proper understanding of North Korea's economy and there arises a new need for more varied and in-depth study on the second economy itself. However, the fact is

⁴ Hy-Sang Lee (1992), p.473.

⁵ Seung-ryul Oh (1996), pp. 115-136.

that even the basic concept of the second economy has not yet been provided, let alone systematic study on the second economy.⁶

The purpose of this study is to provide the basis on which more systemic and active studies can be conducted. I will try to conceptualize a second economy and shed light on the characteristics of the economic activities conducted outside the planned economy by examining detailed information on a second economy. I will also examine the effects and functions of the second economy and discuss the correct nature of the expanded second economy given the policy response of the North Korean authorities.

The Concept of the Second Economy

The concepts and terms that designate the second economy are all different depending on the analysts.⁷ Gregory Grossman, who is thought to be a leading scholar on the systematic study of the second economy, defines the second economy as all the production and trade activities that satisfy at least one of the following two criteria: first, is the purpose of the activities the direct private profits?; and second, do people know that their activities are against the law?⁸

According to Grossman's definition, producing and trading farm products from one's own garden in the free market, as was allowed in the former Soviet Union, is counted as part of the second economy, even though this was officially allowed by the authorities, because it was for direct individual profits.

Dennis O'Hearn criticizes Grossman in that he fails to define the second economy in a way to contrast the second economy with the primary economy, that is, the planned economy.⁹ According to

⁶ Two available studies are that of Seung-ryul Oh (1996), which analyses the secondary economy from the viewpoint of survival strategy, and that of Jae-jin Seo (1994), who sees the secondary economy as an autonomy of private economy in relation to the shift of value system of the NK people.

⁷ There is more conceptual confusion in the study of underground economy of the capitalist countries which is similar to the secondary economy of the socialist countries. Kwang Choi (1987), pp. 5-23.

⁸ Gregory Grossman (1977), p. 25.

⁹ Dennis O'Hearn (1980), pp. 218-219.

O'Hearn, the economic activities of the second economy are those that are not part of the official plan or are not acknowledged as a part of national economy. According to O'Hearn's conception of the second economy, production and trade of such garden products do not belong to the category of the second economy because they were officially allowed and were reflected in the balance of income and outlays. But trading garden products for speculative purposes was against the law and thus is counted as part of the second economy.

Kemeny uses the term "unregistered economy" in his article, "The Unregistered Economy of Hungary."¹⁰ Kemeny defines the unregistered economy as the economic sector whose economic activities are not registered by the central statistics bureau or any other official authorities. According to his definition, all the unregistered economic activities, legal or illegal, constitute the second economy. The unregistered economy is a broader concept than the second economy, and is the same as the underground economy or hidden economy used widely in the study of the underground economies of the capitalist economies.¹¹

This rather broad conception of the second economy reflects the Hungarian background in which the size of the private economy was substantial due to the facts that professionals such as doctors, architects, translators, and engineers were allowed to engage in business, small-scale private businesses were allowed, and the moonlighting of workers were generalized.

Seung-ryul Oh uses the term "unofficial sector," while Won-tae Jang uses the "underground economy." Oh seems to define the unofficial sector as black market activities which are illegal under the North Korea legal system, though he does not specify exactly what he means by the unofficial sector.¹² This definition sees the

¹⁰ Istvan Kemeny (1982).

¹¹ Tanzi of IMF, who is a authority on the underground economy, defines the underground economy as GNP which is not included in the official statistics due to the non-report or under-reporting. The Central Statistics Office of Great Britain also follows the same line of logic by defining the underground economy as the economic activities missed in the process of accounting GNP. Recited in pp.7-8., Kwang Choi (1987).

¹² "Unofficial sector economy which has been expanding in 1990s is different from individual commercial activities observed since the middle of 1980s in that it is illegal under the NK legal system." Seung-ryul Oh (1996), p.16.

garden products and their trade, or individual moonlighting products and their trade, as part of the official sector because they are permitted by the authorities and are legal.

On the other hand, Won-tae Jang (1996) defines the underground economy of the socialist countries as “economic activities outside state control” and points to those economic activities that ensure the income and purchase of commodities through underground production and circulation.¹³ According to this conception, trade of garden products or individual commercial activities in the street stalls are not included in the underground economy. But he mentions in the same article that garden products are one of the major sources of underground goods, which is not consistent with his definition.

Given this varied usage of the term and definition, how should we define the second economy and what is the most appropriate term to refer to the second economy? First, I think in North Korea's case, the term “second economy” is more appropriate because “underground economy” or “unofficial sector” are usually used in the study of capitalist economies. Though there are some who use the term second economy in the study of capitalist economies, most scholars have used the term underground economy or unofficial sector. In the study of socialist economies, the term second economy has been a representative term used for a long time.¹⁴

Moreover, there is a big difference in the purpose and scope of the study between the underground economy of the capitalist system and the second economy of the socialist system. Study of the underground economy in capitalist countries is mainly focused on the size and economic effects of tax evasion, and preventive measures. In contrast, study of the second economy in socialist countries focuses on the impact of the expanded autonomy of the private economy on the socialist system as a whole. Household moonlighting and garden products are registered in the official statistics of North Korea but are subject to

¹³ Won-tae Jang (1996), pp.21-22.

¹⁴ The term “second economy” was first coined by K. S. Karol in 1971, and has been used in studies by Grossman (1977), O'Hearn (1980), Ericson (1982), Wellisz and Findlay (1986), and Katz and Owen (1992).

the market principle of demand and supply, because they are autonomous economic activities pursuing private profits.¹⁵ Terms such as underground economy and unofficial sector do not include garden products and household moonlighting, but the term second economy comprises all these economic activities. North Korea is peculiar in that they call the organization which is in charge of military logistics "the second economic committee,"¹⁶ which can cause some confusion in the usage of the term. However, it seems that the term second economy is the most appropriate one considering the purpose of the study and the international recognition.

In this respect, this study defines the term second economy as the private economy to which mechanism of the planned economy is not applied. Therefore, all economic activities that directly pursue private profits are considered as constituting the second economy regardless of their legality or nature of income--that is regardless of whether they create additional income or simply redistribute existing income.

The Second Economy and the Black Market

The second economy of the socialist countries, which refers to individual economic activities pursuing private profit, needs a sort of market that makes possible trade among individuals. Since the second economy is in most cases illegal, the market that makes possible second economy trade is called the black market. The black market comprises not only a certain location in which many people get together and trade in a narrow sense, but also all the secret trade among the individuals.

The farmers' market which is located at the center of the

¹⁵ Official concept of net material product of NK includes the income made by individual moonlighting. North Korea Institute of Social Sciences, Center for Juche Economics, *Dictionary of Economics*, vol. 1, p. 221.

¹⁶ The Second Economic Committee is officially an organization under the Defense Committee, but is subject to the command of Policy Inspection Bureau for Military Logistics of the Central Committee of the Labor Party. Its work scope includes production, circulation, distribution, and foreign trade of the military materials as well as weapons. Though the armed forces use the materials provided by the Second Economic Committee, they do not directly run the committee. *Choong-Ang Ilbo*, May 22, 1995.

second economy of North Korea was created in August 1958 according to Cabinet Decision No. 140, replacing the rural markets. The farmers' market is a form of commerce in which farmers directly sell part of the products produced in individual or communal moonlighting to the people through a certain locale. According to the "Dictionary of Economics" published by the Institute of Social Sciences in North Korea, the farmers' market contributes to the better life of the workers and office employees by supplying various agricultural products while helping farmers get more income, though the farmers' market is a backward form of commerce containing remnants of capitalist elements found in the initial stage of socialism in which a lower level of productivity causes insufficient supply of daily goods and foods.¹⁷ North Korea has insisted that farmers' market would disappear when all materials are supplied in abundance with the elevation of productive capacity resulting from development of socialism, and when the cooperative possession is transferred to the people's possession. But the fact is that the importance of the farmers' market has increased.

Agricultural products sold at the farmers' market are mainly produced in the gardens of individuals. North Korea limited the size of gardens to 30 pyong and prohibited trade of grain for manufactured goods to prevent the spread of capitalist elements. Garden production and farmers' markets were allowed not only in North Korea but also in the old USSR and East European countries as well as in China. In the old USSR and East European countries garden production played an important role in supplying food stuff other than grain. In the case of the former USSR, cooperative households got 72% of their meat, 76% of their milk, and most of their potatoes and eggs from garden production (excluding those bought from the market). These gardens, which occupied only 3% of the arable land, produced more than 25% of the total agricultural production (in monetary value).¹⁸

¹⁷ North Korea Institute of Social Sciences, Center for Juche Economics, *Dictionary of Economics*, Vol. 1, 1985, pp.367-368.

¹⁸ The average size of a garden in the old USSR was about 0.25 hectare (about the same as 756 pyong). See Nove (1986), p.12, pp.116-117

The farmers' market of North Korea, which did not play any significant role in the 1970s, began to gain importance in the 1980s with the expansion of the black market. It turned into a huge black market from the end of the 1980s with the unstoppable increase in illegal trading as a repercussion to the deepening economic difficulties. The development of the black market in North Korea can be attributed to the following several factors.

First, there was an increase in the trade of grain such as corn despite the prohibition of such trade because authorities could not provide people with sufficient food. The farmers' market was originally a village market opened every 10 days, but with the spread of the black market it became a daily market and even unofficial markets began to appear.¹⁹ In 1992, North Korea authorities prohibited the unofficial market which had been tolerated until then, and changed the daily market into a 10-day-interval market. This hardline policy was not wise, because the survival of the people in the midst of spreading famine was based on the farmers' market, which had taken on the characteristics of a black market. As a result, black markets were opened at changing sites to hide from authorities' supervision. This kind of "fluid market" was made open almost everyday. With the deepening food shortages, the 10-day-interval village market was turned into a daily market and the sale of rice and corn which had been strictly prohibited was also allowed, with the timing of permission varying, depending on the region.²⁰

Second, frontier trade between China and North Korea has increased with the North Korea's decision to allow direct trade between provinces/counties along the border of North Korea and the Yenbian region of China. This decision was a part of the trade promoting policy of the 1980s. The commercial activities of ethnic Korean-Chinese merchants in North Korea territory, and their profit-making by trading North Korean antiques and sea products

¹⁹ Testimony by Soon-hyun Park (who defected on Oct. 11, 1993) and Myung-rak Choi (who defected on Feb. 13, 1994). Recited from Jae-jin Seo (1994), p. 26.

²⁰ Naewoe News Agency, *Bukhan Silsang Chonghap Charyojip* [Comprehensive Collection of Information on the Realities of NK], pp. 71-72.

with the Chinese manufactured goods, stimulated and encouraged the North Korean people to open their eyes to the capitalist style of trade.²¹

Third, North Korean people who were suffering from shortages of food and other necessities of life, began moonlighting by producing foods (liquor, rice cakes, etc), mending clothes and footwear, and working as carpenters. These moves were promoted by the "August 3rd Movement for Producing People's Consumer Goods" which encouraged household moonlighting.

The "August 3rd Movement for Producing People's Consumer Goods" originated from the visit by Kim Jong-Il to the exhibition of manufactured goods of the light industry on August 3, 1984. It was designed to increase the production of consumer goods by utilizing remnant materials or waste articles found in local areas independently of the central government.²² With the launching of this movement, work teams in the factories and household work teams, composed of housewives and dependants, were organized and expanded for the purpose of increasing the production of the necessities of life.²³ The "August 3rd Movement for Producing People's Consumer Goods" has the characteristics of the second economy in that autonomous decision, not central planning, was given priority in the production and sale of the goods and in the setting of price, and in that payment was proportional to the achievement. Moreover, under the influence of this movement that encouraged household manual work, the number of people who were engaged in the individual moonlighting without registering as a household work team increased. The consumer goods produced this way were traded at the farmers' market.

Fourth, the "dollarization" of the North Korean economy—that is, preference for the dollar over the North Korean won—began to be salient from the late 1980s, reflecting the economic difficulties of North Korea. The trend has been fortified in such a

²¹ Jae-jin Seo (1994), pp. 26-27.

²² Seong-guk Hong (1996), pp. 98-99.

²³ Considering that the *Dictionary of Economics* (Vol. 1, p.49), published in 1985, explains the household work team, household work teams seems to have existed before the launching of "August 3rd Movement for Producing People's Consumer Goods." The movement seems to have tried to activate existing work teams.

way that dollar bills were most popular as a means of bribery. With this background, the second economy related with foreign currency expanded in the form of illegal trade and embezzlement by those who were responsible for earning foreign currency.²⁴

The Composition and Size of the Second Economy

The fundamental cause of the development of the second economy in the central planning economy of the old USSR was the chronic shortages of consumer goods. North Korea is no exception to this. The difference worth mentioning is that in the old USSR and East European countries the major portion of trade in the second economy was occupied by durable consumer goods and cultural commodities such as books and phonograph records while in the North Korea, the trade of agricultural products, food, and life necessities are dominant in the second economy. Not only does North Korea lag behind those countries in terms of production capability and level of economic development, but the lack of food and life necessities has intensified in the midst of the prolonged economic downturn.

The sectors of the second economy can be divided into four different categories: 1) trade of consumer goods; 2) financial trade; 3) individual service sector; and 4) real estate trade. The consumer goods sector comprises agricultural products, food, necessities of life, and manufactured goods. Among the agricultural products, corn is the most important. Garlic, beans, glutinous rice, rice, mung beans are also traded, depending on the region, as well as fish such as Alaskan pollack and dried flatfish. Grains are cultivated in the officially permitted gardens and backyards, and also in illegally-plowed patch fields by individuals.

North Korea has allowed workers of factories and companies to privately grow grains and vegetables in small fields of up to 50 pyong for each individual. Fields for subsidiary cultivation were created by reclaiming hillocks assigned to the companies by the

²⁴ See Naewoe News Agency (1995), p.170; *Unified Korea*, June 1996, p.80, and *Choong-Ang Ilbo*, Nov. 24, for the report of dollarization of North Korean economy and ensuing irregularities related to the foreign currency.

state. Companies allow the workers to spend 20 days a year on two separate occasions to grow the crops, and workers are allowed to dispose of the crop at will. Because of this, the productivity of crops is twice as high as that of cooperative farms.²⁵ Patch fields are illegally-plowed and cultivated fields other than those officially given to the workers and farmers. The grains produced this way are partly consumed for one's own use, partly used for trade in the farmers' market, and partly sold directly to people from other local areas who need food. All kinds of foods including liquor, rice cake, tofu, candies, noodles, and kimbab (rice and other ingredients wrapped in dried seaweed) are also consumer goods traded in the second economy. Food stuffs are usually made by the housewives at home, and are bartered with grains or other consumer goods, or sold for money as in the case of kimbab sold on trains.

The life necessities traded in the second economy are very diverse. They include: winter underwear, soap, cosmetics, glasses, footwear, cloth, and sportswear, among others, generally coming from foreign countries such as China or having been stolen from workplaces. On the other hand, manufactured goods such as TVs, radios, refrigerators, bikes, sewing machines, tape recorders, and electric rice cookers are also traded on the black market. Most of these items are smuggled goods, goods received from bribery, stolen articles from the workplace, and goods obtained from the state-run shops or foreign currency shops. The price of products traded in the second economy vary widely depending on the region and time, but as a rule they cost 10 times the state-determined price, though sometime they cost as high as 50 or 100 times the normal price, depending on the article.²⁶

For example, the price of corn, set at 6 chon per kg by the state, is about 15 won at the farmers' market. Bicycles, whose state price is 150 won, are sold for 1,500 won at the farmers' market. Color

²⁵ Naewoe News Agency (1995), p. 230. But Min-bok Lee testified that side-work field was introduced first in 1982, (*Unbun Ilbo*, Feb. p. 39).

²⁶ See for the discussion on the black market trade Jaegun Seo (1994), pp. 28-29, Naewoe News Agency (1995), pp. 71-75, *United Korea*, August 1996, pp. 88-95.

Official Prices and Farmers' Market Prices for Major Goods

(1 won = 100 chon)

Category	Goods	Unit	Official Price	Farmers' Market Price
Foods	Rice	1 kg	8 chon	35 won
	Corn	1 kg	6 chon	15 won
	Pork	1 kg	3 won 40 chon	50 won
	Chicken	1 kg	10 won	160 won
	Egg		17 chon	4 won
	Apple	1 kg	50 chon	12 won
	Liquor	0.5 l	2 won	20 won
	Candy	500 g	5 won	75 won
	Sugar	1 kg	6 won	12 won
	Salt	1 kg	15 chon	7 won
	Cooking Oil	1 kg	4 won	60 won
Clothing	Suit Material	2.5 m	120 won	250 won
	Warmup Suit		150 won	550 won
	Shirt		4 won	9 won
	Sneakers	1 pair	14 won	280 won
	Socks (Blend)	1 pair	80 chon	10 won
	Socks (Nylon)	1 pair	5 won 50 chon	20 won
Other Goods	Color TV		750~1,200 won	50,000 won
	Black & White TV		200~700 won	5,000 won
	Refrigerator		1,400 won	10,000 won
	Tape Recorder		600~800 won	5,000~15,000 won
	Light Bulb		50 chon	13 won
	Electric Rice Cooker		80 won	350 won
	Sewing Machine		220~350 won	3,000~4,000 won
	Bicycle		150 won	1,500 won
	Floor Lining	13 m ²	10 won	170 won
	Smokeless Coal	1 ton	30 won	150 won
	Toothpaste		11 won 40 chon	6 won
	Detergent		50 chon	6 won
	Facial Soap		2 chon	20 won
	Notebook		25 chon	2~3 won
	Fountain Pen		3 won 50 chon~10 won	7~25 won
Facial Cream		1 won	3~4 won	
Dresser		120 won	400 won	
Cigarettes		80 chon~1 won 20 chon	15~20 won	

Source: Naewoe News Agency (1995), p. 225.

Note: Compiled from testimonies by defectors from 1989 to 1995.

TVs, whose state-set price is between 750-1,200 won, cost around 50,000 won at the farmers' market.

The prices of manufactured goods in the farmers' market are mostly formed around the prices at the "collect and remake" secondhand shops. Originally "collect and remake" shops used to buy used or waste articles and after repairing or refurbishing them, resell them for some margin. Recently, though, more and more Chinese immigrants, Korean immigrants from Japan, diplomats, and employees of trading companies are selling goods acquired abroad to these stores. The buying prices of "collecting and remaking shops" are lower than those of farmers' market, but the number of people who sell such goods to these shops has increased despite the lower margin because trade in the farmers' market is socially reproachable and can be punished if disclosed.²⁷

The second most important form of the second economy can be found in the financial sector. More specifically, there are two types of business—black market dealing of foreign currencies and private money-lending. The official exchange rate is one U.S. dollar equals 2.15 North Korean won, but in the black market, 1 dollar is worth 70-100 won, the equivalent of a worker's average monthly salary.²⁸ Officially, one Chinese won (RMB) equals 0.25 North Korean won, but one RMB is exchanged for 18-22 North Korean won in the black market. Such black market dealing of foreign currencies used to be done in secret places, but nowadays they have become so universalized that one can easily observe such dealings even on the streets of Pyongyang.²⁹

More recently, private money-lending has emerged as another form of the financial second economy, for two main reasons. The increase in foreign currency-earning businesses has led to increased demand for money because of the immediate need for money or shortages of funds sometimes facing both individuals and also institutions and businesses. On the supply side, banks are

²⁷ Myung-je Cho (1996), p.10.

²⁸ Based on testimony by Mr. Hae-sung Jang, a North Korean writer who defected to the South in May 1996. *Segye Ilbo*, July 6, 1996.

²⁹ "Pyongyang Seen by a Chinese Person," *Dong-A Ilbo*, September 25th, 1996.

not very attractive to those who have surplus money, not only because interest rates are very low, but also because it is difficult to take out money immediately when needed. Therefore, they prefer private money-lending to those engaged in foreign currency-earning businesses, which yields much higher interest and also allows the lenders to more easily obtain foreign goods that they need by asking the borrowers—that is, the people engaged in foreign trade. The interest rate for private money-lending ranges from 10% to 20%.³⁰

The third form of the second economy is individual service activities. Skilled workers are engaging in side jobs such as carpentry or repairing footwear, clothing, and umbrellas. Around the 80th birthday of Kim Il-Sung (April 15th, 1992), various street stalls also emerged in big cities.³¹ In Pyongyang, they are selling ice cream during the daytime, and at night, one can find more stalls selling hair combs, hair pins, buttons, rice cakes, vegetables, and other types of food. They can be found in apartment complexes, around subway station entrances, and around the West Pyongyang Station.

The exact size of the second economy cannot be known, but one can get a sense of its size and importance from the testimonies of defectors. Recent defectors have testified that North Korea residents buy 50-90% of their food and other daily necessities from the second economy, although there are variances depending on region and social status, and the method of payment could be either bartering or cash payment.³²

In the same vein, Professor Lee Young-wha, a Korean-Japanese scholar who studied in at North Korea's Institute of Social Sciences from March 1991 to December 1991, has testified that North Korean residents buy 80% of their daily necessities at black markets. Additional evidence of the prevalence of the second economy in North Korea could be the data from the Choong-Ang Ilbo's survey on 35 defectors' side-job experiences. According to

³⁰ *Testimony by Defectors*. (Naewoe News Agency, 1995), p. 227.

³¹ *Tong-il Han-guk* [Unified Korea], August 1996, p. 93.

³² Seung-ryul Oh (1996), p. 119.

the data, 20 of them (57%) said that they had engaged in private trading, 3 (9%) responded that their family members had been engaged in private trading, and only 12 (34%) testified that neither they nor their immediate family members had ever done so.³³

Many defectors also testify that official salaries are no longer important in North Korea as many people receive much more income from private side jobs and trading. This indicates that the second economy is a fairly universal phenomenon in society. For example, Mr. Yeo Man-chul and his family members, who recently defected to the South, testify that the heads of families receive an official monthly salary of 70 North Korean won, while housewives can earn 300-400 won from their private trading activities. Therefore, all North Korean residents want to have their own business, and the dream of Mr. Yeo's wife while she was in North Korea was to do business as much as she wanted.³⁴ Considering all these testimonies by defectors, it seems safe to say that the second economy in North Korea and especially black markets are now playing a very important role in providing ordinary residents with food and other daily necessities.

Compared to North Korea, how important was the second economy in the former Soviet Union and East European countries? In the early eighties, 7 million out of 10 million Hungarians had some income from their activities in the second economy, and the income flowing from the second economy was much larger than that from the official economy.³⁵ Meanwhile, R.G. Kaiser, who worked as a Western reporter in Moscow in the mid-seventies, estimated that the size of the second economy amounted to the 20% of the size of the first economy. In the same vein, Z. Katz estimated the size of the second economy to be around 10-15% that of the first economy, a result based on his survey of those who had moved from the Soviet Union to foreign countries.³⁶ Therefore, the

³³ *Choong-Ang Ilbo*, January 26, 1995.

³⁴ Quoted from Jae-jin Seo (1994), p. 29-33.

³⁵ Istvan Kemeny, "The Unregistered Economy in Hungary," *Soviet Studies*, July 1982.

³⁶ Z. Katz, "Insights from Emigrees and Sociological Studies of the Soviet Union," *Soviet Economic Prospects for the Seventies*, Washington, D.C.: Joint Economic Committee, 1973.

second economy of North Korea seems to be smaller and less significant than that of Hungary in the eighties, which was generally considered to be the most developed in East Europe, while its importance is greater than that of the former Soviet Union in the seventies.

Economic and Social Effects of the Second Economy

The effects of the second economy on the North Korean economy can be discussed in two different time frames: the short term and the long term. As to the short-term effects, the expansion of the second economy has the negative effect of aggravating the stagnation of the planned economy sector, as well as the positive effect of mitigating the deficiency of consumer goods.

In the short term, the amount of resources such as labor, capital, and raw materials that exist within an economic system is basically constant. Therefore, the more activities in the second economy increase, the more resources will flow from the first to the second economy, thus resulting in the further shrinkage of the first economy.

The second economy also has some short-term positive effects, however. First of all, it can increase the total amount of supply by making a more efficient use of resources obtained from the first economy and also by illegally importing goods. The second economy can also mitigate the existing regional inequalities in the supply of consumer goods such as foods by stimulating and extending commercial exchanges.

Of course, there is no way of accurately measuring these positive and negative effects, but the positive effects are inferred to be greater than the negative for following reasons. First, the production of farming necessities such as fertilizers and chemicals in North Korea has greatly gone down, and the use of farming machines has become more difficult due to fuel shortages. Under these circumstances, to prohibit any private cultivation in its various forms such as *totbat*, *puoppat*, or *ttwaegibat* and to divert the labor forces into collective farms would result in a net loss. That is, the decrease in the production of small private farms

would be greater than the increase in the production of collective farms.

Second, with only 30% of the industrial facilities being in operation, most private businesses are run by the idle labor. Therefore, the prohibition of such private small businesses would not heighten the rate of industrial operation. It would only deepen the regional inequalities in the supply of consumer goods.

Third, the smuggling of daily necessities from China is mitigating the shortage of consumer goods and reducing inflationary pressure. The prohibition of smuggling would not increase the production of daily necessities in the planned economy sector while reducing the supply of daily necessities in the second economy.

Fourth, the daily necessities such as clothing and footwear that are privately produced are made mainly from idle or waste materials; similarly, liquor, rice cakes, and cookies are all produced without subtracting resources available for the first economy. Therefore, if private side businesses are banned, it will only bring about a production reduction in the second economy without noticeably increasing production in the first economy.

Fifth, the circulation in the second economy of illegally obtained goods only has a redistribution effect. The prohibition of such illegal circulation, therefore, would not change the total amount of supply in the whole economy.

In conclusion, the short-term net effect of the second economy seems to be a positive one. Specifically, it greatly alleviates the problem of the shortage of consumer goods.

The long-term effects of the second economy, however, are negative both in terms of the economic and social aspects. In economic terms, the expansion of the second economy could create a long-term vicious cycle between the stagnation of the national economy and the deficiency of investment. The second economic sector is mostly comprised of commercial and private service businesses, in which production plays only a minor role. Therefore, its expansion does not necessarily lead to an increase in productive investment. If one looks at the case of Hungary, where private and small-scale businesses prospered, one finds that most

of the profits went not to investment, but to consumption (the purchase of resort houses, automobiles, entertainment ships, and so on).³⁷

In North Korea, the expansion of the second economy, consists merely of in-house production of food and other daily necessities (e.g., liquor, rice cakes, cookies, clothing, and footwear), would not lead to an increase in productive investment. On the other hand, the expansion of the second economy could have not only the short term effect of shrinking the first economy by taking away resources, but also the long-term effect of reducing investment resources, and thus deepening the stagnation. Due to the non-registration of private businesses and commercial transactions, the under-reporting or non-reporting of external trade, and the misappropriation of public resources by state employees, the government's revenue will decrease, thus resulting in the reduction of government investment in the planned economy. In addition, the expansion of the second economy will reduce the effective labor input into the planned economy, and consequently reduce the sector's overall productivity. In sum, the expansion of the second economy will only reduce investment resources available for the planned economy, without significantly increasing investment in the second economy. Therefore, its net effect on investment is negative.

According to our discussions thus far, the short-term economic effect of the second economy is positive, while its long-term effect is negative. One thing to consider, however, is the fact that many North Korean residents are now suffering from severe shortages of food and other daily necessities. In such a crisis situation, the present may be much more important than the future, and therefore, the short-term positive effect may be more important than the long-term negative effect, at least for those suffering people.

The long-term effect of the second economy in social terms is even more negative. First of all, by encouraging the spread of materialism, the pursuit of private interests, the deepening of

³⁷ Kemeny (1994), p. 358.

social corruption, the widening of the gap between the rich and the poor, and the sharpening of the conflict between classes, the second economy will gradually destroy the socialist values and morals. With large incomes available from activities in the second economy, many North Korean residents tend to think lightly of salaries from their official jobs. The fact that workers in those sectors producing large non-official incomes (e.g., external trade, diplomacy, and driving) are considered the best prospective grooms by North Korean females testifies how widespread materialism is in the North Korean society.

Moreover, with the expansion of the second economy, party cadres and other officials in various organizations are more frequently engaging in bribery and other forms of corruptive behavior. Recently, all kinds of bribery have begun to emerge, including bribing for college entrance, for service providers, for buying goods in foreign currency stores, for buying houses, for traveling without a permit, and for better positions in working places, among others. This prevalence of corruption in every sector of the society has led people to coin a new name for North Korea—that is, “a bribery republic.”

The expansion of the second economy has also increased the number of rich people in North Korean society, who are able to make use of the expensive black markets, while others cannot afford to do so. This creates or widens the gap between the rich and the poor, something that socialist societies claim not to have. The widening gap, in turn, could result in a new class system based on wealth, as well as social conflicts between classes.

Second, as evidenced in the former Soviet Union and East European countries, the destruction of socialist values and morals could usher in a cynical view of the state and anti-culturalism, which could in turn bring about a new civil society that is emancipated from the state, and organize potential anti-regime political forces. It goes without saying that these were among the most important factors for the eventual collapse of the above-mentioned socialist systems.

The same is happening in North Korea, and capitalist instincts such as materialism and the worship of money are rapidly

spreading into people's daily lives. Of course, we have yet to see these changes in the economic sector penetrate the core element of the society, thus laying the foundation for a new anti-regime civil society, as was in the case of the former Soviet Union and East European countries. There does exist such a possibility, however, if the country becomes more and more exposed to external information with the normalization of relations with Western countries and the expansion of economic opening.

How, then, is North Korea responding to this expansion of the second economy? As we have seen, the North Korean second economy began to emerge in the early eighties and rapidly expanded in the late eighties, thus resulting in the farmers' markets becoming black markets, the dollarization of the economy, and the increase and spread of corruptive behavior related to the second economy. In response to these developments, the North Korean government have taken various measures since the late 1980s designed to check the growth of the second economy, but most of these control measures have gradually lost their effect or disappeared without having significant effects on the second economy.

First, the government prohibited illegal private farming in 1989 and ordered the closing of unauthorized markets and the transformation of daily markets into 10-day interval markets in 1992. From 1993, however, these measures have become ineffective.³⁸ With the deepening of the food shortages in the 1990s, the North Korean government, unable to supply a sufficient amount of food through the official rationing system alone, could no longer ignore the fact that a considerable number of residents were able to support themselves with the extra income from private side jobs and commercial transactions.

Second, the government tried to reduce the number of foreign currency stores in 1992, but in 1993 the number began to increase again. Foreign currency stores started in 1975, exclusively for foreigners, and in 1986 North Korean residents were allowed to use the stores only if they had foreign currency. It was during the

³⁸ Naewoe News Agency (1995), p. 71.

world youth festival for socialist students held in July of 1989 that the number of foreign currency stores greatly increased. The consequent increase in foreign currency transactions created a psychological gap between foreign currency holders and non-holders, and to resolve this social problem Kim Jong-il ordered the number of foreign currency stores and restaurants to be decreased in 1992. The order closed all the foreign currency stores except seven in Pyongyang, and likewise the number of foreign currency restaurants decreased considerably. This order, however, resulted in a shortage of foreign currencies and consumer goods, and in 1993 the number of foreign currency stores and restaurants began to increase again.³⁹

Third, the government also organized “groups for destroying anti-socialist elements” and “resident patrols” in order to discover and punish those who produce liquor illegally, steal others’ property, misappropriate state property, and spend much more than they earn. As these organizations became sources of new types of corruption, however, they did not last long. With increasing complaints on the part of ordinary people, groups for destroying anti-socialist elements stopped their activities in 1993, which was only one year after their establishment.⁴⁰

Conclusion

The fact that any Soviet-style command economy has space for second economy is a reflection of an important structural deficiency of the system— that is, a perennial shortage in consumer goods. In the eighties, the North Korean economy, as it reached its limit in quantitative growth through the input of mobilized production factors, attempted a partial reform of the command economy as well as external opening. These policy changes, in turn, provided momentum for the rapid expansion of the second economy. Non-official economic activities such as secret deals and smuggling led to the prevalence of corruption and

³⁹ Naewoe News Agency (1995), pp. 94-95.

⁴⁰ Seo (1994), pp. 37-38; Naewoe News Agency (1995), pp. 135-136.

the spread of materialism throughout society, and due to these socially undesirable effects, the government tried to strengthen its control over the second economy. With the deepening of economic difficulties and the food shortage in particular, however, the North Korean government had no choice but to ease the control, and thus tacitly accept the second economy as a sort of safety valve.⁴¹

What influences will the expansion of the second economy have on North Korea's economic policies and its system changes? The second economy, while it has the short-term positive effect of alleviating the problem of insufficient consumer goods, a typical defect of a command economy, could undermine in the long term the foundation of the socialist system not only by reducing investment resources, but also by destroying socialist values and morals. The ultimate solution for the problem of the second economy, therefore, is to correct the dual structure of the economy by transforming the first economy into a market economy through fundamental economic reforms.

The former Soviet Union and East European countries also had fairly developed second economies, although their size and importance varied across countries. It must be noted, however, that the existence of such a developed second economy delayed fundamental economic reforms, as it complemented the structural deficiencies of the command economy by mitigating a shortage in consumer goods. The reason was that those elite members within the party and the government who dealt with matters related to economic planning and state control over firms would not give up their vested interests. Therefore, those countries tried to control their second economies in order to prevent their excessive development, but the result was the collapse of their political systems, as well as their economic systems.

In contrast, China initiated economic reforms and opening before its second economy fully developed, and largely due to these early efforts, the country has been able to achieve remarkable economic success throughout the years. Although its politics is still controlled by the Communist Party, the Chinese economy is

⁴¹ Oh (1996) and Chang (1996) also express similar views.

now very close to a market economy. Of course, China also experienced an increase in corruptive behavior and bribery after the reforms and opening, but it must be noted that these can be characterized as a black market generally observed in developing countries, which is fundamentally different from the second economy in a Soviet-style command economy.

Two future scenarios are possible for North Korea's second economy. Depending upon the government's choice, it may co-exist with the planned economy for a while before eventually being destroyed by the system collapse, as in the case of former Soviet Union and East European countries. Alternatively, if the North Korean government introduces Chinese-style fundamental economic reforms, the bulk of the second economy will be absorbed into the official economy while the rest of it becomes a black market generally seen in most capitalist countries.

Entering into the nineties, North Korea has established a Chinese-style special economic zone, called the "Rajin-Sonbong Free Economic and Trade Zone," and encouraged foreign investment for its development. In 1996, the country reformed its cooperative farms by giving more autonomy to the management system of the lowest production unit, called the "Pun-jo." More specifically, the number of members in a Pun-jo was reduced from 10-25 to 7-8, the production target became more reflective of the reality, and the members were given the right to dispose of any amount exceeding the target as they like.⁴² These changes imply that North Korea might be cautiously experimenting with Chinese-style economic reforms. Of course, North Korea's reform policies do not constitute fundamental reforms yet as they aim at autonomy within the planning mechanism. The leadership seems to be worried about the political costs of fundamental economic reforms. Therefore, it is too early to tell whether the expansion of the second economy is a sign of system collapse, or a prelude to economic reforms. For a more definitive conclusion, we must observe carefully the future changes in North Korea's economic policies. In this respect, it will be very interesting to see what

⁴² *Chosun Shinbo*, October 4, 1996.

economic policies Kim Jong-il proposes at the time of his official power succession.

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