

# The Second Economy in North Korea

Hong-Tack Chun\*

This paper shows that the second economy plays a significant role in North Korea and complete picture of total economy cannot be obtained if one looks at only the planned sector of the economy. It also shows that presence of the second economy puts pressure on the first economy for change and the expansion of the second economy results in rising tensions between the first (planned) and the second (private) economy and undermining the socialist values. (JEL Classification: P29)

## I. Introduction

Scholars of the Soviet-type centrally planned economy have long focused their attention on only the planned activities. However, since the 1970s, there has been a significant rise of interest in the unplanned activities of the *Planovoe khozyaistvo* (planned economy). If the term 'first economy' refers to the planned sector of the socialist economic system, then the term 'second economy' describes all economic activities that lie outside the plan. The second economy has existed since the early stages of socialism in Eastern European states, and in the 1970s it has grown in significance to appear on official media such as *Pravda* with some frequency (O'Hearn 1980, pp. 218-34).

The second economy, which has been recognized as an important factor in transformation of the economies of the former USSR and Eastern European countries, has existed also in North Korea. Especially since the late 1980s, it has grown substantially in size due to the economic deterioration of North Korea. What is often called

\* Senior Fellow, Korea Development Institute, 207-41 Choungyang, Seoul 130-012, Korea, (Fax) +82-2-961-5092, (E-mail) htchun@kdiux.kdi.re.kr. I would like to thank two anonymous referees for helpful comments. All remaining errors are naturally my responsibility.

the black market or the underground economy, the second economy can be found in socialist as well as capitalist economies and is not a unique phenomenon in North Korea. Nonetheless, the expansion of the second economy in a socialist state signifies the expansion of private interest in economic activities, which in turn, is identified as an important factor in undermining the socialist system as it was seen in the former USSR and Eastern European countries. In this regard, the fact that the second economy is booming in North Korea is worthy of our attention.<sup>1</sup>

There are varying opinions on how to interpret the second economy in North Korea. Some posit that expansion of the second economy caused by the serious disintegration of North Korea's economic structure is a symptom of eventual collapse. Robert Collins, an expert on Korean affairs, hypothesized "A Seven-Phase Scenario for North Korean Disintegration" in which the country's economy disintegrates from lack of resources, prioritization of resource distribution, secession of the economy from state-governing, repression, resistance, disunion, to power reorganization, in that order.<sup>2</sup> Collins states that as black markets begin to fill in the void left behind by the state's inability to reallocate resources, the third step, secession of the economy from state-governing, will proceed.

According to Collins, during this third phase, embezzlement and larceny are prevalent along with illegal cross-border trade. Black markets expand as independent economic activities take on more visible form by producing and distributing goods with no deference given to the state permission. Once the members of military units and internal security forces begin participating in black market activities, the central authority will perceive it as a threat to their regime and begin to take measures to terminate such activities, inaugurating the fourth phase of repression. Collins adds that, in general, most of North Korea has entered the second phase with some isolated regions exhibiting traits of the third and the fourth

<sup>1</sup>For further readings on the correlation between the spread of second economy and the transformation of the Soviet-style planned economy, see Korea Institute for National Unification (1993) and Seo (1994).

<sup>2</sup>*Chosun Monthly*, May 1996, pp. 364-81. Former Vice-Minister of Unification Song, Young-Dae also identified the expansion of second economy as a precursor to the disintegration of the North Korean regime. See "An Evaluation of North Korean Regime Disintegration Possibility," *National Security in the 21st Century*, December 1996.

phases.

A contrasting view is that the expanding second economy will eventually lead to a market-oriented reform in North Korea (Lee 1992, p. 473). More cautious view is that the expansion of the second economy must be interpreted as part of the struggle for survival now being waged by all North Korean citizens under the tacit approval of the central authorities (Oh 1996, pp. 115-36).

This paper intends to deal with some useful materials and data concerning the second economy in North Korea to provide the momentum for promoting the study of the second economy to understand the total picture of North Korean economy and to analyse the effect of second economy on North Korea, though available materials and data are extremely limited.<sup>3</sup>

## II. Definitions of the Second Economy

Among academics, there exists a rather lively debate on the issue of nomenclature concerning the use of the term 'second economy'.<sup>4</sup> Grossman (1977) writes that the term 'second economy,' refers to "all production and exchange activity that fulfills at least *one* of the following two test: 1) being directly for private gain; 2) being in some significant respect knowing in contravention of existing law (Grossman 1977, p. 25)." According to Grossman's definition, the production and exchange of agricultural products originating from state-sanctioned private plots in the Soviet Union were part of the Soviet second economy because although they were not in contravention of existing law, they were indeed for private gain.

In contrast, O'Hearn (1980) criticizes Grossman for "missing a point of vital importance (pp. 218-9)." O'Hearn argues that since the term 'first economy' refers to all those economic activities occurring within the central authority's plan, a second economy must define activities occurring outside the planning structure. It

<sup>3</sup>There are only two available studies on the North Korean second economy. Oh (1996) analyzed the second economy as a part of North Korean regime's survival strategy, and Seo (1994) analyzed it as an economic liberalization phenomenon resulting in the change in North Korean citizens' values.

<sup>4</sup>The confusion in the terminology and definition is greater in the studies of underground economy in capitalist countries. See Choi (1987, pp. 5-23).

comprises activities that are either (1) not explicitly taken into account in the plan or (2) not officially sanctioned as a part of the national economy. Under O'Hearn's concept of a second economy, products originating from state-sanctioned private plots in the Soviet Union are officially sanctioned as a part of the national economy and are even reflected in the balance of income and outlays. Therefore, they are not a part of the Soviet second economy. On the other hand, a speculative exchange of farm products produced in private plots, because it is an illegal activity, would qualify as a part of the second economy.

Kemény (1982) uses the phrase 'unregistered economy' instead of 'second economy.' Kemény defines the phrase as all economic activities that are not accounted for by the central authorities such as the office of central statistics. Kemény disregards the legality of an activity in his definition, in which a second economy may include both legal and illegal exchange of goods. In this aspect, an unregistered economy is a relatively broader concept than that of a second economy, similar to the concepts of underground, or hidden economy frequently used in studies of capitalist economies. Such indiscriminate definition of a second economy should be understood under the unique context of the pre-reform Hungarian economy, where the size of the extra-plan sector was quite large, and recognized by the state early on in socialist Hungary.<sup>5</sup>

In reference to the second economy of North Korea, Oh (1996) uses the term 'unofficial,' and Jang (1996) uses the term 'underground.' Oh does not specifically define the term 'unofficial,' but it can be inferred that he is referring to the economic activities occurring illegally under the North Korean law (Oh 1996, p. 16). According to this view, exchange of goods produced from the state-sanctioned private plots as well as personal home production and trade are within the legal boundaries, therefore should be included in the official, rather than the unofficial realm of economic activity.

Jang (1996) writes that an underground economy of socialist countries consists of those activities that the state cannot regulate,

<sup>5</sup>Tanzi of International Monetary Fund (IMF), defines the underground economy as a part of gross national product that is not officially recognized due to various inconsistencies of reporting. Similarly, the National Statistics Bureau of the U.K. defines the underground economy as an economic activity that GNP estimation can not identify. See Choi (1987, pp. 7-8).

and that the profits realized and goods purchased through underground production and distribution are considered underground activities (Jang 1996, pp. 21-2). According to this view, the production and distribution of private plot goods or the activities of street vendors sanctioned by the state should all be considered non-underground. It is interesting to note that Jang contradicts himself by identifying private plot cultivation as the primary source of underground goods supply.

Having reviewed such diverse and sometimes conflicting terminologies used to describe the "private sector" of the socialist planned economies, it is important to choose and to define the most appropriate term for the purpose of this paper carefully. The term 'second economy,' is preferred here over 'unofficial,' or 'underground,' because the latter two are often used in studies of capitalist economies. Granted that the term 'second economy' can be found in reference to some aspect of capitalist economy, it has gained wide acceptance among scholars of socialist economy over the years.<sup>6</sup>

There are some very important differences in the purpose and range of the study of an underground economy in capitalist system and a second economy in socialist system. The purpose of the former is to identify and to determine the size of tax evasion and to assess the economic effect caused by it. In contrast, the latter's goal is to analyze the second economy itself to obtain the complete picture of the total economy and the effect of liberal economic culture based on market principles on socialist states' social as well as economic structure. Even though private plot cultivation, home production, and trading in farmers' markets are sanctioned by the state in North Korea, there are no official data and furthermore they are free economic activities with the goal of private profit realization operating under the market principles of supply and demand. The terms 'underground,' or 'unofficial' are insufficient to describe activities such as private plot cultivation, and trading in farmers' markets and home production, whereas the term 'second economy' has the conceptual range to include these activities. In the case of North Korea, there exists an agency called the Second

<sup>6</sup>The term 'second economy' was first used by K. S. Karol in 1971 and has since gained wide acceptance among scholars such as Grossman (1977), O'Hearn (1980), Ericson (1984), Wellisz and Findlay (1986), among others.

Economy Commission (*Joong-Ang Ilbo*, May 22, 1995), which is the administrative body for military supply. This may confuse the reader in so far as the terminology is concerned, but in consideration of this paper's purpose and the degree of international recognition it carries, the term 'second economy' seems most appropriate.

For the purpose of this paper, a second economy is defined as analogous to private economy to which planned economy's mechanisms no longer apply. Whether it is legal or illegal, or whether it is creating value added or just redistributing existing income, any activity that aims to create private profit is considered a second economy's activity.

### III. The Second Economy and Black Markets

The second economy in a socialist country is then, by definition, excluded from the state-coordinated distribution channel, and therefore these activities need to develop their own markets. These activities often are illegal in nature, and the markets in which illegal activities occur are subsequently called black markets.

There are farmers' markets in North Korea, which have replaced the rural markets since August 1958. Farmers' markets refer to the place where farmers of the cooperative farms can sell agricultural products from their private plots to the consumers directly. According to the Academy of Social Science in North Korea, farmers' markets admittedly reflect many aspects of archaic capitalist remnants. However, they are provided for the workers of North Korea to cope with the reality of shortage of goods (Institute for Juche Economy 1985, pp. 367-8). It is maintained that once socialism reaches the stage of development that can supply an ample amount of goods, farmers' markets will naturally become extinct.

Farm products traded on farmers' markets come mainly from the cultivation of private plots (*thut-bhat*). Under these conditions, the North Korean government, worried about the possible spread of capitalistic elements that farmers' markets contain, has limited the area for private cultivation per household to 30 pyung (100 square meters), and forbidden the acts of exchanging grains on these markets. This kind of market had also existed in the Soviet Union (*iarmarka*) and other socialist countries. Private farming in these

countries played an important role in meeting demand for food, with the exception of grain. It was reported that Soviet farmers in 1977 had been able to meet about 72% of their demand for meat, 76% for milk and for almost all potatoes and eggs with products from private farming and stockbreeding. It was also reported that 25% of total agricultural products in the Soviet Union at that time came from this private farming, which accounted for only 3% of the total arable land.<sup>7</sup>

Until the 1970s, the role of the farmers' markets in North Korea had remained insignificant, but during the 1980s with deterioration of the economy, farmers' markets were transformed into black markets exploding in size and significance.<sup>8</sup> Today, even contraband goods are exchanged in farmers' markets. Several causes that attributed to the development of farmers' markets are discussed here.

First, due to the severe shortage of food, corn, which is by law illegal to be traded on farmers' markets, has become one of the major black market items in recent years. Originally farmers' markets were intended to take place every ten days only in rural areas but since the late 1980s, they have begun to spread out to every corner of the country and have become a daily phenomenon.<sup>9</sup> In early 1990's, the North Korean authorities tried to keep these markets under the existing regulations, particularly concerning the frequency of openings without much success. In fact, despite the aggravating economic situation, many North Korean citizens have been able to make their living, thanks to these black markets. Since 1993, even grain, such as rice and corn, has been permitted to be sold on these markets (Hong 1999, p. 83).

Second, in the early 1980s, border trade between Chinese and North Korean cities began to expand. Peddlers, mainly ethnic Koreans in China, crossed the border into North Korea to sell Chinese-made industrial goods in exchange for North Korean fishery

<sup>7</sup>The size of a private plot in the Soviet Union was 0.25 hectre. See Nove (1986, p. 12, pp. 116-7).

<sup>8</sup>Some of trading in farmers' markets are legal and some are illegal. Though, farmers' markets are not identical to black markets, they are interchangeably used in this paper.

<sup>9</sup>From statements of North Korean defectors Park, Sung-Hyun (defected October 11, 1993) and Choi, Myung-lock (defected February 13, 1994). See Seo (1994, p. 26).

products and antiques. These peddlers made North Koreans open their eyes to capitalist ideas (Seo 1994, pp. 26-7).

Third, the "August 3rd Consumer Goods Production Movement" which began in 1984, provided the momentum for North Korean workers and farmers to engage in moonlighting activities to manufacture various items, such as furniture, clothes, footwear, among others. This is a nation-wide movement launched on the orders of Kim, Jong-Il who, after inspecting an exhibition of light industry goods held in Pyongyang on August 3, 1984, called upon the workers and farmers to boost the production of consumer goods by organizing work units on the side to manufacture goods without the support of central planning authority utilizing whatever materials were available on hand in local areas (Hong 1996, pp. 98-9). Under this order, these supplementary work units have been formed in factories and on farms, and household work units in villages.<sup>10</sup> As the economic conditions grew worse, more and more people began to engage in similar activities on an individual basis, instead of as registered members of a work unit. Consumer goods produced in this way began to be traded on farmers' markets.

Fourth, due to the collapse of the domestic economy, the value of foreign currency especially US dollars, has risen, and since the 1990s, US dollars have become the most favorite bribery item among the populace. Those who are engaged in "foreign exchange earning businesses" come to pocket US dollars for their own use. Foreign currencies have come to be traded on black markets.<sup>11</sup>

#### **IV. The Development and Composition of the Second Economy**

The fundamental cause behind development of the Soviet second economy was the chronic shortage of consumer goods. In the case of North Korea, the cause remains the same. The only difference, if one can call it that, is that the second economies of the Soviet

<sup>10</sup>It is inferred that similar work units have existed before August 3, 1984, by the entry in Institute for Juche Economy (1985, p. 49), of such an activity.

<sup>11</sup>For further readings on "dollarization" of the North Korean economy and the subsequent abuse of foreign exchange management, see Naewoe Press (1995, p. 170) and *Unified Korea* (1996d, p. 80).



Union and the Eastern European countries were composed of relatively large shares of durable consumer goods such as books, music recordings, and even automobiles whereas in North Korea, the absolute majority of its second economy is composed of non-durable goods such as agricultural goods and foodstuff. This difference can be attributed to the different level of economic development that these economies have achieved and to the severe economic difficulties in North Korea in 1990's.

The composition of the North Korean second economy can be roughly divided into four sectors: (1) consumer goods sector; (2) financial sector; (3) personal service sector; and (4) real estate sector. The consumer goods sector can be further divided into agricultural/fishery goods, processed food, household necessities, and industrial goods. Corn accounts for most of the agricultural/fishery goods, and depending on the region, garlic, beans, sweet rice, rice, green beans, pollack, and flat fish are exchanged as well. Corn is produced either in officially sanctioned factory-farm or in a much smaller-scale patch-farm, which is illegally cultivated.

Since 1987, the North Korean government allotted plot of wasteland approximately 50 pyong (150 sq. meters) to all rural factory workers for the purpose of subsistence farming. The government grants all rural factories a piece of land, which in turn, is divided and distributed to their workers. Factories also grant 20 days of leave twice a year for them to farm, products from which are given for personal use. The productivity from these factory-farms exceeds that of farm cooperatives by the factor of two.<sup>12</sup>

Patch-farm is a small plot of land that is used for cultivation, not sanctioned by the concerned authorities. Products from patch-farms are in part consumed by the farmer, traded at the farmers' market, or exchanged to people from other towns in need of foodstuff. Liquor, bean curd, candies, noodles, and other home made foodstuff also have become major items traded on the second economy. Peddlers appeared also to sell eatables in trains through barter for other foodstuff such as grains.

Underwear, soap, spectacles, footwear, clothes, and so on are also sold on black markets. Most of these items have come from

<sup>12</sup>Statements from the North Korean defectors. One defector, Lee, Min-Bok claimed that factory farms were allowed since 1982 (*Unified Korea* 1996a, p. 39).

China but some of them are contraband items smuggled out of factories in North Korea. Relatively expensive items such as TV sets, radios, refrigerators, bicycles, sewing machines, tape recorders, and electronic cooking pots also appear on black markets. These items supplied by those who are privileged to buy them at foreign exchange stores where they are sold to get foreign exchange. Although the black market price of commodities tends to fluctuate greatly depending on the region and season, in general, it is 10 times the official price, with some items traded at 50 to 100 times a higher price.<sup>13</sup>

For example, 1 kilogram of corn is 6 North Korean chun when traded at the official price, but the black market price is 15 won, more than 250 times the official price.<sup>14</sup> The official price of a bicycle is 150 won, but the black market price is 1,500 won. The official price of a color TV set is 750-1,200 won, but the black market price is 50,000 won.

The price in the farmers' market is essentially determined by market supply and demand. Thus, prices of agricultural products and fisheries show significant seasonal fluctuations. Current prices in farmers' markets appear to be largely influenced by prices in China. Hong (1999) reported that prices in North Korean farmers' markets are 20-30% higher than prices in China converted to North Korean Won at an exchange rate of 24 North Korean won per 1 Chinese yuan.

Usury and black market deals in foreign exchange are also an important part of the second economy. The official exchange rate of one US dollar was 2.15 North Korean won, but the black market rate ranged from 70 to 100 won in the mid-1990s, an amount equivalent to the monthly salary of an ordinary worker. One Chinese yuan is traded at the rate of 1 to 18 or 22 North Korean won on black markets though the official rate is 1 to 0.25 North Korean won.<sup>15</sup> Black market deals in foreign exchange were initially conducted in relative secrecy, but have become quite generalized

<sup>13</sup>For further readings on black market activities of consumer goods, see Seo (1994, pp. 28-9, pp. 88-95) and Hong (1999, pp. 82-90).

<sup>14</sup>Official and black market prices are obtained from interviews with North Koreans who defected between 1989 and the first half of 1995.

<sup>15</sup>According to writer Chang, Hae-Sung, who defected from North Korea in May 1996, the black market price of foreign exchange is between 32-46 North Korean won (*Segye Ilbo*, July 6, 1996).

now that it even takes place in streets of Pyongyang, where enforcement is most severe.

Recently usury is also prevalent in North Korea taking advantage of the expansion of "foreign exchange earning businesses." Usurers include mainly returnees from Japan who are able to obtain economic support from their relatives in Japan, and Chinese residents in North Korea. These people are reluctant to deposit their money in banks due to low interest rate and, moreover, because of difficulties in withdrawing money from banks on time. Those who borrow money are North Korean businessmen engaged in "foreign exchange earning businesses" and they borrow at the interest rate of 10 to 20 per cent a month.<sup>16</sup>

The second economy exists also in the service sector. Moon-lighting activities such as shoe repair or carpentry are popular alternatives to trade in black markets. Since the early 1992, private street vendors selling ice cream or other foodstuff have begun to appear in the streets of Pyongyang (*Dong-A Ilbo*, September 25, 1996).

Houses and apartments are also traded, though they are not private property in North Korea. North Koreans obtain the right of residence with the permit of residence issued by the housing authorities, but due to a severe housing shortage, two or more families in many cases, are living in the same house. Under these conditions, a family which has been given a permit to live in a house or an apartment alone, may be able to take advantage of this situation. When this household has a chance to move out of the house (in North Korea one has to move out of the house where he is living when he is assigned a new job in another city or country), it will try to find out someone who has enough money and is eager to obtain a house for the exclusive use, but his family members are currently living together with other families in one house. In this case, the one who is going to move out will let a new household move in to live together with his family, and then bribe the officials of the housing authorities into rewriting the permit of residence in the name of the new household. A 20 pyung apartment house in Anju City, South Pyongan Province was traded at 1,000-1,200 North Korean won, and a house with the toilet, at 25,000 won (*Joong-Ang Ilbo*, February 14, 1995).

<sup>16</sup>Statements from the North Korean defectors (Naewoe Press 1995, p. 277).

It may be impossible to depict correctly the overall scale of the second economy in North Korea, but one noteworthy fact is that North Korean citizens are currently purchasing 50-90% of their daily necessities, including food grain, from black markets.<sup>17</sup> Professor Lee, Young-Hwa, a Korean scholar residing in Japan who had stayed in North Korea April-December 1991 to conduct research at the North Korean Academy of Social Science, also wrote that North Korean citizens had been buying 80% of their daily necessities on black markets. A survey conducted by *Joong-Ang Ilbo* newspaper in 1995 showed that 20 (57%) among 35 former North Koreans who defected to South Korea answered that they had experience in black market activities in North Korea, 3 (9%) said that one of his family members had such experience, and 12 (34%) said they had no such experience at all (*Joong-Ang Ilbo*, January 26, 1995).

These defectors also said that a large number of North Korean citizens had been earning more money than their regular salaries through moonlighting in trading in farmers' markets and that now a monthly salary in North Korea is practically insignificant. Yo, Man-chul, who defected to South Korea in April 1994 leading his 5-member family, also said that the monthly salary per worker in North Korea was about 70 won, but a housewife used to earn 300 to 400 won a month through peddling and trading in the markets. Another defector, who had worked as a manager of a factory in North Korea, said that his monthly pay was 170 won, a meager amount only worth 1 kg of pork, but he would have been able to make 4,000 won through black market transactions if he were given a week. Now in North Korea, the official salary has come to be regarded as meaningless, with average monthly salary of 100 North Korean won having little purchasing power (Seo 1994, pp. 29-33).

Testimonies by these defectors indicated that the second economy in North Korea now has become an inevitable fact of the country's economy.

How large were the second economies of the pre-reform Soviet Union and the Eastern European countries? By the early 1980s, approximately 7 million Hungarians, out of 10 million total popu-

<sup>17</sup>Oh (1996, p. 119). Based on 30 interviews conducted in 1996 by the Korea Institute for National Unification with defectors who defected between 1994 and 1996.

lation, were earning more income through second economy activities than through their regular jobs (Kemény 1982, p. 362). Kaiser (1976), a western reporter who was stationed in Moscow in the mid-1970s estimated that the size of the second economy was about 20% of the first economy in Soviet Union. Through an interview with immigrants from the Soviet Union, Katz (1973) estimated such figure to be somewhere between 10 to 50%. It is difficult to compare the size and role of the second economy among countries due to data limitation. Impression from the data, though limited, is that the second economy in North Korea is at least as important as that in pre-reform Soviet Union.

## **V. The Economic and Social Effects of the Second Economy**

The expansion of the second economy may bring about both positive and negative effects on the economy. The scale of available economic resources, such as labor, capital and raw materials, on the domestic scene are limited, so the expansion of the second economy will result in transferring these limited resources from the first economy to the second economy, thus eventually reducing the scale of the first economy.

However, resources diverted from the first economy will be used more efficiently in the second economy. The second economy will also be able to increase the aggregate supply of goods through extra-legal importation of goods from abroad, thus contributing to balancing commodity distribution among localities. All in all, in the case of North Korea, it is likely that the second economy will result in a net positive effect economically.

First, due to a decrease in the production of fertilizers and pesticides, agricultural productivity has been steadily on the decline, and moreover, a severe shortage of fuel makes it impossible for cooperative farms to operate farm machines. Under these conditions, any measure to abolish small-scale farms such as factory-farms and patch-farms for the purpose of mobilizing maximum human resources toward cooperative farms will result only in reducing the output from the much more productive small-scale farms, the magnitude of which will be greater than any gains that can be realized though the output increase of cooperative farms.

Second, North Korea's factories are running at less than 30% of their capacity, and therefore, most of the black market activities are being conducted during the idle time. Idle workers are engaged in private businesses, thus contributing to the easing of economic stagnation by balancing the distribution of commodities and food throughout the country. Measures to forbid these private activities will result in worsening the daily life of the people without improving the productivity of factories.

Third, smuggled goods from abroad, mainly from China, have served to ease commodity shortage and to prevent inflation in black markets. Prohibitive regulations against such activity will not increase planned consumer goods supply while significantly reducing the supply of household essentials from the second economy.

Fourth, daily necessities produced from the North Korean households such as clothes and footwear, as well as liquor, rice cakes, and cookies are made mostly with surplus materials or recycled materials that exist outside the planned first economy. To forbid these private activities will result only in reducing the production of these goods without increasing the output in the planned sector.

Fifth, even the goods embezzled and looted from official capacity, distribution through the second economy will only have an effect of redistribution. Therefore, prohibition against such an activity will have no effect on aggregate production.

In conclusion, the second economy in North Korea can be seen as having a net positive effect of satisfying the demand for consumer goods and increases the welfare of North Koreans. But the effect, seen from the perspective of central planners, should be evaluated as negative economically. The successes of the second economy tend to expose the failures of the centralized first economy and to embolden people to engage in second economy activities that are in competition with the state. Therefore, the prolonged existence of the second economy will eventually bring about a shortage of resources in the planned sector of the economy, thus resulting in the contraction of the planned economy.

The negative impact the second economy imposes on North Korean regime from the perspective of those in power is more grave.<sup>18</sup> The second economy will serve to spread the sense of

<sup>18</sup>If policy makers are more concerned about the well-being of people than

individualism, materialism, and corruption among the populace and also serve to widen the gap between the rich and the poor, thus destroying the core value of socialism. Unlike in the past, young women in North Korea are reported to prefer those who have profitable moonlighting activity potential, such as officials in the foreign trade sector, diplomats, drivers, and the like, as their suitable spouses. This means that North Korean citizens who are brought up under socialist “virtues” are now overtaken by the desire for material gains. Under these circumstances, such North Korean public officials as Party cadres, members of the police and managerial staff members at workshops are accustomed to collecting bribes from those who are found to be engaged in illegal deals. Sometimes these officials themselves are engaged in illegal activities. Bribes are common in all sectors of life in North Korea. For example, one has to bribe an official to obtain a travel certificate or a good job, or to have his son permitted to enter college. Peddlers also bribe border guards when they cross the border into China or back into North Korea from China. Due to the increase of illegal income, the rich can afford to buy expensive black market goods while others are starving.

The North Korean authorities made efforts to eliminate illegal economic activities as the second economy expanded rapidly.

In 1989, the government banned illegal private farming, and in 1992 it proclaimed that all unauthorized markets must be closed and farmers’ markets must open only once every 10 days instead of everyday. But since 1993 the government could not but relax its regulation over these activities due to the aggravating shortage of commodities and food and because it had to admit the reality that the citizens make a living through these underground economic activities.<sup>19</sup>

North Korea in 1975 began to run special stores for the exclusive use of foreigners and where only foreign currencies are used, but since 1986 North Korean citizens who can afford to use foreign exchange also have been given access to these stores. In 1989, when Pyongyang hosted the World Festival of Socialist Youth and Students, these stores appeared not only in Pyongyang but also in

the preservation of the command economic system, then they may view the second economy favorably.

<sup>19</sup>Naewoe Press (1995, p. 71) and *Unified Korea* (1996a, p. 40).

local areas, and the number of these stores was drastically increased. In 1992, on orders of the North Korean government, all these stores, except 7 places in Pyongyang and one in each province, were closed down. But due to these measures, the government had to face difficulties in collecting foreign exchange, and then in 1993 the government began to increase the number of these stores again.

In an effort to root out anti-socialist criminal activities, such as illegal brewing, embezzlement of government property, theft and the like, the North Korean government in 1992 ordered every province and city to organize the special task forces (*groupa*). These *groupa* were composed of members of the Public Security Ministry (police), Public Prosecutor's Office, the Worker's Party, the Socialist Working Youth League and Trade Unions. A *groupa* in each big enterprise was composed of 30 persons, and in the border city of Shinuiju about 300 members were operating. But the operation of these *groupa* produced various adverse effects: the group members used to arrest any citizens at random on the pretext that they should undergo investigation for their illegal activities they committed even 10 years ago, or the group members used to search company offices or individual houses at any time. Moreover, these *groupa* members began to receive bribes from those who were engaged in illegal businesses, thus producing corruption after corruption. Only those who are without money or power have become the victims of these *groupa*. Finally, in 1993, the government ordered the suspension of these *groupa* activities (Seo 1994, pp. 37-8).

## VI. Second Economy and Economic Reform

In the former centrally planned economies, the very presence of the second economy put pressure on the first economy for change. In the former Soviet Union, the second economy provided a major argument for the necessity of economic reforms pioneered by then-General Secretary Gorbachev, and prepared the way for economic reform in the sense that it served as an example of an alternative to the official centralized command system, underscoring the efficacy of decisions based on supply and demand and profit orientation (Grossman 1989, pp. 83-4).

In former socialist Hungary, the existence of a second economy



was a contributing factor in the nonviolent transformation of the Hungarian economy. Although the creation or tolerance of the second economy was originally a pacifying policy, it also had the positive effect of bringing about "the birth of a petite bourgeoisie and a large group of professionals...[who had] invested in and developed a sizable and asset specific capital comprising skills, network, knowledge, prestige, and know-how; and rational actors do not let their investment be ruined (Sik 1992, p. 173)."

Next, in the market-oriented reform process, the second economy facilitates the transition of a command economy to a market economy for it plays the role of a reservoir of entrepreneurship. Individual entrepreneurship is crucial for market-oriented development. Individuals involved in activities for private gain in the second economy possess many qualities of entrepreneurs: ingenuity, flexibility, thriftiness, and a willingness to take risks.

The Chinese experience is an evidence that the second economy is a reservoir of entrepreneurial talent. Economic reforms in China after 1978 led to an explosive growth in the number of farmers who produce for the market (Nee and Young 1991, p. 293). In addition, some farm households formed township-village enterprises in a wide range of petty commodity production to take advantage of local and extralocal market opportunities. These private ventures contributed significantly to the rapid rural industrialization in China, spinning off commercial activities and a class of merchants, peddlers, and shopkeepers.<sup>20</sup> Is there relationship between the second economy and economic reform in North Korea similar to that in other former centrally planned economies?

It is difficult to analyse the relationship between the second economy and economic reform in North Korea because information is too limited and North Korea has not yet undertaken fundamental economic reform.

However, there are some indications that positive effects of the second economy which ease commodity shortage put pressure on

<sup>20</sup>According to Chen *et al.* (1992), rural industry, also called township-village enterprises (TVEs), has become the most dynamic sector of China's economies in 1980's: in the 1980-8 period, over 30% of the growth of China's total material production was contributed by rural TVEs; the share of output value of rural TVEs in GNP increased from 13% in 1980 to 21% in 1988.

the first economy to change in North Korea, too.

First, North Korea practically approved 'black markets' since mid-1990's. In early 1990's, illegal markets besides legal markets were formed in towns and cities almost spontaneously. In addition, transactions in grains and consumer goods in markets which was illegal have spread all over North Korea. Since mid-1990's North Korea approved unauthorized markets and trading of grains and consumer goods. As a result, a large number of North Koreans now engage in private commercial activities.

Second, North Korea attempted to bring about reform in its cooperative farm management system by changing the "sub-work team management system" to provide farmers work incentives in 1996. Notable changes in the sub-work team management system are 1) the number of sub-work team is reduced to 7-8 persons from 10-25 persons and furthermore sub-work team can be composed of family members, and 2) the agricultural output exceeding the team quota can be disposed of freely by team members.

These changes, if well implemented, would increase work incentives of farmers, and promote farmers' markets. There is, however, no evidence yet that these measures increased agricultural production. Severe shortages of fertilizer and energy might have offset the positive effects of reform in North Korea's farm management system.

Third, since June of 1996, residents of Rajin-Sonbong Free Economy and Trade Zone were allowed to engage in private entrepreneurial activities in household industry, light manufacturing, and service industry by opening up retail stores, repair shops, and restaurants.<sup>21</sup> In the city of Rajin, commercial district and markets are springing up where variety of foodstuff and household goods are sold. The legalization and expansion of self-employment though in a limited area is a significant step toward market-oriented reform.

There is no doubt that these measures were intended to overcome North Korea's economic difficulties. However, it is likely that the presence of second economy such as farmers' markets which ease commodity shortage also provided additional arguments for taking these measures.

<sup>21</sup>North Korea established Rajin-Sonbong Free Trade and Economy Zone which emulated Chinese special economic zone in December 1991 to attract foreign direct investment.

## VII. Conclusions

The prevalence of the second economy in the Soviet Union was caused by chronic shortages of commodities, which was the product of the inefficiency of a planned economic system. Such a phenomenon has been visible in North Korea since the 1980s when North Korea began to open up its doors, in its efforts to overcome various economic difficulties. The second economy began to expand especially in the form of black market deals, resulting in the spread of corruption and mammonism.

In the early 1990's, the North Korean government tried to crack down on this second economy by enforcing various measures, such as measures to restrict private farming. But these government efforts ended in vain because the government-run stores and distribution system have already ceased to function normally, thus failing to meet the popular demands for commodities, food, and other daily necessities. North Korean factories have not been operating normally, and under these circumstances the citizens have been making their living through moonlighting. If the North Korean government tries to crack down on the second economy, it will invite popular resistance.<sup>22</sup>

This study shows that the second economy plays a significant role in North Korea and complete picture of total economy can be obtained only by analyzing both the first and the second economy. It also shows that presence of the second economy put pressure on the first economy for change and the expansion of the second economy results in rising tensions between first (planned) and second (private) economy and undermining the fundamental socialist values and virtues from within.

The former Soviet Union had maintained the basic tenet of a centrally planned system and permitted a second economy to operate only at a tolerable level. But this policy eventually brought about the collapse of socialism and communist party. China, on the other hand, allowed gradual but significant expansion of the second economy by launching timely economic reforms starting in 1978. The second economy has expanded continuously during the Chinese-style reform process. The operating and regulatory principles of the two subeconomies (the first and the second economies)

<sup>22</sup>Oh (1996) and Jang (1996) also hold similar view.

have become more and more uniform, and the boundary between them less and less marked as market-oriented reform widened.<sup>23</sup>

What will be the future of the second economy in North Korea? North Korea may follow either the Soviet style-maintaining essential feature of a command economic system and allowing the second economy only at a politically tolerable level—or follow the Chinese model of reform by transforming the first economy gradually to the market economy. If North Korea follows the Chinese model, existence of the second economy will facilitate the market transition by providing entrepreneurial talent.

Can the current North Korean regime push forward more progressive reform following the style of China?

It is by now clear that centrally planned economic system is not sustainable in the long run. Still it is difficult for the North Korean regime to resolve its catch-22 dilemma: economic reform is necessary to prevent potential collapse, but the political and ideological concessions necessary for fundamental reform are likely to threaten the political stability. Therefore, it is still uncertain if the current North Korean regime will undertake Chinese style reform in the near future.

*(Received September, 1998; Revised March, 1999)*

## References

<In Korean>

Choi, Kwang. *A Study on Underground Economy in Korea*. Korea Economic Research Institute, 1987.

Hong, Sung-Guk. *Commerce and Distribution in North Korea*. Bureau of Public Information, 1996.

\_\_\_\_\_. *Current State of Farmers' Markets in North Korea and Their Implications*. The Reunified Korean Economy, February 1999.

Institute for Juche Economy. *Dictionary of Economic Terms*, Volume 1. Democratic People's Republic of Korea: Academy of Social Science, 1985.

<sup>23</sup>An underground economy problem will continue to exist in the post-reform economy, but it is a common phenomenon of market economies.

- Jang, Won-Tae. "Expanding Underground Economy in North Korea." *LG Economics Weekly*, October 24, 1996.
- Korea Institute for National Unification. *Comparative Study of Reform and Liberalization of Socialist States*. 1993.
- Naewoe Press. *Comprehensive Data on North Korea: Testimony of North Korean Defectors*. 1995.
- Oh, Seung-Ryul. "Economic Survival Strategy of North Korea: Functions and Limitations of the Unofficial Sector." *The Korean Journal of Unification Studies* 5 (No. 2 1996). Korea: Korea Institute for National Unification.
- Seo, Jae-Jin. *Change in North Korea Residents' Value Perception: Comparative Look at the Soviet Union and Eastern Europe Bloc*. Korea: Korea Institute for National Unification, 1994.
- Unified Korea. "Interviews with Defectors: Part 2." The Institute for Peace Affairs, February 1996a.
- \_\_\_\_\_. "Interviews with Defectors: Part 6." The Institute for Peace Affairs, July 1996b.
- \_\_\_\_\_. "Interviews with Defectors: Part 7." The Institute for Peace Affairs, August 1996c.
- \_\_\_\_\_. "Interviews with Defectors: Part 8." The Institute for Peace Affairs, September 1996d.
- <In English>
- Chen, Kang, Jefferson, Garry H., and Singh, I. "Lessons from China's Economic Reform." *Journal of Comparative Economics* 16 (1992).
- Ericson, R. "The Second Economy and Resource Allocation under Central Planning." *Journal of Comparative Economics* 8 (March 1984).
- Grossman, Gregory. "The Second Economy of the USSR." *Problems of Communism* 26 (September-October 1977).
- \_\_\_\_\_. "The Second Economy: Boon or Bane for the Reform of the First Economy?" In Stanislaw Gomulka, Yong-Chool Ha, and Cae-One Kim (eds.), *Economic Reforms in the Socialist World*. New York: M. E. Sharpe, 1989.
- Kaiser, R. G. *Russia: The People and the Power*. New York: Pocket Books, 1976.
- Katz, Z. "Insights from Emigrees and Sociological Studies of the Soviet Union." *Soviet Economic Prospects for the Seventies*. Washington D. C.: Joint Economic Committee, 1973.

- Kemény, István. "The Unregistered Economy in Hungary." *Soviet Studies* (July 1982).
- Lee, Hy-Sang. "The Economic Reform of North Korea: The Strategy of Hidden and Assimilable Reforms." *Korea Observers* 23 (Spring 1992).
- Nee, Victor, and Young, Frank. "Peasants Entrepreneurs in China's Second Economy: An Institutional Analysis." *Economic Development and Cultural Change* 39 (No. 2 1991).
- Nove, Alec. *The Soviet Economic System*. Third Edition, Boston: Unwin Hyman, 1986.
- O'Hearn, Dennis. "The Consumer Second Economy: Its Size and Its Effects." *Soviet Studies* 32 (April 1980).
- Sik, Endre. "From the Second to the Informal Economy." *Journal of Public Policy* 12 (No. 2 1992).
- Wellisz, S., and Findlay, R. "Central Planning and the 'Second Economy' in Soviet-Type Systems." *Economic Journal* 96 (September 1986).