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North Korea's economic paradox: how de-marketization is driving up value of North's won

To borrow from Winston Churchill's quote on Russia, North Korea is "a riddle, wrapped in a mystery, inside an enigma." But recent economic reports coming out of North Korea seem to indicate that there is yet another layer inside the riddle: a paradox. The movements in North Korea's foreign exchange market since late last year have been perplexing. The exchange rate between the North Korean won and U.S. dollar (as well as Chinese yuan) has been stable for a long period, balanced at around 8,000 won per dollar since 2013. But this apparent stability collapsed last year as the North Korean won appreciated from the long-term equilibrium of 8,000 won per dollar to 5,000 won per dollar by this June, before falling back to 6,000 won per dollar in July.

Such volatility in the North Korean foreign exchange market has long been anticipated, but in the opposite direction. A strong, stable currency necessarily reflects a healthy economy yet North Korea is anything but. It is beset by one of the most stringent sanctions regimes in United Nations history. And recently trade suspension due to COVID-19 quarantine measures has had a devastating impact on "jangmadang," or unofficial markets on which ordinary North Koreans depend for their livelihood.

The current volatility in North Korea's foreign exchange market is a sign of financial crisis, in which local currency depreciates rapidly vis-a-vis more stable foreign currencies. But contrary to what economic models would predict, the North Korean won is paradoxically showing unexpected strength despite the severe economic crisis.

The key to disentangling the paradox lies with the North Korean regime's desire to roll back the marketization and dollarization of the economy during the last decade. Dollarization of the economy, or substitution of the local currency with stable foreign currencies, is prevalent in economies with long histories of inflation and policy mismanagement, and North Korea, with its long history of economic and financial mismanagement, is no exception. Dollarization in North Korea, or more appropriately yuanization, is so deeply embedded that it is estimated that after 2013, 53 percent of ordinary North Koreans have relied on Chinese yuan in lieu of local currency for daily economic activities according to a study by the South's Korea Development Institute.

Dollarization/yuanization brought many benefits to ordinary North Koreans. Inflation was eliminated almost overnight, as prices were denominated in stable foreign currencies. Just as many economies that adopted dollarization experienced, the resultant macroeconomic stability eliminated economic uncertainty and fostered investment. The period after 2013 coincided with the rapid expansion of jangmadang activity as well as imports from China.

The co-evolution of dollarization, jangmadang activity and Chinese imports formed the triad of North Korea's economic growth of the last decade. These three factors created a virtuous cycle of price stability, economic expansion and rising living standards through increased consumption. Ordinary North Koreans and elites alike enjoyed access to goods and services that they could previously only dream of. There are now 6 million mobile phone subscribers in North Korea and coffee shops with baristas have popped up throughout Pyongyang.

But none of this was free. The expansion in consumption was underwritten by exports of coal and iron ore, as well as remittances by workers posted overseas. As sanctions started to go after the most productive sources of revenue, Kim Jong-un faced the choice between nuclear weapons development and economic development. He evidently chose the former.

The inflection point was the Eighth Party Congress, which made it clear that North Korea would turn back on the marketization that had been so beneficial to so many. Markets would be displaced by a newly empowered state that would regain the role of central economic planner, and Chinese imports would be suppressed through an aggressive import substitution strategy.

But the most critical target of the regime is clearly the dollarization in the economy. It represents ordinary North Koreans' distrust of their government and trust in the foreign ones. By ridding the economy of dollarization, the regime will ensure the public's complete dependence on the state for survival while also pauperizing them complete.

Paraphrasing Churchill again, the COVID-19 pandemic is too good a crisis to go to waste for the regime. The use of foreign currency, particularly of Chinese yuan, is intimately tied to the inflow of goods from China. With the border closed for quarantine, foreign currencies find little use when Pyongyang's supermarket shelves are barren. To compound the woes of those who still maintain faith in the yuan and dollar, the regime is forcing people there, including foreigners, to use North Korean won and sell their foreign currency holdings. The result is the paradoxical appreciation of the North Korean won amid economic crisis.

Renormalizing trade is going to be a long and risky process once the economy is de-dollarized. And without trade there will no longer be any market activity in North Korea. The appreciation of North Korean won is therefore a sign that Kim intends to take North Korea back to his grandfather's era, when there were no markets and certainly no yuan. One can only hope that Kim's other policies, especially on foreign and military fronts, will not be so reactionary.

* The view expressed herein was published on July 26 in the Korea Times and does not necessarily reflect the views of the Asan Institute for Policy Studies