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THE PENINSULA

Barely Afloat: A Depreciating Won Risks Financial Instability for Kim

Jong-un

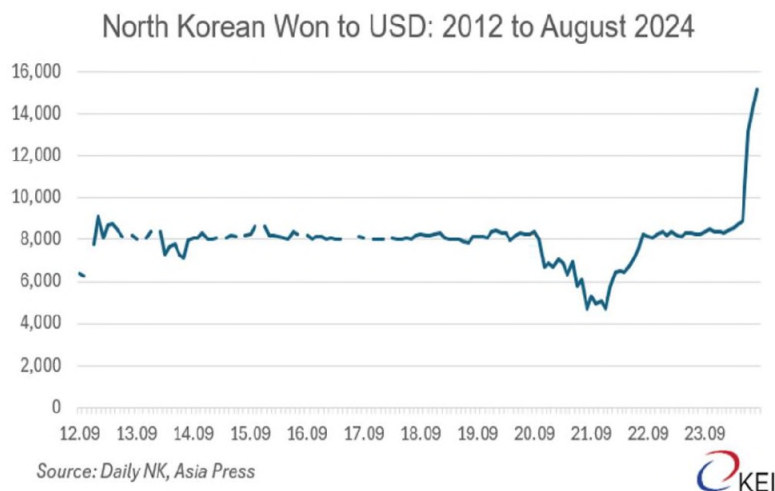
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The Yalu River floods have receded, but Kim Jong-un might still feel underwater. The North Korean won has fallen nearly in half against the US dollar in informal markets this month and similarly against the Chinese yuan, as reliably reported by [Daily NK](#) and [Asia Press](#). This development suggests inflation is on the way in North Korea, and marketplace panic could follow. Most North Korean observers remember a much larger disturbance at the end of Kim Jong-il's regime in 2009 and Kim Jong-un's promises to prevent that from happening again. Kim and his financial administrators have policy options to contain a potential crisis, but none include treading water.



US Dollar Jumps Against the Normally Stable North Korean Won

Likely unrelated to the global financial unrest earlier this month, this sharp move is a reminder that Pyongyang is not impervious to financial trouble despite its self-reliance and Marxist ideology. The country has an unusual, partially dollarized economy, meaning US and Chinese currency circulate in tandem with the won, which makes it difficult for monetary authorities to control the money supply. The North Korean people can trade won for dollars whenever they want and for any reason. In this respect, the country is very liberal, almost like Hong Kong, with its US dollar-based currency board system. Without great care, the North Korean economy is susceptible to panic, as the desirability of the three currencies can change overnight. Hong Kong's currency is fixed to the dollar via its banking system, which automatically adjusts interest rates to keep the local dollar in line with the US dollar. Stability is purchased but at the expense of the state's monetary and fiscal control. North Korea, ironically, is much the same but without dependable banks to intermediate changing supply and demand pressures.

The sharp fall just in the last month likely caused trouble within North Korean marketplaces because anyone who had borrowed dollars from money changers has to pay back nearly twice as much won as they had anticipated, and those who had lent the dollars have suddenly become relatively rich. Citizens who had been induced by the government to change their US dollars into won-denominated bank deposits have likely lost money. Elites, on the other hand, often have large dollar holdings and may be better off, at least until prices catch up. Financial and capital markets are poorly developed and unregulated, which only means more trouble for companies that often deal privately in dollars, yuan, and won. Remarkably, as closed as the country is, this issue has not leaked out in the domestic media, so rumors dominate.

Kim's Best Achievement is in Danger

Arguably, Kim's best accomplishment over his 11-year tenure has been getting a grip on the country's legendary inflation, and he has done so despite the huge 2017 UN sanctions that decimated the country's exports and industrial imports. During a financial crisis in 2009, as he was ruler-in-waiting, Kim likely observed people in the streets demonstrating against his father's disastrous bout of currency debasement, the resulting inflation, and the public execution of the party's finance boss.

By 2015, with inflation already under control, Kim promised the won would be stabilized and people's bank deposits would be protected in a [letter to his financial authorities](#). And he lived up to his promise, at least until last month. From 2013 to 2019, the won held close to 8,000 won per US dollar, almost a Hong Kong-like peg. During the COVID-19 border shutdown, the won even appreciated to about 5,000 won per dollar (the data shows how much won is needed to buy a dollar, so a lower figure shows a rise in the won's relative value). Imports were shut off, causing the country's usual trade deficit to disappear and making dollars or yuan less needed.



It is not clear exactly how Kim managed to achieve stability—likely a very conservative mix of monetary and fiscal policies and turning a blind eye to the use of foreign cash. There would have been little, if any, expansion of bank credit or printing of new cash and very stringent fiscal policy, in addition to no deficit spending and an emphasis on raising state fees. But an experiment to sell won-denominated bonds to finance a Pyongyang hospital appears to have failed as there remains a lack of trust in the won in the long term.

Tight monetary policy, like anywhere else, comes at a cost to investment and growth, and the overall economy suffers greatly. But monetary stability is worth it in the longer term as a boon to private savings and the development of markets, facilitating a slow shift from a socialist ration economy to money-led capitalism. The influx of US and Chinese cash, likely via remittances and illegal cyber theft, would have helped greatly, giving citizens something else they could buy with their won and making it more valuable and competitive.

As the country gradually reopened its border to trade with China, imports of largely consumer goods have been pouring in. This development has not been countered by a rise in exports, so North Korea's trade deficit has widened. This, no doubt, has put downward pressure on the won and may account for the recent fall. But the widely reported sale of artillery shells and missiles to Russia would seem to have offset that loss, in addition to hundreds of millions of dollars in cyber theft. So, it is unclear what is happening. Sentiment can shift quickly, given the lack of regulation and rumor-driven news, and a small drop can spiral into free fall as people panic.

One possibility is that the central government has simply run out of money and is thus resorting to printing cash and expanding won-denominated credit, foregoing its previous fortitude. It badly needs money to raise state sector wages, for instance, which are still

based on the old ration system and have fallen far below market rates. Corruption is endemic as civil servants and military officials must find ways to make ends meet. But, absent a big productivity boost, this will create inflation. Some inflation has already been seen in the rice and corn markets.

Solutions Exist but Entail Dramatic Changes to the Socialist System

Kim should be relieved that the authorities have apparently managed to stop or at least pause the won's fall, which is not an easy task as speculators prefer to spiral the won lower. Russian money might be helping, but North Korea may be resorting to the most capitalist move of all—raising won-denominated interest rates, as seen in Hong Kong. In the longer term, Kim has options if he plays his cards right. He can liquidate some of the state's enormous holdings of property and capital stock, sell socialism to bring in cash for the state, or try to deal with the outside world to lower the sanctions regime that has stymied exports and bring in dollars to support the won. But timing for any such swimmer is important as once financial credibility is lost, it is hard to regain. He will need to exude confidence to prevent a collapse in public trust and the wholesale selling of won. Riding in a boat and observing impoverished people might give him some time to think about a long-postponed reform of his money and banking system.

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