WORLD ECONOMY UPDATE

May 17, 2016 | Vol. 6 No.12

Implication of Financial Reforms in China and Vietnam for North Korea

ISSN 2233-9140

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I. The Present Financial System in North Korea and its Challenges

North Korea's financial system is based upon a mono-banking system, centered on the Central Bank of the DPRK. The Central Bank of the DPRK serves diverse functions - aside from financial activities, it also acts simultaneously as a central bank and a commercial bank.

Such a framework, however, underwent considerable changes following events such as the Arduous March and the currency reform in 2009, along with the weakening of state control and the development of marketization. The Central Bank's function of providing capital has attenuated, with private finance filling the gap. In particular, the 2009 currency reform triggered a spike in both price levels and exchange rates, deepening distrust towards the North Korean won and financial institutions, not to mention worsening the dollarization trend.

Figure 1. Dual Foreign Exchange Rate Structure: Official and Market Foreign Exchange Rate Trends

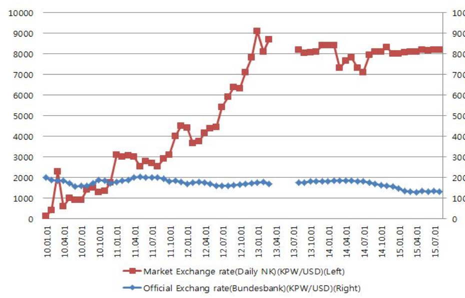
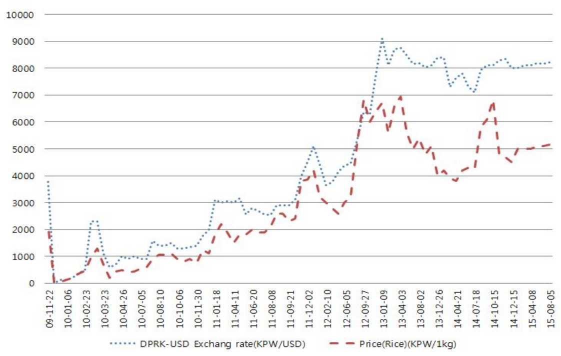


Figure 2. Consumer Price and Foreign Exchange Rate Trends



Source: World Bank.

North Korea is facing challenges in utilizing domestic and foreign capital to foster economic growth. The financial sector, which is supposed to channel private savings into investment through financial institutions, is malfunctioning, and North Korea's nuclear issues serve as obstacles in accessing the international financial market.

North Korea seems to recognize the significance of domestic finance in stimulating the economy, and is seeking to promote savings and absorb foreign capital. The Central Bank Law and Commercial Banking Law also indicate the nation's willingness to move towards a two-tier banking system. However, the current situation North Korea faces cannot be resolved merely through partial changes in operational methods or institutional adjustments. Rather, fundamental change is required for the financial system to fulfill its role as a catalyst for economic progress.

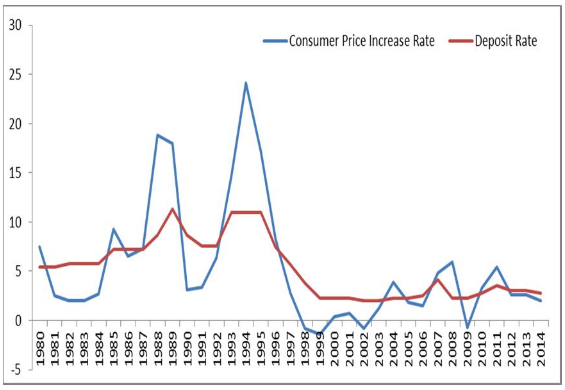
China and Vietnam's experience provides implications for North Korea's financial reform process, specifically from pre-reform to the early institutional settlement phase.

II. Financial Reforms in China

China's economic conditions were favorable in 1978, at the beginning of the reform; the country had stable price levels and growth rates, and a high savings rate under strong government control. While The People's Bank of China initially served as a commercial bank before the reform, the transition to a two-tier system and the enactment of the Central Bank Law led to the establishment of policy banks, commercial banks and other financial institutions.

The savings rate was already high before the reform, and the government worked to guarantee an effective interest rate even after reform was carried out. There were policy efforts to increase the accessibility of banks, for instance in the form of depositing wages into accounts, and there were few issues with withdrawal. Extensive low-interest funds were provided to state enterprises at the initial stages of reform, which triggered large-scale non-performing loans (NPLs). The NPLs were cleared out in 1999 with the formation of the Asset Management Corporation, before the listing of the National Commercial Bank.

Figure 3. Inflation and Deposit Interest Rate Trends



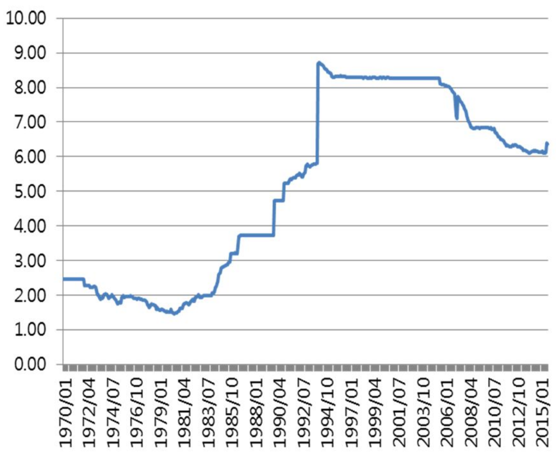
Source: World Bank.

Since the issuance of long-term treasury bonds in 1981, measures such as the diversification of bond maturity and sales methods, or the permission of re-trading, helped invigorate the loan market. After a certain period, the stock exchange market was established in the early 1990s, with a few listed companies. The market initially experienced a stock index spike and bubble burst, which led to the foundation of a supervisory institution.

A dual exchange rate system separating the trade exchange and non-trade exchange rates was implemented, yet the official rate significantly diverged from the market rate. However, the two rates eventually converged, following the shift to a single exchange rate system in 1994. This was also when the inter-bank foreign currency market was set up.

Private loans emerged in some regions in the early phases of reform, but these were soon suppressed and merged into the system. Likewise, there were no noteworthy instances of dollarization.

Figure 4. Foreign Exchange Rate Trends



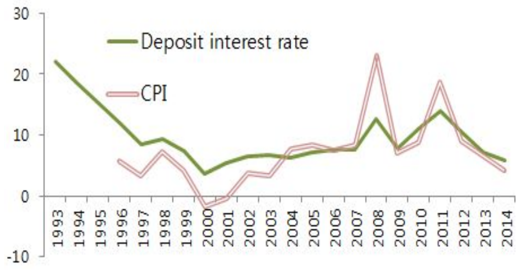
Source: World Bank.

III. Financial Reforms in Vietnam

Unlike China, Vietnam was experiencing several difficulties – low growth rates, international isolation, hyperinflation as a repercussion of the failed 1985 monetary reform - when it took its first step towards reform. To overcome such problems, the Vietnamese government adopted an openness policy called Doi Moi in 1986, which included financial reform measures. The reform sought a transition towards a two-tier financial system, and financial institutions such as joint banks, commercial banks, policy banks, and a number of credit cooperatives were established.

Vietnam's savings rates were initially low, which can be attributed to the distrust towards the domestic currency and financial institutions, caused by the experience of hyperinflation and bankruptcy of rampant credit cooperatives (1991). After its relationship with international financial institutions normalized, financial support from such institutions and FDI expansion were instrumental in securing the necessary financial resources. The government took various measures to mitigate distrust, including the stabilization of inflation, betterment of rural and provincial financial systems that replaced credit cooperatives, guaranteeing of real interest rates through gradual interest rate liberalization, and improvement of the payment and settlement system. Meanwhile, dollarization (foreign currency deposit/total currency deposit) happened to worsen at the incipient phase of reform. This phenomenon was relieved through the stabilization of price levels and the currency, convergence of the market and official exchange rates, and maintenance of the interest rate difference between domestic and foreign currency deposits.

Figure 5. Inflation and Deposit Interest Rate Trends



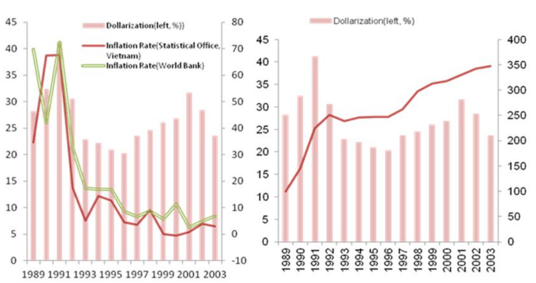
Source: World Bank.

Loans to state-run enterprises were also a problem in Vietnam. While the Vietnam Asset Management Company was set up in 2013 to address this issue, it does not seem to have had any clear effect.

In 1992, dong and foreign currency denominated treasury bonds with 1 to 3-year maturity were first issued, followed by maturity diversification and the opening of the circulation market (1995). The stock exchange market opened in the year 2000 with five listed companies.

The discrepancy between official and market exchange rates was resolved relatively quickly. In 1985, just before the onset of the reform, the market exchange rate was almost eight times the official rate, but the two rates converged in 1992. The foreign currency market was established in 1991.

Figure 6. Dollarization and Inflation in Vietnam



Source: World Bank.

IV. Policy Recommendations

From the experiences of China and Vietnam's financial reform, we draw several implications for North Korea.

With the enactment of the Central Bank Law and Commercial Banking Law, North Korea has already laid the institutional foundations for financial reform. What matters is to draft and carry out specific plans for implementation, create an environment conducive to its enforcement, and to continuously put the plan to practice. It is imperative to ensure the explicit prohibition of financial asset provisions via the central bank, to guarantee the smooth transition to commercial banks taking on the primary role in savings and deposits, to acquire substantive tools for currency and foreign exchange market operation, and to stimulate both the capital and foreign currency markets.

In order for the banking system to run smoothly, one should first secure deposits as the main source of assets. This requires proper compensation for real interest rates, along with assurance on the withdrawal of deposits, alleviating fear for exposure of accumulated assets, and increasing familiarity with financial institutions by depositing wages into bank accounts. This is especially the case for absorbing foreign currency deposits, and the converting of foreign currency deposits into won deposits should be a subsequent matter. NPLs are likely to occur at the initial stage of reform, which calls for stringent supervision from the start, the provision of a mortgage system, and the establishment of a supervisory institution.

Considering the financial situation, and the need to prohibit currency issuances for the purpose of financial funding, it seems advisable to issue treasury bonds early on. Combined with foreign currency denominated treasuries, they should serve as a useful tool in absorbing foreign currency. As the discrepancy between the market and official exchange rates is much more severe than in the case of China and Vietnam, the dual exchange rate problem must be addressed urgently. There also needs to be a foreign exchange market in which all exchange banks participate.

Accessing the international financial market would have desirable effects, including the procurement of foreign assets, building trust towards financial institutions through the operation of foreign institutions, learning from advanced financial techniques, and enhancing the transparency of the accounting system.

In conclusion, North Korea's current situation involves myriads of system-wide problems that cannot be resolved via a fragmentary approach. It is crucial to overhaul the financial sector in parallel with marketization, and to create a favorable environment for carrying out reform.

In order to normalize deposit and savings within the banking sector, private finance should be incorporated into the system. The experiences of the Donju may come handy when managing financial institutions. Also, a comprehensive and long-term approach coupled with consistent policymaking is required to overcome dollarization, also in order to recover trust. This should be accompanied by the forestallment of currency evaporation and securing of a reliable supply of foreign currency and resources.

Moving towards a market-based financial system demands extensive experience and know-how; thus one could make use of foreign capital and the entry of foreign financial companies, through an open-door policy. North Korea would have much to learn from its southern neighbor, which experienced rapid development not only in the economic but also in the financial sector. Moreover, it is imperative to realize that such reform plans require the preconditions of remedying distrust towards the government and meeting the terms required to lift the sanctions against North Korea. KIEP