

Unification and the Korean Economy

Program Book

Date

October 21–22, 2012

Venue

**Sapphire Room (3rd FI)
Lotte Hotel Seoul**



Institute for Global Economics

IGE/KEXIM/KAS/KDI/PIIE Conference

Unification and the Korean Economy

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Agenda

Current State of South-North Relations and Challenges
Benefits and Costs of Unification
Financing Unification Costs
Role of the International Community

Co-organized by

Institute for Global Economics (IGE)
Export-Import Bank of Korea (KEXIM)
Konrad Adenauer Stiftung (KAS)
Korea Development Institute (KDI)
Peterson Institute for International Economics (PIIE)

Invitation

Whatever the scenario may be, it is the order of day that the whole nation prepare for the unification in the Korean Peninsula. In view of this, the Institute for Global Economics has organized an international conference, entitled "Unification and the Korean Economy", in partnership with the Korea Eximbank, the Konrad-Adenauer-Stiftung, the Korea Development Institute, and the Peterson Institute for International Economics.

This conference will feature a wide array of participants from within and outside Korea. The Honorable Manfred Carstens, deputy finance minister of West Germany at the time of German Reunification, will deliver a keynote address as well as participate in the discussion. Relevant top policy makers from the Korean government, too, will take part, including the Minister of Strategy and Finance Bahk Jaewan, the Minister of Foreign Affairs and Trade Kim Sung-Hwan, and the Unification Minister Woo-ik Yu.

We cordially invite you to join us and exchange views in this timely conference.

Thank you.

Il SaKong
Chairman
Institute for Global Economics
October 2012

Program

Sunday, October 21, 2012

18:30-20:30 Welcoming Dinner	<p>Welcoming Remarks Hong-Koo Lee, Former Prime Minister</p> <p>Dinner Speech Jaewan Bahk, Minister of Strategy and Finance</p>
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Monday, October 22, 2012

08:30-09:00	Registration
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09:00-09:50 Opening Session	<p>09:00-09:10 Opening Remarks Il SaKong, Chairman, IGE</p> <p>Congratulatory Remarks Yong Hwan Kim, Chairman, KEXIM</p> <p>09:10-09:50 Keynote Address Woo-ik Yu, Minister of Unification Manfred Carstens, Former Deputy Finance Minister, Germany</p>
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09:50-11:10 Session 1: Current State of South-North Relations and Challenges	<p>Moderator Sung-Joo Han, Former Minister of Foreign Affairs</p> <p>Presenters Brad Babson, Chair, DPRK Economic Forum, Johns Hopkins University Ho-Yeol Yoo, Professor, North Korean Studies, Korea University</p> <p>Panelists In-Taek Hyun, Former Minister of Unification Chung-In Moon, Professor, Political Science and Diplomacy, Yonsei University Michael Funke, Professor of Economics, University of Hamburg</p>
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11:10-11:20	Break
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11:20-12:30 Session 2: Benefits and Costs of Unification	<p>Moderator Oh-Seok Hyun, President, KDI</p> <p>Presenters Marcus Noland, Deputy Director, PIIE Ildong Koh, Senior Fellow, North Korean Economic Team, KDI</p> <p>Panelists Karl-Heinz Paqué, Professor of Economics, University of Magdeburg (former Minister of Finance, East German State of Sachsen-Anhalt, 2002-06) Suk Lee, Director, North Korean Economic Team, KDI</p>
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<p>12:30-13:45 Luncheon</p>	<p>Luncheon Speech Sung-Hwan Kim, Minister of Foreign Affairs and Trade</p>
<p>14:00-15:20 Session 3: Financing Unification Costs</p>	<p>Moderator Marcus Noland, Deputy Director, PIIE</p> <p>Presenters Ulrich Blum, Professor of Economics, University of Halle-Saale Youngsun Koh, Chief Economist, KDI</p> <p>Panelists Hyungsoo Zang, Professor of Economics and Finance, Hanyang University Holger Wolf, Professor of International Studies, Georgetown University</p>
<p>15:20-15:30</p>	<p>Break</p>
<p>15:30-15:50 Special Address</p>	<p>“Eastern German Integration into the World Economy after 1990” Karl-Heinz Paqué, Professor of Economics, University of Magdeburg (former Minister of Finance, East German State of Sachsen-Anhalt, 2002-06)</p>
<p>15:50-17:00 Session 4: Role of the International Community</p>	<p>Moderator Brad Babson, Chair, DPRK Economic Forum, Johns Hopkins University</p> <p>Presenters Holger Wolf, Professor of International Studies, Georgetown University Byung-Yeon Kim, Professor of Economics, Seoul National University</p> <p>Panelists Peter Beck, Korea Representative, The Asia Foundation Joongho Kim, Senior Research Fellow, KEXIM</p>
<p>17:00-17:45 Wrap-up Panel Discussion</p>	<p>Moderator Il SaKong, Chairman, IGE</p> <p>Panelists Manfred Carstens, Former Deputy Finance Minister, Germany Oh-Seok Hyun, President, KDI Karl-Heinz Paqué, Professor of Economics, University of Magdeburg Marcus Noland, Deputy Director, PIIE</p>

Opening Session

Biographies



Il SaKong is the founder and chairman & CEO of the IGE, a private non-profit research institute based in Seoul since 1993. He served in the government of the Republic of Korea as Minister of Finance, Senior Secretary to the President for Economic Affairs, Senior Counselor to the Minister of Economic Planning Board, and Senior Economist of the Council on Economic & Scientific Affairs for the President. He previously spent nearly 10 years at the Korea Development Institute. More recently, Dr. SaKong led Korea's endeavor for the G20 Summit in 2010 in Seoul. As the chairman of the Presidential Committee for the 2010 G20 Seoul Summit, he was wholly responsible for the preparation and coordination for the Seoul G20 Summit. Simultaneously, he chaired the Korea International Trade Association from February 2009 to February 2012.



Yong Hwan Kim is the current chairman and president of the Export-Import Bank of Korea.

On February 2011, Yong Hwan Kim became the 17th President of the Export-Import Bank of Korea, an official export credit agency extending financial supports to overseas projects in order to promote import and export activities of Korean corporations. The Bank is also entrusted by the Korean government to manage two significant funds—EDCF and IKCF. Before joining the Export-Import Bank of Korea, Dr. Yong Hwan Kim served as First Senior Deputy Governor of the Financial Supervisory Service (FSS) and oversaw the supervision of financial institutions in Korea from December 2008 to February 2011. Through a successful career as a Standing Commissioner of the Financial Services Commission (FSC) and the Securities & Futures Commission (SFC), he has gained extensive experience and knowledge in financial and derivative markets as well as in financial supervisory and regulatory policies of Korea. After passing the higher civil service examination and beginning his career at the Korean Ministry of Finance in 1980, Dr. Kim has been actively involved in financial supervisory and public economic policies and has gained much expertise in international financial market and economic policies. Dr. Kim graduated from Kyung Hee University in 2003 with a doctorate in business administration. He also earned a master's degree in economics from Vanderbilt University in 1991 and a bachelor's degree in economics from Sungkyunkwan University in 1980.



Woo-ik Yu is the current Minister of Unification. Prior to his appointment, Minister Yu was ambassador to China from December 2009 to May 2011 and served as President Lee Myung-bak's chief of staff in 2008. Minister Yu also worked as a member of the 21st Century Presidential Advisory Committee and the Presidential Advisory Committee on Policy Planning under President Kim Young-sam. Minister Yu has led a distinguished academic career as a professor of geography at Korea Military Academy and Seoul National University. During his career at Seoul National University from 1980 to 2009, he held various important positions, including dean of the department of geography and dean of academic affairs. He has long served as vice president and secretary general of the International Geographical Union and was director of the Institute for Korean Regional Studies at Seoul National University. Minister Yu received his B.A. and M.A. from Seoul National University and holds a Ph. D. in philosophy from the University of Kiel, Germany.



Manfred Carstens is a German politician (CDU). From 1989 to 1993 he was Vice Minister in the Federal Ministry of Finance, from 1993 to 1997 in the Federal Ministry of Transport, and from 1997 to 1998 in the Federal Ministry of the Interior. After graduating from a commercial college, Carstens underwent an apprenticeship at a savings bank that he finished with a diploma as management expert for savings banks. He has been director of the Regional Savings Banks Emstek since 1967. Manfred Carstens is married and has three children. Since 1962 he has been a member of the Christian Democratic Union (CDU). From 1972 to 2005 he was a member of the German Bundestag. From October 14, 1982 to April 21, 1989 he was chairman of the *Budget* working committee of the CDU/CSU faction of the Bundestag. From 2002 to 2005 Carstens was chairman of the budget committee of the Bundestag. Manfred Carstens was always directly elected as a representative of his constituency Cloppenburg and since 1980 Cloppenburg-Vechta to become a member of the Bundestag. In the federal elections of 2002 he won 62.2% of the votes. On April 1, 1989, during a cabinet reshuffle, Carstens was appointed Vice Minister to the Federal Minister of Finances under the government of Chancellor Helmut Kohl. On January 1993, he moved to the Ministry of Transport in the same position, and finally, on May 1997 to the Federal Ministry of the Interior. After the federal elections in 1998, he quit his position on October, 26 of that year.

Session 1

Current State of South-North Relations and Challenges

Moderator

Sung-Joo Han

(Former Minister of Foreign Affairs)

Presenters

Brad Babson

(Chair, DPRK Economic Forum, Johns Hopkins University)

Ho-Yeol Yoo

(Professor, North Korean Studies, Korea University)

Panelists

In-Taek Hyun

(Former Minister of Unification)

Chung-In Moon

(Professor of Political Science and Diplomacy, Yonsei University)

Michael Funke

(Professor of Economics, University of Hamburg)

Session1

Biographies



Sung-Joo Han is Chairman of the International Policy Studies Institute of Korea. He is also a Professor Emeritus at Korea University. Prof. Han previously served as the Minister of Foreign Affairs (1993-94), UN Secretary-General's Special Representative for Cyprus (1996-97), a member of the UN Inquiry Commission on the 1994 Rwanda Genocide (1999), Chairman of the East Asia Vision Group (2000-2001), Ambassador of the Republic of Korea to the United States (2003-2005), and Acting President of Korea University (2002, 2006-2007). Prof. Han is a graduate of Seoul National University (1962) and received a Ph.D. in Political Science from the University of California, Berkeley (1970). Previously, he taught at City University of New York (1970-78) and was a visiting Professor at Columbia University (1986-87) and Stanford University (1992, 1995). He was also a Distinguished Fellow at the Rockefeller Brothers Fund (1986-87). His English publications include *Korean Diplomacy in an Era of Globalization* (1995), *Korea in a Changing World* (1995), and *Changing Values in Asia* (1999). He has many publications in Korean, including *Nam Gwa Puk, kurigo Sekye* (The Two Koreas and the World) (2000).



Brad Babson is a consultant on Asian affairs with a concentration on North Korea. He worked for the World Bank for 26 years before retiring in 2000. Since then he has consulted for the World Bank and United Nations and been involved in projects sponsored by various institutes, foundations and universities. He presently is Chair of the DPRK Economic Forum at the U.S.-Korea Institute, John Hopkins School of Advanced International Studies, and serves on the Advisory Council of the Korea Economic Institute of America and Executive Committee of the National Committee for North Korea. In Maine he is President of the Brunswick-Topsham Land Trust and a Director of the World Affairs Council of Maine. Recent publications include: "Evaluation and Prospect of North Korean Economy," EXIM North Korea Economic Review, Export-Import Bank of Korea, 2011; "After Kim Jong Il: Will there be Change or Continuity in North Korean Economic Policy?" 38 North.org, U.S.-Korea Institute, John's Hopkins School of Advanced International Studies, Washington DC, December 20, 2011; and "Will North Korea's Plans for Foreign Investment Make it a More Prosperous Nation?" 38North.org; U.S.-Korea Institute, Johns Hopkins School of Advanced International Studies, Washington DC, May 2, 2012. Mr. Babson received his BA degree from Williams College in 1972, and MPA degree from the Woodrow Wilson School of International and Public Affairs at Princeton University in 1974. He lives in Brunswick, Maine.



Ho-Yeol Yoo is former Dean of the Graduate School of Public Administration of Korea University and a professor and director of North Korean Studies at Korea University. At Korea University he is responsible for teaching undergraduate and graduate students on the inter-Korean relations and North Korean politics and foreign policy since 1999. Prior to taking up his teaching position at Korea University, he served for the Ministry of Korean National Unification as a research fellow at the Korea Institute for National Unification (KINU). He is going to be President of the Korean Political Science Association in 2013, and also led various academic associations like The Korean Association of North Korean Studies in 2008. He works for Non-governmental Organization like Citizens' Unity for Right Society as a co-chairman. He also works for the ROK government as a policy adviser of the Ministry of National Unification, and the Ministry of Defense, a policy adviser for the Unification Committee of the National Assembly. He is now acting as a chairman of the advisory group in charge of planning & guidance for the National Council for Democratic & Peaceful Unification. He is President of the Korea Policy Research Center, a private think-tank supported by the ROK Ministry of Unification. He was also a visiting scholar at the Mershon Center of the Ohio State University, USA in 2003-2004. He is an author of *Socialism in North Korea: Construction and Frustration* (2004) and co-authored *North Korean Policy toward Overseas Koreans* (2003) and *North Korean Political System* (2000). Ho-Yeol Yoo was graduated from Korea University at the department of Political Science and International Relations with B.A. and M.A. and has a doctorate majoring comparative politics from the Ohio State University, Columbus, Ohio, USA.



In-Taek Hyun is now serving the President of Ilmin International Relations Institute at Korea University. He has served in the Lee Myung-bak Administration as the Minister of Unification from February 2009 to September 2011, where he was responsible for all matters related to national unification and inter-Korean affairs, including North Korea policies, inter-Korean dialogue and exchanges, and public education on national unification. Dr. Hyun is currently also serving as the Special Advisor to the President for Unification Policy. He received his B.A. and M.A. at Korea University. He holds a Ph. D. in international relations from the University of California, Los Angeles. He has published numerous academic articles and books both in Korean and English.



Chung-in Moon is a professor of political science at Yonsei University and editor-in-chief of *Global Asia*, a quarterly magazine in English. He served as Dean of Yonsei's Graduate School of International Studies, Ambassador for International Security Affairs at the ROK Ministry of Foreign Affairs and Trade, and Chairman of the Presidential Committee on Northeast Asian Cooperation Initiative, a cabinet-level post. He has published over 40 books and 230 articles in edited volumes and such scholarly journals as *World Politics*, *International Studies Quarterly*, and the *World Development*. His recent publications include *The Sunshine Policy: In Defense of Engagement as a Path to Peace in Korea* (Yonsei Univ. Press, 2012), *Exploring China's Tomorrow* (Samsung Economic Research Institute, 2010 in Korean, 2012 in Chinese), and *the United States and Northeast Asia: Issues, Debates, and New Order* (Rowman & Littlefield, 2008), co-edited with John Ikenberry. Dr. Moon served as a long-time policy advisor to South Korean government agencies such as the National Security Council of the Office of the President, the Ministry of Foreign Affairs and Trade, the Ministry of National Defense, and the Ministry of Unification. He was a fellow of the Woodrow Wilson International Center in Washington, D.C. He served as Vice President of the International Studies Association (ISA) of North America and president of the Korea Peace Research Association. He is currently a member of the Pacific Council on International Policy (Los Angeles), the Institute of International Strategic Studies (London), and fellow of the Club of Madrid. He is an ARF-EEP representing South Korea and served as co-chair of the first and second AFR-EEPs meetings in June 2006 and February 2007. He is a board member of the East Asia Foundation and The Asia Research Fund



Michael Funke is Full Professor of Economics at the Department of Economics, Hamburg University, Germany. He received his Ph.D. in Economics from the Free University of Berlin. His research interests are in applied and theoretical macroeconomics. In the past Professor Funke was a Heisenberg Fellow of the German Science Foundation. Currently he is chair of the Standing Committee on Macroeconomics of the German Economic Association. He also is a CESifo Fellow at the University of Munich.

North-South Relations: Present Situation, Challenges, and Opportunities

Brad Babson
Chair,
DPRK Economic Forum, Johns Hopkins University

NORTH-SOUTH RELATIONS

PRESENT SITUATION CHALLENGES AND OPPORTUNITIES

TOPICS TO COVER

- HISTORICAL FACTORS
- PRESENT SITUATION OF NORTH-RELATIONS
- TRANSITION IN NORTH
- SOUTH KOREAN ELECTIONS AND DOMESTIC CHALLENGES
- RISE OF CHINA AND NORTH-CHINA RELATIONS
- U.S. TILT TOWARDS ASIA AND ELECTIONS
- LESSONS FROM SUNSHINE ERA AND LMB ERA
- GUIDING PRINCIPLES FOR FUTURE NORTH-SOUTH RELATIONS

HISTORICAL FACTORS

- NOT JUST COMPETITION BETWEEN COLD WAR IDEOLOGIES AND ECONOMIC SYSTEMS.
- UNRESOLVED BRUTAL CIVIL WAR
 - COMING TO GRIPS WITH FAMILY DIVISIONS AND FRATRICIDE
- REPLACING THE VACUUM OF KOREAN SOCIAL AND POLITICAL ORGANIZATION AFTER ERA OF JAPANESE OCCUPATION.

PRESENT SITUATION

- LOW POINT.
- KIC IS ONLY COOPERATION THAT HAS REMAINED ACTIVE IN LMB ERA.
- 2012 A TRANSITION YEAR – NO MILITARY CONFRONTATION DESPITE RHETORIC BY BOTH.
- SOME INDICATONS OF KEEPING DOORS OPEN.
- RECENT ISSUES: HUMANITARIAN AID AND DEBT REPAYMENT.

TRANSITION IN NORTH

- END OF LINE FOR HEREDITARY RULE.
 - MORE COLLECTIVE AND DECENTRALIZED
- MORE FUTURE ORIENTED AND FOCUS ON YOUTH.
- MILITARY-FIRST TO PARTY-LED WITH MORE AUTHORITY FOR CABINET ON ECONOMY.

SOUTH KOREA'S ELECTION AND FUTURE DIRECTIONS

- EXPECT A POLICY OF RE-ENGAGEMENT NO MATTER WHO WINS.
- CHALLENGES OF SLUGGISH GLOBAL ECONOMY FOR SOUTH KOREAN ECONOMY.
- LABOR UNION ISSUES.
- SHRINKING LABOR FORCE.

RISE OF CHINA

- BOTH KOREAS ARE VULNERABLE TO AN ECONOMIC DOWNTURN IN CHINA.
- BOTH KOREAS HAVE CAUSE FOR CONCERN ABOUT CHINA'S MARITIME ASSERTIVENESS.
- CHINESE DOMINANCE IN NORTH KOREA'S EXTERNAL ECONOMIC AND POLITICAL RELATIONS POSES CHALLENGES FOR FUTURE INTER-KOREAN RELATIONS.

LESSONS FROM SUNSHINE POLICY

- HALLMARK SUCCESS: SIMULTANEOUS MULTI-DIMENSIONAL ENGAGEMENT.
- TWO MAJOR PROBLEMS:
 - CASH FOR CONCESSIONS.
 - AID AND TRADE THAT PROPPED UP STATUS QUO SYSTEM IN NORTH.
- TWO LESSONS FOR FUTURE:
 - REVERT TO MULTI-DIMENSIONAL RELATIONSHIP.
 - BASE ECONOMIC RELATIONS ON GOOD BUSINESS PRACTICES.

LESSONS FROM RMB ERA CONDITIONALITY AND RECIPROCITY

- POSITIVE: ENCOURAGING NORTH TO BE MORE RATIONAL AND BUSINESS-LIKE.
- NEGATIVE:
 - “WOLF IN SHEEP’S CLOTHING” – DESPITE OFFER OF LARGE-SCALE ECONOMIC ASSISTANCE, REAL INTENT WAS TO SQUEEZE NORTH INTO SUBMISSION.
 - PROVOCATIONS AND TENSIONS INDUCED BY SOUTH HAVE REINFORCED JUSTIFICATION FOR MILITARY-FIRST POLICY IN NORTH.
 - FORCED NORTH TO LOOK TO CHINA.

GUIDING PRINCIPLES FOR THE FUTURE

- RELY MORE ON COMMERCIAL AND CIVIL INTERACTIONS AND LESS ON GOVERNMENT-TO-GOVERNMENT TRANSACTIONS.
- ECONOMIC RELATIONS SHOULD SUPPORT A VISION OF FUTURE NORTH ECONOMIC DEVELOPMENT SHARED BY OTHER COUNTRIES.

GUIDING PRINCIPLES FOR FUTURE

- SHAPING A FUTURE POLITICAL AND SOCIAL ORDER ON THE PENINSULA SHOULD BE A KOREAN-LED PROCESS.
- BEST STRATEGY IS TO ENCOURAGE NORTH TO MAKE CHOICES TO BECOME MORE COMPATIBLE WITH SOUTH.
- REDUCE NEED FOR NORTH TO REQUIRE AN ENEMY FOR REGIME LEGITIMACY.

CONCLUSIONS

- NORTH-SOUTH RELATIONS ARE AT A HISTORICALLY IMPORTANT JUNCTURE.
- 2013 IS AN OPPORTUNITY TO REALIGN RELATIONS AND BOTH SIDES SEEM WARILY READY.
- TAKING STOCK OF LONG-TERM FACTORS AND CURRENT CONTEXT IS WORTHWHILE AT THIS TIME.
- HOPE FOR NEW CLARITY OF VISION FROM DEBATES TAKING PLACE IN BOTH KOREAS ABOUT THEIR FUTURE RELATIONS THAT WILL PUT THEM ON A PATH TOWARDS UNIFICATION THAT WILL BE ENDURING.

SOUTH-NORTH RELATIONS: PRESENT SITUATION AND FUTURE CHALLENGES AND OPPORTUNITIES

Bradley O. Babson

A paper prepared for presentation at the IGE/KEXIM/KDI/PIIE Conference on Unification and the Korean Economy, October 22, 2012

Following what so far is a stable and relatively rapid regime transition in North Korea in 2012 and with widespread expectation that any new South Korean President elected in December will give high priority to reconsidering future policies on South-North relations, it is timely to reflect on the current situation and issues that should be taken into consideration in planning a realignment of relations beginning in 2013.

As an outsider on the Korean Peninsula, I feel privileged to have been asked to provide some perspectives on these questions. My frame of reference is informed in part by my long-standing interest in Korea, which began with my first assignment with the World Bank in 1974 that evolved over several decades and which deepened after I started studying and engaging North Korea in the late 1990's. It is also informed by my experiences working with other Asian countries that were divided by war in the 20th century, notably Vietnam and Myanmar, as well as reflecting in a more personal way on my own country, the United States, where I have family roots on both sides of the civil war that wracked our society in the mid-1800's and which still reverberates even today.

I say this because even while our focus in this conference may be on the short-term question of how to take advantage of an upcoming opportunity to realign South-North relations and try to put them on a less volatile and more sustainable path than we have seen in the past, it is important to keep historical and deeper challenges in our minds that cannot be overcome in a few years or even decades.

So the organization of this presentation will be first to discuss several of these historical and circumstantial factors that make the Korean situation and its challenges different from other countries and which form the foundation for assessing long-term success of policies guiding South-North relations and the shared aspiration for eventual unification. Second, I will summarize several features of the present situation of South-North relations that I think are important. Third, I will look at challenges and opportunities posed by the current context in North Korea, South Korea, China and U.S. that will need to be taken into account in reframing future South-North relations. Fourth, I will make a few comments on lessons of experience from both the era of the Sunshine Policy and the policy of conditionality and reciprocity of the Lee Myung-Bak administration, and discuss their implications for a future strategy of realigning relations both between the two Koreas and coordinating policy with other major partners. And finally, I will discuss some general principles to follow in addressing these challenges and opportunities.

Historical Factors

Several deep historical factors for decades have underpinned North-South relations as these have vacillated between hostility and engagement. Efforts to recalibrate relations in the coming years will also be influenced by these long-term issues, and alternative strategies moving forward should be assessed in relation to them.

First, it is important to recognize that while both Korea and Germany were separated by the victors of World War 2, and both became entwined in Cold War competition between the ideologies of socialism and free market capitalism, Korea also experienced a violent civil war that was not only highly disruptive of Korean society but also left the psychological scars of widespread fratricide. While foreign powers intervened in the Korean war on both sides, this reality remains an unresolved wound for Korean society in both countries that tends to be downplayed if not ignored. Indeed, anger in both Koreas against the experience of the Japanese occupation and the overwhelming influence even today of outside powers, notably China and the U.S., on the existential condition on the Korean Peninsula, elicit a historical feeling of vulnerability commonly expressed as the “shrimp among the whales” syndrome. But while this shared sense of ultimate Korean vulnerability may reinforce aspirations for unification, regaining a lost feeling of wholeness, and strengthening of Korean pride, it is important to recognize that repairing the wounds of fratricide in Korean society will be a sub-text of any process leading towards unification and reframing of Korean identity after more than half a century of militarized and ideological division.

Second, the breakdown of five centuries of traditional social order in Korea in fact took place during the era of Japanese occupation and is not the result of the Korean war per se. Ultimately, the Korean war itself and the fundamental challenge still facing the Korean Peninsula, is a competition of visions of the political and social order of a reunified Korea that replaces the vacuum left by the Japanese defeat and withdrawal after World War 2. At its simplest, this competition is between the effort pursued by the North to reassert dynastic leadership supported by an elite based on patronage and control over a stratified social order, with the modern democratic order that has evolved away from authoritarianism in the South. The economic policies adopted to advance these alternative visions have reinforced and amplified the gap between the two approaches to governance and social organization.

From a historical perspective, since the Korean war did not result in a winner, this competition has continued and become more extreme over time. The common view in South Korea and the U.S. is that North Korea’s inward-focused strategy for national development, depleted economic power, and literally stunted human development, together with excessive dependence on political and economic support from both Russia and increasingly China over the years, has not produced the “strong and prosperous” nation that is the declared national goal. It continues to be a widely held belief that this systemic failure of the North Korean governance experiment will ultimately give way to unification on South Korean terms as the successful winner of the competition. The North Korean view, however, is that they have successfully defended their system against the might of the South Korean-American alliance through military deterrence, national character and fortitude, and political alignment with Russia and

even more with China in recent years. These differences of perspective persist despite the changing international environment both economically and politically, and internal developments in both Koreas that create both challenges and opportunities for advancing their national development aspirations. Any evolution in South-North relations from the current situation should be assessed from the perspective how the changes in relationship advances or hinders the underlying interests and strategies that the two Koreas are pursuing to win the ultimate competition.

Assessment of the Present Situation of South-North Relations

Now is a very good time to assess the South-North relations as a baseline for what is widely expected to be realignment in 2013. The combination of the Lee Myung-Bak administration being in lame duck mode and the need to attend to internal regime succession and transition in the North, have placed inter-Korean relations nearly in limbo for much of 2012.

Overall, South-North relations are at the lowest level of cooperation in all the years of ups and downs following the signing of the Basic Agreement in 1992. During these years the inter-Korean relationship has had to adjust to the economic crisis and famine in the North in the mid-1990's, the financial crisis in the South in the late 1990's, ten years of Sunshine Policy in the South while the North expanded its nuclear program and experimented with economic changes, and five years of policy in the South based on conditionality and reciprocity while the North was expanding its nuclear program and contending with increased need to plan for possibility of regime succession sooner rather than later. These relationship challenges have not brought the two Koreas closer to agreeing on a shared vision of a viable path towards unification.

While the Kaesong Industrial Complex continues to be the primary arena for South-North cooperation because of the mutual economic benefits that have withstood the test of overall deterioration of relations in recent years, derogatory rhetoric and provocative actions by both Koreas have dominated inter-Korean relations. While military confrontation has been avoided in 2012, North Korean jamming of aircraft global positioning systems and the long-range missile test aimed at a southern trajectory, and South Korean warning shots in the disputed waters of the West Sea eliciting North Korean threats in response as well as joint military drills with the U.S., have contributed to maintaining high tensions this year. North Korea's recent warnings about tax compliance in the Kaesong Industrial Complex and high penalties, signal that finding ways to raise foreign exchange still is being given priority over improving the investment climate for private companies.

While inter-governmental relations have been decidedly cold, there have been some informal meetings in third countries and occasional visits of civic groups to the North that have served to keep some lines of communication open and signaling mutual desire to not shut all doors completely. North Korea's recent decision to permit shipments of food aid by civic groups following the typhoon-induced floods is also a sign of some relaxation of North Korea's cold shoulder policy.

Some issues have surfaced in recent months that will need to be addressed in the next round of relationship adjustment. One is the refusal of North Korea on several occasions to accept humanitarian aid on the terms offered by the South Korean government. While this is couched in terms of the North wanting a different composition of aid than what was offered, underneath the surface it also reflects ambivalence about being perceived as the needy relative next door to the wealthy provider of largess who arbitrarily sets the terms for assistance. After experiencing the loss of fertilizer and food aid under the Lee Myung-Bak administration's policies, North Korean pride is likely to require a more collaborative approach to inter-governmental humanitarian relations in the future, even if North Korea adopts a more relaxed posture in accepting humanitarian aid from civic groups.

Along with this development is the issue of payment of loans due on rice aid provided in the past that technically came due for payment in June 2012. While taking the rice as a loan in the first place may have been more a face saving requirement for North Korean pride than a serious loan arrangement, the fact that South Korea is now publicly raising the debt repayment question means that a more formal respect for the obligations of both sides in future humanitarian and economic relations will be needed.

As 2012 winds down, inter-Korean relations are likely to remain tense but stable. Any efforts by North Korea to try to influence the outcome of the Presidential election in the South is not likely to be well received by any of the parties in contention.

In contemplating possible future directions of South-North relations there are quite a number of considerations to be assessed, including challenges and opportunities posed by domestic developments in both Koreas, and international factors particularly regarding China and the U.S.

The Current Context: Implications of Transition in the North

The seemingly successful succession of Kim Jong Un as third generation family leader in the North now poses several interesting challenges for the evolution of the North Korean system of governance. These could fundamentally alter the equation of the competition between the two Koreas and create new openings for recalibrating inter-Korean relations in the coming years.

First, inter-generational succession may have come to the end of the line for North Korea as a model for regime stability. While it seems that Kim Jong Un is married, the prospects for an heir to succeed him anytime soon look dim indeed. This fact alone must change the equation for ensuring stable succession planning in the North and motivate moving in the direction of less personal and more collective mechanisms for decision-making and public visibility at the highest level. As we have already seen, part of this strategy is to broaden inner family collaboration in the decision-making process, and part is to strengthen collective decision-making organs at the national level while at the same time decentralizing and empowering decision-makers at the local level, enterprises, and agricultural cooperatives. This is being pursued in the Party through refurbishing the role of the Politburo and modernizing the Party apparatus, in the military by diversifying the membership of the National Defense

Commission, and in the Cabinet by giving it more authority for national economic development and raising its technocratic competence. In any case, North Korea needs a Plan B for future succession scenarios, if for no other reason than accidents can happen and an untimely demise of Kim Jong Un would be a major blow to a system dependent on personality leadership culture.

The implication of these developments for future inter-Korean relations is that more diversified areas for collaboration and engagement would reinforce the trend of greater collectivization and decentralization of decision-making in the North. The more players that are engaged in relationship activities, the more likely that mutually beneficial positive impacts can be obtained and the constituency broadened for pursuit of inter-Korean shared interests. Also, the more North Korea evolves in the direction of collective and diversified decision-making, the weaker the traditional top-down socialist planning model will become, and whatever evolves will be more compatible with more disaggregated and market-friendly modalities for cooperation, and creating an environment more amenable to a competition of ideas rather than reliance on top down directives. South Korean strategy in this context would be best served by avoiding reverting to centralized government-to-government transfers of money or commodities in the form of humanitarian aid or economic cooperation agreements, and more reliance on seeking engagement at the local level and with multiple actors at the central level, and promoting enterprise-to-enterprise cooperative agreements under improved legal frameworks.

A second important feature of the changing context in the North is the more future oriented and worldly interested perspectives being promoted by the youthful new leader. From displaying modern fashion to embracing foreign food and cultural icons, Kim Jong Un's initial public images signal generational change and openness to lightening up of social expectations that seem to resonate at least among the elite in Pyongyang. The implicit permissions that are attached to these gestures could provide new openings for inter-Korean social, cultural and athletic initiatives. Even though South Korean soft culture has penetrated the North through clandestine means in recent years, a lower threshold of official fear of cultural intrusion would make it easier for younger Koreans to interact and to seek creative new collaborations in this sphere. Building a dimension of younger generation involvement into a future strategy on inter-Korean engagement thus might be more feasible than in recent years and also motivate better understanding and ambitions for unification in this age group which has become increasingly disinterested in time-worn renderings of inter-Korean issues as the decades pass. The fact that Kim Jong Un's wife participated in the delegation that visited South Korea for the Asian soccer games could provide an impetus to pursuing such a strategy.

The surprise focus of the September 25 Supreme People's Assembly meeting on education reform is another sign of Kim Jong Un's orientation to the future rather than defending the past. Steps to improve the learning environment as well as adding another year to compulsory education seem to signal his concern about human resources development that will be an important aspect of any eventual process of North Koreans engaging the rest of the world more effectively as well as improving domestic productivity and social well-being. The implication for future South-North relations is that initiatives for cooperation that support this interest in human

development in the general population, both in education and health, might have more traction than in the past and provide space for expanding understandings and congruent interests in the younger generation.

There is also much speculation that Kim Jong Un needs to earn respect among the professional military by demonstrating his willingness to be tough on national security issues and maintaining military strength and morale. Visibility, rhetoric and provocation are all tools at his disposal. So far, we have seen willingness to use visibility and rhetoric, but also restraint on provocative action following the failed missile test (which was in the works before Kim Jong Il's death and probably not in Kim Jong Un's power to stop at that stage of the transition). Reducing tensions between the two Koreas should be high priority in any recalibration of South-North relations, and identifying steps that can give Kim Jong Un incentives to refrain from provocative actions without appearing weak on defense should be part of the strategic calculus.

If Kim Jong Un is indeed shifting focus from a military-first politics advanced by his father to a more Party-centric politics, then the question of the rationale for legitimacy of his rule becomes an important factor for thinking about future South-North relations. By speaking early and publicly about improving economic performance and the livelihoods of ordinary North Koreans, Kim Jong Un seems to be shifting the underpinning of legitimacy from maintaining a credible military deterrent to a constantly threatening enemy, to delivering on economic growth. This shift would be consistent with both Chinese and Vietnamese experience in tying the legitimacy of Party rule to economic growth. It is also consistent with the moves that have been made in the North in recent months to elevate the role of the Party and put constraints on the military, both in control over senior personnel and in taking the military out of its own economic silo by giving the Cabinet more authority for integrated national economic management.

Redefining regime legitimacy based on economic performance rather than maintenance of a constant enemy would be a major change in the context for future South-North relations as well as prospects for an eventual peace accord. Any future strategy for realigning South-North relations should take as a major objective the reinforcement of the desirability and possibility of such a shift. Improving the environment for military-to-military communications and even collaboration on joint projects of mutual benefit to both countries should be considered. Helping Kim Jong Un to succeed in rebalancing the role of the Party and military in North Korea's core governance should be supported by the South as in its long-term interest. It similarly behooves South Korea to shift its rhetoric and action from military quasi-provocation to potential economic cooperation and willingness to find sustainable solutions to long-standing issues such as the Northern Limit Line.

The Current Context: South Korea's Election and Future Directions

The Presidential election on December 19 will certainly set the stage for a new era of South Korean policy towards North Korea. While it can be expected that a win by the liberal candidate, whether it is Moon Jae-In or Ahn Chol-Soo, will be strongly pro-

engagement, it can also be expected that policy under the conservative candidate Park Geung-Hee will be more positive toward engagement than the present administration. In all cases more attention to economic cooperation is likely, but the contours of how this will take shape are not yet clear. This will depend both on developments in the North as regards their economic management initiatives and creative new thinking about ways best to take advantage of the prospects for setting the relationship on a new path. A lively debate within South Korea on how to calibrate a new North Korea policy can be expected over the coming months. This conference is a contribution to that process.

The new President will also need to be mindful in setting the new directions for North Korea policy of the challenges facing the South Korean economy and business environment as exports slow in response to the weak international economic situation globally and tensions mount in labor relations. Both will have some impact on the shaping of future economic engagement with North Korea, particularly in any resumption of the plan to expand significantly the scale of investment in the Kaesong Industrial Complex and rebuilding the processing-on-commission trade with North Korea that declined sharply under the Lee Myung-Bak administration.

A longer-term issue that also should be factored in is the demographic reality that the South Korean labor force is at a turning point and will begin to shrink in 2013. This is likely to bring to the fore more debate about the merits of importing contract labor and hiring North Korean labor either in North Korean enterprise zones or in factories built in China where there is growing use of North Korean labor under new visa arrangements. The intersection of these issues with trade union concerns about wages and working conditions for the lower end of the labor force, are likely to become part of the South Korean context for realigning its future relations with the North.

Also, as noted in a recent Bank of Korea report on the financial implications of demographic changes¹, a contraction in the working population is likely also to lead to declining asset values and pose new macroeconomic challenges for government finances. These issues are thus likely to be considerations in discussions of strategies for financing reunification with the North and foster a cautious approach.

The Current Context: Implications of the Rise of China and China-North Korea Relations

Both Korea's economies have become increasingly yoked to the Chinese economy in the last decade, although driven by different objectives and dynamics. Any major economic crisis in China thus can be expected to impact both Koreas significantly and the North is especially vulnerable to an unforeseen disruption in its Chinese trade, aid and investment relations. It behooves both countries to hedge against these downside risks and this should be a significant motivator for giving higher priority to deepening inter-Korean economic ties and cooperation for mutual benefit.

Similarly, Chinese maritime assertiveness has been growing increasingly strident, contributing to tensions in both Northeast and Southeast Asia that offset the

¹ Korea Times, September 16, 2012. http://www.koreatimes.co.kr/www/news/biz/123_120053.html

benefits of increased economic ties with China. Fears of heightened nationalism and pursuit of hegemonic interests reinforce the age-old “shrimp among the whales” sentiments in both Koreas and this provides political as well as economic rationale for seeking to improve inter-Korean relations in the present international environment. It is also in China’s interest that the Korean Peninsula remain stable and to maintain good relations with both Koreas, so Chinese policy towards improved inter-Korean relations and especially economic cooperation is likely to be positive regardless of the leadership transition taking place in China at this time.

On the other hand, a significant challenge for future South-North relations is the dominance of China in North Korea’s current external economic relations and the diversity and genuinely commercial motivations for the rapidly expanding trade and investment activities along the China border. These are indicators of a process of economic integration underway despite the many hurdles faced by enterprises involved on both sides. The large ethnic Korean population on the Chinese side of the border also provides a fertile soil to nurture this process of gradual economic integration in the border areas. In addition to the two Special Enterprise Zone initiatives on the East and West border areas where Chinese investment in infrastructure as well as production factories are essential for their success, the recent decision to allow North Korean workers to be employed in China under new visa arrangements are further evidence of the commitment of both governments to pursuing this integration as in their long-term interest.

The relatively open border with China contrasts sharply with the closed border with South Korea and this has in recent years been accompanied by a “look North” policy that involves not only deepening local level economic integration but also increased cooperation between central government Party officials. As North Korea has begun to rebalance the relative roles of the Party and military, China has been quietly nurturing a political evolution that would be more in line with the collective leadership set-up in China and Vietnam. From the Chinese perspective, this would both serve to improve prospects for regime stability over time and offset inducements to evolve towards South Korean democratic values. This evolution of contrary interests derived from North Korea’s increasingly complex relationship with China adds a complicating dynamic to shaping future South-North relations to enhance prospects for eventual unification and is likely to place the North Korean leadership in an uncomfortable position of having to make difficult long-term strategic existential choices. China does, however, face major domestic challenges as its model of linking Party legitimacy to maintaining high economic growth has reached a critical turning point that raises the stakes for both political and economic reform policies. In this increasingly uncertain situation, it is in South Korea’s interests to manage its own domestic political and economic changes in ways that give the North Korea leadership good reasons to appreciate the strength of democratic governance compared with the risks of following the Chinese model too closely.

The Current Context: U.S. Tilt towards Asia and Post-Election Prospects for the Two Koreas

American commitment to its Asian security alliances and interests is strong and underpins its tilt towards Asia. While continuing threats posed by North Korea are always cited as the prime reason for maintaining a strong military presence in the region, American interests are also linked to encouraging peaceful solutions to the various maritime disputes that are potentially disruptive within the region, and using assurances of American security presence to support an environment conducive to maintaining the economic dynamism of the region.

Despite this tilt, the U.S. continues to be primarily occupied by security threats in the Middle East and Southwest Asia and is not keen to have a flare up in East Asia and especially on the Korean Peninsula, even though it is prepared to deal with them if need be. For this reason in recent years there has been a high degree of compatibility between the policy of “strategic patience” pursued by the Obama Administration and the policy of conditioning South Korean relations and economic engagement on prior actions by North Korea to go down the denuclearization road. This convergence of a de facto policy of disengagement has been reinforced by the warm personal relationship of Presidents Lee Myung-Bak and Obama. The consequence, however, has been to drive North Korea more deeply into dependence on its relationship with China, despite apprehensions in Pyongyang. The result has been a decline in leverage over North Korea policy and actions, which have been reinforced by the military aggressions that occurred during this period, the continuing development of the nuclear program, and launching of missiles despite overtures to restart a bilateral dialogue by the U.S. and offers of humanitarian aid.

Also, despite this convergence on North Korea policy, there has been a growing consensus among analysts in the U.S. that the objective of verifiable denuclearization of North Korea may now be out of reach as a feasible policy goal. U.S. focus has increasingly been on strategies for containment and non-proliferation. While this conflicts in detail with the present South Korean insistence on pressing for full denuclearization, the shared priority attention to North Korea’s nuclear program over other objectives in engaging North Korea has been firm².

Neither the tilt towards Asia nor the U.S. Presidential election, are likely to shift American priorities away from the nuclear issue. However, some adjustment in American North Korea policy can be expected. If Obama wins, he will have four years in legacy mode to work towards some more positive developments on North Korean issues than just maintenance of the status quo. Some changes in the national security team for a second term can also be expected and this could open space for reconsideration of the U.S. posture moving forward. Also, American policy will need to accommodate likelihood of more pro-engagement policy in South Korea regardless of who wins the election in South Korea. On a more substantive level, if U.S. policy makers are becoming more accepting of the need to find new strategies to address non-proliferation and nuclear containment objectives, then the question of how economic engagement factors into these strategies may become less of a secondary question that

² Korea Herald, September 19, 2012.

<http://www.koreaherald.com/pop/NewsPrint.jsp?newsMLId=20120918000828>

it has in the past, where sanctions rather than principled economic engagement has been the dominant posture.

If Romney wins the U.S. election, it can be expected that a Korea policy review would be undertaken by the new administration and this would involve both Koreas given both American security and economic policies pursued by the Obama administration and Obama's personal rapport with the outgoing South Korean President. While the contours of a future Korea policy at this stage remain vague given the combination of hard line and moderately minded advisors in Romney's campaign team, it most likely would include a tough stand towards the North not very different from what exists at present, and also be reactive to developments on the Korean Peninsula and to responses to U.S. policy towards the East Asia region in general that is likely to be strongly influenced by domestic U.S. economic reform priorities.

Lessons from the Eras of Sunshine Policy and Conditionality and Reciprocity

Both the eras of Sunshine Policy and policy of conditionality and reciprocity of the Lee Myung-Bak administration can be assessed as having had positive and negative features for advancing inter-Korean relations in ways that are supportive of eventual unification aspirations. Recognizing the lessons of these experiences over the past 15 years as North Korea has struggled to overcome the existential challenges it faced since the mid-1990's should provide some valuable guidance as inter-Korean relations enter a new era of possibility.

The hallmark success of the Sunshine Policy was the multi-dimensional character of inter-Korean relations. By pursuing simultaneously advances in economic cooperation in trade and investment, humanitarian assistance provided by both government and civic groups, family reunions, cultural and sports activities, and confidence-building measures between the two militaries, South-North relations evolved beyond the one-issue-at-a-time situation that prevailed previously. Concrete advances in all of these areas are evidence that with lowered tensions, inter-Korean relations can produce cooperation and mutually beneficial activities that expand the space for alignment of interests and joint endeavors that are consistent with a strategy of encouraging North Korea to open up to the outside world and evolutionary progress towards unification.

The primary negative aspects of the Sunshine era were two-fold. One is the over-reliance on a strategy of providing cash for concessions. Whether overt or under-the-table, these gifts reinforced the impression that South Korea is willing to buy or bribe its way to achieve its unification objectives. This only served to undermine efforts to help the North Korean leadership adopt more businesslike ways of conducting their relations with South Korea and other countries and certainly influenced their behavior in seeking rewards for concessions in the Six Party Talks aimed at reducing North Korea's nuclear threats, and American frustrations expressed in unwillingness to "buy the same horse twice."

The second negative aspect of the Sunshine era policies was acceptance of aid and trade arrangements that effectively propped up the status quo system in Pyongyang,

rather than providing incentives for systemic changes that would be more conducive to the growth of a market economy. Specific examples are: (a) wage payments in U.S. dollars for North Korean workers in the Kaesong Industrial Complex where these payments and foreign exchange go to the government with no transparent linkage to what the workers actually receive as take home pay; (b) processing-on-commission trade where North Korean trading companies act as intermediaries and payments for services rendered by North Korean production firms are also not transferred directly to the production enterprise but rather to the central state coffers; and (c) transfers of fertilizer, rice and other humanitarian assistance on a government-to-government basis that propped up the Public Distribution System rather than expanding the role of markets and allowed rents for those goods which did leak to the North Korean markets to accrue to senior government officials, not to needy North Koreans. Two counter examples to this pattern of distorting incentives of South Korean economic cooperation are: (a) the decision by Hyundai Assan when the Mt. Kumgang Tourism project appeared to be headed for bankruptcy to switch from an agreement to pay North Korea a fixed amount per month to a share of the receipts from tourists, thereby giving North Korea a stake in the economic success of the project; and (b) the use of Choco pies to give North Korean workers in the Kaesong Industrial Complex an incentive for performance and that they can sell in North Korean markets for considerable cash value that is not siphoned off by the government.

The primary lessons to be learned from the Sunshine era for future inter-Korean relations are thus to: (a) revert to a robust multi-dimensional relationship where issues needing to be resolved in one area do not necessarily lead to breakdown of cooperative engagement on other areas in the relationship; and (b) establish economic relations based on good business practices that will help the North Korean economy develop in appropriate ways for participating in the international economic system and longer-term integration with the South Korean economy based on market principles. This means more emphasis on trade and investment at the enterprise level than government-to-government aid, and practices which support the development of North Korean enterprises to be successful in market-based activities both domestically and in inter-Korean economic cooperation.

The policy of conditionality and reciprocity that has been the centerpiece of South Korean expectations of South-North relations under the Lee Myung-Bak administration also has positive and negative features. The biggest positive aspect is the admirable aim to encourage North Korea to adopt rational and businesslike behaviors in its relations with South Korea based on specific interests and honest give and take, which should be the foundation of a long-term relationship of mutual respect needed to underpin a gradual unification process. This prior insistence on North Korea accepting these principles before receiving significant new South Korean aid or economic cooperation can be assessed as a necessary antidote to the excessive one-way largess of the Sunshine era.

The fact that North Korea did not respond in positive way to this shift in South Korean policy is due in part to North Korean truculence at losing the easy monies it had come to expect, and in part to a perception in the North that the real intention of this policy was to squeeze North Korea into submitting to South Korean terms without

genuine consultation and to use insistence on denuclearization and economic pressure to advance longer-term South Korean objectives of dominance on the Peninsula.

This “wolf in sheep’s clothing” quality to the policy of the Lee Myung-Bak administration was reinforced by anti-North Korean rhetoric and provocations in the West Sea that predated the attack on the Choenan. The consequence was both to elicit the North Korean military provocations in 2010 (which may well have been motivated in part by domestic considerations within North Korea), and the rapid escalation of North Korean solicitation of political and economic support from China. Large joint American and South Korean military drills have also been regular reminders of the South Korean-American alliance to maintain military readiness to counter North Korean military provocations. One consequence of the more explicit South Korean policy of confrontation with the North has been reinforcement of the justification for military-first politics in the North and the domestic case for regime legitimacy being closely tied to the need for a strong defensive capability and economic self-sacrifice.

Despite their differences, the impact of South Korean economic engagement policies from the Sunshine and Lee Myung-Bak eras on needed changes in the North Korean economic system were both essentially negative and fundamentally different from the character of economic relations that grew dramatically between North Korea and China during this period. China, not South Korea, has come to be the dominant influence on the evolution of the North Korean economy and deepening of the role of markets. Chinese support for informal border trade and enterprise-led economic engagement based on commercial interests has reinforced bottom up changes in the North Korean economic system despite official reluctance to the growth of markets in Pyongyang. While investment from Chinese firms remains low and wary, recent efforts to develop special enterprise zones on the North Korea-China border and to promote foreign investment under laws that are much more flexible and liberal than what exists for the Kaesong Industrial Complex, signal continuing evolution of economic activity in essentially desirable directions. This is a distinctly different story from the largely problematic character of inter-Korean economic relations.

Politically, China has been nurturing a tilt toward a stronger role for the Party and reigning in the independence of the military in the North Korean political alignment and is committed to both maintaining stability and improving the legitimacy of the regime as it undergoes a critical transition. Indeed the dramatic shift from inter-Korean cooperation under the Sunshine era to multi-dimensional elaboration of the North Korean relationship with China could be a lasting impact of the Lee Myung-Bak policy of disengagement that will make more difficult a rebalancing in the future on terms that are more in line with longer-term South Korean unification interests and expectations of eventual dominance. Finding ways to moderate this trend should be given priority in reconsidering future inter-Korean relations.

One way to do this would be to consider aligning more closely future South Korean economic engagement policies with those being pursued by China, so that commonly agreed principles of supporting the development of the market economy and business practices with foreign investors and trading partners could be advanced on both borders in a more coherent way. Bilateral dialogue with China and ideally tri-

lateral dialogue among the two Koreas and China could be one area for future initiative that could prove beneficial for all parties. Specific steps that South Korea could pursue are creative approaches to expanding inter-Korean economic cooperation in the future such as seeking more flexible options for investment in expansion of the Kaesong Investment Zone and more diverse cross-border interaction. Also, South Korean companies could actively participate in the Special Enterprise Zones on the China border as they are invited to do explicitly under the laws governing these zones adopted in December 2011.

Guiding Principles for Future South-North Relations

In considering how best to recalibrate inter-Korean relations in 2013, it would be useful to articulate guiding principles that are informed by historical challenges, lessons from past experiences, recent developments, and potential new opportunities.

1. *Resolution of the long-term challenge of shaping a new political and social order for a unified Korea must be primarily a Korean-led process.* While China and the U.S. remain guarantors of the security interests of both Koreas, they cannot be expected to provide the leadership needed to resolve the existential Korean issues. Ultimately, the aim should be to shift both U.S. and Chinese relationships with both Koreas to ones based on multi-dimensional partnerships that allow for more nuanced mechanisms of maintaining security through being stakeholders in interdependencies than reliance on visibly deployed military commitments to separate nation states. A peace accord to replace the Armistice remains an essential step in stabilizing South-North relations and supporting a process of integration that can lead towards unification. Informal discussions of the obstacles and potential opportunities to move towards a peace accord should be encouraged and given more prominence South-North cooperation with each other and other concerned countries.
2. *The most desirable strategy for eventual reunification is for North Korea to make choices that result in evolution of its system of governance and economy in ways that are increasingly compatible with the democratic polity and outward-oriented economy of South Korea.* This should include in the near-term encouragement for the evolution towards more collective leadership and decentralized decision-making in the North. Re-establishing a multi-dimensional framework for expanding inter-Korean cooperation on various fronts simultaneously should be given high priority. Given the undercurrent of competition between the path of democratic governance that the South has chosen, the path advocated by China of aligning Party dominated socialism with market economic features, and the path of independent family dynastic authoritarianism that has been the preferred path of the Kim family to date, what is important is not so much to aim for the collapse of the North Korean regime and wholesale replacement, but a migration of its self perception of legitimacy and historical integrity in ways that are compatible with a peaceful process of unification with South Korea. This necessarily would have to involve a vision of successive approximations in which choices are made to move incrementally in this direction, whether in response to changing realities on the ground or as a matter of deliberate decisions for

managing change in a controlled way. While South Korea should have contingency plans for managing various scenarios of developments in the North and for financing various alternative strategies of achieving reunification, domestic economic and social challenges facing South Korea in the current global economic environment suggest that a gradual process led by evolutionary change in North Korea is the most realistic basis for future engagement policy.

3. *South Korean policy towards inter-Korean relations should aim to reduce the need for North Korea to require an enemy for maintaining regime legitimacy and reinforce the migration towards economic development as the primary foundation for regime legitimacy at least in the medium-term.* Steps should be taken to reduce overt military confrontation and tensions, at least tacitly to encourage the shift to a dominant role for the Party in the medium-term, while making more obvious the risks of relying on socialist principles and authoritarian social control, and to support expanding the authority and competence of the Cabinet in economic and social governance.
4. *Inter-Korean relations should incorporate more commercial and civic interactions between the two Korean societies and less reliance on government-to-government transactions.* Large transfers of humanitarian aid between the two Korean governments should be avoided to a significant extent and future humanitarian offers by South Korea should be both calibrated to meet real needs of the vulnerable North Koreans and planned in a cooperative way with North Korea to achieve shared objectives. Expanded enterprise-to-enterprise business relations governed by improved legal frameworks and increased interactions among civic groups and younger Koreans should be pursued.
5. *Inter-Korean economic relations should support a vision of the future development of the North Korean economy that is shared also with other major economic partners.* It is important both that efforts be made to forge a common vision of the desirable economic future for North Korea and align economic engagement policies with moving towards fulfillment of the vision. It is also important to seek consensus, possibly through the Six Party Talks mechanism or some successor framework, on the linkage of reducing security threats, including the nuclear program, missiles and conventional weapons, to economic engagement. The 2007 Joint Statement does not provide an adequate basis for what such economic engagement would require to be effective. Rationalizing the role of sanctions and economic incentives for cooperation requires coordination of substantive economic engagement policies, which can only come from multiparty diplomacy and cannot alone be accomplished through realigned inter-Korean relations. On the other hand, a new South Korean policy of pursuing expanding economic relations would be an important consideration in rethinking multilaterally the dynamics of influencing positive change in North Korea and the relative sequencing of moving forward on security and economic agendas.

Conclusions

South-North relations are at a historically important juncture. After a decade of Sunshine Policy and five years of antagonism linked to conditionality and reciprocity on the South side, and the transition from the military-first politics and tight personal control that was the hallmark of the Kim Jong Il era in the North to the still emerging policies and politics of the Kim Yong Un regime, the opportunity to realign the inter-Korean relationship is palpable and seems to be warily desired by both sides. Taking stock of longer-term factors as well as the present domestic and international context that defines the challenges faced by both countries is a worthwhile undertaking at this juncture. Hopefully, some clarity of vision for taking best advantages of the opportunities that will be available for efforts to recalibrate South-North relations in 2013 will emerge from a needed debate within both Koreas in the months ahead and their underlying desire to find a path to reunification that will be enduring.

Inter-Korean Relations and Prospects for the Future

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Inter-Korean Relations and Prospects for the future

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Dynamics of the Inter-Korean Relations

- Changes of South Korean Domestic Politics and their Implications on its North Korea Policy
- Changes inside the DPRK and its Internal and External Policies
- Changes of Situations around the Korean Peninsula and Contending Interests of Neighboring Countries.
- Changes of International Structure & Order

Inter-Korean Relations under Lee Myung-bak Government

- Changes of South Korean Domestic Politics and their Implications on its North Korea Policy
- Changes inside the DPRK and its Internal and External Policies
- Changes of Situations around the Korean Peninsula and Contending Interests of Neighboring Countries.
- Changes of International Structure & Order

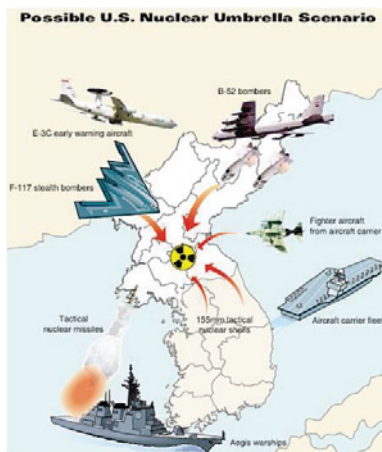
Inter-Korean Relations in Crisis

- DPRK's Misunderstanding and Accidents(i.e.,Shooting a South Korean female tourist at Kumkang Mountain in July, 2008)
- Nuclear development program and unconditional demands for fulfilling June15 Joint Declaration and October 4th Agreement
- South Korea's bold approach to North Korea to reverse the way in dealing with its counterpart
- Chairman Kim Jong Il's Sudden Death in 2011 and uncertainty in the succession process in the DPRK

World-wide Leadership Changes in 2012



Peace and Stability through Denuclearization and Deterrence on the Korean Peninsula



- Resumption of the 6-Party Talks
- Presteps for the 6-Party Talks.
- Agenda at the 6-Party Talks: Peace System on the Korean Peninsula and Construction of LWR
- New US-ROK Missile Agreement

Peace and Stability through Denuclearization and Deterrence on the Korean Peninsula



- Tourist Business in Kumgang Mountain and Kaesung City
- Extend Business in Kaesung Special Economic Zone(123 South Korean Firms with 50,000 North Korean Workers),i.e.FTA
- Join to invest in NE region with China/Russia
-

Future of the Inter-Korean Dialogue

- South Korea's Presidential Election in December on behalf of building Inter-Korean confidence/trustship
- Major Changes in South Korea's Domestic Politics in 2012: Non-ideological approach to the North
- Precondition: Resolving Nuclear Problem and Resumption of Official Dialogue between the Two Korean Governments

Candidates for 2012 Election



South Korea's Domestic Measures to Improve Inter-Korean Relations in 2012-2013

- Management of Stable Inter-Korean Relations to Remove Burdens for the Next Government(i.e. May 24 Measurement)
- Non/Pan-partisan Communication and Cooperation in the Transition Period
- Flexible and Realistic Approaches to Inter-Korean Agreements
- Beyond the policies of Sunshine or Strategic Patience

Future Agenda for Better Inter-Korean Relations

- Resumption of Government-level Dialogue to Examine and Reconsider Accidents and Provocative Actions against each other
- Efforts to Re-build Confidence and Trustship for Normalization of Inter-Korean Relations(reduction of tensions and conflicts/threats etc)
- Exchange of Envoys to Resolve Humanitarian Issues by Extending Food Aid to the North
- Recovery of Economic Difficulties under Kim Jong Un

Comments on Brad Babson's and Ho-Yeol Yoo's papers

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October 2012

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Inescapable Economic Realities

**The
Economist**

Economics focus

Parallel economies

What the North and South Koreans can learn from the reunification of Germany

Dec 29th 2010 | from PRINT EDITION

SOUTH KOREANS dread the prospect of renewed fighting across the "38th parallel" that divides their country from the communist North. But not all of them savour the alternative ending for their cold war: rapprochement and reunification.

North Korea's indigence is almost as scary as its belligerence. The collapse of its rogue dictatorship—improbable but not unthinkable—would replace a military threat with a variety of economic perils, including a possible flood of cheap migrant labour and costly obligations to support the North's people and infrastructure. Germany's example is hardly reassuring. Two decades after reunification, the East still subtracts heavily from Germany's budget and adds greatly to its unemployment figures.

Before the last Korean war in 1950, the North was home to most of the country's heavy industry. As late as 1975, its income per head still exceeded the South's, according to Eui-Gak Hwang of Korea University in Seoul. "Obviously, sooner or later the country must be reunited," wrote Joan Robinson, a Cambridge economist, in 1977, "by absorbing the South into socialism."

South Korea's central bank reckons that North Korea's annual income per person was only \$960 in 2009, or about 5% of South Korea's. (This estimate values the North's output using South Korea's prices and its exchange rate against the dollar.) This disparity dwarfs the income gap between the two Germanys on the eve of reunification (see chart). Poorer than East Germany, North Korea is also bigger. Its population of 24m is about half the size of the South's, whereas East Germany's was only about a quarter the size of the West's.

-2-

Migration Dynamics, Growth and Convergence

- An important driver of change in a Korean unification scenario is projected patterns of mass migration of northerners into South Korea.
- The South Korean constitution affirms that South Korea consists of the entire Korean Peninsula and, as such, that North Koreans are citizens of South Korea.
- In a reunified Korea, assuming a completely free labour market, why would North Koreans stay in a devastated landscape when crossing the previous border will bring them into a vastly more developed country?

-3-

New Realities - East-West Migration in Germany

- Overall, cumulative net migration East-West amounted to 1.7 million persons. This relates to a share of **10.3 %** of the original East German population at the beginning of 1989.
- The **first wave** of migration occurred immediately after the fall of the Berlin Wall. Between November 1989 and October 1990, around 600,000 East Germans - or 3.7 percent of the country's population - abruptly moved to West Germany.

-4-

- By 1997 high unemployment in the East and an economic boom in western Germany ignited a **second wave** of East-West migration that peaked in 2001.

Who stays, who goes?

- East-West migration is **age specific**. Over 60 percent of the migrants are younger than 30.
- A **higher education level** makes migrants looking for jobs in western Germany.

-5-

Baseline Model Without Migration I

- Two-region semi-endogenous growth model with capital accumulation and interregional transfers.
- The effect of infrastructure on regional productivity is modelled according to Barro (1990). Thus, the model is a generalization of Barro's (1990) model on government spending and economic growth.
- Tax earnings are spent on the accumulation of regional infrastructure, income redistribution within a region, and income redistribution between regions.

-6-

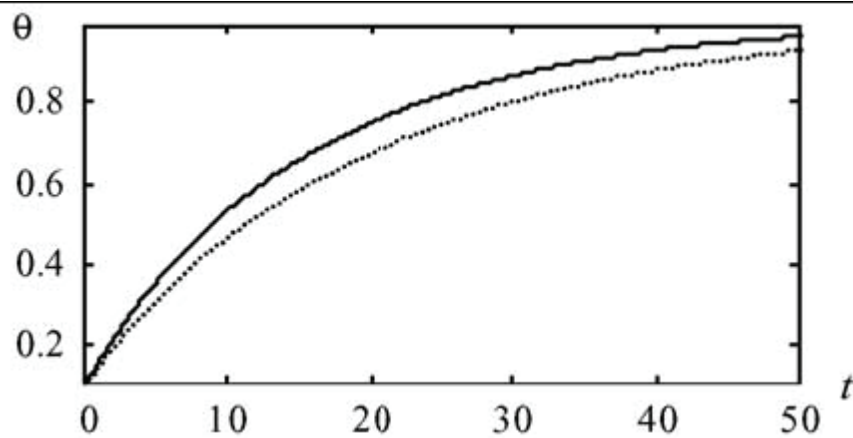
Baseline Model Without Migration II

- The intertemporal approach can be used to think rigorously about national intertemporal budget constraints and government intertemporal budget constraints.
- The growth model allows us to address rigorously a number of issues related to Korean unification.

-7-

Model Calibration Results for Regional Convergence (GDP per Capita)

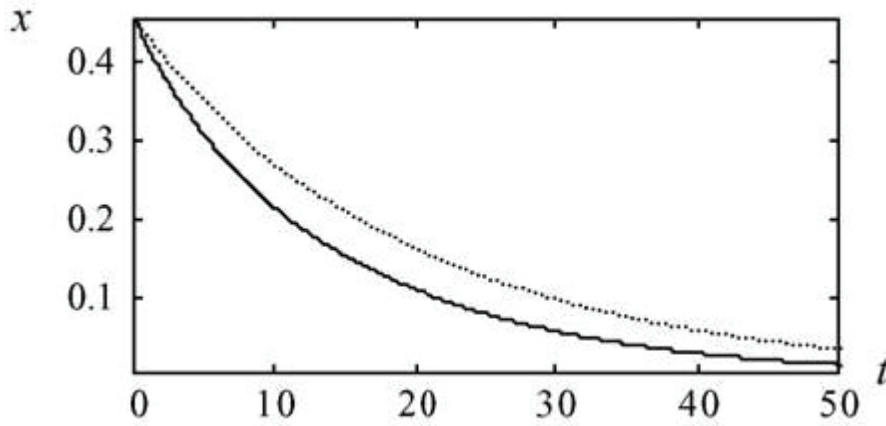
$$\theta(0) = 0.10$$



-8-

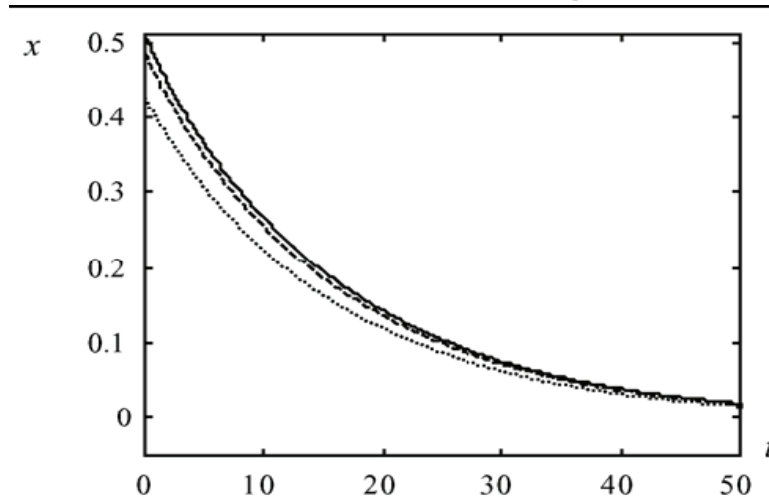
Regional Transfers (% of the South Korean Tax Revenues)

$\phi = 0.75$ vs. $\phi = 0.50$



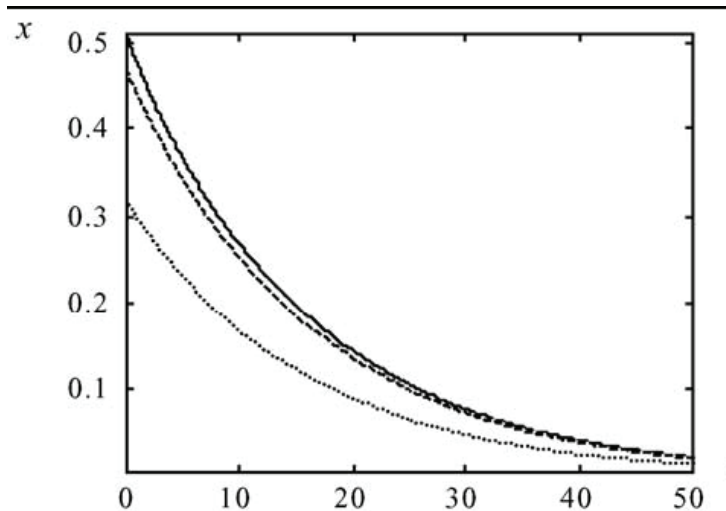
-9-

Economic Convergence with 1.4 – 4.0 Million Migrants



-10-

Economic Convergence with 2.0 – 8.0 Million Migrants



-11-

Migration in the Aftermath of Korean Unification

- A closer look at North-South migration points to several important areas that need attention from policymakers.
- **Skills** Migrants typically have lower skill levels or skills that are more difficult to recognize or translate into the southern economy.
- **Experience** Migrants often have less work experience and face more or less formal “last hired/first fired” policies.
- **Contingent employment** Migrants are often in jobs that are more temporary in nature and expand and contract to reflect demand cycles.

-12-

Boosting Flows of South-North Remittances

- Governments have often offered incentives to increase remittance flows and to channel them to productive uses.
- Matching-fund programs to attract remittances channel remittances to investment.
- Enhancing bilateral and multilateral dialogue on these issues, as well supporting the full engagement of civil society, may be a confidence-building measure in itself and promote the idea.

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Summary

- The path to a market economy will no doubt be bumpy.
- South Korea's communist sibling is both poorer and more populous than West Germany's ever was.
- But Korea politicians have one advantage Germany lacked. The benefit of past experience may allows policymakers to understand what sort of pitfalls to avoid when unification occurs.

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Session 2

Benefits and Costs of Unification

Moderator

Oh-Seok Hyun

(President, Korea Development Institute)

Presenters

Marcus Noland

(Deputy Director, Peterson Institute for International Economics)

Ildong Koh

(Senior Fellow, North Korean Economic Team, Korea Development Institute)

Panelists

Karl-Heinz Paqué

(Professor of Economics, University of Magdeburg)

Suk Lee

(Director, North Korean Economic Team, Korea Development Institute)

Session 2

Biographies



Oh-Seok Hyun is the President of the Korea Development Institute (KDI), Korea's leading think tank. He is a member of the Presidential Council on National Competitiveness, Presidential Committee on Green Growth, Advisory Council on Presidential Committee for G-20 Summit, and Prime Minister's International Development Cooperation Committee. Also he is further partaking in the international development and cooperation as a member of Knowledge Advisory Commission of the World Bank. Hyun's extensive experience in policy making and research in the public sector is a unique career path for a government official in Korea. Dr. Hyun served as Deputy Minister of Finance and Economy, and Special Advisor to Deputy Prime Minister and Minister of Finance and Economy. He worked as Secretary for Economic Affairs at the Office of the President, and an Economist at the World Bank. Dr. Hyun received his Ph.D. in Economics from University of Pennsylvania in 1984. His pursuit in teaching and research rewarded him for a professorship at the Korea Advanced Institute of Science and Technology (KAIST) and an experience as the Dean of the National Tax College.



Marcus Noland is the Deputy Director of the Peterson Institute for International Economics and a Senior Fellow at the East-West Center. He was a Senior Economist at the Council of Economic Advisers in the Executive Office of the President of the United States, and has held research or teaching positions at Yale University, the Johns Hopkins University, the University of Southern California, Tokyo University, the Japanese National Graduate Institute for Policy Studies, the University of Ghana, and the Korea Development Institute. Noland has authored, co-authored, or edited numerous books and articles. Among these are *Japan in the World Economy* (co-authored with Bela Balassa); *Reconcilable Differences? Resolving United States-Japan Economic Conflict* (co-authored with Fred Bergsten); *Industrial Policy in an Era of Globalization: Lessons from Asia* (co-authored with Howard Pack); *Famine in North Korea: Markets, Aid, and Reform* (co-authored with Stephan Haggard); and *Arab Economies in a Changing World* (co-authored with Pack). His book, *Avoiding the Apocalypse: the Future of the Two Koreas*, won the prestigious Ohira Memorial Prize. His latest books, co-authored with Haggard, are *Witness to Transformation: Refugee Insights into North Korea* and *Engaging North Korea: The Role of Economic Statecraft*.



Ildong Koh is a senior fellow and the managing director of the Economic Information and Education Center at the Korea Development Institute (KDI). At KDI, Dr. Koh previously served as the director of the North Korean Economy Division, vice president of the department of Research Coordination and Planning and managing director of the International Development Exchange Program. He holds advisory and consultation positions for the Korean government including the National Intelligence Service and the Ministry of Unification and National Security Council, alongside for other public organizations such as the Korea International Trade Association and the Federation of Korean Industries. After receiving his Ph.D. in Economics from Iowa State University in 1988, he rejoined KDI and has stayed there thereafter up to now. Dr. Koh also stayed at the Kiel Institute of World Economics in Germany and Keio University in Japan as visiting scholar. Maintaining a research interest in North Korea economy, economic integration, transition economies and comparative economic systems, he has published a number of works spanning from regional economic integration to inter-Korean relations.



Karl-Heinz Paqué is Professor of International Economics and Dean of the Faculty of Economics and Management at the Otto von Guericke University Magdeburg, Germany. He was educated at the universities of Saarbrücken, Kiel and British Columbia (Vancouver, Canada). He was research fellow at the Center of Public Choice, Blacksburg (VA) and head of the Department of Growth and Structural Change at the Kiel Institute of World Economics. From 2002 to 2006, he was Minister of Finance in the German state of Saxony-Anhalt. He is a member of the Enquete Commission of the federal German parliament on Growth, Prosperity and Quality of Life as well as the Korean-German Joint Consultation Committee on National Unification. His most recent research focus is on economic matters of growth, structural change, regional convergence and re-unification of Germany and Europe as well as new trends in the labor market. In this context, he has published three widely acclaimed books (titles translated from German): *The Balance Sheet: An Economic Analysis of German Unification* (2009), *Growth: The Future of Global Capitalism* (2011), and *Full Employment: The New German Job Miracle* (2012).



Suk Lee is a research fellow at Korea Development Institute (KDI). He received his BA and MA in economics from Seoul National University and his PhD in economics from the University of Warwick, England. He served as an intelligence analyst at ROK National Security Planning Agency (currently National Information Service), and also worked for Korea Institute for National Unification as the director of the Information Center for Unification Studies. Dr. Lee has worked on the DPRK economy, especially on the DPRK economic structure, foreign trade, food crisis, demographic change, and recent economic reform and changes. His most recent publications include *Economic Comparison of North and South Korea and Its Implication* (Seoul: KDI, 2011, in Korean), *Issues and Analysis of the 2008 DPRK Population Census* (Seoul: KDI, 2011, in Korean), *Economic Consequence of Unification Policy: Empirical Evidence and Implications* (Seoul: KDI, 2010, in Korean) and *Analyzing and Restructuring the DPRK Trade Statistics of 1990~2008* (Seoul: KDI, 2010, in Korean).

Contemplating Unification

Marcus Noland
Deputy Director,
Peterson Institute for International Economics

Contemplating unification

Marcus Noland
Peterson Institute for International
Economics and
East-West Center
October 2012

Key points

- Two scenarios for unification:
 - Gradual, consensual
 - Unplanned, abrupt
- With respect to latter scenario
 - Establishment of civil order is critical (cf. post-Saddam Iraq)
 - Rapid clarification of property rights is essential
 - Lessons of the German case appear to have been miscomprehended or ignored
- Good news: unification would accelerate peninsular economic growth and dramatically reduce poverty
- Bad news: price tag easily exceed \$1 trillion

Gradual integration



- Engagement as an instrument, not an end
- Effectiveness contingent on North Korean policy—today's institutional environment weak
- From South Korean standpoint
 - Product market effects minor
 - Factor market effects potentially large
 - Political economy effects potentially important

Abrupt integration starting points

- Assume away mass violence
- Bad news:
 - Much of the capital stock obsolete/worthless
 - Human capital may be lower than expected
 - Environmental degradation extensive and expensive
- Good news:
 - South Korea
 - Younger population than South Korea
 - KIC suggests reasonably disciplined labor
 - Pockets of excellence

German experience

- West German political goals
 - Stem feared flood of immigrants,
 - Protect West German wages,
 - Achieve restitution of property
- Standard challenges of transition
 - Macroeconomic stabilization,
 - Liberalization of trade and prices,
 - Privatization,
 - Creation of social safety net,
 - Creation of legal framework for commercial transactions
- Privatization: means to end, slowed by restitution, 90% of assets ended up in non-East German hands
- Monetary union: wage increases and collapse of output



Economics of absorption

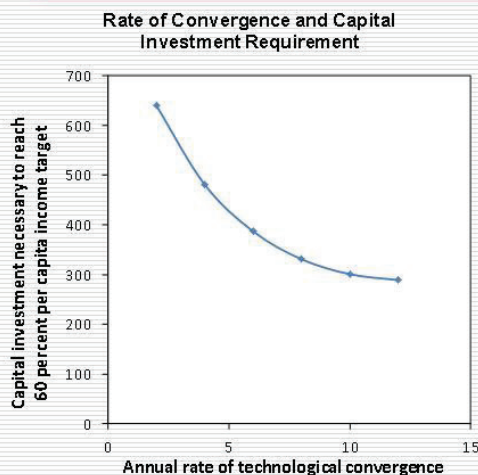
- Comparison of Korea and Germany
 - North Korea is larger and poorer relative to South Korea than East Germany was in comparison to West Germany;
 - North Korea's economy is probably more distorted than East Germany's was,
 - South Korea is not as rich as West Germany.
 - North Koreans much more isolated than East Germans
- Impact of fundamental reform on North Korea
 - Increased exposure to international trade and investment
 - Changes in output composition; millions of workers switching jobs
- Product market integration little impact on South
- Factor market integration key; implicit ability to maintain enormously different levels of income across the two parts of the peninsula, possibly by maintaining DMZ

Critical parameters

- How fast can North Korea absorb new technology,
- How much labor migrates from the North to the South,
- How much capital would be invested in the North?
 - How much of it would come from the South and how much from other parties?
 - Would this capital be invested on market or concessional terms?
- A review of illustrative modeling results follows



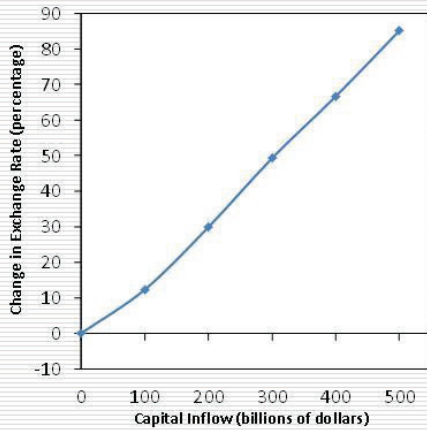
Some illustrative modeling results



- Source: Noland, *Avoiding the Apocalypse* (2000), calibrated to 1996
- Benchmark costs as capital investment needed to raise North Korean incomes to 60% of South's
- "Costs" function of technological upgrading
- Under plausible parameterization on the order of \$100s billion

Capital inflow and exchange rate

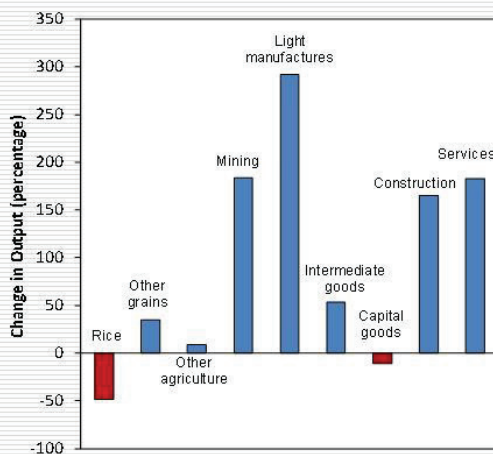
Capital Inflow and Exchange Rate
 Appreciation



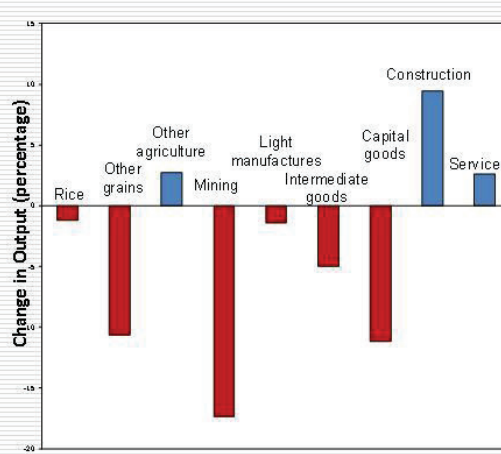
- Specific results depend on what share of capital comes from abroad, and
- Whether it is grant or profit-seeking

Composition of output effects

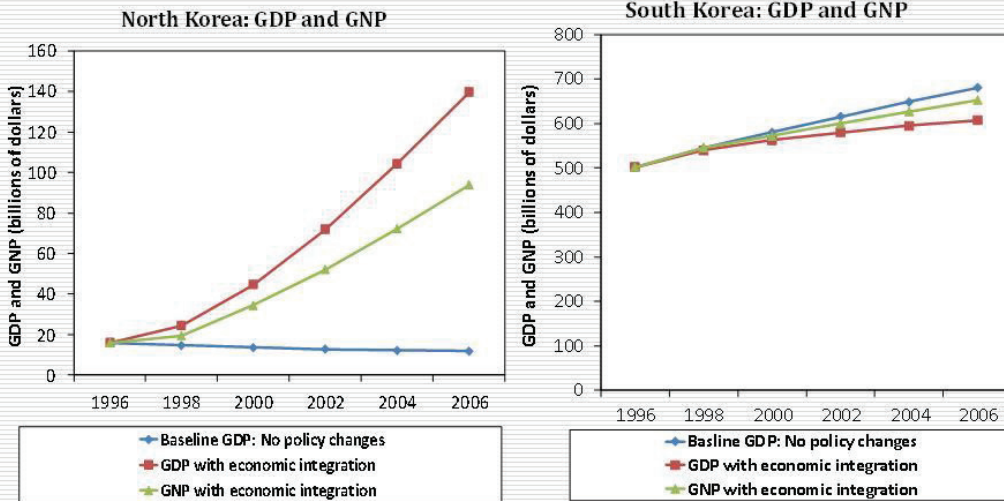
External Capital Inflow Case: Composition of Output Change in North Korea



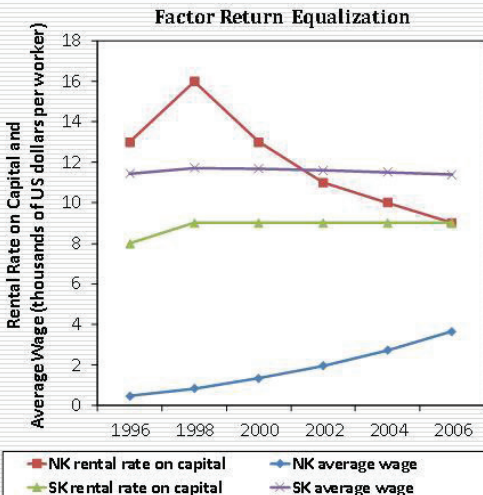
External Capital Inflow Case: Composition of Output Change in South Korea



Growth acceleration in North Korea, slowdown in South Korea

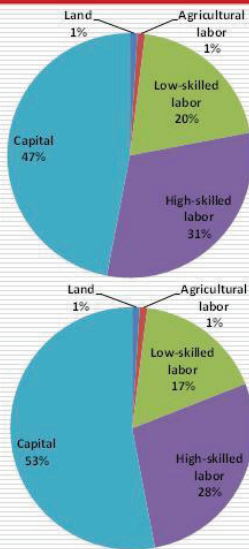


Factor market effects



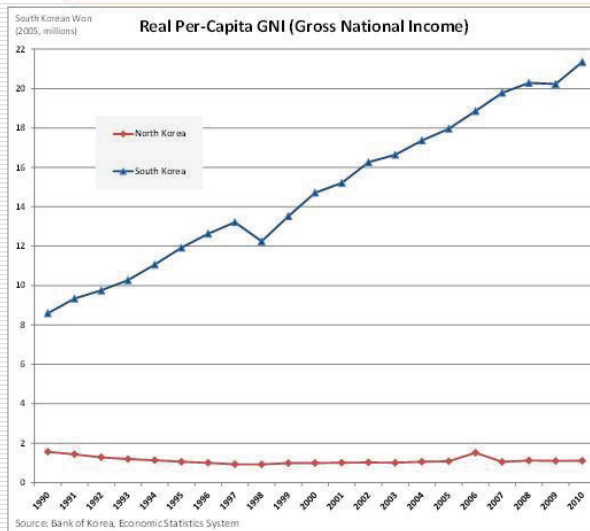
- Under plausible parameterization, wages and income converge,
- Rates of return on capital equalize over decade

Income distribution



- In South, shifts toward capital,
- And within labor toward higher skilled
- Absent policy, increased income, wealth inequality,
- Traded v. non-traded effects possible as well

Diverging Income, Rising costs



- Income gap widened since calibration year
- Models roughly log-linear, investment needed to generate same result today over \$1 trillion

Policy prescriptions

- ❑ Engagement to achieve transformation as precondition to reconciliation and eventual unification
- ❑ Budget surplus for eventual unification costs
- ❑ Strengthen KFTC and campaign finance laws
- ❑ Monetary union:
 - Get an idea of North Korean real exchange rate
 - Focus on wage setting, not initial conversion rate
- ❑ Clarify property rights quickly for investment
 - Compensation, not restitution
 - Owners with skin in game will restrain wages
 - Land to tiller, housing to resident
 - Privatization, but avoid wholesale transfers to foreigners at fire-sale prices

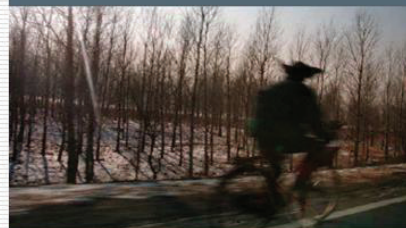
Thank you for your attention

North Korea:
Witness
To
Transformation
blog

<http://www.piie.com/blogs/nk/>



WITNESS TO
TRANSFORMATION:
REFUGEE INSIGHTS
INTO NORTH KOREA



Stephan Haggard and Marcus Noland

PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Benefit and Cost of Korea's Unification: Major Issues and Possible Responses

Ildong Koh
Senior Fellow,
North Korean Economic Team, Korea Development Institute

IGE/KEXIM/KAS/KDI/PIIE Conference

Benefit and Cost of Korea's Unification: Major Issues and Possible Responses

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Korea Development Institute

Korea's Leading Think Tank



Oct. 22, 2012



1. Evolution of Issues on Unification Costs
2. Basic Assumptions and Constraints
3. Migration & Demographic Change
4. Monetary Union and Financial Integration
5. Privatization and Industrial Restructuring
6. Macro-Stability and Wage/Productivity Gap

Evolution of Issues on Unification Costs



What if Korea is to be unified?

- Juxtaposition of German case on Korean peninsula
- Examined in the framework of contingencies (with relatively low probability)
- General conclusion was higher per capita burden (as proportion of per capita income) than West German people

Varied estimation results

- Mainly due to the differences in Definition (or coverage) of costs and unification scenario

-3-

Evolution of Issues on Unification Costs



Repercussions to unification costs estimates

- Demonstration of too high burden – detrimental to unification
- Varied estimation results – social confusion

Responses to these problems

- No singularity in cost estimates has to be tolerated
- The problem of too high burden - to be redressed by demonstrating benefits of unification
- Consequently, the issue of unification shifted from contingency planning to cost/benefit analysis (as if it's under own your choice)

-4-

Evolution of Issues on Unification Costs



Limits of Cost estimates

- Mainly focused on capital requirements (capital/labor ratio) – assuming physical capital to be key for economic development
- Catch-up model – basically assuming two separate economies without substantial inter-regional migration
- Lack of due consideration on human capital or labor obsolescence

Limits of Benefit estimates

- Demonstration of benefit side (alongside the cost estimate) can contribute to have balanced view for unification, but can you say that benefit is greater than cost, so unification is desirable?
- If yes, then who will tie the bell on the cat's neck? – discrepancy between social desirability and individual willingness to sacrifice

-5-

Evolution of Issues on Unification Costs



Constraints of B/C approaches on unification

- Most benefits are non-economic values such as self-esteem, national pride and sovereignty, humanitarian values etc. which can hardly be handled with economic apparatus
- Significant part of benefits(peace dividends) can be achieved with certain level of rapprochement between North & South – i.e., unification may not be an optimal decision unless the decision is binary
- Various other issues such as how to deal with social rate of discount, uncertainties, and specification of social welfare functions, etc. are unaddressed
- In all, viewing unification in B/C framework may be non-sense.

-6-

Evolution of Issues on Unification Costs

Most economic benefits of unification are path-independent

- Most of economic benefits are to be realized in the long-term and relatively independent of the unification process, while cost factors are dependent on the path to unification
- This means that cost-minimization might be a good proxy for overall net benefit maximization.
- Practically speaking, how to come up with cost-minimizing policies, this might be the relevant way to prepare for unification in the economic aspect.

-7-

Evolution of Issues on Unification Costs

German case: a unique historical outcome

- German unification was not historical inevitability, rather it was a miraculous outcome in a very unique historical context
- This type of history will never repeat itself, then how can we expect the German outcome to be replayed on Korean peninsula?

Can we draw some lessons from German unification?

- If the process of Korea's unification to be far different from the German path, then how to draw practical lesson?
- Limited in direct applicability, but still useful *Gedankenexperiment*

-8-

Basic Assumptions and Constraints



German type unification in the context of Korean environment

- Considering the environment in and around Korea, German-type of sudden integration can hardly be expected
- German being the only reference case, simple extension of German case can be the starting point to draw some meaningful lessons
- Still need to make modification to take into account Korea's unique factors

-9-

Basic Assumptions and Constraints



Different constraints that Korea faces

- Inter-regionally, much higher heterogeneity that runs deep between North and South Korea
- N. Korea's domestic condition is much dire and repressive, hardly comparable with former E. Germany on the eve of unification
- Internationally, Korea's unification may not pose threat to neighboring powers but absence of regional integration movement like EU (or EMU)

-10-

Basic Assumptions and Constraints



Constraints in building legal & Institutional arrangement

- In German case, simple extension of W. Germany's existing system was feasible thanks to high level of national homogeneity
- In Korean case, due to severe heterogeneity, direct application of S. Korean system would not be feasible for N. Korean society (either readjusted or rearranged for local adoption)
- This means full integration in social institution would take longer time esp. in such areas as education, medical services, public administration, and various other social services including social safety nets

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Migration & Demographic Change



Migration prior to unification

- Low probability of mass migration before unification due to geographical population distribution and heavily fortified DMZ
- Under humanitarian disaster, defection or escape is to be made toward China taking advantage of softer border
- Tiebout-type of voting with feet is less likely to become as prime locomotive of unification in Korea

Remaining question

- Then, how to construct a plausible unification scenario for sudden integration to emulate German situation?

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Migration & Demographic Change



Migration after unification

- Once humanitarian crisis is resolved, and minimum social order is restores in addition to guarantee of tolerable living standard, then migration is to be proceed in relatively gradual way
- References can be made from migration of ethnic Koreans with Chinese nationality, recently observed North Korean defectors' pattern, and South Korea's migration during industrialization era

Expected migration pattern (1)

- One family member to migrate to settle down, then another member follow , sending money to their families back home

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Migration & Demographic Change



Expected migration pattern (2)

- Young age group and female population would move first, then follow middle-aged group, and finally children
- Old age group may stay in the North, as is recently verified in the case of family-level organized defection
- Migration to South may concentrate in and around capital to take advantage of job availability and anonymity, and also for better educational opportunity

Who are to be affected?

- South Korea's manual labor is to be less affected than foreign workers, esp. ethnic Koreans from China

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Migration & Demographic Change



Will the marriage pattern be affected?

- The question is whether international marriage, which accounts for about 10% of total marriage, is to be replaced by marriage between North and South Korea
- Among the international marriage in Korea, Chinese account for 36.6%, Vietnam 36.6%, and Philippine 7.3%
- Considering the case of Germany where the marriage barrier between East and West has been much higher than international border, unified Korea may demonstrate similar phenomenon
- In addition, as is the case with ethnic Korean groups in China, disproportion in gender may pose serious social issue in N. Korea

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Monetary Union and Financial Integration



Initial conditions

- Considering the extreme breach of financial discipline in N. Korea, a long clean-up process is called for prior to financial integration
- North Korea is maintaining *de facto* exchange rate system with huge discrepancy between statutory and market levels (several hundred times), which makes almost impossible to find equilibrium exchange rate between N. and S. Korea
- Financial accounting for industries is nothing more than formality, far from the reality of its real asset value

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Monetary Union and Financial Integration



Direction and sequence of integration

- Quite clear is the fact that monetary union has to be completed with full integration of regulatory system for banking industry as well as fiscal integration (not EMU but GMU)
- Conversion of market exchange rate between N. and S. Korea is hardly be expected, and existing relative prices so distorted, thus simple adoption of conversion rate for financial flows (factor and commodity prices, wage and pension) may neither be feasible nor desirable
- Property rights for individual financial assets can hardly be respected from the perspective of social justice and income distribution

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Monetary Union and Financial Integration



Initial prices and initial distribution of cash for household

- This means that initial prices have to be assigned administratively on the basis of S. Korea's price vector, with some consideration of political as well as social situation – no needs of conversion rate for flow
- Basically, the property rights for individual's existing financial assets have cannot be fully guaranteed in view of social justice and potential imbalances in banking industry's balance sheet (technically infeasible due to absence of equilibrium exchange rate)
- Distribution of initial financial assets for households has to be proceeded in lump sum per head, with consideration of ages

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Monetary Union and Financial Integration



Financial accountings for industries

- For industries, high level of writ-off for financial assets (and liability too) would be inevitable
- Considering that existing financial statements can hardly be any reference, new balance sheets have to be newly made out based upon the market values (if exist) of existing physical and immaterial assets

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Privatization and Industrial Restructuring



Social consensus against restitution

- In view of German lesson, high level of social consensus has been built on denial of restitution, which is neither technically feasible nor socially desirable
- But certain level of compensation may become inevitable

Two opposing view : nationalization or privatization

- Ministry in charge of land development (and related institutions) in support of gradual privatization in such sequence that firstly to nationalize all land and then to privatize step by step
- Other ministries and private sectors in support of swift privatization including land, which might be the major marketable asset in the North

-20-

Privatization and Industrial Restructuring



Relatively easy to handle: small privatization

- As is widely viewed in E. Germany and various other E. Europe, small and medium-sized industries as well as housing have to be auctioned off to residents, respecting their tenants' right and manageability with local information
- Some conditions can be attached to privatization in an effort to discourage migration (especially to the South)

Big question 1: how to deal with military industries

- To what extent, N. Korea's military industries can be restructured into civilian use? Most of them have to be decommissioned

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Privatization and Industrial Restructuring



Big question 2: how about large-scale industries for civilian use (1)

- Hardly found any competitive firms with big size in manufacturing sector – inevitably applying junkyard hypothesis to N. Korean industries
- Fast scrapping of existing industries is required to attract green field investment
- Thus, the fundamental question is not the speed of privatization but how to help set up new viable firms and how to create environment in support of such move

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Privatization and Industrial Restructuring



Big question 3: how to take care of labor

- With employment guarantee for existing workers, the market prices of firms would become negative, which means without government subsidy privatization can hardly proceed
- The question is whether to provide wage subsidy at work or to support minimum living expenses at home: economically the former is desirable which calls for less money, but socio-politically the latter will become much effective approach
- In all, in spite of negative firm value, high level of redundant labor has to be retained at firm level, but the question is who will manage those labor?

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Macro-Stability and Labor Productivity Gap



Major shocks faced by Germany at the stage of integration

- Market-opening shocks: unavoidable under any type of economic integration
- Loss of export market due to the collapse of CMEA: irrelevant for North Korea
- Exchange rate shock with conversion rate favorable for E. Germany: manageable and limited relevance for N. Korea
- Wage shock due to unbalanced wage bargaining: manageable and limited relevance due to deep intervention of government which pays out high level of wage subsidy

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Macro-Stability and Wage/Productivity Gap

Limited impacts of initial shocks

- Under integrated labor market, the impacts of exchange shocks or wage bargaining shocks will dissipate quickly
- This is because North's wage level will converge to South's corresponding labor's wage

Fundamental questions: how to fill the wage/productivity gap

- Economically speaking, the fundamental questions of sudden integration are first how to fill the gap between N. Korean's wage and productivity gap and second how to reduce the labor productivity gap between North and South Korea

-25-

Macro-Stability and Wage/Productivity Gap

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Macro-Stability and Wage/Productivity Gap



Any policy measures available?

- Berkeley Model (self-eliminating flexible employment bonus) by Akerlof et.al?
- Organic system transformation (Sinn & Sinn)?
- Or else?

Who pays the burden during the interim period?

- The worries arising from this problem can be reduced with simple demonstration of unification benefit?

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Korea's Leading Think Tank

Thank you



Comments on Marcus Noland's and Ildong Koh's papers

Suk Lee
Director,
North Korean Economic Team, KDI

Some Questions about Unification Costs and Benefits

Suk Lee (KDI)

Korea's Leading Think Tank **KDI**

1. Identifying Unification Costs and Benefits? **KDI**

- Most Cost/Benefit factors are uncertain and controversial.
- Example 1 - Defence Spending
 - o <Benefit> Unification will reduce defence spending.
 - o <Cost> Unification will increase defence spending (Unified Korea will be bordered with China and Russia, not with North Korea any more)

1. Identifying Unification Costs and Benefits?

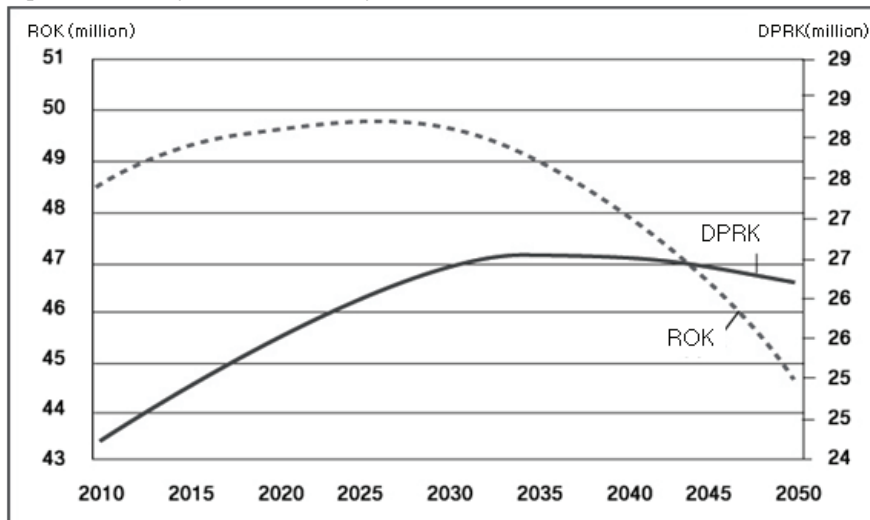


- Example 2 - Demographic Effect
 - o <Benefit> Unification will improve the demographic situation of Korea.
 - o <Cost> Unification will worsen the demographic situation.
- Can we identify what factors are costs and what are benefits?

1. Identifying Unification Costs and Benefits?



[Figure 1] Population Prospects, 2010~50



1. Identifying Unification Costs and Benefits? KDI

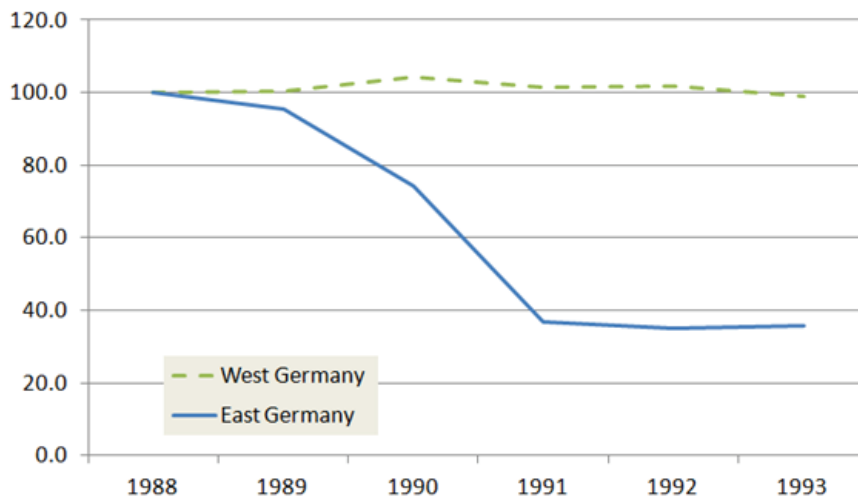
<Table 1> Number of Marriage and Births in Germany, 1980~95

(unit: case)

	West Germany		East Germany	
	Marriage	Births	Marriage	Births
1980	362,408	620,657	134,195	245,132
1985	364,661	586,155	131,514	227,648
1988	397,738	677,259	137,165	215,734
1989	398,608	681,537	130,989	198,922
1990	414,475	727,199	101,913	178,476
1991	403,762	722,250	50,529	107,796
1992	405,196	720,794	48,232	88,320
1993	393,353	717,915	49,252	80,532

1. Identifying Unification Costs and Benefits? KDI

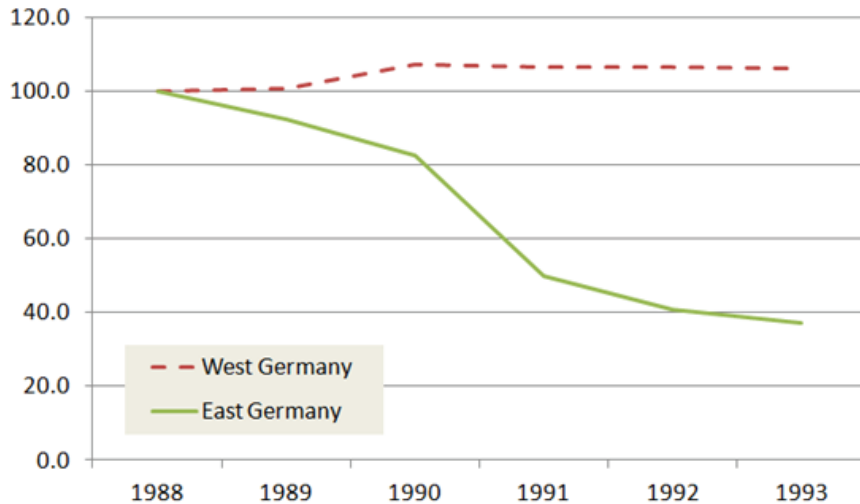
[Figure 2] Number of Marriage in Germany (1988=100)



1. Identifying Unification Costs and Benefits?



[Figure 3] Number of Births in Germany (1988=100)



2. Calculating Costs and Benefits?



- Calculating Unification Costs/Benefits depends on so many uncertain variables.
- <Example> ‘(so-called) Welfare Cost for North Koreans’ - perhaps the biggest cost factor concerning unification

2. Calculating Costs and Benefits?



- The cost will differ greatly
 - o Gradual vs. Sudden Unification
 - o Agreement Between North and South Koreans (and within South Koreans)
 - o Even the level of South Korea's Welfare at the time of Unification
- Can we calculate actual Unification Costs and Benefits?

2. Calculating Costs and Benefits?



<Table 2> Imaginary Costs for North Korean Economic Development and Welfare (unit: USD, billions)

	Cost for Economic Development	Cost for Welfare and Education
2015	6,8	71,2
2016	7,7	71,2
2017	8,8	71,3
2018	10,1	71,3
2019	11,5	71,4
2020	13,1	71,5
2021	15,0	71,8
2022	17,1	71,9
2023	19,6	72,2
2024	22,3	72,4
2025	24,5	72,8
2026	27,0	73,0
2027	29,7	73,3
2028	32,8	73,5
2029	36,1	73,7
2030	39,8	73,9
2031	43,9	74,0
2032	48,5	74,2
2033	53,5	74,2
2034	59,2	74,1

3. Cost Approach or Benefit/Cost Approach?

- For Unification Costs and Benefits, everything is uncertain.
- Benefit and Cost Approach
 - o Ideal
 - o But Practically Difficult (perhaps almost impossible We can not show whether benefits/costs are greater than costs/benefits)
 - o Easily Transformed into Ideological Debates

3. Cost Approach or Benefit/Cost Approach?

- Cost-Only Approach
 - o Relatively Practical
 - o But Possibly Making (South) Koreans Afraid of Unification
 - o Easily Transformed into Ideological Debates
- Should we talk about Unification Costs only, or Benefits together?

4. Discussions for What?



For Better Unification Of Course

- o But when we discuss some details, the situation might not be so simple.

4. Discussions for What?



<Example> Assuming that 'welfare cost for North Koreans' will be huge, then what Next?

- o Warning that unification can be a negative shock to the Korean economy?
- o So making funds to prepare for such costs?
- o Discussing whether or not we will provide North Koreans with the same level of welfare service as that of South Koreans after unification?
- o Even discussing South Korea's welfare level from the viewpoint of Unification Costs?

4. Discussions for What?



- But the problem is: Nobody knows when Unification will be achieved.
- If so, should we start such discussions? Do it now? Or when?

Thank You

Session 3 Financing Unification Costs

Moderator

Marcus Noland

(Deputy Director, Peterson Institute for International Economics)

Presenters

Ulrich Blum

(Professor of Economics, University of Halle-Saale)

Youngsun Koh

(Chief Economist, Korea Development Institute)

Panelists

Hyungsoo Zang

(Professor of Economics and Finance, Hanyang University)

Holger Wolf

(Professor of International Studies, Georgetown University)

Session 3

Biographies



Marcus Noland is the Deputy Director of the Peterson Institute for International Economics and a Senior Fellow at the East-West Center. He was a Senior Economist at the Council of Economic Advisers in the Executive Office of the President of the United States, and has held research or teaching positions at Yale University, the Johns Hopkins University, the University of Southern California, Tokyo University, the Japanese National Graduate Institute for Policy Studies, the University of Ghana, and the Korea Development Institute. Noland has authored, co-authored, or edited numerous books and articles. *Among these are Japan in the World Economy* (co-authored with Bela Balassa); *Reconcilable Differences? Resolving United States-Japan Economic Conflict* (co-authored with Fred Bergsten); *Industrial Policy in an Era of Globalization: Lessons from Asia* (co-authored with Howard Pack); *Famine in North Korea: Markets, Aid, and Reform* (co-authored with Stephan Haggard); and *Arab Economies in a Changing World* (co-authored with Pack). His book, *Avoiding the Apocalypse: the Future of the Two Koreas*, won the prestigious Ohira Memorial Prize. His latest books, co-authored with Haggard, are *Witness to Transformation: Refugee Insights into North Korea* and *Engaging North Korea: The Role of Economic Statecraft*.



Ulrich Blum is professor of economics at the University of Halle-Saale, Germany. Following his PhD (1982) and his “Habilitation” (1986) at the University of Karlsruhe, he was visiting professor and Lynen-Scholar of the Alexander von Humboldt Foundation at the University of Montreal in 1986/87 and in 1987/88. From 1987 to 1991 he was professor of economics at the University of Bamberg. In 1991 he was appointed professor of economics at the Dresden University of Technology and became its Founding Dean for the new Faculty of Economics and Management. Here he obtained an honorary doctoral degree in 2008. In 2004 he changed to the Martin-Luther University of Halle Wittenberg and was, until 2011, president of the Halle Institute for Economic Research. His academic interests are institutional economics, industrial organization theory, regional economics, and transition economics. He has published more than 220 scholarly articles, many in refereed academic journals, and has chaired national and international committees in the fields of competition, standardization, innovation and technology policies. He is member of the European Academy of Sciences and Arts.



Youngsun Koh is a senior research fellow of KDI. He studied economics in Seoul National University (B.A.) and Stanford University (Ph.D). After joining KDI in 1993, he has been working in various fields, including fiscal policy, social welfare and macroeconomics. He served as Director for the Department of Macroeconomic and Financial Policy and for the Department of Public Finance and Social Policy. He is currently serving as Chief Economist, overseeing KDI’s research activities. He is also a member of the National Economic Advisory Council.



Hyoungsoo Zang is currently Professor of Economics and Finance at Hanyang University, Seoul, Korea. Prior to joining the Hanyang University faculty, he was affiliated with the Korea Institute for International Economic Policy (KIEP, 1997-2000) and worked for developing countries in transition at the World Bank (Washington, DC, 1993-97). He has regularly provided policy advice to the Korean government on various issues on the Korean peninsula. Specifically, he had serviced as National Intelligence Officer (NIO) for the DPRK affairs at the National Intelligence Service (NIS) of the Republic of Korea for two years during 2005 through 2007 on leave of absence from Hanyang University. He has published various academic papers and research reports on the DPRK economy, agenda for international cooperation on the Korean peninsula, interim development assistance for the DPRK in a multilateral perspective, and the role of the international community in the development process of DPRK, among others. He was born in 1960 in Korea and holds a Ph.D. in Economics from Brown University in the USA (1993).



Holger Wolf is an associate professor in the BMW Center for German and European Studies at Georgetown University, Washington DC. He received a B.Sc. in Monetary Economics from the London School of Economics and a PhD in Economics from the Massachusetts Institute of Technology. His research focuses on the German economy, on monetary history and on exchange rate regimes. Publications on transition issues include *Economic Transition in East Germany* (with Rudiger Dornbusch, Brookings Papers 1992), *Large Scale Privatization in Transition Economies* (with Raul Laban, American Economic Review, 1993), *Curing a Monetary Overhang* (with Rudiger Dornbusch, 2001, Festschrift for Robert Mundell, MIT Press), *Monetary Overhang* (New Palgrave, 2007) and *Internal Devaluations in a Monetary Union, International Economics and Economic Policy, 2011*.

Unification Costs – an International Endeavor

Ulrich Blum
Professor of Economics,
University of Halle-Saale



MARTIN-LUTHER-UNIVERSITY
HALLE-WITTENBERG

Faculty of Law and Economics
Chair for Economic Policy Analysis
Prof. Dr. Dr. h.c. Ulrich Blum

Unification Costs – an International
Endeavor

Seoul, October 22, 2012

Martin-Luther-Universität Halle-Wittenberg, Lehrstuhl für Wirtschaftspolitik und Wirtschaftsforschung
Prof. Dr. Dr. h.c. Ulrich Blum



Why is the Question Important

- Only scenarios on the potential sequencing of unification and estimates of cost will generate an adequate economic and political preparation.
- South Korea must retain its stability – politically, socially, economic and military – in case of unification.
- Unification costs to a smaller or larger extent will always be financed – willingly or not – by the international community because of macro- and micro-adjustments.
- In an area where security is always challenged, only transparency helps.

04.10.2012

Unification, Seoul November 22, 2012

2



Cost Factors that Cannot Be Changed

- Differences in economic performance 20:1 (Germany: 5:1)
- Differences in population size 2:1 (Germany: 4:1)

	East Germany	West Germany
Population (m)	17	65
per capita GDP (€, RiKo)	5 469	
GDP (m €, RiKo)	90 246	
per capita GDP (€, PPP)	8 322	25 160
GDP (m €, PPP)	137 313	1 622 791

	North Korea	South Korea
Population (m)	24	49
per capita GDP (US-\$, exch. rate)	1 167	20 129
GDP (m US-\$, exch. rate)	28 000	986 300
per capita GDP (US-\$, PPP)	1 667	29 340
GDP (m US-\$, PPP)	40 000	1 437 660

Source: Blum 2013

RiKo: Richtungskoeffizient, direction coefficient, internal exchange rate of the GDR that measured, how many East marks were necessary to earn 1 DEM on world markets: 1970: 2,0; 1989: 4,6

04.10.2012

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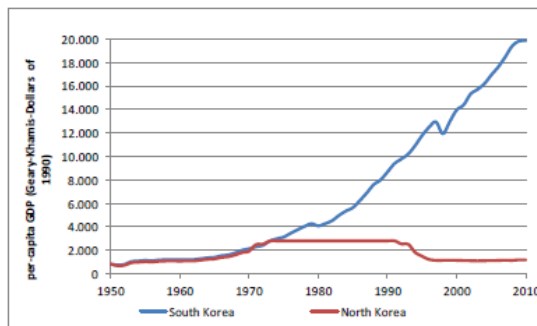
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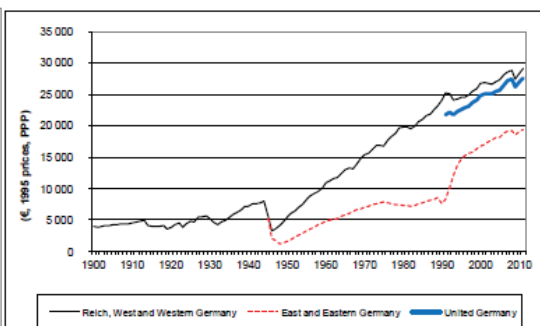
Economic Development

Korea

Germany



Source: Blum 2013



Source: Blum 2013

The German example suggests a very strong path dependence!

04.10.2012

Unification, Seoul November 22, 2012

4



Costs Factors that Korea Can Change

- Liberalization of the education system and the labor markets
- Innovation inventory and conversion policy: best performers (e.g. Saxony) in Eastern Germany have about 25% of the innovation potential of leading-edge Baden-Württemberg, worst performers only about 5% (e.g. Saxony-Anhalt) – a sign that policy matters!
- Fiscal stability and “unification fund”: best performers (e.g. Saxony) in Eastern Germany have about 15% of the per-capita public debt against worst performers (e.g. Saxony-Anhalt) – again a sign that policy matters.
- Privatization regime (danger: zombification, destruction of network structures).

04.10.2012

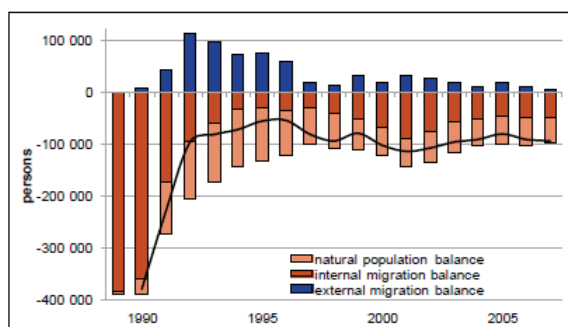
Unification, Seoul November 22, 2012

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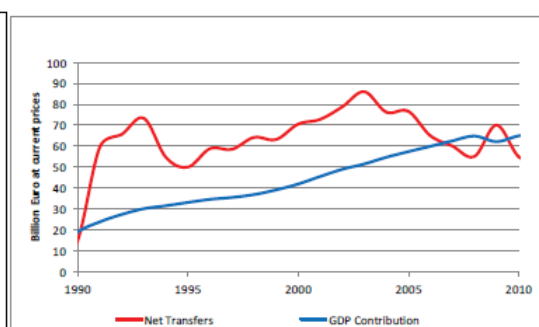


Public Finance and Migration

Making use of the workforce matters!



Source: Blum 2013



Source: Blum 2013

As a „business case“, German unification has broken even!
 In terms of global competitiveness, it has forced the West to
 abandon its continuous procrastination!

04.10.2012

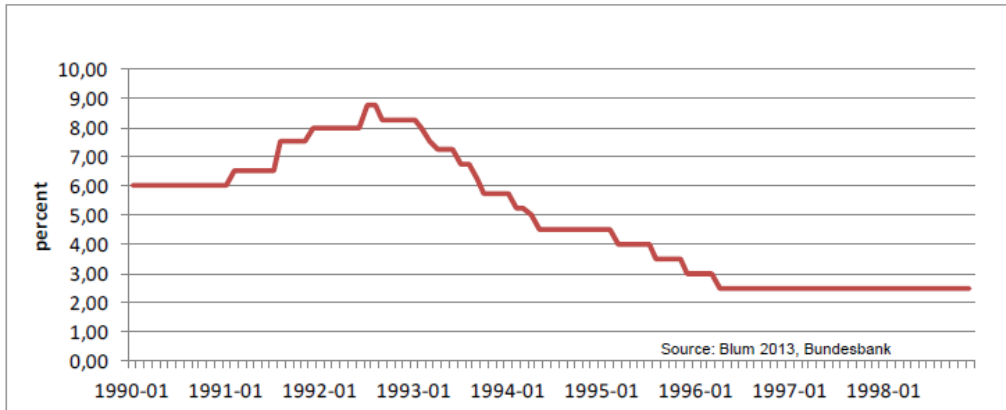
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6



National – International Factors

- Impact on the exchange rate, inflation, interest rates, absorption, bubbles, etc.
- E.g. discount rate of Bundesbank.



04.10.2012

Unification, Seoul November 22, 2012

7



Estimate Based on German Experience

	Korea	Germany
Population Share North / East in Total (%)	33	20
Share of Per Capita GDP (%)	5	20
Gap against 60% Income (%)	55	40
Initial Transfer Amount (US \$1,000 / €)	265,697	166,053
Gross Transfer Share (%)	27	10
Average Multiplier (%)	35	80
Tax Share in GDP (%)	30	50
Net Transfer Share (%)	24	6

Source: Blum 2013

The size of the task is nationally beyond reach!

04.10.2012

Unification, Seoul November 22, 2012

8



References (selected)

- BLUM, U., 2013a, East Germany's Economic Development Revisited: Path Dependence and East Germany's Pre- and Post-Unification Economic Stagnation, *Journal of Post-Communist Economies*, forthcoming.
- BLUM, U., 2013b, German Unification: Lessons for Korea? *Jahrbuch für Wirtschaftswissenschaften (Review of Economics)*, forthcoming.
- BLUM, U., 2013c, Vade Mecum for Korean Unification, forthcoming.

Financing the Unification of Two Koreas

Youngsun Koh
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Korea Development Institute

IGE/KEXIM/KDI/PIIE Conference
on Unification and the Korean Economy
October 22-22, 2012

Financing the Unification of two Koreas

Youngsun KOH

Korea's Leading Think Tank **KDI**

CONTENTS

Estimating the fiscal costs of unification

Sectoral demands for spending

Financing the spending

Summary

Estimating the fiscal costs of unification

Germany has been transferring 4-5% of the Western GDP to the East each year.



German unification costs (1991-2003)

Author	Costs	€ billion	(%)
Infrastructure investment	Road, railroad, local transport system, housing, urban development, etc.	160	(12.5)
Economic revitalization	Regional economic development, agricultural support, coastal preservation, etc.	90	(7.0)
Social assistance	Pensions, labor market programs, childcare, higher education, etc.	630	(49.2)
Voluntary contributions	German Unification Fund (1991-1994) Assistance to sales tax Fiscal equalization across <u>Länders</u> Federal grants	296	(23.1)
Other spending	Wages and salaries, defense	105	(8.2)
Total transfer (A)		1,281	(100.0)
Revenue from the Eastern <u>Länders</u> (B)		300	(23.4)
Net transfer (A – B)		981	(76.6)

Source: German Federal Ministry of Construction and Transportation; Recited from Seung Hyun Lee and Kap-sik Kim, "The Issues and Alternatives on the Reunification Cost of the Korean Peninsula, *Policy Studies*, The Institute for National Security Strategy Winter 2011, pp.163-206.

-4-

Circumstances are less favorable in Korea.



Comparing Germany and Korea

		Population (thousand)	GDP (Mark bn/won tn)	GDP per capita (Mark/won thou)
Germany (1989)	East	16.4	353.4	21,500
	West	62.3	2,237.0	36,300
	E/W	0.26	0.16	0.59
Korea (2010)	North	24.2	29.9	1,235
	South	48.9	1,172.8	23,996
	N/S	0.49	0.03	0.05

Source: Jaewoo Lee, "If North Korea integrates into the world economy..." Bank of America Merrill Lynch, Feb. 1, 2012.

-5-

There have been suggested widely different estimates for unification costs.

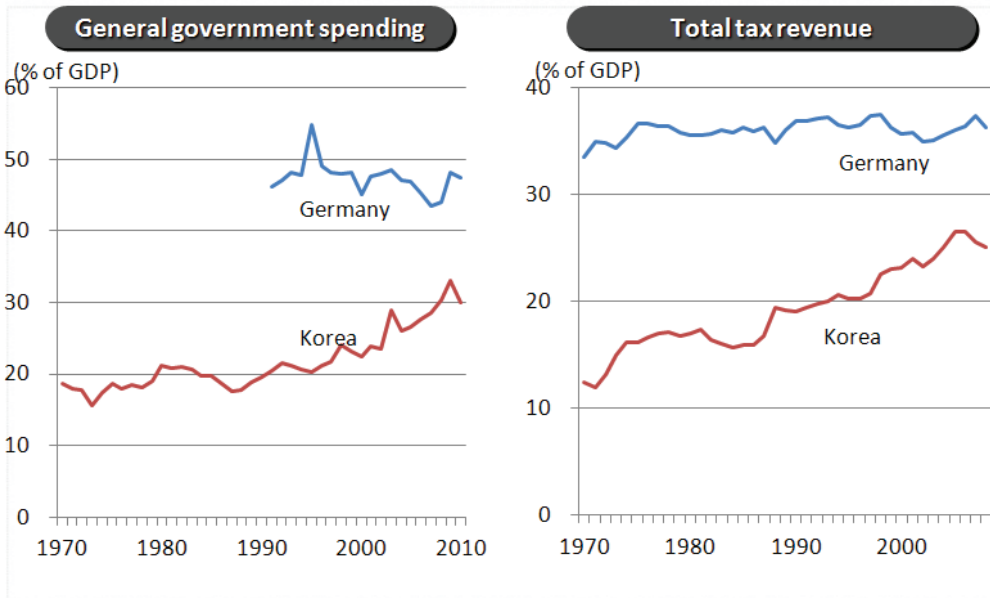


Author	Year of publication	Estimated costs	Basis for calculation
KDI	1991	US\$ 2-3 trillion	Gradual or rapid unification
Samsung	2005	US 500 billion	Minimum income support and investment funding for 10 years
Rand	2005	US\$ 60-800 billion	Increase N. Korean GDP by more than 200% in 50-60 years
Korea Institute of Public Finance	2009	12-7% of GDP for 10 years	N. Korean productivity converges to 80-90% of the South in 50-60 years
Peter Beck	2010	US\$ 2-6 over 30 years	Pull up N. Korean income to 80% of the South
Charles Wolf	2010	US\$ 70 billion-2 trillion	Increase N. Korean GDP by 200% in 5-6 years (70 billion), or increase N. Korean income to S. Korean level
Jaewoo Lee	2012	US\$ 3.2 trillion, or 10-3% of GDP through 2050	Maintain investment in physical infrastructure and welfare expenditure at a level comparable to the South

Source: Jaewoo Lee, "If North Korea integrates into the world economy..." Bank of America Merrill Lynch, Feb. 1, 2012.

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But the actual costs will depend ultimately on budget constraints, or availability of resources.



-7-

Sectoral demands for spending

Investment in physical infrastructure



- Massive investment will be required in transportation, electricity, telecommunication, water and sewage, etc.

Expansion of transportation facilities in South Korea

Year	Roads		Railroads		Metro		Seaports		Airports	
	(km)	Index ¹	(km)	Index	(km)	Index	(million tons)	Index	(1,000 flights)	Index
1962	27,169	0.58	3,032	0.97	-	-	-	-	140	0.14
1970	40,244	0.86	3,193	1.02	-	-	-	-	600	0.60
1980	46,951	1.00	3,135	1.00	40.7	1.00	82.3	1.00	1,006	1.00
1990	56,715	1.21	3,091	0.99	123.0	3.02	224.3	2.73	1,331	1.32
1993	61,301	1.31	3,098	0.99	161.5	3.97	267.7	3.25	1,471	1.46
1994	73,833	1.57	3,101	0.99	170.1	4.18	274.8	3.34	1,551	1.54
2001	91,396	1.95	3,125	1.00	401.4	9.86	469.6	5.71	2,122	2.11
2002	96,037	2.05	3,129	1.00	411.5	10.11	486.5	5.91	2,165	2.15
2003	97,252	2.07	3,140	1.00	412.0	10.12	486.5	5.91	2,149	2.14

Note: Index = 1.00 in 1980.

Source: Youngsun Koh, *The Growth of the Korean Economy and the Role of Government: Past, Present and Future*, KDI, 2008.

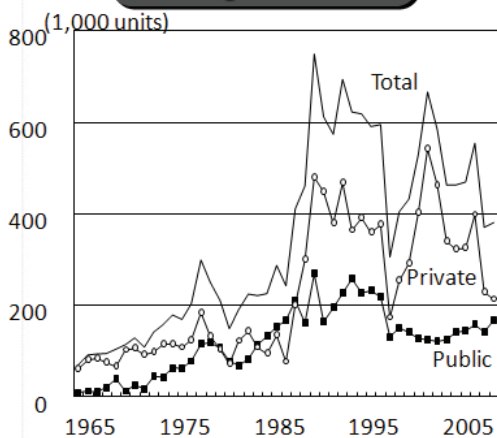
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Construction of housing and community facilities



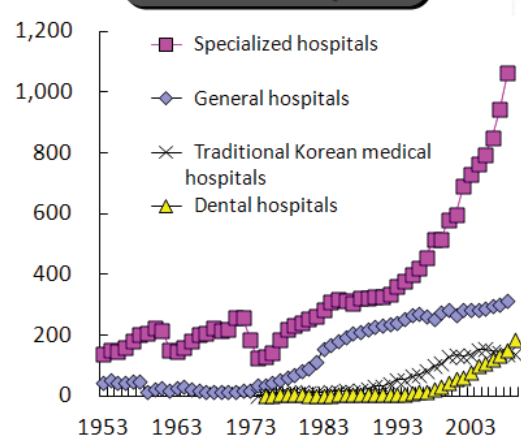
- Existing stocks of houses, schools and hospitals in the North would need to be revamped and new stocks added rapidly.

Housing construction



Source: National Statistical Office.

Number of hospitals



Source: Youngsun Koh, "Social Policy," in Il SaKong and Youngsun Koh, (eds.) *The Korean Economy: Six Decades of Growth and Development*, KDI, 2010.

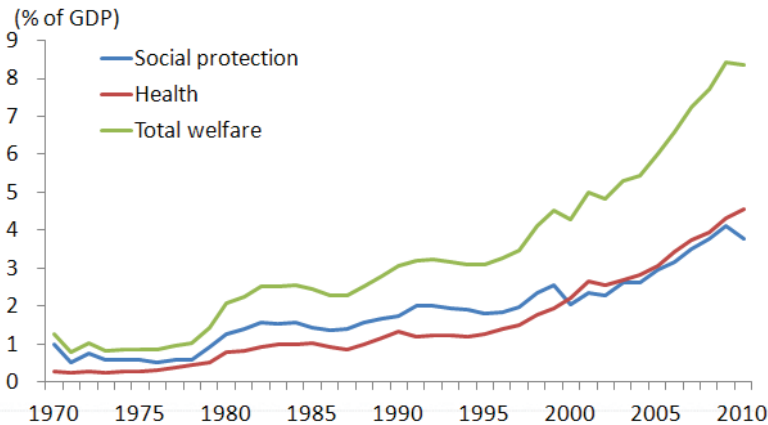
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Health expenditure



- Public health expenditure, channeled mainly through the National Health Insurance and already taking up close to 5% of GDP and a half of total welfare spending, would rise rapidly after unification.

Public spending on social protection (SNA)



Source: Bank of Korea.

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Social insurance programs



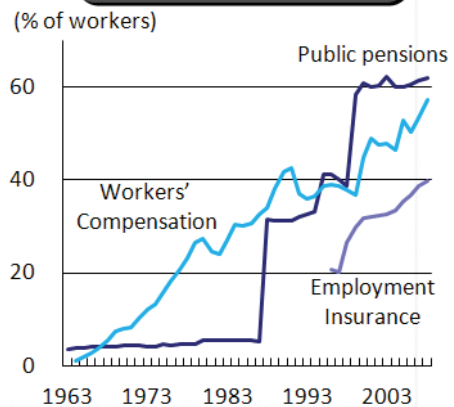
- The National pension and the unemployment insurance programs were introduced as late as in the 1980s and 1990s with limited coverage, and will pose less of a threat to public finance.

Years of introduction

	Germany	UK	Sweden	US	Korea
Workers' compensation	1884	1906	1901	1930	1964
Old-age pension	1889	1908	1913	1935	1988
Unemployment insurance	1927	1911	1934	1935	1995
Family allowance	1954	1945	1947	-	-
Health insurance	1880	1948	1962	-	1977

Source: P. Flora and A. J. Heidenheimer, (eds.), *The Development of Welfare States in Europe and America*, New Brunswick: Transaction Books, 1981; Il SaKong and Youngsun Koh (eds.), *The Korean Economy: Six Decades of Growth and Development*, KDI, 2010.

Program participants



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Public assistance programs



- Various tax-based programs, jointly funded by the central and local governments, provide supports to the poor, the elderly, children, and others, totaling 1.4% of GDP in 2012.

(Unit: Won trillion)

	Central government	Local governments	Total	Notes
Basic Livelihood Security	7.0	1.8	8.8	About 3% of population below the minimum living standard.
Basic Old-age Pension	3.0	1.0	4.0	70% of the elderly (65+)
Childcare	2.4	2.4	4.8	Free day-care center for all children aged 0-2 and for 70% of the children aged 3-4; Childcare allowance for children (less than 36 months old and from poor families) not attending day-care centers
Others	0.5	0.2	0.7	
Total	12.8	5.4	18.3	

Note: The budget for childcare in 2012 was recently increased by 0.7 trillion won to accommodate the unexpected increase in the number of signing up for day-care centers.

Source: National Assembly Budget Office.

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- Public spending could balloon if these programs were to be extended unconditionally to the North after unification.

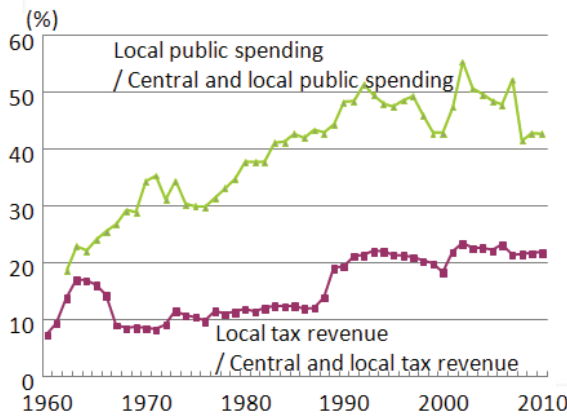
- Basic Livelihood Protection Program
 - Given that North Koreans on average earn around 5% of the South Korean per capita income, a majority of them would become eligible for benefits.
 - Number of beneficiaries: 1.5 million → 10 million or 20 million (?)
- Basic Old-age Pension
 - Virtually all of the elderly in the North would get covered by the program without a concurrent reduction in coverage in the South.
- Childcare
 - The National Assembly is currently seeking to expand the coverage further.

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Fiscal Equalization



- A large part of central government revenue is currently being transferred to local governments in the form of mandatory “local tax sharing” and various categorical grants.
 - Transfers to local governments in the North will impose a heavy burden on the central government.



	Local tax sharing (won tn)	% of central gov't tax revenue	% of GDP
2007	50.8	31.5	5.2
2008	58.8	35.1	5.7
2009	58.6	35.6	5.5
2010	59.7	33.6	5.1
2011	65.4	34.0	5.3
2012 ¹⁾	71.5	34.7	5.5

Note: 1) Based on the FY 2012 budget.

Source: National Assembly Budget Office; Ministry of Strategy and Finance.

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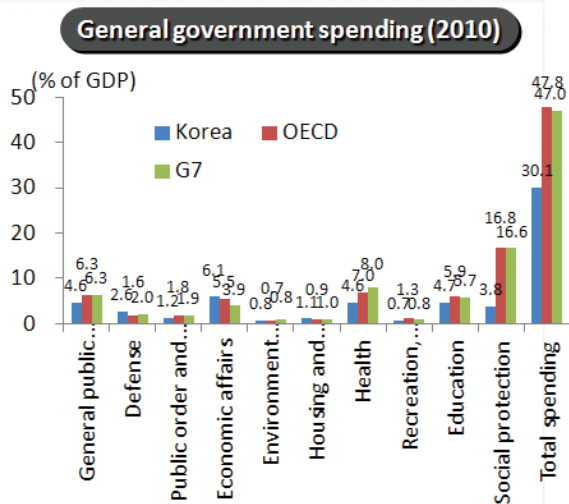
Financing the spending

Reallocation of spending



■ **A significant part of public spending would need to be diverted to the North.**

- The diversion would be particularly large in the spending categories of economic affairs (infrastructure investment, subsidies to farmers and SMEs, etc.), education, housing, and transfers to local governments.



Source: OECD.

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Mobilizing private-sector resources



■ **The government can mobilize the private sector through public/private partnership arrangements and also by the market mechanism.**

- In the healthcare sector, for example, private non-profit organizations and individuals currently own 90-100% of hospitals, clinics and pharmacies.

Number of hospitals and clinics by ownership

(2nd quarter, 2012)

	General hospitals	Hospitals	Clinics	Pharmacies
Total	318 (100.0)	2,626 (100.0)	55,930 (100.0)	21,151 (100.0)
Government	31 (9.7)	71 (2.7)	55 (0.0)	
Non-profit organizations	221 (69.5)	993 (37.8)	991 (1.8)	
Individuals	66 (20.8)	1,562 (59.5)	54,884 (98.1)	21,150 (100.0)

Source: National Statistical Office.

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Raising taxes



■ Tax increase can take advantage of the relatively low burden on personal income and consumption.

- The low burden on personal income comes from extensive exemptions and credits rather than low marginal tax rates.

General government tax revenue

(% of GDP)

	OECD (2009)	Korea (2010)
Personal income tax	8.7	3.6
Corporate income tax	2.8	3.5
Social security contributions	9.2	5.7
Property tax	1.8	2.9
General consumption tax	6.7	4.4
Special consumption tax	3.4	3.8
Others	1.1	1.2
Total	33.8	25.1

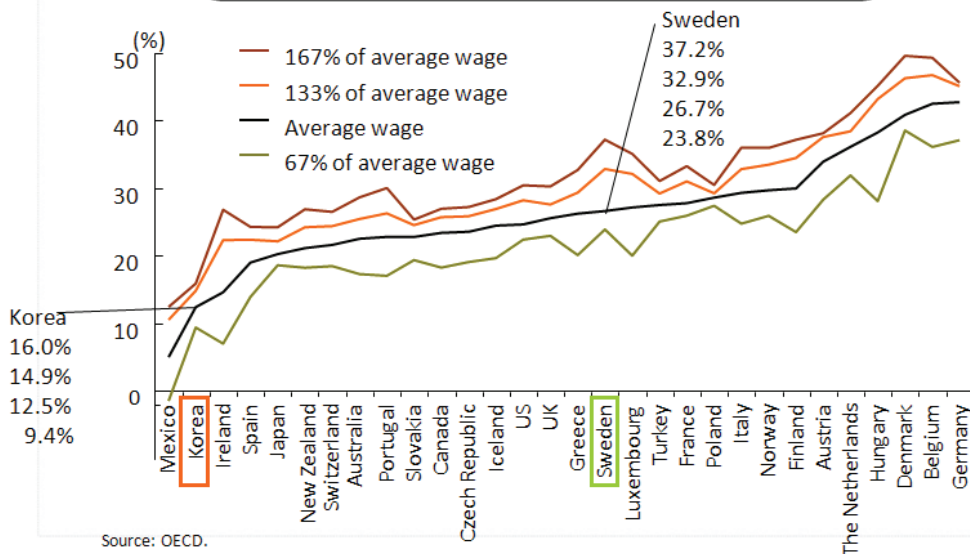
Source: OECD.

-19-

Average tax rates on wages



Personal income tax plus social security contributions as % of personal income (2008)

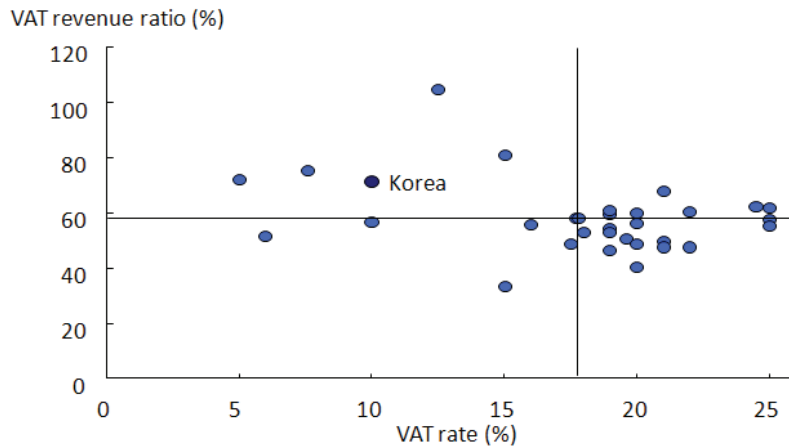


-20-

Value-added taxes in OECD countries (2005)



- There is room to raise the VAT rate (10%), which will entail some loss in the efficiency of tax collection.



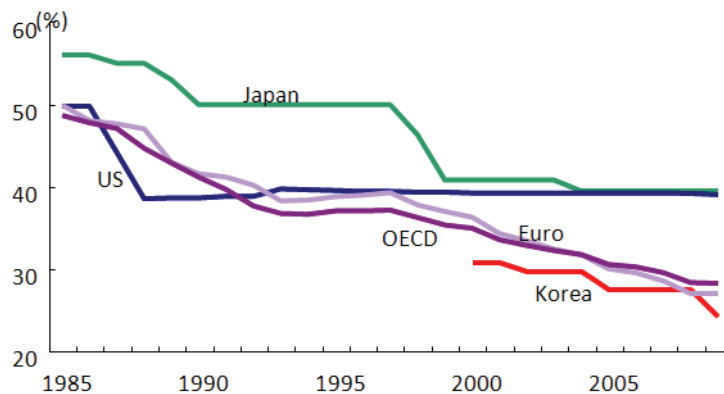
Note: 1) VAT revenue ratio = VAT revenue / [(Consumption expenditure - VAT revenue) × VAT rate].
 2) The vertical and horizontal lines indicate the OECD averages of VAT rates and VAT revenue ratios, respectively.
 Source: OECD.

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Corporate income tax rate



- But it will not be easy to raise the corporate income tax rate because of the intensifying tax competition between countries.



Note: "OECD" refers to the simple average of 22 countries available for data.
 Source: OECD.

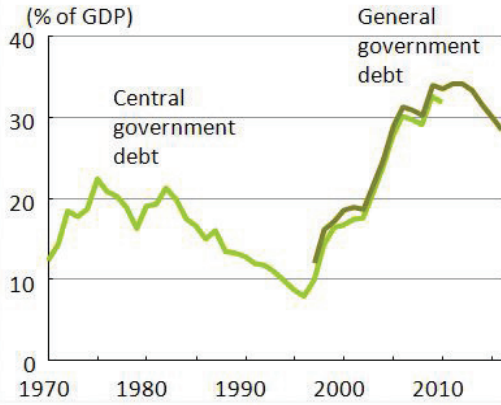
-22-

Debt financing



■ A bulk of spending would be financed by debts.

- The government can also tap into overseas bond markets.



Note: The figures for 2012-2016 are projections by the MoSF.

	Moody's	S&P	Fitch
Germany	Aaa	AAA	AAA
UK	Aaa	AAA	AAA
Canada	Aaa	AAA	AAA
Australia	Aaa	AAA	AAA
US	Aaa	AA+	AAA
France	Aaa	AA+	AAA
Korea	Aa3	A+	AA-
China	Aa3	AA-	A+
Japan	Aa3	AA-	A+
Taiwan	Aa3	AA-	A+
Mexico	Baa1	BBB	BBB
Russia	Baa1	BBB	BBB
Italy	Baa2	BBB+	A-
Brazil	Baa2	BBB	BBB
Spain	Baa3	BBB+	BBB
India	Baa3	BBB-	BBB-
Turkey	Ba1	BB	BB+
Greece	C	CCC	CCC

Note: As of Aug. 27, 2012. For Korea, as of Sep. 17, 2012.

Summary

Financing the spending demands



- **The Korean government will face enormous demands for public money after unification.**
- **It will be necessary to ...**
 - Reallocate budget across spending categories and across regions,
 - Increase tax revenues, possibly with a broader income-tax base and a higher VAT rate,
 - Mobilize private-sector resources, and
 - Run larger budget deficits.
- **Most important would be the prioritization of spending demands.**
 - Otherwise, public debts will grow uncontrollably and can destabilize financial markets and ultimately invite crises.

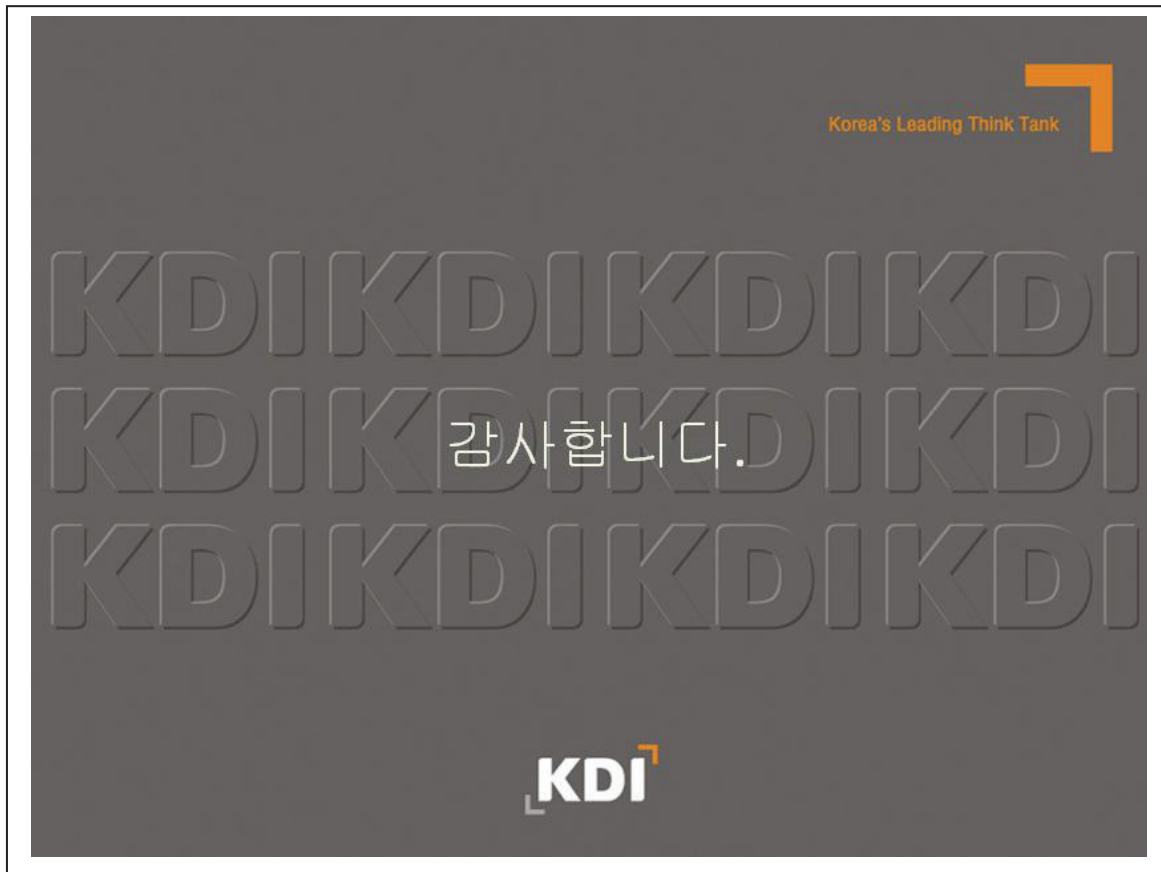
-25-

Minding the macroeconomic constraints



- **The government should pay attention not only to the budget constraint but also to current account deficits.**
 - Excessive amounts of public spending can lead to external imbalances and macroeconomic instabilities.
 - If the central bank raises the interest rate to stabilize the economy, a cycle of boom and bust can set in and hamper reconstruction efforts.
- **In the expectation of these difficulties, current efforts should be directed at ...**
 - Improving the financial health of the government by limiting the growth of debts, and
 - Rationalizing welfare programs and strengthening their delivery system.

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Comments on Dr. Koh's and Dr. Blum's papers

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Comments on Dr. Koh's and Dr. Blum's papers:
Financing the Unification of two Koreas &
Unification Costs – an International Endeavor



Hyungsoo Zang
Professor of Economics and Finance
Hanyang University, Seoul, Korea

1

General Observations

2

Three Conditions for Korean Unification

3

Reflections on the German Experiences

4

Financing Korean Unification

1

General Observations on the Papers' Arguments

- Acknowledge the relative financial burden of Korean unification would be heavier than German case
 - Differences in population and economy size imply that per-capita burden of South Koreans be heavier
 - Western part of Germany has transferred 4~5% of its GDP to the Eastern part a year
 - The task might be beyond reach and needs to be prepared
- Most important would be the prioritization of spending demands
- Mobilize the private sector through PPP arrangements and also by the market mechanism

2

Three Condition for Peaceful Korean Unification

- North Korean people need to prefer unification with the South to the status quo
- There should exit North Korean authorities that can represent the North Korean people who want unification
- No influential country should interfere in the unification process of the North and South Korean people
- ❖ The German case in 1990 would demonstrate that the three conditions were indeed fulfilled in sequence
- ❖ The first one > second one > third one
- ❖ The implication of these conditions: these 3 conditions would affect what the nature and costs of Korean unification would be

3

Reflections on the German Unification

- East Germans wanted unification and also purchasing powers of the West German Mark
 - To fulfill the wishes, conversion of East German Mark into West German Mark was extremely favorable to the East
 - Similar arrangements of transferring significant wealth would be required to get the minds of North Korean people
 - This should be done with fiscal resources, increases in tax or (and) fiscal debts
- Differences: restitution issue would be less severe, have accumulated lessons and implications, modern financing mechanisms, and more benign international community

4

Financing Korean Unification

- Differentiate the nature of financing Korean unification
 - A major portion of the costs would be income transfers to the North
 - The rehabilitation of the North Korean economy would be shared by the (international) private sector
 - IFIs could be a partner in early stages
- More utilization of public-private partnership (PPP) would be possible
- Most important would be the economic strength and fiscal soundness of the Korean government
 - To become a strong economy such as the West Germany in 1990

5

Thank you for your attention

6

Session 4 Role of the International Community

Moderator

Brad Babson

(Chair, DPRK Economic Forum, Johns Hopkins University)

Presenters

Holger Wolf

(Professor of International Studies, Georgetown University)

Byung –Yeon Kim

(Professor of Economics, Seoul National University)

Panelists

Peter Beck

(Korea Representative, The Asia Foundation)

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Session 4

Biographies



Brad Babson is a consultant on Asian affairs with a concentration on North Korea. He worked for the World Bank for 26 years before retiring in 2000. Since then he has consulted for the World Bank and United Nations and been involved in projects sponsored by various institutes, foundations and universities. He presently is Chair of the DPRK Economic Forum at the U.S.-Korea Institute, John Hopkins School of Advanced International Studies, and serves on the Advisory Council of the Korea Economic Institute of America and Executive Committee of the National Committee for North Korea. In Maine he is President of the Brunswick-Topsham Land Trust and a Director of the World Affairs Council of Maine. Recent publications include: "Evaluation and Prospect of North Korean Economy," EXIM North Korea Economic Review, Export-Import Bank of Korea, 2011; "After Kim Jong Il: Will there be Change or Continuity in North Korean Economic Policy?" 38 North.org, U.S.-Korea Institute, John's Hopkins School of Advanced International Studies, Washington DC, December 20, 2011; and "Will North Korea's Plans for Foreign Investment Make it a More Prosperous Nation?" 38North.org; U.S.-Korea Institute, Johns Hopkins School of Advanced International Studies, Washington DC, May 2, 2012. Mr. Babson received his BA degree from Williams College in 1972, and MPA degree from the Woodrow Wilson School of International and Public Affairs at Princeton University in 1974. He lives in Brunswick, Maine.



Holger Wolf is an associate professor in the BMW Center for German and European Studies at Georgetown University, Washington DC. He received a B.Sc. in Monetary Economics from the London School of Economics and a PhD in Economics from the Massachusetts Institute of Technology. His research focuses on the German economy, on monetary history and on exchange rate regimes. Publications on transition issues include *Economic Transition in East Germany* (with Rudiger Dornbusch, Brookings Papers 1992), *Large Scale Privatization in Transition Economies* (with Raul Laban, American Economic Review, 1993), *Curing a Monetary Overhang* (with Rudiger Dornbusch, 2001, Festschrift for Robert Mundell, MIT Press), *Monetary Overhang* (New Palgrave, 2007) and *Internal Devaluations in a Monetary Union, International Economics and Economic Policy, 2011*.



Byung-Yeon Kim is Professor of Economics at Seoul National University. He specializes in the economies of former socialist states and North Korea. He published a number of articles on economic transition in the prestigious journals of economics as well as several books on the North Korean economy. He is currently a member of the National Economic Advisory Council and the Policy Advisory Committee of the Ministry of Unification of the Republic of Korea.



Peter Beck is the Korea Representative for the Asia Foundation in Seoul. He is also a columnist for *Joongang Sunday* and Korea *Joongang Ilbo*. Prior to joining the Foundation, he was the Council on Foreign Relations-Hitachi Research Fellow at Keio University in Tokyo. He was also a visiting POSCO Fellow at the East-West Center in Honolulu and a Pantech Fellow at Stanford University. Previously, he launched the International Crisis Group's Northeast Asia Project in Seoul (2004 – 07). He was the Director of Research and Academic Affairs at the Korea Economic Institute in Washington, D.C. (1997 – 2004). He has taught at American University, Georgetown University, the Naval Post Graduate School and U.C. San Diego in the U.S. and at Ewha Womans University and Yonsei University in Seoul. Beck has served as an advisor to the International Republican Institute and as a member of the Ministry of Unification's Policy Advisory Committee. He has also been a columnist for *Donga Daily*, *The Korea Herald*, and *Weekly Chosun*. He has published over 100 articles, including in *Asian Survey*, *Bangkok Post*, *Encyclopedia Britannica*, *Foreign Policy*, *Japan Times*, *Oxford Analytica*, *Wall Street Journal*, and *Yale Global*. He has also testified before Congress. Beck received his B.A. from the University of California at Berkeley, completed the Korean language program at Seoul National University, and conducted his graduate studies at U.C. San Diego's Graduate School of International Relations and Pacific Studies.



Joongho Kim is serving as a Senior Research Fellow at the Export-Import Bank of Korea (KEXIM), to which the Inter-Korean Cooperation Fund (IKCF) has been entrusted since 1991. Dr. Kim's research interests include strategic approaches to international cooperation for economic development in North Korea and Northeast Asia, and the impact of changing Sino-U.S. relations on inter-Korean relations. His recent publications include "An Awkward Trio: The Two Koreas and China" (2011) and "North Korea's Demand for Hard Currency and U.S. Strategic Responses" (in Korean in 2011). Before joining the KEXIM, Dr. Kim taught at the University of Hawaii the courses including U.S.-Korea Relations, American Foreign Policymaking and East Asian Politics. Also, he served as a research analyst at the Institute of Foreign Affairs and National Security (IFANS) of the Korean Foreign Ministry. He received M.A. in international relations at the George Washington University and Ph.D. in political science at the University of Hawaii at Manoa. Dr. Kim serves as an editorial writer for the KEXIM's quarterly journal *Pukhankyongje* [EXIM North Korea Economic Review].

Reunification and Economic Transition in Germany: The International Dimension

Holger Wolf

Professor of International Studies,
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Reunification and Economic Transition in Germany: The International Dimension

Holger Wolf
BMW Center for German and European Studies
Georgetown University

Outline

- I Motivation
- II The Core Constraint: Internal Migration
 - Politics: Transition Strategy Options
 - Economics: Relative Wages
- III: The Transition Process
 - Front Loaded Adjustment
 - Performance and Hysteresis
 - Short term
 - Long term
- IV: Conclusion
 - Caveat: 1948 and 1990
 - Lessons

Motivation

- Unique among the countries embarking on the transition from central planning to markets in 1990/91, the former GDR reunified with the Federal Republic at the same time.
- How did reunification constrain and shape the process of economic transition?
 - In the initial phase
 - Over the long run
- Broader international political landscape



Transition Strategy Choice

Strategies: The Battle of Proverbs

A chasm cannot be crossed in two steps.

The wise man tests the stones before crossing the river.

Strategies

- Two Conceptual Paths
 - Two states: Transition followed by reunification
 - One state: Reunification accompanying transition
- Rapid consensus on early unification:
 - Broad political support
 - Economic arguments based on migration option
- Reunification in turn implied a front-loaded transition strategy, alongside front-loaded adjustment costs
 - Immediate adoption of institutional framework
 - Immediate full convertibility
 - Immediate reduction of trade barriers
 - Comparison to CEEC
- Reunification constrained the choice of strategy but also reduced the costs and enhanced the benefits of front-loaded adjustment

The Cost-Benefit Calculus of Front Loaded Reform with Reunification

- Frontloading bears the promise of
 - resolving uncertainty early
 - enhancing allocative efficiency by avoiding second best outcomes
 - reducing the risk premium and promoting investment.
- The advantages come at significant costs
 - The inability to fine tune the institutional adjustment to reflect the evolving needs of a transition economy undergoing rapid change
 - The higher upfront costs of front-loaded adjustment poses challenges to political support for the transition process and creates fiscal challenges for funding social spending to buffer the costs of higher unemployment
 - On a technical level, governments and economies face reform capacity constraints.

The German Case

- Known institutional structure
- Migration option constrain on alternative strategies
- Fiscal support for investment and social spending
- Seconded experienced officials lifted capacity constraint
- Drawbacks of front-loading substantially reduced relative to other transition economies
 - Reluctance to use opportunities to introduce limited fine-tuning through temporary institutional and fiscal (tax holidays) intra-national variation
- Institutional adjustment substantially completed before the mid 1990s.
- Contrast to CEEC

Outcomes- The Early Period

The Unit Labor Cost Shock

- Sharp reduction in capital stock of new states enhanced capital-labor ratio gap between old and new states
- Concerns about resolving imbalances through migration
 - Congestion effects in old states
 - Critical mass effects in new states leading to permanent productivity gaps
- Desire to limit migration contributed to large increase in nominal wages in the new states
 - Contrast to CEEC
- Rapid relative wage convergence exceeded productivity convergence, resulting in steep rise in relative unit labor costs

Caveats: Migration and Wages

- Theory and evidence suggests that migration decisions are based on expected present discounted value of real income difference between source and destination location during the migration period.
 - Tradeoff 1: Current versus future wages
 - Tradeoff 2: Wages and unemployment
- Policy options: Limited use of options differentiating between wages and income
 - tax holidays
 - reductions in non-wage costs
 - wage subsidies
- In the specific setting of the new states, the prospects for a successful low wage strategy, even if conceptually feasible, was however doubtful
 - Relatively small size translated into relatively modest investment needs shortening the time until the public and private capital stock could be replenished
 - Presence of low wage sectors in the neighboring CEEC

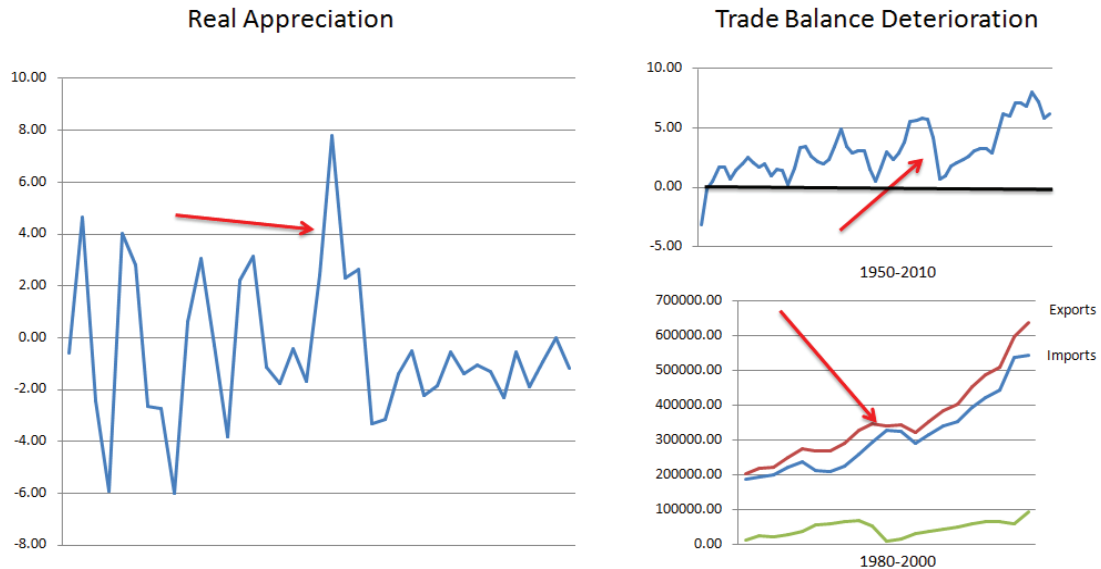
External Adjustment of Reunified Germany

The Dollar is our currency but your problem

John Connally (1972)

- Reunification with transition combined a large negative supply shock (for the new states) with a large positive demand shock (to a significant extent for the old states)
- Adjustment process involves a current account balance reduction through both income and price effects
- Policy influences on the mechanism of real appreciation
 - Standort Debate
 - Effect on European Monetary System

Adjustment



Real Appreciation: Price competitiveness in manufacturing against Eurozone (annual percentage change). Source: Deutsche Bundesbank.
External Balance: Trade Balance in percent of GDP, export and imports in millions Euro 1950 to 2010. Source: Destatis

Economic Performance in New States: Early Period

- Multiple adverse shocks
 - ULC increase in new relative to old states
 - Commodity price shock
 - Real appreciation
 - Transition in traditional trading partners
- Sharp decline in manufacturing employment, output and exports

After The Initial Adjustment: Short and Long Term Hysteresis

Two Hypothetical Scenarios

- Short term hysteresis:
 - The sharp contraction permanently weakens the manufacturing base of the new states, resulting in sustained emigration and bringing about the permanent gap outcome the wage increase was meant to avoid.
- Long term hysteresis:
 - A long history of high quality, export oriented manufacturing, coupled with the high productivity of the firms able to withstand the initial cost shock results in a sustained export renaissance gradually decreasing the productivity gap.

The Outcome: Export Renaissance

	Old States	New States	Current gap	Gap to 1992
1992	26.8	13.9	12.9	12.9
2000	37.5	21.1	16.4	5.7
2005	42.1	27.3	14.8	-0.5
2011	47.5	34.5	13.0	-7.7
Change	+20.7	+20.6		

Manufacturing and mining. Due to basis changes, figures not perfectly comparable over time. 1992 and 2000: firms with 20+ employees, new states include east Berlin. 2005: New states include Berlin. 2011: firms with 50+ employees. Share in turnover. Source: Federal Ministry of the Interior, 2012, Jahresbericht der Bundesregierung zum Stand der Deutschen Einheit, 2012, Berlin.

Explaining the Renaissance

- Historical strengths well supported by policy
- Paradigm shift in labor markets in mid 1990s
 - New states: shift to decentralized, firm-level wage setting (notably in the new states)
 - Germany: shift to productivity-oriented wage setting
 - Result:
 - New states: Relative unit labor cost of the new relative to the old states decreases, reaching parity in the early 2000s before falling further
 - Germany: Relative unit labor cost relative to trading partners begins sustained decline from mid 1990s
- Jointly necessary: Improving cost competitiveness allowed potential of long-term strengths to be realized

Lessons

During the next reunification we'll do everything better

Kurt Biedenkopf, former Prime Minister, Saxony (attr.)

A Caveat on the Predictive Value of Precedent

	1948	1990
<i>Pre-Reform</i>		
Monetary Overhang	Yes	Yes
Fixed Prices	Yes	Yes
Poor Infrastructure	(Yes)	Yes
Inconvertible Currency	Yes	Yes
Trade Disruption	Yes	Yes
Optimism	No	Yes
<i>Post-Reform</i>		
Negative shock to capital	No	Yes
Real appreciation	No	Yes
Convertibility	Current	Full
Tariff barriers	Substantial	Low
Migration	Inward	Outward
Unit labor cost	Stable	Increase

Two Reforms: Outcomes

	1948	1990
<i>Short Term Performance</i>		
Output	Up sharply	Down sharply
Employment	Initial dip	Sharp decline
Unemployment	Up	Up sharply
Exports	Rising	Falling
<i>Long Term Performance</i>		
Output	Steady rise	Steady rise
Employment	Steady increase	Slow growth from reduced levels
Exports	Strong growth	Sustained rebound from low levels
Unemployment	Steady decline	Peak in 2005, then decline
Unit Labor costs	Stable	Continued decline from high initial levels
Population	Growth	Decline

Transition with Reunification: Lessons

- Feasible transition strategies
- Policy Challenges
 - Facilitating institutional change
 - Minimizing long-duration effect of front-loaded adjustment cost
 - Maximizing potential of long-range hysteresis

The Roles of the Global Community for the Korean Unification

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The Roles of the Global Community for the Korean Unification

Byung-Yeon Kim
(Seoul National University)

Presentation at International Conference on **“IGE/KEXIM/KAS/KDI/PIIE
Conference on Unification and the Korean Economy**

”



Contents

- 1 The Complexities of the Unification
- 2 Three Principles for the Unification
- 3 Roles of the Global Community

Complexities of the Unification

- **A huge income gap but smaller population gap**
 - It is a big challenge to unite the two regions with huge income difference.
 - The income gap in Korea is much larger than Germany (20-50:1 vs 2.5-3:1).
 - However, population gap is not so large.
 - South Korea vs North Korea – 2:1
 - West Germany vs East Germany – 4:1
 - These indicate that enormous subsidies should be transferred from South to North.
 - Political stability may be undermined given the size of the Northern population.

3

Global Community for the Korean Unification

Complexities of the Unification

	South Korea (1)	North Korea (2)	Ratio (1)/(2)
GDP per capita (PPP)	31,714 USD (2011)	1,392 USD (2007)	22.78
GDP per capita (nominal)	22,778 USD (2011)	471 USD (2007)	48.36
Population (million)	48.8	24.0	2.03

Sources: IMF (2012), Kim (2009)

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Global Community for the Korean Unification

Complexities of the Unification

- **Uncertainties**
 - It is highly uncertain how the unification is achieved (sudden vs. gradual, peaceful vs. violent, regime collapsed vs. regime sustained).
- **Multiple tasks**
 - Unification
 - Economic Transition
 - Catch-up Growth
 - State Building (if necessary)

5

Global Community for the Korean Unification

Three Principles

1. Peace and order are the most important determinant of successful unification.

- The sufferings of the society will be long-lasting.
- Economic costs will increase drastically with military conflicts.
- GDP declines by 15% when it is measured after 10 years as the extent of conflict (military, political and social) increases by one unit between 0 to 3.

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Global Community for the Korean Unification

Three Principles

2. The unification process should be led by South Korea with a cooperation with the US and the neighboring countries.

- South Korea has the legitimacy, willingness, and resources to lead the unification process.
- South Korea should cooperate with the other countries and negotiate on matters having international implications.
- Having said that, the US and China may have to discuss on some important matters such as the US military presence in North.

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Global Community for the Korean Unification

Three Principles

3. The provision of the basic welfare for North Koreans in North should be a top priority.

- Otherwise, mass migration to South and China is expected.
- Healthy North Koreans can contribute to growth but malnutrition results in a higher cost of unification.
- Political and social stability is facilitated.

8

Global Community for the Korean Unification

Roles of the Global Community

- We assume the collapse scenario because it will demand more roles of the global community.
- But the many parts of the roles are needed also for the Chinese-style gradual transition and unification.
- We discuss the roles of the global community in terms of the issues, firstly assuming the collapse scenario, followed by the discussion on what to do now.

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Global Community for the Korean Unification

Roles of the Global Community

1. Emergency Governance in N. Korea

- The global community should consider the issue of who should intervene to create order and prevent chaos.
- South Korea should involve but with whom? The decision may require coordination among S. Korea, the US, and China.
- One realistic solution is that S. Korea should negotiate with China to allow it to intervene in North Korea and to let the Chinese define conditions under which they are comfortable with such an intervention.

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Global Community for the Korean Unification

Roles of the Global Community

2. Emergency measures and humanitarian aid

- Assistance from the global community is required in diverse areas (eg. weapon disarmament, food delivery, health care, keeping peace and order).
- Sufficient and swift food aid is essential, for which the help of experienced NGOs is crucial.
- Sufficient food and electricity supply should be a key to success.

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Global Community for the Korean Unification

Roles of the Global Community

3. Dealing with refugees

- South Korea and the international community should try to prevent mass migration from happening.
- Refugee camps are needed in S. Korea and neighboring countries. Resources and technical assistance from NGOs and the global community for setting-up and running such camps are essential.

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Global Community for the Korean Unification

Roles of the Global Community

4. Knowledge on transition policies can be shared.

- N. Korea should go through economic transition to a market economy.
- International financial institutions (IFIs) have a wide range of expertise on policies for transition from socialism to a market economy.
- This accumulated knowledge should be transferred to the Korean case.

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Global Community for the Korean Unification

Roles of the Global Community

5. The approach by the global community should be flexible.

- Approaches should take the initial conditions of N. Korea into account.
- The straight-jacket type approach such as Washington Consensus should be avoided to allow more flexibility to local conditions.
- Institutional development underpinning performance takes time, which requires patience of the global community.

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Global Community for the Korean Unification



Roles of the Global Community

6. Investment into N. Korea

- The privatization of N. Korean firms and the opening-up of markets will encourage foreign investment into N. Korea.
- Opportunities will be open for investment in natural resources.
- North Korea has some comparative advantage in textile and clothing industry.
- Huge demand for building infrastructure will be an excellent business opportunity (eg. gas pipe from Russia to S. Korea).

Roles of the Global Community

- **Preparing for the collapse scenario is necessary but it is better to induce N. Korea to transform to a normal state.**
 - Isolating and sanctioning N Korea are not generally effective for such a transformation, especially given the presence of China.
 - Instead, the global community should engage for the survival of ordinary N Koreans and for equipping them with higher human capital.

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Global Community for the Korean Unification

Roles of the Global Community

- 7. Education projects should be expanded.**
 - Several international NGOs have been involving in education projects for N Koreans.
 - NGOs should help struggling N Korean schools.
 - Education-related activities should be further explored and expanded.

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Global Community for the Korean Unification

Roles of the Global Community

8. Helping local business activities should be expanded.

- European and S. Korean NGOs involved in helping N Koreans by teaching them job and business skills.
- Local activities are less controlled by the center and often more effective.
- This will turn out to be useful when transition began in N. Korea (these people may open their own business and thus create jobs).

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Global Community for the Korean Unification

Roles of the Global Community

9. IFIs should start doing something.

- IFOs are suggested to create a task force or a mission team.
- Initially they can start from gathering data on N. Korea and sending fact-finding teams to N. Korea.
- They should work closely with S. Korean scholars and policy makers.
- A discussion on admitting N Korea as a member country should start.

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Global Community for the Korean Unification

