
Reflections on Korean Unification

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Introduction

The Seoul stock market has dropped more than 30 percent this year, reaching a five year low. The won has depreciated by nearly 20 percent against the dollar. Five of the largest 30 chaebols are, in effect, bankrupt. Private sector guesstimates of the share of bad loans in GDP range from 6 to 30 percent, with most guesses towards the higher end of that range. (The official figure is less than 1 percent.) To put this into some perspective, South Korea is facing a banking crisis of the magnitude of the savings and loan crisis in the US with an economy less than one tenth as large and without the cushion that high incomes provide.

In response to this economic distress, the government has bailed out or nationalized failing financial and non-financial firms. The market's response has been to increase the risk premium on Korean sovereign debt. Of the major developing countries, only in

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Thailand has the interest rate increased more than in Korea this year. International ratings agencies such as Moody's and Standard and Poor's have downgraded government debt, as well as bank debt. The country is flirting with a sovereign debt crisis.

If only a banking crisis were the major problem facing North Korean policy makers. North Korea has the most distorted, autarkic economy on earth. Guesstimates of the fall in GDP during this decade are on the order of 40 percent, but no one really knows how bad it is. The fact of the matter is that the DPRK economy is broken — it does not generate enough output to sustain its population biologically.

Yet contrary to popular belief, the source of North Korea's suffering is not a lack of food, but rather a shortage of foreign exchange. There is no reason an economy with North Korea's characteristics should pursue a policy of quasi-self-sufficiency. South Korea does not. Japan does not. China does not. They all import food from countries such as the US, Argentina, and Australia which have a comparative advantage in producing food. North Korea should take a cue from its neighbors and do the same thing — it should be earning foreign exchange from mining and manufacturing and importing food. In other words, famine is simply the manifestation of underlying systemic problems in the economy — problems that were apparent well before the floods and drought of the past several years.

On current trends the DPRK will require external support for the foreseeable future, but this is unlikely to be forthcoming unless the DPRK continues to pose a security threat. (Point of comparison: there are plenty of poor countries in Central Asia and sub-Saharan Africa and they do not receive the degree of largesse we extend to the DPRK.) In this regard the status quo more resembles extortion than charity.

This is the nub: our goal should be the elimination of the security threat posed by the DPRK; we should be willing to trade both economic and material support to achieve this — that is, we

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should enter into a "grand bargain".

The Grand Bargain

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For a "grand bargain" to be achieved, two things have to happen: 1) there must be political rapprochement between Seoul and Pyongyang, and 2) the North Korean elite must be convinced that they would face a brighter future through cooperation and reform than through playing out the status quo.

Is this possible?

In 1994 North and South Korea were poised on the brink of a major diplomatic breakthrough which could have led to a significant reduction in tension on the peninsula. The death of Kim Il Sung and the subsequent hardline actions of Kim Young Sam short-circuited the process. Suppose the next South Korean president repudiated his predecessor's actions and offered Kim Jong Il the olive branch. It would seem reasonable to suppose that the North Koreans might respond, especially if South Korea's offer was couched in terms of Kim Il Sung's statements of the period from June-August 1994. The US, China, and Japan would be supportive, in that they all fear instability on the Korean peninsula. At this point, we would have South Korea and the major powers willing to assist North Korea economically in return for diminution of hostility by the North.

How far would the North be willing to go? How capable would it be of reforming?

Fundamental reforms would change the North Korean economy enormously: there would be tremendous changes in the composition of output and international trade would increase enormously. Much of this trade would be conducted with Japan and South Korea — two countries with which North Korea historically has had very problematic relations. Indeed, for reform to work, massive amounts of foreign investment and technology transfer would be required, and the obvious sources are South

Korea and Japan.

Moreover, economic reform is liable to prove more difficult, costly, and protracted than many suppose. Today the DPRK is less like the heavily agrarian economies China and Vietnam were when they initiated their reforms, and more like the industrialized economies of Eastern Europe. Furthermore, unlike China or Vietnam it does not face the ideological challenge posed by the existence of a democratic and prosperous South Korea.

It is unlikely that North Korean leaders would be willing to embrace fundamental reform.

It might be possible, however, to undertake less extensive reforms, which would have much smaller pay-offs, but which might be easier to control politically, and might insure the continued economic and political dominance of today's elite. The model here would be Ion Illiescu's Romania of the immediate post-Ceausescu period, in which the state maintained an important role in the economy and was used to channel rents to politically influential groups.

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The Extortionist's Path

A bargain requires reciprocal exchange — however the status quo provides the DPRK a mechanism for triggering unilateral transfers without reciprocal action.

For reasons of humanitarian concern and historical precedent, the US and other countries respond to World Food Program (WFP) appeals. If the DPRK wants food all it has to do is invite in the WFP and wait for the US and others to respond to the WFP appeal. This amounts to unconditional in-kind balance of payments support. The DPRK does not have to do anything in

return.

Adding together various payment and aid schemes (food assistance, KEDO, MIAs, etc.), the DPRK is now a major recipient of US assistance. Thus the extortionist approach has yielded a stream of tactical payoffs, but these appear to be insufficient to reverse the secular deterioration of the economy — to use a martial metaphor, the DPRK is winning the battles, but losing the war. Moreover, it would seem to me that maintaining this largesse to the world's first example of dynastic Stalinism would be politically unsustainable in the donor countries, especially the US.¹

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In a narrow, literal sense, no — North Koreans are starving. Is it politically sustainable in North Korea? Who knows? Kim Jong Il's government is "hard regime," and there is little sign of discontent. Nor for that matter does there appear to be institutions or organizations capable of channeling mass discontent if it existed. Nevertheless, one might expect famine to undermine support for the regime. Political change typically occurs after, not during famines, when people take stock and assign responsibility for their misery.

Setting aside the horrific possibility of lashing out in external violence, or mass internal violence which could accompany a collapse of the state into civil war, warlordism, or anarchy, it is worthwhile to examine how the Korean situation compares to the essentially peaceful collapse of East Germany and its absorption into West Germany.

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¹ If one accesses the DPRK website (www.kcna.co.jp), one is regularly subjected to descriptions of the US Secretary of Defense as a "war-maniac" and the US Embassy in Seoul as the "imperial governor's residence." (The descriptions of South Korean officials is far worse.) What is the political calculation that leads the North Korean government to believe that making this material universally available in English promotes their political interests?

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The conventional wisdom that the Germans ruined unification by adopting the wrong exchange rate at the time of monetary union is incorrect. The exchange rate was right. Rather, it was the subsequent wage policy that pushed East German wages to unjustifiably high levels that caused so much difficulty in East Germany. Indeed, one of the lessons of the German experience is that when it comes to monetary union, it is better to be too generous: the citizenry of a centrally planned economy has few assets, and some wealth transfer in the form of conversion of their meager savings at a generous rate is economically desirable. If what one is concerned about is migration, then that can be better addressed by assigning property rights to land and housing to its current residents — conditional on continued residence, rather than by pushing up wage rates and causing unemployment as was done in the case of Germany.

A second lesson from the German case is the need to privatize quickly — without privatization and the assignment of clear property rights essential investment and technological transfer will not occur. Compensating those who claim the assets from the era preceding the current regime is acceptable, but restitution is not — claims and counterclaims involving restitution needlessly hamstrung the German privatization effort and impeded East German economic rehabilitation.

In this context, maintaining production in North Korea will be a priority. The government should discourage the chaebol from

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flooding North Korea with consumer goods (which could displace North Korean production), as well as taking over North Korean enterprises with the intention of shutting them down (to eliminate competition).

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With respect to trade policy, most of the increase in trade will be internal (that is, between North and South Korea). The next biggest share will be with Japan. It is not difficult to imagine circumstances in which the united Korea and/or Japan wish to pursue non-WTO consistent trade policies vis-a-vis each other. Japan has yet to settle the issue of post-colonial claims with the North. There should be plenty of scope for dealmaking.

Lastly, South Korea will have to address the very real issue of transition from the North's state-oriented system of delivering many necessary services (such as health care) to the less extensive Southern system. South Korea is likely to find itself having to cope with a Northern population physically weakened from years of deprivation without any significant financial assets. Introduction of market-based systems for things like the delivery of health care services, while arguably necessary in the long-run, could be a disaster in the immediate post-unification period unless handled adroitly.

Imponderables

History does not operate by analogy. Though there are surely lessons to be learned from the German experience, the Korean situation will evolve according to its own unique internal logic. Jiang Zemin is not Mikhail Gorbachev, and China may play a very

different role on the Korean peninsula than the Soviet Union did in Germany. North Koreans are far more isolated than the East Germans were, and may react to events and possibilities in ways far different than the East Germans did. Similarly, actions of the German government (such as the disastrous wage and restitution policies) were products of the particular institutions and incentives confronting German policymakers at the time. Korean policymakers will operate in a different context. For example, business-government relations are closer and less transparent in Korea than in Germany, creating both possibilities for greater policy flexibility — and greater mischief.

A fundamental issue will be the extent that North Koreans are accorded political rights. When Helmut Kohl looked east he saw a potential one fifth of the electorate. South Korean politicians looking north will see a potential one third of the electorate. Choices regarding critical issues such as the level and composition of transfers and the degree of cross-border labor mobility will be shaped by politics. Recent proposals to operate North Korea as a Special Administrative Zone after unification may or may not be politically sustainable no matter how attractive they might be to technocratic officials.

A second key issue will be the condition of the South Korean economy at the time of unification. An insolvent South Korean banking system will be incapable of constructing (not rehabilitating — constructing) a modern banking system in the North. Maximally leveraged South Korean industrial firms will not have the financial wherewithal to invest massively in the economic reconstruction of the North. Hence it is imperative that South Korea address the problems noted at the outset of this article as a precondition for economic engagement with the North.

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Conclusion

The problem that we face today is precisely this one: to convince the North Korean elite that they can achieve a brighter future through a "grand bargain" than a playing out of the status quo. This requires that South Korea, the US, and other concerned neighbors offer a comprehensive set of inducements.

The DPRK must make a fundamental choice: either continue down the extortionist's road (which requires periodic threat reminders) or undertake the difficult and uncertain task of economic reform. The problem that we face today is precisely this one: to convince the North Korean elite that they can achieve a brighter future through a "grand bargain" than a playing out of the status quo. This requires that South Korea, the US, and other concerned neighbors offer a comprehensive set of inducements. Rather than process for process sake talks (as the Four Party Talks initiative sometimes resembles) or low levels of unilateral transfers (our responses to the WFP appeals), we should inundate the DPRK with cooperative proposals, always trying to keep the ball in their court.

Such a strategy will force the DPRK to explicitly consider trade-offs and encourage and deepen cleavages within the DPRK polity. At the same time their responses to our overtures will provide indications of their capabilities, preferences, and intentions.

The alternative is unpleasant to contemplate. If constructive engagement fails and North Korea collapses, South Koreans will face a more desperate situation, auguring greater challenges than those the West Germans confronted and making it all the more critical to get the lessons of Germany right. ■■