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

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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

## 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

## 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)

## 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

## 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.

## 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.

## 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*

## 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

### 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)

### 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

## 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?

## Migration after unification

- Once humanitarian crisis is resolved, and minimum social order is restored 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

## 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

### 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

## 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

## 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

## 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

## 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

## 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

## 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

## 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

## 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?

## 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

## 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

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## 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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Thank you

