

# **Economic Policy: During and after the Unification in Korea\***

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## Contents

### I. Introduction

### II. Transition

A. Fast Track Approach  
Fiscal Policy  
Monetary Policy  
Development Policy

B. Gradual Approach  
Fiscal Policy  
Monetary Policy  
Development Policy

C. Example: Income support and labor mobility

### III. After Unification: What does the final outcome look like?

A. Korea's Development Experiences

B. New Environment in the Post-Unification Period  
Peace Dividend  
Globalization  
Macroeconomic Stability as an Exogenous Environment

### IV. Conclusion

## **I. INTRODUCTION**

A continuing unresolved issue in economics concerns the role of the government in managing a national macro economy. In other words, it pertains to the appropriate position of the line that must be drawn between the government and the private sector in economic management. One important strand of this debate can be traced back to the early 20th century, during the time of Mises and Lange, and relates to the desirability and feasibility of socialist economic planning in reproducing allocations associated with a market-based economy and price mechanisms.

In more recent times, we have been able to witness the relative merits of both economic systems as historical accidents gave rise to the division of nations into two states, one that adhered to the doctrines of socialism while the other sought a free-market system. The examples that spring most readily to mind are the recently reunified Germany and the still divided Koreas. While both systems appeared in their own ways to work well, global developments starting from the late 1980s have conclusively proven that, sooner or later, an economic system based on central dictates fails to ensure the well-being of the members of the society. Aside from witnessing the astonishing collapse of the Soviet Union and the widespread famine in North Korea, perhaps the most persuasive evidence can be drawn from the fact that market economy-based West Germany has actually successfully managed to absorb socialist-communist East Germany.

For the purposes of this paper, we hypothesize a merging of the two Koreas in

which the Southern half will play a role akin to that of the West Germany in its own reunification with its Eastern counterpart.

Numerous studies conducted on the subject of Korean reunification have taken developments in Germany as a case history from which lessons should be drawn. In these studies, there are two prevalent conclusions. First, it is broadly acknowledged that reunification on the Korean peninsula will be a much more complicated affair, owing to factors peculiar to the two Koreas. For example, the two Germanys never experienced full-scale war, as was the case in Korea, where armed conflict lasted for nearly four years with millions of casualties on both sides. The second commonly put forward view is that the economic burden of a German-style rapid unification will be much higher in Korea. There are very simple reasons for this. The Koreas have a much larger income gap than the Germanys did at the time of their reunification. The Koreas also have an unfavorable North/South population ration which means that while every East German was effectively supported by taxes from six to seven West Germans, each North Korean will have to rely on only two South Koreans.

We intend to explore three issues in this paper: (i) likely transition scenarios, (ii) basic guidelines for economic policies during the transition period, and (iii) the desirable role of the government in promoting sustainable economic development in the post-unification period.

As regards the first issue, a large majority of studies support the view that a gradual approach is more desirable to a sudden one. However, the opposing view is that a faster reunification might actually be necessary in order to halt the desperately deteriorating conditions in North Korea (e.g., Eberstadt, 1997). In addition to security-related concerns, economic reasoning for advocating an early reunification asserts that substantial benefits can be derived from reduced military expenditure. For example, despite the fact that Jo (1997) does not explicitly advocate an early unification, he does make a case for the substantial potential economic gains that could be cultivated under this setting. Our own view maintains that a gradual unification is preferable and, ideally, that two distinct economic zones should be administered for a period prior to the complete merging of the two economies. The main consideration behind such a conclusion concerns the huge economic burden that the South will have to bear. At the same time, we acknowledge that external developments of the South could make rapid unification necessary, or present a sudden unification-like situation as a *fait accompli*.

The case of Korea presents an interesting challenge. South Korea has experienced an accelerated economic growth since the 1960s, during which time the government played a very active role in making resource allocation decisions vis-a-vis markets. Since the early 1990s, however, many Korean economists have spoken of the need to gradually shift the market into a central role in the allocation of resources. The financial and economic turmoil of 1997 has

crystallized the ultimate ineffectiveness of a strong-hand government policy regime in coping with a new economic reality.

At the same time, the government does have an important active role to play during the transition. In most transition economies, the apparent lack of market institutions - ranging from physical markets to commercial codes and contract laws - have given rise to anarchic conditions.<sup>1</sup> The introduction of a basic set of economic regulations to the North should be a top priority.

In this paper, we offer some guidelines and policy prescriptions for the transition period, with a view towards laying down the foundations for a market-based economic system in the North that will eventually come into harmony with the market-oriented economic system in the South.

To be specific, one of the first decisions that need to be made concerns the speed of assimilation, in particular with respect to population mobility. Two scenarios are possible. The first would allow for the completely free movement of residents of both halves of the country, as was permitted in the German case.

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<sup>1</sup>In some transition economies in Eastern Europe and Russia, the end of the socialist period was succeeded by very chaotic free-for-all conditions. Perhaps the most extreme example of a 'get-rich-quick' scheme can be found in Albania, where nation-wide pyramid schemes flourished in all parts of society. Eventually, such conditions led to the collapse of the government and an acceptable social order, not to mention the effect on well-functioning markets.

The second option is to only allow limited population movement to begin with. These two options entail very different sets of policy prescriptions.

No matter which policy is adopted, North Korea's transition to a part of a fully functioning market economy will involve substantial costs. However, the initial cost will be higher if the 'fast track' approach is taken. The substantive income gap between the two regions will encourage a massive population movement in the initial period, which would not only necessitate higher up-front costs (mainly in the form of income supports), but could also delay the development of the North by removing from the region potentially the most plentiful production factor, i.e., labor. In addition, 'fast track' policy recommendations focus on a quick currency union to remove a key potential source of unnecessary shocks, and implementing a rapid industrial reorganization.

It is our belief that the pro-active stance adopted by the government should be surrendered as soon as the early stage of assimilation successfully passes. Any policy proposals should also include a clear exit strategy and be compatible with the ultimate vision of the market-based economy. Once the transition is completed, the ultimate success of the government's role in managing the transition should be judged by how successfully the government makes itself redundant in various areas of economic life in the period following the unification. Beyond that, the government role should be confined to preserving the spontaneity and endogeneity of the market order and cultivating a better

environment for the working of the market order. To this purpose, the government should establish a regime of fair competition in the economic and social system so that the discovery function of the market order can be utilized to the maximum.

Next, we consider various economic issues that are will gain importance during the transition period. Aside from monetary union between the two currencies, a key issue is that of privatization in production facilities and other properties that have hitherto been under the control of the North Korean government.

## **II. TRANSITION**

It is foreseeable that a situation may arise in which large-scale emergency aid will be necessary. If there is a rapid implosion in the North, for any reason, the first task should be to stabilize the situation by providing rapid aid on a massive scale. By definition, such a scenario would develop suddenly and thus would not give policy-makers in the South much time for on-the-spot planning. Hence, it is necessary to stabilize the condition in the North as soon after reunification as possible, with the government making rational and level headed assessments while proceeding along pre-prepared and well-thought out plans.

This scenario could also be affected by factors other than those directly related to the government's unification policy. The recent economic turmoil in South is a case in point. If the South Korean economy is in a serious downturn, the ability and willingness of the government to expend large financial resources may be



limited. Even though such investments would most likely contribute positively to the Korean economy in the long-run, the burden over a short period could be too costly to bear. Hence, it is both prudent and practical for policy-makers to prepare some alternative programs to choose from, each with different configurations of financial burden over the transition period. On the other hand, at times when the South's economy experiences a boom, unification-related expenditures and increased money supply could prove inflationary.

Barring any catastrophes, two scenarios are possible. The first allows for the completely free movement of residents of both Koreas. This was the method followed by Germany and here we call this the 'fast track' approach. The second allows only limited population movement and for this reason we call this the gradual approach. These two options entail very different sets of policy prescriptions. Table 1 summarizes the likely outcomes and policy options for each of the two approaches.

Our focus on population mobility as the key demarcation point perhaps requires some explanation. Many existing studies assume some orderly process of population movement during and after unification. For example, Koo (1997) offers a careful examination of the issue by estimating the expected levels of migration from the North to the South using detailed data on demography and wage differentials for various job categories. However, it is our belief that the kind of gradual and orderly movement of labor force motivated by better pay

elsewhere will only take place under very limited circumstances. Such a scenario would deny the possibility of a large-scale shut-down in production capacity but would mean that the population in the North would have to be sufficiently provided for to maintain national stability into the foreseeable future. It is unlikely that such a tranquil atmosphere will prevail immediately after unification. Rather, we believe a different kind of indicator altogether will be more successful in predicting population movement in the immediate post-unification period.

A long established practice in the North is to sort the general population into three categories: the core group, the neutral group, and the hostile group. This categorization, officially instituted during the early 1970s, is based on the ideological history of family members and their social class throughout the generations (ie. the family of a Korean War veteran is favorably looked upon while the descendants of landlords are not). According to 1992 data, the three groups made up 28%, 45%, and 27%, respectively (Park, 1997). It is no coincidence that during the recent famine in the North, many western aid workers and agencies complained about the uneven distribution of food supply among the population.

It seems clear therefore that those North Korean residents categorized as members of the least popular group will have strong reasons to move away from a system that has treated them unfavorably for almost three decades. Thus, it might be

safe to assume that at least 30% of the overall population in the North, about 6.7 million, would migrate given the opportunity and capability to do so.

In making reference to the two approaches of reunification, it is imperative to take a look at the major costs and benefits involved. In this regard, Cho (1997) offers interesting estimates of the expected benefits of reunification (a reduction in the cost of maintaining the status quo). The cost estimates for 1995 for example, runs at about 5% of the potential GNP for that year. According to his calculations, freeing up and shifting resources in the South (man-power, lands) from the area of defense to more economically productive areas will have growth-enhancing effects starting in the first year after the unification and cumulatively thereafter. However, this consideration may not be so important in assessing the two approaches considering the fact that the benefits will eventually arise, regardless of the speed of reunification. The crucial criterion of our demarcation between the two approaches is about limiting the mobility of the general population between the North and the South. The gradual approach might entail the costs of maintaining a large border police force. However, given that we envision a complete cessation of military hostility between the two Koreas, the benefit of not having to maintain two large separate military forces in the North and South should still accrue.

Many existing studies come up with cost estimates for reunification. The key assumption behind their estimates concerns the amount of time required for a

certain degree of income equalization to be realized in both part of the country. However, our view is that most existing papers have an additional built-in assumption of low population mobility after the reunification. Once a large migration and large-scale assimilation of the Northern population with those of the South takes place, it will be extremely difficult to discuss the income levels of Northerners in isolation.

## **II. A. Fast Track Approach**

This course might end up being less of a choice and more of a *fait accompli*, if the process of unification becomes sudden, and hence, hard to control. Consequently, this scenario puts greater emphasis on early preparation in terms of contingency plans and ensuring the healthiness of reserve financial resources. Political demands to address immediate instability would be overwhelming. Such an environment will make it extremely difficult to implement policy measures that are compatible with long-term goals. Key policy decisions need to be made quickly. What is the conversion rate going to be between the two currencies? How will the issue of property rights be resolved? What kind of administrative mechanisms will be used in implementing income support programs? Examining some aspects of the German experience should be useful in planning for this scenario.

### **Fiscal Policy**

It would not be absurd to predict immediate heavy spending as a necessary tool of

absorption. A rapid and large-scale migration to the South is very likely if the current income gap between the two regions persists. Most of the South-bound immigrants would not find gainful employment, not only due to the limited numbers of newly available jobs, but more importantly, because an overwhelming proportion of the new immigrants will lack marketable skills. If the government does not want to condone the formation of a large refugee under-class, it will have to launch substantial income support drives, as well as worker-training programs. As it happens, what the government does or does not want to condone may become irrelevant in the face of mounting public demands for the government to deal with social problems associated with surging numbers of unemployed refugees. Absorption programs would require a particularly large budget considering how much more it would cost to support a North Korean population at the much higher standard of living in the South.

One instructive way of gauging the cost of supporting Northern immigrants in the South is to use some recent Southern benchmark figures. One useful figure is the minimum wage as this has been calculated on the basis of the minimum subsistence level of income. As of 1998, the monthly minimum wage was about 340,000 won (about 280US\$ using a 1200 won per dollar conversion rate). This is about 30% higher than the minimum subsistence income of 234,000 won in the same year. The corresponding annual figures for the minimum wage and subsistence income respectively are 4.1 million won (US\$3,360) and 2.8 million won (US\$2,340). To provide subsistence incomes to the 6.7 million people from

the North will cost roughly US\$15-16 billion in the first year alone. This is no mean sum, considering that the South Korean central government budget for 1997 was about US\$60 billion. Let us not forget that the number of immigrants moving to the South could be even larger if the dire economic conditions in the North persist, thereby raising the costs even higher.

It is also conceivable that costs could be lowered if the level of emergency provision for the North is set at a level lower than the subsistence income in the South. However, no matter what policies are implemented, it is inevitable that “fast track” reunification will place a tremendous burden on the government and ultimately upon the southern tax payers.

A possible alternative is to normalize the economy in the North before integration with the South. For example, infrastructure upgrading would have to be accelerated, particularly for road and railways and in the development of ports and telecommunications. Efforts to develop the North will put a heavier burden on the South under this scenario as the tax base in the North will be close to zero at the beginning then slow to grow thereafter, while expenditures would be front-loaded. Some boosts in tax revenues from residents and businesses in the South might be in evidence, but might not be large enough to offset initial outlays. Thus, under this scenario, the South might still have to bear the full cost of the unification during the transition period.

## **Monetary Policy**

Monetary policy makers in the South should already have started calculating the exchange rate between the two currencies. A massive movement of people and goods will take place immediately following the reunification and there will be little time to establish a well-thought exchange rate policy at this time. Under this scenario, the issuance of currency in the North will have to stop immediately and monetary policy should focus on taking all North Korean currency out of circulation. This could be done either by a once-and-for-all absorption approach or by following a fixed conversion schedule. It might be best to make a one-time currency conversion and completely withdraw all outstanding stocks of the North Korean currency. Achieving currency unification early has the effect of removing a potential source of disturbance to the economy. When goods and labor markets are assimilated, having two currencies presents an artificial hindrance to transactions.

Monetary policy makers in the South need to have a clear understanding of the economic value of various productive assets and the outstanding quantity of money stock in the North. The estimated exchange rate should not be fixed at the same level from now until the time of reunification, but should be made to fluctuate over time as economic conditions improve or deteriorate. Of course, once these steps are completed, monetary policy should be conducted on macroeconomic conditions of the whole nation, and not used as a development policy tool solely for the North.

As was seen in the case of Germany, two issues arise from currency conversions. One concerns the conversion rate - it is very likely that the conversion rate calculated on the basis of economic reality will place the Northern currency at a lower value than that demanded by political considerations. In this regard, the economic cyclical condition in the South is going to be important. If the Southern economy is experiencing a boom, an artificially high conversion rate between the two currencies will have an inflationary impact. On the other hand, if the Southern economy is going through a sluggish phase, a somewhat over-valued Northern currency could substitute for an expansionary monetary policy measure – a one time money injection.

The second issue involves the limit on how much each individual is allowed to exchange. Given the regimented nature of the Northern economy, the distribution of money generally reflected that of power and privilege enjoyed by the Northern residents. It seems fair that this formerly privileged group should bear some cost of the demise of their economy. By setting an upper limit on the allowable amount to be converted into Southern currency, this group will find their remaining North Korean wealth effectively confiscated.

### **Development Policy**

Development of the North could be slower under the fast track scenario. For one thing, there would be little indigenous demand in the North - thus shrinking the



pool of economically viable producers supported regionally. Furthermore, the formation and growth of businesses in the North might also be slow. A massive exodus of working age members of the population will reduce the labor pool and deter businesses wanting to locate production facilities in the North for want of workers. A reversal of the population flow (from South to North) might take much longer than the initial flow from North to South, as there would be many disparities in terms of amenities and perceived opportunities in the North in comparison with the South.

It might be necessary to provide tax incentives and other benefits to firms investing in the North. One reliable source of industry in the North is the desire of countless Southern residents to visit destinations in the North. Strongly supporting the tourism industry in the North could well be the first step in encouraging the formation of local businesses in the North. Other sensible areas to focus on include generation of electricity and building up of the road and rail systems. Given that the South already faces a chronic need for electricity, it should be easy to find an immediate market demand for power-generation. Furthermore, an increased electricity-generation capacity will be important in attracting future production facilities to the North.

One potential advantage of this approach is that radical industrial reorganization will be possible with little attention paid to the issue of worker displacement. Such massive restructuring will enable the preparation of the groundwork

necessary for a well-thought out, longer-term industrialization plan for the region.

## **II. B. Gradual approach**

Under the assumption of gradual integration, it would be possible to implement a distinct set of policies in the North during the transition period. This option would entail smaller up-front costs but require a clear vision regarding various aspects of economic affairs. The pressing concern is how best to encourage the formation of a viable and self-sustaining economy that could be merged with the South further down the road. Sustaining some existing firms, as well as encouraging new businesses would be one aspect of the policy mix. Compared with the fast track case, the selection criteria for choosing firms to be rehabilitated might be somewhat less demanding. Another aspect is the provision of some minimum social safety net for the residents. The size of the economic burden of the social safety net would partly depend on how well and how fast the rehabilitation and formation of businesses progress over time. For the eventual currency unification, the multiple-stage approach taken for the EMU provides a possible model for emulation.

### **Fiscal Policy**

Compared with the fast track case, the up-front costs for gradual integration would be lower. The contrast will be most visible in terms of the financial cost for supporting displaced Northern residents. Let's

use the same population group used in the previous section to make the point with the assumption that the Northern half will function in a completely controlled environment. We will use detailed data on the average cost of living in the North compiled by Noh and Yeon (1998).

To support the 6.7 million at the low-end of average standard of living in the North (including expenses for education, medical care, pension), we estimate a cost of approximately 5.3 billion North Korean won. To apply the 1998 North Korean official exchange rate of 2.2 North Korean won per one U.S. dollar, this translates into 2.4 billion US\$. Although this is hardly a small sum, it is only about one-fifth of the estimate reached in the case of supporting the same people in the South at the local subsistence standard of living. Additionally, the use of the official exchange rate between the North Korean won and US\$ seems to give a higher cost estimate than necessary. The ranges offered by many studies (see Lee and Lee, 1998, and citations therein) put the realistic conversion rate between the two currencies at 200-500 Southern won per one Northern won. To extrapolate from this, the realistic North Korean won to US\$ exchange rate is about 5.5. If we substitute in this figure, the cost estimate stands at less than US\$1 billion.

However, this approach will entail a steady stream of fiscal outlays over the duration of the transition period. For example, it might take longer

for the Northern economy to start growing and to provide economically viable income generating opportunities for the affected Northern population if they remain in the North compared to the case should they move South. Also there could be multi-year outlays in terms of expenses in the form of industrial subsidies to production facilities that would have been shut down under the fast track scenario.

To foster the ground for a self-sustaining economic unit, it will be imperative to provide incentives to businesses to offer employment to workers in the North. The package could include a host of things: upgraded infrastructure (roads, rail, ports, telecommunications), lower and uniform corporate income tax rates, and no minimum wage. In addition, in terms of the tax system, a consumption-based tax (CT) would be preferable to an income-based tax. The CT has the advantage of encouraging savings and the formation of capital should be encouraged to meet the high demand for savings.<sup>2</sup>

As the North Korean economy becomes more vibrant, it should expend tax revenues raised in the North to take over some of the financial burdens of providing a social safety net as well as making investment in

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<sup>2</sup> Some economists argue against the CT on the basis of distributional ground, i.e., regressivity. That is, the poor will pay a relatively higher share of their income as tax compared to the rich. However, here is a case where as far as possible, there is an equal distribution of wealth based income, thus regressivity of CT is a non-issue. Furthermore, lower income tax would add an important incentive to work!

infra-structure. Once this kind of burden sharing becomes routine, a more complete merging of the two economies is more likely to come about. Eventually, tax systems of the North and South will also have to be reconciled to prevent one side handicapping the other.

### **Monetary Policy**

During the transition, the North Korean currency could conceivably co-exist with the South Korean won. North Korea could maintain its monetary policy anchored on the exchange rate between the two currencies. In the early stages, it might be desirable to adopt a flexible exchange rate approach so that policy makers need not engage in defending a rate that is not sustainable. Gradually moving towards a system with a pegged rate with a trading band around it might be desirable once some stable trading ranges emerge. For the complete integration of the two economies, the exchange rate will have to be pegged first, then completely converted into a single currency. It is important that the monetary authorities in the South maintain control over the monetary policy in North for this process to be completed successfully. Otherwise, incentives to push up the money supply in the North might be created and attempts might be made to expand the monetary base at the last minute to exploit the conversion opportunities.

As mentioned in the previous section, Southern monetary authorities need to guard against the transition in currencies imparting an undue inflationary

momentum. A basic rule of thumb would be to set the exchange rate between the two wons according to the relative size of the two economies. This is based on a version of the ‘real bills doctrine’. There should not be much inflationary pressure as long as the existing amount of money roughly equals the amount of economic activity.

In this regard, the recent study by Lee and Lee (1998) is instructive in that it offers an estimate of the money stock in the North and also offers a sense of whether or not a ‘money over-hang’ condition currently exists in the North. They suggest that there is about 40% money over-hang. This figure might have materially worsened in recent periods due to rapid shrinkage in the Northern economy from the early 1990s.

At the same time, capital inflow to the North needs to be encouraged. Due to the limited scope of (industrial) goods the North is able to export to the South, a current account imbalance could persist for awhile. However, this should not pose a serious problem.

Even during the transition, the preservation of the value of the currency becomes very important for new entrants to the market economy to develop a proper understanding of the monetary system. Also, for the basic banking system to take hold, people need to be encouraged to use banking facilities. A wide range of banking services such as various types of savings, as well as some lending

facilities, should be offered. Recognizing the time value of money, i.e., the concept of interest payments, as well as developing an individual sense of responsibility in terms of making saving-borrowing decisions is very important.

### **Development Policy**

With most of the Northern population remaining in the region, there will be a fair amount of indigenous demand for various consumer products. This could offer significant support for sustaining and rehabilitating old production facilities and starting new ones. However, the utmost consideration for deciding whether to sustain it should be based on the economic viability of the facility. The (un)employment as well as the income support consideration should not precede the viability test. For the ultimate formation of a flexible labor market, it will be much more desirable to proceed according to strict economic efficiency. Displaced workers will have to be dealt with as a problem of the labor market as well as an income support issue. For the effective dissemination of labor skills, the government will need to implement policy measures encouraging the flow of labor forces within the North and some between the North and South.

### **II.C. EXAMPLE: Income support labor mobility**

Here we discuss examples of some specific policies about income support and labor mobility during the transition. For a certain segment of the adult population (those without marketable skills or physical ability), it might be

necessary to provide income support. This could be carried out in two ways. One option is to provide blanket support of some fixed amount with a designated cut-off age. Let us assume that the total cost is X won. This method will be easier to administer and might appeal to the general cultural inclination of Koreans to be respectful of their elders. Another option might be to devise an income support scheme that would encourage more active participation in the labor market by members of this group. Suppose the following: set a fixed amount of income payments at a level based on some acceptable minimum expenditure, which we will call the lower boundary. However, this lower boundary amount will be smaller than the payment envisioned in the first scenario (i.e., X won). Also set an income level, say, twice the amount of the first low one, as the upper boundary. In this way, everyone can expect to receive the minimum level of the lower boundary income per period. In addition, any person of this group could work and earn income without paying tax up to the level where the sum of the lower boundary and any generated income does not exceed the upper boundary. This second option will offer an incentive to work.

In implementing this scheme there will be considerable temptations and pressures to provide various types of “public” works, above and beyond what is really necessary to improve the infrastructure, to make it easier for the affected people to find employment. It is quite possible that it will be confusing for willing workers to find suitable jobs early in this process. However, this hurdle has to be overcome as one very important purpose of this scheme is to offer first-hand



experience about the importance of personal choice and economic rewards. It also imparts the understanding that the government (or government owned employer) is not the sole and final provider of income.

Making such income support transportable is also important. Each person can decide for himself whether to stay or move to a different location based on the economic opportunities available at either site. Any measures to enhance mobility and flexibility should be encouraged. People moving for economic reasons would contribute to the prevention of labor market rigidity in very basic ways.

In principle, the scope of such mobility should include the southern region. However, a temporary restriction of say, five to ten years, on such movement could be considered. During this temporary period, immigration to the South could be permitted for people who have demonstrated that they are both productive and have secured legitimate employment. At the same time, they would have to give up the income entitlement enjoyed while in Northern Korea. For instance, a company that has established manufacturing plants in the North could decide to shift a number of competent workers who are interested in the opportunity, to similar jobs in the South. Requiring a minimum amount of work experience that can be verified by the employer would ensure that the population inflow to Southern Korea is indeed productive and economically viable. This will reduce the chance of social discrimination against Northern Koreans from

developing and will hasten the acceptance of Northerners as fully functioning equal members of the society.

### **III. AFTER UNIFICATION: WHAT DOES THE FINAL OUTCOME LOOK LIKE?**

In this section, we discuss the issue of the role of the government in post-unified Korea. In particular, we argue that the merging of the halves should not alter the course of the transition from the government-led management of the economy to a market-based one that started in the 1990s. A temporary activist government should end once the early stage of assimilation successfully passes. In some senses, the ultimate success of the government's role in managing the transition should be judged by how successfully the government makes itself redundant in various areas of economic life in the period following the unification. We will briefly review first, the history of South Korean (Korea for short, henceforth) economic development as well as its legacy, then present an overview of the general debate regarding what is an "appropriate" role for the government in a market economy. Finally, we will argue that the role of government policy should be confined to cultivating a better environment for the working of the market order in which the optimal outcome is found by the competition process.

#### **III.A. Korea's Development Experiences**

Korea has achieved remarkably high economic growth during the last thirty years.

A government-led export promotion strategy has been followed and the government has actively involved itself in almost every important aspect of economy-related decision-making, while the private sector has followed the signals given by the government.

In this process, Korea came up with a very peculiar macroeconomic management pattern. While the economy was subject to inflationary pressures, stemming from the base money and credit expansion out of concern for maximum resource mobilization, monetary policy instruments such as the control of the base money became non-operational. As a result, direct controls on important individual prices and even on economic activities within the private realm became widely utilized as the main instruments for maintaining macroeconomic stability. In sum, the macroeconomic policy function was performed by micro regulations.

Government macroeconomic management tends to rely on direct regulations, such as credit rationing over open market operations for money supply control and on wage-price controls over aggregate demand management for anti-inflationary policy. In addition, government microeconomic policy takes the form of picking the winners before the market process works itself out and of providing the means (such as financial support) necessary for the chosen to win.

However, in order for this type of economic management to be successful without causing distortions in resource allocation, the government must have

informational superiority over the private market participants. In addition, the government should have a complete set of solutions ready to be put into action against a host of difficult economic policy issues that may potentially arise. Furthermore, the requirements that must be fulfilled for government intervention to be beneficial are difficult to satisfy as the economy grows in size and complexity.

More than thirty years of active government intervention into private economic matters has created many legacies that pose serious stumbling blocks to the policy regime shift toward greater private sector participation. Even as the informational requirements for efficient economic policy-making become increasingly difficult to satisfy, economic policy makers, including economists who are accustomed to the mind-set of the past regime, still think that they can and should manage the economy down to the finest details. This mentality poses a serious obstacle to economic reform and liberalization. They even think they can and should regulate deregulation.

To compound this problem, many private economic agents have lost their sense of independence and fear that liberalization may create chaos. Therefore, they often seek government intervention, even in the affairs of the private sector, and ask the government to “control the process of economic liberalization.”

Moreover, active government economic management has created various barriers

to entry that have produced monopolistic and oligopolistic economic structures. The tendency to rely on direct regulations for economic management has also produced widespread regulations of prices and quantities that has created a distortion in the economic incentive structure. As a result, these phenomena have tended to discourage the individual economic agent's will to economize and his motivation to innovate.

Finally, as government intervention has become more widespread, thereby creating an excess demand for intervention beyond its real capabilities and necessity, the effectiveness of government economic management is rapidly declining.

### **III. B. New Environment in the Post-unification Period**

#### **Peace dividend**

The resources tied to defense-related areas have been enormous. The three most easily identified areas for savings in the post-unification period are: a) compulsory military service related man-power, b) reduction in defense budgets (to a lesser degree reduction in diplomatic cost of dual representation of the two Koreas), and c) better use of land. In the South, every able-bodied man faces the compulsory military service for two to three years. Although military service might have some skill enhancing benefits to a small segment of the population, it is an economically unproductive use of time. The compulsory military service is

even more taxing in the North. One way to quantify this potential benefit is to anticipate expected reduction in the size of military personnel in the post unification period. Jo (1997, and other studies cited therein) puts the optimal number of military personnel for the unified Korea at about 400 thousand. This translates into about 270 thousand for the South alone. Just to compare the related figures for the South, the current size of the military is about 680 thousand (as of 1995). Thus, the expected reduction in military personnel is about 390 thousand. The first direct benefit will be a commensurate reduction in defense budget required to maintain the level of forces. We will discuss this issue shortly. However, a rough economic benefit estimate for the additional 390 thousand able-bodied workers can be obtained by calculating the expected income that group can generate. For this we use the average wage rate of 1998 of 1.3 million won per month, or little over 1,000US\$. Given that nominal wages actually fell in 1998 after continuously rising for close to ten years running, using the 1998 figure should not bias this estimate upward. Every year the group of new workers can earn 4.7 billion US\$ (390,000 persons x US\$1000 x 12 months). This is a simple calculation that does not include related benefits in the North.

In terms of budget, defense expenditure takes up about 30% in the South and more in the North. A large part of this can be saved with the advent of a cessation of hostile conditions between the two Koreas almost immediately. According to Jo (1997), the defense expense to GNP ratio was about 3.7% in 1995. Out of this total defense expenditure, about 70% was expended for troop

maintenance, while the rest went on equipment. Thus, reduction of the size of troops will yield about 1.7% reduction in the South's defense budget per year.

Cutbacks in military holdings will not only mean savings in the governmental budget - a good part of land will also become newly available for economically productive uses. According to Kim (1995), about 8.8% of the total South Korean land is off-limits to civilians due to military-related usage. The economic value of this land mass, based on the average price of land in 1993, was estimated to be 152 trillion won (or about 127 billion US\$) according to Jo (1997). The border area between the North and South (De-Militarized Zone) is heavily fortified at present and contains large amounts of potential agricultural land and areas rich with pristine natural vegetation that can be converted into large scale natural parks or resort areas. The situation in the North should be similar in that they have large areas cordoned off for military use. A good part of those restricted areas in both Koreas will become available for commercial and residential use.

This section does not mean to give an exhaustive list of expected economic benefits. Rather, our aim is to show that there would be substantial and tangible peace dividends in the wake of reunification.

### **Globalization**

Globalization will have two distinct meanings. For the South, it is the usual

expansion of sphere of activities that has been taking place for a while now. However, for the North the unification will offer a completely new opportunity to become a legitimate member of international political and commercial society. We could see the rise of a “piranha state to model state” story. If we focus only on the economic aspects, it means that there will be ready markets and buyers for any goods and services produced in the North that are competitive. At the moment, there are many North Korean products in high demand but unavailable to consumers abroad due to restrictions put on international trade with the North Korea. (Similarly, Cuban cigars are not available to the U.S. consumers due to a trade ban). However, such a lack of desirable products of the North might have more to do with the ideological straightjacket that preached *juche* (self-reliance) and the reality of international isolation that the North Korea has experienced over the past thirty years. This situation should change rapidly once capital and entrepreneurship from the South reaches Northern residents. The fact that the North remained in isolation for so long could be used as a key attraction for international tourists.

### **Macroeconomic stability as an exogenous environment**

One of the most important economic conditions for a market-oriented economy to prosper is the stability of the macroeconomic environment. Maintaining macroeconomic stability is understood as a precondition for efficient long-term economic decisions and therefore regarded as the most important responsibility of the government. As mentioned earlier, the World Bank (1993) has consistently



contended that the most important contributing factor for the East Asian economic miracle was macroeconomic stability. One can also argue in the current context that maintaining macroeconomic stability is just like providing a better exogenous environment for the market order and should belong to the realm of the government active policy function.

#### **IV. CONCLUSION**

This paper explores basic guidelines for economic policies during the transition period around the time of the eventual unification of Korea, and discusses what role the government should assume in order to promote sustainable economic development led by private sector initiative in the post-unification period. Basically, there could be two possible approaches to the transition delineated by the speed of assimilation of the population.

Under the fast track scenario, the fiscal burden on the government would be heavy to begin with and the conversion of currencies would have to take place rapidly. Perhaps the most serious drawback of this path will be that it might take longer to establish a vibrant sphere of economic activity in the North. At the same time, the potential benefit would be that a forced rapid assimilation might help speed up the closing of the skill gap between those North Korean residents who are equipped and motivated to move to the South initially and those who are not.

The gradual approach would entail fewer up-front costs and a more orderly

adjustment process. Various policy measures could be used to develop an economic basis for the region to be a productive partner to the unified economy, although this might extend the transition period. The estimates for the cost of providing under the two scenarios differ by wide margins as it would be less costly to support displaced Northern population if they remain in the North. Furthermore, a massive population movement from North to South could bring about general instability in the South. Thus, based on these considerations, a gradual approach, unlike in the German case, seems more advisable.

The merging of the nation's halves should not alter the course of the transition from the government-led management of the economy to a market based one that started in the 1990s. In particular, a temporary surge in the activist government should end once the early stage of assimilation in Korea passes. In a sense, the ultimate success of the government's role in managing the transition should be judged by how successfully the government makes itself redundant in various areas of economic life in the period following the unification.

Once the transition period has been successfully weathered, a unified Korea will offer a significant market for both domestic and foreign businesses. Harnessing the benefits of an enhanced pool of overall resources, Korea could propel itself and convert itself into a more mature economy with a diversified economic landscape and self-assurance. It is imperative in this context that the interventionist instinct of the government so pervasive in the past needs to be

checked in the unified Korean environment since the size and complexity of the overall economy will be such that the information superiority of the government cannot be guaranteed. Thus, the government role should be confined to preserving the spontaneity and endogeneity of the market order and to cultivating a better environment for the working of the market order.

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**Table 1. Likely Outcome and Policy Options for the Fact Track and Gradual Approaches**

	<b>Fast Track</b>	<b>Gradual</b>
<b>Population mobility</b>	<ul style="list-style-type: none"> <li>● Full and immediate mobility</li> </ul>	<ul style="list-style-type: none"> <li>● Limited and gradual mobility</li> </ul>
<b>Fiscal Policy</b>	<ul style="list-style-type: none"> <li>● Large up-front costs</li> <li>● Income support and worker training</li> <li>● Identical tax policy</li> <li>● (No initial tax base in the North)</li> <li>● South will have to bear most of the costs</li> </ul>	<ul style="list-style-type: none"> <li>● Small up-front costs</li> <li>● Infrastructure building</li> <li>● Separate tax policies possible</li> <li>● A partial burden sharing by North possible early on</li> </ul>
<b>Monetary Policy</b>	<ul style="list-style-type: none"> <li>● Immediate removal of the North Korean currency</li> <li>● Single sphere of economic activity</li> </ul>	<ul style="list-style-type: none"> <li>● Two currencies could co-exist</li> <li>● Exchange rate between the two currencies become important policy tool</li> <li>● Gradual currency unification, (EMU model)</li> </ul>
<b>Development Policy</b>	<ul style="list-style-type: none"> <li>● Little indigenous demand in the North</li> <li>● More incentive necessary to induce investment in the North</li> <li>● Need to encourage re-migration of population back to North</li> <li>● Radical industrial reorganization possible</li> </ul>	<ul style="list-style-type: none"> <li>● Modest indigenous demand in the North</li> <li>● Less incentive necessary to induce investment in the North</li> <li>● Industrial reorganization might be slower</li> </ul>
<b>Potential Conflict</b>	<p>Either approach might conflict in places with the optimal political schedule</p>	