



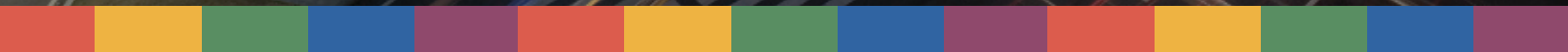
KOREA'S ECONOMY

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a publication of the Korea Economic Institute and
the Korea Institute for International Economic Policy



Volume 27



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ISSN 1054-6944



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THE ECONOMICS OF REUNIFICATION

By Dong Yong-sueng

The term “reunification” can be defined as a process of forming one united country from two or more countries that had been separated by internal or external causes. Based on this definition, South Korea and North Korea, and China and Taiwan, can be considered as separated nations that aim to achieve reunification. These countries look at the reunifications of Germany and Vietnam as main references. The German reunification was achieved through absorption—when a capitalist country absorbed a socialist one—when the East German regime suddenly started to falter. In contrast, the Vietnamese reunification is an example of a socialist regime absorbing a capitalist country through war. In addition, we can also regard a regional integration process between countries with different ideologies and regimes; the European Union is an example of this type of reunification.

We can consider German reunification and the European integration process as valuable models for the reunification of South and North Korea. In addition, the reunification of Germany formed a foundation for European integration. Vietnamese reunification can be excluded because it was achieved through war and it was led by a socialist regime. As a result, the best model for Korea’s reunification is the one used by Germany; yet there are limitations to adopting exactly the same model. The environmental background behind the nations’ separation was different, as East and West Germany were separated by external forces. After Germany lost the Second World War, the four victors retained authority over Germany as the Soviet Union took control of eastern Germany and as the United States, Britain, and France took control of western Germany. In Korea, in contrast, both internal and external factors caused Korea’s separation after the tragedy of the Korean War, during which the United States, China, and the Soviet Union interfered in Korea’s internal affairs. As a result, aggression of one of the Koreas toward the other and a victim mentality are much stronger in the case of Korea.

Also, East and West Germany shared the same culture, and they had already experienced an economic and social development process up to a point where they had a capacity to initiate the Second World War. Because Korea was separated almost immediately after it was freed from 36 years of Japanese colonization, South and North Korea hardly share an experience of social development, and at the time of separation the absolute level of development itself was also very low. Based on these facts, it can be concluded that the cost of Korean reunification may be much higher than that of the German reunification.

Approaching the reunification problem from an economic perspective, we always face issues related to costs. Various types of costs arise when two different regimes are integrated with each other. We can refer to German reunification as the most recent example, but, as Korea’s situation is dissimilar in a number of ways, the types and the amounts of the costs will be different. Korea now has an opportunity to formulate an efficient reunification process as it has learned a great deal from German reunification during the past decades. This means that the benefits of reunification, not just the costs, can now be given proper consideration. Approaching the reunification problem from an economic viewpoint can be understood as a process of creating maximum benefits with the least cost; the possibility of achieving this will be discussed in the next section.

Lessons from German Reunification

After East and West Germany were reunified, studies on the cost of Korean reunification were widely undertaken, and consideration and discussion of the studies almost became a trend. The interest in the cost of reunification intensified in the public arena as the expected possibility of reunification surfaced with the death of Kim Il-sung, the leader of North Korea, in 1994. This did not last long, however, and the intensity

of debate on reunification started to weaken in Korean society as time passed. This was because the economic cost of German reunification became known, and the estimated cost of Korean reunification exceeded the amount that South Korea could bear. Moreover, public hostility toward reunification started to appear in Korea. The lesson from the German reunification at that time was that if Korea followed the same path, it would go broke.

The methodology of calculating the cost of reunification is based on totaling the capital injected into North Korea up to the point where the economic level of North Korea is equal to that of South Korea. Depending on the estimation model, the cost of reunification ranges from hundreds of billions to a few trillion dollars. When East and West Germany reunified, West Germany's GDP was 10 times larger than East Germany's, and West Germany's population was four times larger. The cost of raising eastern Germany's economic level up to western Germany's was not extreme as East Germany's income per capita was around 30 percent of West Germany's. Also, West Germany at the time was the second-largest economic power in the world after the United States.

In the case of South Korea, however, in 2009 its GDP was 18 times larger than North Korea's, yet its population was only twice the size. Based on these facts, a simple calculation leads to a conclusion that the cost of Korean reunification would be more than double the cost of German reunification. In the early 1990s when Germany was reunifying, it was impossible for the South Korean economy to take on such a burden and follow the same path as West Germany. Perhaps it was a natural economic phenomenon for such public hostility toward reunification to arise in Korean society.

The political necessity of introducing West Germany's deutsche mark in eastern Germany and exchanging East German marks at a rate of 1:1 has been pointed out as a factor that raised the cost of German economic integration. These decisions aimed to avoid a rash of emigration of laborers from eastern Germany into western Germany and to ignite eastern Germany's economic development, yet the additional cost burdened Germany's government finances. Also Germany's finances worsened as the level of its social security

benefits—one of the highest in the world—was adopted in eastern Germany. This meant that the capital available for social overhead investment had to be reduced in relative terms.

“Korea must focus on the fact that taking early action can reduce the total reunification cost. West and East Germany planned a gradual economic integration when they decided on political integration, but they went through shock therapy at the end when they chose a quick integration of their currencies. South and North Korea must find a way to integrate their economies effectively”

Now that 20 years have passed since Germany reunified, there needs to be a reinterpretation of German reunification. To be more precise, a reinterpretation of the cost of German reunification is required. When calculating the cost of reunification, one should not just factor in the expenses needed in the process but also include the reunification benefits and calculate the net reunification cost. Germany is still paying for the reunification 20 years on, and Germany also experienced an economic recession for more than 10 years. A number of economists even predicted that the German economy was going to collapse as a result. Currently, social integration between eastern and western Germany is an ongoing process, and the German economy is on a recovery trajectory as eastern Germany is providing a valuable domestic market. Germany has now once again become a major economic power. Also, German reunification has sped up the European integration process, and Germany has naturally become a pivotal member in the process. It has achieved great strides in social integration, and German people's pride in overcoming difficulties in the past drives the competitiveness of the country.

The economic lessons from German reunification can be summarized in three points. First, a nation must escape from the fear of the burden of the initial reunification cost. The economic power of West Germany was regarded as great enough to bear the cost of reunification. It is true that some excessive costs arose, but it was within reach of West Germany.

It is expected that Korea will also face an enormous reunification cost, yet it cannot exceed what the South Korean economy can endure.

Second, Korea must focus on the fact that taking early action can reduce the total reunification cost. West and East Germany planned a gradual economic integration when they decided on political integration, but they went through shock therapy at the end when they chose a quick integration of their currencies. South and North Korea must find a way to integrate their economies effectively, and the goal should be to naturally suppress the movement of labor.

Third, Korea needs to concentrate on finding its future competitiveness. Korea must discover its growth engine by commercializing in areas where benefits are likely to arise after the reunification. Germany, for example, utilized European integration and Germany's pride as the major economic growth engine.

Reunified Economy of the Korean Peninsula

Decisions by separated nations to reunify do not depend on future economic benefits and costs. Calculating the economic outcome should be regarded as finding a way to maximize the economic efficiency when the reunification draws near. Can the reunification of South and North Korea be economically meaningful?

The reunification cost of Korea is not going to be at a level that would be worryingly significant. The economic gap between North and South Korea has widened much more since the 1990s. The population of South Korea exceeded 50 million in 2011 while the population of North Korea in 2008 was less than half that, at 24 million, according to a UN census. But the UN figures may not reflect reality, and the population of North Korea has been estimated elsewhere to be around 20 million.

South Korea's income per capita is also much larger—approximately \$20,000—while that of North Korea is around \$1,000, according to estimates by the Bank of Korea. Yet this also seems it could be an overestimation, and it is more likely to be around \$500 if we compare the economic reality of North Korea with that of other countries. As a result, the GDP of South Korea is currently more than 80 times larger than the

North Korean economy. From these estimates, we can conclude that if we push hard for reunification on an unreasonable basis South Korea's government expenditure will exceed a manageable level. As a result, setting a restriction on the reunification budget will be inevitable, and this budget limitation may equal the maximum amount that South Korea will be able to afford.

South Korea's government debt, without taking reunification costs into account, is expected to rise to 42 percent of GDP by 2030, caused by various reasons such as its aging population. If South Korea commits 3 percent of GDP per year into reunification-related expenditures, the economic development of North Korea would accelerate; South Korea, however, would have a government debt as large as 82 percent of GDP. This situation would be dangerous as South Korea's government debt would then be close to 90 percent of GDP, which is regarded as the level where a fiscal crisis is likely to occur. If South Korea were to allocate 1 percent of GDP per year instead, government debt would rise to 55.4 percent, which is 13.4 percent higher than the baseline, yet the burden for the Korean economy would be relatively much less because the government debt would be still below the level that is required to join the European Monetary Union.

These estimates lead us to conclude that the limitation on South Korea's government expenditure in reunification-related areas will be approximately 1 percent of GDP per annum. Conversely, it could be interpreted that if South Korea overinvests in order to raise the economic level of North Korea to meet that of South Korea, the probability of getting a low output relative to its input is high. For example, North Korea's external trade currently amounts to only approximately \$4 billion annually. Its exports are concentrated in natural commodities such as minerals and agricultural products and its imports are mostly food and daily necessities. This shows that industrial activities that can create value-added products are absent in North Korea.

Reinvigorating North Korea's economy will require starting from a zero base. Even if North Korea adopts the development model used by South Korea in the 1960s and 1970s, its capacity to absorb investment will be limited. As a result, if we consider the North

Korean economy's absorption capacity and the restriction imposed on South Korea's government expenditure, the cost of Korean reunification is not going to be alarmingly significant. It is important, however, that South Korea does not adopt impractical policies at the beginning—such as pushing for currency integration—aimed at achieving rapid economic integration. Currency integration is usually a final stage of economic integration, out of political necessity.

Next, the invisible cost, or the so-called Korea discount, that arises from the division of Korea cannot be overlooked. The cost of issuance of dollar bonds and their interest rates are a little higher for South Korea than for countries of a comparable economic situation. This is because the political instability that stems from the division acts as a negative factor when devising an investment strategy.

Apart from this somewhat apparent component, there are many more discounts that are not visible. South Korea is currently a de facto island nation: three sides are surrounded by ocean and one side—the North—is a cliff. As a result, South Korea has found it difficult to carry forward a business plan related to the Asian continent. But if North and South Korea reunify, new opportunities such as connecting gas pipes to the Siberian area, trading electricity with China and Russia, connecting Japan with Asia in terms of trade by linking up railways and roads, pushing for economic integration, and creating a new cooperation structure in Northeast Asia among China, Korea, and Japan will arise.

Korea's excessive military spending and the related social costs are also an important part of the Korea discount. South Korea's military spending is currently around 2.7 percent of GDP. The military spending itself is a significant cost, but there is also a discount in terms of labor. Because of the mandatory military service, young Korean men spend two to three years in the military, and the utilization of young labor power is delayed by two to three years compared with other countries as a result.

Last, the benefits of reunification are unimaginably enormous. From a business perspective, reunification is a business with very high profitability. It can be understood as taking over a country with a population of 20 million, underground resources estimated

to be worth \$3 trillion, and a land mass of more than 120,000 square kilometers. South Korea will have a new domestic market of 20 million people, and it will enjoy the benefits of development in this new market. Because North Korea will start from a zero base, the profitability of development is expected to be extremely high. If North Korea adopts the development model used by the South Korean economy in the 1960s and 1970s, the annual economic growth rate of North Korea will exceed 10 percent for decades.

Foreign investors will also take an interest in investment projects, and it will be possible to form international consortia for infrastructure construction in North Korea. Profitability in areas of energy and transportation is going to be particularly high depending on the business development method. The construction industry, including building housing, will also show high profitability. The Korean economy will be able to produce businesses in the new industry areas, and a number of globally competitive firms will emerge as a result of an expansion of the domestic market. When we consider the benefits, it is certain that the reunification will act as a new growth engine for the Korean economy.

Conclusion

Thus, reunification is an economically valuable business. The costs of reunification are limited while the benefits will arise for an indefinite period of time. The capital injected will be restricted to a level the South Korean economy will be able to afford, but the benefits will continue to increase with time.

South Korea should start preparing for reunification right now. Korea and the international community should begin to discuss the areas in which various stakeholders will have to cooperate in order to raise the economic efficiency when the time to reunify suddenly comes. Korea should actively search for new business projects that are potentially viable after reunification and construct an international cooperation system that can link these new opportunities with the international capital market in order to develop them into highly profitable businesses.

South Korea should also find various ways to close the economic gap between itself and North Korea. The best case would be if North Korea decides to reform

by itself and open up. It will also have to become a responsible member of the international community. Such changes in North Korea's behavior would mean that the two Koreas could gradually carry out their economic integration process before their political integration, and North Korea would contribute to maximizing the economic efficiency of reunification by taking up a share of the limited reunification cost. In addition, South Korea should concentrate on expanding the economic pie as this would mean that the size of the restricted spending would increase with it. With a stronger economy, Korea would be able to manage the reunified economy more flexibly and enjoy the resulting benefits.

Dong Yong-sueng is with the Samsung Economic Research Institute.

Selected Commentary

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