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# NORTH KOREA

## THE COSTS OF KOREAN UNIFICATION: REALISTIC LESSONS FROM THE GERMAN CASE

*By Rudiger Frank*

### **Abstract**

German unification is often used as a preview on what is going to happen in Korea. Such a position is rejected in this article. Not only have the costs of German unification been grossly overestimated or misinterpreted, the costs in the Korean case will in many areas be lower than in Germany, and the benefits of unification will be much bigger, which further decreases the net costs. South Korea will, however, experience problems of a structural nature that have not occurred in Germany. The potential role of external partners for shouldering the costs of unification should also not be underestimated in the Korean case, although it will come at a political price. Finally, a highly speculative but not completely unrealistic scenario of unification is briefly presented that would incur almost no unification costs at all.

## Introduction

Ever since Germany's unification in 1990, Koreans, mostly from south of the 38<sup>th</sup> parallel, have been studying that case in the hope to find lessons for their own future. Not only did such comparisons often rest on a shaky methodological foundation,<sup>1</sup> the results, too, were sobering. Most if not all concerned academics, politicians and journalists in the Republic of Korea (ROK, or South Korea) agree that despite the usually undisputed desirability of unification, this process will cost their country huge amounts of money and should thus be approached carefully.

Opinion survey in South Korea seems to confirm this atmosphere of growing skepticism. The number of supporters for a Korean unification dropped from around 64 percent in 2007 to less than 55 percent in 2013. In the same time period, the number of opponents rose from about 15 to 24 percent. For supporters, economic aspects do not seem to play a crucial role; among the reasons why a unification was seen as potentially beneficial, over 40 percent expressed nationalist considerations and 31 percent saw unification as a way to prevent a second Korean War.<sup>2</sup>

Economic fears are not off the mark. The country is sandwiched between a technological leader in Japan with whom it wants to catch up, and a rising China that is breathing down the neck of companies like Samsung or Hyundai on whom the destiny of Korea's economy depends to a large degree. In such an environment, a unification-induced recession, even if it lasts for just a few years and is followed by a strong rebound, could turn out to be a strategic disaster. As a result, unification is commonly welcomed in principle, but usually in combination with warnings that it should happen gradually and slowly.

Such demands for caution are highly justified, but perhaps for the wrong reasons and based on incorrect assumptions. South Korea should not be too worried about gigantic South-North monetary transfers; the real danger lurks elsewhere.

The purpose of this essay is threefold: It will be shown that the data on the costs of German unification need to be understood properly in order not to draw the wrong conclusions; that Korean unification costs will be very different in nature compared to Germany; and that external factors will under certain circumstances turn out to have an impact on the economic and financial side of Korean unification, something that has happened only to a very minor degree in Germany.

## Real German Unification Costs Were Not Nearly as High as is Often Assumed

It does not need much explanation to see that the merger of two countries will in all likelihood not come for free. This is even

more so when we consider the huge economic gap between South and North Korea (Democratic People's Republic of Korea, or DPRK). Comparative statistics on that issue seem to be a favorite field of research for South Korean scholars. Data are easily available from a wide range of institutions such as the Bank of Korea, the Ministry of Unification and private think tanks. One example is Lee Bu-hyoung at the Hyundai Research Institute who dramatically explains that North Korea is no less than 40 years behind South Korea in terms of economic development.<sup>3</sup> Numbers for nominal GDP per capita in 2013 are \$854 in the North versus \$23,838 in the South. While the expressiveness of the GDP as such, as well as the reliability of estimates on North Korea's macroeconomic data can be disputed, hardly anyone would disagree that the gap is huge and thus the costs of catching up quickly will be enormous.

The German example is often cited as proof of such an assessment, but perhaps supporters of the above argument need to look for better evidence.

Transfers from West Germany to East Germany (German Democratic Republic, or GDR) between 1990 and 2005 in the context of the so-called "Solidarpakt I" amounted to about 1.4 trillion Deutschmarks, or 700 billion Euros.<sup>4</sup> This is an impressive amount, but how much of it was "lost" in the sense of a unilateral, unidirectional transfer that ended up in the East? Not much, if we take a closer look.

Huge sums went into infrastructure development such as the renovation or installation of telecommunications lines or the rehabilitation of highways. But when driving past the construction sites, there were adverts by companies such as Hochtief, Zueblin, Max Boegl, Heilit und Woerner, Bilfinger und Berger, Teerbau, Phillip Holzmann and others. These were, except Strabag from Austria, West German companies, for whom the "Eastern Reconstruction"<sup>5</sup> meant nothing less but an unprecedented expansion in demand. Most of the money, except for wages paid to local workers, went promptly back to West Germany where they had their head offices and their employees, and where they paid their taxes.

Much was invested into building modern state institutions in East Germany, such as fiscal authorities, police, federal and provincial governments, and so forth. But even as of 2014, very often West German dialects are heard when executives and top bureaucrats appear on TV. Kurt Biedenkopf as the long-time leader of the federal state of Saxony is just one prominent example out of many. While at the lower levels of the administration, East Germans were hired, the number of West Germans in higher levels was considerable, especially in the first years after unification.<sup>6</sup> In other words, the transfers to the East in the form of wages and other funds for institution-building went straight back to West Germany, too.

A key component of unification-related transfers were social benefits for health insurance, pension and unemployment benefits.<sup>7</sup> Those went straight to the East Germans. So far, so good, but what did they do with this money? Economists know that the rate of so-called autonomous consumption, that is, the percentage of their income that people spend more or less necessarily on food, housing and clothes, is particularly high in the lowest income brackets. Receivers of social benefits are by definition among the poorest; they thus spend most of their income immediately. But on what did they spend it in post-1990 East Germany? Private possession of apartment buildings was uncommon in that formerly state-owned socialist economy. After 1990, investors with the appropriate understanding of the market were able to acquire apartment buildings from the “Treuhand”<sup>8</sup> or the communes. Most of these investors inevitably came from West Germany, because hardly anybody in the East had accumulated the necessary resources or was risk-taking enough to buy on credit. Therefore, when receivers of social benefits paid their rent, the money usually went west.

The same is true for food. After 1990, even locally produced staple food temporarily disappeared from the supermarkets in East Germany; people were unwilling to spend the only recently acquired hard Deutschmark for products that they had previously bought for their own unpopular currency. Needless to say that the supermarket chains like Kaiser’s, Spar, Aldi, Lidl were all West German. They had taken over the former East German food store chains Konsum and HO. Thus, money spent on foodstuff went to the West as well.

This exercise can be repeated for textiles, consumer electronics and of course the German’s favorite – cars. Mercedes, BMW, Audi, VW and Opel quickly replaced the East German Trabant and Wartburg. Even Japanese, French and Italian cars were imported through dealers located in West Germany.

Last but not least, receivers of direct and indirect transfers were taxed. Income tax on wages and value added tax on consumption (between seven and 16 percent) flowed straight back into the unified German federal budget.

If seen from this perspective, German unification and the massive transfers that resulted from it were nothing less but a gigantic economic stimulus package for the West German economy. They secured employment in the West and increased incomes there. At this point, it is necessary to emphasize that the transfers were very welcome in the East and are still seen there by many with a sense of deep appreciation. Occasional accusations of colonization are as incorrect as they are unfair. However, it is important to understand that a large proportion of the transfers was not unilateral, but circular. In fact, if such a scheme would be repeated today, Brussels would very likely intervene out of concerns of an inappropriate subsidy for the West German industry. Back in the years after 1990, however,

the extraordinary circumstances of German unification seem to have justified almost anything.

From that perspective, South Korea’s industry should be looking forward to a unification. Provided that things work the same way as they did in Germany, unification will result in a massive business activity support program for South Korean companies. This is at least what those analysts should believe who expect a Korean unification to proceed along the German lines. It is very unlikely that this will be the case, however; but more on that later.

The above argument – that most of the transfers in reality flowed back to where they came from – needs to be supplemented by a consideration of the actual necessity of such transfers. It is hard to dispute the fact that North Korea’s infrastructure is in dire need of expansion and rehabilitation. But the expectation of massive flows of funds for social security spending is less realistic. In the years 1990 to 2014, not less than 60 to 65 percent of all German transfers were made for social benefits, and among them, pensions took the lions share<sup>9</sup>. In 2012, about 30 percent of the German state budget was spent on pensions.<sup>10</sup> But the situation in South Korea is very different. In 2014, the state spent 0.26 percent of its budget on pensions who received a maximum of \$83 per month.<sup>11</sup> The real situation is of course more complex, as many South Koreans receive a pension from their former employers or from private insurance companies. But regarding the state’s expenses, we cannot avoid noting that the level of social security in South Korea, which would become the standard in case of a sudden German-style unification, is worlds apart from the West German standard that was to be installed in East Germany.

## **Korean Unification Costs will be Different in Nature**

This leads us to the question of unification costs in Korea. The National Assembly Budget Office (2015) estimates that the total unification cost for the 45 years from 2016 to 2060 will amount to 10,428 trillion won at current prices (about \$9.2 trillion).<sup>12</sup>

It is not just that the German transfers are overstated; there are many reasons to believe that the actual costs in the Korean case will be lower. Social security is just one example. The crucial yardstick here is the South Korean standard – and knowledge thereof as well as promises made by politicians. We should not forget that East Germans had for decades lived with regular, that is, daily, consummation of West German TV and radio. This included more or less subtle propagandistic messages to the effect how plentiful life was in the West, and how similar the standard of living of the East Germans would become if they only got rid of Soviet occupation and Communist oppression and

joined their brothers and sisters to the West. Such general propaganda was supplemented and supported by many individual experiences, be it the jealous observation of thousands of West German cars on East German highways, the frequent visits by West German relatives, the millions of parcels that were sent East for Christmas and other holidays, or the infamous hard currency stores “Intershop”.

After the peaceful revolution of 1989, West German politicians intensified their campaign to appeal to the materialistic desires of East Germans. The formula, most prominently spread by Chancellor Helmut Kohl and his Christian Democrats, was simple: If East Germans wanted exotic fruits, fashionable brand clothes, high-quality cars and travel to tropical islands, they needed the hard Deutschmark. The only way to get it was fast unification. This won the Christian Democrats the March 1990 election in East Germany. The promised currency conversion came in July, even a few months before formal unification in October 1990, and at an economically unrealistic, but politically inevitable rate of 1:1 or 1:2 for most funds.

This is not the place to debate the justification of that decision. What is more important is to understand how deliberately inflated and fanned East German expectations became a push factor to guide economic policy decisions related to German unification. So far, it is fair to say that North Koreans do not have the same high expectations, despite DVDs and USB sticks with South Korean soap operas that find their way via the semi-permeable Chinese border. As long as this stays that way, Korean politicians will be faced with much less costly pressure to elevate the standard of living in North Korea instantly up to the actual or imaginary South Korean standard.

Another point regarding costs is that net costs matter, that is, the difference between costs and benefits of unification. The much-criticized trust agency Treuhand finalized the privatization of East Germany’s state owned assets with a deficit.<sup>13</sup> East Germany was the richest country of the socialist camp – if it was worth so little on the flea market, what could reasonably be expected from North Korea? The fact that the material value of East Germany turned out to be so low, if not to say negative, after unification should perhaps be seen as an anomaly rather than normality. In the Korean case, the benefits of unification will not only be of ideational value.

One important reason to think so is the fact that the painful adjustment of foreign trade to a rapidly and profoundly changing environment, which happened in parallel to German unification, has already been completed by North Korea. The effects of a conversion of foreign trade from preferential barter trade agreements with partners susceptible to political blackmail, to regular trade relations in hard currency and at world market prices are known as the “arduous march” or the great famine of the mid-1990s. But as dreadful as it was, this transition has been completed and will not have to be

repeated in case of Korean unification. North Korea’s trade will survive a systemic change because it is already being conducted according to the rules of the game in a market economy. If we consider that the wave of bankruptcies of East German companies after unification, along with an exploding unemployment rate and the resulting need for social security transfers, had not only to do with the chronic inefficiency of socialist enterprises, but also with the sudden vaporization of their foreign trade connections, then there is room for optimism that the unification-induced economic downturn in Korea will be less severe.

Regarding assets that North Korea will add to the then joint Korean household, the prospects are also much better than in Germany. While most of North Korea’s production facilities might indeed turn out to be a liability, there are also strengths that East Germany did not have. One of them concerns mineral resources. East Germany had very little except potassium salt and lignite, demand for which was low in 1990 although it seems to have recovered somewhat as of 2014. But North Korea promises to be a treasure chest in this regard, if we can believe reports like those by Edward Yoon.<sup>14</sup> If South Korean capital and know-how could be used to extract, process and export gold, anthracite, magnetite, zinc, rare earths and other resources, then this could create an economic boom of sorts. The fact that resource-hungry China is an immediate neighbor would only magnify the effects. And by the way: What more could an export-oriented economy like that of South Korea wish for but, unlike for example Japan, to have 1,400 kilometers of land border with the biggest and most dynamic market of the world?

The above is an optimistic scenario, but it is not completely unrealistic. However, there is also a fly in the ointment. In addition to the fact that China, and very soon perhaps also Japan, has already begun to uncover that North Korean treasure while South Korea is watching helplessly and increasingly frustrated, there is also the specter of structural change looming over the heads of South Koreans.

Much to the disappointment of East Germans, not many sizeable West German enterprises relocated to the East after 1990. Frankly, why should they have done so? Wages had very quickly risen to a level that made relocation less attractive from the perspective of lowering labor costs. Taxes were more or less the same. Importantly, there were no locational advantages that would induce a massive migration of employers from West to East Germany. The South Korean National Assembly Budget Office (2015) seems to expect a similar development in Korea. It argues that Korean unification will “re-energize” the currently sluggish economy of South Korea, especially because development projects in North Korea are hoped to increase demand, thus leading to large-scale corporate investments and substantial job creation in the South. However, a major

precondition for this would be to keep the North under separate economic management, which at least in the German case turned out to be politically unrealistic.

There are more reasons to be skeptical about such scenarios. A look at the industrial structure of Korea before 1945 is an indicator for how a “natural” distribution of industries along the peninsula would look like: agriculture and light industry in the South, heavy industry and electricity in the North. And that was when China had not yet been the economic jackpot that it is today. After Korean unification, industry will move. It will go to where the natural resources are, where electricity from hydropower is produced, and it will move as close as it can to its biggest market. In 2004, China has become South Korea's biggest export market and currently receives about 25 percent of South Korean exports, and still growing.<sup>15</sup>

If South Korea has a reason to be afraid of unification, then not because of its huge costs, but because of a massive structural change that will result in a dramatic loss of jobs and tax income in the South. This points to the fact that the costs and the benefits of Korean unification will not be distributed equally among all Koreans. As shown above, in Germany taxpayer's money was used to fund projects that created immediate revenue for a number of companies in the construction and retail sector. Another asymmetry will emerge in the distribution of transfers over time. In the German example, the logic of politics, and the logic of economics all suggest that spending will be particularly significant during the first years after unification. Unless this can be cushioned by a unification fund or external transfers, it will put a major short-term strain on fiscal resources and thus on society, despite the fact that in the long run of 45 years, the benefits of Korean unification are estimated to exceed its costs by a whopping three times.<sup>16</sup>

## **The Neighbors Might be Willing to Pay – at a Political Price**

Last but not least, we should consider that a Korean unification will hardly take place in a foreign policy vacuum. It makes little sense to speculate about the actual attitudes of China, Japan, Russia and the United States regarding unification as long as we do not know when, and under what conditions, Korea's unification will take place. However, given the experience of South Korea after the normalization treaty with Japan in 1965 and considering the infrastructure projects currently being pursued by China and Russia in the northwest and northeast of the peninsula, it is fair to expect that those countries will be willing to invest into the building and rehabilitation of roads, railroads, harbors, pipelines, telecommunications facilities and even large-scale industries.

South Korea, mindful of the colonial past, has traditionally been skeptical regarding Foreign Direct Investment and rather opted for loans to finance its economic development.<sup>17</sup> But that was then, with the U.S. as a potent ally who was willing to go very far, and to bend the rules really strongly, in the context of the Cold War. While the latter might be coming back in its 2.0 version, it is unlikely that a unified Korea will again have so much leverage over an economic giant. And even though North Korea is supposedly even more xenophobic, nationalistic and self-reliant, reality is very different. Just think about the alarming trade dependency on China of 89 percent in 2013.<sup>18</sup>

Whether Koreans like it or not, if a unified Korea finds itself in a financially tense situation, offers of investment by the neighbors will have to be accepted. Because one lesson that can be learned not just from Germany, but also from other transformation economies in Europe, is that speed matters. As long as the necessary infrastructure is missing, economic development will not take place, and economic problems will accumulate, turn into social problems, and have political consequences.

That said, economic power usually comes along with political influence. The price for a most welcome external support of a quick upgrading of North Korea's economy after unification might be a lingering loss of independence – a nightmare scenario for most Koreans.

## **Outlook: An Alternative Unification Scenario**

To end on a note that is, depending on who is reading this, either positive or disturbing: Things might in fact proceed very differently. So far, although I have rejected it, I have implicitly applied the German scenario to Korea's unification, that is, an economically and politically weak North unifies with a South that is in most respects overwhelmingly superior. As of 2014, this is the most realistic expectation to have. But as much as the world has been waiting for a North Korean collapse since 1990, and even more so since 1994, we might end up waiting for the above kind of unification for another decade or two. Meanwhile, how could the situation have changed, and how would this influence the cost calculation of Korean unification? South Korean estimates of future developments point into the direction of a widening gap between the economies of the two Koreas, and thus growing costs of unification (National Assembly Budget Office 2015). But we should also consider another option.

Ever since the July measures of 2002 I have been writing about the possibility of an indigenous North Korean reform.<sup>19</sup> Back then I was criticized by colleagues who today propagate as commonsensical knowledge much of what I had foreseen, such as the social transformation triggered by North Korea's

re-monetization and the emergence of a middle class. So perhaps we should not completely and instantly push aside this admittedly somewhat outlandish scenario.

Imagine: North Korea's leader, who is obviously intent on improving the living standard of his people, realizes that this will not be possible without more external economic cooperation, an at least partial privatization, competition, and price liberalization. Feeling safe enough to do so under the protection of his own nuclear umbrella, he embarks on a reform path that is North Korean in principle but also utilizes adjusted lessons from cases like China and Vietnam, namely the dual-track system<sup>20</sup> and special economic zones. China is a potent partner who provides necessary inputs of technology and finance, and serves as an export market to nurture infant industries. North Korea improves its capacity to utilize its rich natural resources and rehabilitates crucial parts of its infrastructure. Constant interaction with capitalist partners leads to a gradual but steady and broad buildup of capacities among North Koreans. As the knowledge gap between North and South Koreans diminishes, so does the economic gap. Eventually, both sides have reached more or less equal status. At the same time, U.S. influence in East Asia decreases. North Korea's pressure to expel American troops from the peninsula becomes more and more effective in South Korea. Finally, the Americans retreat to Japan, although they are not terribly welcome there as well. China acts as a broker between both sides that have long ago started to grow together through numerous instances of economic and cultural exchanges. Eventually, unification becomes just a formality. Costs of adjustment, infrastructure rehabilitation or social transfers are simply not an issue. A federal state is formed that initially consists of two parts but will later develop into a single central state or a federation that consists of all Korean provinces.

I should repeat that at this point, and perhaps at any point in the near future, this scenario is not overly realistic. But thinking ahead means also to leave the constraints of what too easily establishes itself as conventional wisdom. Using the German example as a magic orb that allows us to foresee Korea's future is tempting, but risky. Not only have the circumstances and details of German unification been incompletely understood; too many so-called lessons might actually be dangerously misleading.

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- <sup>1</sup> This, and the question of a comparability of the German and the Korean case, is extensively discussed in Frank (2013). Frank, Rudiger (2013): "The Political Economy of Unification: North Korea and Implications of the German Experience", Choe Sang-Hun, Gi-Wook Shin and David Straub (eds.): *Troubled Transition. North Korea's Politics, Economy, and External Relations*, Stanford: Shorenstein Asia-Pacific Research Center, pp. 229-254.
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- <sup>3</sup> Lee, Bu-hyoung (2014): "Estimation of the Economic Potential of Unified Korea", *Weekly Economic Review* 14-16, No. 587 (April 18, 2014), Seoul: Hyundai Research Institute.
- <sup>4</sup> Hietschold, Marco (2010): *Die Integration des ‚Aufbau Ost‘ in die bundesdeutsche Finanzordnung: Potentiale und Perspektiven wachstumswirksamer Transfermittelverwendung* [The integration of "Eastern Reconstruction" in the federal German financial order: potential and perspectives of the use of transfers with effects on growth], Göttingen: Cuvillier, see in particular pp. 34-50.
- <sup>5</sup> In German: "Aufbau Ost", the official name of the massive rehabilitation program of East Germany's economy.
- <sup>6</sup> Thiessen, Friedrich (ed., 2009): *Die Wessis. Westdeutsche Führungskräfte beim Aufbau Ost* [The West Germans. West German executives in the reconstruction of the East], Cologne, Weimar and Vienna: Boehlau.
- <sup>7</sup> An extensive discussion of these and other aspects can be found in Paqué (2009) and Ritter (2007). Paqué, Karl-Heinz (2009): *Die Bilanz. Eine wirtschaftliche Analyse der Deutschen Einheit* [The balance sheet: An economic analysis of German unification], Munich: Hanser Verlag. Ritter, Gerhard A. (2007): *Der Preis der Deutschen Einheit: Die Wiedervereinigung und die Krise des Sozialstaates* [The price of German unity: Unification and the crisis of the welfare state], Munich: C.H. Beck.
- <sup>8</sup> Trusteeship agency, established after unification to liquidate the former East German state property.
- <sup>9</sup> FAZ (2014): "Deutsche Einheit hat fast zwei Billionen Euro gekostet" [German unification cost more than two trillion Euros], *Frankfurter Allgemeine Zeitung*, 04.05.2014, <http://www.faz.net/aktuell/wirtschaft/expertenschaetzung-deutsche-einheit-hat-fast-zwei-billionen-euro-gekostet-12922345.html> (accessed 12.05.2014).
- <sup>10</sup> Schipper, Lena (2013): "Die Rente frisst den Bundeshaushalt auf" [Pension is eating up federal budget], *Frankfurter Allgemeine Zeitung*, 04.09.2013, <http://www.faz.net/aktuell/wirtschaft/wirtschaftspolitik/staatsausgaben-die-rente-frisst-den-bundeshaushalt-auf-12556533.html> (accessed 12.05.2014).
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- <sup>15</sup> Song, Jung-a and Shawn Donnan (2014): China and South Korea poised for bilateral trade deal, *The Financial Times*, 03.07.2014, <http://www.ft.com/cms/s/0/4ec9ab36-02aa-11e4-8c28-00144feab7de.html#axzz3BbSRlrZk> (accessed 27.08.2014).
- <sup>16</sup> My thanks go to an anonymous reviewer for pointing out these important aspects.
- <sup>17</sup> Woo, Jung-en (1991): *Race to the Swift. State and Finance in Korean Industrialization*, New York: Columbia University Press.
- <sup>18</sup> KOTRA (2014): 2013 *Pukhanŭi taewoemuyŏk tonghyang* (Trends in North Korea's foreign trade 2013), Seoul: Korea Trade and Investment Promotion Agency.
- <sup>19</sup> Frank, Rudiger (2005): "Economic Reforms in North Korea (1998-2004): Systemic Restrictions, Quantitative Analysis, Ideological Background", *Journal of the Asia Pacific Economy*, Vol. 10, No. 3, pp. 278-311.
- <sup>20</sup> Roughly: State owned enterprises work for the state under state-set conditions until they reach a given production target and are then free to produce whatever they want and to sell it on the free market.



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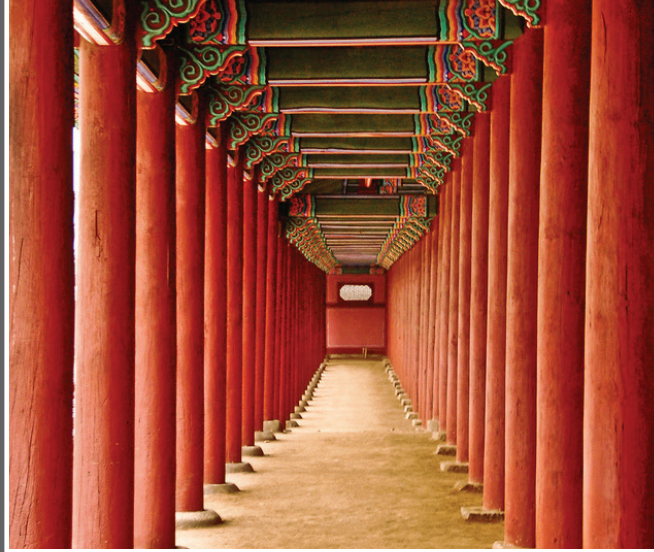
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