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001. talking points	re POTUS-KDJ Meeting (2 pages)	05/00/1998	P1/b(1)
002. email	Charles Pritchard to Leonard Hawley re Talkers (1 page)	05/27/1998	P1/b(1)
003. memo	Len Hawley and Jack Pritchard to Samuel Berger re Pol-Mil Planning (4 pages)	12/18/1997	P1/b(1)
004. memo	Intelligence to distribution re North Korea (10 pages)	11/29/1995	P1/b(1)
005. paper	re Pitfalls and Prospects [partial] (1 page)	00/00/1998	P3/b(3)

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Korea-KDJ [Kim Dae-jung] and ROK [Republic of Korea] Priorities

2009-0528-F
kc1504

RESTRICTION CODES

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Discussion Topics for KDJ State Visit

Security

- Alliance Issues. (State and DOD)
  - Military Coordination (DOD)
  - Defense Modernization (DOD)
  - Contingency Planning (NSC)

Need full paragraph and Talking Point to allow POTUS to introduce our contingency planning and desire to begin sharing/planning w/ South Korea.

- Peninsula Issues. (State and DOD)
  - Agreed Framework. (State)
    LWR (70%).
    KEDO HFO Contribution.
  - Four Party Peace Talks. (State)
    Next Steps.
  - North-South Dialogue. (State)
    Fertilizer for Families/Envoys.
    Results in Beijing.
  - U.S.-DPRK Bilateral. (State)
    Berlin Matrix.
  - WFP/UNDP. (State)
    Food Needs/Bertini assessment.
    US Food-for-work MOU.

Economic

- IMF Package. (Treasury/USTR)
  SEAsia Contagion Effect.
  Japan/China economic factor.
- Bond Sales. (Treasury)
- Super 301 - Autos. (USTR)
- OPIC (Treasury/OPIC/USTR)

Regional

- APEC (State/USTR)
- ARF (State)
- Cambodia and Burma (State)
- China (NSC)
- Climate Change (State)

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Kim Dae-jung's "Three Stage Unification" Proposal [Booklet] [45p]

Kim Dae-jung's "Three-Stage Unification" Proposal

Explained through Questions and Answers

Kim Dae-jung Peace Foundation [KPF]
Seoul, Korea

Kim Dae Jung's "Three Stage Approach" to Korean Unification

CONFEDERATION ... FEDERATION ... COMPLETE UNIFICATION

Three Principles	**Ideological Perspective**	**Assumptions**	**Justification**
1. Self-reliance—Koreans solve unification problem	1. Open nationalism	- A NK state exists? - ROK has $ support?	- Single culture - Bury the tragedy - Economic survival
2. Peace—dissolve inter-Korean hostilities	2. Peaceful co-existence Avoid hostilities No absorption	- No war, no collapse?	- Avoid divided rule - Regional stabilizer
3. Democracy-plan based on popular consent throughout	3. Global democracy	- NK accepts gradual democratization? - U.S. participation?	

Pre-conditions	**Stage 1: South-North Confederation** Duration 10 years	**Stage 2: Federation** Duration TBD	**Stage 3: Unified State**
Public support Gov't agreement	One nation, two states, Two systems, Two independent gov'ts	One nation, one state, One system, Two regional gov'ts	One nation, one state One system One gov't a. U. K. R. b. U. S. K.
CBMs: Basic Agreement Force reductions Arms control 4-party recognition	Continue ROK/DPRK Soveringty	Unify defense, foreign policy and trade matters	

Book Contents: Chap 1: Overview *
2: Confederation
3: Peaceful Coexistence
4: Economic Cooperation
5: Social-Cultural Cooperation

OUTLOOK
The Washington Post
SUNDAY, APRIL 12, 1998
Commentary
C
Editorials
Columnists
Close to Home

Korea's New Leader Turns North

By DON OBERDORFER

SEOUL

The car passed through two sets of heavily guarded, high steel gates and entered the grounds of the Blue House, South Korea's equivalent of the White House. We proceeded past the presidential offices up a hilly, winding road lined with majestic pine trees. I took off my shoes and donned slippers, as is the custom in most Korean homes, and was guided into a big living room. There, sitting alone, was a man whom I had met many times in the past quarter-century as a political prisoner, an opposition leader and fighter for democracy. Suddenly, the reality of a historic transformation came home to me. Kim Dae Jung, the country's most renowned dissident, has taken office as president of South Korea.

In many respects, this 74-year-old veteran politician has the most difficult job since South Korea's founding president, Syngman Rhee, led the country through its birth pangs and the Korean War in the 1950s. Due to the financial crisis that struck without warning in November, Kim must engineer extensive changes in the economic system that has been a remarkably

See KIM DAE JUNG, *C4, Col. 1*

Don Oberdorfer, a former Post reporter, is journalist-in-residence at the Foreign Policy Institute of Johns Hopkins University's Paul H. Nitze School of Advanced International Studies and author of "The Two Koreas: A Contemporary History" (Addison-Wesley).

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Kim Dae Jung's Initiative Goes Forward

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KIM DAE JUNG, *From C1*

successful engine of growth. Amid a painful recession, he must fulfill the requirements of the global economy and the strictures of the International Monetary Fund.

Even more daunting, he is trying to change the mind-set of Koreans toward the world outside and especially toward the brother enemy, the North Korean state just above the misnamed Demilitarized Zone, the most heavily fortified border anywhere in the post-Cold War world. In a decisive turn, Kim has put aside South Korea's traditional aspirations for both supremacy and unification, and has set out to coexist with the fierce but failing North Korean regime, relaxing restrictions on interaction between North and South. This policy shift has important consequences for the United States, which still maintains 37,000 troops on the Korean peninsula to preserve the fragile peace.

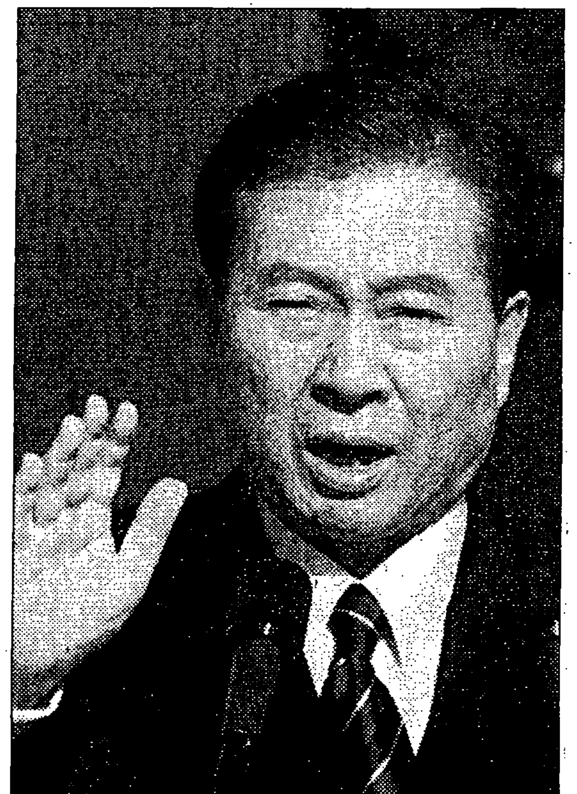
Instead of confrontation with the purpose of bringing about surrender or collapse, Kim's policy is to engage the North. By so doing, he wants to lower the tension on the peninsula to encourage what a senior aide calls "a gradual system transformation" in the North similar to that taking place in China and Vietnam.

Kim seemed serenely confident in his meeting with me that North Korea would validate and advance his policies by pursuing North-South dialogue and engagement, which it has shunned for most of this decade. His hopes were given a boost more quickly than almost anyone expected, when North Korea agreed last week to start official talks with the South for the first time in four years. The initial discussions, at the deputy-minister level, were scheduled to begin this weekend in Beijing.

Nonetheless, the track record of the North Korean regime, including its hard-line behavior at the just-completed four-party talks in Geneva, makes Kim's "sunshine" diplomacy a risky bet.

Yoo Chong Ha, foreign minister of the last government, says North Korea has a "structural inability" to deal with the South. Its political system rests on internal repression and external hostility justified by the life-or-death struggle for supremacy with the South, Yoo says, and it is impossible for the regime to give this up.

Kim's initiative began on the day of his inauguration. "We do not have any intention to undermine or absorb North Korea," Kim declared in his address on Feb. 25. This remarkable statement might not have been widely accepted by the South Korean populace three months earlier. However, the South's economic disaster underscored its inability to face the huge undertaking of unifying the peninsula by absorbing its poor cousins to the north. Because of the much wider disparity involved, this task would be several times as difficult and expensive as that faced by West Germany in absorbing East Germany after the collapse of the Berlin Wall.



FILE PHOTO BY YUN JAI-HYOUNG—ASSOCIATED PRESS

South Korean President Kim Dae Jung's efforts will have a greater chance of succeeding with U.S. backing.

In pursuit of his policy of "reconciliation and cooperation," his government has begun lifting existing restrictions on the flow of gifts, goods and investments from South to North. It is also lifting restrictions on travel to the North, seeking to develop people-to-people contacts ranging from reconciliation of divided families to joint tourist activities, and encouraging fund-raising activities in the South to provide aid to its impoverished cousins.

Plans have been announced to lift the long-standing ban on listening to North Korean radio and television, and eventually to eliminate the ban on North Korean written propaganda, possession of which has long been a crime in South Korea.

While Kim's steps are incremental and deliberately low-key, they add up to a reversal of the attitudes and operations of the predecessor government of his longtime rival, Kim Young Sam, who could never decide whether he wished to work with North Korea or to induce its final collapse.

In a more traditional mode, the new president has also set forth a warning: "We will never tolerate armed provocation of any kind."

I have known all of South Korea's presidents since Syngman Rhee and most of its senior politicians since I began covering Northeast Asia for the Post in 1972. Of them all, Kim Dae Jung has had the clearest and best articulated ideas about where he wanted to lead the country and especially about North-South issues. He was falsely accused of communist leanings by his political opposition in each of his four campaigns for the presidency, but never gave up his desire to engage the North. Kim's opposition to authoritarian rule and the fears his populism evoked in Korea's past military rulers led to his kidnapping from Japan by South Korean secret police, six years of imprisonment on trumped-up charges, a death sentence for sedition commuted under pressure from Washington and eight years of house arrest or forced exile.

Most recently, in a currently unfolding scandal, former leaders of the country's intelligence agency have been accused by prosecutors of agreeing to pay $250,000 to a U.S.-based Korean businessman to falsely accuse Kim of collaboration with North Korea in a series of news conferences during the latter days of the election campaign.

Kwon Young Hae, a former general who headed the spy agency at the time, slashed himself with a paper-cutting knife on March 21, in an apparent suicide attempt while under interrogation. There are extensive press reports—not confirmed by hard evidence at this writing—that South Korean agents or officials paid large sums of money to North Koreans in various secret attempts to smear Kim or assist his political opponents.

The North-South intrigue that has swirled about Kim has made the new president leery of clandestine contacts. North Korea sent signals to him during the post-election transition period that it would look favorably on a "personal" channel for secret dealings. Kim told me he rejected such entreaties, maintaining that such communications must be through official channels, although they might be "informal" for a time. Kim explained that he took this stand because the secret dealings of his predecessor were "not productive."

For the United States, Kim's decision to accept coexistence with Pyongyang for the foreseeable future should settle a debate in Congress and elsewhere about whether preservation of North Korea is a legitimate interim outcome. While nobody is anxious deliberately to prolong the life of that failing and abhorrent regime, a sudden or violent change would threaten stability, which is a central U.S. goal in Korea. Supplying food to North Korea's starving millions, as Washington is doing, helps prop up that regime, but is essential for inescapable humanitarian reasons.

During the dangerous struggle over the North Korean nuclear weapons program in the first half of this decade, Washington had to take the lead in policy toward Pyongyang. The United States is a nuclear weapons power, as South Korea is not; Washington alone possessed spy satellites, the main means of monitoring the North Korean program.

After the program was frozen in a negotiated deal, however, the North-South confrontation once again became the central issue. Neither the United States nor the three major powers surrounding Korea—China, Japan and Russia—has the foresight or the responsibility to work out the peninsular future. This task belongs to Koreans.

Washington should encourage South Korea to take the lead in North-South affairs. The United States should support Kim's policy by taking parallel steps, in close consultation with Seoul, to lift some of its own economic sanctions against North Korea. Kim's efforts have a greater possibility of succeeding—however great or small that may be—if they are backed by his powerful ally.

The United States apparently has gotten the message. U.S. Ambassador Stephen Bosworth is telling Koreans here in symbolic but unmistakable terms that a change is in the making: "We are both in the front seat of the car, and it is probably time for you to take the wheel for a while." Lest Koreans feel bereft of continuing U.S. support, Bosworth adds, "We'll be sitting right beside you."

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[005]

Pitfalls and Prospects: An Economic Roadmap to Korean Reunification

Pending Publication in Asian Survey, Spring 1998.
Brian Barna
APLA/Korea

b(3)

Introduction

The universe of "Soviet type" economies has now collapsed to one country—North Korea—that has yet to undertake fundamental reform.[1] [2] Although the North's economic system has endured the collapse of communism elsewhere, it is under severe stress. By its own admission, North Korea cannot produce enough food to feed its population—the most basic of economic failures—and observers report that industry is at a standstill. Once-generous Soviet aid is gone and assistance from China is limited.[3] The P'yongyang regime also faces these challenges without its charismatic founder, Kim Il-song, who died in 1994. The possibility that these economic stresses will overcome even the North Korean regime's brutal system of totalitarian controls is growing. Whatever the mechanics of the end of the current North Korean regime--coup or political and economic collapse--the most likely end result is that South Korea would be left to reconstruct the North.

This outcome is likely enough that the mechanics of such a reunification are worth considering.[4] If South Korea did inherit the North Korean economy, it would be faced with a problem of economic transition similar to that faced by Germany and reformers in other former communist nations. German unification has been more difficult and costly than expected; the Korean case would be worse. Korea would confront all the difficult issues that Germany faced but with fewer resources, a heavier relative burden, and a larger income gap. A particular problem would arise in applying South Korean institutions to North Korea. The South's economy contains distortions—such as dominance by large business groups and an underdeveloped financial sector—created by Seoul's past industrial policies. Indeed, some observers claim that South Korea developed rapidly by

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[1] The official name of North Korea is the Democratic Peoples' Republic of Korea; South Korea is formally known as the Republic of Korea. For convenience, I use North and South Korea.

[2] Reforms in Cuba may or may not qualify as "fundamental," but they go far beyond policy changes in North Korea.

[3] See Eberstadt, 1995.

[4] Some have argued that the North could revive its economy through a gradual opening to the outside world and economic reform. I would argue that the current North Korean leadership could not survive the ideological challenges broad market reform would pose. The most likely alternative to South Korean takeover if the current regime ended would be a takeover by elements of the Party or military, who would probably opt for reform in cooperation with South Korea. This scenario would present similar challenges to those outlined here. Another distinct possibility is that South Korea would maintain the North as a "client state" of sorts for an extended period--10 years or more. The country would be theoretically reunified, but the DMZ would remain and the North might keep a separate currency and economy. This option is potentially attractive to South Korean leaders seeking to minimize the turmoil and cost of reunification.

getting prices "wrong"—a questionable legacy for a government seeking to reform a command economy.[5]

An additional complicating factor would be the active animosity that has characterized North-South interaction since the Korean war. A product of this hostility—and the North's information controls—has been a virtually complete absence of contact between residents of North and South Korea, and lack of information on the part of North Koreans on true conditions in the South. The result would be greater suspicion of motives on both sides, making it more difficult to implement reforms.

Setting aside this animosity, reunification with the South would appear to present considerable advantages for North Korea over the difficulties of reforming without such support. The East German experience provides a warning, however:

> ...having a big brother has turned out to be not quite as beneficial as it first seemed to be. The big brother insisted on the restitution of his old property rights, he demanded the right to buy his little brother's assets, and he effectively protected himself against his little brother's low-wage competition. (Sinn and Sinn, Jumpstart, pg. 27.)

Literature Review

The reforms in the former East European states, Russia, China, and Vietnam have generated an extensive literature on the problems of transitioning from a planned to a market economy; German reunification has inspired work on the particular problems of repairing a national division. The literature is too extensive to summarize completely here, but examples on Eastern Europe include Patterson (development of the private sector in former command economies, examination of the private sector prior to transition); Blommestein and Marrese (property rights reform and macroeconomic stability); and Earle, Frydman, and Rapaczynski (privatization). Perhaps the best overall guide to the issues raised in economic transition (including information on China and, to a lesser extent, Vietnam) is the World Bank's From Plan to Market (World Development Report, 1996), which covers all major phases of transition from a cross-country perspective. Sinn and Sinn provide a thorough analysis of the economic problems of German reunification, including summaries of other studies.

Most work to date on Korean reunification has focused on estimating the costs, typically with models of capital accumulation. Lee (1996, 1994), for example, uses a Harrod-Domar growth model to estimate the rise in North Korean income (and the fall in South Korean growth) resulting from various levels of capital transfer to North Korea. Lee distinguishes between the "accounting costs" of reunification—direct spending—and foregone income in South Korea; he concludes lost income in the South would be more than offset by income gains in the North. Noland (1996c) presents a number of scenarios contingent on different levels of capital transfers from South to North Korea, and takes

[5] See Amsden.

the prize for the most frightening total cost figure—more than $1 trillion over 10 years. Noland (1996d) models the gains from reform in the North with a computable general equilibrium model that uses a Chinese input-output matrix as a proxy for the North Korean economy.

A few authors have addressed the implications of the German experience for Korea, although for the most part they have devoted more effort to summarizing the German case than speculating about Korea. Examples include Noland (1996a), which briefly covers currency conversion, wage policy, and restitution for seized property, and Wegner, who deals almost exclusively with Germany. The South Korean government has also dispatched a number of officials to Germany to study reunification. There is also the broader issue of language; for this paper, I have reviewed only English-language publications, and there are certainly relevant works in other languages, particularly Korean.

The focus on unification costs is understandable given that the most obvious concern for South Korea is the enormous financial burden of reunification. There is a need, however, to examine the steps necessary to transform North Korea's economy, since the difficulties of this endeavor go far beyond the financial burden it would generate. The institutional environment in the former North Korea—and corresponding incentives to investors, savers, entrepreneurs, and labor market participants—would be perhaps even more important to a successful transition than financial transfers. Persistent underdevelopment in many third-world nations despite decades of aid illustrates that financial flows alone are not sufficient to ensure development, and the same would be true in North Korea. Moreover, a major influence on what sort of market institutions would arise in a reunified Korea would be those in South Korea, institutions that, although market oriented, reflect decades of interventionist industrial policy.

The North Korean Economy

Essential to any study of economic transition is an understanding of the economy to be transformed. This is particularly difficult in the North Korean case because the North's government has not released meaningful economic statistics for several decades; it treats economic data as state secrets, and severely restricts the activities of visitors. This is true even in comparison to other communist nations—the Soviet Union, for example, provided a wealth of data compared to North Korea. A partial opening to international aid workers in the past two years has allowed a bit more information out, however, and North Korean officials have recently made general statements about economic problems.[6] The South Korean government has also long released estimates of North Korean

[6] North Korean officials have also made sporadic claims about macroeconomic indicators, most recently when they reported to the United Nations that their GDP was $5.2 billion, down from $11.7 billion in 1993, or $239 per capita, down from $547. (According to a South Korean official quoted in the South Korean Yonhap news service, 23 July 1997.) There is little reason to believe that this figure represent anything but carefully targeted propaganda. The most recent disclosure, for example, was apparently an attempt by the North to cut its UN dues.

economic performance, presumably based on intelligence information.[7] According to these estimates—published by the Bank of Korea—North Korean GNP in 1996 was $21.4 billion, or $910 per capita.

There is a consensus that economic performance in North Korea has deteriorated sharply in the 1990s as a result of the loss of Soviet aid; according to official South Korean estimates, the North's GNP has contracted by more than 25 percent in real terms since 1989; figures provided by P'yongyang to the United Nations in mid-1997 imply an even sharper drop of more than 75 percent.[8] Reports from international aid workers and tales from defectors indicate that shortages of food and medicine are widespread, and even North Korean officials have admitted that their most recent harvest fell more than 1 million tons short of what is needed to feed the population at even modest levels.

There is also general agreement on the structure of the North Korean economy, including the fact that it is the world's most centrally planned.[9] More notably, this is also a claim that could have been made 10 years ago. The state owns nearly all property; industry, particularly heavy industry, has been developed at the expense of light and service industries; and consumption has been suppressed. North Korean economic management depends heavily on moral exhortations and coercion to a degree equaled only in Maoist China and the Stalin-era Soviet Union; material incentives are weak at best.[10] Other than very small garden plots, agriculture is completely collectivized. Most farms are organized as collectives—where workers receive a percentage of output—the rest as state farms, where workers are paid salaries. North Korea is also one of the world's most autarkic economies, with exports and imports together equal to roughly 10 percent of GNP.

The North devotes considerable resources to its military. A commonly accepted figure is 25 percent of GNP; it is impossible to know the true number given the lack of macroeconomic data and the distortions in North Korean prices, but this is probably on the correct order of magnitude. ~~It may even understates the current burden, given that the North Korean economy has been shrinking since 1990 without a corresponding drop in size of its military.~~ At the very least, the military places a tremendous drain on labor supplies. Roughly 6 percent of the North Korean population is on active military duty—

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[7] South Korean estimates are available for North Korean overall GNP and some subsectors. There are basic problems using market measures of performance to assess a command economy, however. For example, North Korean goods must be valued by some proxy prices, which are unlikely to be equal to the prices the goods would received on an open market.

[8] Eberstadt (Policy and Performance..) also makes a convincing case that growth in North Korea has been slowing since the 1970s as the country exhausted extensive growth opportunities, a decline masked by a jump in Soviet aid from 1984-1989.

[9] The best overview of openly available literature is Noland (1996a); see also the CIA World Factbook. South Korean estimates are published by the Bank of Korea, and are quoted extensively in the literature, including in Lee (1996).

[10] Scalapino and Lee present an excellent overview of North Korean economic management techniques, an overview that remains current despite the age of the book.

only slightly less than the percentage of the US population in service at the height of World War II, and this figure does not include many ten of thousands more devoted to internal security forces. Given the decline in the North's industrial output, the labor drain may be the largest current burden the military places on the economy. The accumulated capital stock in military industries represents a sunk cost, an important point in that the resources that could be freed up through demilitarization may be essentially limited to labor.

It is also apparent that North Korea spends quite a bit to support the Kim family personality cult and on prestige and showcase projects. The nation is littered with monuments, statues, and museums devoted to Kim Il-song and Kim Chong-il, his son and current North Korean leader; any place where either Kim has ever set foot immediately becomes a shrine of sorts. Many large construction projects—including a recently built tourist highway; private citizens in the North generally do not own cars—appear to have prestige rather than practical value. In one extreme example, North Korean officials claimed they spent over $3 billion—more than 10 percent of GNP—on construction projects related to the 1989 World Youth Games in an attempt to match Seoul's Olympic success.[11]

Stages of Economic Transition

The limits of prediction. The lack of information on North Korea's economy limits the detail with which the specifics of transition can be predicted. For example, attempts to formally model the North's economy—including Noland (1996d)—are at least somewhat unconvincing because the lack of data forces the use of improbable proxies. In Noland's model, for example, a Chinese input-output table is used to simulate North Korea's economy; this may capture the appropriate technological coefficients, but probably provides only rough approximations of dynamic changes. This lack of knowledge of the current state of the North Korean economy also makes any specific predictions about its transformation highly suspect. For this reason, estimates of the costs of reunification should be treated with great skepticism as well. They are most usefully interpreted as orders of magnitude. Costs will be strongly influenced by the manner in which the North Korean economy is reformed and integrated into that of the South; models of capital accumulation alone do not take this into account.

It is possible, however, to say something about the issues that would arise in transition and sketch out the environment that would condition Korean policy choices. The experiences of other transition economies, particularly the former East Germany, offer a roadmap to the issues a reunified Korea would confront. There are a number of stages common to all transitions from planned to market systems, such as price liberalization and privatization, and particular issues that arise in reunifying a divided nation, such as currency conversion and unification of factor markets. There is a natural order to only

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[11] The North Koreans may have been converting domestic *won* expenditures to dollars at the official rate of 2.2 *won* per dollar. Black-market rates are much higher, reflecting the *won's* lower real value, suggesting that actual expenditures, while still significant, were much lower.

some stages—currency conversion and price liberalization almost certainly come first, but privatization and other structural reforms have no definite order.

There are clear lessons for Korea from the German case, and the basic outlines of the process would be similar. That said, there are a number of key differences. Most obvious are the different relative population and wealth ratios. The residents of the former East Germany comprise only about one-fifth of the population of the unified country; former North Koreans would make up a third of a united Korea. The relatively higher ratio of North Koreans suggests a larger relative burden for South Korea, all other things being equal. And they are not. Per capita income in West Germany at the time of unification was perhaps two to three times that in East Germany, and East Germany was the most advanced economy of the Soviet bloc.[12] The income differential between South and North Korea is much higher—perhaps as high as 10 to 1—suggesting that the gap would take much longer to close, and that incentives for North Koreans to move southward and other social tensions would be that much greater.[13]

West Germany was also much better able to bear the burdens of unification than South Korea would be. West Germany was (and a united Germany still is) one of the world's preeminent developed economies, with considerable foreign assets, a long-standing trade surplus, and leading-edge industries. South Korea is a successful newly-industrialized country, with a significant trade deficit—nearly 5 percent of GDP in 1996--and net foreign debts of more than $30 billion. South Korean political and legal institutions are also much less developed than those in Germany—the current South Korean President is the first to assume office without a military background since the 1960s, and only the second to be freely elected since the Korean war.

Institution building—property rights and the rule of law. Perhaps the most difficult issue faced by most transition economies is building the institutions and legal assurances of a market economy from scratch. For example, ensuring individual rights to use, receive income from, sell, or alter private property requires a legal framework. This requires contract law, police enforcement, and a broad societal acceptance of market principles. On an even more basic level, those who hold property must have assurances (explicit or implicit) that it will not be arbitrarily confiscated by the state. Without this framework, individuals have little incentive to acquire property, to improve properties they own, or make other long-term investments. For example, the owner of a firm must be certain that a contract to sell his output will be honored; that his property will be protected against theft; that his neighbors will not seek to punish him should he become successful; and that the state will not arbitrarily seize his profits. Without these assurances, few

[12] Noland, 1996e, pg. 14.

[13] Estimating North Korean per capita income is a tricky business; the 10-1 ratio is drawn from the official South Korean estimate of North Korean per capita GNP of $920 in 1996. Based on anecdotal reports of North Korean living conditions and the long tradition of overestimating GNP in communist countries, I suspect that this figure overstates North Korean welfare. However, Noland (1996e) calculates a much smaller ratio, on the order of 5-1 on a purchasing power parity basis.

owners will be willing to risk their money to produce and employ workers.[14] Even more complex issues arise over competition policy and other issues.

Implementing all these things simultaneously has proved a tall order for many transition economies (see Rapaczynski, McFaul, and Pistor and Turkewitz for examples). The proper theoretical model is also a subject of intense debate, including the dilemma of building a government strong enough to ensure the institutions of a market economy, yet somehow constrained against using its strength to confiscate private resources. Or put another way, the question is how the government can credibly promise not to do this in future, in order to foster long-term private investments. In practice, this credibility appears to be something that is most often built up over time, as in the developed West and Japan; it is particularly difficult when the current government's immediate predecessor was explicitly devoted to state control over economic activity, as in Eastern Europe.

The counterpoint to building the proper government institutions is instilling popular belief in the market mechanism. This "mental transition" is particularly important in Eastern Europe and most of the successor states of the Soviet Union, where countries are attempting to move to a democratic government and market economy simultaneously. If citizens in a new democracy are unsure as to the rewards of a market economy, they may well use their new political powers to redistribute resources, rather than putting in place safeguards against such redistribution. Barro's results, for example, suggest that democracy is a "luxury good," and that poor democracies are more likely to engage in rent-seeking behavior that then undermines democratic freedoms and market incentives.

The German experience suggests that one way out of this dilemma is to be taken over by a state that has well-developed legal institutions and a long history of market-oriented behavior; the former East Germany faces few of the problems outlined above (compared to other transition economies). The Korean case would probably be closer to the German experience than that of transition economies, but shortcoming in the South Korean record would present complications not faced in Germany. The former North would inherit South Korea's market institutions including contract law, a court system, and a tradition of moderate state respect for private property. Even given that the South's institutions fall short of the ideal--particularly compared those of West Germany--they still form the essential institutional foundations of a market economy, and the former North Korea would probably avoid many of the problems of formal institution building that have plagued other transition economies. Of course, former North Koreans might not be so quick to trust South Korean officials and institutions.

Popular acceptance of the operations of a market economy might present even more problems, including raising social tensions and complicating the eventual transition to democracy in the former North. After the economic transition, some North Koreans would do much better than others, simply because a market economy rewards individuals

[14] Certainly, the "rule of law" is a continuum rather than an absolute condition; China so far has grown with less than robust property rights. The lack of secure property rights is an increasing source of difficulty in China, however, as more complex businesses develop.

disproportionately (although typically in relation to effort and talent). Although there are income gaps now in the North—mainly due to political influence—such disparities would certainly become more widespread and visible. Some former Southerners would also likely lose from reunification, particularly low-skill workers who would have to compete with cheap labor in the former North and would face lower wages or unemployment as a result.[15] There would be a natural tendency for politicians in a unified nation to exploit these feelings, building coalitions to redistribute income. This would cause tensions in the former South, and might lead to delays in extending voting rights to former Northerners, because these tendencies would certainly become apparent before political rights are extended.[16]

Currency conversion. In the Korean case, the first issue to be dealt with is currency conversion—what would the North Korean won be worth?[17] There are two main theoretical issues in setting a conversion rate—the "traded-goods" exchange values of the two currencies, and the purchasing power equivalent. The traded-goods rate would be the rate that would prevail in the free exchange of goods across an international border, with a freely floating exchange rate. Such an exchange rate measures the price ratio of domestic to foreign goods; the higher the rate (the weaker the domestic currency), the more domestic goods it takes to buy a set quantity of foreign goods. In a transition to a market economy, a nation that produces uncompetitive goods will find that its currency is worth little on traded goods basis; it will take a relatively greater quantity of poor quality domestic goods to purchase a set quantity of foreign goods.

The other theoretical framework for currency conversion is purchasing power parity (PPP)—an attempt to account for the actual buying power of each currency in its home country. In international comparisons, PPP is a theoretically constructed exchange rate that takes into account the lower prices of nontraded goods in some countries; per capita GDP is then converted at this new rate, rather than at market exchange rates. A PPP exchange rate can imply lower or higher national wealth; national income in most developing countries appears much higher when measured in PPP terms because of their lower prices of services and land. By contrast, PPP measures reveal that some nations such as Japan and Switzerland, which have the highest per capita incomes based on

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[15] Changes in relative prices for some goods in a unified Korea--such as those produced by cheaper labor in the North--might raise real incomes in the former South, however, potentially offsetting some of this effect.

[16] The entire question of when to extend voting rights to the former Northerners is greatly complicated by Article 4 of the Republic of Korea constitution, which says the ROK will "carry out a policy of peaceful unification based on the principle of freedom and democracy." This strongly implies that efforts to delay granting voting rights in the North beyond some "emergency" period could face legal challenges, mounted perhaps by forward-looking Southern politicians.

[17] Of course, South Korea could retain a separate currency for the North and declare a North-South free trade area with flexible exchange rates between North and South Korean currencies. According to Sinn and Sinn, this option was rejected in the German case out of fear that it might delay or prevent unification—a concern that would probably not be relevant if South Korea absorbed the North. Kwon makes a persuasive case for this option based on a comparative study of monetary unification in Germany, Yemen, and the European Union.

exchange rate conversions, are not as well off as they appear because of the higher prices they pay for nontraded goods.

The first question is: is there a traded-goods rate, or a reasonably proxy, between the North and South Korean *won*? The official fixed exchange rate is roughly 2.2 North Korea *won* per US dollar—or roughly 400 South Korean *won* per North Korean *won*—but there is no reason to believe this reflects anything other than an arbitrary value, perhaps based on the perceived prestige of having a currency near parity with the US dollar. In fact, there is very little information on which to decide, in advance, what a "correct" conversion rate would be for the currency held by former North Koreans.[18] It is possible, however, to use the theoretical framework outlined above to consider the likely influences on a conversion rate, and point out a number of issues that would arise depending on that rate.

It may first be useful to summarize what Germany did.[19] East Germans were allowed to convert *ostmarks* (East German currency) to *deutchmarks* at a 1-1 exchange rate up to a limited amount of money based on age, 6,000 marks at most, and at 2-1 after that amount. Wages, prices, and pensions were converted at 1-1, while debts and other financial claims were converted at 2-1. East German currency acquired for speculative reasons (in the year before unification) was converted at 3-1. The conversion rate was primarily a political decision; the head of Germany's central bank publicly referred to it as a "disaster."[20]

Although it is possible that South Korean politicians would arbitrarily set a conversion rate, it is likely they will be more systematic, given the widespread perception that the German experience was indeed catastrophic. The first step in setting a conversion rate would be to discover what the traded-goods rate would be. Although there is no open market for North Korean currency, there are a number of indirect sources of information on what a free market rate might be. The most appealing on one level is the black-market rate, which does at least represent a market-determined rate of exchange. Although there is no direct exchange of North and South Korean currency, there is a black-market exchange rate between North Korean *won* and other hard currencies, including the US dollar. This rate could provide a proxy for an exchange rate with South Korean *won* (since the *won* and dollar are freely traded). Some recent press reports claim that the North is now allowing "free" exchange in the Najin-Sonbong Free Economic and Trade Zone at the rate of 200 *won* per dollar; this implies a rate of roughly 4 South Korean *won* per North Korean *won*.[21]

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[18] North Korea has a number of different types of currency, including "local use" *won* and foreign exchange *won*, a hard currency proxy. The North also uses "friendship" *won* for visitors from other socialist countries, although the importance of this currency has obviously declined.
[19] See Sinn and Sinn, chapter 3, for a detailed discussion of German currency conversion.
[20] Ibid., pg. 51.
[21] See Hoon, pg. 75.

A conversion rate based only on a black-market rate is likely to understate the value of North Korean currency, however. A black-market rate is one that prevails under a number of distortions, most obviously, a restricted supply of foreign currency. In socialist systems, there may also be an excess supply of domestic currency—a "monetary overhang"—if citizens have been forced to hold cash because desired goods are rationed. There is also a risk premium associated with a black-market rate—since such exchange is illegal—that would further distort such transactions. This risk premium is a function of the probability of being caught and the severity of the punishment; given the North Korean state's pervasive security apparatus and reputation for severe punishments for minor offenses, this risk premium could be quite high. The direction of this distortion is uncertain, however, since it is illegal both to sell and to buy foreign currency.

Despite these complicating factors, it is still possible to say something in general about what a traded-goods conversion rate for the North Korean *won* might be. Recalling that such a rate is determined by the attractiveness of domestic goods relative to foreign products, the North Korean won is likely to be worth very little. The shadow exchange rate that prevailed in trade between the two Germanys, for example, was roughly 4 *ostmarks* per *deutchmark*, reflecting low East German productivity in export goods. Judging by the relatively higher quality of East German goods compared to North Korean products, the North Korean rate will reflect an even lower relative value. The most important indicator here is that North Korea manages to export very little to market economies. Also, the prices the North receives for the few goods it does sell on international markets—such as cement and steel—probably fail to cover their true costs, particularly if energy and other inputs are also at market prices. In fact, North Korean output may actually reflect negative value added at market prices (a final output value of a good less than the value of inputs used to produce it; steel that would sell for less in an open market than the iron ore and energy used to produce it), although this would be very difficult to calculate in that it would require knowledge of market-equivalent capital costs, wages, and input prices.

The other major factor Korean authorities would want to take into account in setting a conversion rate is relative purchasing power. In a unified nation, many nontraded goods would suddenly become tradable, and a conversion rate based only on the traded-goods exchange rate may shortchange one side. Sinn and Sinn (chapter 3), for example, argue that in the German case, the purchasing power of the *ostmark* and the *deutchmark* may well have been equal because of the lower price of nontraded goods in the East. As evidence for parity, they argue that if a 1-1 rate undervalued the *ostmark* (as many at the time held), then the currency conversion should have resulted in a huge increase in East German wealth and a subsequent economic boom. In fact, a severe recession followed.[22]

The implications of a relative purchasing power argument for Korea are unclear, if only because of the extreme distortions of the North Korean economy. In theory, services in lower-wage North Korea should be cheaper, but in practice, North Korea has so thoroughly suppressed the service sector that this might not be the case, at least initially.

[22] There were of course many other reasons for this economic contraction.

Land should be cheaper as well—but there is no way to tell under current prices, since land is all owned by the state. The relevant measure then would probably not be prevailing prices, but prices that emerged after a market economy began to develop—presenting a serious problem if currency conversion is one of the first post-reunification tasks. The only solution would be for South Korean policymakers to assume that lower wages and incomes in the North would leave the prices of non-traded goods lower, and accordingly set a conversion rate higher than that implied by traded goods alone.

There are a number of practical effects that would flow from the conversion rate. The first is the wealth effect. The more even the rate of exchange, the more wealth the former North Koreans would bring to a unified Korea. In East Germany, for example, demand deposits turned out to be the only wealth many households had, since they were largely forbidden to accumulate property or financial assets, and consumption was suppressed. The possibility exists, however, that North Koreans do not hold large amounts of even their own currency--because of periodic (1972, 1992 at least) official currency swaps, apparently designed to flush out illegally earned cash--and conversion policies designed to provide wealth may not do so.

The currency exchange rate would also help determine the initial competitiveness of (former) North Korean goods in the unified market by determining how high North Korean nominal wages were relative to those in South Korea. The more even the exchange rate, the lower the competitiveness of North Korean goods, both in competing in the South, and against imported South Korean goods in the North. In Germany, the 1-1 conversion rate for wages left Eastern nominal wages at about one-third of those in West Germany. German officials thought this would keep many Eastern firms competitive, since labor productivity in East Germany was estimated at one-third to one-half of West German levels. Severe problems arose in export industries, where East German productivity was much lower and wages in terms of export goods were far too high to compete with West German products. (Even worse, nominal wages also rose rapidly—see below). Even where productivity was in line with wages, East German capital had long been devoted to producing goods for which there was no market, at almost any price. For example, almost nobody was willing to purchase a new Trabant at a price anywhere close to covering manufacturing costs when used Volkswagens were readily available. (For more detail on this point, see below in the discussion on privatization).

North Korean workers would certainly be willing to work for low wages, but North Korean productivity remains a bit of a mystery. The "highly skilled, low wage North Korean worker" is a popular image in the South Korean press, fueled no doubt by hopeful South Korean business leaders who have weathered rapid wage increases in the South. Compared to workers in still-rural China or Vietnam, North Koreans certainly have more experience in industrial settings, and are by all accounts more literate. They may work harder simply out of relief at being rid of the constant ideological hectoring that pervades North Korean factories. The counterpoint is the question of what sort of work habits have developed under decades of socialism (and accompanying lack of material incentives). Coercive management methods may have minimized gross shirking, at least in comparison to the former Soviet Union and Eastern Europe, but poor habits have probably taken root in the years that North Korean factories have been running at small fractions of capacity. It remains uncertain how North Korean workers will respond once these methods end.

Price liberalization. Once the medium of exchange is settled, the next question concerns what it would be used to purchase, or price liberalization. Price signals are the most fundamental market mechanism. Rising real prices induce producers to produce more and lead consumers to consume less; the lack of price signals is one of the fundamental problems of command economies. Clearly, liberalization is needed, since currently all North Korean prices are controlled and queuing—rather than the price mechanism—is the rationing system for most goods. Lessons from other transition economies in this case are mostly negative; there has been a marked tendency to retain controls on the prices of a number of goods on equity grounds. The former Soviet Union, many countries in Eastern Europe, and China continue to subsidize items such as household energy, rents, and public transportation.[23] Even in East Germany, rents were frozen for a time. Although there are valid concerns about the affordability of basic necessities in transition economies, continued price controls retain the same inefficiencies that crippled overall economic performance in the past. For example, consumers will certainly overuse subsidized energy, and controlled rents will result in underinvestment in real estate. These issues are also often entwined with difficult privatization questions, such as for monopoly energy producers.

The disastrous state of the North Korean economy might actually make price liberalization easier. In other transition economies, authorities have been reluctant to lift existing controls because consumers were actually obtaining some quantity of the goods in question at the subsidized prices. Consumers who are forced to trade subsidized food and electricity for high market prices are sure to complain, but the relevant choice in the North Korean case is between no food or electricity, and market pricing. The magnitude of North Korean humanitarian needs would make it easy for assistance to be delivered in a transparent fashion, with direct grants rather than subsidies. The one subsidized benefit North Koreans apparently still enjoy is housing, and rents as a result may be difficult to liberalize.

Internal factor movements. A reunified Korean government would also need to make immediate choices about internal movements of goods and factors of production. The theoretical basis for this is relatively simple. The argument for free movement of goods is that a larger market supports larger scale production and specialization. Free movement of factors of production—labor and capital—allows them to move to their highest valued uses, or where returns are greatest. All these arguments would apply doubly to the former North Korean economy, where decades of central planning have misallocated resources.

[23] See World Bank, pg. 24 (boxes 2.1 and 2.2).

The least controversial is probably movement of goods. North Korea's economy is such a small fraction of that of the South's that, from the standpoint of most South Korean firms, a unified market will essentially still be South Korea. To be sure, Northern firms (whenever they come into existence), will benefit greatly from the existence of the South Korean market—which has been largely closed to them to date. In the short run, however, North Korean factories would be unlikely to produce much in demand in the South, and aid programs would account for most Northern consumption of Southern products. Even with greater North Korean initial wealth—for example, from a generous currency conversion program—North Korean factories do not exist to produce the consumer goods that would probably be in highest demand as a result of decades of suppressed consumption.

Free movement of capital also seems to present few problems; the obvious direction is from South Korea to North Korea. Since most of North Korea's capital stock is essentially worthless, the former North would be labor abundant and capital scarce, suggesting high marginal returns to capital. There are also obvious advantages to the South Korean government of private firms investing in North Korea.

The only potential policy concern here is that to the extent South Korean firms do invest in North Korea, they would do so at the expense of investing in the South—with potential consequences for employment and output there. Gross fixed capital formation in South Korea in 1996 topped $140 billion; diversion of even a fraction of this to North Korea would represent a substantial sum of investment by North Korean standards.[24] It is also reasonable to assume that South Korean companies would shift some portion of their overseas investments to the North. Total South Korean outbound foreign direct investment (FDI) is relatively modest as compared with Japan or even Taiwan, $3 billion in 1995, but even this amount could have a substantial positive effect on the North. South Korean investment is not vitally important to any FDI recipient; the most severe effect would probably be in northeastern China, where South Korean firms have been the leading investors.

Labor movement—internal migration—however, would present serious complications. The model here is uncomplicated—the tremendous gap between Northern and Southern wages is an obvious inducement for Northerners to migrate to South Korea. As in Germany, there would be no language barrier, and some Northerners have relatives in South Korea who might assist them. There would be demand for North Korean labor in the South. The South Korean labor market is very tight, with one of the world's lowest unemployment rates and shortages of low-skill labor have already led to inflows of perhaps 200,000 foreign workers. Noland and others have estimated potential flows from North Korea at several million. Such a migration would strain South Korean social services (which are rudimentary in any case) and undermine wages in the South.

There are two possible ways South Korean authorities could limit North Korean migration. The first is to maintain existing controls on internal migration and keep the

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[24] Economic Statistics Yearbook, pg. 275.

Demilitarized Zone as a barrier. This could be combined with a guest worker program to ease South Korean labor shortages, and other limited movements, such as for family reunification. This strategy, however, would probably spur protests from many South Koreans as well as South Korean allies including the United States, not to mention international human rights groups. It would put South Korean officials in the difficult position of using deadly force to restrain the movements of their own citizens. Any attempt to confer "junior" status on former Northerners would also clash with Article 4 of the ROK constitution, which implies that even present North Korean residents are citizens of the Republic of Korea.

The other solution is to make it economically unattractive for North Koreans to migrate. A short-term strategy would be to distribute aid only in the former North Korea, and only to individuals in their original places of residence—the North Korean government has detailed records. This raises practical questions, however, since it is likely that only some members of North Korean families will move; a typical pattern could be a younger son or daughter going South, while the parents stayed in the former North to collect assistance. The only check on this would be some system that requires that beneficiaries physically present themselves to receive aid, inevitably raising costs.[25] The only viable long-term strategy is to raise income levels in the North sufficiently high to keep at least most North Koreans home. It is important to note that income equality is not necessary to achieve this. As Noland (1996e) notes, a per capita income gap of 100 percent between the poorest and richest US states has persisted for decades; similar gaps persist in South Korea and the former West Germany.

In the German case, the 1-1 conversion rate for wages was supposed to result in incomes sufficiently high to choke off migration, yet keep East German industries competitive.[26] Whether this policy alone would have worked is unknown. East German workers, urged on by West German unions, demanded and received rapid wage increases following unification. Sinn and Sinn (pp. 164-168) also argue that the wage increases resulted from a principal-agent problem; the negotiations were conducted between the East German workers and the *Treuhand* (privatization agency), which represented the interests of business owners in that it "owned" all the firms. The *Treuhand*, however, as a government agency did not feel it was its place to resist wage demands; it failed as the "agent" of future owners of East German enterprises, now made uncompetitive by unrealistically high wages.

All this presents a seemingly simple lesson for South Korea; keep North Korean wages in line with productivity. This will be an easier task than it was in Germany, if only because the German policy has so clearly been disastrous. Also, the relative bargaining position of unions in South Korea remains much weaker than those in Germany, and thus they would probably lack the political clout to push for high wages in North Korea. North Korean productivity and wages are likely to be very low at first, if only because

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[25] Most costs would probably be in the form of time of former North Koreans who would be forced to take time off work, etc.
[26] See Sinn and Sinn, chapter 3.

South Korean workers have much more capital to work with. There is a natural tension, however, between low wages for North Koreans and a desire to head off migration. The only solution seems to be a long-term system of direct income transfers, which would minimize distortions (relative to forced wage increases or goods subsidies).

Privatization. The most fundamental aspect of communism is state ownership of the means of production, so arguably the most fundamental issues of economic transition is privatization, the transfer of state assets into private hands. It is difficult, however, to construct a single theoretical model of privatization, since the issues raised depend greatly on the overall environment of privatization—one firm in an otherwise private economy presents far different problems from an attempt to privatize large portions of an economy at once. The privatization of firms in the United Kingdom, such as British Airways, represents one limiting case—the issues raised concern only the firm. At the other end of the spectrum are the efforts in Eastern Europe to privatize large parts of the economy, including the entire industrial sector. The reforms in Latin American in the 1980s represent the middle ground—the privatization of hundreds of state firms at one time in an otherwise market economy.

All these models, however, present complex trade-offs on issues including fairness; speed; access to new technology, capital, and management skills; and government revenue.[27] The pace of privatization is also important; moving too swiftly risks exhausting the stock of potential investors and their financing, while moving too slowly requires continued subsidies for unproductive enterprises, and risks missing a political window of opportunity for difficult reforms.

Perhaps the simplest model for disposing of businesses is cash sale of intact enterprises, to either local residents or outside parties. This was the method chosen by Germany; it has also been used in other advanced countries, such as the United Kingdom. In theory, investors in the privatized firm will pay the present discounted value of the company's expected future income stream. When firms are actually sold, this method results in better management, access to capital and new technology, and immediate government revenue, so long as the firm's liabilities are low enough. This method appears to work best in developed countries privatizing a limited number of firms; there are plenty of investors (with management skills) relative to the number of firms being offered, and well-developed financial markets to support sales. This method foundered in Germany, however, mostly because the *Treuhand* attempted to sell off essentially an entire economy over a limited time period.[28] This overwhelmed potential investors; there was not enough capital or management talent to absorb such a large number of companies at once on a cash sale basis. The result was a dramatic fall in prices received for firms; the *Treuhand* realized just 10 percent of the revenue it initially expected.[29]

[27] See World Bank, chapter 3, for a succinct overview.
[28] The reasons listed here are a very short summary of a detailed discussion in Sinn and Sinn, pp. 81-132.
[29] Ibid.

Another major form of privatization is to transfer ownership of a firm to its employees and management, either through a management/employee buyout, or a legal version of "spontaneous privatization" where current users of a property claim ownership, essentially a buyout without the formalities. The advantages of this method are that it transfers firms quickly to private ownership, and it may put them in the hands of those with some knowledge of the business. There are numerous difficulties, however. Current managers know how to operate only under a planned system, and are almost certainly ill-prepared to compete in the market. There are no resources available for the new investments almost certainly needed to make firms competitive. Workers may vote themselves wage increases, and manager "owners" may loot assets. This method is also confers smaller gains on those who happen to work for less valuable firms—their stake in the privatized economy is reduced compared to those who happen to work for more viable concerns.

A number of countries, most notably the Czech Republic, have tried some sort of voucher program, where all citizens are given a set number of coupons that can be used to purchase shares of private corporations.[30] These vouchers can also be used to buy shares in investment funds that then purchase companies. This method scores high on fairness—citizens share equally in the value of former state firms, and given sufficient secondary markets for vouchers, they can convert this wealth into cash. It also divorces ownership from management, and may make it easier for foreign firms—with management skills—to buy into privatized firms.

The main problem with privatizing North Korean firms is that most of them are likely to be worthless. For one, a large fraction of the North's industry is devoted to military production; a reunified Korea would have no need for a such a large defense complex, and these facilities produce obsolete equipment in any case. Large parts of the North's capital stock are devoted to producing other goods with no possible market, such as black and white televisions that receive only one channel. Also, the North's factories are based on obsolete Soviet technology, with the exception of a few turnkey factories imported from the west in the 1970s that have been probably been poorly maintained. A few enterprises—such as hydroelectric power plants—still operate Japanese equipment from the colonial period. More generally, North Korean industries are organized around factor proportions that would not be efficient at world input prices (for example, a factory constructed under the assumption that subsidized Soviet oil will be available may be hopelessly inefficient at world market oil prices), and much of this capital must be scrapped. This is an example of the "putty-clay" theory of capital—before investment, it can be devoted to any number of projects (like putty), but after, it is fixed to a specific use not easily changed (like clay).[31] North Korean industrial capital is thus fixed in inefficient combinations.

[30] For the details of the Czech program, see Jan Mladek 'The Different Paths to Privatization in Czechoslovakia, 1990-?" in Earle, Frydman, and Rapaczynski, pp. 121-146.
[31] See Ibid., 221-224 for a detailed application to the German case.

As a result, cash sales are likely to find few takers, and management/employee buyouts simply shift the problem—firms will be no more viable under private management than they were in state hands. This lack of value would obviously undermine any privatization method for North Korean enterprises—the state may need to pay potential buyers to take over firms, leaving no wealth to distribute to former North Koreans.

If nearly all North Korean enterprises would not be viable, then the question shifts to how they should be closed down—immediately, or with some delay? This would be a difficult issue. There would be considerable temptation to subsidize North Korean industries, if only to avoid social upheaval, since private investment would take quite some time to provide jobs for displaced workers. There would also be a temporary need for the products of some North Korean basic industries. For example, reconstruction in the North would temporarily boost demand for steel and cement; there is ample production capacity for both in the North. South Korean steelmaking capacity is already insufficient to meet demand there, so the alternative to purchasing North Korean steel is imports.

The problem arises when the temporary increase in demand is over, and these factories must be shut down. The problem in other countries is typically that subsidies, once started, are politically difficult to stop. This is one area where the interventionist legacy of South Korean industrial policy may actually be a plus—South Korean officials have a long and credible record of disciplining firms independent of the potential political consequences that would serve them well in eventually cutting loose temporarily subsidized North Korea enterprises.[32]

Competition policy is a necessary complement to privatization. The *Treuhand* took care to ensure that East German enterprises were not sold to West German competitors, who might have simply closed them down (although there is debate on the degree to which this has actually been accomplished). Also, another key facet of the transition to a market economy is the entrance of new firms into the market. How privatization is handled has serious implication for this. South Korea's economy is characterized by significant industrial concentration, with a few top-tier international firms such as Hyundai, and many technologically backward small companies. The privatization of North Korean enterprises presents either a chance to introduce more competition, or strengthen the hand of current market leaders (also see *Building financial institutions* below).

Other categories of former North Korean assets may present fewer problems; unlike industrial capital, land and residential and commercial property will retain value in a market economy. First is agricultural land. Privatization here could be relatively easy—land could simply be allotted to current workers on collective farms. A near-universal response to breaking up collectives has been increased output, as those who work land now have greater incentive to invest time and inputs since they receive the full benefits of such efforts. If agricultural land is truly a "national" asset, then this would shortchange urban residents—some 75 percent of the population—but this would need to be balanced

[32] See Amsden, pp. 14-18.

against the speed and simplicity offered by this method. Farmers could also claim that their effort over the years had given them particular claim to the land.

Another difficult issue would be the extension of current South Korean agricultural policies to the North. South Korean agriculture is highly protected and inefficient. After unification, South Korean farmers would certainly press for some sort of protection from Northern agriculture, which could compete on the basis of lower wages, if nothing else. The most costly, albeit likely, alternative is the intact extension of the South Korean system. For example, the South Korean government buys the entire rice crop at prices far above world market levels, and sells it to consumers for less than it pays farmers, resulting in substantial costs. This could simply be extended to North Korean farms. A more courageous South Korean government could seize on unification as an opportunity to push through much-needed reforms in the South.

Privatization of commercial property presents modest, but not insurmountable challenges. Most important, such property, particularly in urban areas, will almost certainly increase in value under a market system as retail and other services develop. As a result, there will be buyers, and such sales should reap substantial revenue. The simplest solution would be for the government to sell it off at auction, perhaps with some reservation for former Northerners (who would otherwise be out-spent by Southerners). The North's massive array of monuments and public buildings, however, might not be so easy to dispose of, although they might serve as tourist attractions.

The final category of assets is housing. This may well be the easiest of all—housing could simply be given to current residents. North Koreans, even in rural areas, tend to live in apartments rather individual houses; this would present some problems of indivisible common property, but no more than those that the affect a condominium development in the United States.

Restitution. Regardless of the privatization method chosen, a major complicating factor in privatization is the issue of restitution for property seized by the North Korean government. Of course, most claims would be made by North Korean residents for properties seized by the former North Korean state. Most politically difficult, however, would be claims by former North Koreans who fled southward before and during the Korean war, particularly if current North Korean residents are occupying such properties.

Restitution was a major issue in Germany. The German government opted for "natural restitution" where claimants were compensated with the return of the seized property.[33] Difficulties arise when there are a number of claims to a property—as was common in Germany—and investment in privatized firms has been reduced. Investors were never certain that a former owner would not emerge—one who has first claim on the property. The main alternative German policymakers considered was for the government to pay monetary compensation, which allows privatization to proceed regardless of the

[33] Sinn and Sinn., chapter 4.

speed of settlement for restitution claims. This was rejected because of the expense; it is unclear how expensive this would be in the Korean case.

Some other former communist nations, such as Estonia, have tried restitution in kind. This appears to work well when small enterprises are returned to their former owners, who often put the firm back into operation far more quickly then if the state had to sell it; claims also appear to be less complex than the German case.[34] By contrast, Hungary compensated former owners with privatization vouchers. As a result, some assets have been held out of production longer, but investors are freed of the possibility that their claim to a property might be disputed.

There are a number of reasons why claims in the Korean case are likely to be more limited than in Germany. Before partition, Germany had a well-developed private sector, with tens of thousands of firms, and widespread private ownership of land. Thousands of East Germans fled west during the years of division. By contrast, Korea before division was a Japanese colony, and nearly all major firms and a majority of agricultural land were in Japanese hands.[35] Although millions fled south between 1945 and 1950--abandoning significant amounts of property--there has been almost no migration between the two countries since the war. Also, the devastation of the Korean war—and subsequent construction—have ensured that few buildings once owned by Northerners who fled south still survive, except possibly in small towns. Still, the main lesson remains that compensation—rather than in-kind restitution—would result in more investment because potential investors need not worry about restitution claims muddying property rights.

Building financial institutions. The good news in North Korea is that, unlike most other transition economies, it would not face the major task of building a market system of financial intermediation from scratch. A system that encourages savings, and then channels those funds to investment projects is one of the fundamentals of a market economy. Institutions such as stock and bond markets allow companies to finance larger investments than they could with cash flow alone. Building such institutions is difficult for a number of reasons, including the problems of finding skilled regulators and of building appropriate legal structures and informal market understandings.

The bad news is that the North would be saddled with South Korea's distorted financial sector. South Korean banks were long used as tools of industrial policy, and the rest of the financial sector is similarly underdeveloped, a legacy of heavy-handed control

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[34] See World Bank, pg. 59, box 3.7.

[35] Japanese claims will not be forthcoming—in fact, the Japanese government has acknowledged its obligation to pay reparations for its colonial rule to North Korea, although the lack of diplomatic relations between Japan and North Korea has stalled payment. Japan paid $600 million in reparations to South Korea when the two countries normalized ties in 1963. An equivalent amount today would be between $1 billion and $8 billion~~, depending on assumptions about inflation and accumulated interest~~. Lower estimates assume only accumulated inflation on the original dollar amount; higher estimates add interest and exchange rate changes; the original amount was in yen, and the yen is now worth three times as much in dollar terms as it was in 1963.

by the Ministry of Finance.[36] South Korean interest rates remain higher than world levels, and smaller companies often cannot obtain loans even at these rates since banks lack loan evaluation skills and often demand collateral rather than performing cash flow analyses. The recent Hanbo scandal and Kia bankruptcy and associated banking problems have only highlighted the weaknesses of the South's financial sector.

One of the main effects of the distorted South Korean financial system is to perpetuate a two-tier economy, with a few world-class large enterprises (Samsung, Hyundai, Daewoo) and many small, weak, firms. This has important transition implications, because the emergence of new companies in a transition economy is at least as important as privatizing former state enterprises. This would be particularly important in North Korea, because there are huge gaps in North Korea's industrial structure, including light industrial and service industries, and few existing firms are likely to be viable in any case.

If South Korean financial institutions are transferred intact to North Korea, new North Korean firms will probably find it nearly impossible to obtain bank financing, making it even less likely that significant numbers of indigenous North Korean firms would arise. As a result, most of the economy would be under South Korean control. More specifically, if the pattern that exists in South Korea is perpetuated in the North, the former North Korean economy will be dominated by large South Korean conglomerates.

External economic policies. Transition economies also must make decisions on trade and inward foreign direct investment (FDI) policies. There are of course the standard benefits of free trade—including static income gains through reallocation of resources to take advantage of comparative advantages and the more dynamic gains from exposing firms to the pressures of international competition, forcing innovation. FDI flows also present possible benefits, including an increased capital stock (and higher wages), transfers of technology and management techniques, and potential linkages with domestic firms.

It seems likely that the former North Korea might have to forego many of these advantages. The trade policies of a unified Korea would be strongly influenced by South Korea's still-restrictive trade and foreign investment regime. As a result of these protections, many sectors of the South Korean economy, including retail and other services, are highly inefficient. Export oriented companies became competitive only because of government-mandated export targets which forced them to compete on world markets.[37] The economy of the former North Korea might develop in a similar fashion, or even worse if similar export performance standards are not imposed.

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[36] See Amsden, chapter 3, which focuses on the success of the South's industrial policies, but pays less attention to the resulting distortions.
[37] See Ibid., and Eberstadt (Policy and Performance), who argues that export orientation was the "one big thing" South Korean authorities got right that overwhelmed the negative effects of other distortions.

There is also the issue of current South Korean commitments to multilateral organizations, including the WTO and the OECD. For example, South Korea acceded to the WTO as a developed country—with attendant requirements for faster liberalization—only with great reluctance; a unified Korea would suddenly be a much less developed nation, and have some justification in demanding less stringent terms that those applied to South Korea alone. The trade interests of a united Korea would also change. South Korea's largest export is electronics, followed by autos, chemicals, and other heavy manufactures. The former North Korea's comparative advantage would certainly be in low-wage, labor-intensive products such as textiles and footwear, but the North is currently locked out of at least the US market. ~~most major markets since it has not joined multilateral trade agreements on the subject.~~ A unified Korean government might demand new textile quotas, and perhaps other trade benefits from the United States and other developed nations.

South Korea also presents a questionable legacy on FDI, which after all, could ease the burden of reunification by providing outside capital to aid in the reconstruction of the North. South Korean economic officials have long limited foreign investment, and the South met most of its foreign capital needs through extensive borrowing. South Korea's gross foreign debt is now more than $100 billion, although growing South Korean assets overseas reduce the net total to just more than $30 billion in mid-1997. Many South Korean officials have also expressed concern that Japanese and US companies would exploit opportunities in North Korea at the expense of South Korean firms. All these factors make it likely that a reunified Korea will restrict FDI into the former North; the only question may be to what degree.

The counterpart to FDI policy is regulation of capital flows, important here in the context of external financing of unification. The situation would be very different from that faced by Germany, which was a capital exporter before reunification (and thus had a substantial current account surplus). South Korea has a perennial current account deficit (other than a short period in the late 1980s) and the current account gap in 1996 was nearly 5 percent of GDP. Also the 1996 gap represents in part short-term events such as a fall in semiconductor prices and rise in oil import costs; deficits of anywhere near that size would certainly be unsustainable under the pressures of reunification, suggesting that austerity policies of some flavor might be necessary. Perhaps the good news here is that South Korea is not big enough to move world interest rates; tight German monetary policy following reunification and the resulting high interest rates posed major problems for other EU nations.

Looking Ahead

It is possible to draw some tentative conclusions about what sort of economy might emerge in North Korea. Noland (1996b) has constructed estimates of potential North Korean comparative advantages based on an examination of areas where South Korea and Japan are losing comparative advantage; unsurprisingly, he finds the former North Korea would have a comparative advantage in light, labor-intensive manufactures. He also used a gravity model to predict a reformed North's likely trade structure, predicting North Korea would trade mostly with South Korea, Japan, and the United States. China would occupy a relatively less important position than it does now as the North's current largest trading partner, a position that apparently depends largely on political, rather than economic causes.

Reunification would probably be initially welcomed by most Northerners, as it would provide an immediate relief from pressing food shortages. It is likely, however, that considerable resentment would develop over time. Under unification, North Korean residents would see two points of pride—heavy industry and the military—disappear. North Korean workers who once built and operated steel mills and hydroelectric dams would make cheap textiles and athletic shoes, and work for South Korean or foreign firms. Economic improvements in the North could also result in a crisis of rising expectations, particularly given that the large income gap between North and South would persist for decades under the most favorable assumptions.[38]

There also would inevitably be "donor fatigue" on the part of former South Koreans—once again, a lesson drawn from the German experience. This would probably manifest in growing political opposition to the taxes needed to finance unification, labor actions against North Korean competition, or calls for restrictions on North Korean products. North Korean workers would be obvious targets for organization by South Korean unions. There also probably develop social tensions between former Northerners and Southerners. South Korea currently has significant regional tensions, with the residents of the southwestern *Cholla* provinces looked down upon by the rest of the nation, a role North Koreans would undoubtedly step into.[39]

The Good News

Unification would bring economic gains, although these would be concentrated in the North until quite some time after. In the long term, a unified Korea would be a more significant world player, if only because of its larger population—65 million—and resultant larger internal market for its companies. It would be a nation with a much lower defense burden, and one with the 50-year-old threat of military conflict removed.

A unified Korea would also quickly become the region's most sought-after ally, as the largest, richest, and most powerful nation without "historical baggage" of territorial ambitions. China would no doubt be eager to ensure that a unified nation was at least not hostile to Chinese interests; Japan and the United States could not afford a Korea that was

[38] This is simply a mathematical exercise; the speed of convergence depends on the relative difference in growth rates. Lee (1994) predicts income equality in 32 years under the most optimistic assumptions. Another set of reasonable assumptions—based on gradually slowing growth in both the North and South, and a narrowing growth gap as they converge to world technological frontiers—leaves the North behind for nearly 100 years.

[39] I am indebted to a senior colleague at the Central Intelligence Agency for these thoughts on social tensions in a united Korea.

tied too closely to China. A new Korea would thus be in an historically unprecedented position of strength in foreign affairs.

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