

CHAPTER 8

ECONOMIC ALTERNATIVES FOR UNIFICATION¹

Marcus Noland

Introduction.

On the Korean peninsula, the world confronts a face-off between what is surely one of the greatest success stories of the post-war era and one of the last of a dying breed of totalitarian dinosaurs. This situation creates fundamental policy dilemmas of enormous practical and ethical import for the rest of the world. Judged in terms of the share of population under arms or the share of military expenditures in national income, North Korea continues to maintain the most militarized society on Earth. It produces and exports ballistic missiles and is thought to possess large stores of chemical and biological weapons, and possibly nuclear weapons as well. It invaded the South once and in subsequent years engaged in state-sponsored terrorism against the South. Internally, it maintains a personality cult around the deceased Kim Il Sung and his son, Kim Jong Il, of religious proportions and has one of the worst human rights records of any state existent today. A famine has claimed the lives of perhaps 10 percent of the pre-crisis population. This is fundamentally a systemic crisis, not a period of aberrant performance due to bad weather or unfavorable external shocks, though both have contributed to North Korea's current predicament. Yet to paraphrase Mark Twain, reports of the regime's collapse have been an exaggeration, and its durability has confounded numerous observers.

The Kim Jong II regime presents the United States with strategic and humanitarian challenges, and its peaceful elimination would surely be the first-best solution from a U.S. perspective. Two aspects of that statement bear elaboration. First, note the use of the term “regime.” Ultimately, it is the Kim Jong II regime that presents the United States with such challenges—not the existence of an independent North Korean state. Presumably the United States could easily live with a divided though suitably demilitarized peninsula. Whether a non-Kim regime would be viable in the North for any extended period of time is another matter, and there are reasons for skepticism. But from the standpoint of logical consistency, we should be clear that it is the regime, not the state, to which we fundamentally object.

Second, note the modifier “peaceful.” Obviously, if we could obtain our first-best solution in a relatively costless manner, that would be our preferred option. Presumably, as costs increase, less ambitious outcomes would begin to appear more attractive. At the extreme, few, if any, U.S. policymakers would regard total war as an acceptable cost for the elimination of the Kim Jong II regime.

These two considerations quickly lead us into the gray world of choosing among second-bests. I have been charged with writing a chapter on the economics of Korean unification. However, as implied in the discussion above, unification itself could take different modalities and be achieved through different paths. For the sake of concreteness, I will focus on two possibilities. In the first, unification is a protracted, negotiated process yielding some kind of confederation or “one nation, two systems” outcome. This is the official position of both the North and South Korean governments today as reaffirmed in the June 2000 summit.

The other option, of course, is the collapse of North Korea and its absorption into South Korea along the lines of the German experience. These two options are neither

exhaustive, nor mutually exclusive: the two states could enter into a consensual process of unification and the North could collapse before this was completed, or one side or the other could attempt a forcible unification. Nevertheless, the dichotomy is useful for illustrating some alternative conceptions of the economic precursors to unification as well as to its effects.

Consensual Unification.

Both North and South Korea have expressed a desire for a consensual unification of the peninsula. Kim Dae Jung has repeatedly indicated his lack of interest in undermining the DPRK and has instead called for peaceful coexistence. In his "Berlin Declaration" of March 2000, President Kim indicated that the South Korean government was willing to directly support the economic rehabilitation of the North, and "economic cooperation" was identified as one of the priorities for action in the June 2000 summit declaration. The South Korean unification plan is gradual in the extreme, envisioning a process of unification lasting two generations. It put forward a plan for federation at the summit.

For its part, North Korea has proposed a Confederal Republic of Koryo to be governed by a national assembly consisting of an equal number of representatives from North and South Korea.² The statement in a 1999 meeting at the Council of Foreign Relations by North Korean Foreign Minister Paek Nam-sun that North Korea could consider a "one country, two systems" model along the lines of Hong Kong and China could be interpreted as a signal that North Korea was open to this kind of engagement.

The announcement in April 2000 that leaders of the North and South would meet in the first ever North-South summit stunned the world. While this could be no more than a tactical move on the part of the North Koreans timed to extract maximum concessions out of an electorally weak Kim Dae Jung and pliant Clinton administration, the

possibility that this represents a significant strategic shift on the part of a newly confident Kim Jong Il cannot be entirely discounted.³ Only time will tell. It is hard to argue, though, that recent diplomatic developments reduce the likelihood of consensual integration.

In a formal sense, one can imagine a series of progressively deeper steps of integration that the states could undertake. Perhaps the first, and simplest, would be the formation of a free trade area, freeing trade between the two Koreas but permitting each to restrict trade with third parties according to their own interests. This would be equivalent to the North American Free Trade Agreement (NAFTA) in which trade is unencumbered among the United States, Canada, and Mexico, but each country maintains its own trade policies with respect to nonmembers. Even this first step would appear to be far beyond anything that can be seriously expected in the near term. The next step would be the formation of a customs union which would involve applying a common policy to trade with third parties. This would be akin to the European Economic Community (EEC).

Economic union would be a deeper form of integration, permitting the free movement of labor, capital, and goods across borders, as exists in the European Union (EU) today. A monetary union would involve the adoption of a single currency, as is in process in some EU member states today. A social union would involve the adoption of common labor and social welfare policies in the two states. The final stage would be political union and the surrender of independent claims on sovereignty. The EU has managed to create an economic union and is in the process of forging social and political union. Within this schema there are differing degrees of surrender of local authority to central governments. Presumably, given the radically different social and political systems of North and South Korea, any form of consensual political integration would involve the maintenance of extensive local autonomy. Indeed, given the highly centralized nature of the governing systems of both

North and South Korea, issues of local autonomy and control would presumably be highly contentious under any unification scheme.

Coping with the Present. Thus the prerequisites for a consensual unification would be maintenance of two independent states and a sufficient degree of convergence of economic and political practices to make the outcome plausible. In the case at hand, this means averting a collapse in the North and generating sufficient reform in the North's economic and political system to make some degree of integration with the South sustainable. The issue of political change is well beyond my competence, and I will focus on the economic issue.

In the simplest terms, the North Korean economy no longer works. It does not generate enough output to sustain its population biologically, nor, absent fundamental economic reforms, will it do so in the future. Faced with this situation, Pyongyang has pursued essentially two coping strategies. The first strategy has been the pursuit of "one-off" projects to generate foreign exchange without affecting the systemic organization of the economy. These projects would include the Rajin-Sonbong special economic zone (SEZ) and the Mt. Kumgang tourism project. The October 1998 agreement between Hyundai and Pyongyang is important in this regard. First, payments committed to by Hyundai dwarf anything that North Korea could plausibly earn in Rajin-Sonbong, and, second, the Hyundai agreement extends the possibility of the construction of a new SEZ.

With respect to the former, Hyundai has guaranteed North Korea \$942 over 75 months, with the payment schedule front-loaded for the first 6 months. (Indeed, the North Koreans used brinkmanship to extract up-front payments before the first tour visited Mt. Kumgang in November 1998.) At \$300 per passenger, North Korea stands to make \$450 million per year off the tourism agreement alone in the admittedly unlikely case that

Hyundai is able to reach its target of 1.5 million visitors per year in 2005.⁴ To put this in perspective, this money, if properly deployed, would be enough to close the North Korean food gap and end the famine. Unfortunately, it is believed that the funds are going into the Macau bank account of "Bureau 39," a party organization controlled by Kim Jong Il, to be used to reward his cronies and prop up his rule. If this is how the Mt. Kumgang tourism project plays out, it will amount to a successful version of what Rajin-Sonbong is not—a regime-preserving hard currency earner with no real systemic implications for the organization of the North Korean economy or society.

In this respect, the rest of the Hyundai deal might be more significant. The agreement also calls for the development of a second SEZ in Haeju, north of Incheon. This appears to have far greater prospects than Rajin-Sonbong. First, the geographical location is far more auspicious. Second, it has the backing of Hyundai (and presumably the South Korean government). This is critical both from the standpoint that it provides the necessary infrastructure (which Rajin-Sonbong sorely lacks) and carries the imprimatur of Hyundai (and by extension the South Korean government). Thus, South Korean small- and medium-sized enterprises are far more likely to move light manufacturing operations to Haeju than Rajin-Sonbong.⁵

The second has been the use of implicit or explicit threats in developing nuclear weapon and missile capabilities in order to extract resources from the rest of the world. In this view, the aversion of a military confrontation with the United States in 1994 has given North Korea an opportunity to develop more effective means of extorting resources from the rest of the world and pushing for unification on their terms. North Korea's August 1998 public announcement of its missile exports and its test of a multistage rocket, and its apparently renewed nuclear-related activities, perhaps give some indication of the country's future course. The marriage of the rocket and nuclear programs would give the North Koreans impressive

tools with which to intimidate their immediate neighbors and create proliferation nightmares for the rest of the world. The truly frightening aspect of such reasoning is that this scenario would be a continuation of the status quo. Ironically, given obstacles to successful reform, such an externally high-risk strategy might be the path of least resistance internally to a weak and risk-averse regime. North Korea could continue to play a strategy of attempting to extort resources out of the rest of the world, offering to abandon weapons development and export while continuing to make clandestine sales. In this regard, recent diplomatic interchanges potentially represent a major step forward in stopping the North's nuclear weapons and long-range missile programs and in normalizing its relations with the rest of the world.

In the absence of significant economic rehabilitation, North Korea will require external support for the foreseeable future. Yet the world community is unlikely to continue this support unless North Korea continues to pose a security threat to its neighbors. Collapse would pose great risks to international political stability, especially if it were accompanied by civil war and military intervention by external powers. Surrounding countries—South Korea, China, and Japan—and the United States have demonstrated a willingness to provide this support and more, for fear of North Korea's collapse, or, what would be worse, an internal conflict or lashing out which could put millions of people in Northeast Asia in harm's way, including thousands of U.S. troops stationed in South Korea and Japan.

The provision of such aid is tied to the existence of this security threat. If North Korea was simply a country with a broken economy and 22 million impoverished citizens, it is extremely unlikely that a multinational consortium would be pouring in billions of dollars of aid in the form of food and infrastructural investments. There are plenty of such countries in Central Asia and Africa, but the rest of the world does not build them light water nuclear reactors or

refurbish their electrical grids. Indeed, one could argue that not even the famine distinguishes North Korea—the contemporaneous situations in Africa are as bad if not worse.⁶ Rather, North Korea's ability to extract such resources from the world community is intimately related to the threat it poses, so that, in this sense, the status quo more closely resembles extortion than charity. The threat North Korea poses is its sole asset. It is unlikely to negotiate away this asset very easily.

Getting from Here to There. All this is to say that successful consensual unification would require a significant reorientation of North Korean policy. Cooperation could be expected to yield economic benefits to North Korea in the form of enhanced trade and investment, assistance from multilateral development banks, and settlement of post-colonial claims against Japan. At the same time, to obtain these benefits North Korea presumably would have to forego its current revenues from exportation of medium-range missiles and weapons of mass destruction, drug trafficking, and counterfeiting. Furthermore, North Korea would have to settle private claims arising from past international loan defaults were it to reenter international capital markets. Such a deal could well involve the alteration or renegotiation of the Agreed Framework upon which much of North Korea's economic interaction with the rest of the world is conditioned.

Fundamental reform of the North Korean economy would have two profound effects: first, there would be a significant increase in exposure to international trade and investment (much of this with South Korea and Japan, two countries with which North Korea maintains problematic relations), and second, changes in the composition of output could be tremendous, involving literally millions of workers changing employment.⁷ Both developments could be expected to have enormous political implications; or, alternatively, these implications could be thought to present significant, perhaps insurmountable, obstacles to reform under the current regime. Moreover, prospective

reformers in the North would have to deal with their divided country situation—something with which the authorities in China and Vietnam did not have to contend.⁸

Nevertheless, it is possible that North Korea could attempt a less ambitious reorientation of its economic policies and practices supported by help from abroad.⁹ The North Korean economy desperately needs two things to meet the minimum survival requirements of its population: food and energy. It may well be that the country obtains enough income through production or aid to attain the minimum survival basket, but chooses not to do so (i.e., the regime has a strong preference for guns over butter). Taking these preferences as given, how much additional income would the country need to hit the minimum survival basket? Under current conditions North Korea runs a structural annual food deficit of around two million tons. The cost of closing this gap through commercial imports would be on the order of several hundred million dollars, depending on prevailing global prices. For the last 5 years, this gap has mainly been closed through the provision of international assistance.¹⁰ This reflects both North Korean political interests—why pay for something that can be obtained for free?—and the political interests of Western governments, most prominently that of the United States, which face less domestic resistance to providing in-kind “humanitarian relief” to North Korea than straight aid to the Kim Jong II regime.

In addition to food, North Korea needs energy. It is reliant on imported oil to generate fuels and fertilizer for use in transportation and agriculture. Electricity is mainly generated using coal and hydropower. Generation has been hampered by difficulties in extracting increasingly inaccessible and low-quality domestic coal reserves. Beyond this problem, the power grid (largely underground for security purposes) is said to suffer from extraordinarily large transmission losses. The 1994 Agreed Framework between North Korea and the United States provides for the construction of two light water reactors and the provision of

oil in the interim. The problem is that this is essentially a diplomatic agreement concerning North Korea's nuclear program, and does not really address the true needs of the North Korean economy. From an economics standpoint, it would be better to renegotiate the Agreed Framework, scrapping the costly light water reactors and instead building more cost-effective electrical generating systems, refurbishing the existing electrical grid, and building the necessary infrastructure that would allow North Korea to export electricity to South Korea and China, thereby earning foreign exchange.¹¹

Nevertheless, if these estimates are correct and the Framework Agreement as negotiated is fully implemented, the actual cost of purchasing the estimated shortfalls in grain and energy inputs, as well as desperately needed supplies of fertilizers, pharmaceuticals, etc., might not be very large, less than \$1 billion dollars.¹² Assuming no more interruptions in service, the Hyundai-Mt. Kumgang tourism deal guarantees North Korea nearly \$150 million annually over the relevant period. This is a minimum. North Korea receives a payment per visitor. If Hyundai were to fill all the berths on its ships, North Korea would stand to net approximately \$450 million per year—or enough to cover its grain deficit on commercial terms. Moreover, other South Korean firms have expressed interest in similar tourist ventures. If the North Koreans went through with the other projects in the Hyundai agreement, including the establishment of a new SEZ at Haeju, this could generate additional revenues.

For \$2 billion annually, one could fix the North Korean economy sufficiently that it would generate rising living standards and possibly reduce discontent and contribute to political stability.¹³ Around half of this would be for recurrent flow consumption expenditures, and around half would be for industrial and infrastructural investments that could be self-financed through export revenues. Most of this trade would be with South Korea and Japan, with China and the United States playing smaller roles—even

with the United States partially lifting its embargo against North Korea in June 2000.¹⁴ Thus the necessary recurrent external financing needs would be around \$1 billion annually.

Where could this money come from? There are many possibilities, but the single biggest potential source of additional financing would be the resolution of North Korea's post-colonial claims against Japan. This issue was raised by former U.S. Secretary of Defense William Perry during his visit to Pyongyang last year. The Japanese government paid the South Korean government \$800 million in compensation for colonial and wartime activities at the time of normalization of diplomatic relations in 1965, with \$300 million in the form of grants, \$200 million in development assistance loans, and \$300 million in commercial credits. The North Korean government expects similar compensation. Adjusting the South Korean payment for differences in population, accrued interest, inflation, and appreciation of the yen since 1965, one obtains a figure in excess of \$20 billion.

An additional issue raised by the North Koreans that was not included in the South Korean package is compensation for "comfort women" who were pressed into sexual slavery during the Second World War. Reputedly, settlement figures on the order of \$5-8 billion have been discussed within the Japanese government. In comparison, Yi Chong-hyok, Vice Chairman of the Korea Asia-Pacific Peace Committee, a Korean Workers' Part (KWP) organization, in remarks before a Washington audience in 1996 indicated that \$10 billion would be the minimum compensation. Japan will certainly argue that its food aid and its billion dollar contribution to the Korean Peninsula Energy Development Organization (KEDO) should be counted against this charge. Some have speculated that Japan will even try to claim credit for the costs of recapitalizing bankrupt *Chochongryun*-controlled financial institutions in Japan. In any event, such sums, properly

deployed, could go a long way in restoring North Korea creditworthiness and financing economic modernization.

If North Korea were to accept the Perry review's terms of engagement, another carrot that the United States, Japan, and South Korea could hold out would be membership in the international financial organizations and the prospect of multilateral economic assistance. Pyongyang has periodically expressed interest in joining the International Monetary Fund (IMF), World Bank, and Asian Development Bank (ADB). Membership talks have never made much progress, however, for they have snagged on North Korea's unwillingness to permit the kind of access to economic data and information required for membership in these organizations and Japanese opposition relating to unresolved political issues, most notably the alleged kidnapping of Japanese citizens. Under normal circumstances, if North Korea were to join these organizations in the absence of considerable reorientation in domestic economic policies, it would be unlikely that the multilateral development banks would make significant loans.

However, given the political importance of North Korea to the United States and Japan (influential shareholders in the World Bank, and the dominant shareholders in the ADB), one would expect that North Korea might receive favorable treatment.¹⁵ Technical advice and assistance would really be more important than direct lending activities, which would ultimately only complement the activities of private investors. Working from the case of Vietnam (another Asian transitional economy where the government undertook rapid economic reforms) and scaling down the multilateral development banks' lending program for the smaller size of the North Korean population, one projects lending on a scale of \$150-250 billion annually. Not trivial, but not enough to finance even a bare-bones recovery program. More money might be available if the United States, Japan, South Korea, and others set up a special fund for North Korea at the World Bank or ADB. Such a fund

might be a particularly useful way of politically laundering Japanese reparations.

It is possible that under some circumstances North Korea could obtain international financial institution loans even if it were not a member.¹⁶ For example, the World Bank maintains a special program for peace and sustainable development in the Middle East through which it makes loans in the areas controlled by the Palestinian Authority. It also has adopted a policy that allows it to assist countries which are emerging from crises even though they are not members in good standing of the Bank. This policy was adopted after the Bank was precluded from lending to Cambodia because of a debt arrearage problem. The key attributes in these cases appear to be a cooperative recipient government and strong support from major Bank shareholders. Bank staff have also expressed the view privately that an independent, poor North Korea would probably be able to access more lending than a unified middle-income Korea. Either way, the settlement of post-colonial claims with Japan would dwarf anything North Korea could expect from the multilateral development banks.

These developments might be thought of as the necessary, though not sufficient, conditions for consensual unification. Even if they were to occur, they would get the two Koreas only part way down the road. Moreover, these developments do not necessarily imply progress toward consensual unification. North Korea could adopt the minimalist reform program and reject unification overtures from the South. Indeed, while implementing such a program, the North might feel compelled to limit discussion of unification precisely to prevent system overload and a loss of control.

Collapse.

Of course, although this minimalist reform scenario appears relatively attainable, there is no guarantee that

such an outcome will eventuate. It is possible, though unlikely, that North Korea will not undertake the policy changes necessary to ensure its own survival, and instead could collapse and be absorbed by South Korea as was the case in Germany.¹⁷ Such a development could greatly change the economic calculus on the Korean peninsula.

The relatively cheap minimalist reform scenario depends on the stability of the North Korean state and the consequent ability to maintain enormously different levels of income across the two parts of the Korean peninsula. A collapse would set in motion economic and political forces that would make the maintenance of such enormous disparities difficult, if not impossible, to sustain for any protracted period of time.

Differences between the German and Korean situations may be revealing in this regard. For one thing, North Korea is relatively larger. Its population is roughly half that of the South, whereas East Germany's was roughly a quarter of West Germany's. Second, income disparities are far greater across the two Koreas than across the two Germanys. Although the whole notion of income is problematic in centrally planned economies, pre-unification per capita income was probably three to four times higher in West Germany than in East Germany. In the Korean case, the ratio is more likely to be on the order of 12 or 15 to 1. Finally, demographically today the population of North Korea is younger than the population of East Germany was at the time of unification. The relatively larger, poorer, and younger population of North Korea all points to migration as being a potentially more important issue in the Korean case than in the German case.¹⁸

Indeed, were Korean unification to occur, the government would face rising expectations among the populace of the North and a desire to migrate south in search of better lives. It is possible, though unlikely, that the government could use the Demilitarized Zone as a method of population influx control for an extended period

of time while conditions in the North slowly improved. However, the political imperative would be to improve conditions in the North rapidly.

The conventional wisdom is that the Germans made a fundamental mistake in setting the unification exchange rate, and considerable economic distress in East Germany was due to this avoidable error. A more careful analysis suggests that it was wage policies, a product of German institutions and political incentives, not the exchange rate that priced East German labor out of the market. Moreover, misguided labor market policies were compounded by mistakes regarding privatization and restitution policies, as well as competition (antitrust) policies, all of which combined to greatly reduce the demand for goods produced in East Germany.¹⁹ However, even under a relatively optimistic scenario of moderate, controlled, cross-border migration, and rapid convergence in North Korea toward South Korean levels of productivity, bringing the level of income in North Korea to half that of the South would require a decade and hundreds of billions of dollars of investment—transfers larger in relative terms than in the German case.²⁰

This would not be pure “cost,” however. Some in South Korea could arguably benefit in this scenario. Investment in the North would earn remitted profits to owners of capital in the South, and the process could be expected to shift the distribution of income away from labor and toward capital. At the same time, there would be shifts in the income distribution among different classes of labor, with the distribution of income shifting toward higher skilled classes of labor. Another cleavage would be between sectors producing internationally traded goods such as manufactures, and nontraded goods such as construction, with the nontraded goods sector doing relatively better. The bottom line is that if you are a South Korean construction magnate with savings to invest in unification bonds, Korean unification could be very good for you. If you are a

low-skilled manufacturing worker, it could be a very different story.

The question then arises as to what, if anything, can South Korea, the United States, and others do to prepare for such a contingency? South Korea's need to prepare for the contingencies of unification with North Korea and its need to strengthen its financial system in the wake of its own financial crisis coincide. In the event of unification, there is absolutely no reason to finance the construction of infrastructure out of current tax receipts. Instead, the government will want to use both taxes and bonds to finance unification expenditures. Hence the development of a robust government bond market prior to unification should be a priority. A second priority would be the rejuvenation of South Korea's flagging privatization program: there is no reason why the privatization agenda in the North should be more aggressive than the one that currently exists in the South.²¹ Finally, once the current crisis in South Korea is surmounted, South Korea will want to return to a policy of fiscal rectitude, and salt away some reserves for this potential rainy day. A strong government financial position would both allow it scope for immediate expenditures in the event, and facilitate the issuance of "unification bonds."

At the moment of collapse in this scenario, there will be a critical need for close coordination among the militaries of the United States, South Korea, and China, since presumably they will be central to maintaining order, handling refugee flows, etc. This cannot be overemphasized, though further discussion is really beyond the scope of this paper. Once the situation on the ground has stabilized, longer-run political and economic policies come to the fore. As indicated earlier, there is an extensive literature on the lessons for Korea from German unification, and the South Korean government has devoted considerable resources to studying this topic.

At the time of unification, the South Korean government will have multiple (and potentially conflicting) policy

objectives. On the one hand, maintenance of economic activity in the North on market-consistent terms will be the top priority. At the same time, the government should seek to effect a one-time-only wealth transfer to the current North Korean population since they will have to adjust to market institutions with virtually no household wealth. One can imagine a multi-pronged approach:

- Adopt dual rate monetary conversion. Aim for slight undervaluation of the North Korean won to maintain competitiveness, thereby making North Korea an attractive location for investment. Convert personal savings at an overvalued rate (effecting a wealth transfer).

- Deed land to the tiller and the housing stock to its occupants, contingent on maintained use for some specified period of time.

- Maintain some kind of temporary, emergency, non-market social safety net in the North.

Having given the land to the tiller, one must confront the issue of property rights claims by past owners or their descendants and the more general issue of assignment of property rights to commercial or industrial assets. Lessons learned from the experience of Germany and other former centrally planned economies (CPEs) are instructive in this regard:

- Avoid the policy of restitution for seized assets. Monetary compensation for seized assets might be considered, though even some South Korean analysts have argued that this would be a mistake.

- Privatize quickly and avoid the cash-on-the-barrel-head model.

- Abolish inter-enterprise debts.

- Emphasize investment, not consumption, transfers.

- Accept assistance from foreigners, including the Japanese.

With respect to privatization, the experience of East Germany and other CPEs suggests that it would be best to move quickly and avoid the cash-in-advance model, since it would severely restrict potential buyers. Attempts to restructure these enterprises before privatization should also be avoided. That is better left to the market. Inter-firm debts, which are a legacy of irrational policies under the centrally planned regime, should be written off. Debt-equity swaps could be used to pay off external debt and at the same time create a stake in the viability of North Korean enterprises for South Korean or foreign firms.

Given these considerations, there appears to be one institution in South Korea ideally suited for the task of making North Korea competitive: the *chaebol* (conglomerates). Unfortunately, one policy goal (to get the North Korean economy functioning as rapidly as possible) and another policy goal (to clean up business-government relations in South Korea) would conflict. It goes without saying which one will receive the greater weight. The *chaebol* are probably ideally suited for refurbishing the North Korean economy. However, saddling them with unproductive North Korean enterprises would have an economic price (in terms of reducing *chaebol* competitiveness internationally and possibly encouraging anti-competitive behavior domestically) as well as a political one (in the form of the quid pro quo that the *chaebol* could be expected to extract).

With respect to the other actors, many of the policies that one would want to see in place in the case of collapse (North Korean involvement with the international financial institutions, for example) are really not contingent on collapse. Since in the case of collapse one would want to see the multilateral development banks involved as quickly as possible, it would make sense to get them involved and developing some country-specific knowledge and expertise prior to the event.

The big money issue would be how to resolve post-colonial claims against Japan if this had not already been done prior to collapse. If it were the case that this issue had not been resolved, it would be essential that Japan and the government of Korea quickly reach an accord so that resources could begin flowing into Korea. In the case of the United States, its role would probably be one of providing political leadership (a la KEDO) than direct financial assistance. One could imagine, for example, the United States leading a multilateral effort, possibly through a special window at one of the multilateral development banks, to provide additional financial assistance.

Conclusions.

How this all plays out, indeed whether unification along either of the modalities examined in this paper is likely in the near future, depends, at least in part, on the intentions of the North Korean elite. A necessary condition for consensual unification would be a willingness of this elite to countenance considerable reform of current practices. Today the North Korean elite appears to be split in this regard. Pyongyang's hesitant steps toward economic reform, for example, have a two-steps-forward, one-step-back character. At the same time, there is evidence that North Korea is increasing military expenditures, even while continuing to receive a considerable volume of international food assistance and enhanced revenues from the Hyundai deal.²² But the question remains whether its system-preserving reforms in the form of tourism projects, mining enclaves, and special economic zones will be sufficient to maintain social stability and avert collapse.

North Korea could count on a fairly supportive international environment were it to undertake the kinds of reform necessary to make the consensual reform path plausible. The June 2000 North-South summit, Kim Jong Il's visit to China, the 1999 visit of former U.S. Secretary of Defense William Perry, the resumption of discussions

between Japan and North Korea, and the expected visit of a high-ranking North Korean official to Washington during the spring of 2000 would appear to support this interpretation of events. Yet there is no guarantee that Pyongyang's current modest opening is anything more than opportunistic. History is replete with examples of countries that did not go the way their foreign patrons desired. In the case of North Korea, whether the regime is willing and able to make the necessary changes to ensure its own survival is still uncertain.

ENDNOTES - CHAPTER 8

1. Paper prepared for the Nonproliferation Policy Education Center. Copyright 2000 Institute for International Economics, all rights reserved.

2. For details of this proposal, see Song-ryol Han and Tong U-choe, "Perspectives of Issues by the DPRK," New York: DPRK Mission to the United Nations, mimeo, 1995; and Suk-ryul Yu, "Problems for Korean Reunification," conference paper, Joint Conference of the Council for U.S.-Korean Security Studies and the International Council On Korean Studies, Arlington, VA, October 23-24, 1997. For highly informative interpretations of North Korea's unification policy, see Han-shik Park, "North Korea's Ideology and Unification Policy," in Jay Speakman and Chae-Jin Lee, eds., *The Prospects for Korean Unification*, Claremont, CA: Keck Center for International and Strategic Studies, 1993; and Nicholas Eberstadt, "North Korea's Unification Policy: 1948-1996," in Samuel S. Kim, ed., *North Korean Foreign Relations*, Oxford: Oxford University Press, 1998.

3. North Korea has a history of extorting resources from foreigners to secure its participation in diplomatic activities. Conversely, South Korea has engaged in "checkbook diplomacy," most notably in the process of normalizing relations with the USSR. Given the Berlin Declaration and Kim Dae Jung's willingness to directly underwrite the economic rehabilitation, it is tempting to speculate on what President Kim may have promised the North.

4. North Korea and Hyundai have been in conflict over Hyundai's desire to significantly increase the number of tourists that it brings to Mt. Kumgang by including large numbers of non-Koreans. At present, non-Japanese foreigners are permitted to join the Hyundai tour.

5. Kim Jong Il reportedly has expressed a preference for Shinuiju over Haeju, despite the latter's greater attractiveness as an economic hub. Some (e.g., Chung-in Moon, "Korea and Asian Security in the 21st century," *Asian Voices: Promoting Dialogue Between the United States and Asia*, Washington, DC: Sasakawa Peace Foundation U.S.A, 2000) have argued that the choice between Haeju and Shinuiju will signal whether economics or politics are driving policy. The possibility of a second Hyundai-developed SEZ, located at Tongchon on the east coast near Mt. Kungang, has also been reported.

6. Indeed, bad weather does not even distinguish North Korea. At its peak, most observers believe that the North produced about 6 million metric tons of grain. This fell by roughly half by 1996 (Marcus Noland, *Avoiding the Apocalypse: the Future of the Two Koreas*, Washington, DC: Institute for International Economics, 2000, Table 5.1). In comparison, Morocco also typically produces around 6 million metric tons, but bad weather in 1999 knocked domestic production down to around 1.5 million metric tons, a decline of roughly three-quarters—more than the drop experienced in the North Korean case. While times have been hard, there is no famine in Morocco, however. The food shortfall has been closed by importing food on commercial terms.

7. On the first point, see Marcus Noland, "The North Korean Economy," *Joint U.S.-Korea Academic Studies*, Vol. 6, 1996, pp. 127-178; and Noland, *Avoiding the Apocalypse*. For detailed analyses pertaining to the second point, see Marcus Noland, Sherman Robinson, and Monica Scatasta, "Modeling North Korean Economic Reform," *Journal of Asian Economics*, Vol. 8, No. 1, 1997, pp. 15-38; and Marcus Noland, Sherman Robinson, and Tao Wang, "Rigorous Speculation: The Collapse and Revival of the North Korean Economy," *World Development*, September 2000.

8. See Noland, *Avoiding the Apocalypse*, for a discussion of the political economy of reform in the North Korean context.

9. Kim Jong Il's statements in China, praising Chinese economic reforms, may signal a new North Korean willingness to consider economic reform and accept Chinese tutelage.

10. See Noland, *Avoiding the Apocalypse*; or Marcus Noland, Sherman Robinson, and Tao Wang, "Famine In North Korea: Causes and Cures," *Economic Development and Cultural Change*, forthcoming, 2000.

11. See David Von Hippel and Peter Hayes, "DPRK Energy Sector: Current Status and Scenarios for 2000 and 2005," in Marcus Noland,

ed., *Economic Integration of the Korean Peninsula*, Special Report 10, Washington, DC: Institute for International Economics, 1998.

12. This would amount to a fairly bare-bones reconstruction program. For example, James H. Williams, Peter Hayes, and David Von Hippel, "Fuel and Famine: North Korea's Rural Energy Crisis," paper presented to the Pentagon Study Group on Japan and Northeast Asia, Washington, DC, October 22, 1999, estimate that a rural energy rehabilitation program would cost about \$2-3 billion over 5 years. Their estimated price tag for a more comprehensive economy-wide program is \$20-50 billion over 20 years.

13. One should be careful about drawing too simple a causal link between material conditions and political change. There is no theory that reliably maps deprivation to political change. Indeed, in his classic study of political change, Samuel P. Huntington, *Political Order in Changing Societies*, New Haven, CT: Yale University Press, 1968, argues that political change more often occurs in the context of material gains and rising expectations than stagnation. In particular, to the extent that political change has accompanied famine, it has usually occurred after famine episodes when conditions have sufficiently stabilized for responsibility to be assigned and blame to be assessed. During famines, populations are typically too focused on survival to engage in political activities. However, in the case of North Korea, Bill Gertz, *Betrayal*, Washington, DC: Regnery Publishing, 1999, reproduces a secret State Department cable that refers to "extensive evidence of a major coup attempt by elements of the VI Corps in 1995, which appears to have been crushed only with some difficulty" (p. 264). The State Department has not denied the authenticity of this cable. According to Don Oberdorfer, *The Two Koreas*, Reading, MA: Addison-Wesley, 1997, after the uprising, the corps, based in the famine-stricken northeastern city of Hamhung, "was disbanded, its leadership purged, and its units submerged into others under circumstances suggesting disarray in the ranks" (p.375).

14. This assumes that liberalization in the North was on a non-preferential basis. As shown in Marcus Noland, Sherman Robinson, and LiGang Liu, "The Economics of Korean Unification," *Journal of Policy Reform*, Vol. 3, 1999, pp. 255-299; and Marcus Noland, Sherman Robinson, and Tao Wang, "Modeling Korean Unification," *Journal of Comparative Economics*, June 2000, the formation of a customs union between North Korea and South Korea would have a big impact on the North, while it would have a trivial impact on the South. The customs union would represent a major trade liberalization on the part of the North, while the North's economy would be too small to have much of an impact on the South's economy. (Think of the impact of

NAFTA on the United States or the accession of a small central European economy on the EU.) This story—big impact on the North, small impact on the South—would change considerably if integration were to come through collapse.

15. Under U.S. law, the U.S. executive directors at the development banks could not vote in favor of extending loans to North Korea until it was removed from the list of countries engaging in state-sponsored terrorism.

16. An April 2000 statement to this effect by the IMF resident representative in Seoul, David T. Coe, was immediately denounced by Representative James Saxton (R-New Jersey).

17. It is theoretically possible that a collapse of the Kim Jong Il regime would not necessarily result in the disappearance of North Korea as a state. Yet, in reality, it is hard to see how a non-Kim Il Sungist government could be much more than a transitional regime to unification on essentially South Korean terms, much as was the case for the short-lived East German government of Lothar de Maizière.

18. See Noland, Robinson and Liu; and Noland, Robinson, and Wang, "Modeling Korean Unification," for modeling of cross-border factor flows in the Korean case. The latter paper finds that North Korea would be virtually depopulated before wage rates converged sufficiently to choke off the incentives for mass migration. They conclude that either cross-border migration would have to be limited, or the opening of the border would have to be combined with hundreds of billions of dollars of investment in the North.

19. See Gerlinde Sinn and Hans-Werner Sinn, "What Can Korea Learn from German Unification?" in Byong-Moo Hwang and Young Kwan Yoon, eds., *Middle Powers in the Age of Globalization*, KAIS International Conference Series No. 5, Seoul, Korea: Korean Association of International Studies, 1996; Marcus Noland, "German Lessons for Korea: The Economics of Unification," in C. Fred Bergsten and Il Sa Kong, eds., *The Korea-United States Economic Relationship*, Washington, DC: Institute for International Economics, 1997; Christian Watrin, "Monetary Integration and Stabilization Policy: The German Case," in Il Sa Kong and Kwang Suk Kim, eds., *Policy Priorities for the Unified Korean Economy*, Seoul, Korea: Institute for Global Economics, 1998; Holger Wolf, "Korean Unification: Lessons From Germany," in Marcus Noland, ed., *Economic Integration of the Korean Peninsula*, Washington, DC: Institute for International Economics, 1998; Noland, *Avoiding the Apocalypse*, including references therein, for more extensive discussions of the German "lessons" for Korea.

20. See Noland, Robinson, and Wang, "Modeling Korean Unification," for a detailed assessment.

21. Jin-young Bae, "The Fiscal Burden of Korean Reunification and Its Impact on South Korea's Macroeconomic Stability," *Joint U.S.-Korea Academic Studies*, Vol. 6, 1996, pp. 185-202, makes recommendations to improve tax collection. He raises the possibility of privatizing South Korean government assets as a means to finance unification as well.

22. According to the Ministry of Defense, *White Paper*, Seoul, Korea: Ministry of Defense, 1998, North Korea has increased its reserves of chemical weapons, boosted KPA manpower by 10,000 troops, created a missile division, and added 10 submarines to its fleet. In August 1999 it was revealed that North Korea had purchased roughly 40 aging MiG-21 fighters and 8 military helicopters from Kazakhstan. It was subsequently reported that North Korea was trying to obtain more advanced MiG-29 and SU-30 fighters as well. In September 1999, a classified U.S. Air Force report describing alleged continued North Korean work on its *Taepodong* missile was leaked to the press. In October, in testimony before the Senate Armed Forces Committee, General Thomas Schwartz, the newly appointed commander-designate of U.S. Forces Korea stated that North Korea had accelerated its arms buildup and was forward-deploying artillery and rocket-launchers in underground facilities. In March 2000, Admiral Dennis Blair, Commander-in-Chief U.S. Pacific Forces, indicated that North Korean military exercises during the winter of 1999-2000 had been the most extensive in recent years. Russian observers claim that North Korea is emphasizing "high impact" arms over conventional weapons.