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Korean Unification?

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I recently attended a meeting of Asian Leaders in Seoul, South Korea, which was also attended by five former presidents and prime ministers and numerous other senior officials from Asian countries. An important theme of this meeting was devoted to unification of the Korean peninsula, that is, between the Republic of Korea in the south and the Democratic Peoples Republic of Korea (DPRK) in the north. I was much surprised, since I see no prospect of unification any time soon. The stated rationale for the topic was that while near-term prospects are not good, human history is full of surprises. It could happen suddenly and unexpectedly, so some systematic thought, and even advance planning, should be devoted to the issue.

The major example the Koreans have in mind is the re-unification of east and west Germany in 1990, which was sudden and unexpected. No one envisioned that possibility a year before it occurred. It came about when the leader (Honnecker) of the German Democratic Republic (DDR) faced a popular revolt in the fall of 1989 and Mikael Gorbachev, president of the Soviet Union, informed him that he could not rely on Soviet troops (which were stationed in the DDR) to suppress the revolt; he had to find his own way, which he failed to do. The Berlin Wall, constructed in 1961 to separate definitively the two parts of Berlin, was torn down, and discussions with the Federal Republic of (West) Germany (FRG) began on associating the two parts of the former country. It quickly became clear that the most expeditious approach was for the FRG to absorb the DDR as several new, partly autonomous, states under its federal constitution.

Germans on both sides of the border were elated. Unification was an aim of many Germans since the late 1940s, when Germany was divided into communist and a non-communist parts following the Second World War. As in Korea, many families were separated, and after 1961 it was difficult to visit relatives legally, and dangerous to do so illegally.

The fundamental economic challenge arose from the fact that in the intervening four decades the standard of living – supported by productivity – was at least three times higher in the FRG than it was in the DDR. Germany made several initial decisions that strongly shaped subsequent events. First, under the new political arrangements, east Germans had freedom of movement throughout Germany – indeed, after 1992, throughout the entire European Union. Second, the former DDR adopted the German mark as its currency – but at what exchange rate to the East German mark? It was decided that wages, pensions, and small savings should be converted at a rate of one-to-one, compared with the previous official rate of 3 east marks to one German mark and a black market rate of around 8 to one. This decision, along with opening the former DDR markets to west German goods – indeed, to goods

from all over the world, since the FRG was an important trading country – meant those east Germans who continued to have jobs, and pensioners, were suddenly much wealthier than they had been. This was an immediate benefit from the unification for most east Germans, and was designed in part to discourage them from migrating in large numbers to the west. But productivity in the eastern states was too low to support the high wages, so many east German firms, public or private, could not compete in the west German market, and either had to be closed or heavily subsidized. This problem was compounded when west German unions started to organize east German workers, with an objective to raise their wages to west German levels within five years – an insupportable objective that receded over time.

Finally, to encourage the importation of modern techniques of production as well as management and marketing skills, the German government induced western firms to invest in the former DDR, with attractive financial terms regarding the purchase of property or existing east German firms. The increased expenditures, including for infrastructure, was financed in part by a “solidarity tax” augmenting existing income taxes by 5.5 percent.

Over two decades have passed since this process began. Productivity has risen in the former DDR, from roughly 30 percent to about 70 percent of that in the west. Wages are still lower in the eastern states (except Berlin), but despite that unemployment is significantly higher. Estimates of the cumulative expenditures by the German government to integrate the eastern states vary, but are on the order of \$1.5 trillion, and still run at two percent of GDP each year.

In short, the integration of the two economies took much longer than anyone expected, and cost much more than anyone expected.

Needless to say, many Koreans have become close students of the unification process in Germany. The initial conditions are more difficult than in Germany, since the population of the DPRK is roughly half that of the ROK (compared with one-fourth in the case of east Germany), and the initial gap in living standards is much greater than one-third, perhaps even one twentieth. Thus the challenge of integrating the two economies is much greater.

But Korea does not have to be unified quickly. If migration can be restrained, and the exchange rate set such that goods produced in North Korea are competitive, one can imagine a process of convergence that will last several decades. But will that be politically tolerable to Koreans?

President Park of South Korea has described Korean unification as a “bonanza,” and cites such new possibilities as rail connections from Busan to Rotterdam, in the Netherlands, opening up land transportation to Europe. No doubt there will be some material benefits as well as psychological and sentimental ones, but the overall process is likely to be extremely challenging.