Policy Forum 03-13A: North Korea and the South Korean Economy

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North Korea and the South Korean Economy

By Marcus Noland

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I. Introduction

This essay is by Marcus Noland, Senior Fellow at the Institute for International Economics. Noland asserts the following three arguments: (1) engagement with the aim of transforming North Korea is a desirable policy from the standpoint of South Korea; (2) collapse and absorption along German lines would not be catastrophic for South Korea; and (3) regardless of South Korea's stance toward the North, it remains economically vulnerable to the vagaries of North Korean behavior. This paper is to be presented to the Roh Government Transition Team in Seoul, Korea on February 24, 2003.

It was originally posted on the Institute for International Economics website:
http://www.iie.com/papers/noland0203.htm

A more detailed analysis of the North Korean economy can be found:
http://www.iie.com/papers/noland1002.htm

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II. Essay by Marcus Noland

"North Korea and the South Korean Economy"
by Marcus Noland
Senior Fellow, Institute for International Economics

A few years back I asked a South Korean Minister of Finance if he took North Korean behavior into account when formulating South Korean economic policy. "No," he replied, "those guys in the North are crazy. We don't pay any attention to them."

More recently I met with an associate of the incoming Roh Moo-hyun government. When asked which outcome he preferred-North Korea with an ongoing nuclear weapons assembly line or its collapse and absorption by South Korea a la Germany-he chose the former. "We couldn't afford [the collapse outcome]-the US would have to pay for it."

This paper will make the following three arguments: (1) engagement with the aim of transforming North Korea is a desirable policy from the standpoint of South Korea; (2) collapse and absorption along German lines would not be catastrophic for South Korea; and (3) regardless of South Korea's stance toward the North, it remains economically vulnerable to the vagaries of North Korean behavior.

Engagement

The rationale for an engagement policy is quite simple. Pyongyang already holds Seoul hostage with its forward-deployed artillery. The marginal increase in effective threat associated with revitalization of the North Korean economy is minimal. Ergo, it is worth engaging with the North and hoping that through a policy of engagement either Pyongyang will evolve toward a less threatening regime, or engagement will undermine the ideological basis of the Kim Jong-il regime and eventually cause its collapse. Either way the military threat to Seoul is eliminated. (Parenthetically, the same cost-benefit calculus does not hold for the United States, which has strategic interests beyond the Korean peninsula, and this creates the real basis for divergence in US and South Korean preferences regarding engagement with the North.)

The risks for South Korea of this engagement strategy are not the ones that would create symmetric dependency as is sometimes alleged. Economic integration with the North would have a trivial impact on the far larger and richer South Korean economy but would have a huge impact on the smaller, poorer North Korean economy. The disparity in the relative economic impact would be reinforced by disparity in political and social impact as well. In sum, the process of economic integration would create highly asymmetric dependency in favor of the South.

The real threat to the South of economic integration lies elsewhere. The South Korean economy has real problems with non-transparent and corrupt government-business relations. In the North, there is no real difference between the state and the economy. Any large-scale economic integration between the North and the South will be by its very nature a highly politicized process, and will in all likelihood retard progress in cleaning up business-government relations in the South. This does not have to be: There are ways, through the tax code for example, to encourage South Korean economic integration with the North in a transparent and relatively efficient manner. But these approaches have not been tried by Seoul.

Collapse

My impression is that over the past decade, South Koreans have swung from an excessively optimistic assessment of their ability to handle an East German-style collapse in the North ("we won't make the same mistakes the Germans did") to an excessively pessimistic assessment of collapse and absorption, to the point of fearing it more than an ongoing North Korean nuclear weapons program! On the basic comparisons, the prospective Korean case does look worse than Germany: Compared to South Korea, North Korea is larger and poorer than East Germany was in comparison with West Germany. The one criterion in which the Korean case comes out ahead is demographics: North Korea has a younger population than East Germany and young North Koreans are presumably more risk-taking and adaptable than middle-aged East Germans. Moreover, with a younger population the existing educational and training institutions can play a central role in preparation for the new democratic, market-oriented society. Korea also has the advantage of learning from German mistakes, though it is unclear that it is actually doing so. The conventional wisdom that the fundamental German policy-error was in overvaluing the East German mark at the time of monetary union is wrong and obscures more important lessons of how to manage institutions during the transition.

Several key factors will determine the macroeconomic impact on the South Korean economy of a collapse and absorption of North Korea along the lines of the German experience:

* What efficiency gains are possible in North Korea simply though marketization and the removal of self-imposed distortions-without any additional resources? * How fast can North Korea absorb new technology? * How much labor will be permitted to migrate from the North to the South? * How much capital will be invested in the North? How much will come from the South and how much from other parties? Will this capital be invested on market or concessional terms?

Depending on how these factors are parameterized, one can come to a variety of conclusions about the impact of collapse on the South. Choosing a plausible and prudent set of parameters, the CGE models suggest that over the course of a decade the collapse and absorption scenario would yield the following results:

* A mild slowing of the South Korean growth rate, a rapid acceleration of the North Korean growth rate, and an increase in peninsular output relative to the no collapse scenario. * Within South Korea a shifting of income from labor to capital, and within labor, from relatively low-skilled to relatively high-skilled labor. If one assumes that capital is predominately owned by high-skilled labor, then this

suggests that the process will be accompanied by increased income and wealth inequality in South Korea. * Across the various sectors of the South Korean economy, there would be a tendency for sectors such as construction to expand, while internationally traded-goods sectors would be disadvantaged. * There would be a modest peace dividend in the South and a huge peace dividend in the North.

In sum, while collapse and absorption would negatively impact the South relative to a no collapse scenario, the effect is relatively modest and a South Korean government committed to cushioning the impact on the poorest parts of South Korean society could do so through the adoption of appropriate policies. On a personal note, I am always struck when visiting South Korean universities by the apparent affluence of students. While it is not my role to lecture South Koreans on their social preferences, that tenured-for-life academics would be unwilling to sacrifice their cell phones and hair dye in the pursuit of liberating 22 million of their countrymen from the world's most odious regime strikes me as utterly incomprehensible.

South Korean vulnerability

In the end, it may not matter. Regardless of its economic policy stance, South Korea remains vulnerable to the vagaries of North Korean behavior, as the present situation demonstrates.

Financially, South Korea is more integrated into the world economy now than it was in 1994. Foreigners are major players in the capital markets, accounting for nearly 40 percent of stock market transactions, and South Korean residents have greater opportunities to move their funds abroad. The use by South Korean financial firms of off-balance sheet transactions and financial derivatives, which did not exist in 1994, is expanding rapidly. While it is true that the South Korean stock market actually rose during the last crisis, the expanded role of foreign participants and the increased complexity of the financial transactions mean that the market today is far less susceptible to political intervention than it was a decade ago.

The popular image of capital flight occurring when foreigners flee for the exits is belied by historical experience the world over-almost invariably it is the better-informed locals who are out the door first. Indeed, the latest figures indicate that while foreigners were net buyers in the stock market, South Koreans were net sellers. And although at present there is no indication of capital flight, enabling mechanisms that did not exist in 1994 are in place today and if December's election is any indication, the South Korean population is badly split with respect to its attitudes toward the North. South Korean investors may prove more risk-averse than their new government and move their savings abroad. A slowdown in the purchase of consumer durables is another possibility.

Indeed, the incoming government-populist and untested-is another source of uncertainty. While Roh has largely managed to avoid economic controversy in the run-up to his inauguration, the markets will monitor his government's economic policies particularly closely during the early stages of his administration. Which brings us back to North Korea. Given the complexity of the situation-two separate and distinct nuclear programs that require different solutions, the administrative transition in South Korea, and the looming war in Iraq-all point to a protracted resolution of the crisis, which almost certainly will involve multilateral negotiations, if not the UN Security Council. As a consequence the crisis is likely to drag on for months, punctuated by intermittent periods of heightened tensions. As a result, South Korea is likely to experience an extended period of market sensitivity, regardless of the insouciance of South Korean politicians.

What is to be done?

South Korea should do three things. First, commit to the principle that engagement should be done on efficient, transparent terms. Subsidization of engagement with the North can be justified from a social standpoint but it should be done as neutrally as possible with respect to specific projects and firms. No more implicit hidden subsidies and political quid pro quos should be delivered through the public-sector financial institutions.

Second, while engaging, South Korea should prepare for the possibility of collapse. The relevant policies could be thought of as those that are contingent on specific circumstances and those that are relatively invariant to the timing and specifics of an eventual North Korean collapse.

North Korea can be thought of as the world's largest contingent liability. South Korea should, as it has been doing, pursue a fiscal policy that might be considered relatively restrictive in the long run to minimize current public borrowing and debt under the expectation that this liability will come due sometime in the future.

South Korea should also pursue a variety of policies that would strengthen its economy. Such policies would be desirable whether or not North Korea existed-North Korea's existence simply underscores the desirability of their adoption. The overarching goal should be to improve the functioning of markets. For this to occur, accurate information must be accessible, property rights must be enforced, and agents should be motivated by efficiency, not political considerations. In practice, this means:

* Continued strengthening of accounting conventions and practices. * Continuing the process of denationalization and privatization, especially in the financial sector where the state still owns about one-third of the banking sector.

In the financial sector:

* Continue the policy of the Financial Supervisory Service to tighten risk assessment and to increase provisions for bad loans and increase scrutiny of financial derivatives and off-balance sheet transactions by South Korean financial entities. * Create firewalls to limit industrial firms' ownership of financial entities. * Consider using national pension assets to foster domestic institutional investors capable of monitoring corporate managements, independent of the chaebol. * Look more favorably on foreign ownership.

In the corporate sector:

* Maintain limits on cross-shareholding and cross-subsidization. * Strengthen insolvency/bankruptcy system to make process more efficient. * Strengthen corporate transparency and accountability. Permit minority shareholder suits as a method of disciplining insider management abuses.

With respect to labor-market policy it is important to recognize two things. First, financial-market policies impact labor-market behavior. Situations in which managements do not face hard budget constraints encourage labor militancy. Corporate bail-outs through the provision of concessional loans by public-sector financial institutions discourage compromise on the part of unions. Second, the rate of unionization is not much different in South Korea than it is in the United States or France but labor markets are far less flexible in France than in the United States-i.e. policies and institutions count. As a consequence it is important that the Tripartite Commission not become the locus of efficiency-reducing corporatism as similar bodies have become in continental Europe.

Finally, it is important to note that these reforms are self-reinforcing: Reforms in the financial sector will encourage better results with respect to corporate decision-making and labor-market outcomes, for example.

III. Nautilus Invites Your Responses

The Northeast Asia Peace and Security Network invites your responses to this essay. Please send responses to: napsnet-reply@nautilus.org . Responses will be considered for redistribution to the network only if they include the author's name, affiliation, and explicit consent.

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Northeast Asia Peace and Security Project (napsnet-reply@nautilus.org)
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