

A Note on Unifying the Two Korean Economies

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This note is written in the hope of contributing to a debate regarding the privatization of state-owned enterprises and collective farms in North Korea if and when unification takes place upon the collapse of the North Korean regime. The German experience of unification suggests that the task of privatization should be separated from that of restructuring and employment creation. A comprehensive development plan as well as an efficient and equitable privatization method are thus needed to minimize the cost of unification on the Korean peninsula (JEL Classifications: P52, O53).

I

Korean unification, if and when it takes place, will entail two separate, but related economic problems—transforming the centrally planned socialist economy in North Korea into a market economy and integrating it with the market economy of the south.¹

The transformation of the North Korean economy will require the establishment of private ownership and market institutions. The union of the two economies will entail such difficult problems as determining the conversion rate between the North Korean won and the South

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¹Since the mid-1980s North Korea has carried out various reforms to correct the problems typical of centrally planned socialist economies such as the soft budget constraint and ineffective worker incentive provisions. If the Chinese experience with similar reforms is anything to go by, the North Korean reforms are, however, bound to fail (Kang and Lee 1992). It is assumed here, given the unlikelihood of minor reforms being successful in North Korea, that the most likely path to unification will be through the collapse of its economy.

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Korean won and taking measures to prevent massive and de-stabilizing migration from North to South Korea.

As now widely recognized, the cost of unifying the two German economies has turned out to be much higher than anyone had expected; between 1989 and 1992 East Germany's manufacturing output decreased by one-third and GDP and employment by one-half (Schmidt and Sander 1993; Siebert 1993). Any structural change that is necessitated by the unification of two disparate economies is, of course, costly. But there are reasons to believe that if the problems relating to unification could have been foreseen the cost of German unification would have been less. Korea is thus fortunate to have the German experience to help it prepare for its own unification.

The discussion that follows in this note is based on the scenario that the North Korean regime will collapse and its economy will have to be absorbed into the South Korean economy. There are, of course, many other scenarios for Korean unification, but this one deserves the greatest attention as, in comparison with others, it will have the most severe impact on the two Korean economies.

It is likely that some of the conclusions and recommendations discussed in this note will have to be re-evaluated when and if more information on the North Korean economy becomes available. However, given the enormity of the issue involved we cannot wait until that time to start a debate on how to unify the two Korean economies. This note is written in the hope of contributing to such a debate.

II

In Germany, the Treaty on German Economic, Monetary and Social Union of July 1, 1990 established the Deutsche mark as the only currency and the Deutsche Bundesbank as the only central bank in the unified Germany. It also transferred all the civil, commercial and public laws of West Germany to East Germany and set a conversion rate averaging 1.81 ostmark for one Deutsche mark.²

²The main conversion rates agreed upon in the Treaty on the Creation of a Monetary, Economic and Social Union between the Federal Republic of Germany and the German Democratic Republic (approved by both parliaments 20 September 1990) are:

- a. Salaries, retiring pensions and housing rents 1:1
- b. Credits of enterprises and individuals 2:1
- c. Liabilities of enterprises and individuals 2:1

All contracts concerning the current income were converted, however, at a rate of 1:1, which had the immediate effect of drastically reducing the viability of East German enterprises.³ To keep them viable, however, would have required a conversion rate significantly below 1:1. But such a rate would have reduced East German wages to less than one third of those in West Germany (Schmidt and Sander 1993), and it was feared that such a large difference in wages would cause a mass exodus from East to West Germany.⁴

What has made the contraction in output and employment worse in East Germany was a real wage cost explosion which far exceeded the market-clearing level (Akerlof et al. 1991).⁵ In anticipation of favorable terms of conversion, wages began to rise even before the currency union. In fact, between the fourth quarter of 1989 and the second quarter of 1990 wages rose by 20 percent (Schmidt and Sander 1993).

The workforce in the old socialist firms and the trade unions, which had spread quickly from West to East Germany, pressed for higher wage contracts. The old socialist management did not resist the pressure for higher wages and, moreover, had every incentive to agree to the demands of the workforce in the hope of gaining its goodwill (Schatz and Schmidt 1992). In other words, with the absence of the state at the wage bargaining table the interest of the owners was not adequately protected during the transition from a centrally planned to

- d. Savings of citizens of the GDR up to certain amounts depending on their ages 1:1
- e. All savings above these ceilings and cash 2:1
- f. Claims of individuals living outside the GDR 3:1.

The average conversion rate calculated by the Deutsche Bundesbank is 1:1.81 (Hasse 1993).

³Hessentius (date unknown) argues that productivity in East German industry was around 35-40 percent of the West German level and given the ratio of wages that prevailed at the beginning of 1989 the one-to-one conversion rate was economically justifiable.

It should be added, however, that until its productivity increased East German labor would have to be paid 35-40 percent of West German wages for East German enterprises to remain competitive. Whether they could have retained their work force at that wage level is another matter.

⁴According to a survey of East Germans it is the lack of work for a sufficiently long period, not wage differentials, that would induce them to migrate to West Germany (Akerlof et al. 1991).

⁵A secondary reason is a sharp drop in demand for East German goods as West German goods became available to East Germans and as exports to CMEA (Council for Mutual Economic Assistance) countries declined drastically.

a market economy. There was not even a soft budget constraint on the demands of the management and labor as the state completely abstained itself from wage negotiations.

The opportunistic behavior of the workforce and management of the old socialist enterprises was further abetted by the self-interest of both West German trade unions and employers associations. As they saw it, low East German wages would have put downward pressure on West German wages and would have given new or restructured firms in East Germany a competitive edge against the established firms in West Germany. Thus, from the very beginning, labor unions and employers associations in West Germany supported the rapidly rising wages of their East German counterparts (Bofinger and Cernohorsky 1992).

Clearly, given that the absence of the ownership interest at the wage bargaining table was a major cause for the wage cost explosion in East Germany, rapid privatization would have had a dampening effect by firmly establishing the ownership right. The lesson for Korea is clear: it should carry out privatization as quickly as possible, and in the cases where that is not possible the government should represent the ownership and act firmly in its interest. It might be even necessary to adopt some form of incomes policy during the transition period.

III

One of the first tasks that must be carried out in North Korea is, therefore, the privatization of most, if not all, of state-owned enterprises and collective farms. The German experience in privatization points out that although privatizing small-scale enterprises, especially those in the service sector, is relatively easy, there are several obstacles to privatizing large state-owned industrial enterprises.

Uncertainty regarding the property right, i.e., who owns what, has been identified as a major obstacle to privatization and thus a main cause for lack of investment and even depletion of the existing assets in East Germany (Schmieding 1992; Sinn 1992). Establishing the original ownership title can be, however, a costly process for various reasons, including the difficulty in distinguishing between the ownership of a firm and the ownership of land, incomplete and neglected records, the administrative bottleneck in processing claims applications (1.2 million applications in the case of Germany), and multiple ownership claims when a firm has added pieces of land and buildings over time (Siebert

1991).

In Germany, until March 1991 any attempts at privatization by the Treuhandanstalt were frozen whenever claims by previous owners were announced.⁶ A decision on April 23, 1991 by the German Constitution Court has reduced, but not eliminated, the role of restitution by making the ruling that restitution does not have to be the only solution for the expropriations that took place after 1949. The decision has thus separated in principle the issue of the claims of dispossessed previous owners from the issue of compensation and thus facilitated the process of privatization. A formerly state-owned enterprise can now be privatized without concern for its original ownership, and any ownership dispute can be settled in accordance with due process and followed by compensation by the state where appropriate.

IV

Privatizing large state-owned industrial enterprises in North Korea will also certainly run into various obstacles. But it is likely to be less of a problem than for Germany, as most of the private enterprises socialized in 1946 were Japanese-owned and these will not become the objects of ownership dispute. Most of the enterprises that were established after 1946 were created by the state or local authorities, and there cannot be, therefore, private claims for restitution or compensation. Even in these cases, however, potential disputes could arise over the ownership of the land on which state-owned enterprises were established. To prevent such disputes from stalling the privatization process, Korea should early on establish compensation, not restitution, as a general rule for settling ownership disputes. Enterprises can then be rapidly privatized with the ownership firmly established in the new owners. Compensation can be made at a later date by the state whenever and however ownership disputes are resolved. Resolving the disputes will be still costly, but it will have no effect on the control and management of formerly state-owned enterprises.

⁶The Treaty on German Economic, Monetary and Social Union of July 1, 1990, which formalized the economic union of the Federal Republic of Germany and the German Democratic Republic, established the Treuhandanstalt ("trust fund") to help privatize the state-owned enterprises while restructuring and supporting them temporarily (Carlin and Mayer 1992).

V

Once compensation, not restitution, is adopted as the method of settling ownership disputes, privatization becomes a matter of choosing between the sales and give-away approach. The German Treuhand approach is basically a sales approach whereas the voucher scheme used in the former Czechoslovakia is a give-away approach.

In deciding which approach to privatization to adopt, Korea may consider the three criteria proposed by Blanchard and Layard (1992)—speed, fairness, and efficient control.

Clearly, speed is an important factor in privatization. As pointed out by Blanchard and Layard, speed hastens arrival; it prevents reversal; it removes uncertainty; it protects the government budget from being siphoned off to support inefficient firms; and it may help fairness by minimizing the danger of insider privatization. Given that the Treuhandanstalt, which in effect began privatizing East German assets in June 1990, still has some assets to privatize (as of August 1993), one can easily conclude that for speedy privatization give-away is superior to sales.

To achieve fairness in privatization, i.e., a fair distribution of the assets of state-owned enterprises, Blanchard and Layard advocate giving them away via a distribution of shares or vouchers to the citizens preferably in equal amounts to all, including children.

An additional argument in favor of give-away is that sales will favor the former *nomenklatura* as they are the ones with liquid assets and can thus purchase the assets typically undervalued in the transition economy. In the case of Korea, however, it is likely that a majority of North Korean assets will be purchased by South Korean residents and businesses and not by the North Korean *nomenklatura*. Furthermore, with the inflow of money and businesses from South Korea it is unlikely that North Korean assets will remain undervalued for long once privatization begins. Fairness can be then achieved through the distribution of privatization proceeds among the North Koreans in equal amounts.

In considering fairness in the context of Korea we need to pay special attention to the question of regional balance between north and south. If most of the North Korean assets are purchased by South Koreans and the revenues from these sales are distributed to North Koreans.

the class structure that will emerge in North Korea will be politically divisive. It will consist of South Korean "carpetbaggers" who will own and manage formerly state-owned enterprises and North Koreans who will be working for them. Considering that for more than forty-five years capitalists have been pictured as exploiters of the working class, we can very well foresee the possibility of economically prosperous southern "capitalists" becoming an object of envy and hatred especially if unification brings about large unemployment in North Korea as severe as that in East Germany. Given the fractious regionalism that has plagued its long history, Korea cannot afford to ignore the possibility of such a regional imbalance and conflict emerging from privatization.

For achieving a regional balance, the give-away approach is a preferred method of privatization. A free distribution of shares or vouchers will give the North Koreans a clear title to properties in the north and, with proper educational efforts, a sense of being themselves capitalists. Certainly, there will be some people who would like to sell their shares or vouchers to increase their current consumption, but then the decision not to become capitalists will be their own choice.

It may be, however, advisable to ban trading in shares or vouchers for cash for a year or so until North Koreans become better informed about the nature of vouchers and shares. Given that they will initially lack adequate information about the workings of the capitalist market economy, especially those of the stock market, the banning of trading in vouchers or shares (except in the manner discussed below) for a year or so seems fully warranted on the grounds of equity as well as economic efficiency.

The third criterion for privatization is efficient control of assets. In terms of this criterion the sales approach is superior to a free distribution of shares or vouchers as it is simple in administration and leads to good corporate governance. The voucher system has some serious drawbacks in efficiency as the share ownership will be widely diffused among a large number of people and consequently the interest of owners cannot be adequately protected.

As a way of getting around these drawbacks Blanchard and Lanyard propose mutual funds or holding companies which will own a controlling block of shares in a certain number of enterprises. Citizens will then be given shares in each of these mutual funds or holding companies.

There are, however, problems in having mutual funds manage a multitude of privatized enterprises as they may lack the capabilities to do

so efficiently. Furthermore, given the possibility of their committing fraud the mutual funds will have to be supervised by the government. This may result in privatization in name only as it is still the government that will be managing the enterprises through the mutual funds (Schmieding 1992).

Given that in the case of Korea the influx of money and businesses from South Korea will minimize the possibility of undervaluing the North Korean assets, a combination of sales and give-away may be the best approach to privatization. This combined approach, which takes into account some of the lessons from the German privatization experience (Schatz 1992), may work in the following manner.

VI

The government establishes an independent institution, a trust fund, to which all the properties to be privatized are transferred. A controlling block of shares in each of the enterprises to be privatized is then sold to an investor (an individual or a firm) who offers the highest price. The investor will be then in control of the enterprise and thus in charge of necessary restructuring.

Vouchers, which are claims against the trust fund, are given to every North Korean in an equal amount and are to be exchanged for shares in a special account to be established in every mutual fund currently in operation in South Korea. This special account is only for the North Koreans with its assets consisting solely of the shares in the former North Korean state-owned enterprises and some of the land in North Korea.

The vouchers are to be exchanged for shares in one or several mutual funds. These will then be used by the mutual funds to purchase the remaining shares in the privatized enterprises that are still held by the trust fund.

In this process of privatization, three competitive markets will emerge: (1) a market for a controlling block of shares in the enterprises being privatized by the trust fund, (2) a market for the vouchers held by the North Koreans in exchange for shares in the mutual funds, and (3) a market for the remaining shares held by the trust fund in exchange for the vouchers now held by the mutual funds.

As a result of privatization, a North Korean will have cash from the trust fund and shares in a mutual fund. The price of the share will be,

however, in terms of the voucher and is unlikely to have a cash market value for a while. Only when the mutual fund has used all of its vouchers to acquire some of the remaining shares held by the trust fund will there be cash offers for the shares of the mutual fund. Only then will North Koreans be able to convert their shares into cash.

Given the great uncertainty regarding the viability of many of the newly privatized enterprises, as evidenced in the case of East Germany (*International Herald Tribune*, July 12, 1993), it may be economically rational to ban trading in shares in the mutual funds for a year or two. Such time may be needed for the necessary restructuring by the privatized firms and for corresponding portfolio adjustment by the mutual funds. A management-fee schedule directly proportional to the price of the share will give the mutual fund a strong incentive to maximize the value of its portfolio for the time when trading in shares will be allowed.

The process of privatization outlined above will be rapid as the trust fund functions solely as a privatizing agency not involved in the restructuring task. It has the advantage of putting the privatized enterprise under the direct control of a single individual or firm. It also has the advantage of turning the North Koreans into "capitalists" (at least for a short period of time for those who decide to sell their mutual fund shares). It transfers the task of evaluating privatized enterprises from North Korean individuals to the mutual funds; it is far easier for the North Koreans to shop around for a mutual fund with a demonstrated track record than for a proper mix of shares in the enterprises just recently privatized. The trust will be dissolved once the shares held by it are exchanged for vouchers offered by the mutual funds by a predetermined future date.

VII

Four types of land ownership will have to be dealt with in privatizing the collective farms in North Korea. The first is the ownership of the land that belonged to the Japanese colonialists until 1945; the second is the ownership of the land that was expropriated from "rich" or absentee Korean landowners under North Korea's Law of Land Reform (1946); the third is the ownership of the land that was distributed to cultivators under the same law and held by them until 1958 when collectivization was completed; and the fourth is the ownership of the land that was held privately by small cultivators until 1958.

In the first case, neither compensation nor restitution to the former Japanese colonialists will be necessary. In the second case, restitution to previous owners will be unnecessary given that similar land reforms redistributing land from absentee landowners to cultivators were also carried out in South Korea. Compensation will have to be made, however, for the land that was expropriated in 1946 and its primary purpose will be to reaffirm the principle of private property in the unified Korea. Since these so-called "rich" or absentee landowners are probably no longer alive, nominal compensation may be made to their descendants who may now reside in South Korea or abroad. In the third case—the ownership of land given to cultivators in 1946 but later turned into collective farms—restitution may be a preferred solution as the land reform of 1946 was probably not that different, except for the matter of compensation, from the land reforms carried out in South Korea. In the fourth case, the matter is straightforward; the land should be restituted to the previous owners. (The farmers who receive land will have to be disqualified from receiving cash and vouchers from the trust fund).

VIII

The above method of privatizing the collective farms will in effect re-establish the pattern of landownership—"Land to the tiller"—brought about by the 1946 Law of Land Reform. It may be, however, no longer appropriate in an industrialized Korea where agriculture accounts for a relatively small share of GDP. In such a case it may be economically more rational to make no distinction between collective farms and state-owned industrial enterprises and between farmers and industrial workers. Collective farms will then be privatized by the trust fund in the same manner as state-owned enterprises.

It should be noted that there may be no records left on land ownership in North Korea. If that is true, then there is an additional reason for privatizing collective farms in the same manner as state-owned enterprises. Again, compensation can be made subsequently if and when claims to land ownership are resolved in accordance with due process.

IX

The ultimate purpose of privatizing state-owned enterprises and collective farms is to transform the centrally planned economy in North Korea into a market system. Privatizing state-owned enterprises is in fact only one of the twin privatization processes that must take place in such transformation. The other is the creation of new private enterprises.

New private enterprises will be created with investment from South Korea and the rest of the world as well as with investment by some North Koreans. The latter will be, however, in a disadvantaged position since, having lived in a socialist planned economy, they will lack the necessary knowhow and perhaps even the inclination for entrepreneurial activities. They may also lack access to credit necessary for investment. Thus, to achieve a tolerable regional balance in bottom-up privatization, it will be necessary to establish specialized financial institutions such as a North Korea Development Bank that will allocate subsidized credit only to North Koreans for a pre-determined period of time.

X

In preparing itself for eventual unification, Korea needs to devise a method of privatization that is rapid, efficient, and equitable. For this purpose it is necessary to *separate the task of privatization from that of restructuring and employment creation*. The former should be done by a trust fund in the manner described above. To achieve the latter, there must be a comprehensive development plan that can help the privatized enterprises become viable, create new enterprises, and thus create employment for the North Koreans. Such a plan must include measures for transferring market institutions from the south and developing human capital that can effectively function with these institutions. Dismantling a centrally planned socialist system will not automatically lead to the establishment of an efficient market system. The transition to a market economy will be a difficult process, requiring the nurturing hand of the government. (*Manuscript received August, 1993; final revision received December, 1993*)

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