

Economic Aspects of Korean Reunification

Lessons From History

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Asia Economic Community Forum

creating tomorrow together

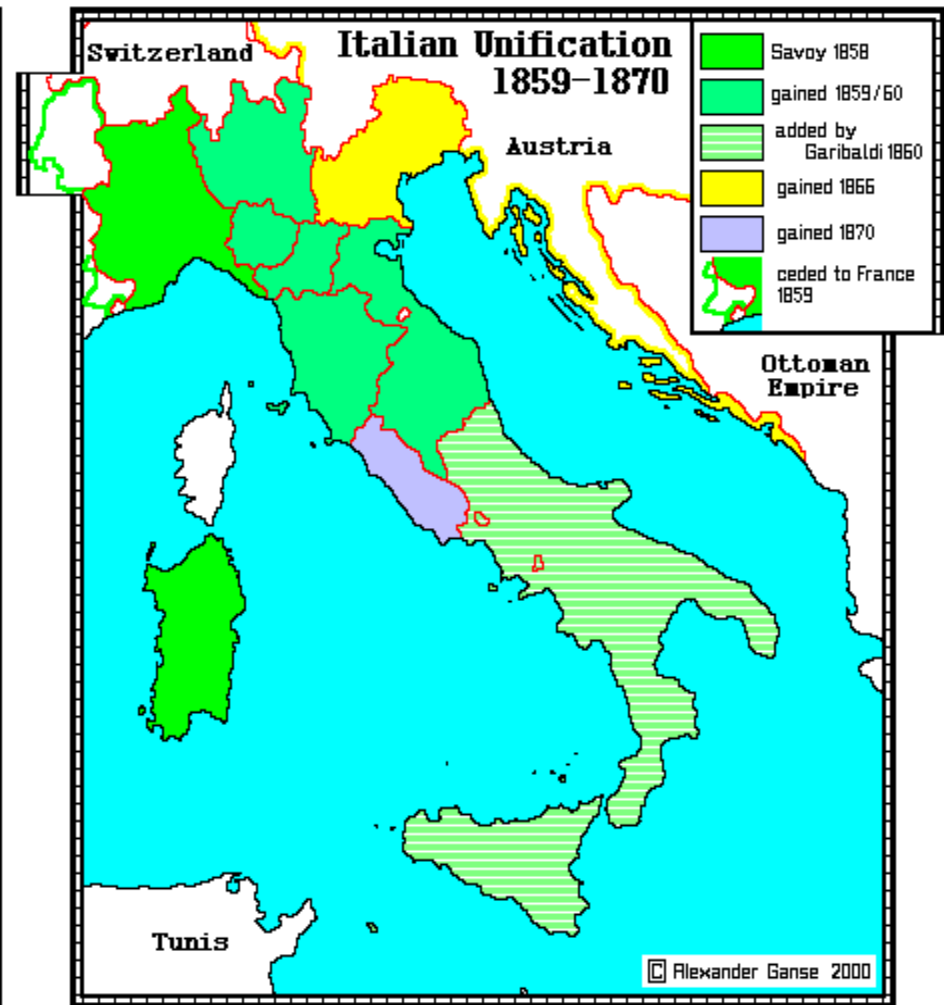
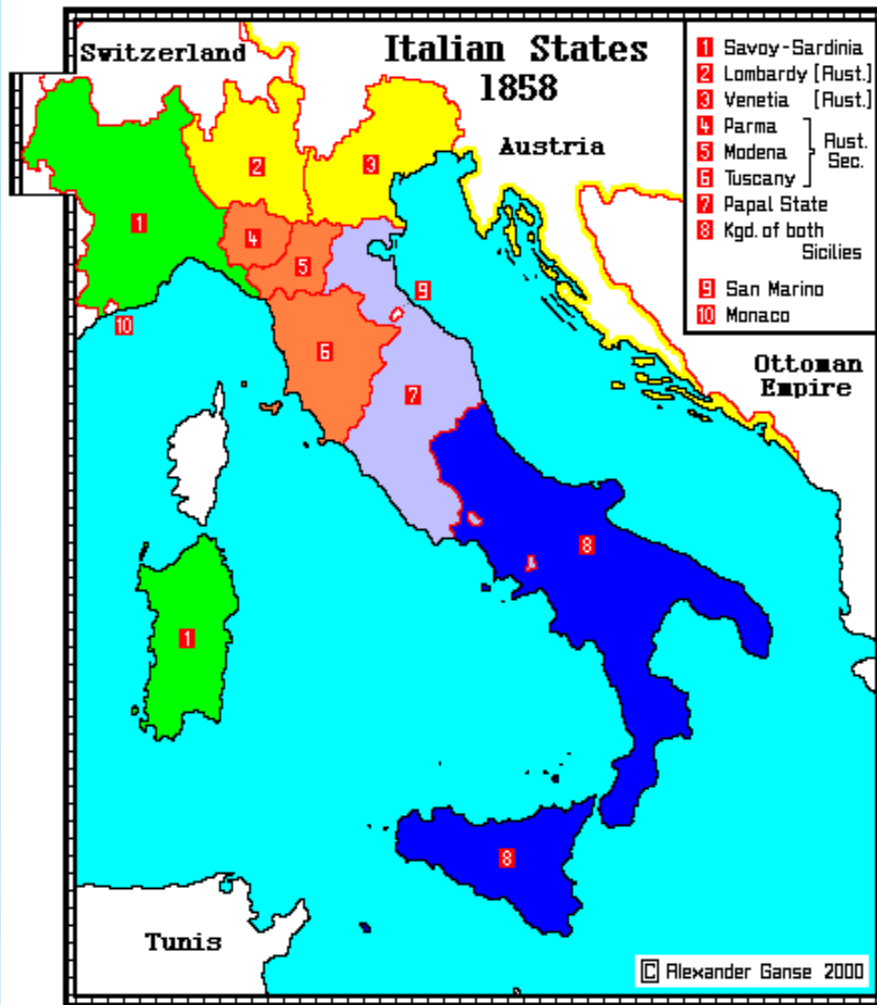
Why a Historical Perspective?

- Uncertainly about how Korean reunification would come about.
- Strong presumption that reunification leads to economic gains and social convergence.
- History enables us to see how differences among uniting regions and unification policies influence outcomes.

Three (re-)unifications

- Italy – 1858 – 1870
- United States – 1865 – 1877
- Germany – 1990 – now

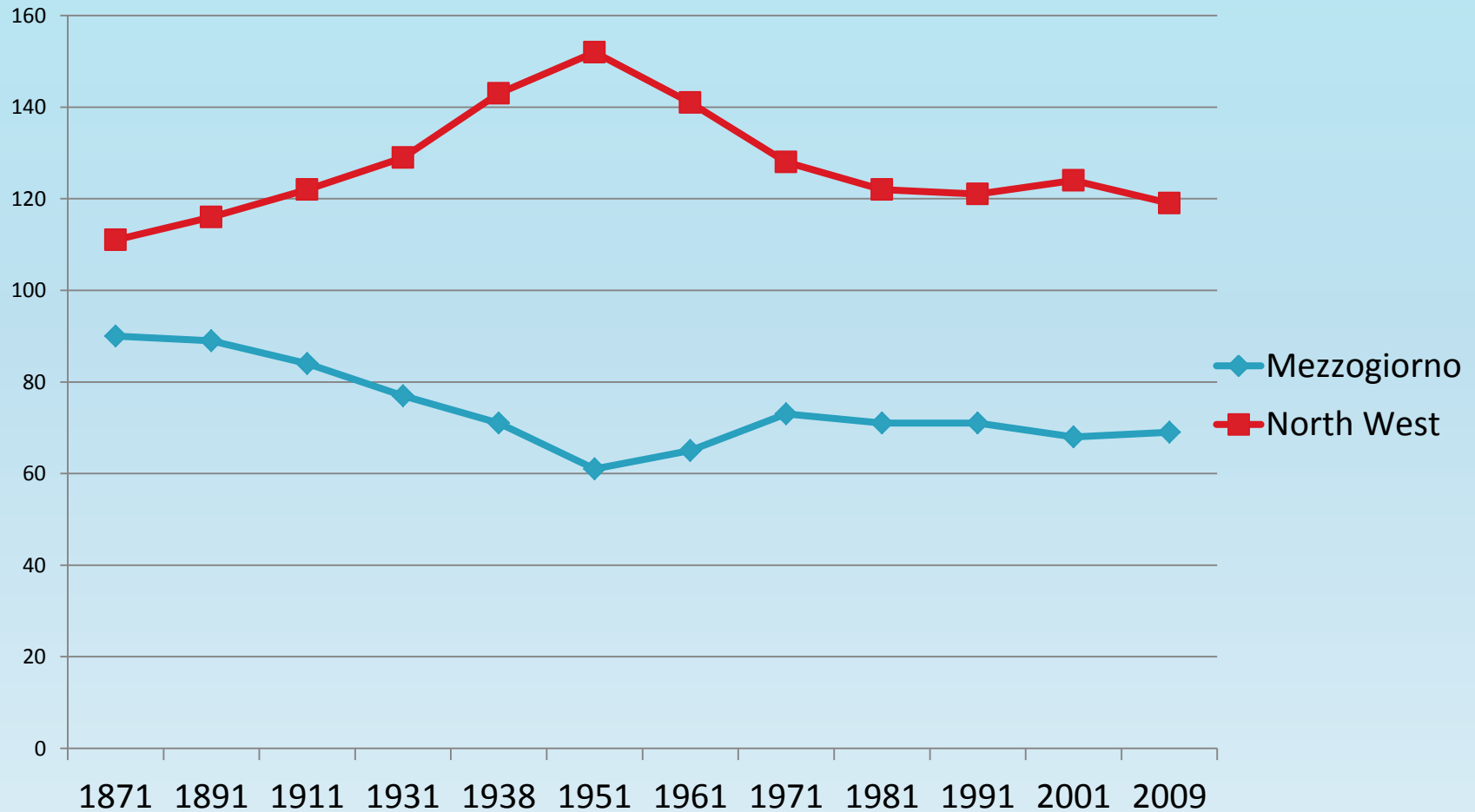
Italian Unification



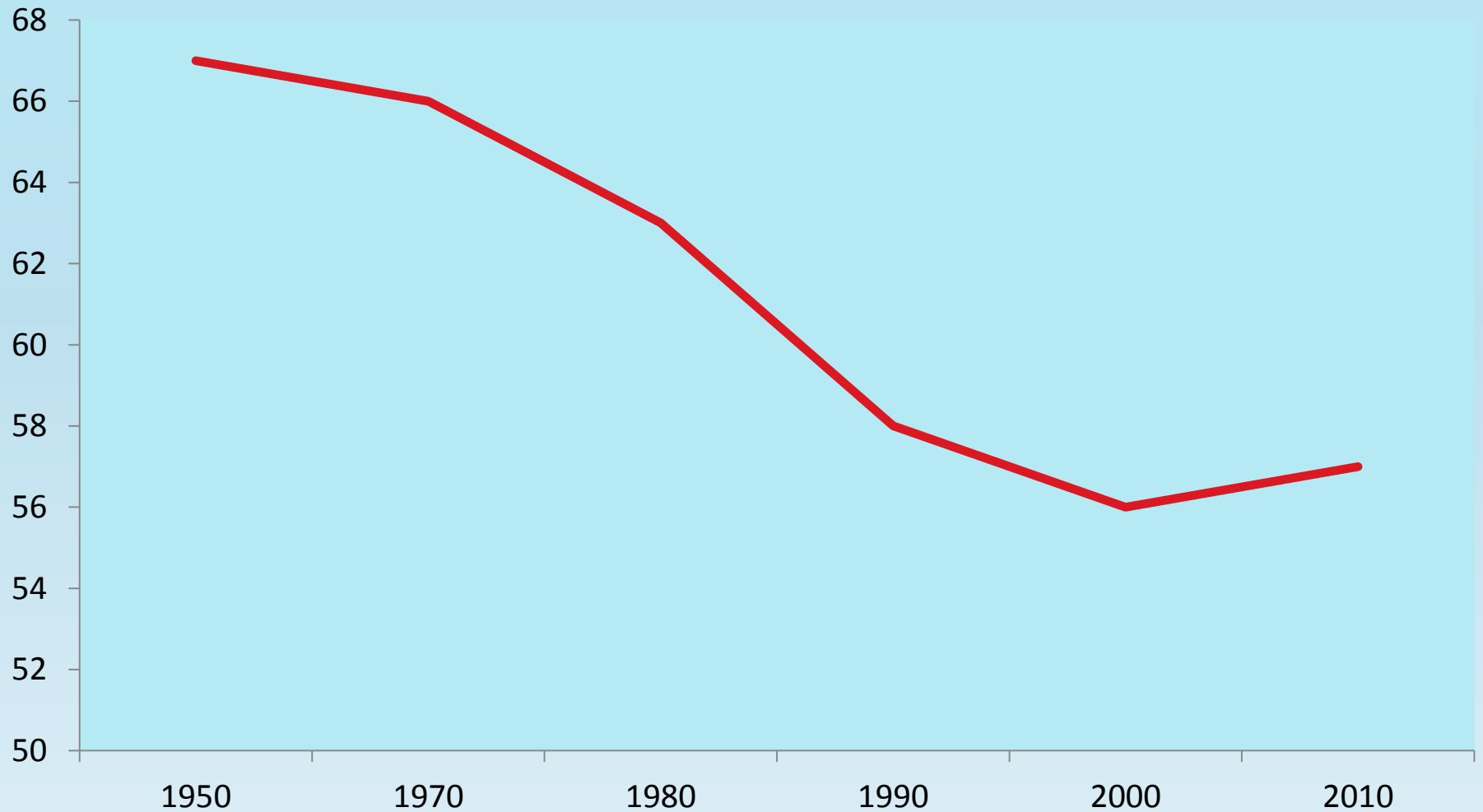
Piedmont vs. Mezzogiorno

- Piedmont (former Savoy/ Lombardy) in the Turin – Genoa - Milan region today is one of the highest per capita GDP areas in the world.
- Prosperity based on liberal economic policy, infrastructure development and industrialization.
- Mezzogiorno (former Kingdom of the Two Sicilies) is the largest underdeveloped and poverty-ridden area of the European Union. 21% of families live in poverty.

Regional per capita GDP (all Italy = 100)



Mezzogiorno GDP per capita as % of North-West Italy After WWII



Italian GDP and Employment During the Crisis



Source: The Economist

Some North-South Comparisons

	GDP/POP (Euro)	Unemployment (%)	PISA Math Score
North	31,670	9.5	502
South	17,171	20.7	459

Like
Germany
& France

Like
Greece
and
Portugal

Like Spain
and
Croatia

Like
Austria
and
Germany

Like
Greece
and
Croatia

Source: The Economist

Causes

Different cultures –

entrepreneurial/industrial/urban North
rent seeking/agrarian/rural South

Different policies –

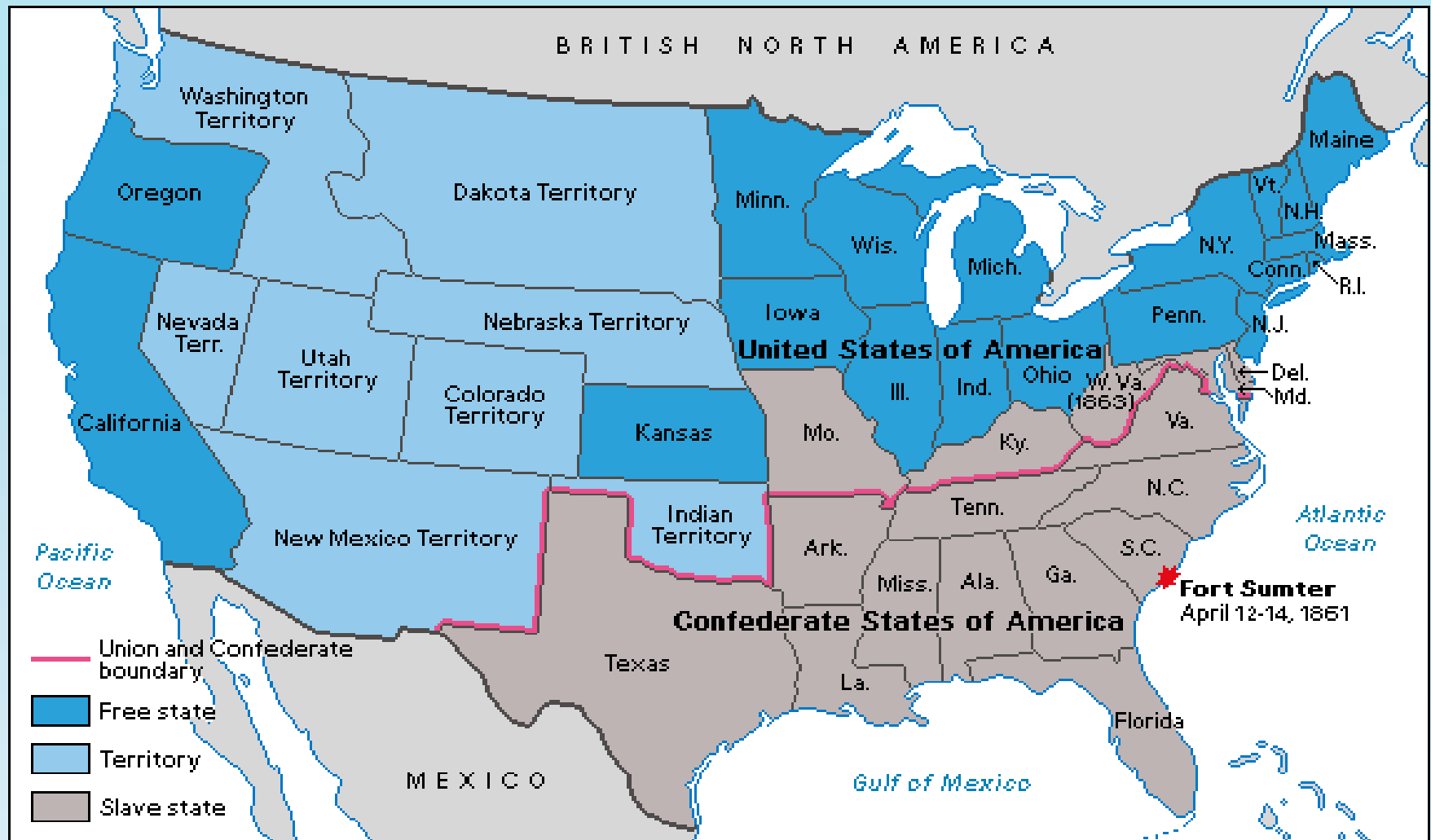
Infrastructure investment in pro-business North

Benign neglect in South - no big change in economic or political system until post-WWII, then government involvement in land reform and large-scale industrial projects

Outcomes

- Growing differences in income levels.
- Mezzogiorno losing competitiveness.
- High levels of out-migration from Mezzogiorno. Between 1870 and WWII, 29 million people.
- Mezzogiorno has large criminal and informal sectors.
- Support for Mezzogiorno is a drag on the government budget.

US Reunification: “Reconstruction” 1865-1877



Civil War 1861-1865

- Economic background:
 - North(east): Industrializing & urbanizing – produced 90% of US manufactures.
 - South: Produced 2/3rds world's cotton
 - Would have been world's 4th richest country on eve of war
 - Wealth tied up in slaves
 - War further stimulated industrialization of North, war damage in South was extensive.

Reconstruction: How to Reintegrate the South into the US Politically and Economically

- 2 approaches: reconciliation vs. reconstruction
- Reconciliation: retain pre-war political system (slaves freed but not able to vote) and quick political reintegration.
- “Radical” Reconstruction: destroy pre-war economy and political system by freeing slaves and making them full citizens and voters. “Confederate” officials and military excluded from government.

Reconstruction 1867-1877

- Army administered Southern states.
- New elections created Republican legislatures and local governments based on votes of blacks and poor whites.
- Sharecropping replaces slavery, shifts income in favor of freed slaves.
- After 1877, reconstruction faltered. Democrats regained power in state legislatures, freed slaves disenfranchised and repressed. Many migrated to northern cities.

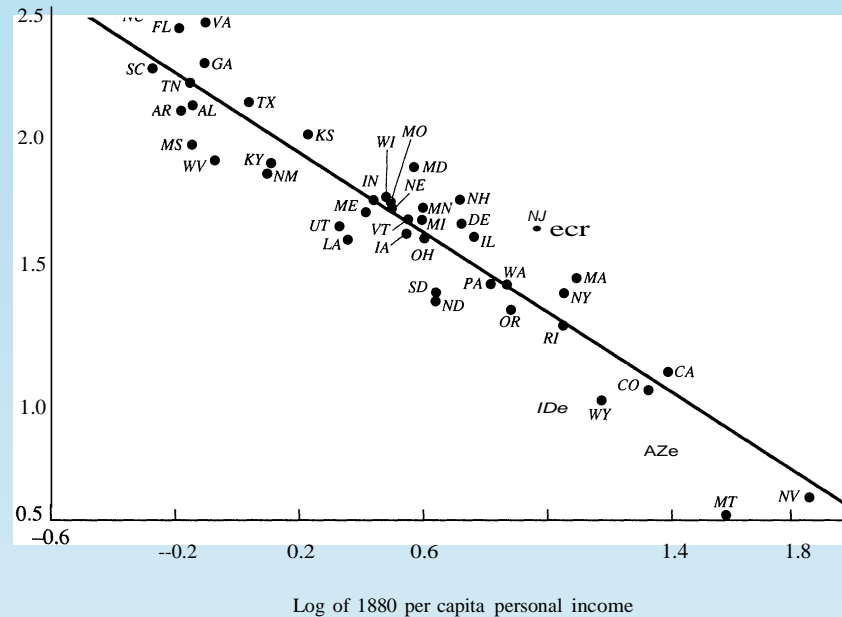
Long-Term Outcome

“By the end of the (19th) century, Southern per capita income had fallen to roughly two-thirds the national level, and the South was locked in a cycle of poverty that lasted well into the twentieth century. ”

US States Show Convergence

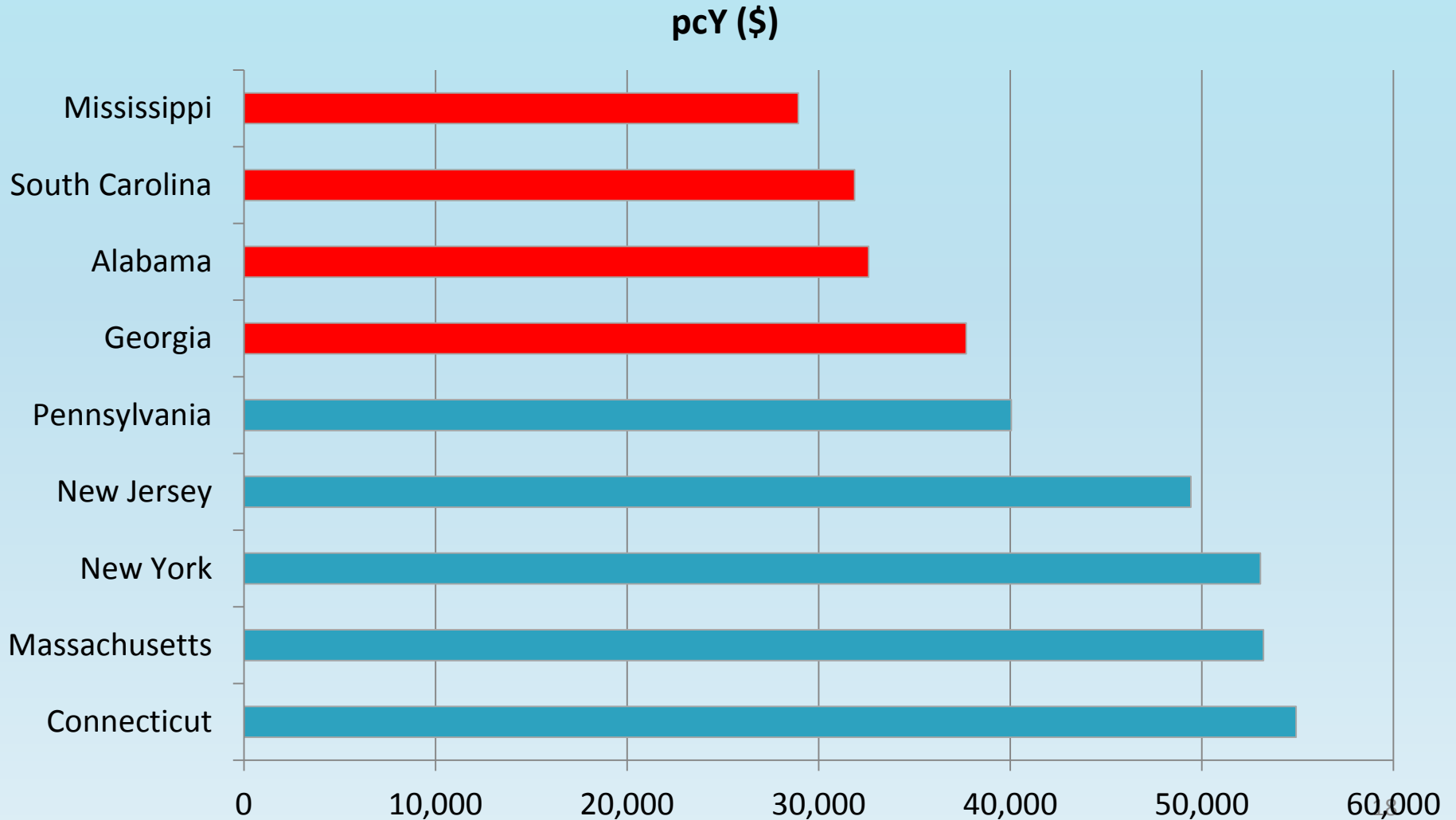
Figure 1. Convergence of Personal Income across U.S. States: 1880 Income and Income Growth from 1880 to 1988

Annual growth rate, 1880-1988 (percent)



But very slowly

per capita GDP of Selected States



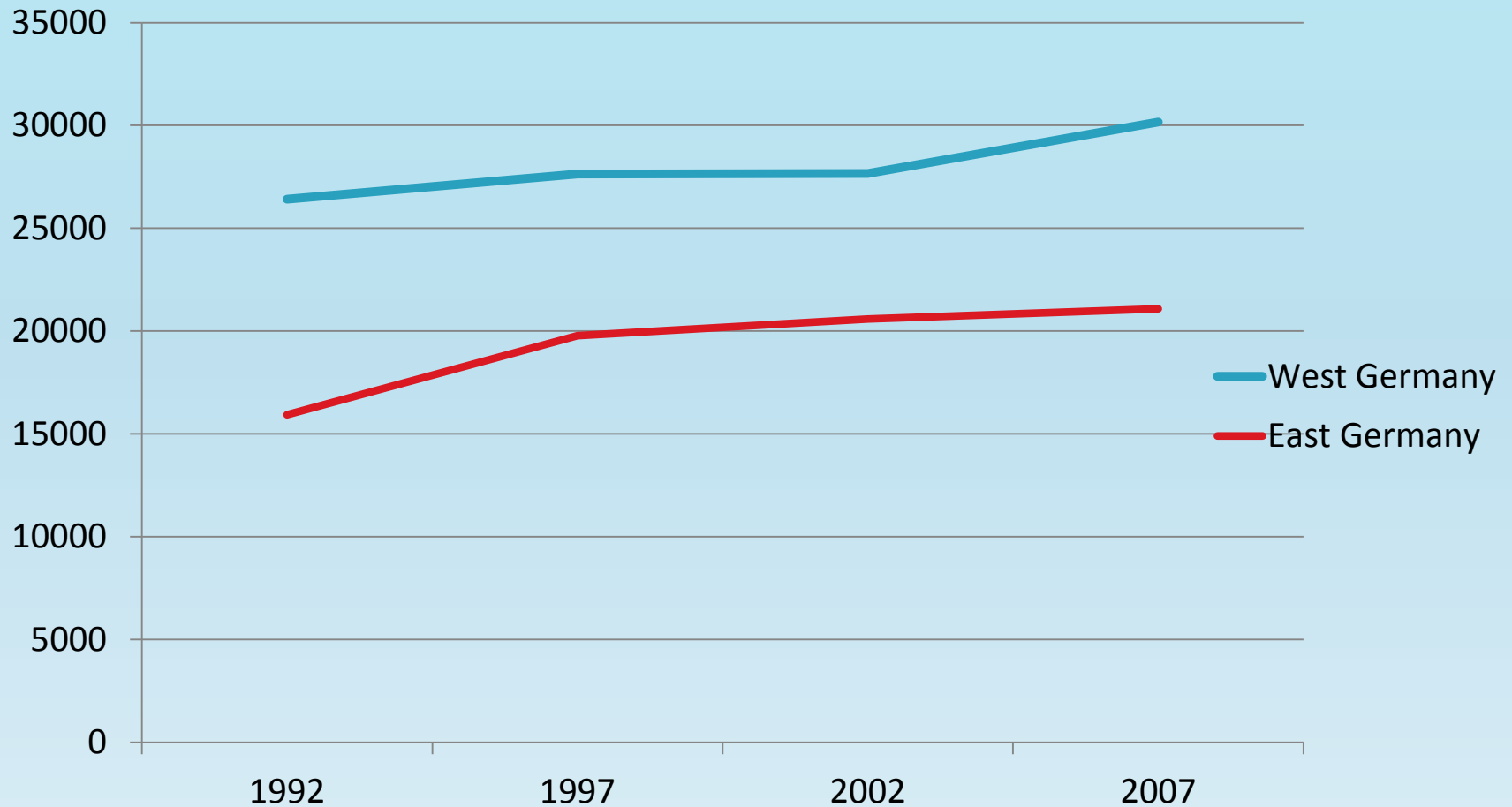
German Reunification



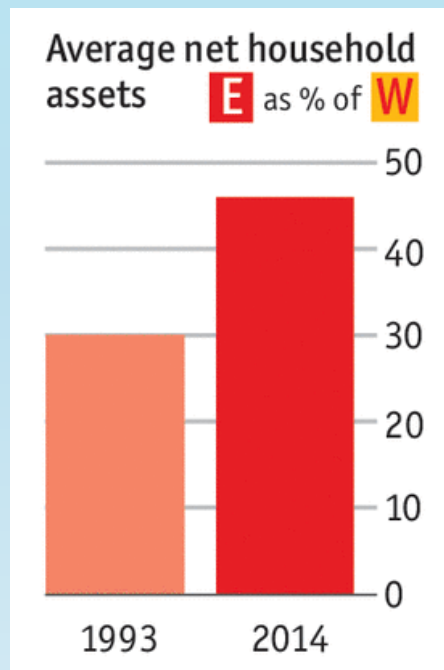
Germany Seemed to Do Everything Right

- East's military, police and government replaced by national (West) organizations.
- West's political system, political parties and institutions transplanted (including social assistance, pensions, etc.)
- Treuhand provided for orderly privatization of state assets.
- Conversion of currency at 1:1 good for incomes, pensions, savings – provided consumption cushion.

Germany: Real Gross per capita Income (Euro)



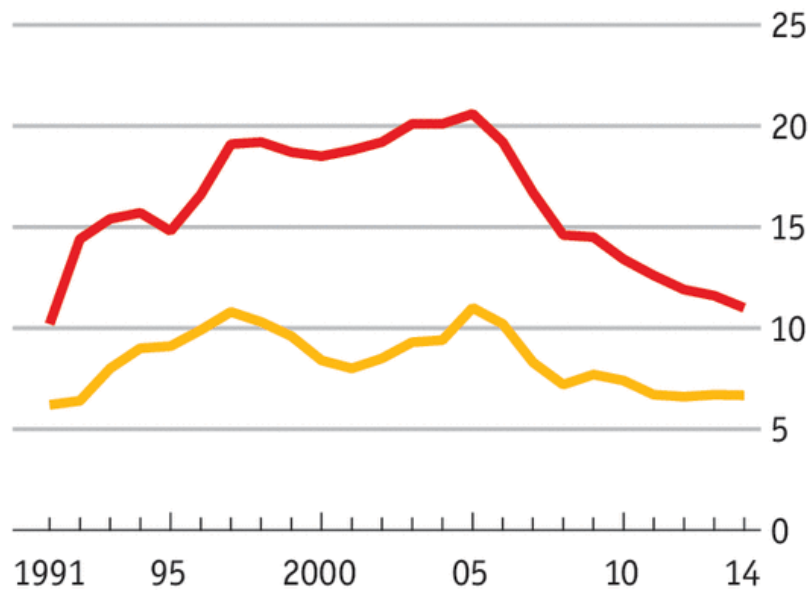
Wealth Catches Up Even More Slowly



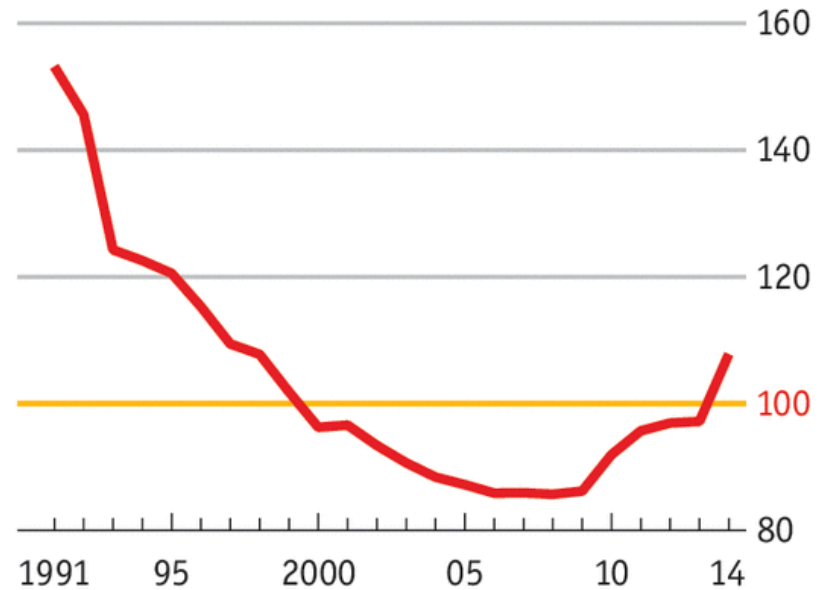
Source: The Economist

Procyclical Movements

Unemployment rate[‡], %



Eastern German unit labour costs
Western Germany = 100



Shortcomings

- East dependent on government activity and transfers – real economy is weak.
- Outmigration from East – population decreased from 18.1 to 16.3 million, West grew from 61.9 to 65.5 million.
- 1:1 currency conversion for wages made East's businesses uncompetitive, they remain so.
- \$1.6 trillion cost.
- Unemployment rates at least double those in the West.

Summing Up

Some Lessons from Three
Unifications

Common Elements

- Do not expect big positive changes in economic performance of region being “acquired”.
- Culture matters.
- Outmigration from poorer regions is quite large.
- Acquired regions are more vulnerable to cyclical shocks.
- Structural differences seem to play an important role.

Policy Implications

- Do eliminate to the extent possible existing economic, social, military and political structures in the region being acquired. They will persist!
- Do not rush local autonomy.
- Monetary union carries risks.
- Long-term consistency of policy is important.

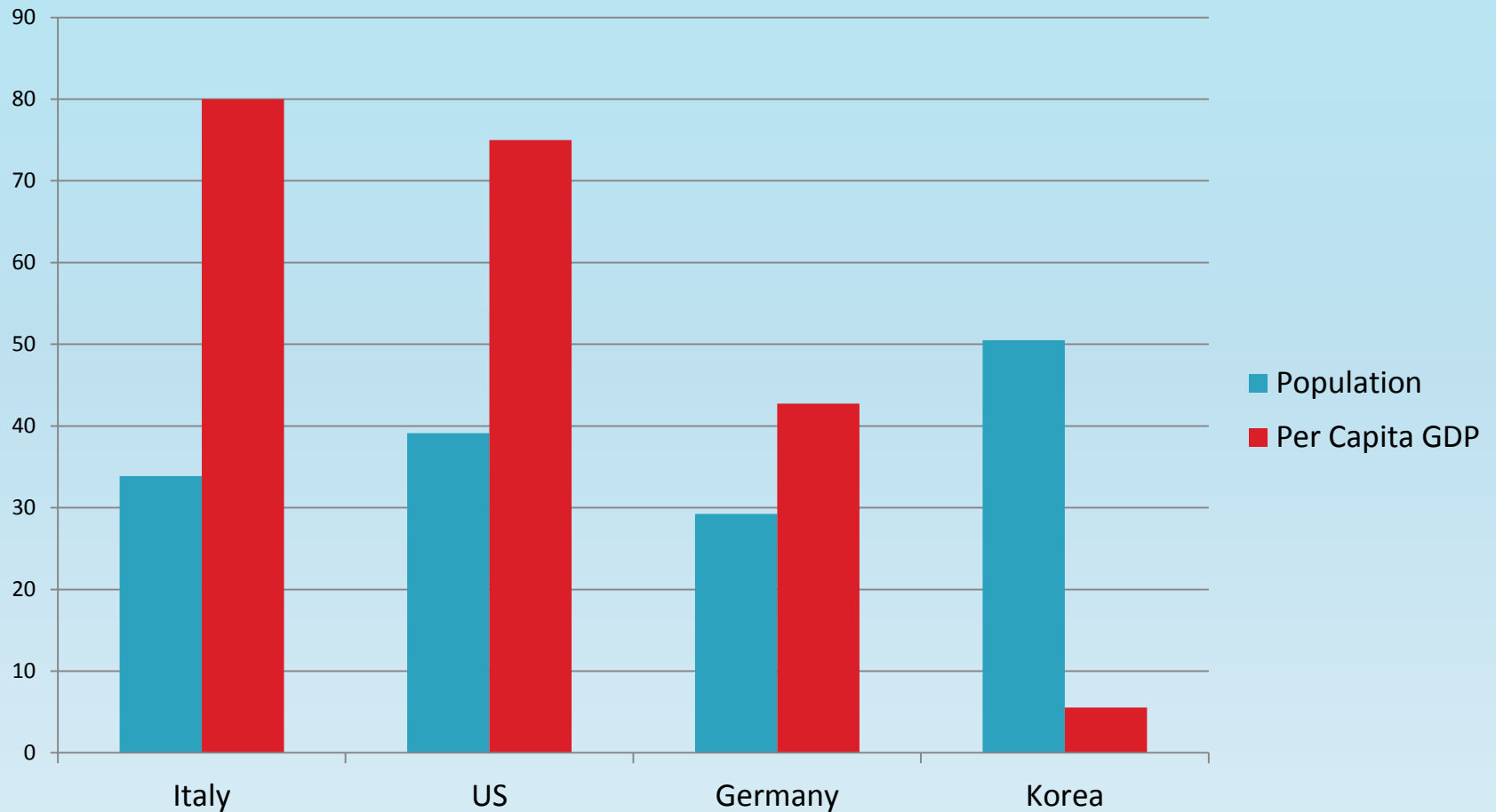
Question 1

- Is South Korea willing and able to follow the recommendations in the previous slide and to bear the costs? Can it do so for the long term?

Question 2

- Korean unification is different from other unifications. Does this matter ?

Acquired Country as % Acquiring Country



North-South Structural Differences

- Barro Growth Projections - Use long-term time series and socio-economic causal factors.
- 89 countries 1960- 2010 (uses 5 year periods).

The Model

Positive influence on growth of pcGDP

- Rule-of-law
- Investment/GDP
- Female school years
- Trade/GDP
- Terms-of-trade change
- Democracy

Negative influence on growth of pcGDP

- Log(lagged per capita GDP)
- 1/(life expectancy at birth)
- Log(fertility rate)
- Male school years
- Government/GDP
- Democracy²
- Inflation rate

3. Can unification overcome negative exogenous factors?

- End of a period of high total factor productivity (TFP) growth from innovations (Gordon, 2016).
- Global glut in saving, secular stagnation.
- Policy errors following global financial crisis – austerity vs stimulus.
- Slowdown in growth of world trade.
- Demographics.

TFP and Innovation

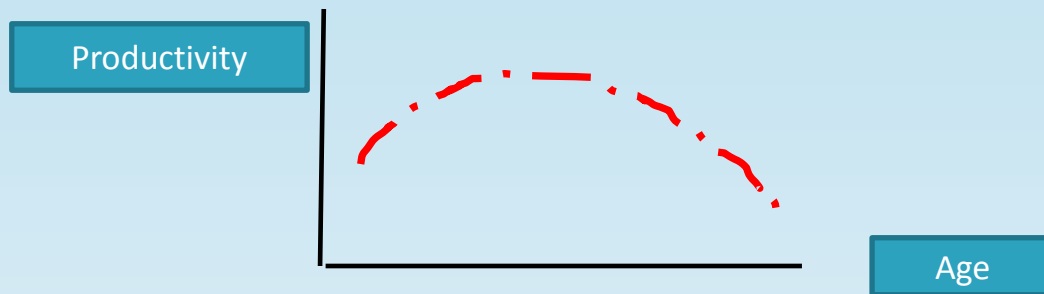
- TFP has suffered a secular decline
 - US 1.5% in 1950s, less than 1% 1960-2010, now less than 0.5% and Japan does worse.
 - EU TFP has grown at about 0.8% for past 20 years. Attributed to loss/exhaustion of innovation
 - Gordon - *Rise and Fall of American Growth*
 - Innovation vs TFP

Declining and ageing populations create a dilemma

- GNP/Pop vs GNP/L
- L is declining faster than Population
 - Demographic factors – stagnant or declining working age population
 - Declining LF participation and growing part time work
- Could be offset by
 - Higher participation rates for women and older people
 - Lower unemployment
- If increases in L do not make a contribution to GDP growth, then it must come from capital or TFP growth

Slow population growth and TFP and investment

- More older people means more government expenditures.
- More older and fewer young people implies less R&D.
- Saving effect of ageing is unclear for households (Wang & Tang , 2013), but corporate saving increases even as Investment declines.
 - Total and Optimal plant size
- Labor productivity vs age follows an inverse U shape



.....and finally, to the extent that we create more low productivity jobs, we increase income inequality

- Gini coefficients rising in Asia and elsewhere
- Higher Gini coefficients
 - Reduce educational attainment as measured by the PISA index
 - Reduce institutional quality (WB political stability index)

Question 3

- What to do with 1 million+ North Korean military and the many CP members and functionaries ?



Question 4

- Will geopolitical conditions in North-East Asia enable South Korea to follow necessary reunification policies?

Thank You

Germany: East's per capita GDP Shortfall from West (%)

