

## Prospects and Economic Impacts of Korean Unification: An Introduction\*

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Since Korea was divided into South and North, it has not been able to establish a strong foundation for bringing a peaceful end to the 70 years of division in the Korean Peninsula. The catastrophic war in 1950–1953 involving the USA, the United Nations (UN) and China ended with an armistice agreement but not with a peace settlement.

The two Koreas have followed very different development paths. South Korea has experienced strong economic growth and transformed into a democratic society. North Korea remains the most isolated, centrally planned communist country in the world. The North Korean economy has been stagnant and its income gap with South Korea has widened. Its average economic growth over the past decade was less than 1 percent and current per-capita income remains only approximately \$US1300, according to estimates by South Korea's central bank.<sup>1</sup>

Despite considerable economic hardship, North Korea has developed its nuclear weapons and missile programs. Tensions between North Korea and the USA have risen to an unprecedented level since 2017, when North Korea launched a number of intercontinental ballistic missiles and undertook a sixth nuclear test. The USA and the UN took a tough stance against North Korea and imposed tougher sanctions. Fears of military conflict on the Korean peninsula continued to escalate as the USA warned of preemptive action against North Korea. In turn, North Korea threatened countermeasures.

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1 The data are available from the Bank of Korea's Economic Statistics System ([http://ecos.bok.or.kr/flex/ClassSearch\\_e.jsp](http://ecos.bok.or.kr/flex/ClassSearch_e.jsp)).

The situation in the Korean Peninsula has dramatically changed in 2018. South Korean President Moon Jae-in held summit talks with North Korean leader Kim Jong-un at the border village of Panmunjom on 27 April and 26 May. The two leaders made a number of pledges regarding cooperation and peace in the Korean Peninsula, including an agreement to convert the Korean Armistice Agreement into a full peace treaty. It was followed by a historic first summit meeting between US President Donald Trump and North Korean leader Kim Jong-un on 12 June 2018 in Singapore. They signed a joint statement, agreeing to security guarantees for North Korea, complete denuclearization of the Korean Peninsula, and a new, peaceful relationship.

However, there is still significant uncertainty and concern about the current situation and prospects in the Korean Peninsula. Although the possibility of a serious military conflict in the Korean Peninsula has been reduced significantly, it could take more than a decade to achieve complete denuclearization of the Korean Peninsula. Furthermore, the North Korean leadership may not want to undertake serious domestic reforms and institutional changes that will undermine its iron grip on power. There are several possible scenarios in terms of reforms in the North Korean economy (see Haggard and Noland (2018), Lee and Pyun (2018), McKibbin et al. (2018) and Kang and Park (2018) of this special issue on reforms of the North Korean economy). First, the North Korean regime may abandon nuclear weapons and embark on comprehensive market-oriented reforms that open the domestic economy to international trade and investment. Although it might seem unlikely, another possibility is that the North Korean economy collapses and the unification of the Korea Peninsula comes abruptly, as was the case for the unification of German. North Korea's economic reform and integration into the international community and the process of Korean unification would have significant consequences for the two Koreas as well as the Asian region.

This special issue covers key issues on economic development, trade and investment related to North Korea and the overall development of Korean Peninsula. The special issue includes four studies that analyze economic issues related to North Korea's reform and opening up and Korean unification, starting with analyses of the potential gains from successful reform and economic integration with its neighbors. The special issue also considers scenarios of what could happen if such efforts were unsuccessful and if the North Korean economy experienced an abrupt collapse and was absorbed by South Korea, as occurred with German unification.

The first paper, by Lee and Pyun (2018), quantitatively assesses the future growth potential of the North Korean economy, conditional on economic reform and integration with the South Korean economy. This paper adopts an empirical approach by relying on historical cross-country data on bilateral trade volume and foreign direct investment (FDI) flows and an empirical gravity model of trade and direct investment, and estimates the effect of economic integration on trade and FDI flows of the North Korean economy.

Lee and Pyun carefully examine the scenario of North and South Korea pursuing economic integration and cooperation, and find that North Korea's trade with South Korea could increase North Korea's GDP by up to 36 percent and its FDI flows from South Korea by up to 6 percent of its GDP. They derive quantitative estimates of North Korea's potential economic growth rate with increased trade and FDI integration, based on cross-country growth regression results. Overall, by promoting trade and FDI integration with South Korea, North Korea could increase its GDP growth by approximately 3 percentage points per year. If North Korea were to adopt serious market-oriented reforms and integrate with other industrialized economies, it could achieve further growth momentum. In contrast, if tougher sanctions imposed on North Korea continue, its trade and investment with South Korea will cease and its GDP growth rate is expected to fall by approximately 2 percentage points.

The second paper, by Kang and Park (2018), examines the issue of North–South integration from an institutional perspective. The authors argue that political rivalry has generated a prisoner's dilemma outcome that yields a suboptimal degree of economic integration between the two economies. They then sketch out the case for a comprehensive economic integration agreement (CEIA) between North and South Korea that would cover trade in goods and services, investment, and labor mobility. The paper then uses a computable general equilibrium (CGE) model to examine the gains from a cooperative solution through CEIA under several scenarios. They conclude that an expansion of North–South cooperation could yield GDP gains of 3–5 percent annually for North Korea during the transition.

In the third paper, Haggard and Noland (2018) address a similar set of issues but through a different lens. In part due to the effect of sanctions, China accounts for more than 90 percent of North Korea's recorded trade. Using a formal survey of Chinese enterprises engaged in economic exchange with North Korea (as well as a control group including firms not doing business in North Korea at the time of the survey), the authors examine how economic integration has occurred in the absence of modern market-supporting institutions. The study finds that dispute settlement mechanisms are weak and do not appear to have consequences for relational contracting. Rather, firms rely on personal ties for identifying counterparties and resolving disputes. The results have two important implications: first, the study raises several issues on the integration between China and North Korea, at least as it is currently proceeding, and whether it will foster reform and opening. Second, the current institutional weaknesses are likely to penalize North Korea; if they were carefully addressed, the North's integration with China (and other countries) could proceed on more favorable terms.

Finally, the fourth paper, by McKibbin, Lee, Liu and Song (2018), assesses the economic impacts of Korean unification on North and South Korea under hypothetical scenarios, including (i) North Korea's reform and gradual convergence; (ii) North Korea's sudden collapse and immediate unification; and

(iii) chaos and crises in North and South Korea. The analysis is based on a global dynamic stochastic general equilibrium model that integrates a new consistent database of macroeconomic, sectoral and trade data (including an input–output table) for the North Korean economy with South Korea and other economies in the world.

The paper shows that the integration and unification process would have significant economic impacts on the two Koreas. Korean unification could also have far-reaching consequences for neighboring economies in Asia and the Pacific through trade and financial linkages. If North Korea adopts comprehensive market-oriented reform, it will have an opportunity to display strong GDP growth over the coming decades. If South Korea helps in the reform of the North Korean economy, it will inevitably suffer a drain in resources. However, as long as the unification process is gradual and sequential along an anticipated path, South Korea will have adequate time to construct better policies and will have the financial resources to reduce the unification costs and to mitigate the adverse effects of unification. There are important effects of the reform process on investors' confidence in South Korea and the Korean Peninsula more generally, which suggests potentially large costs if the process of unification is not handled well.

In sum, under the current economic conditions, the North Korean economy significantly underperforms. It faces major challenges both with respect to its domestic reforms as well as integrating into regional and global value-chain activities. If North Korea is unsuccessful in managing its multiple sources of stress, it has the capacity to impose significant negative externalities on its neighbors. Yet if those distortions and inadequacies can be successfully addressed, their very magnitude implies enormous potential gains. South Korea and the wider global economy are potential sources of capital and technology. The country borders rapidly growing China and is just a short distance away from Japan. If North Korea were to begin to reform and open, it would face a very supportive environment and potentially enormous returns on investment given the initial conditions.

It is this unique combination of upside and downside risks and the important strategic location of the two Koreas in the Asia Pacific region that makes the North Korean situation compelling and implies that the present potential turning point is of genuine historical importance. The papers in this volume are aimed at improving our understanding of the many issues surrounding Korean unification and at providing a platform on which to build the large amount of research that will be needed to improve the design of policies in a rapidly evolving environment.

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