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Implications for Korean Political Economy and Unification

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Chapter 12

What Can Korea Learn from German Unification?

Gerlinde Sinn and Hans-Werner Sinn*

Germany: An Experiment for Korea

German unification is a fascinating experiment in economic history from which Korea should try to learn before it too decides to unify. When Korean unification will come about is unclear, but that it should come about is clear. Korea is a great nation with an admirable cultural history. The two parts of the country should and will, at some stage, come togerther. Given the worldwide collapse of communism, including the reforms in China and Vietnam, it is difficult to image the current communist regime in North Korea surviving in the long run.

Although there are similarities, there are also a number of differences between Korea and German that imply less political pressure for unification than in Germany.

First, in contrast to Germany, Korea is not looking through a small opening in the window of history. In 1990, Germany had to act because it was not known how long Gorbatchov's regime could

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last. Had the coup d'état in the summer of 1991 succeeded, unification would not have subsequently been possible.

Second, the two Koreas have had fewer political contacts than the two Germanies. As a result of Willy Brandt's policy of "change through rapprochement" (Wandel durch Annäherung) there had been plenty of cross-border personal contacts that showed the east Germans what life was like in the west. Prior to unification, east Germany had even allowed western TV programs to be seen in the east, and had supported the construction of special transmission stations for this purpose. This would be inconceivable in north Korea. North Koreans are kept ignorant by the regime, unable to anticipate the wealth enjoyed by their fellows in the south.

Third, the two Koreas are more equal in size as the two Germanies. In west Germany unification meant that a family of four had to support one relative from the east. In south Korea unification would mean that a family of four would have to make room for two northern relatives at the dinner table. This aspect is particularly important since the cost of German unification turned out to be much higher than expected. It is understandable for Koreans to think twice about the need for unification. Up until now west Germany has pumped a net amount of DM 820 b. or more than $500,000 b. through the public budget into the east German economy. Currently the transfer is DM 150 b. per year, 5% of the west German GDP or, on a per capita basis, nearly three times the Polish disposable income. If south Korea wanted to adopt Germany's policies it would have to be prepared to pump 10% of its GDP into north Korea for the foreseeable future, clearly not a feasible option.

Korea, however, does not have to follow the German example. It can avoid the policy mistakes Germany made and carry out unification at a much lower cost. Basically Korea would have to try to keep the north Korean economy running during the unification process.

In east Germany unification put a halt to many economic activities. GDP declined by nearly one half in the first two years after unification, and industrial output fell by two thirds.

Employment declined by nearly 40% in the aggregate, and industrial employment by 80%. The east German slump was, in percentage terms, greater than any depression that had previously haunted an industrial economy during peace-time; it was about twice as severe as in the Great Depression of the thirties. There are now signs of recovery of the east German economy. The real rate of growth is currently 8% and construction activity is above the pre-unification level. Still, employment is hardly increasing at all, and the preunification level of output has not yet been reached. It will take another decade or two for the west German per capita output to be reached.

Some of the east German problems were unavoidable. Clearly privatization and restructuring implies temporary output losses. All eastern countries experienced such losses in the order of 20% of GDP, though some were almost as great as the east German one. Also, the problem of the breakdown of Comecon, the eastern trade system, had consequences from which no single country could escape. Nevertheless, a number of east Germany's problem are home-made, and these are the ones that Korea could avoid.

Currency Unification

The first problem Korea can avoid is the immediate unification of the two currencies. Germany had to introduce a currency union because otherwise the political union would have been at risk. Korea has more options.

Without a currency unification, Korea would always have the option of maintaining its competitiveness by devaluating its currency. Today east Germany urgently needs a devaluation to compensate for aggressive wage policies and the breakdown of eastern markets, but such a solution is no longer available. The economy is trapped in a high-wage/high-cost position which makes it difficult to sell its products in west Germany or to the rest of the world.

The European community is planning a currency unification, but it is very cautious about this and has described an adjustment path of many years before such a union becomes effective. A similar strategy is advisable for Korea.

Wage Policies

The largest single mistake of German unification policy was the failure to control the wage adjustment in the east. In 1989, east German wages were 7% of the west German wages measured at the current exchange rate. Today, east German wages are about 10 times higher, and it is set down in the wage controls that, by the end of 1996, union wages in the east will be identical with those of the west.

The wage increase immediately destroyed east German competitiveness with the result already mentioned that four out of five industrial jobs have been lost without a replacement.

The wage increase had been defended by politicians with the argument that it would prevent a mass migration to the west. This argument is incomplete or inconsistent as it does not clarify what should happen with those who lose their jobs because of the wage increase. Since real capital needs a long time, perhaps decades, to move to the east and create new jobs, the problem arises of where the workers should go in the meantime if their jobs cannot survive because of the wage increase. There are just two possibilities. Either they stay in the east and become unemployed, or they move to the west to get a job there. The first possibility is inefficient and the second is exactly what was to be avoided. Germany has chosen an intermediate solution. The net migration to the west has been nearly 10% of the population, and about 40% of the work force has been set free, leaving a total of about 25% unemployed. Only half of the unemployed are officially counted as unemployed and the rest have disappeared in early retirement schemes, short term jobs or unregistered employment.

An efficient labour market policy would have involved voluntary migration and competitively determined wages. The wage

gap between east and west would have induced some people to migrate and would thus have created a shortage in labor supply in the east. Wages would then have risen to a level at which the wage differential would have equalled the marginal migration cost. All those people whose migration cost was lower than the wage differential would have worked in the west, and all those whose cost was higher would have maintained their jobs in the east. With wages equal to the respective marginal productivities of labor, the allocation of the work force would have been efficient. It would have maximized German GDP net of the objective and subjective migration costs.

The reason why the market was not allowed to bring about such an efficient allocation of the work force can be found in the interests of west German employers and trade unions. In Spring 1991, long before the privatization of the east German economy had been completed, these parties had founded employers organizations and unions in the east so they could determine the wage policies in their respective industries. Their common goal was to prevent low wage competition from the east so as not to endanger west German jobs, and they found support among the east German workers who liked high wages, because they would either receive these wages or the unemployment benefits which they knew to be closely linked to them. The only interested party that could have prevented the wage increases would have been private east German employers, but this party did not exist then. Korea will have to avoid a similar mistake although this will not be easy. It will have to make every attempt to keep the north Korean employers' organizations and trade unions separate from those in the south so that they can make their own independent decisions. It will also have to ensure that wages cannot be negotiated before privatization is completed. Government regulated wage controls are indispensable ingredients of a suceessful transition strategy.

Privatization

A substantial fraction of state assets in east Germany were privatized by means of restitution to previous owners. Korea will be able to avoid this complicated and time-consuming privatization method since a substantial fraction of these owners are Japanese, who will probably not be seen as eligible far either compensation or restitution.

Korea's real choice lies between the German Treuhand's cash sale method and the Czech voucher privatization. Cash sales establish a dominant owner and solve the problem of corporate governance, but they will bypass the north Korean population. Voucher privatization will benefit the north Koreans but will not, in itself, establish well functioning management and will not contribute to bringing southern know-how to the north. Both methods have substantial drawbacks.

An intermediate solution would be to apply a participation model that combines the advantages of both methods. Instead of selling the old assets for cash to a southern investor, the government could establish a joint venture between this investor and a mutual fund. Each party would receive shares for whatever it brought in - the investor for his know-how and restructuring capital, the fund for the old assets belonging to the state. Shares in the fund could then be given (without compensation) to the north Korean population.

The participation method would imply that none of the state assets are actually sold to the south and and that 100% of their value is reserved for the population in the north that once created these assets. At the same time, a competent shareholder with restructuring capital and the necessary know-how would be found, who could actually run the firm and prepare it for competition in the world markets.

If the fund's share is non-voting, this method is very likely to increase the interest of potential investors and to speed up the upswing in the north. In effect, the shares ceded to the fund mean that the current payment of a purchase price is being transformed

into later dividend payments. This has the advantage for credit constrained investors that less capital is needed and for risk averse investors that the payment is only due if, and to the amount that, profits are made.

A major advantage of the participation model would be that it will help the north Koreans accept a persistent wage differential relative to the south. When the conditions of the joint venture are determined in a competitive bidding process, the value of the fund's shares will be higher the lower the wages, and in present value terms, the northern population cannot lose from wage restraint. In fact it will win. If the restraint will not preserve jobs, then wage restraint will be translated one to one into higher share values for the north Korean population. If, as can be expected, restraint implies that more jobs can be preserved, then the share values will go up by more than the wage restraint; it will also reflect the profits of those firms that otherwise would have become bankrupt.

The policies of privatizing the north Korean economy via the participation model and setting moderate wages must go hand in hand. Together they make up the principal way in which Korea could avoid Germany's problems.