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Potential of United Korea

Bolstered by improved sentiment among consumers and business and fiscal stimulus, economic growth rate of South Korea in the second quarter of 2009 increased 2.6% from the first quarter, sharply up from 0.1% in the first quarter. Given an easing in the global financial crisis and heightening expectations of economic recovery, financial markets have been stabilized. The KOSPI has surged by 48.8% since the beginning of the year to 1673 as of September 30, and the Won has risen 5.3% to 1,189/USD from 1,255/USD since the beginning of the year. Apart from BRIC, we are also positive to the long term economic outlook of Korea and we believe that a peaceful and gradual economic integration between North and South Korea, if possible, would be the super factor of Korea's economic growth. With reference to Goldman Sachs Global Economic Paper No.188, this article studies the potential and the cost of the integration.

North Korea's economy is increasing lagging behind its former planned-economy peers – not to mention South Korea; living standards in China and Russia and more recently in Vietnam and Mongolia, have improved rapidly along with market reforms. North Korea's per capita income in 2008 is 23% lower than in 1990 and it has declined from 12% of South Korea's in 1993 to 5.5% in 2008, according to Bank of Korea estimates. These developments could eventually spark powerful political and economic changes in North Korea.

The economic integration could take various shapes or forms – from instant unification to a gradual integration – with diametrically different implications for the economy and markets. Experience from Germany's unification suggests that the choice of integration modality may be dictated by the process itself rather than left to the discretion of policymakers. The assumption of a peaceful and gradual integration is reasonable, given the policy stance of the South Korean government and the international community, and the apparent lack of alternatives for the North Korean leadership other than economic reform and cooperation with neighboring countries.

In the paper, Goldman project that a united Korea could overtake France, Germany and possibly Japan in 30-40 years in terms of GDP in USD terms, should the growth potential of North Korea be realized. This projection would put the size of a united Korea in 2050 firmly on a par with, or in excess of, that of most G-7 countries, except for the US. North Korea's currency is assumed to appreciate at 11% per annum over 15 years, real GDP could grow on average at 7%-8% per annum.

North Korea has strong untapped potential, which could be unleashed once meaningful economic reforms start and investment flows in. The three main factories are: 1) An abundant and competitive labor force; 2)ample room for synergies between South Korea capital and technology, and North Korean natural resources and labor; and 3) the potentially large gains from productivity and currency appreciation typical in transition economies .

Abundant and competitive labor force

Per capita income in North Korea stood at around US$1,100 in 2008 market prices, which is similar to that of Vietnam and India, and about one-third of China's, which can provide the competitive wages. In addition, more than a third of the population (37%) lives in rural areas, as was the case in South Korea in the late 1970s, providing an ample pool for the industrial workforce. Mirroring the population structure, the primary sector represents about 22% of GDP, also similar to that of South Korea in the late 1970s.

Strong synergies between North and South Korea and North Korean natural resources and labor

North Korea is rich in minerals, unlike South Korea. It has large potential deposits of minerals, including magnesite, coal, uranium and iron ore, valued at around 140 times North Korea's 2008 GDP at current market prices. Its demographics are relatively young and the population is growing roughly twice as fast as in South Korea. The working age population, according to 2008 UN projections, will grow at 0.7% a year over the next 10 years, compared to zero growth in South Korea. Experience from the Gaesung Industrial Complex also suggests that North Korean workers have a strong work ethic and a good potential for productivity enhancement.

Productivity gains and currency appreciation

The experience of transition economies suggests that the North Korean economy could benefit substantially from productivity gains and currency appreciation once economic reforms take hold. Asian transition economies have average annual growth of 8.4% over 1992 – 2008, without much of the initial output contraction. Productivity growth, not explained by investment and employment growth, accounted for nearly 40% of total growth over 1996 – 2006 in transition economies, indicating that a sizeable part of GDP growth in transition economies has come from better allocation of resources and a more efficient use of existing resources. So, North Korea's growth potential is estimated conservatively at around 7%-8% pa should it pursue integration with the South.

Cost estimates of inter-Korean integration vary widely, depending on the speed of integration and policy assumptions. The most expensive option for South Korea would be the German-style of unification, where South Korea would need to provide large income subsidies to North Korea. Fiscal transfers in the case of Germany were 3.6%-4.6% of GDP a year over 1991-1999 (Swiss Institute for Business Cycle Research 2004). This option would be prohibitively expensive in the case of Korea, given the relatively large difference in incomes (North Korea's per capita income is 6% of South Korea's as opposed to 33% in the German case) and small population gap (North at 48% of South Korea's population versus 27% in the German case) between North and South Korea (IMF 1997). The least expensive option would be a China/Hong Kong-style integration, which allows two economic and political systems to coexist in a country with limited inter-Korean migration. The gradual integration seems the most likely scenario and the integration costs are affordable if backed by appropriate policies.

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