



Korea's Reunification & Financial Policy Tasks

※ Please note that this material is to encourage constructive discussion among academia, policy banks and financial institutions about Korea's reunification. This is not the Korean government's official stance at the moment, which needs further discussion in the future.

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1. Historical Implication of Korea's Reunification

 The year 2015 marks the 70th year since the Korean peninsula was divided.
→ Reunification is ①historical mission as “one” nation and ②opportunity for the Korean economy's further growth.

Korea's structural problems

✓ Low growth

Potential growth rate : 6~7%(90s)→3%(after 2000~)

✓ Low price

Consumer price index(%) :
4.7(2008), 3.0(2010), 2.2(2012), 1.3(2013)

✓ Low employment

Youth employment(%): 44.9(2005)→39.7(2013)

✓ Low fertility rate

Fertility rate(2000, person): 1.45 (2000)→1.18(2013)

✓ Aging population

Working age population: expected to fall after it peaks in 2016(37million)

Reunification as an economic opportunity

Strong Economy

- ✓ 80 million population
- ✓ Investment for NK's development
- ⇒ **Strong domestic demand**

Sustainable Economy

- ✓ NK's labor and natural resource
- ✓ SK's capital and technology
- ⇒ **Strong competitiveness**

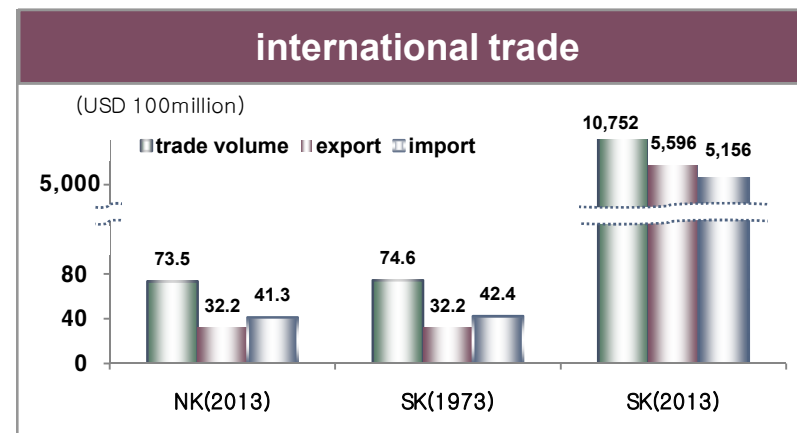
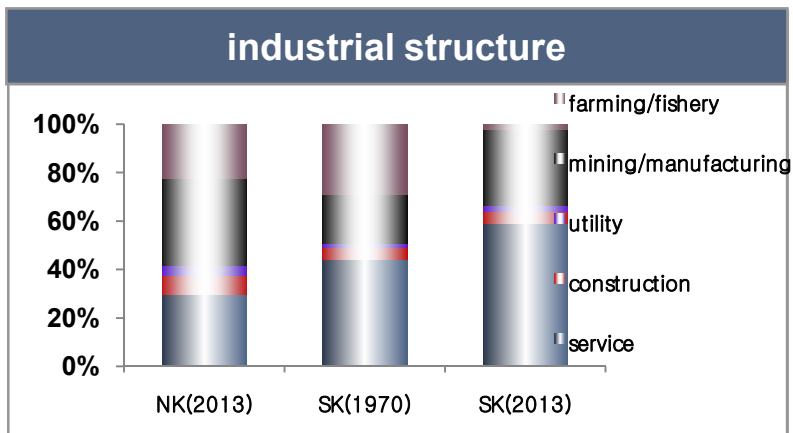
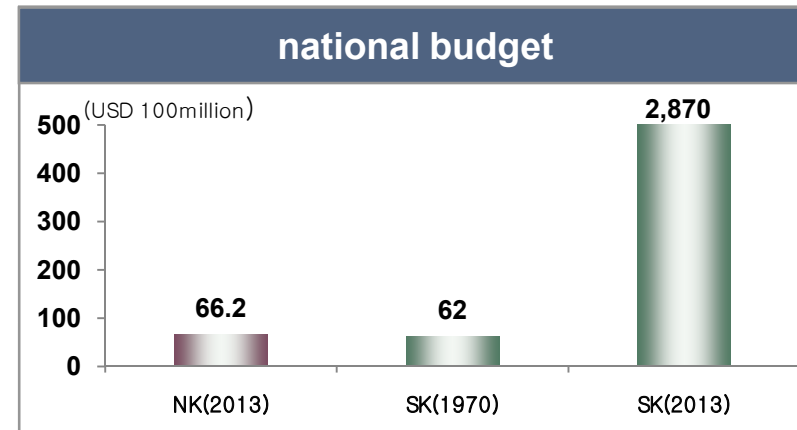
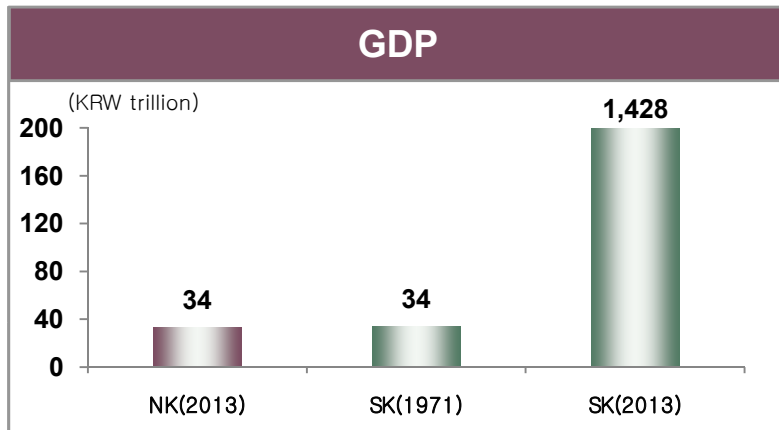
Good Economy

- ✓ Nuclear-free
- ✓ No “arms race”
- ⇒ **No geopolitical risk**

2. Current Status of NK's Economy

① Overview

 NK's GDP is around 34 trillion won. NK's economy remains at the levels of SK's in 1970s (national budget, industrial structure, international trade, etc.)





② Comparison with German Case

Big economic gap between the two Koreas, compared to the German unification case

National GDP : West Germany= East Germany x 9.7 vs. South Korea = North Korea x 42.5

		Germany		Comparison (W/E)	Korea		Comparison (S/N)
		West	East		South	North	
Economic size	Population (thousand)	62,600	16,400	x 3.8	49,770	24,030	x 2.0
	Economic Growth (%)	3.8%	1.9%	x 2.0	3.6%	0.8%	x 4.5
	National GDP (USD 100million)	1,317	135.5	x 9.7	1,428	33.6	x 42.5
	GDP per Capita (USD 1000)	21.3	8.2	x 2.6	26.0	1.3	x 20.0
Available Resource	Gov't Spending	45~50% of GDP			30% of GDP		
	Total Tax Revenue	35% of GDP			25% of GDP		
Aid to East Germany or NK		KRW 2 trillion per year (1971~1989)			KRW 14.1billion (2012)		



③ Major Events & Enactment

-  Enactments & revisions to introduce market economy since 1980s, but no significant improvement
-  Some measures taken to improve economic management after economic crisis in 1990s, but no significant change

Major Events	
1980~1990s	Sharp fall in int'l trade after the collapse of Soviet Union & China's economic opening
1992	Enactment of the private property system initiated
1994	Death of Kim Il-sung(July 8)
1994~2000	Economic deterioration
2002	Measures to improve economic management(July 1)
2007	Downfall of Premier Park Bong-ju(July 4)
2009	Appointment of Kim Jeong-eun as successor to leadership
2011	Death of Kim Jeong-il(Dec.17)
2012	Economic Reform under Kim Jeong-eun's leadership
2013	Return of Premier Park Bong-ju

Enactments/Revisions	
1984	Joint Venture Act
1992	Foreign Investment Act, Foreign Companies Act, Joint Investment Act etc.
1993	Economic & Trade Zone Act, Foreign Exchange Management Act, Foreign Investment Banks Act, etc.
1998	Revisions to foreign investment-related Acts
2002	Special Economic Zone Act
2004	Central Bank Act
2006	Commercial Bank Act
2009	Revisions to foreign investment-related Acts
2011	Revisions to Economic & Trade Zone Act
2013	Economic Development Zone Act

④ Financial System

-  Single banking system · state-controlled monetary system · supply-oriented financial system · no cash transaction
-  Widening gap between financial laws and economic realities

Financial Institutions

- ✓ **Central Bank of the DPRK**
Functions as both a central bank and a commercial bank; government spending
- ✓ **Foreign Trade Bank of the DPRK**
Specialized in int'l finance e.g. forex management, foreign exchange rate
- ✓ **Foreign exchange-specialized banks**
Specialized in foreign exchange assets and trade settlement
- ✓ **Joseon Joint Bank**
Established to attract foreign capital

Financial System

- ✓ **Domestic sector**
(money supply) central bank as the only source of money supply
(monetary policy) control size of bank loans
- ✓ **International sector**
(foreign exchange rate) fixed rate exchange system. Widening gap between official rate and commercial rate
(foreign exchange management) direct control by the state

3. Financial Policy Task Upon Economic Integration

① 3 Main Tasks



Transformation of economic system can proceed in different ways according to political, economic, and historical backgrounds



In general, it leads to 3 main tasks – ‘development’, ‘implementation’, and ‘integration

Development

Create foundation for sustainable growth

- ① Develop industry
- ② Re-establish railroad and harbor
- ③ Open markets, foster trade
- ④ Develop provincial areas and natural resources

Implementation

Implement core system for market economy system

- ① Liberalize price
- ② Privatize properties
- ③ Adopt market system

Integration


Integrate two different economic systems

- ① Integrate legislative system
- ② Integrate infrastructure
- ③ Integrate markets



Although it is hard to predict the speed and method of economic integration, it is necessary to thoroughly prepared for all possible challenges

② Cases of Economic System Transformation

-  **Benchmark overseas cases of 'Development' and 'Implementation'**
-  **Benchmark Germany's 'Integration' phase considering the Korean peninsula's unique situation**

Germany

- ✓ Efforts for reunification was centered by economically dominant West Germany
- ✓ Economic systems were rapidly integrated due to East Germany's sudden collapse
- ➡ **Economic systems were integrated after going through 1 to 2 years of implementation period**

Russia

- ✓ Despite Mikhail Gorbachev's economic reform during 1989-91, the Soviet Union was faced with economic uncertainties such as stagnant growth and rapid, inflation ultimately leading to the collapse of the socialist system
- ➡ **Political and social uncertainties resulted in collapse and transformation of system**

China

- ✓ China achieved gradual and continuous transformation of system since active reforms(profit reserve system, gradual price liberalization, privatization of properties) from 1978 led by Deng Xiaoping
- ➡ **China realized economic development and implementation of new economic system based on stable political structure**

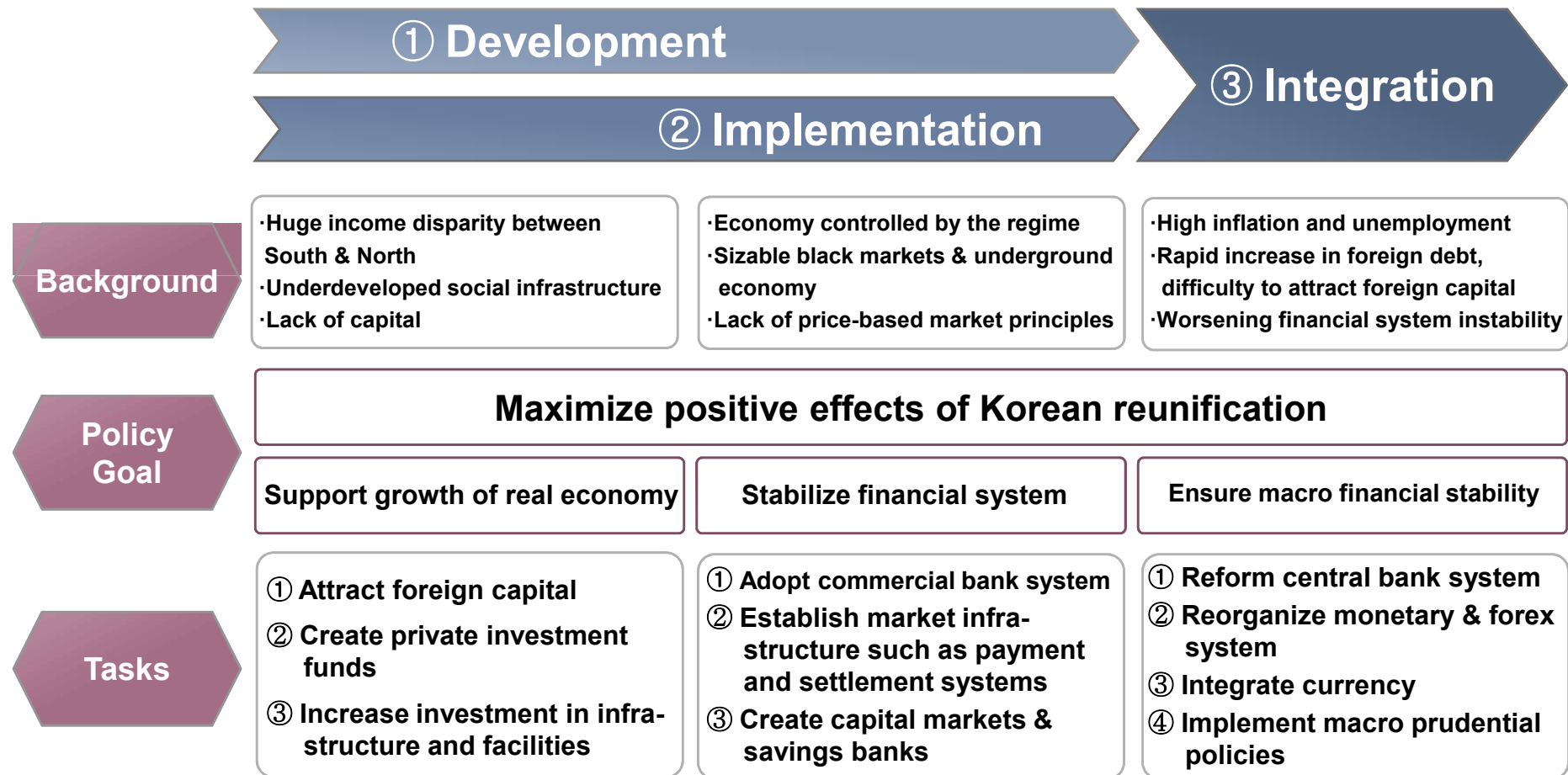
Vietnam

- ✓ Vietnam established multisectoral economic system after implementation of Doi Moi policy in 1986
- ➡ **Swift economic reform led successful economic development and implementation of new system**

③ Financial Policy's Role and Task



It is crucial to be thoroughly prepared to respond to various financial issues in order to fully enjoy the positive effects of the Korean reunification



4. Measures to Support NK Development

① Necessity to Raise Fund through Finance

- 📌 Reunification is expected to cost huge amount of money considering NK's underdeveloped economy
- 📌 However, it is impossible to cover such cost only from the budget or through foreign ODA

Huge Economic Gap

- ✓ NK's nominal GDP (KRW 33.6 tn) is only 2% of the South's
- ✓ Development of infrastructure and industries significantly lag behind
- ➡ **Significant amount of economic burden is expected to support NK's development needs**

Limited Gov't Budget

- ✓ West Germany's sovereign debt to GDP rose 22%p (40%→62%) in 6 years since reunification
- ➡ **Relying heavily on gov't budget to support development can cause social conflict**

Limited Foreign ODA

- ✓ Vietnam's average foreign ODA volume stands at mere USD 900mn for 20 years since 1986
- ➡ **Fund raised through ODA is not sufficient to fully cover development costs**



Role of finance is crucial to maximize synergy effects of reunification

② Estimation of Fund Needed for NK Development



Cost for NK development is estimated at approx. USD 500bn



Cost to build infrastructure and foster industries is estimated at approx. USD 175bn among the total USD 500bn

Cost for Development(estimate)

√ Estimated Cost

Approx. USD 500bn is needed to raise NK's per capita GDP to USD 10,000 in 20 years from the current USD 1,251

√ Estimation Method

- ① Set target economic growth rate needed to realize NK's per capita GDP of USD1,000 in 20 years
- ② Set capital increase rate needed to achieve target economic growth rate
- ③ Set total development cost by adding the amount of increased capital needed for 20 years

Cost to Build Infrastructure(estimate)

√ Develop NK Infrastructure
(approx. USD 140bn)

(USD billion)

Railway(77.3), Road(37.4), Electricity(10.4),
Communications(9.6), Airport(3), Harbor(1.5)

Cost to Foster Industries(estimate)

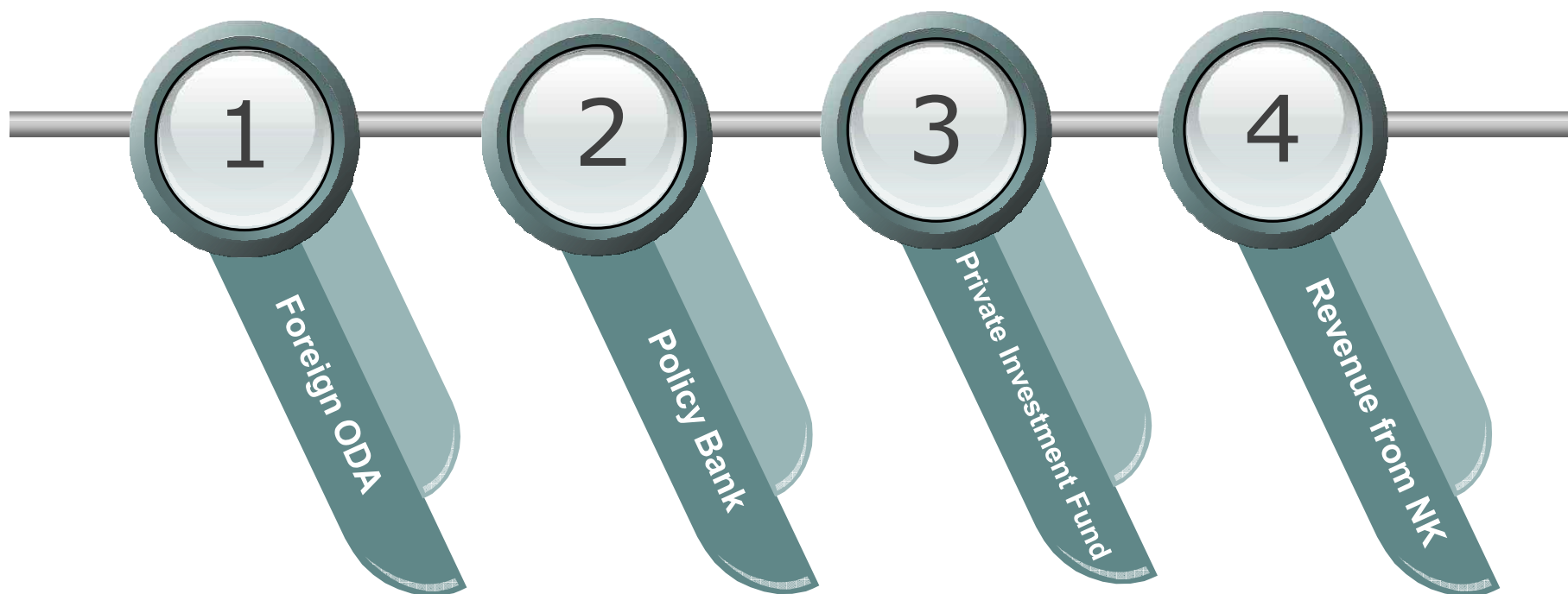
√ Approx. USD 35bn estimated to foster NK's
industries

(USD billion)

Agriculture & Fisheries(27), Mining(2),
Electrical & Electronics(2), Light Industry(0.8),
Special Economic & Commercial Zone
Development(3)

③ Ways to Raise Development Cost - 1

📌 Raise USD 500bn in 20 years through foreign ODA, policy bank, private investment fund, and profit created by NK



③ Ways to Raise Development Cost - 2



Raise USD 17bn through foreign ODA



Raise USD 250-30bn through policy banks

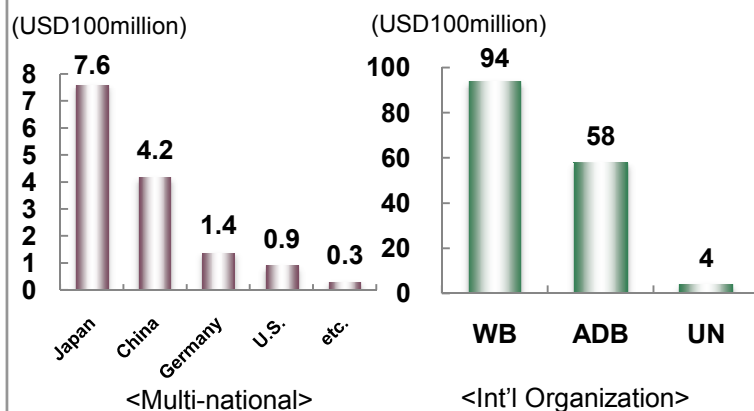
Foreign ODA

✓ Multi-national ODA

Raise USD 1.4bn through ODA's from countries such as US, Japan, China, and Germany

✓ Support from International Organization

Raise USD 15.6bn through support from international organizations such as WB, ADB, and UN



Policy Finance Institution

✓ Amount of Fund

50-60%(USD 250-300bn) of total development cost will be raised by policy finance institutions

✓ Expected Outcome

- ① Government's fiscal burden will be greatly reduced because policy banks are capable of financing fund worth 8-10 folds more than the government
- ② Fund will be channeled effectively because policy banks have capacity to select promising industries
- ③ More investment will be attracted by encouraging private financial firms to participate

Germany

KFW(Germany's development bank) provided 56.8% of total fund needed for development from 1990-98.

③ Ways to Raise Development Cost - 3

- 📌 Raise approx. USD 107.2-186.5bn from domestic and foreign private investors
- 📌 Raise approx. USD 100bn through NK's tax revenue and profit earned by natural resource development

Private Investment Fund

- ✓ Raise USD 107.2-186.5bn by attracting private investment in profitable projects and special economic zones

*Set NK's target FDI ratio to GDP to the level between Vietnam(4.6%) and Bulgaria(8.0%)

Vietnam

Vietnam actively attracted FDI after opening market by enacting Foreign Investment Act(1987) and Corporate Act(1990), and granting tax benefits to foreign investors(1990).

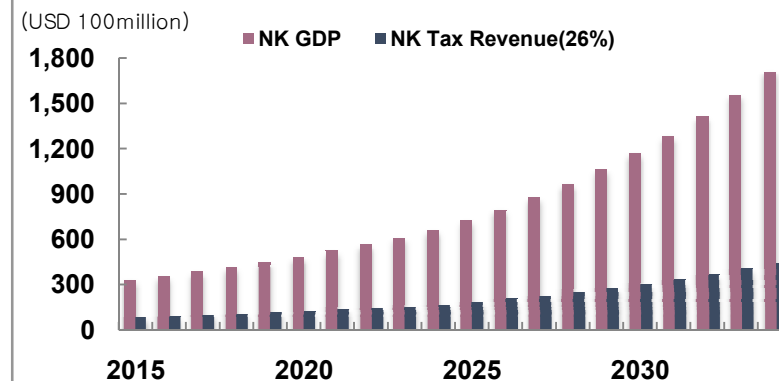
Revenue from NK

- ✓ Approx. USD 330bn is expected to be earned in NK for 20 years after reunification due to NK's economic development and GDP increase

→ Approx. USD 100bn will be used for NK development

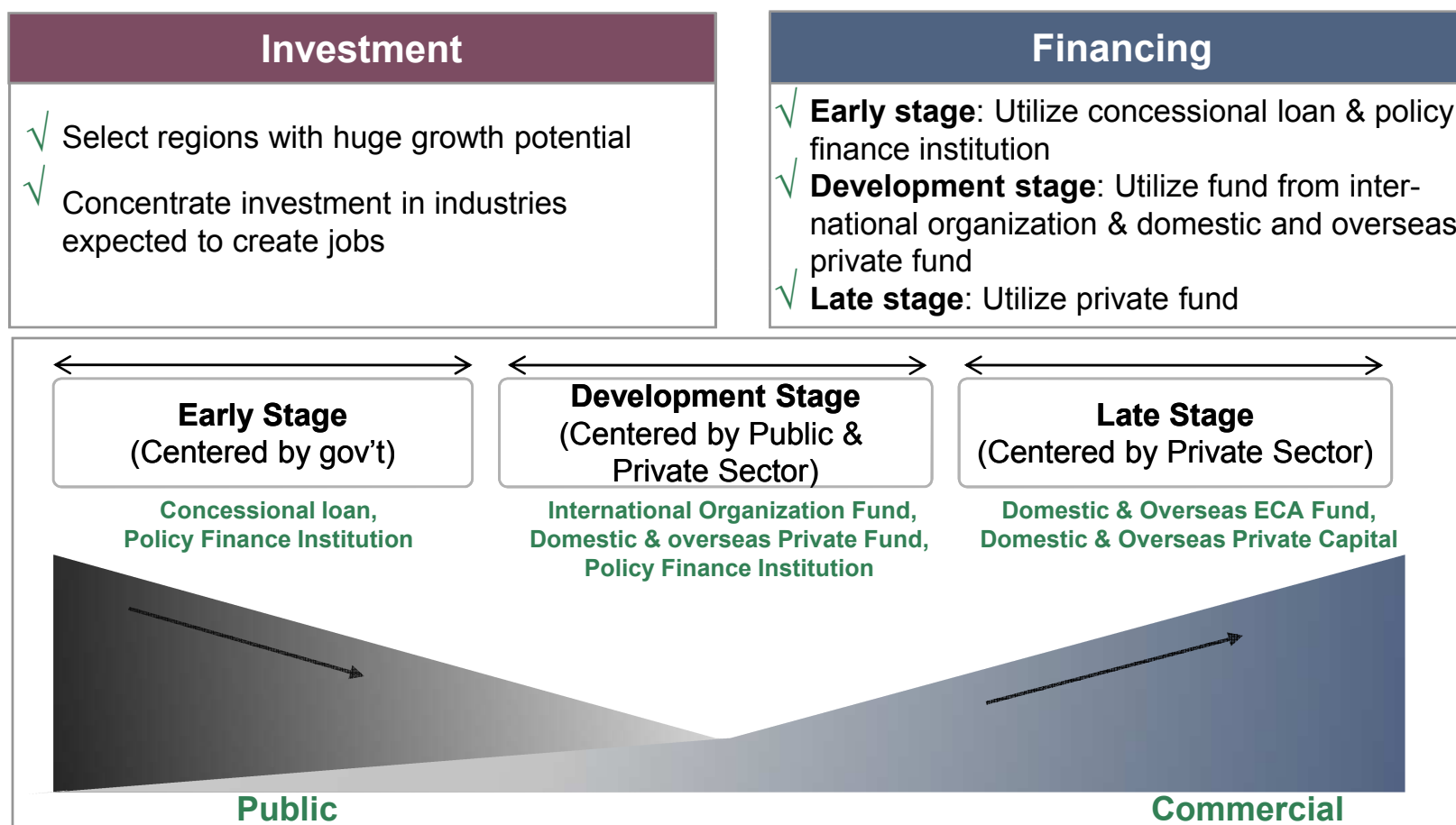
*Assumed NK's annual growth rate at 8% during the first 10 years and 10% during the next 10 years

*26% tax rate applied





④ Utilization of Development Fund - 1

- Investment will be concentrated in areas that can rapidly increase NK economy's productivity
- Finance development fund according to NK's development phase by using various private financial instruments



④ Utilization of Development Fund - 2


-  Evaluate NK's major special economic & economic development zones to select areas for development fund to be invested
-  ①Industrial location ②Economic cooperation condition ③Prioritize areas with high potential and concentrate investment

Major Special Economic & Economic Development Zone in NK



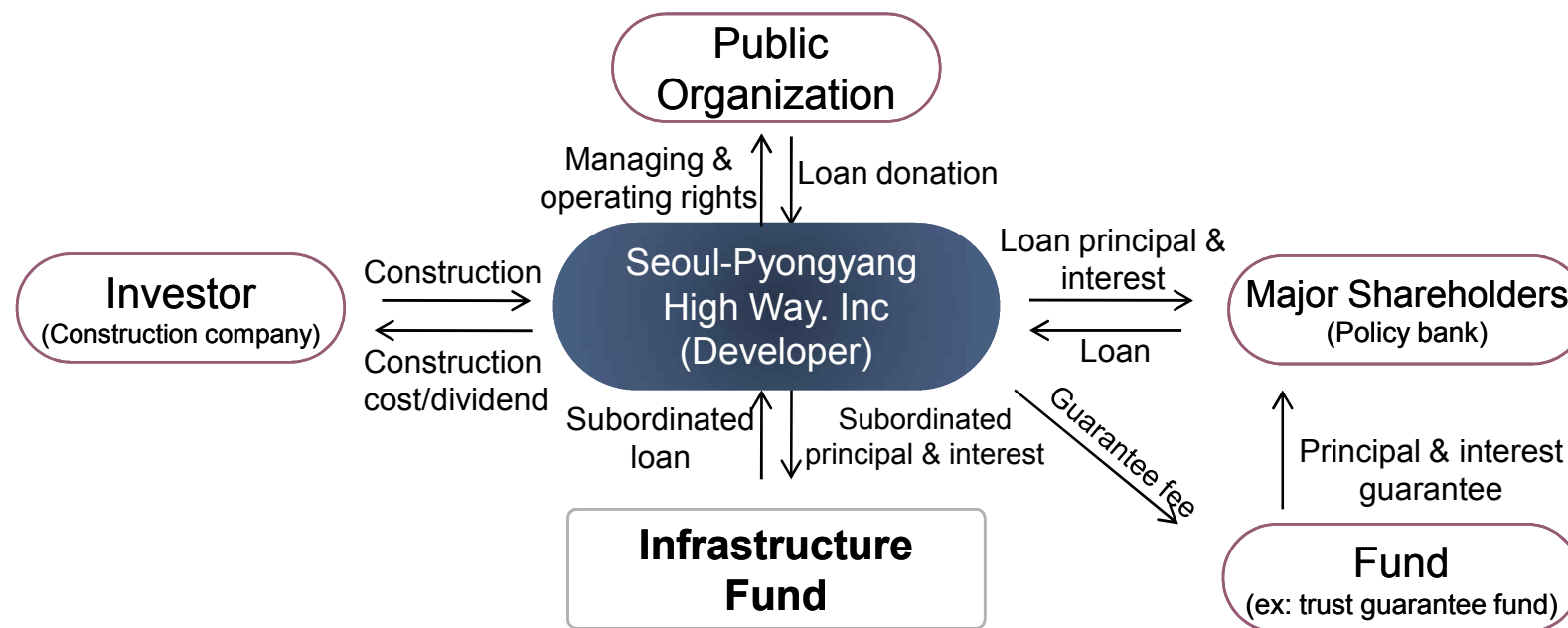
Region	Industrial Location			Link to int'l economic dev. plan	Investment Potential
	Pop.	Infrastructure	Logistics Infrastructure		
Pyongyang·Nampo	○	◇	●	◇	○
Kaesong·Haeju	□	■	○	◆	●
Najin·Sonbong	○	◆	◇	□	□
Sinuiju	●	○	■	○	●
Chongjin	◇	□	●	□	◆
Wonsan	●	□	◇	■	○
Sinpo·Tanchon	◆	○	●	□	○
Hamhung	◇	□	○	○	□
Hungnam	■	◆	○	◆	●
Hyesan	○	●	◇	□	◇
Wiwon	□	◇	◆	◇	■
Manpo	●	○	◇	○	●

④ Utilization of Development Fund - 3

 Policy Bank's participation is crucial when investing in infrastructure projects which are expected to be profitable but hard to finance cash in early stage

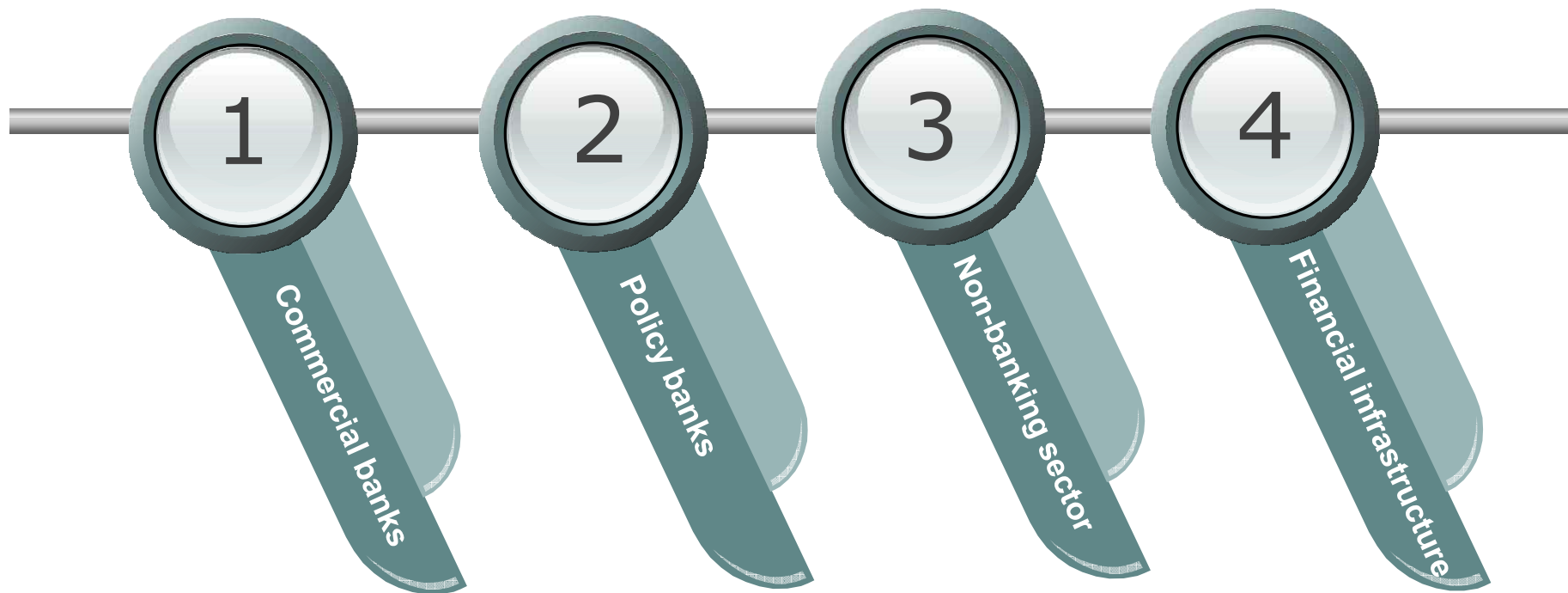
NK Infrastructure Investment Fund(example)

- ✓ Infrastructure fund is created centered by policy finance institutions
- ✓ Infrastructure fund finances projects






5. Plan to Build Financial System for Stable Economic Integration

- Financial system is essential for stable transition from “state-controlled economy” to “market economy”
- Establish financial infrastructure with more focus on indirect financing in the early stage



① Commercial Banks·Policy Banks·Non-banking Sector

-  Introduce commercial banking system and devise plans to help South Korean & foreign commercial banks enter North Korea
-  Establish policy banks to encourage industrial development & infrastructure investment
-  Nurture the non-banking sector depending on development of banking system

Commercial Banks

- ✓ **State-owned Commercial Bank**
build commercial banks with broad operational network across North Korea
- ✓ **South Korean & Foreign Commercial Banks**
allow branches of South Korea's major commercial banks & foreign banks

Policy Banks

- ✓ **Support for Industrial Development**
Raise funds at low interest rate in the long term and support exporters
- ✓ **Infrastructure Investment**
Invest in local infrastructure and gradually expand into large-scale SOC project

Non-banking Sector

- ✓ **Insurance**
Establish state-owned commercial insurance company
- ✓ **Specialized Credit Finance**
License credit business in the form of banks' in-house service
- ✓ **Microfinance**
Build microfinance Institutions with strong local networks
- ✓ **Financial Investment**
securities firms

② Financial Infrastructure



Introduce systems for deposit insurance, payment settlement and financial supervision; and gradually build infrastructure for capital markets

Deposit Insurance

- ✓ Introduce to both banking and non-banking institutions to integrate excess money into established financial system
- ✓ Temporarily introduce deposit insurance with a full-coverage

Payment Settlement

- ✓ Invest in infrastructure for payment settlement
- ✓ Create inter-bank money market to strengthen stable and efficient intermediary functions of commercial banks

Financial Supervision

- ✓ Establish a financial supervisory organization across all financial sectors
- ✓ Give the financial supervisor greater flexibility in macro prudential regulation until the financial system is firmly established

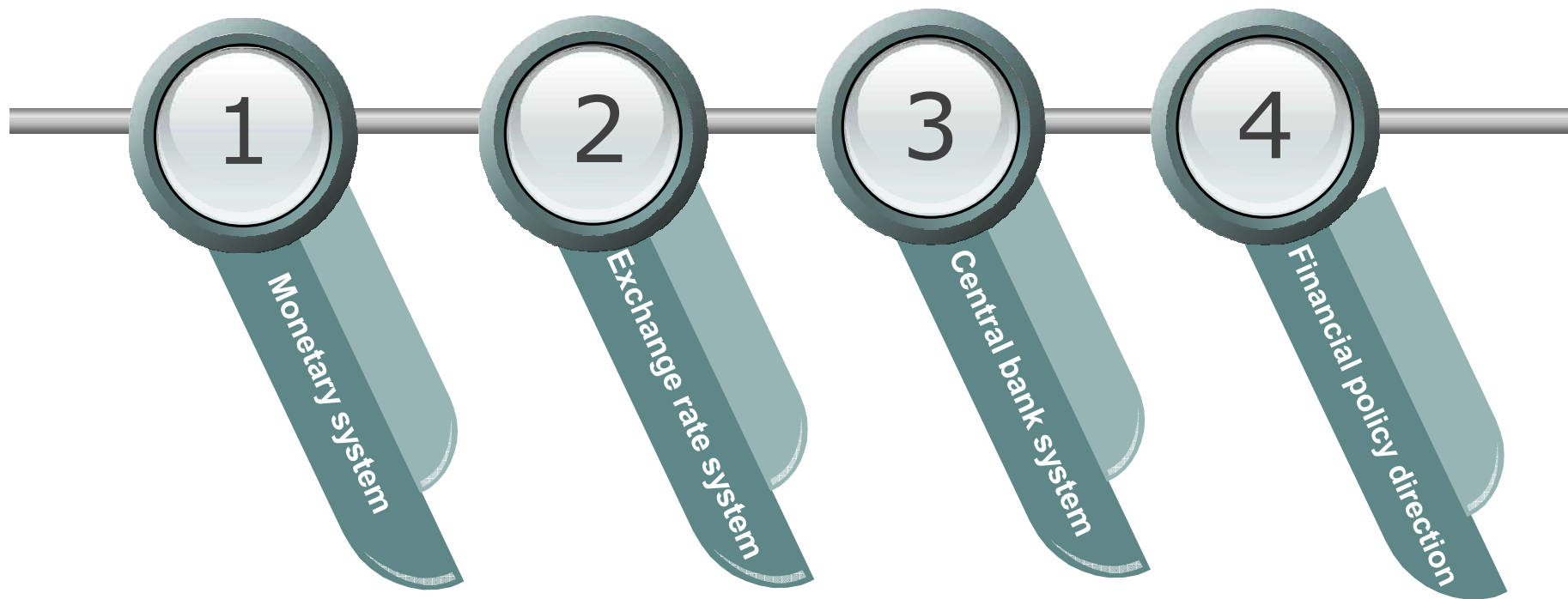
etc.

- ✓ Resolution of bad loans & restructuring on a regular basis
- ✓ Introduce accounting & credit rating system
- ✓ Establish a securities market in the long term



6. Plan to Reform Financial System for Macroeconomic Stability



Reform financial system to deal with macroeconomic problems (e.g. high inflation) that might occur in the course of economic integration



① Monetary·Foreign Exchange ·Central Bank System

-  Monetary integration to be determined from a comprehensive perspective including economic aspects
-  Set up monetary policy system by the central bank

Monetary & Foreign Exchange System

✓ **Monetary System**

- Consider ① economic gap between the two economies ② macroeconomic variables ③ features of monetary & forex systems
- Determine the currency exchange rate for each category of monetary transaction

✓ **Exchange Rate System**

- Establish a single exchange rate system
- Fixed exchange rate system → Managed floating exchange rate system

Central Bank System

✓ **Re-establish central bank's role**

The central bank will maintain its genuine role (One-tier Banking System → Two-tier Banking System)

✓ **Revise monetary credit system**

The central bank will gradually reduce its microeconomic control and revise operational system & policy tools

Germany's monetary integration

The German monetary integration was done in the initial stage of unification discussion. The currency exchange rate was determined with taking into account political factors as well as economic factors .

- ▶ flow(e.g. wage, pension) /converted at 1:1 with high value applied to East Germany's currency,
- stock(e.g. deposit, loans) /converted at 2:1 with low value applied to East Germany's currency
- ⇒ The monetary integration raised East German workers' wage, helping them financially stabilize and boost their purchasing power. It caused side effects at the same time. Sudden rise in wages eroded East German companies' profitability and increased unemployment rate.

② Financial Policy Direction



Countries in transition experience high inflation, difficulties in external debt payment and surge in fiscal deficit.

✓ High inflation

Excess money supply, price liberalization, expanded gov't spending
e.g. (East Germany) CPI : after monetary integration 21.7%(1991) → 13.4% (1992)→ 10.6%(1993)

✓ Difficulties in external debt payment

High external debt, shortage in foreign exchange reserve, weak fundamentals
e.g.(Hungary) Since Hungary shifted to floating exchange rate system, its external debt sharply rose; the country asked for rescue money to IMF

✓ Surge in fiscal deficit

Rising cost in social welfare system & economic development
e.g. (China) fiscal reform since 1980
→ The ratio of tax to GDP, once reached 33%, fell to 20% or above in 1990s.

✓ Flexible financial policy to respond to possible macro-economic problems in the process of economic integration

7. Conclusion



- ◆ **Reunification is the biggest opportunity for the Korean economy**
- ◆ **Need practical and specific plans in the financial sector to be prepared for reunification**