Economics focus
Parallel economies
What the North and South Koreans can learn from the reunification of Germany
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SOUTH KOREANS dread the prospect of renewed fighting across the "38th parallel" that divides their country from the communist North. But not all of them savour the alternative ending for their cold war: rapprochement and reunification.

North Korea's indigence is almost as scary as its belligerence. The collapse of its rogue dictatorship—improbable but not unthinkable—would replace a military threat with a variety of economic perils, including a possible flood of cheap migrant labour and costly obligations to support the North's people and infrastructure. Germany's example is hardly reassuring. Two decades after reunification, the East still subtracts heavily from Germany's budget and adds greatly to its unemployment figures.

Before the last Korean war in 1950, the North was home to most of the country's heavy industry. As late as 1975, its income per head still exceeded the South's, according to Eui-Gak Hwang of Korea University in Seoul. "Obviously, sooner or later the country must be reunited," wrote Joan Robinson, a Cambridge economist, in 1977, "by absorbing the South into socialism."

South Korea's central bank reckons that North Korea's annual income per person was only $960 in 2009, or about 5% of South Korea's. (This estimate values the North's output using South Korea's prices and its exchange rate against the dollar.) This disparity dwarfs the income gap between the two Germanys on the eve of reunification (see chart). Poorer than East Germany, North Korea is also bigger. Its population of 24m is about half the size of the South's, whereas East Germany's was only about a quarter the size of the West's.

If the Koreas reunified, the government would face a stark choice. It could try to fill the gap in living standards between North and South, through handouts, public investment and subsidies. Or it could brace itself for heavy migration, as poor Northerners moved to the South in search of higher wages. Germany leaned towards the first option. East German Ostmark wages were converted into West German D-marks at a rate of one to one, then raised by union pressure closer to Western levels. This allayed fears that migrant workers would flood into the West, or that capital would flood out. But it also deterred private investment in the East—except for heavily subsidised property speculation which ultimately failed—and priced many of its workers out of the market.

Michael Funke of Hamburg University and Holger Strullik of the Leibniz University in Hanover are two of the many economists who have studied Germany's reunification. In 2005 they used the same framework to model the Korean case. Their calculations (which they describe as "rigorous speculation") illustrate the scale of the problem. To equalise the standard of living in both parts of the country would initially cost over half of the South's tax revenues. The government could reduce the fiscal burden to 30% of revenues, but only at the cost of receiving 8m migrants, the two economists estimate.

The government could, of course, spread the cost over time by borrowing abroad: there is no reason why today's Koreans should pay the full cost of reunifying their country. And in principle, North Korea's productivity might catch up with the South's quite rapidly. Because capital is scarce

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in the North, returns should in theory be high. Investors will be drawn to its promising location, its raw materials and its workers, who are young, reasonably well educated and cheap. (Many South Korean and Chinese firms have already taken the plunge. Hyundai Asan and Korea Land Corporation, for example, run the Kaesong Industrial Complex a few miles inside the North. It hosts 116 factories, employing 40,000 North Koreans, producing over $20m-worth of textiles, chemicals, electronics and other goods a month.)

Despite North Korea’s obstinate commitment to central planning, the market is growing like a vine in the cracks of the socialist edifice. In their new book, "Witness to Transformation", Stephan Haggard and Marcus Noland document this market reform “from below”, drawing on surveys of refugees in South Korea and China. They find that 62% of the refugees in China had relied on the market as their primary source of food; only 3% relied on the state. And almost 70% of the refugees said they got more than half of their income from some form of private enterprise, such as selling crops or repairing bikes.

North Koreans have turned to the market out of sheer desperation. During the famine of the mid-1990s, for example, the public distribution system broke down, forcing households to rear livestock, collect acorns and sea algae, or cultivate crops in their kitchens. Informal markets sprouted, as people either bent the law or defied it. In 2002 some of these exchanges were decriminalised. But from 2005 the regime cracked down again.

**Planning the end of planning**

This surreptitious system of truck, barter and exchange might eventually be the kernel of a more dynamic market economy. But the breakdown of North Korea’s central planning is a mixed blessing. One of the few communist countries to liberalise its economy without a big drop in output was China. It did so by keeping its central plan in place long enough to grow out of it. In the early years of reform, households and firms kept their centrally allotted entitlements and obligations. But they were free to sell or buy anything extra for whatever they could get. This allowed prices to do their job of signalling scarcity and abundance, even as it avoided the disruptions and hardship suffered by other transition economies.

North Korea would profit from following China’s example, argues Gérard Roland of the University of California, Berkeley. (At the very least, households should be entitled to a ration of essential goods at controlled prices.) Before the North can make a successful transition to a market economy, therefore, it may have to revive something like its public distribution system. The country’s best route may lie in reviving a rudimentary plan.

The path to a market economy will no doubt be bumpy. South Korea’s communist sibling is both poorer and more populous than West Germany’s ever was. But as Messrs Funke, Strulik and Roland all point out, the Koreas have one advantage Germany lacked. They can learn from its example.

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