

Despite the limited success of the North Koreans, it is doubtful that extortion is a sustainable development strategy.

Stumbling Toward Apocalypse

The Economics of Korean Unification

By Marcus Noland



Winston Churchill once called Stalinist Russia "a riddle wrapped in a mystery inside an enigma." What might he have made of the geopolitical catastrophe that is contemporary North Korea?

No one knows exactly how many people have died in the current North Korean famine. Most guesses are

around two million, or nearly 10 percent of the pre-crisis population – though no one is certain what that was, either. North Korea may have a nuclear weapon. Or it may have several. Or it may have none. No one outside of Pyongyang knows for sure, but many are concerned. Indeed, the potential fallout – figurative or literal – from the collapse of the North Korean government, has created some strange bedfellows: Today, North Korea is the largest recipient of United States assistance in Asia.

PEOPLE'S REPUBLIC OF MISERY

The Democratic People's Republic of Korea (D.P.R.K.) was established under Soviet tutelage in 1948. After failing to unify the peninsula by force, founder Kim Il-Sung set about to construct an orthodox Stalinist state – a task to which the Great Leader applied himself with a vengeance. Yet despite the official ideology of *juche*, or self-reliance, this was self-reliance of a very strange sort. While constructing the world's most autarkic economy, the North Koreans managed to extract substantial resources first from the Soviets and later the Chinese, apparently regarding these inflows as a form of tribute rather than a sign of weakness. Western bankers learned a bit about *juche* in the mid-1970's when the North Koreans defaulted on billions of dollars in loans.

It was fun (for some) while it lasted, but by the mid-1980's things began to

sour. The disenchanted Soviets began demanding repayment on decades of loans and succeeded in reversing the net flow of transfers. Then the Iran-Iraq War ended, depriving the North Koreans of a major export opportunity – they had been selling arms to both sides. Finally, with the collapse of the Soviet Bloc in 1990, North Korea lost access to imports that did not require payment in hard currency.

Shut off from nearly all international commercial transactions, the North Korean economy deteriorated rapidly. The following year the government launched a "let's eat only two meals a day" campaign, and in 1994 North Korean radio broadcasts admitted the existence of hunger. In May 1995, South Korean President Kim Young Sam (whom the North Koreans would regularly vilify as a "puppet," a "traitor" and a "whore") made an unconditional public offer of emergency assistance to the North. The following month a deal was struck among Pyongyang, Seoul and Tokyo for the provision of food.

For decades the D.P.R.K. had been quixotically attempting to achieve food security through self-sufficiency. Due to its northerly latitude, short growing seasons and lack of arable land, this required highly intensive cultivation along with the most intensive use of agricultural chemicals in the world. Hillsides were denuded as increasingly inappropriate land was brought into cultivation, and the resulting erosion led to river silting. By no coincidence, unusually heavy seasonal rains in July and August 1995 triggered catastrophic floods.

Both the North Korean government and the international aid community portrayed the emerging famine as a product of natural disaster. But this famine was less an act of God than the culmination of decades of economic and ecological mismanagement.

NUKES FOR SALE

While stumbling into famine, North Korea was also drifting toward military confrontation with the United States. North Korea had begun an experimental nuclear program with Soviet assistance in the 1950's. As a condition for their help, the Soviets had insisted that the North Koreans accept the obligations of the Nuclear Non-Proliferation Treaty despite the fact that they were not signatories. Then in 1985 the U.S.S.R. agreed to supply four light-water reactors on the condition that the D.P.R.K. sign the non-proliferation pact. North Korea did, but soon thereafter the Soviet Union collapsed. The ironic upshot: the North Koreans were formally obligated by the treaty, yet had not obtained the Soviet reactors.

Having been hoodwinked by Iraq, the International Atomic Energy Agency (the organization tasked with preventing nuclear proliferation) was determined not to be fooled again. In May 1992 an agency inspection team confirmed United States intelligence findings that the North Koreans were building facilities capable of producing weapons and possibly had enough weapons-grade plutonium to make one or two "Hiroshima-size" bombs. What followed was a period of deteriorating diplomatic relations, highlighted by a North Korean statement (later "suspended") that it would withdraw from the non-proliferation treaty. In May 1994 the D.P.R.K. proceeded with the removal of spent fuel rods from their reactors, making it impossible to construct a reliable account of the disposition of North Korea's fissionable materials.

Although the United States had lived with the threat from tens of thousands of troops arrayed along the northern border of the demilitarized zone for 40 years, the specter of a cash-strapped North Korea selling nuclear weapons and missile delivery systems to the highest bidder was something else entirely. The United States began preparing for war on the peninsula.



Great Leader Kim II-Sung and his son.

Enter former President Jimmy Carter. On his own initiative, Carter decided to pay a call on another visionary, the Great Leader, Kim Il-Sung. On the evening of June 16, while General John Shalikashvili, chairman of the United States Joint Chiefs of Staff, was in the White House presenting the war plan to President Clinton for his approval, Carter and Kim agreed that the D.P.R.K. would freeze its nuclear activities and halt the planned expulsion of the International Atomic Energy Agency. In return Carter would recommend that the United States support the D.P.R.K.'s acquisition of light-water reactors,

along with a resumption of the United States–D.P.R.K. nuclear meetings. Carter then called the White House, interrupting Shalikashvili's presentation to relay the import of his conversation with Kim and inform the White House that, having averted nuclear war, he was about to spread the good news via a live interview on the Cable News Network.

Nuclear confrontation defused, diplomatic talks resumed the following month. But in July the Great Leader died. With the United States and South Korean governments convinced that the D.P.R.K. would collapse within a couple of years – if not a couple of weeks – and that any reactors would become the property of the current South Korean government, the United States and the D.P.R.K. concluded their Agreed Framework. The deal: North Korea froze its own nuclear development program in exchange for two light-water reactors worth billions of dollars.

TIN-CUP DICTATOR

Upon the death of his father, Kim Jong-Il (a.k.a. the Dear Leader), became the D.P.R.K.'s paramount chief. Kim Jong-Il inherited a country with a collapsing economy on the brink of a famine. The Chinese, who had taken up some of the slack after the Soviets had withdrawn support, were no help; they, too, had become disenchanted and were scaling back aid.

In this situation, one obvious course of action would have been to take a page out of China's book and liberalize the economy – as the Chinese have urged. However, reform would have had profound and unwanted effects on North Korea's leadership. First, there would be a significant increase in exposure to international trade and investment, the bulk of which with South Korea and Japan, countries maintaining problematic relations with the D.P.R.K. Second, changes in the composition of output in a heretofore-autarkic economy would be tremendous, forcing literally millions of workers to change employment. Both developments could be expected to have enormous domestic political implications.



**Dear Leader
Kim Jung-II.**

Indeed, North Korea's reform path would be more difficult than the ones traversed by China and Vietnam, Asia's other major transitional economies. At the time they initiated reforms, China and Vietnam had more than double the share of population employed in the agricultural sector than North Korea apparently has today, and their reform strategies were facilitated by the existence of this enormous pool of low-productivity labor. A transition route hewn from surplus agricultural labor is simply not available to North Korea, which in economic terms more closely resembles the over-industrialized economies of the former Soviet bloc than it does China or Vietnam.

The second hurdle that reformers would face is ideological. Consider the case of Vietnam. The North Vietnamese government and its Vietcong allies defeated the South Vietnamese government in a civil war, allowing Vietnamese communists to claim an ideological victory in the united Vietnam. Likewise, while China has had to contend with the rump of Taiwan, no one seriously has claimed that the survival of Taiwan represented an ideological threat to the Chinese government. Thus reformers in both China and Vietnam had been relatively free to construct rationalizations – albeit tortured – about how their market-oriented reforms were what Marx or Mao or Ho really had in mind.

The ideological terrain faced by the current North Korean regime is very different. Rather than monopolist purveyors or dominant definers of national ideology, the North Koreans are very junior partners to South Korea in both size and achievement. Moreover, the dynastic aspects of the Kim regime make it even more difficult for the son to disavow the legacy of the father. While the ideologues of Pyongyang could certainly turn ideological somersaults to reinterpret *juche* to mean market-oriented reform, the existence of a prosperous, democratic South Korea makes their task very difficult. After all, why be a second-rate imitation South Korean when one can head south and become the real thing?

This, of course, raises a third point. Reform would mean vastly increased exposure to the outside world, in particular to South Korea and Japan. While today's North Korean economy has latent, unexploited potential, its isolation reduces opportunities to transform this potential into products that the rest of the world wants to buy. In China, after all – an economy with internal command over relatively sophisticated technology – enterprises bolstered by foreign investment still account for 40 percent of exports. In prosaic terms, North Korean enterprises need blueprints as well as worldwide distribution and marketing networks.

Foreign direct investment (and through it, an infusion of new technology and management) would undoubtedly play a key role in creating the necessary links between domestic resources and world markets. However, the most likely investors in North Korea are companies from South Korea and Japan, and United States economic sanctions are a disincentive for potential investors.

It is unlikely that either Japan or the United States would normalize relations with North Korea without significant improvements in North-South relations. Indeed, this issue looms over any strategy for salvaging the North Korean government without bringing down the government.

Normalization with Japan would permit the Japanese government's investment guaranty agency to insure Japanese investments in North Korea, paving the way for mainstream companies to make large-scale investments. Normalization with the United States would permit the termination of the embargo – and the disincentive it presents to potential investors of all nations. Thus even with the "right policies," a series of diplomatic tumblers would have to fall into place for an export-led reform strategy to work.

FOOD FOR TALKS – WHO SEZ CRIME DOESN'T PAY?

DATE	VALUE	FORM	CHANNEL	DIPLMATIC OBJECTIVE
February 1996	\$2 million	food	World Food Programme	Encourage North Korean adherence to the Agreed Framework during a period of increasing tension between the two Koreas.
June 1996	\$6.2 million	food	World Food Programme	Encourage North Korean flexibility with respect to a secret proposal for four-way talks between the US, North Korea, South Korea, and China.
February 1997	\$10 million	food	World Food Programme	Quid pro quo for North Korean agreement to participate in joint US - South Korea briefing on Four-Way Talks proposal.
April 1997	\$15 million	50,000 metric tons of food	World Food Programme	Quid pro quo for North Korean agreement to participate in missile proliferation negotiations.
July 1997	\$27 million	100,000 metric tons of food	World Food Programme	Quid pro quo for North Korean agreement to participate in Four-Way Talks.
October 1997	\$5 million	grant	UNICEF	Quid pro quo for North Korean acceptance of 10 additional food relief monitors.
February 1998	n.a.	200,000 metric tons of food	World Food Programme	Quid pro quo for North Korean agreement to participate in ad hoc committee meeting associated with the Four-Way Talks.
September 1998	n.a.	300,000 metric tons of food	World Food Programme	Quid pro quo for North Korean agreement to resume missile talks, attend the third plenary session of the Four-Way Talks, enter into negotiations over the second suspected nuclear site, and resume talks aimed at removing North Korea from the list of states.

The extent to which Kim Jong-Il is motivated by this reasoning is unknown. What is apparent, however, is that the North Koreans have not approached economic reforms in a serious way. Although a constitutional revision promulgated in August 1998 mentions "private property" (Article 24), "material incentives" (Article 32) and "cost, price, and profit" (Article 33), the pronouncements are in the context of an otherwise orthodox elaboration of a planned, self-reliant economy. It appears, moreover, that some prominent "reformers" have been purged and the Committee for the Promotion of External Economic Cooperation, the body tasked with encouraging international trade and investment, has been dissolved in the recent governmental reorganization.

Instead, the North Koreans have tried to preserve their centrally controlled system while pursuing a two-track strategy to generate badly needed foreign exchange: one-time revenue schemes that do not alter the organization of the economy, and strategic brinkmanship to extract resources from the rest of the world.

Examples of the former include, the Rajin-Sonbong Trade and Economic Zone (née the Free Trade and Economic Zone – Kim Jong-Il didn't like the adjective "free" and had the name changed), a failed export processing zone in the extreme northeastern part of the country, and the Mt. Kumgang tourism venture with Hyundai. In both cases the projects were literally fenced off from the rest of the economy.

The other track is to extort foreign aid. On eight occasions the United States government has provided North Korea with food to induce North Korean participation in diplomatic talks. The use of brinkmanship with respect to the military is more ominous. In August 1998 North Korea publicly admitted that it was exporting missiles – and then asked the United States for \$1 billion to discontinue the practice. The following month it invited prospective buyers in for a visit, and then without warning fired a multi-stage rocket across Japan. Most recently, the D.P.R.K. and the United States have engaged in talks over a second suspect nuclear site. The North Koreans initially asked for \$300 million for a single inspection of the site, but now say that they would be willing to accept another donation of food, instead.

The marriage of the rocket and nuclear programs would give the North Koreans impressive tools with which to intimidate their neighbors and create proliferation nightmares for the United States. North Korea could continue to play the extortion game, offering to abandon weapons development and export while continuing to make clandestine sales. Stepping back, the most frightening aspect to this scenario is that it represents a continuation of the status quo. In light of the previously noted obstacles to reform, such an externally high-risk strategy may well be the path of least resistance for a weak and risk-averse regime.

Despite the limited success of the North Koreans in using such tactics, it is doubtful that, absent reform, extortion is a sustainable development strategy. In the end it is quite possible – some would say probable – that the regime will prove incapable or unwilling to make the economic and diplomatic moves necessary to insure its own survival. While the United States, South Korea, China, Japan and others may attempt to sustain the North Korean regime, intention does not insure outcome. History is replete with examples of countries and regimes that did not go the way that their patrons desired.

SUNSHINE OR MOONSHINE?

In December 1997, former dissident Kim Dae Jung was elected president of South Korea, and articulated a policy toward North Korea based on three principles. First, no provocations would be tolerated – i.e. the United States-Republic of Korea military alliance would remain a cornerstone of South Korea's policy. Second, economic initiatives with North Korea would be separated from politics. Third, South Korea would not seek to undermine or absorb North Korea.

This so-called sunshine policy is based on the proposition that with enough constructive engagement, North Korea can be weaned away from confrontation. But even before Kim's statement, the South Korean passion for unification had begun to cool as the potential costs became more apparent and the South Koreans became preoccupied with their own economic crisis.

The putative model underlying the sunshine policy, German unification in 1989, is often thought of as a failure. For nearly a decade and a trillion dollars worth of transfers after the fact, unemployment in the former East Germany remains at more than 17 percent. But this judgement may be overly harsh. The Germans did, after all, achieve national unification through the peaceful liberation of a communist state. Faced with a starving, possibly nuclear-armed, experiment in dynastic totalitarianism, would only the South Koreans be so lucky.

Suppose they did get lucky and North Korea collapsed without lashing out or descending into anarchy. What would be the implications for South Korea?

The Korean case could be more problematic than the German experience for two reasons. North Korea is relatively larger and poorer in comparison to South Korea than East Germany was compared to West Germany. Then, too, North Korea is in more dire straits today than East Germany was at the fall of the Wall.

By the same token, Korea appears better off in some ways. Korea (North Korea in particular) is demographically younger than Germany. Young people are presumably more adaptable than old people. What's more, conventional education can be used for training young people, reducing the need for adult-retraining initiatives.

Much of the North Korean population lives within 100 miles of the demilitarized zone, a reality that casts a long shadow over any analysis of economic unification between the two Koreas. Migration, after all, acts as a substitute for the movement of capital. The more that labor is allowed to migrate south, the lower the amount of capital necessary to reconstruct the North Korean economy.

If no investment were made and North Koreans were free to move south, North Korea would be virtually depopulated before differences in labor productivity were sufficiently narrowed to choke off the incentive to migrate. Conversely, I estimate that if incomes in North Korea were raised solely by infusions of capital, the amount needed to choke off the incentive to migrate could be as high as \$1 trillion. Presumably, neither of these extreme approaches would be acceptable to South Korea. So the real issue is how to fashion an intermediate solution that would involve a combination of cross-border movements of both labor and capital.

Of course efficiently allocated investment generates profits, not just costs, and it is possible to imagine unification scenarios in which South Korea comes out a winner from investments in the North. Moreover, the "peace dividend" associated with military demobilization on both sides and elimination of redundant government security agencies would be considerable, easily amounting to billions of dollars annually.

The point is not that unification would necessarily benefit the South Korean economy – it is not difficult to imagine scenarios in which it is made worse off, in some cases significantly so. But rather that unification offers the possibility of increasing useful output for Korea as a whole. Even if unification boosted the aggregate economy, though, there is no guarantee that every South Korean would benefit. Indeed, unification would have significant implications for who gets what.

The addition of millions of unskilled workers from the North would transfer income toward the owners of capital and away from labor – and, within labor, from lower- to higher-skilled groups. To the extent that the highly skilled are also the predominate owners of capital, unification would cause greater income and wealth inequality in the South.

Moreover, unless the government responded with offsetting policies, foreign

capital inflows could lead to an exchange-rate appreciation in Korea. This would hurt sectors subject to international competition such as manufacturing, while helping untraded goods and services such as construction. Put more simply, if you are a South Korean blue-collar worker in a low-tech factory, your cousins in the North represent a threat. By contrast, if you are a South Korean construction magnate with savings to invest, Korean unification could be very, very good for you.

The economic policy variables of unification boil down to this: Southerners can send money north, or northerners can be permitted to head south.

And, it need not be said, the policies that are ultimately adopted will be a function of politics. A number of fault lines could appear: between the North and the South, between South Korean capital and labor forces, and within South Korea between the traded- and domestic-goods sectors.

It is possible to conceive of policies that would deny North Koreans most of the economic gains from unification. South Korea might maintain the military border and administer North Korea as a Special Administrative Zone, preventing the equilibration of wages and rates of return on capital between the North and South. Or, in theory, the South Korean government could confiscate the assets in the North. But these would only be viable if North Koreans were denied political rights. Thus a key economic question is the terms on which today's North Koreans participate in the political system of a unified Korea.

LESSONS FROM GERMANY

Korea does have an opportunity to learn from Germany's mistakes. Conventional wisdom has it that German monetary authorities made a fundamental – and avoidable – mistake in setting the conversion rate between West and East German marks at one-to-one. This is not true. While one can argue over the equity of crediting eastern Germans with western D-marks at parity, the policy represented a manageable, one-time transfer of wealth from the rich West to the poor East.

The fundamental mistake affecting economic efficiency was in the subsequent wage policy that pushed East German wages far above competitive levels, creating massive unemployment and necessitating large social welfare expenditures in the East. Wages were artificially raised in the East, not because the Germans were stupid, but because West German labor unions feared competition from their East German counterparts and no one in the negotiations represented the interests of future owners of East German capital.

That suggests a partial solution for Korea. If South Korea wants to give Northerners an incentive to stay at home, the government should assign property rights to land and housing to current residents contingent on some period of continued residence.

More broadly, the lesson from the other transition economies is that one must privatize quickly – not because private managers are uniquely competent (though they may be), but because without clear property rights and privatization, there will be no investment. Without investment, there cannot be economic rehabilitation.

DÉJA VU ALL OVER AGAIN?

	EAST GERMANY	WEST GERMANY
	17	61
POPULATION (MILLIONS)	73	70
LIFE EXPECTANCY (YEARS)	42	97
AREA (1,000 SQ MILES)	8,500	14,900
PER CAPITA INCOME (\$ PURCHASING POWER)	28	243
EXPORTS (\$ BILLIONS)	27	191
IMPORTS (\$ BILLIONS)		



In this respect, the Germans made two related mistakes. They tried to restructure enterprises by fiat before putting them on the market, thereby slowing the process of privatization. Better to get the assets into private hands and let markets, not bureaucrats, handle restructuring.

Second, they accepted the principle of restitution whereby people could claim assets confiscated by the Communist regime. This led to claims and counterclaims, leaving properties to deteriorate in limbo. If South Korea decided to compensate previous owners in North Korea, it would be better to do so through monetary compensation – not

though reassignment of ownership to the disputed asset.

The priorities are clear: Get assets into a responsible owner's hands as quickly as possible, and begin the rehabilitation process. The issue of whether someone should receive a payment from the state for an allegedly seized asset can be settled later: after all, if the asset was confiscated a half-century ago, another year or two wait for compensation is unlikely to be important.

Rapid privatization does not necessarily mean cash auctions, however. In the German case, East Germans had virtually no financial assets and certainly little buying power relative to the West Germans. The German government's demand for cash payment in exchange for assets formerly held by the East German state effectively excluded East Germans from the privatization process, and more than 90 percent of the assets eventually ended up in West German hands. To prevent this from happening in North Korea, models such as the Czech voucher system, which gave every citizen an equal slice of newly privatized property, should be considered.

Finally, maintaining production in the North would be a priority. There are at least two important issues here. First, there would be a need for well-functioning capital markets to channel investment into the North. If, as widely assumed, unification occurs through collapse, the process of absorption will inevitably focus attention on the state of South Korean capital markets – and the picture is not pretty.

South Korea needs to restructure its banking system, improve the operation of its bond market, create a better climate for foreign direct investment and better integrate foreigners into its financial markets. Compared with the German case, Korea will likely face greater challenges with a far-less-efficient financial system to re-channel resources. From this perspective, the current financial crisis in South Korea and the resulting expedited liberalization of South Korean financial markets could prove a blessing in disguise.

A second aspect of this problem involves the role of West German – more to the point, South Korean – companies in their new markets. In the case of East Germany, a flood of West German consumer goods temporarily depressed local production. West German companies also attempted to take over potential competitors in the East, either shutting them down or turning them into sales offices. They were blocked by the West German Cartel Office. Similar dangers are obvious in Korea. But unlike Germany, South Korea does not have an antitrust authority capable of blocking anticompetitive actions by the

"If one wants the prosperity of the national economy, he should thoroughly reject the idea of dependence on outside forces, the idea that he cannot live without foreign capital... Ours is an independent economic structure equipped with all the economic sectors in good harmony and with its own strong heavy industry at the core. It is incomparably better than the export-oriented economic structure dependent on other countries... We must heighten vigilance against the imperialists' moves to induce us to 'reform' and 'opening to the outside world.' 'Reform' and 'opening' on their lips are a honey-coated poison. Clear is our stand toward 'reform' and 'opening.' We now have nothing to 'reform' and 'open.' By 'reform' and 'opening' the imperialists mean a revival of capitalism. The best way of blocking the wind of 'reform' and 'opening' of the imperialists is to defend the socialist principle in all sectors of the economy... We will never abandon the principle, but will set ourselves against all attempts to induce us to join an 'integrated' world."

– From a joint editorial published by Rodong Sinbum, the newspaper of the Central Committee of the Korean Workers Party, and Kunroja, the Central Committee's political theory magazine, September 17, 1998.

chaebols, the powerful conglomerates.

DENOUEMENT

North Korea is experiencing a humanitarian nightmare internally and poses a strategic threat externally. From the American perspective, probably the best solution would be the internal collapse of the Kim Jong-Il regime. However, with 10,000 artillery weapons deployed near the border, the North Koreans effectively hold hostage Seoul's 15 million residents. North Korea's neighbors, who might experience the fallout from an untimely end to Kim Jong-Il far more directly than America, are unenthusiastic about such an alternative. As a consequence, the United States and its allies are forced to pursue second-best alternatives.

America, South Korea, Japan, China and others have slipped into an ad hoc policy of propping up the Kim Jong-Il regime. Can it work in the long run? North Korean provocations have already badly undercut domestic political support for engagement in the United States, and Japan. South Korean President Kim Dae Jung continues to pursue his "sunshine" policy. But unless he can begin to show some tangible gains, support for such a policy in South Korea will evaporate as well.

That leaves China. North Korea may eventually revert to a Chinese tributary state – its status for much of the past millennium, and an inversion of the self-reliance ideology of Great Leader Kim Il-Sung. But even the Chinese have limited influence on the North. In the end the regime's internal rigidity may make it impossible to sustain, even with Chinese assistance. The problem is that there is no guarantee that the D.P.R.K. would disappear quietly.

Even if North Korea were to exit with a whimper rather than a bang, the challenges that this could present to South Korea would be enormous. North Korea's is a larger, poorer and more distorted economy than the former East Germany's. Moreover, unlike the Germans, the Koreans fought a horrific civil war that will exacerbate political differences created by decades of isolation.

Differences in living standards between the North and South are overwhelming. The North Korean population is young and Seoul glows like a beacon just south of the DMZ. Unless they are forcibly restrained, one must assume that large numbers of North Koreans will head south if given the opportunity. If they were restrained, pressures for cross-border migration would persist until the income gap was substantially reduced. This could require hundreds of billions of dollars of capital investment and considerable transfer of technology.

As a consequence, the political rights afforded to the residents of North Korea will likely prove the key determinant of economic outcomes, affecting the assignment of property rights and the extent of cross-border migration. Thus for all the economic problems, absorbing North Koreans into the emerging liberal political culture of South Korea looms as the critical challenge of unification.

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