

Korean Reunification

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Transforming the
Eastern German
economy after
Unification



1. An ailing economy collapsed in 1989/90

Unproductive, uncompetitive economy of the GDR

- > Productivity of the GDR's economy in 1990 was approximately 30% of that of West Germany
- > Outdated economic structure, outdated capital stock, decrepit infrastructure
- > Low quality, high production costs: GDR products not competitive in western markets

Economic activities collapsed on a grand scale

- > Industrial output dropped 70% by early 1991
- > Large swathes of the East German economy were bankrupt
- > Eastern European sales markets were collapsing
- > West German products replaced eastern products on the shelves

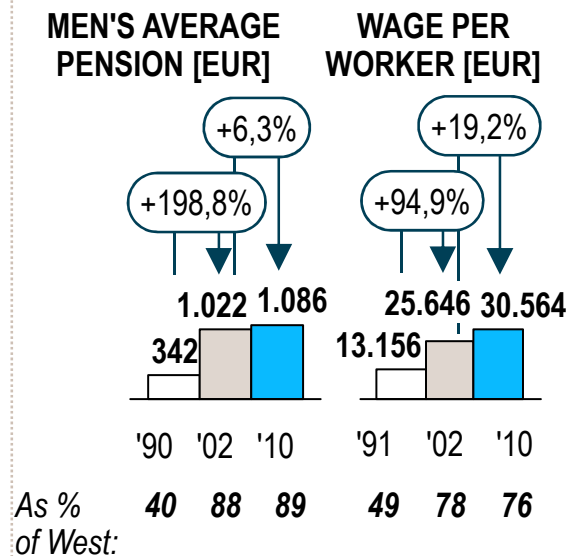
Nearly 4 million jobs lost within 3 years

- > 1989: Full employment with 9.7 m workers
- > 1992: Only 5.9 m jobs left in the East (1.2 m unemployed and 1.9 m in job-creation schemes)

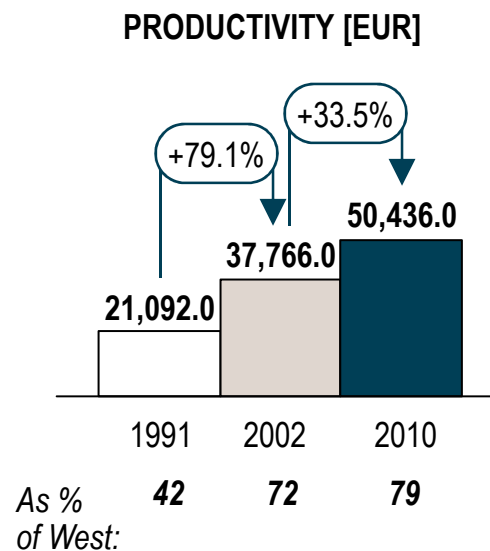
> No chance of survival without fundamental transformation

2. Achievements since then – East successfully rebuilt

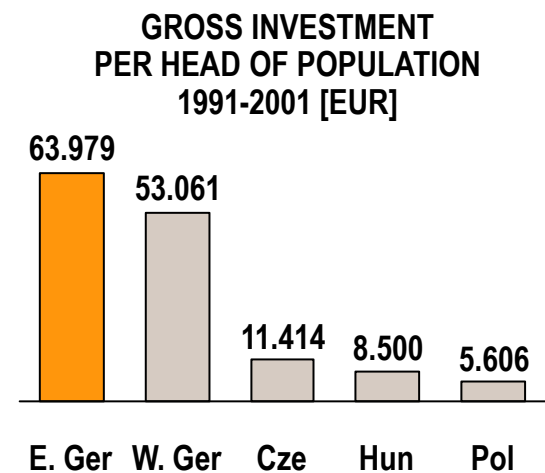
A Equalizing the standard of living in east and west



B Transforming the socialist planned economy into a capitalist market economy



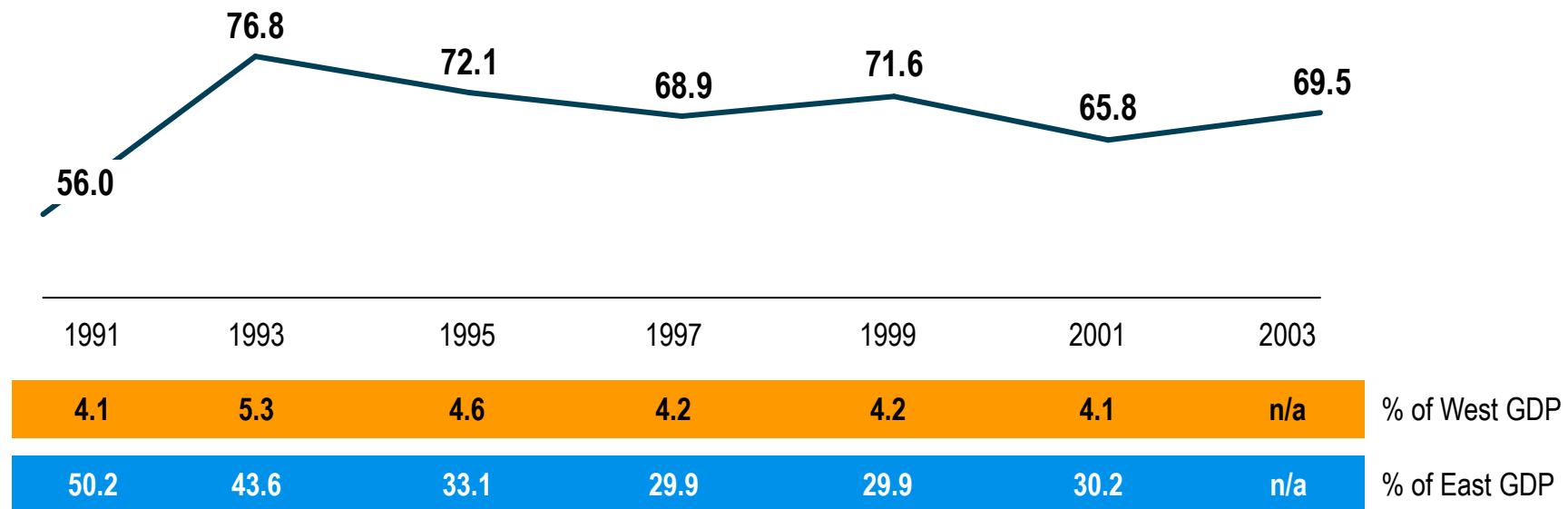
C Building and modernizing infrastructure in eastern Germany



> Huge efforts by all Germans to reunite a country divided for 40 years

3. These improvements were enabled by huge transfers of funds from West Germany

NET TRANSFERS FROM WEST TO EAST¹⁾ [EUR bn]



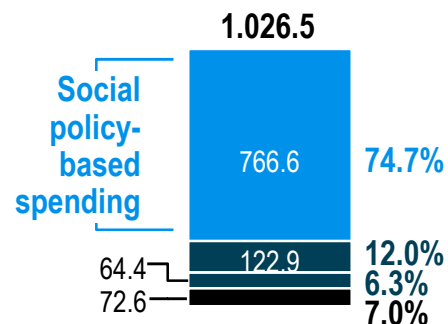
> W. Germany has helped rebuild the East with over EUR 2 trillion to date²⁾

1) Data only available to 2003 2) 2013 Estimate

4. But instead of "becoming lean & healthy" and creating self-supporting econ. struct. in the east...

A ... transfers were spent mainly on con-sumption or social security, not invested in the future

TOTAL TRANSFERS
1991-2001 [EUR bn]



B ... rapid wage equalization and currency exchanged 1:2

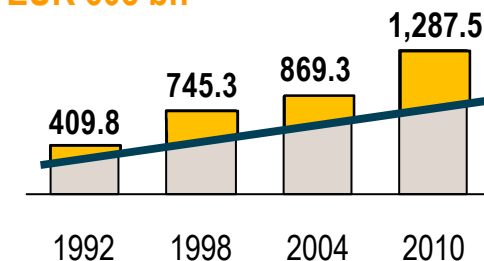
AVG. EXCHANGE RATE¹⁾



C ... unification financed by loans: financial burden shifted to future generations

FEDERAL GOVERNMENT DEBT
REPAYMENT STATUS^{*)} [EUR bn]

EUR 608 bn



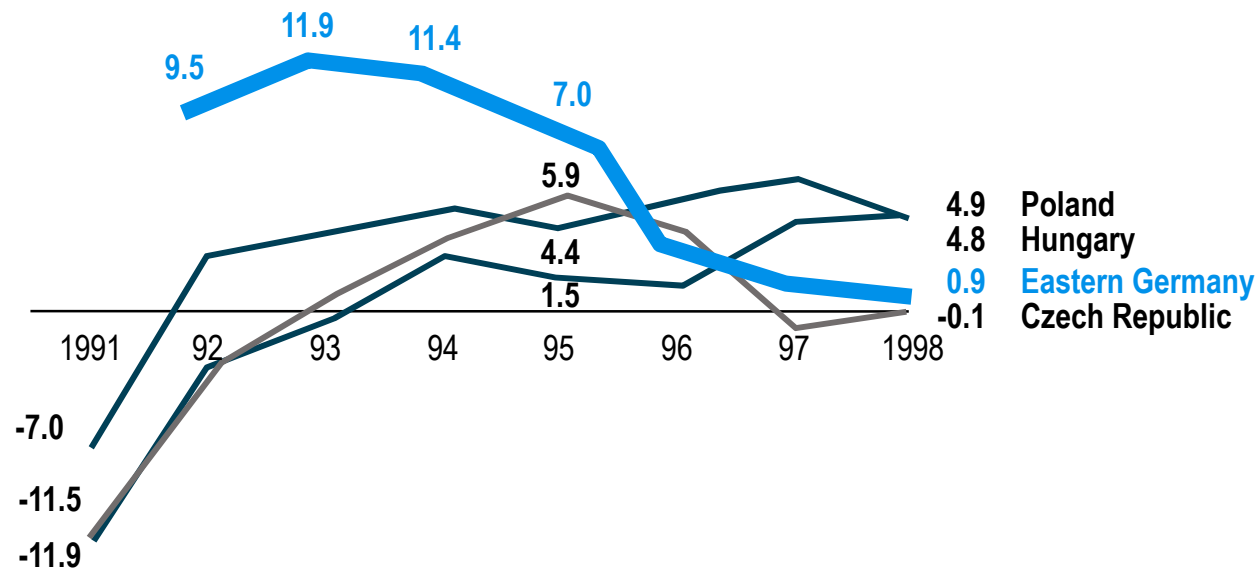
> Desire for rapid political agreement took precedence over economic necessities

¹⁾ Exception: Exchanging small amounts of cash up to max. 6.000 ostmark at a ratio of 1:1

^{*)} Include fund assets

5. Result by 1998: Eastern Germany initially grew fast – Then ran out of steam

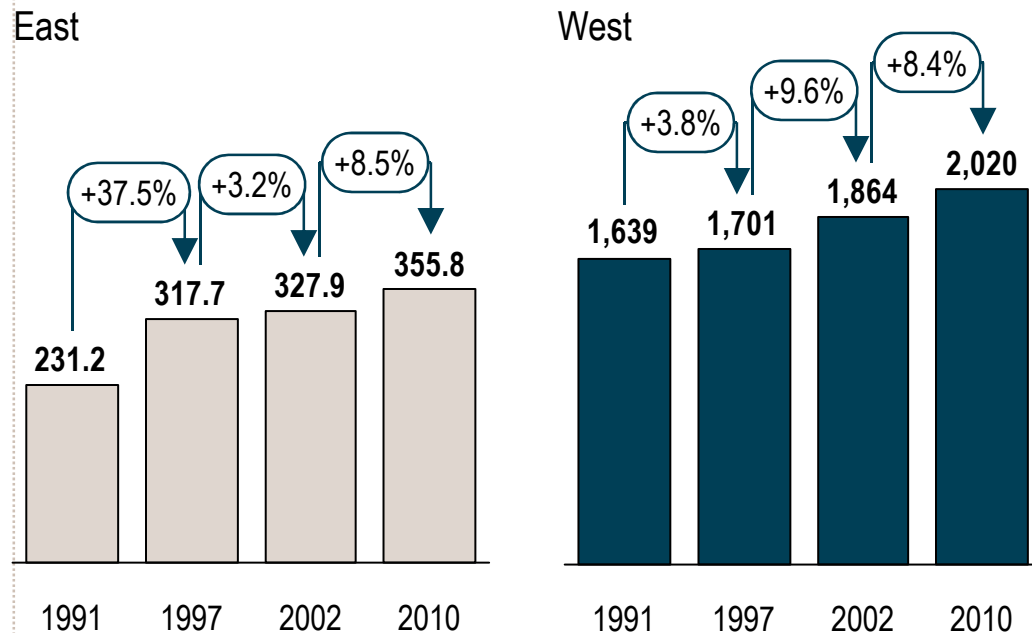
GDP GROWTH [%]



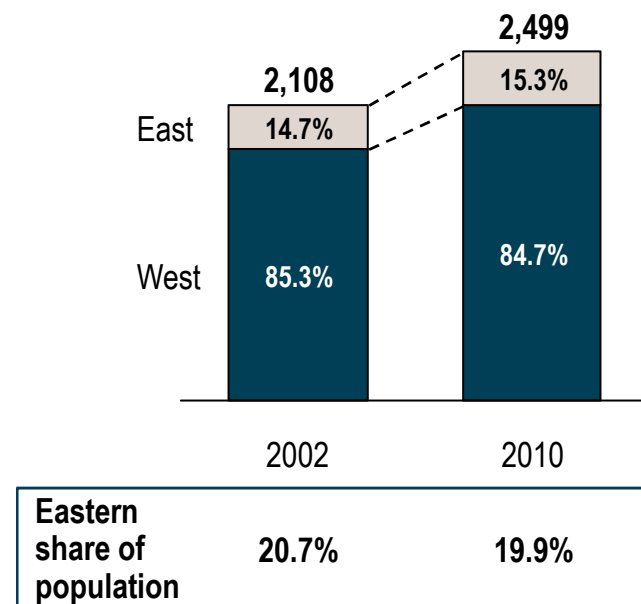
> No economic basis for sustainable growth!

6. Post 1998, recovery becomes steady: East Germany grew slower than the West until 2002, but has recovered to reach a similar rate as the West

Real GDP [EUR bn]



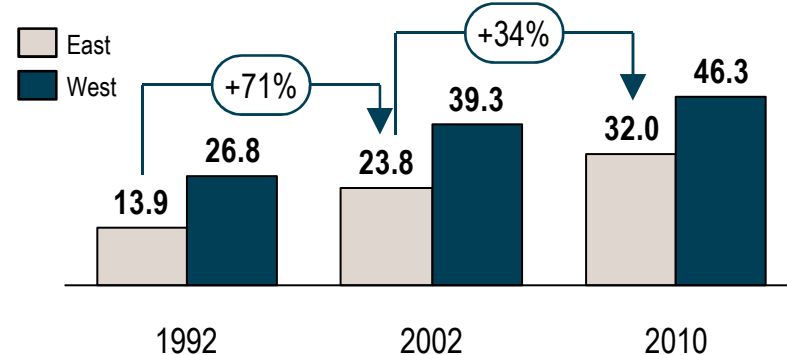
Nominal GDP [EUR bn]



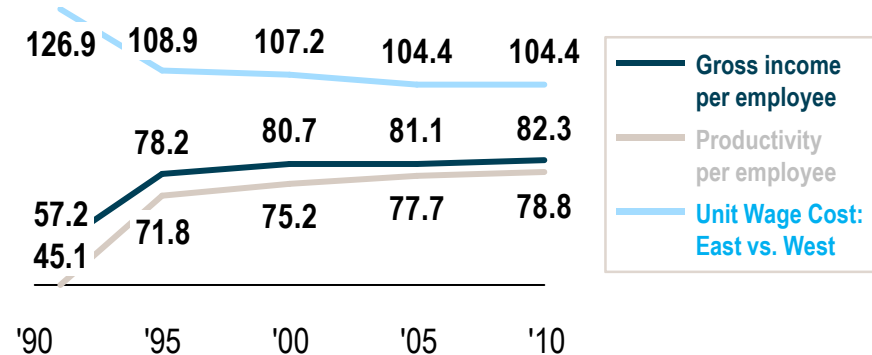
> Eastern share of GDP is still smaller than its share of population

7. Several indicators of successful development still being developed despite lagging behind Western Germany

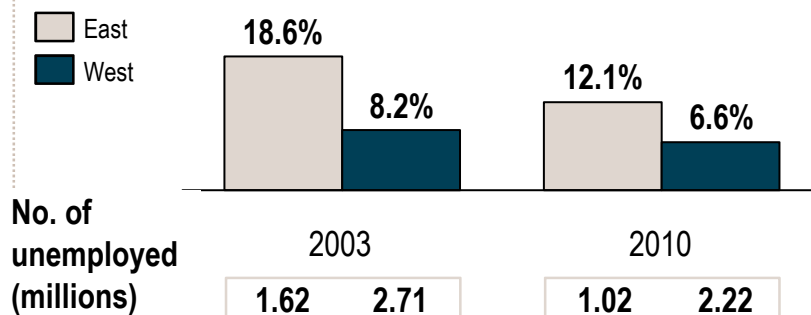
EXPORT RATES IN INDUSTRY [% of sales]



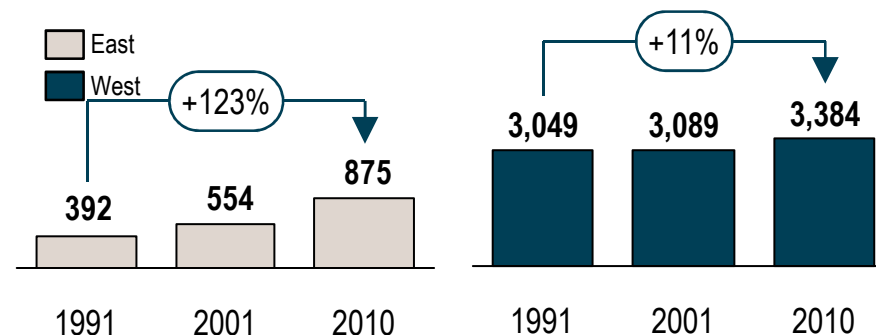
PRODUCTIVITY, GROSS INCOME, WAGE [% of West]



UNEMPLOYMENT RATES [%]

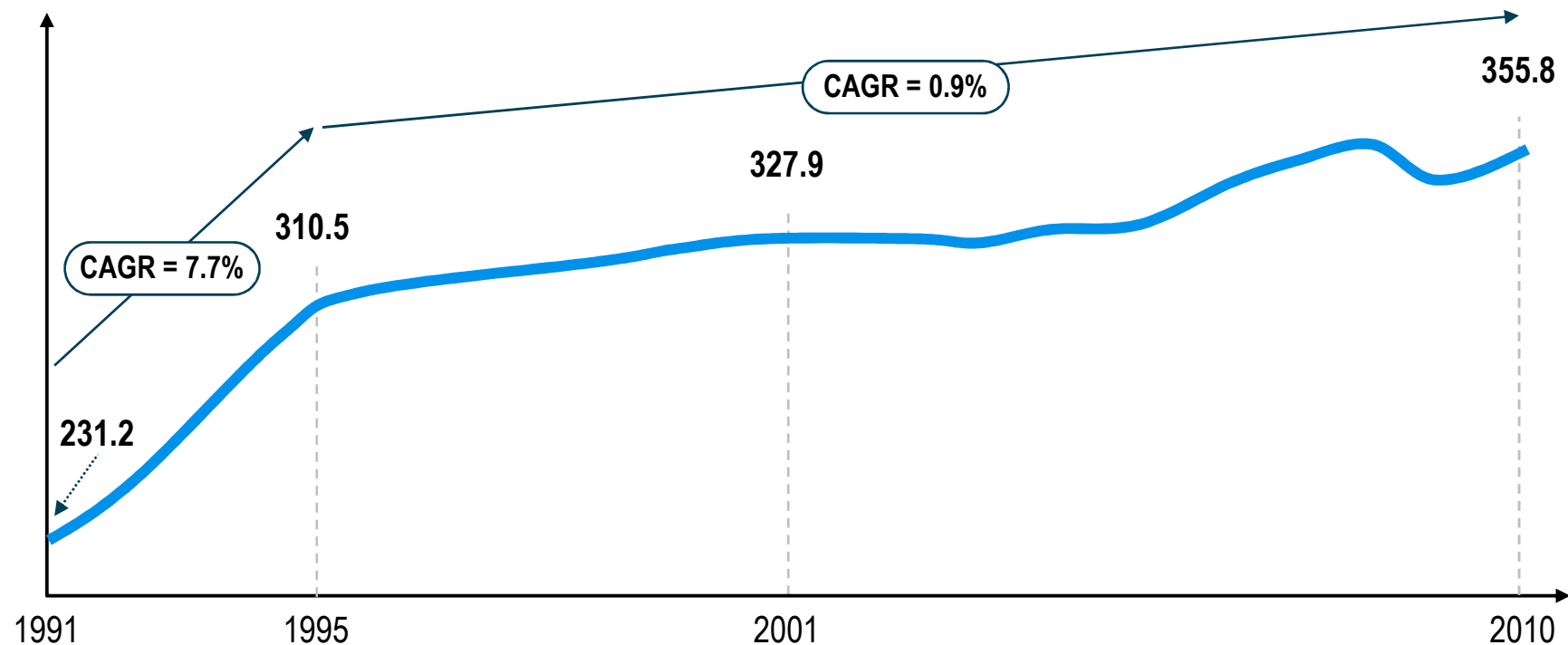


SELF EMPLOYED ['000]



In conclusion, free-market reformation has created a solid market economy in Eastern Germany

E. Germany Real GDP
[EUR billion]



> East Germany needs to find solutions to reinvigorate growth

Treuhandanstalt
(THA) -
Privatization Agency



The Treuhandanstalt (THA) was specially established to privatize the state-owned enterprises of the former GDR

Historical overview of the economic reforms in East(ern) Germany



Fall of the Berlin Wall



- > Establishment of the **Treuhandanstalt (THA)** in Eastern Germany
- > Agreement on Monetary, Economic and Social Union



Reunification



- > Winding up the Treuhandanstalt
- > Introducing new specialist structures to complete the privatization process



Nov 9, 1989



Jul 1, 1990



Oct 3, 1990



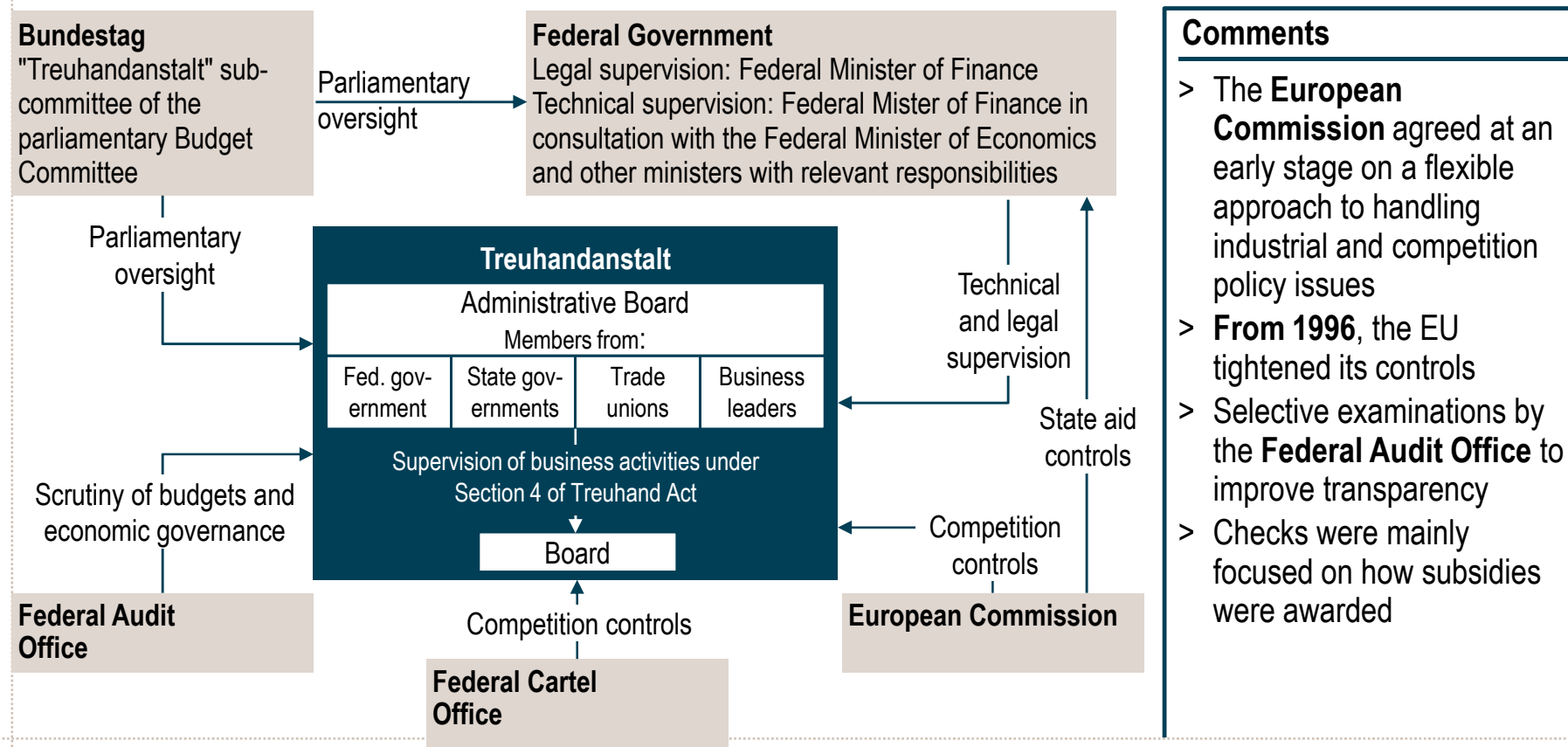
Dec 31, 1994

- > Bundling all East German enterprises within the Treuhandanstalt-Holding
- > Recording and classifying all the enterprises – suitable/unsuitable for restructuring and further privatization
- > Restructuring projects for enterprises
- > Privatizing enterprises

- > Transferring the remaining functions of the THA to five specialist institutions
- > Completing the privatization process and selling off the remaining assets

The THA was integrated into the political landscape by the participation of all relevant ministries and supervisory bodies

The Treuhandanstalt in the political context up to 1995

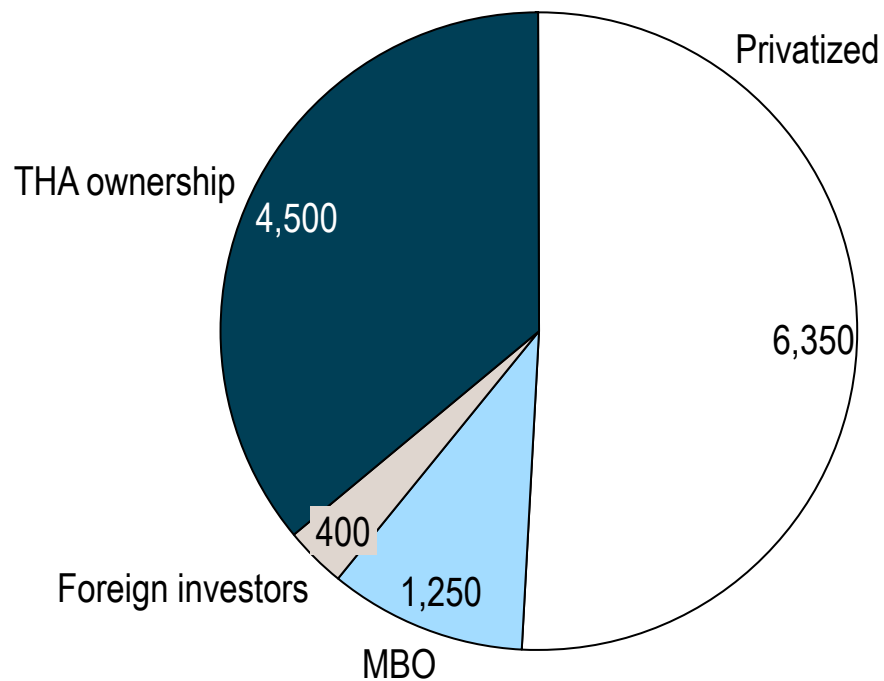


RESULTS

By mid-1992, THA had managed to privatize 66% of the companies – Securing more than 1.2 million jobs

Overview of company sales [no. of company sales]

Initial stock held by THA: 12,500 companies



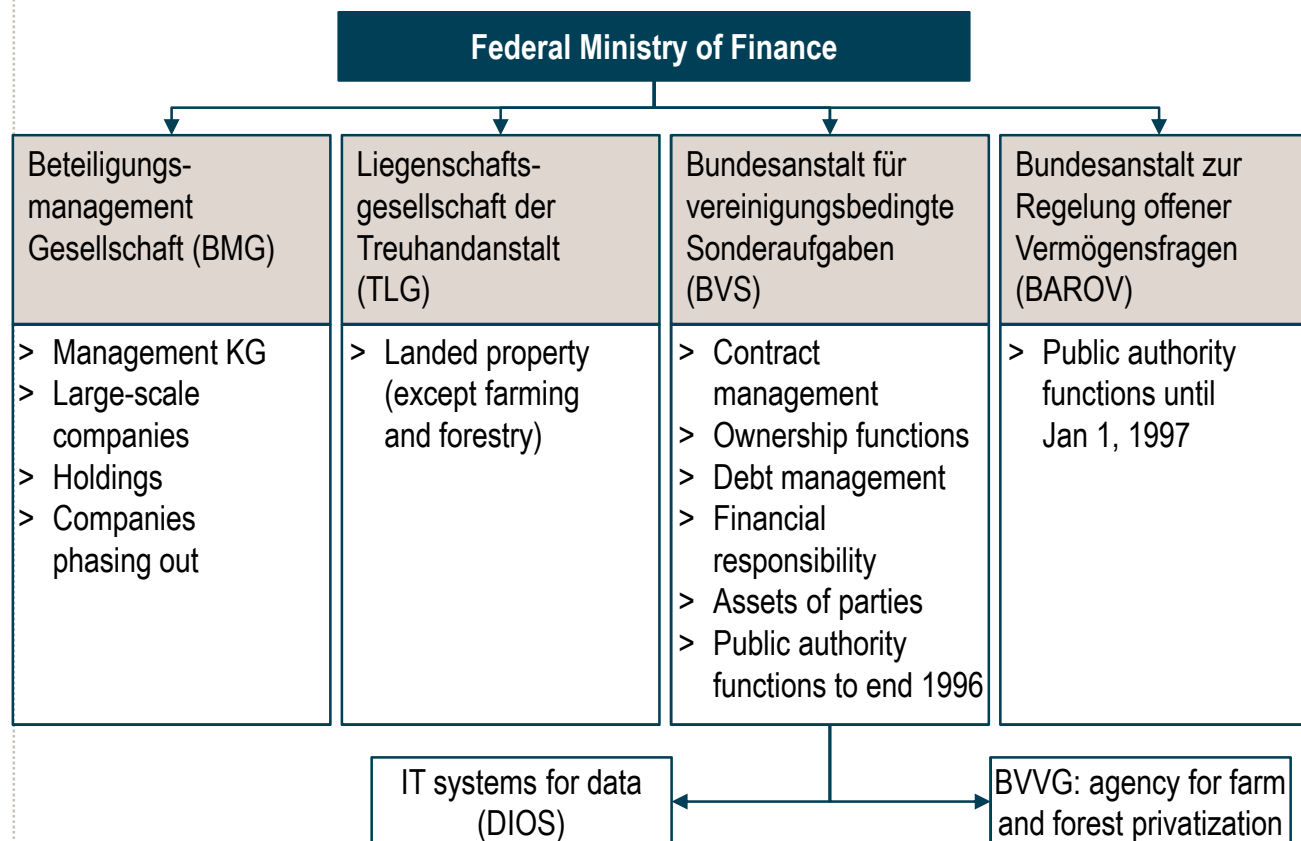
Comments

By 1992, privatization had achieved:

- > Over 1.2 million long-term jobs
- > Investment pledges of more than DEM 140 bn
- > Privatization proceeds exceeding DEM 30 bn

When the THA was disbanded, new institutions were set up – Focus on managing contracts and holdings and winding up companies

Reorganization of the Treuhandanstalt from 1995



Comments

- > With the disbanding of the Treuhandanstalt, the focus of privatization activities shifted and new institutions were founded under the auspices of the Finance Ministry
- > The main functions of the new institutions were:
 - Contract management
 - Managing the remaining holdings
 - Winding up companies

Implications to Korean Reunification



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A. FACTS: ECONOMIC OVERVIEW

B. FORECAST OF ECONOMIC SYNERGIES AFTER UNIFICATION

5. CONCLUSIONS AND NEXT STEP

There is an enormous economic gap between North and South Korea

North-South Key statistics comparison (2011)

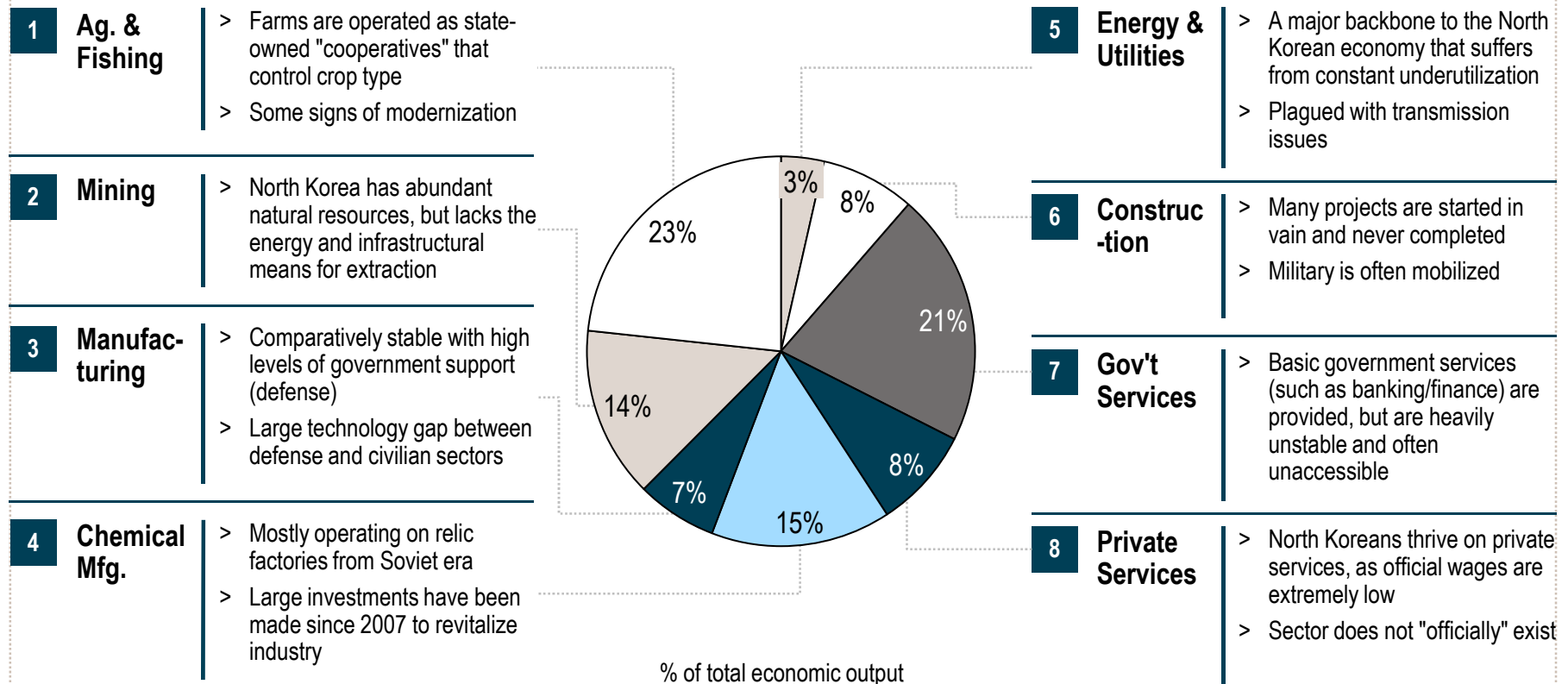
Category	 North Korea	Multiplier	 South Korea
Population ['000]	> 24,900	x 1.98	> 49,410
Area	> 120,538 km ²	x 0.83	> 100,003 km ²
GDP Per Capita	> USD 854 (2013 est.)	x 30.6	> USD 26,205 (2013 est.)
Urbanization ¹⁾	> 60.2%	N/A	> 90.8%
Total Road Length	> 25,950 km	x 4.07	> 105,565 km
Power Generated	> 23,700,000,000 kWh	x 20.0	> 473,900,000,000 kWh
Underground Resources	> USD 3.9 trillion	x 0.06	> USD 239.7 billion

1) As defined by the Ministry of Land Infrastructure and Transportation in 2009; 2) Denotes potential value; estimates based on H2 2012 and H1 2013 market prices

North Korea has many of the basic sectors established – all major corporations are state-owned and operated

Industry overview

Proportion of North Korean Economic Sectors



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Korean reunification yields many potential benefits that can be realized both economically and socio-politically

Reunification benefits & synergies overview

	South Korea	Mutual	North Korea
Economic	<ul style="list-style-type: none"> > Access to larger market > More efficient export to Asia and Europe via rail > Creation of additional jobs as new management positions and ventures are created in N. Korea > New opportunities for investment ... 	<ul style="list-style-type: none"> > Decrease in defense and foreign relations expenses > Increased foreign investment & tourism from political stability > Access to cheaper energy > Synergies from merger of resources and EPHT¹⁾ sector ... 	<ul style="list-style-type: none"> > Creation of new jobs as infrastructure projects are undertaken > Increase in per worker productivity with modern technology > Access to economies of scale as the North itself is divided ...
			
Socio-political	<ul style="list-style-type: none"> > Liberation of captured and oppressed people > Lowering of average age and simultaneously increasing total to approx. 80 million > Reunification of separated families > Increase in national brand value, better international stability, and increased territory > Drastically decreased threat of war outbreak ... 		

1) Engineered Products and High-Tech

A variety of diverse synergies can be created in Human Capital, Logistics, Finance, and other categories

Key areas of high-potential synergies

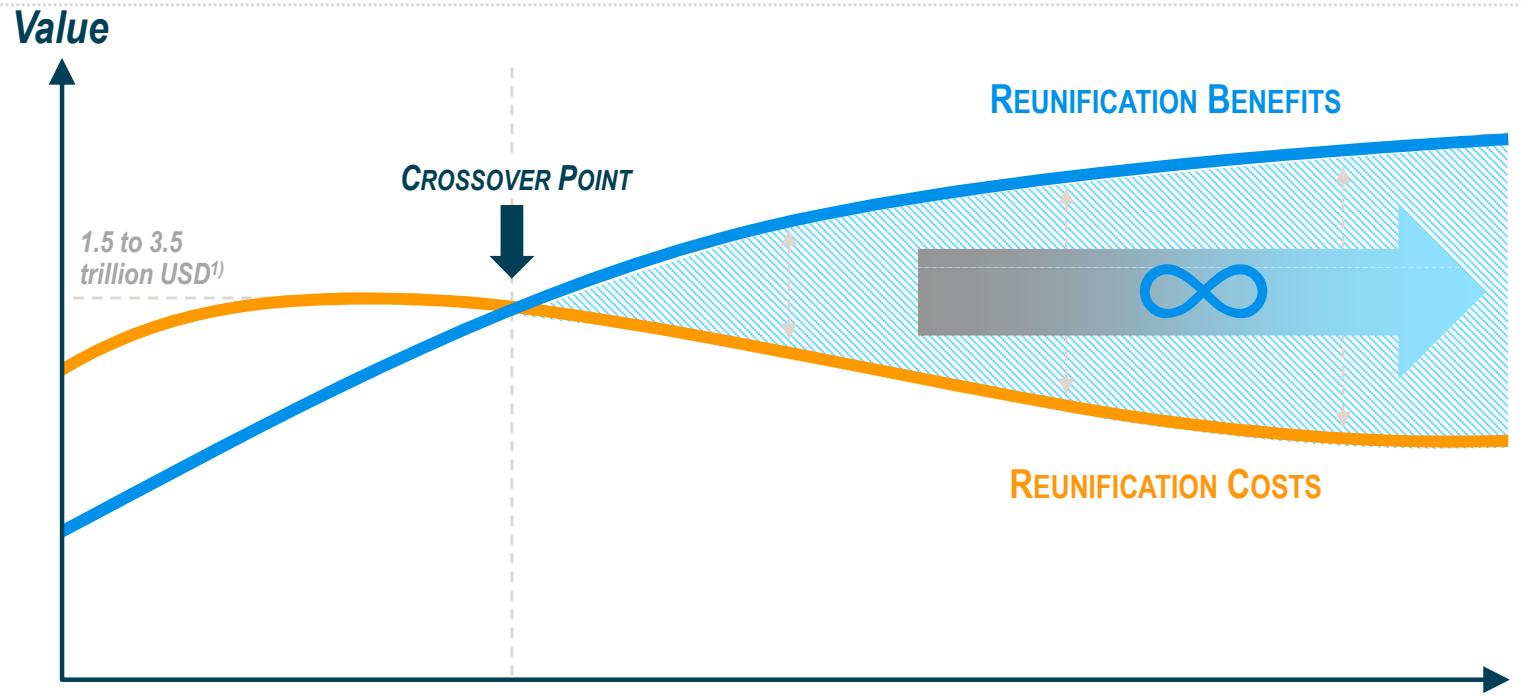


- 1 Improved population distribution
- 2 Economic boost for Corporations and N. Korean Workers
- 3 Reduction in required military size
- 4 Positioning as a trade hub
- 5 Reduced reliance on foreign raw materials
- 6 Improved national credit rating
- 7 Growth in tourism industry

VALUE OF BENEFITS

Overall, the value of reunification definitely exists given that Korea creates the necessary benefits in the long run

Value of reunification over time



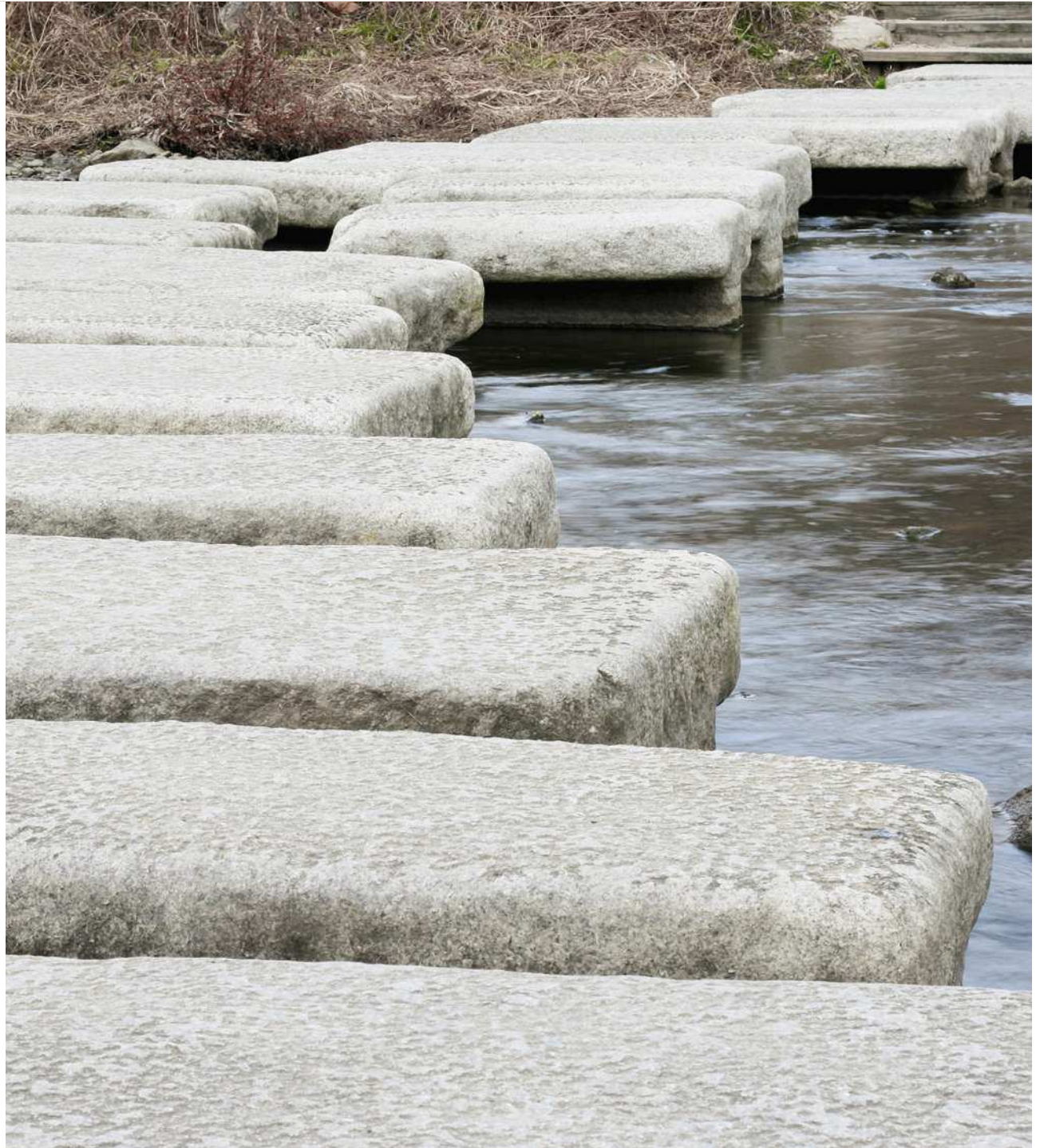
> Although the initial costs may be high, the sum of all possible benefits is nearly infinite and net present value is positive

1) Estimates by Credit Suisse and Goldman Sachs

Source: Credit Suisse, Goldman Sachs,

Considerations and the Next Step

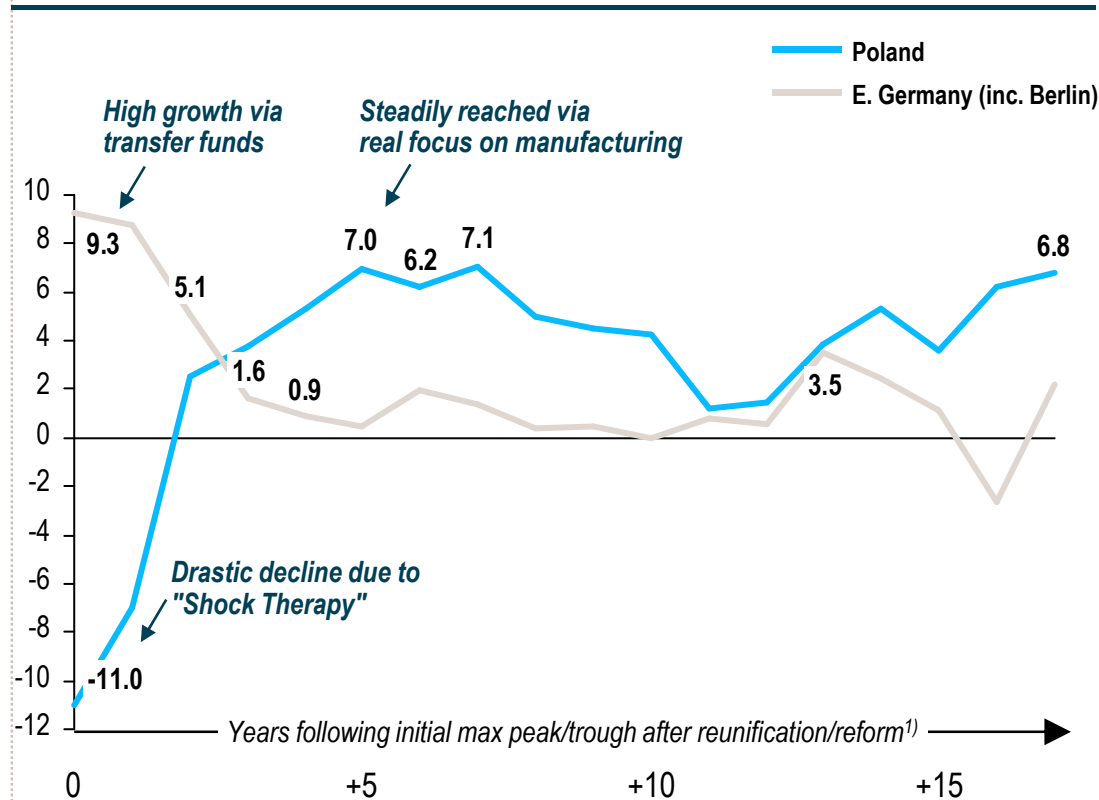
Roland Berger
Strategy Consultants



Polish Shock Therapy is a reference case with solutions that can be reapplied to building North Korea

Characteristics of different approaches to rebuilding

Real GDP Growth of Poland & East Germany [%]



1) In Germany and Poland, respectively

Source: World Bank, IMF, VGRDL,

Implications

- > **Success is highly dependent creating an economic foundation (as in Poland)** over pursuing economic equality (as in Germany)
 - Poland created a strong manufacturing base that accounted for **over 60%** of cumulative value added between 1991 and 1998
- > **Sudden population migration is detrimental to long-term growth** – especially in the younger working age group (as in Germany)
 - North Korea faces this same type of risk, and policymakers should be aware of the long-term consequences
- > Large transfer funds does not equate to high, long-term growth (as in Germany)

The costs of unification cannot be initially covered by near- or medium-term economic synergies, and transfer funds must be used wisely

Areas of uncertainty



New taxes and other forms of domestic funding will need to be developed

- > What amount is socially acceptable given that reunification is not certain?
- > Which generations should bear the financial burden?



Korea will also need to look abroad for financial assistance to fund reunification efforts

- > How will Asian neighbors react to the creation of a economic powerhouse?
- > What amount of assistance will allied nations provide?



Funding needs to be spent on building a strong economic foundation, not "quick fixes"

- > How do we find a good balance between short-term struggle and long-term gain?
- > What is the near-term goal for more economic equality?

In order to realize the potential of a unified peninsula, South Korea needs to prepare to "foot the bill" for reunification

Steps to success

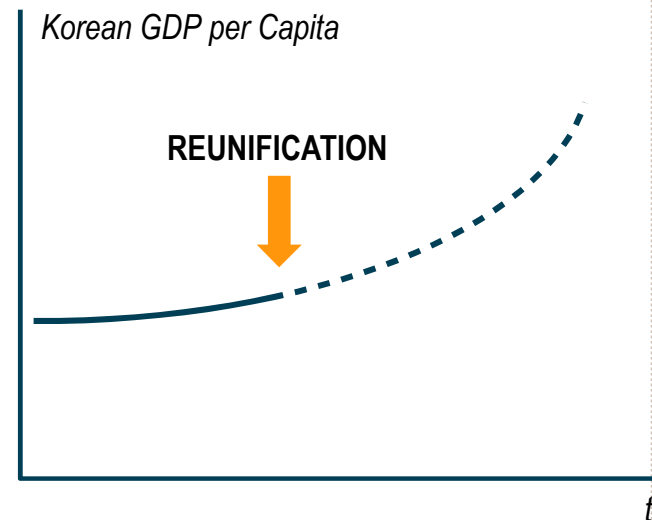
Start Early

- > Conservative estimates put reunification costs in the trillions - **Korea needs to begin investing in reunification**
- > **Germans are still taxed to support post-unification stability after over USD 2 trillion in transfers**

Invest in Long-term Benefits once Reunified

- > **Invest in the long-term gains** that create a foundation for a strong economy
- > Quick wins are necessary as well, but they should be mutually exclusive from investments
- > Develop creative methods to lure for-profit investment

Realize Potential Long-term Returns



> **There is potential for tremendous gains!**