Korean Unification and the Financial System

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Abstract

Unification of the two Koreas will require eventual integration of two very different financial systems. This paper explores issues and options for South Korea in pursuing unification from a financial perspective under both a scenario of a gradual negotiated unification process and a rapid South Korea-led unification process. In both cases, maintaining financial stability should be a guiding principle and phased integration of the two financial systems will be needed. However the strategies and priorities for action would be different in the two scenarios.

Keywords: North Korea, Democratic Peoples' Republic of Korea, DPRK, economic reform, finance, financial stability, international financial institutions, institution building, sanctions, unification, Korean reunification, Korean Peninsula

Introduction

Any path towards Korean unification will necessarily have to deal with the question of how to handle the merging of two radically different financial systems. South Korea's system is fully integrated in the global financial system and has evolved with the changing structure of the South Korean economy and demographics since the 1960's and with changes in the regional and global economic and financial environment. The financial crisis of 1997/98 revealed deep vulnerabilities despite these advances, and aggressive efforts to address these and pursue prudent macroeconomic management positioned South Korea to weather the global financial crisis of 2008 better than most OECD countries. A recent International Monetary Fund (IMF) review concluded that the financial system resilience has increased since 2008 and the near-term vulnerabilities are limited.[1]

North Korea adopted a Soviet-style financial system serving the state-planned economy model early on and has remained isolated from the international financial system in part by its own policy choices and in part as the result of international sanctions. With the emergence and growth of markets in North Korea in the last 20 years, it is notable how little effort has been made to modernize the financial system as has been done by virtually all other countries set adrift by the collapse of the Soviet Union in 1992. Neither the public financial system nor banking system have been adapted to the reality that North Korea has become a mixed economy with both state-directed and market mechanisms co-existing with increasingly blurred lines. Attempts at innovation have been rare and timid, reflecting a deep distrust of capitalism and the risks to the role and authority of the state. Institutionalized segmentation of the military, Korean Workers' Party (KWP), and cabinet has also militated against the establishment of an integrated financial system that can be used for both fiscal and monetary management of the economy as a whole. This segmentation along with the absence of a meaningful legal and regulatory environment to support the growing market economy adds greatly to the inefficiencies in the mobilization of savings and allocation for investment in the North Korean economy.

These disparities in the evolution of the financial systems of the two Koreas provide an important challenge for unification, whether it proceeds gradually or suddenly. This paper explores a number of considerations and policy options for South Korea in planning for unification and also examines the potential role of the international community is supporting this process. Realistically, however, the larger political and security questions facing unification overshadow financial system considerations and thus linkages between these needs to be addressed. This paper thus considers both a gradual unification scenario of a collaborative and negotiated process that is staged and compatible with a confederation model pending full unification, and a rapid unification process requiring more unilateral decisions and action on the part of South Korea.

Overview of North Korea's Financial System

North Korea does not publish financial and economic statistics except high-level budget data, so it is impossible to know with any accuracy the financial condition of the country, its banks, its enterprises, or its households. Normal financial practices such as creditworthiness assessments are not possible in a system with no transparency. Under such conditions, effective macroeconomic management of an economy where markets are playing an increasingly important role is virtually impossible. This alone makes the prospect of unification of the financial systems and coordinated economic management of the two Koreas a daunting prospect.

It is useful to distinguish between North Korea's ways of managing its external finances and its internal finances. Historically, the banking system has primarily addressed the need to mobilize foreign exchange to finance essential imports for its military programs, luxury goods for the elite, and economic development. The Foreign Trade Bank and numerous specialized sector banks have been devoted to providing services for trade finance and foreign investment, and have been aligned with trading companies that are controlled by the military, party, and cabinet separately with no system-wide banking supervision. Rooms 38 and 39 of the KWP have had special responsibilities for raising and managing foreign currency for the inner elite, including through both legal and illicit methods. Their operations have dwarfed those of financial institutions under the control of the cabinet. The Ministry of Finance has had lead responsibility for official interactions with the international financial system, including hosting IMF and World Bank missions in 1997 and 1998, involvement in the technical delegation to negotiate the return of funds from Banco Delta Asia in 1996, and negotiating debt relief with Russia.

Domestically, the public financial system was developed under the Soviet model as essentially an accounting mechanism in which monetized transactions were minimal. The dominant form of taxation has been the turnover tax, negotiated between the Ministry of Finance and state enterprises. Allocation of foreign exchange for needed imports and investments under the state plan was also negotiated.

The Central Bank has some functions typical of a central bank, including issuing notes, currency control, and account settlement. It also provides services relevant to the national budget, including capital supply, collection of national income, registration and valuation of fixed assets, and safekeeping of precious metals. Unlike most central banks, it does not have supervision authority over other banks and has a large number of local level units.

Prior to 2002, inter-firm transfers were treated as accounting transactions under the budget. Inter-firm transactions were managed through the Instant Payment Demand system and Instant Payment Form system, which did not involve cash transfers, but credits and debits to existing accounts. After the reforms of 2002-2003, after which firms were permitted to source inputs for production from the markets, cash transactions between firms also became allowed and are now widely used. Adoption of a Commercial Banking Law in 2006 provided the legal basis for establishing a commercial bank separate from the Central Bank to operate as a regular bank responsible for deposits, loans, and other account activity. Under Chapter 6 Article 57, it is stated that the bank was formed in order to ensure stability of financial transactions and protect the interests of account holders. The Commercial Banking Law includes overseas account activity, overseas currency services, loans, sales, trade in precious metals, and fixed asset registration. However, enterprises and businesses cannot deposit funds into personal accounts. A parallel system has also emerged with the establishment of joint venture banks, who have taken a leading role in introducing new types of services, such as individual deposit accounts. However, despite these innovations, the expansion of the market economy has led to large cash accumulations in both domestic and foreign currencies by firms and households outside the banking system. The failed currency reform of 2009 reinforced a distrust of banks and reluctance to hold domestic currency as a store of value for savings.

Recent Financial System Reform Initiatives

In January 2015, KCNA announced that North Korea is committed to implementing an action plan for coming into compliance with international standards for anti-money laundering and terrorist financing after being accepted as an observer at the Asia Pacific Group on Money Laundering (APG). North Korea has attended meetings of the APG for several years and has signaled before its desire to become an observer. Being granted observer status under APG will give the North Korean financial authorities access to technical guidance from the APG Secretariat to make the legal and organizational improvements needed to work towards meeting membership requirements. This development is significant because for the first time North Korea will be working with outside financial experts in a disciplined process to make important changes to its financial system management that would be recognized as meeting international standards. This is similar to a process that could be undertaken if North Korea were to decide to work towards membership in the International Monetary Fund, and is analogous to the process used by the European Union to help prospective member states meet technical requirements for joining the EU, and also the process leading to accession to World Trade Organization.

It is also noteworthy that the Central Bank president in an interview said that the effort to come into compliance with APG requirements was being coordinated by a national committee. This committee is chaired by a deputy premier from the cabinet and includes officials from the Central Bank, Foreign Ministry, Finance Ministry, and law enforcement authorities.[2] This signals both high-level attention and support for this initiative and a meaningful effort to integrate different parts of the North Korean bureaucracy in the various measures that will be needed to succeed.

Thus, the APG process will provide North Korean financial authorities experience in working with technical experts on changes to the financial system and its management, and will be a test of the political will of North Korean leadership to accept legal and transparency requirements they will need to adopt to achieve eventual membership status and whether cross-agency cooperation and coordination can be effectively managed in a high profile undertaking of this type[3].

Despite these positive signals, the challenges of successfully introducing anti-money laundering capabilities intp the North Korean financial system will require certain conditions within the system more generally. These include: laws of corporate ownership and transparency; integrity and soundness of the financial infrastructure; the ability to obtain, manage, use, transmit, and trust transactional information; and a strong regime for regulation of the financial sector[4]. It is not at all certain that North Korean authorities appreciate the scope of changes required in the present financial system to accommodate the APG standards.

An interview given by Central Bank president Kim Chong-gyun in early February 2015 is also important because it indicates that serious attention is finally being given to reforms in the domestic financial system[5]:

- "Our mission is providing the capital to build the country's economy through means of smoothly circulating domestic funds."
- "As part of the effort, we are developing new financial products and promoting credit card usage by the public."
- "With the establishment of our-style economic management

> methods, there are plans of improving the methods of financial and economic institutions and installing financial measures in accordance with the emergence of entrepreneurial activities."

These statements indicate that in addition to the reforms in agriculture and enterprise management that have been reported as part of the May 30 measures, there now seems to be the emergence of a serious effort to build financial mechanisms to reinforce these new directions, to mobilize savings from the population, and to expand financing of capital investment in a mixed economy that increasingly relies on private entrepreneurial initiative and market mechanisms. If people are willing to place their savings in deposit accounts and use credit and debit cards, this would be a very significant sign of growing trust in financial institutions, which is essential for a banking system that serves both households and enterprises. As we learn more details about the new financial instruments that are being planned and how responsive they are in practice to the needs of individuals and businesses, we will see whether they have any actual traction or will be another failed effort. Important questions, such as interest rate policy, security for loans, ownership of assets, and protections against abuse, will need to be addressed if financial system reform is going to get off the ground. While North Korean officials and academics have been studying financial practices in other countries, there is no structured advice or technical assistance being sought from or given by external experts except through occasional study tours and workshops. This is a glaring gap compared with other countries embarking on financial system reform. Additionally, the North Korean predilection for doing things "in our own style," does not inspire confidence that they will be successful. Acceptance of the need for broader reforms in the financial system and building linkages to macroeconomic management capacity still seems remote.

Strategies for Unification

Against this backdrop of history and recent initiatives, there are two sets of issues that will need to be addressed in whatever scenario of financial system unification unfolds. One set is the range of issues that face all transitioning economies moving from a centrally-planned economy to a market one. North Korea's history and policy choices have created a deeply challenging situation in this regard which adds to the complications associated with the second set of issues, which involve the challenges of integrating the systems of the two Koreas. One argument for pursuing a gradual unification process is to address these two sets of issues sequentially rather than at the same time. The more the North Korean financial system can adapt to the growing market economy and become more integrated in the international financial system, the easier it will be to knit the two systems together in the future.

Major issues internal to North Korea will need to be addressed to develop a financial system that better serves the growing role of markets in the economy and North Korea's external financial system needs involve the rule of law, transparency, institutional development, and capacity building. There are many topics that need to be addressed, including:

1. Financial and economic statistics
2. Roles and capacities of the Central Bank, Foreign Trade Bank, and Ministry of Finance
3. Relations with the international financial system
4. Expansion of domestic banking system
5. Banking supervision and regulation
6. Integrity of payments system
7. Capacity for creditworthiness and risk assessment
8. Financial services for households
9. Financial services for enterprises
10. Macroeconomic management capacity and policies
11. Trust in national currency
12. Trust in banks
13. Property ownership and collateral
14. Transparency in corporate accounting
15. Foreign and domestic debt obligations
16. Tax policies and administration
17. Legal enforcement

A strategic challenge for South Korea is how to inspire both the motivation in North Korea to develop the financial system in ways that facilitate unification and the willingness of North Korea to cooperate with South Korean and other foreign experts in developing policies and institutional capacity that would move the financial system in a desirable direction. For a gradual unification process, one question is what incentives and negotiating mechanisms are be feasible to pursue to make positive progress in a reasonable period of time. Another is what sequence of reforms and capacity improvements are logical and practical within the larger political environment internationally and domestically inside North Korea. For a sudden unification process, the challenge would be to formulate a financial system reform plan that would be effective in containing downside risks to the South Korean economy while putting in place phased changes supportive of a restructuring of the economy under policies dictated by South Korea and not strongly resisted by North Korean firms or households that can lead to economic integration and monetary union.

In either scenario, unification of the financial systems of the two Koreas is only one component of unification of the two economies and will need to be tethered to the larger process of property rights reform, legal system reform, labor market reform, state enterprise reform, and social system reform. All will impact the feasibility and riskiness of financial system integration. While the ultimate goal of unification will be a full monetary union and integrated factor markets, this will be both technically and politically complex and challenging. Thus, an essential part of the strategy for full unification must be prudence and the recognition that financial stability should be the underlying guiding principle guiding judgments about the pace and sequence of steps to full unification.

Issues and Options under a Gradual Unification Process

Strategic considerations: A gradual unification process will require finding space and means to deepen partnerships between the North and South Korean governments, enterprises, and financial institutions while recognizing the reality of differences and managing risks. The general strategy should be to define space where such collaboration is politically feasible, and adopt principles and activities that will lead to expansion of that space as confidence grows and technical issues constraining what is possible are overcome. It is also important to avoid practices that may have short-term benefit but undermine longer-term unification objectives. This implies in the early stages, working on multiple tracks guided by a long-term vision of peace, stability and growing inter-dependence, supplemented by problem solving mechanisms. In retrospect, the "Sunshine Policy" achieved meaningful progress from this perspective, which was eventually undermined by military provocations, over-reliance on bribes for concessions, and political developments in both countries.

Another strategic consideration is the model of financial system development to pursue in North Korea as it manages the transition from planned to market economy. Here the German experience is likely to be helpful, as the German financial system relies heavily on the role of banks, not equity markets, to finance economic development. The role of stock market development in transition economies has received considerable academic attention[6], but in the case of Korean unification objectives in addition to transformation of market objectives, it is hard to imagine a US/UK-style equity-focused strategy would have as much traction as relying on banking system development and integration.

South Korean priority actions: Given the current state of inter-Korean relations where tensions remain high and economic collaboration restrained, initial steps towards unification in the financial area should proceed modestly on several different tracks:

1. <u>Expand exposure of North Korean enterprises to South Korean banking services.</u> This could be done through allowing joint venture arrangements at the Kaesong Industrial Complex with financing from South Korean banks guaranteed by the South Korean partner. Another option would be to establish South Korean banking services in Special Enterprise Zones (SEZs) where the legal basis has been created for foreign banks to serve companies investing in these zones. South Korean banks could start by supporting joint ventures of foreign and North Korean firms or North Korean firms providing inputs to wholly-owned foreign firms in the SEZs. Involving South Korean banks in financing multi-party partnerships, such as the one being proposed by Russia for energy cooperation, would be another avenue to explore. Such engagement would expose North Korean firms to risk assessment requirements and legal recourse for failure to honor financial obligations of the South Korean banks. Meeting bank requirements would help North Korean firms focus on property rights and collateral issues, accounting and reporting practices, and performance incentives for future

financing.

2. Expand interactions between North Korean banks and South Korean banks through foreign exchange transfers. This could be done by re-negotiating the processing-on-commission trade that was suspended in 2010 and permitting trade finance between participating enterprises on both sides to be handled by South and North Korean banks in an internationally transparent and disciplined manner. Another option would be to permit private transfers and remittances to North Korea from South Korea to be processed by banks from the two countries. Such engagement would give banks on both sides experience with each other's requirements, procedures, and the use of accepted international foreign exchange transaction procedures.
3. Establish a joint venture bank for domestic financial services in North Korea. North Korea has already accepted the principle of joint venture banks providing new services to firms and households. A joint venture inter-Korean bank could be a powerful mechanism to introduce South Korean financial service products into North Korea and would significantly facilitate eventual unification objectives. It might also help build trust in banks inside North Korea and attract deposits to expand intermediation of private savings and investment. Lending products would help firms and entrepreneurs with both working capital and investment resources while providing education to firms focused on the domestic market to risk assessment and creditworthiness requirements and practices.
4. Use financial mechanisms to provide both humanitarian aid and official development assistance to a greater extent than in the past and avoid bribery. Financial relations between the two Korean governments should be gradually developed in ways that promote financial integration. In the first instance, the development funds managed by Korea EXIM Bank could be partially transferred to a responsible North Korean party for local expenses associated with development projects and to establish proper financial accounting and reporting for South Korean funded projects that are, at least in part, implemented by the North Korean government or firms. Bilateral loans for development projects could be administered using procedures compatible with those adopted by multilateral lending

institutions, thus helping North Korea build policies and capacity for international borrowing that would advance their eventual expanded participation in the international financial system.

Direct contact and negotiations between Korea EXIM and the North Korean Ministry of Finance would help build relationships and understanding of institutional capacities and constraints to advancing inter-Korean collaboration of economic development projects. Where possible, transactions should aim to use financial channels and transparent financial dealings rather than relying on in-kind transfers. What should be avoided are past practices of making cash payments for concessions from North Korea and making humanitarian aid such as rice and fertilizer in the form of a loan that neither country expects to be paid back. These practices undermine financial discipline in both countries.

5. <u>Establish macroeconomic dialogue and policy coordination mechanisms.</u> Sooner or later it will be necessary for the finance ministries and central banks of both Koreas to have direct contact with each other and to establish mechanisms for cooperation. One priority is to work towards building commonly agreed financial and economic statistics reporting so that an integrated picture of the condition of the two countries is possible and to eliminate the need for the central bank of South Korea to report statistics on the North Korean economy that are derived from estimates based on very limited information and questionable production functions. This is also essential for coherently managing the eventual integration of the two economies. One unavoidable issue is the treatment of inter-Korean trade and financial transactions on balance of payments calculations, since the South Korean Constitution does not recognize North Korea as an independent country.

   Another priority would be to identify areas where policy coordination would be beneficial to both countries and to build cooperation processes in policy analyses, decision mechanisms, and supervision of policy implementation. This will be increasingly important as and when North Korea becomes a more active member of the international financial system and as the economies of the two Koreas become more tightly integrated over time in a gradual unification process. If North Korea joins the International Monetary Fund, such coordination will become particularly important and visible to the international community. Article IV consultations would necessarily have to take into account the growing impact of inter-Korean economic and financial activities on the macroeconomic stability of both countries, risks to their economies, and what policy measures would best serve both countries.

A third area that will need attention is the question of how to manage currencies as the two Koreas move towards unification. National pride will be a significant factor, but the behavior of firms and households will also be a major factor. It is unlikely that in the early phases of a gradual unification process that the North Korean government would accept the use of the South Korean won as a medium of exchange within the North. At the same time, circulation of foreign currencies in North Korea has become the dominant monetary reality for those actively participating in the growing market economy. Periodic efforts to suppress the use of foreign currencies have not yielded more than temporary success. The failed currency reform of late 2009 created a heavy burden on the government to honor household savings and maintain their value for many North Koreans. Because North Korea is not likely to agree to replacing the North Korean won with another currency such as the US dollar or South Korean won, an interim strategy to pave the way for an eventual monetary union would be to find ways to improve the value of and trust in the North Korea won and reduce the need felt to hold foreign currencies. This might include technical collaboration between the two Korea's central banks, adopting a peg of the North Korean won to the South Korean won or US dollar, and strengthening the independence of the Central Bank in monetary policy making and currency management.

6. <u>Re-negotiate outstanding foreign debt.</u> North Korea has already renegotiated its Russian ruble debt. South Korean assistance to North Korea in resolving its outstanding debt obligations would help clear the way for financial unification. This could include writing off outstanding inter-Korean debt tied to food aid provided by South Korea and technical assistance in managing re-negotiation or sale of the outstanding foreign debt in arrears that goes back to the 1970's.

Involvement of the international community. In a gradual unification scenario, the international community can play a very important role in providing incentives and technical assistance for reforms and institution building in the North Korean financial system, even if inter-Korean relations are at a beginning stage of expanding cooperation. It may be easier to begin engagement on policy and capacity building issues through multilateral channels rather than relying on South Korean-led efforts to gain North Korean acceptance of foreign assistance in developing its financial system. This can evolve in parallel with the expansion of inter-Korean economic relations and progress in resolving the long-standing political and security issues on the peninsula.

In an environment where North Korea is pursuing a managed transition in its financial system to integrate a growing market economy, seeking to deepen its connectivity to the international economy, and pursuing gradual unification with South Korea, the international community can play an equally valuable role in helping North Korea adjust to the reduction and removal of sanctions and helping to mobilize capital for investment in economic development. A significant program of official development assistance and improvement in the environment to attract foreign direct investment would take the financial burden off South Korea and lower the challenges to eventual unification. In expanding the involvement of the international community in North Korea in ways designed to have a positive rather than negative impact on the future of the North Korean economy, the financial and knowledge resources, and the coordination capabilities of multilateral financial institutions can be a critical catalysts for accelerating progress. Thus, part of the South Korean strategy should be to encourage and support directly and indirectly opportunities for North Korea to gain access to relations with multilateral financial institutions and to advocate for expanding the role and activities of these institutions as political conditions improve.

To pursue such a strategy it will be necessary to link political negotiations on resolving outstanding security issues with North Korea to incentives for economic development and integration in the international financial system. For the IMF, World Bank, Asian Development Bank, and new Asian Infrastructure Investment Bank to play constructive roles in supporting a gradual unification process, there will need to be political support for their involvement not only from South Korea, but also from the major shareholders of these institutions. The current North Korea policy of pursuing economic development and simultaneously expanding its nuclear program together is not acceptable to these shareholders, so an immediate priority is to explore options for structuring future negotiations in a way that would give North Korea sufficient economic incentive and face-saving means to relinquish this policy in favor of a more productive approach to maintaining its long-term interests, including unification. One way to do this is to gradually expand access to technical assistance and funding from international organizations through linking them to a road map of political and security milestones in a reinvigorated Six Party process or new framework for multilateral negotiations that can also support longer-term unification objectives.

Issues and Options under a Rapid Unification Process

Strategic considerations. A rapid unification process would require a very different strategy for financial system integration. South Korea would need to make unilateral decisions and shoulder much greater risks. International support would need to be channeled through South Korea, not in parallel with South Korea. Much debate in the past decade has focused on the costs of unification and the lessons of the German experience. Most analyses concluded that South Korea does not have the financial capacity to follow a German-type process and thus staged unification, even under the circumstances of a regime collapse in the North or a military occupation, would be an important element of strategy. If North Korea has not made much progress in developing its financial system before the rapid unification process begins, South Korea will have the additional burden of managing transition to market economy issues. The challenge will be to establish a sequence of policies and institutional arrangements that will support the integration both of the two differently structured economies and financial systems.

South Korean priority actions. There are a number of measures that South Korea could take to manage financial affairs and integration under a rapid unification scenario:

1. <u>Adopt policies to maintain financial stability in South Korea and contain the risks of instability in North Korea.</u> While international capital markets have already factored North Korea uncertainties into their risk calculations for South Korea, a sudden requirement for South Korea to embark on rapid unification could trigger repercussions on the won and stock markets. It will be critical for South Korea to take bold steps to reassure the markets and the international community that it will

be prudent in undertaking these responsibilities. One way to accomplish this would be to work with the IMF on a program that would ensure both financial stability in the South and containment of instability in the North. The involvement and support of the international community for such a program would help reduce risks of market instability and strengthen confidence in South Korea's ability to successfully manage such an undertaking.

2. Use South Korean banks to either take over existing North Korean banks providing commercial services to firms and households or establish South Korean owned banks in the North. A 2001 analysis of the German unification experience in the banking system and its implications for the Koreas[7] concluded that at that time, South Korean banks were too weak to carry the burden of providing significant assistance to the North Korean financial system. The German experience of West German banks essentially taking over wholesale the East German banks was considered a success story and integration of the banking systems of the two Germanys went relatively smoothly. The recommendation for South Korea at that time was to seek a large external source of funds in order to play the role in North Korea that West German banks were able to play in East Germany. In addition to funds, North Korean banks will need substantial capacity building in savings mobilization and credit assessment for loans. Today, however, South Korean banks are stronger than in 2001 as a result of continuing efforts to strengthen the financial system and reduce vulnerabilities following the Asian financial crisis of 1997 and 1998. It would be prudent for South Korea to consider designing a stress test to evaluate the capacity of South Korean banks to play an expanded role in North Korea in a rapid unification process. This would help identify both strengths and potential vulnerabilities. A strategy to expand the presence of South Korean banks in North Korea should also be articulated, both in their financial role and in their capacity building role for North Korean partners or branches.

3. Establish a unification fund to channel resources to the public finance system operating in the North under South Korean management and for defined projects and social expenditures that meet high priority needs. Regardless of the role played by

South Korean banks in building a future North Korean financial system, North Korea will need a huge inflow of investment capital to put its economy on a growth path and to integrate it with the South's economy. Public funds for investments in infrastructure and for the provision of a social safety net in the early stages of unification will need to be channeled through the South Korean public finance system. Both funds from the South Korean budget that are consistent with macroeconomic stability and funds from the international community will be needed. To manage these funds and maintain the integrity of the South Korean public finance system, a special fund for North Korea could be established, possibly building on the existing fund managed by the Korea EXIM Bank. A challenge will be to integrate the operations of this fund with reform of the North Korean public finance system and to bring these closer in line with the South Korean public finance system over time to permit eventual full unification.

4. Create a new monetary system in North Korea that can function in parallel with that of the South and move towards integration in a phased way. It will be desirable in a rapid unification scenario to move quickly to change the monetary system. This could be done by declaring the US dollar the primary unit of exchange in North Korea and converting private holdings of North Korean won to dollars, given the already extensive use of US dollars in the country. Chinese RMB would be an option if by the time of unification the Chinese government allows convertibility, which it does not at present. Another option would be to establish a currency board that pegs a new currency to the South Korean won or US dollar as an interim step towards eventual monetary union. The Central Bank would need to set positive interest rates to mobilize savings and maintain the peg while stepping up lending to creditworthy borrowers among firms and households and expanding supervision of commercial banks legally allowed to operate in North Korea[8].

5. Build an information and regulatory system that supports macroeconomic stability in the North, strengthens banking supervision, and provides holders of bank accounts with deposit security. The underdeveloped state of the North Korean banking system and of the underpinnings for effective macroeconomic

management will need early attention. A dedicated team of experts will need to be deployed to bring South Korean expertise and capabilities to accelerate reforms and institution building in the North. To facilitate the accomplishment of unification objectives, this team should draw from South Korean ministries, institutes, and academia. Foreign expertise should also be mobilized from both multilateral and national sources. Training centers will need to be established and linkages between North Korean universities and training centers should be developed to support the reform effort. A policy and operational coordination mechanism will also be needed to guide the reform process.

6. Renegotiate North Korean debt. To clear the way for financial system integration, a strategy to deal with North Korea debt issues will also need to be developed. This will need to address long-standing foreign debt, outstanding inter-Korean debt (e.g. such as the rice and fertilizer aid given for humanitarian purposes but recorded as loans), and both foreign and domestic enterprise debt. A mechanism to manage the restructuring of debt that is linked to policies to ensure overall financial stability will be needed.

Involvement of the International Community

The international community will have a critically important role in a rapid unification scenario. Both financially and politically, the support of the international community for a South Korean-led unification process will be needed to maintain financial stability in South Korea and to enable the implementation of reforms and investments in the North that will pave the way to unification. Given the high degree of North Korea's isolation from the international financial system and impact of sanctions on the North Korean economy and financial system, it will important not only to support South Korean policies and programs, but also to remove sanctions that impede progress on unification and enlist technical expertise to support the reforms and institution building needed to advance the unification process.

The IMF can play an especially important role in monitoring the risks of financial instability, helping to define macroeconomic policies and programs that will support unification objectives, and providing technical assistance and training to officials from the North as part of an internationally supported capacity building effort. Similar support from the World Bank and Asian Development Bank could amplify the expertise and resources devoted to the policy and capacity building agendas. The new Asian Infrastructure Investment Bank could leverage resources available for priority infrastructure investments within prudent South Korean set borrowing frameworks. Private foreign direct investment could also be mobilized by setting up joint venture frameworks using North Korean assets as collateral with guarantees provided by organizations such as the Multilateral Investment Guarantee Agency of the World Bank Group.

Bilateral support from China, Japan and Russia could also help facilitate a rapid unification process. A large Japanese financial package similar to that provided to South Korea when relations were normalized in the 1960's could be channeled through South Korean unification funding mechanisms and help reduce the burden on South Korea. Chinese support through trade and investment that reinforces unification objectives could help accelerate the transition to a market economy and increase the economic growth potential in the North. Russian energy cooperation both in cross-border electricity supply and in negotiating financial arrangements to advance a gas pipeline to serve the energy needs of the whole Korean peninsula would give a significant boost to the unification process.

Conclusion

The financial aspects of Korean unification will be an important part of any successfully managed unification process. There are both technical and political challenges that will be faced. Maintaining financial stability in South Korea and containing the risks of financial instability in the North during the unification process should be given high priority in any overall strategy. Regardless of whether the process is gradual and negotiated or sudden and South Korean-led, it will be necessary to sequence efforts to restructure the economy to facilitate economic integration and develop the North Korea financial system in a staged way to be able to make a monetary union safe and workable. In either scenario, the international community will need to play a supportive role both in funding and financial system institution building for a successful unification process.

Notes:

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[1] "IMF Executive Board Concludes 2015 Article IV Consultation with the Republic of Korea," Press Release No. 17/217, *International Monetary Fund*, May 13, 2015, accessed September 19, 2015, https://www.imf.org/external/np/sec/pr/2015/pr15217.htm.

[2] "N. Korea launched anti-money laundering body," *The Korea Herald*, February 3, 2015, accessed September 19, 2015, http://www.koreaherald.com/view.php?ud=20150203001006.

[3] It is noteworthy that Cuba undertook a similar process while still under U.S. sanctions and is now in compliance with its commitments to the Financial Acton Task Force. The example of Cuba is a good model for North Korea and one that should be encouraged if one important objective of financial and economic engagement with North Korea it to find ways to help them integrate in appropriately with the international system of financial relations based on non-political criteria and performance in meeting standards.

[4] The observations were made at a 2008 workshop sponsored by the International Council of Swedish Industry and the Stanley Foundation held in Stockholm.

[5] "Pyongyang promoting credit cards," *Korean JoonAng Daily*, February 5, 2015, accessed September 19,2015, http://koreajoongangdaily.joins.com/news/article/Article.aspx?aid=3000551; and "New Economic Management Improvement Measures to Support Financial System Reform," NK Brief 15-02-03, *the Institute for Far Eastern Studies*, February 3, 2015, accessed September 19, 2015, http://ifes.kyungnam.ac.kr/kor/PUB/PUB_0203V.aspx?code=FRM150205_0001.

[6] Niels Hermes and Robert Lensik, "Financial System Development in Transition Economies," *Journal of Banking and Finance*, 24, no.4 (2000), p.507-524.

[7] Ralf Muller, "Korean Unification and Banking System – An Analysis of German Experiences and Korean Differences," Discussion Paper No. 139, *Halle Institute for Economic Research*, April 2011.

[8] These proposals incorporate and build on ones made by William Brown in an unpublished paper.