

On the road to Korean reunification

By Jan Dehn

A solution to the Korean Conflict is about a quarter of a century overdue, but now there is movement.

The outlook is naturally highly uncertain at this point. Still, we explain here what we imagine may happen in the coming months and decades. Reunification of the two Koreas would be a logical consequence of a peace deal, in our view. This possibility should therefore now be given serious consideration.

Reunification would require significant and sustained social and infrastructure investment in the North by the South. The return would take decades to materialise, but would ultimately favour Korea itself, while China would be the other major beneficiary, mainly via increased economic influence. The US President would gain from being seen to strike a deal to help end the Korean conflict, but the US as a nation would lose political and military influence. If Korean reunification takes place Japan would also become more isolated as America's last remaining ally in the region.

Introduction

A solution to the Korean Conflict is about a quarter of a century overdue. On one side of the negotiation table, South Korean President Moon Jae-in gets the credit for spotting the opportunity for peace, while US President Donald Trump has so far been kind enough to side-line the national interest of the US in order to pave the way for a deal. On the other side of the table, economic necessity is driving Kim Jong-un towards a deal, while China is quietly facilitating the process by applying economic pressure on the North. As one of the most dangerous unresolved geopolitical conflicts in the world, a solution to the Korean Conflict would clearly be good for world peace. However, a deal could yet fail, not least because the situation facing Kim Jong-un is particularly precarious. Still, eventual reunification of two Koreas would be a logical consequence of a peace deal, so this possibility should now be given serious consideration.

The outlook is naturally highly uncertain at this point, so much of this report reflects what we imagine may happen in the coming months and years. There is no way to be sure our expectations will be realised, of course. Still, if we are right, then one of the implications of reunification would be a significant requirement for additional social and infrastructure investment in the North by South Korea in particular – think at least twice South Korea's GDP spread over some thirty years or more. The return to this investment would take decades to materialise, but ultimately we expect Korea to gain significantly, while China would be the other major beneficiary, mainly through increased economic influence. On the other hand, the US would stand to lose political and military influence in the Fast East, although Trump himself would gain. Japan looks set to become increasingly isolated as America's last remaining ally in the region if Korean reunification takes place.

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Low hanging fruit

A solution to the Korean conflict is well overdue. The Korean conflict was rooted in the ideological battles, which prevailed at the height of the Cold War. Yet, the struggle for ideological hegemony between Capitalism and Communism ended a quarter of a century ago. Today, Communism, at least in its 1950s format, is not regarded as a viable framework for economic development or political control anywhere, not even in China, which is rapidly becoming a free market economy. Solving the Korean Conflict is a low hanging geopolitical fruit.

Moon reaches for the fruit

To pluck a low hanging fruit requires someone to reach for it. South Korean President Moon Jae-in was clearly the first leader to realise the potential for a deal. Throughout his election campaign in 2016 and early 2017, Moon campaigned ceaselessly on a platform of closer ties with China and reunification with North Korea. He was elected as President of South Korea on 10 May 2017. Even at that late stage, most saw his stance on the conflict on the Korean Peninsula as little more than meaningless political rhetoric due to the perceived intractable nature of the Korean conflict. Yet, Moon realised that the ground was shifting and he has been proven correct: this week US President Donald Trump shook hands with North Korean leader Kim Jong-un in Singapore. Other than Moon's vision, what has brought us here?

Trump gets out of the way

Clearly, Trump is due some credit. His main contribution has been to get out of the way of a deal. He has done so by proving willing to sacrifice US national interest in the Far East in order to make a deal possible with Kim Jong-un. Trump has consistently been scaling back US influence in the rest of the world since getting elected, so this latest move is entirely consistent with his approach so far. Many still worry that US withdrawal from hotspots around the world is risky for world peace, but we beg to differ. In fact, the pursuit of US national interest around the world has kept conflicts alive, which could otherwise have been solved, including on the Korean Peninsula. It is precisely the fact that Trump is so keen to get out of Asia that has made it possible for Moon Jae-in to reach out to Kim Jong-un.

Economic necessity

Economics has also played a part in making détente in relations between North and South Korea a possibility. The enormous cost of defence spending, the inefficiency of the economic system and sanctions have slowly been undermining the North Korean economy for decades. North Korea is in collapse for exactly the same reasons that the inconsistencies of its economic model undermined the Soviet Union from the inside in the 1980s. North Korea's economic decline has gone hand in hand with increased political repression, but Kim Jong-un may now be realising that this cannot go on forever.

China

China's role should not be underestimated either. China has gradually been stepping up economic pressure on North Korea, including matching Western sanctions in some areas. China is not applying pressure on North Korea due to Western pressure, however. Rather, China plays a far longer game. President Xi Jinping knows that China's destiny is to replace the United States as the world's economic and financial hegemon. To achieve this, Xi must gain the trust of other nations, especially Japan and Europe. Xi rightly thinks this can best be achieved by China playing a responsible and constructive part in finding solutions to international problems. In addition, China knows that a scaled down US presence in the Far East will only increase China's influence. In short, there is little downside and significant potential upside for China in supporting a Korean détente.

The conflict on the Korean Peninsula ranks as one of the world's most dangerous geopolitical hotspots. There is no doubt that a solution to the conflict would greatly reduce global geopolitical tail risks

World peace and all that

The conflict on the Korean Peninsula ranks as one of the world's most dangerous geopolitical hotspots, alongside the Middle East conflict and occasional tensions between nuclear powers Pakistan and India. North and South Korean forces have regularly clashed. Indeed, as recently as 2010 North Korea shelled a

South Korean island.¹ There is no doubt that a solution to the conflict will greatly reduce global geopolitical tail risks. Moon Jae-in should receive the Nobel Peace Prize for his vision and efforts to secure peace, and Trump may get the prize too for getting out the way of a deal.

America's interest or Trump's interest?

With the Nobel Peace Prize within his grasp, there is no doubt about the massive personal upside for Trump from striking a deal with North Korea. However, it is less clear how a solution on the Korean Peninsula is in America's national interest. Denuclearisation of the North will have to be matched by a reduced US military presence in the South, which will help the US to save some money, but the US will ultimately lose its strongest foothold in the Far East. It is impossible to rule out the possibility of eventual Korean re-unification once détente gets underway. A unified Korea would almost certainly be militarily neutral, but this means in reality that China will become the most important partner of a unified Korea. The Philippines is already turning towards China, so once Korea does the same the last remaining solid US ally in the Far East will be Japan.

Peace in the Koreas cannot yet be taken as a given. Aside from Trump unpredictability, there is a clear possibility that things turn sour for Kim in North Korea

Kim's precarious situation

Peace in the Koreas cannot yet be taken as a given. Aside from Trump's unpredictability, there is a clear possibility that things turn sour in North Korea. History offers a tough lesson for dictators – once they start to relinquish control, they often find that it is difficult to hold on to any power at all. For example, apart from a few exceptions, such as Belarus, all the leaders of erstwhile Warsaw Pact states were ousted from power as the Soviet Union collapsed. Some leaders, such as Romania's Ceausescu met even worse fates. How will Kim Jong-un react when power begins to slip from his grasp? The reality is that Koreans, like Germans in the 1980s, are longing for reunification, but if the two Koreas are to become one then either Kim Jong-un or Moon Jae-in will be served with an unemployment notice. This may explain why so few people talk openly about reunification yet. However, we think this issue cannot be ignored forever, because reunification is a logical consequence of the end of this conflict just as it was in Germany.

Other risks

Aside from U-turns by Trump and Kim Jong-un, there are plenty of other risks to a deal. A period of back and forth is inevitable. China could get cold feet, although China's acquiescence so far has been encouraging. Sequencing will be challenging; for example, Kim could demand that US bases in South Korea are dismantled before or in tandem with denuclearisation in the North, which may be unacceptable to South Korea and/or the US, though so far he has not made such demands in public. A unified Korea could emerge as a battleground for US and

¹ See: bbc.co.uk/news/world-asia-pacific-11818005

Chinese influence and thus a potential flashpoint, especially if future US presidents turn out not to be as isolationist as Trump.

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Cost of reunification and opportunities

The official South Korean government position is that it will not foot the cost of reunification à la Germany. However, we think this position will change if reunification goes ahead.

Economically speaking, South Korea is well-placed to initiate reunification. Gross government debt to GDP is below 40%, while the current account is in large surplus (4.5% of GDP).

However, the cost of reunification should not be underestimated. The cost of German reunification is probably a good initial guide, because in 1990 East Germany's GDP was about 1/8th the size of West German GDP, which is not dissimilar to the situation in the Koreas today.² The total cost of German reunification has so far exceeded USD 2trn, which is about twice the combined East and West German GDP at the time of reunification. Moreover, the process will take time, at least thirty years.

Why is the cost so high? Mainly because South Korea will need to extend enormous amounts of social and infrastructure investment to the North, whose economy is archaic, hopelessly uncompetitive and excessively specialised in defence industries. Without social assistance, such as unemployment benefit, pensions, wage equalisation and retraining of the labour force there will likely be a mass exodus of North Koreans to the South in search of jobs during the challenging early stages of economic transition. Without infrastructure investment, there will be no jobs at the end of the transition period and Korea would then face the risk of social implosion. It seems clear that South Korea's debt burden will rise sharply with negative implications

for future taxes for all Koreans, which in turn may dampen current spending. As some South Korean businesses move production to the North there will also be a loss of jobs and downwards pressure on wages in some sectors in the South.

On the other hand, there is potential for enormous productivity gains in the North, which, by providing a source of relatively cheap labour, will make Korea as a whole more competitive than it currently is. This clearly mitigates some of the obvious costs and negativities associated with reunification. North Koreans will want to consume goods from the South, so businesses in the South stand to benefit by supplying goods and services. South Korean business will also get the lion share of government infrastructure contracts in the North. Finally, Korea will be a much larger nation with more international clout.

China and Korea itself emerge as winners, while US and Japan stand to lose under a unified Korea

Winners and losers on the international stage

China is likely to be a big source of investment in a unified Korea. China's consumer will be the single most important driver of consumption in the world economy over the next thirty years, so closer ties with China will clearly be good for an exporting nation like Korea. China's economic influence will therefore unambiguously increase. US military and political influence will decline in direction proportion with the rise in Chinese influence. This will render Japan increasingly isolated. In this context, the recent G7 debacle should worry Japan. Trump appears to get along far better with Kim Jong-un than with America's closest economic and security allies, including Japan. Regardless of the undisputed merit of contributing to peace in the Koreas, America and her allies may well be justified in calling to question the priorities of the US President: is Trump really acting in the best interest of America and her allies, or is he merely serving his own best interest?

² South Korean GDP is about ten times larger than North Korean GDP.

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