Binding Up the Nation’s Wounds: 
An Economic Analysis of the Korean Reunification

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Abstract

When economies of different levels of development integrate, the post-integration transition dynamics is slow and the convergence between the economies is accompanied by divergences within. We develop a task-based macro model with individual skill heterogeneity that can account for these facts. In the model, individuals sort into differentiated worker tasks (or occupations) and differentiated managerial tasks based on one-dimensional skill. Managers produce differentiated products, and each product combines worker tasks differently for production, in a way that in equilibrium there is positive assortative one-to-many matching between managers and workers. Individual skills are accumulated stochastically over the life cycle.

In our theoretical analysis, imperfect substitutability across worker tasks is key for the income divergences within along the transition, and the life-cycle considerations can explain the slow convergence between the economies.

We apply the model to a hypothetical reunification of North and South Korea. Although data on North Korea is almost non-existent, we overcome this challenge by putting together available data on North Korean refugees in the south and on South Korean firms that operated in (now-defunct) Kaesong Industrial Complex employing North Korean workers. Using the model, we project the transitional dynamics of the unified Korean economy under various integration scenarios and policy regimes.

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