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Macroeconomic Impact of Korean Reunification: The Role of Factor Market Opening

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Abstract

We examine the macroeconomic impact of reunification between North and South Korea with a focus on factor market integration. We consider three integration regimes: a benchmark regime in which the North opens its capital market globally, but labor markets remain closed between North and South; a regime in which both capital and labor markets are opened; and a regime in which the capital market of the North as well as its labor market are both closed. Further, we consider alternative scenarios for the growth rate of total factor productivity in the North. A general equilibrium model with overlapping generations is constructed for the purpose. Overlapping generations allow for a gradual catch-up in the education levels of Northern workers. The best outcome with respect to total output derives from the regime in which both capital and labor markets are opened. However, this openness comes at the cost an initial sharp drop in output for the North as labor flows south. We conclude that to balance overall output gains against worsening disparity between North and South, liberalization of the labor market should proceed gradually.

Keywords: Korean Unification, Economic Integration, Overlapping Generations Model

1. Introduction

This study examines the macroeconomic impact of economic integration between North and South Korea. To quantify the effects, we construct an overlapping-generations model with two regions in which households are subject to idiosyncratic labor productivity risk. The analytical

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