Devaluation and Investment
In the Presence of Labor Market Rigidity

Abstract

This paper analyzes the impact of devaluation on investment as well as other macroeconomic variables of interest, particularly in the small open developing economy with two, tradables and nontradables, sectors. Particular attention is paid to the nontradables sector where labor market is rigid by workers' reservation wage. I intend to see how much the results of this paper differ from those of the full-employment model, as in the Buffie and Won's (2001) European Economic Review paper. To do this, I make use of a perfect foresight dynamic optimizing model, emphasizing the role of imported capital goods, and the labor market distortions that are prevalent in most developing countries. Various simulation results show that the introduction of labor market rigidity in the nontradables sector significantly changes the consequences of devaluation: The situation following devaluation in the typical developing countries is likely to be worse than that of the full-employment model. While devaluation improves the balance of payments on impact in all cases considered, both sectoral and aggregate investment fall larger when compared to the full-employment model. Moreover, real output of the economy as well as employment in the nontradables sector falls in all cases considered, and falls larger than in the full-employment model. The results of the paper show that devaluation may turn out to be quite a harsh experience for developing economies, especially those with labor market rigidity.

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