

Unemployment dynamics with international capital mobility

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Received 13 April 2004; accepted 21 November 2005

Available online 10 March 2006

Abstract

We study the response of domestic unemployment rates to shocks in total factor productivity for economies with high capital mobility and low labour mobility. We show that high capital mobility amplifies the impact on the domestic unemployment rate of domestic fluctuations in total factor productivity, shortens the lag of the response to shocks and raises the variability of unemployment. But average unemployment is unaffected. Capital flows increase the riskiness of labour income and reduce the riskiness of capital income but do not reduce mean welfare.

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JEL classification: E24; E32; F21; J64

Keywords: Unemployment fluctuations; International capital mobility; Foreign direct investment

1. Introduction

One of the most striking recent changes in the world economy is the speed with which the capital markets of industrial countries have become integrated. Table 1 gives sample means for a measure of the penetration of foreign capital in OECD economies, the inflow of foreign direct investment as a fraction of total domestic investment. This measure is likely to understate the extent to which foreign capital penetrates domestic labour markets, as it includes only foreign capital that remains under foreign control. Yet, the striking

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Table 1
Ratio of foreign direct investment inflow to domestic investment, percent

Country	Sample means		
	1976–1985	1986–1991	1992–1997
Australia	5.05	10.95	9.57
Austria	1.27	1.48	4.86
Belgium	7.09	16.41	26.11
Canada	5.35	5.34	6.59
Denmark	0.45	3.01	8.56
Finland	0.56	1.34	6.76
France	1.98	4.13	8.43
Germany	0.80	0.97	0.56
Greece	6.75	6.43	5.04
Iceland	2.33	0.00	2.37
Ireland	5.70	4.59	15.78
Italy	1.00	1.93	2.02
Japan	0.25	0.40	0.29
Netherlands	3.65	11.10	12.59
Norway	2.55	1.75	6.63
New Zealand	7.98	19.22	21.83
Portugal	2.27	7.93	5.80
Spain	4.09	8.83	7.68
Sweden	0.96	4.89	20.94
United Kingdom	6.98	12.91	12.07
United States	0.48	1.52	1.48
Unweighted average	3.22	5.96	8.85
Small economies	3.62	7.00	11.04
Large (G7) economies	2.41	3.89	4.49

Source: IMF CD-ROM, *International Financial Statistics*.

feature of the data is the big increase in international capital mobility after the mid 1980s, which is about four times as large as the increase in trade flows. The increase is world-wide, although it is on average bigger in European countries, following the single market process that started in 1986 and culminated in 1992. The rise is much bigger in small economies than in the G7.¹

Concurrently with this increase in international capital flows there has been an increase in both the average rate of unemployment and the standard deviation of its cyclical component (henceforth, volatility). Table 2 gives data for unemployment in OECD countries. On average unemployment increased by 60% between 1970–1985 and 1986–1998 and volatility increased by about 50%. Moreover, as in the case of FDI flows, the increase in both the average rate and volatility is larger in smaller economies.

Is there any connection between the rise in international capital mobility and the higher and more volatile unemployment? Usually, a big foreign investment such as the relocation of an industrial plant from one country to another is greeted by the receiving country as good news and by the losing country as bad news. Is this reaction justified? How does

¹See de Menil (1999). There is no convincing explanation in the literature for this large increase in FDI flows. The increase in trade flows and removal of capital controls are contributory factors.

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