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Efficiency wages, disinflation and labor mobility

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Abstract

The paper analyzes the role of labor market segmentation and relative wage rigidity in the transmission process of disinflation policies in an open economy facing imperfect capital markets. Wages are flexible in the nontradables sector, and based on efficiency factors in the tradables sector. With perfect labor mobility, a permanent reduction in the devaluation rate leads in the long run to a real appreciation, a lower ratio of output of tradables to nontradables, an increase in real wages measured in terms of tradables, and a fall in the product wage in the nontradables sector. Under imperfect labor mobility, unemployment temporarily rises.

Keywords: Open economy; Labor market segmentation; Disinflation; Unemployment
JEL classification: E24; J23; J42

1. Introduction

The nature and extent of labor market segmentation in developing countries has been the subject of much debate over the years, particularly in the context of discussions related to urbanization and migration between rural and urban areas. In a seminal paper, Harris and Todaro (1970) showed that the existence of a binding minimum wage in the urban sector leads, even if the rural labor market is competitive, to a persistent wage differential between the rural and urban sectors and to the emergence of unemployment in equilibrium. Expansion

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of labor demand in the urban sector, moreover, may raise urban unemployment by raising expected earnings relative to prevailing wages in rural areas.

More recent work has focused on the role of labor market segmentation in the context of trade and structural reforms.[1] By contrast, the implications of various types of labor market segmentation for the short-run determination of output and employment in small open developing countries have not received much attention in the existing analytical literature.[2] In particular, the role played by labor markets in disinflation programs in developing countries has been largely neglected – although numerous stabilization attempts were recorded in the past three decades, most notably in Latin America. Nevertheless, some recent studies have recognized that understanding the mechanisms through which labor markets operate in a developing country setting is essential for assessing the transmission process and the effectiveness – or the lack thereof – of stabilization and structural adjustment programs (Horton et al., 1994). In particular, the evidence available on the behavior of real wages and employment at the inception of exchange rate-based stabilization programs in Latin America in the 1970s and 1980s has led a number of economists to recognize the role of labor markets and the structure of the supply side in replicating some of the stylized facts.[3] However, the extent to which the output and employment effects of disinflation policies depend on the behavior of relative wages and the nature of labor market segmentation remains an open issue.

This paper analyzes the effects of a disinflation program based on a reduction in the nominal devaluation rate – the backbone of a number of stabilization plans adopted notably in Latin America in the past two decades, as documented by Rebelo and Végh (1995) – in a dynamic, two-sector general equilibrium model of a small open economy with a cash-in-advance constraint. Two key features of the model distinguish the analysis from previous research. First, labor markets are assumed to be segmented and the relative wage (defined as the ratio of wages in the traded to the nontraded goods sectors) turns out to be constant over time as a result of efficiency considerations. This assumption has important implications for the determination of the long-run unemployment rate under imperfect labor mobility across sectors. Second, as a result of capital market imperfections, the cost of foreign borrowing on world capital markets depends not only on domestic

[1] Edwards (1988), for instance, examines the relationships between terms of trade disturbances, import tariffs, and the labor market, under alternative assumptions about wage formation and the degree of sectoral labor mobility.

[2] Demekas (1990) provides an early study attempting to examine the macroeconomic implications of labor market segmentation in an open economy. The issues he focuses on are, however, quite different from those considered here. A more recent study is by Agénor and Aizenman (1994), whose analysis is further discussed below.

[3] See Roldós (1995), Uribe (1995), and the survey by Rebelo and Végh (1995).

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