



# Real exchange rates, dollarization and industrial employment in Latin America<sup>☆</sup>

Arturo Galindo, Alejandro Izquierdo, José Manuel Montero<sup>\*</sup>

*Ministry of Finance, Colombia and Universidad de los Andes Inter-American Development Bank Banco de España, Spain*

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## Abstract

We use a panel dataset on industrial employment and trade for 9 Latin American countries for which liability dollarization data at the industrial level is available. We test whether real exchange rate fluctuations have a significant impact on employment, and analyse whether the impact varies with the degree of trade openness and liability dollarization. Econometric evidence supports the view that real exchange rate depreciations can impact employment growth positively, but this effect is reversed as liability dollarization increases. In industries with high liability dollarization, the overall impact of a real exchange rate depreciation can be negative.

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## 1. Introduction

Increased openness in financial markets implies that emerging market economies are heavily exposed to big swings in capital flows, as it has been the case throughout the 1990s. These swings

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<sup>\*</sup> Corresponding author. Alcalá 48, 28014 Madrid, Spain. Tel.: +34 91 338 5382; fax: +34 91 338 6212.

*E-mail address:* [jmontero@bde.es](mailto:jmontero@bde.es) (J.M. Montero).

are usually accompanied by large fluctuations in real exchange rates (RER) which have important micro and macroeconomic implications. Some lines of research have focused on the impact of RER movements on the economy, analysing whether a devaluation has a contractionary impact, especially when the economy presents heavy liability dollarization.<sup>1</sup> Traditionally, the prevailing view has been that exchange rate depreciation has an expansionary impact on output. However, in the last two decades, this view has been challenged, given the succession of financial crises in which liability dollarization reduced, or even reversed, the positive effects of depreciation on economic activity. On the microeconomic side, there has been an eruption of studies focusing on the impact of RER fluctuations on firm's investment decisions in emerging market economies and, in particular, in Latin America.<sup>2</sup> However, so far little attention has been paid to its impact on firm employment decisions. This paper fills this gap by analysing the impact of RER changes on industrial employment in Latin America, emphasising the role of liability dollarization.

Early work about the impact of RER fluctuations on industrial employment has focused on developed economies. Pioneer studies were those of [Branson and Love \(1988\)](#) and [Revenga \(1992\)](#). [Branson and Love \(1988\)](#) study the effects of real exchange rate movements on manufacturing employment in the period 1970 to 1986 in the US and Japan, and find significant effects of both dollar appreciation and depreciation on employment and output of US manufacturing industries, in particular, in the durable goods sector. Similarly, they find significant effects of movements in the yen on output and employment in the Japanese durable goods sector. [Revenga \(1992\)](#) investigates the impact of increased import competition on employment and wages in US manufacturing industries over 1977–1987. Her estimates suggest that the misalignment of the dollar (over-appreciation) between 1980 and 1985 reduced employment on average by 4.5–7.5% and wages by 1–2%. Also, [Burgess and Knetter \(1998\)](#) find that employment is significantly related to real exchange rate movements in G-7 countries. According to their estimates, real appreciation is associated with a decline in manufacturing employment in most cases.

Another related avenue of research focuses on gross employment flows. [Klein, et al. \(2003\)](#) test whether there is a relevant effect of the real exchange rate on job creation and job destruction in US manufacturing industries over the period 1973 to 1993, and find that the responsiveness of job flows to movements in the RER increases with industry openness to international trade. They show also an asymmetry in this responsiveness, since appreciations play a significant role in job destruction, but job flows, either job creation or job destruction, do not respond significantly to currency depreciation. [Gourinchas \(1998\)](#) finds that exchange rates have a significant effect on gross and net job flows in the US traded goods sector, and also, that appreciation is associated with increased turbulence in the labour market, i.e. job creation and job destruction increase. Conversely, during depreciation phases, the tradable sector chills as creation and destruction rates fall.

A key contribution is that of [Campa and Goldberg \(2001\)](#) who, using two decades of annual industry-level data for the two-digit SIC US manufacturing industries, find that exchange rates have statistically significant effects on industry wages, with a positive elasticity when interacted with industry export orientation and a negative elasticity when interacted with imported input use

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<sup>1</sup> For a theoretical exposition see, among others, [Krugman \(1999\)](#), [Aghion et al. \(2001, 2003\)](#), [Céspedes et al. \(2002\)](#), and [Calvo et al. \(2003\)](#). For an empirical approximation, see [Bleakly and Cowan \(2004\)](#), [Calvo et al. \(2004\)](#) and [Galindo et al. \(2003a,b\)](#).

<sup>2</sup> See [Bleakly and Cowan \(2002\)](#) and the December issue of *Emerging Markets Review* (2003) for an extensive discussion of six case studies in Latin America. See also [Harvey and Roper \(1999\)](#) for a discussion about Asia.

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