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Real exchange rates and skills



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ABSTRACT

Recent developments in trade theory strongly emphasize that international trade requires an intensive use of skilled workers. Against this background, we explore in this paper whether labor skills are a key determinant of real exchange rates in the long run. Using panel regressions covering 22 countries over the period 1950–2010, we find that labor skills are indeed a structural determinant of real exchange rates, with a permanent increase of the skilled–unskilled labor ratio leading to a long-run appreciation of the real exchange rate. This finding is robust to the inclusion of several control variables, like those used in traditional analyses of real exchange rates.

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1. Introduction

Inspired by recent developments in trade theory, which emphasize that international trade requires a more and more intensive use of skilled workers, and by the Bhagwati (1984) theory of real exchange rate determination, we explore in this paper the role of labor skills as a key determinant of real exchange rates in the long run.

It is a stylized fact that richer countries have higher price levels than poorer countries. Stated differently, as countries become richer, their real exchange rate appreciates. A standard explanation of this fact, which can be found in any textbook in international macroeconomics, is the Balassa–Samuelson theory, which relates real exchange rate changes to differences in productivity gains between

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the sector that produces non-tradable goods and the sector that produces tradable goods¹. While this theory is very popular and has been the focus of numerous empirical studies, it is not the only explanation of real exchange rates in the long run. One major competing theory, provided by Bhagwati (1984) 20 years after the publication of the seminal papers of Balassa (1964) and Samuelson (1964), emphasizes instead the role of relative factor endowments as an alternative structural determinant of real exchange rates in the long run. In a two-good, two-factor, relative factor endowment model where one of two good (services) is capital intensive and the other one (commodities) is labor intensive, Bhagwati (1984) shows that the real exchange rate depends positively on the capital–labor ratio: as the capital–labor endowment ratio increases, the real exchange rate appreciates. This alternative theory on relative factor endowments has however received much less attention than the Balassa–Samuelson story.

By making a connection between the Bhagwati (1984) relative factor endowment theory of real exchange rate determination and recent developments in trade theory, our paper investigates whether the relative level of skilled and unskilled labor is a structural determinant of real exchange rates in the long run. Recent leading theories in trade tend indeed to emphasize that skills are a key factor in the production of tradable goods, as the production of tradable goods requires a more intensive use of labor skills than the production of non-tradable goods. The theory of Matsuyama (2007) suggests for instance that firms that are willing to enter the export market must adopt better technologies and utilize more skilled labor. The reason for this is that exporting requires the combination of multiple tasks, many of them being skill labor intensive, as for instance marketing, distribution, maritime insurance, international business, and language knowledge. Brambilla et al. (2012) argue moreover that “the act of exporting to high-income destinations may require technologies and tasks that are yet more skill-intensive” and that, accordingly, economies that trade with high-income countries will utilize high level of skills more intensively. Another leading trade theory, provided by Verhoogen (2008), suggests that exporting requires to upgrade the quality of goods, an activity that demands skilled labor. Empirical evidence also suggests that the export sector uses skilled labor more intensively than the non-tradable sector. For instance, Maurin et al. (2002) show that French exporting firms employ more skilled workers than non-exporting firms.

More generally, the evidence seems to indicate that the whole tradable sector is using more and more intensively skilled labor, and that this change is more pronounced than in the non-tradable sector. One reason for that is the increased international tradability of numerous service activities, in particular business services. For instance, Gonzales et al. (2012) document that tradable business services (which include in particular professional services, finance and insurance, and computer services) offer jobs mainly to high and medium skilled workers (p. 182) and that tradable business services jobs are better paid and workers are better educated than in manufacturing and non-tradable services (p. 178).² Similar evidence is provided by Jensen and Kletzer (2005) for the United States, by Eliasson and Hansson (2013) for Sweden and by Department of Labor, N.Z. (2011) for New Zealand. For the United States, Mazzolari and Ragusa (2013) also show that, between 1980 and 2005, the employment of low-skill workers has progressively concentrated in non-traded activities while, conversely, the employment of the most-educated workers has shifted toward activities (such as financial and business services) that are increasingly tradable (because of falling communication and transportation costs). That’s also one of the results provided by Eliasson and Hansson (2013) in the case of Sweden. Constructing data about the distribution of skilled and less-skilled labor in manufacturing, tradable and non-tradable services, they find that, between 1990 and 2010, the share of skilled labor has grown faster in sectors exposed to international trade (and the fastest in tradable services). Data reported in table 2.1 of their paper show that, between 1990 and 2010, the ratio of skilled to less-skilled workers has increased

¹ According to the Balassa–Samuelson theory, richer countries tend to have a more productive tradable sector. Given perfect labor mobility across sectors, and since the productivity gains in the non-tradable sector are usually lower compared to those in the tradable sector, increasing wages tend to push the prices of non-tradable goods up and to support an appreciation of the real exchange rate.

² In their study, they define high-skilled workers as workers with a college degree and above, medium-skilled as having a high-school degree and some college, and low skilled as high-school dropouts. Their study covers five countries: Chile, France, India, the United Kingdom, and the United States.

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