Title: Devaluation, Export Quality and Employment in a Small Dependent Economy

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Abstract

This paper investigates the effect of currency devaluation by a small open economy on its export quality, and ramifications of such quality changes on the labour market and real income or welfare of the economy. These issues are examined in a simple general equilibrium structure of a small open economy as developed in Acharyya and Jones (2001), suitably modified for our purpose.

The small open economy under consideration produces three goods – a quality differentiated export good, produced by skilled labour and capital; and a composite traded good and a non traded good produced by capital and unskilled labour. The quality of the export good is selected endogenously, and tastes for the composite traded good and the non-traded good are assumed to be homothetic in the benchmark case. Under a pegged exchange rate for domestic currency and a fixed unskilled money wage in terms of domestic currency, the initial free trade equilibrium is characterized by unemployment of unskilled workers. In such a context, it is shown that the effect of devaluation on export quality is contingent upon whether higher quality calls for more intensive use of capital or skilled labour; while it deteriorates in the former case, exporting firms upgrade quality in the latter. However, devaluation always improves the level of employment of unskilled labour regardless of the factor intensity of non-traded good relative to that of the composite traded good, and whether export quality is upgraded or downgraded. The reason is that at initial quality level, devaluation raises the demand for the non-traded good when it is relatively labour intensive and lowers it when it is relatively capital intensive; and subsequently, devaluation induced quality change releases some capital from production of the quality-differentiated export good thereby making it possible for expansion of production of both the non-traded and the composite traded good. On both counts the aggregate employment of unskilled workers increases with devaluation.

On the other hand, under certain reasonable conditions, the aggregate real income (and welfare) rises too. Further, under plausible assumptions regarding relative skill intensity of the export good and the income elasticity of demand for non-traded good, the results qualify two robustness checks in terms of generalized quality upgrading technology and non-homothetic taste.

 All are welcome to attend.

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