

Abstract

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Exchange rate is one of the most volatile macroeconomic price variables. The fluctuations in the exchange rate generate volatility in the profits of firms and reduce the incentives of firms to enter the market or to expand their capacity. In response to exchange rate volatility firms may reduce labor costs to mitigate the negative impact through firing workers, reducing the work hours etc. However, labor market rigidity restricts a firm's ability to implement such adjustment, consequently amplifying the negative impact of exchange rate volatility on economic outcomes. This study investigates the interaction effects of exchange rate volatility and labor market rigidity on industrial exports growth. We utilized a country-industry-level disaggregated panel dataset covering 17 industries for the span of 14 years (2005-2018) across 62 developed and developing countries. For our benchmark regression analysis, we employ the labor market regulation rigidity index developed by Campos et al. (2018), employing alternative indices constructed by Rama and Forteza (2006) and Botero et al. (2004) for robustness checks. Our unique measure of exchange rate volatility captures unpredictable fluctuations in the real exchange rate over the last three months. We used the fixed effects model, analogous to the triple-D estimation for the empirical analysis. We find negative and statistically significant impact of the interaction between exchange rate volatility and labor market rigidity on export growth. The findings indicate that in a country where labor market rigidity is one standard deviation higher, a one standard deviation increases in exchange rate volatility reduce export growth by 3.45 percentage points. The estimated coefficient is economically significant as well. This implies that the estimated coefficient reduces annual export growth by 3.45 percentage points relative to the annual average export growth of 3.2%. However, the estimated coefficient is smaller relative to the 40% standard deviation of annual average export growth. In subsample analysis, the results for developed and developing countries are consistent with the main findings.