Research Working Papers

On the Perverse Effect of Capital Account Liberalization: the Role of Labor Market Rigidity

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Developing countries may fail to benefit from capital account liberalization if their labor markets are rigid.

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We propose a new explanation for why developing countries may fail to benefit from financial globalization, based on labor market institutions. In our model, a combiation of a rigid labor market and a low economywide productivity generates a low domestic interest rate in financial autarky. With financial openness, there is a net capital outflow and a worsening of domestic unemployment rate. In comparison, financial opening in a developing country with labor market flexbility produces improved employment. Similarly, financial opening in a developed country need not produce a worsening unemployment even with labor market rigidity. We show such predictions are broadly consistent with the patterns in the data.

JEL Classification: E24; J08; F41; F44

Article Citations

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Related Research

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- Kose, M. A., Eswar Prasad, Kenneth Rogoff, and Shang-Jin Wei. 2009. "Financial Globalization: A Reappraisal." *IMF Economic Review*, vol. 56, no. 1, pp. 8-62.