Sectoral Labor Adjustment and Monetary Policy in a Small Open Economy

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Summary

Recently, the framework of a two-sector small open economy model has been extensively used to study monetary policy and welfare for small open economies. However, the literature on the two-sector small open economy model usually assumes domestic resource allocation is costless. In particular, labor is perfectly mobile across sectors. This prevalent assumption overlooks some important consequences of the friction in sectoral resource reallocation.

This paper constructs a two-sector model of a small open economy based on Devereux, Lane, and Xu (2006). The main feature of the model is that we assume that sectoral labor reallocation involves adjustment costs, expressed as resources lost in the adjustment process. Our model shows that the presence of sectoral labor adjustment cost does not affect the welfare ranking of monetary policies. However, the welfare consequence of labor market friction depends critically on the nature of monetary policy rules. For example, if a monetary rule that can stabilize the real economy is chosen, such as a non-traded goods price targeting (NTP) rule, then there is a small welfare loss caused by the presence of sectoral adjustment cost. However, if a policy rule that cannot stabilize the real economy is given, such as a fixed exchange rate rule, then the presence of labor market friction will lead to welfare gain instead and this gain will be significant.

Our results imply that sectoral adjustment cost actually plays a substitute role in stabilizing the real economy when there is lack of output-stabilizing monetary policies. This is because the labor market friction can offset the friction caused by nominal rigidities.