

VOLATILITY, LABOR MARKET FLEXIBILITY, AND THE PATTERN OF COMPARATIVE ADVANTAGE

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Abstract

This paper studies the link between volatility, labor market flexibility, and international trade. International differences in labor market regulations affect how firms can adjust to idiosyncratic shocks. These institutional differences interact with sector specific differences in volatility (the variance of the firm-specific shocks in a sector) to generate a new source of comparative advantage. Other things equal, countries with more flexible labor markets specialize in sectors with higher volatility. Empirical evidence for a large sample of countries strongly supports this theory: the exports of countries with more flexible labor markets are biased towards high-volatility sectors. We show how differences in labor market institutions can be parsimoniously integrated into the workhorse model of Ricardian comparative advantage of Dornbusch, Fischer, and Samuelson (1977). We also show how our model can be extended to multiple factors of production. (JEL: F1, F16)