"Reassessing the role of labor market institutions for the business cycle"

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Summary

Goal is to assess the role of LMI for BC fluctuations

Empirical literature
◦ Classic paper by Bruno and Sachs (1985), Blancher and Wolfers (2000): unemp. response to macro shocks depends on institutions. Focus on long term adjustment to structural shocks. LMI-shock interaction important.
◦ Recent empirical literature investigate impact of LMI on volatility. Inconclusive

Empirical approach here: Panel VAR where parameters governing impact of shocks and endog. adj. are interacted with measures of LMI. Identification through ordering of variables.

Framework

Estimating equation:

$$\mathbf{A}_0\left(\Lambda\right)\mathbf{y}_t = \mathbf{A}_1\left(\Lambda\right)\mathbf{y}_{t-1} + \mathbf{B}_0\left(\Lambda\right)\mathbf{z}_t$$

$$\mathbf{C}_0\mathbf{z}_t = \mathbf{C}_1\mathbf{z}_{t-1} + \varepsilon_t$$

Linear structure in Lambda in A and B

Identifying assumptions for shocks:
◦ Z not affected by y contemporaneously, world demand (z2) affects oil price (z1) after 1 lag.

Estimation with OLS and bootstrapped SE.

Summary (cont'd)

Difference from literature: instead of regressing measures of volatility on measures of LMI and other controls, derive implied second moments from estimated VAR model.

Advantage: can tease out the conditional response of endogenous variables driving the overall volatility. Separate the role of LMI by evaluating the interaction term at different values for LMI.

Results: LMI important for response to shocks, but depending on precise measure of LMI and depending on nature of shock. Similarly for unemployment and inflation volatility.

Results

High versus low values for LMI (EPL, BRR…) have quantitatively different implications for the response of UR (and inflation) to given oil price and world demand shocks.

Magnitude and significance of these differences depend on the specific LMI and the shock.

LMI therefore also trigger different degrees of overall volatility of UR and inflation.

Different LMI can have offsetting effect on volatility (high EPL vs. high BRR), important to consider interactions of specific LMI, not only compare "rigid" versus "flexible" LMI.

Comments 1

Paper addresses interesting, topical question, in light of debate on structural reforms in the wake of the crisis in EA economies.

Also active academic literature on the nature and cost of BC fluctuation.

Progress toward more structural understanding of volatility determinant by moving beyond reduced form panel regressions.

Offer important insight regarding pitfall of viewing LMI as unidimensional

Comments 2

"LMI have large and significant effects on unemp. & infl. dynamics"
- Interpreting interaction as purely driven by LMI may be misleading: apart from reverse causation, omitted variables pose a more severe threat. LMI vary little over time, potentially correlated with other country-specific variables (other policies, institutions, culture…)

Are findings consistent with theory?
- Paper aims to build a story around empirical findings (Q vs. P adjustment margin, type of shocks). Important to have a model framework to rationalize/illustrate. Predictions not always straightforward (e.g. EPL and volatility).
- Response varies with type of shocks: not clear theoretically why this should be (both are LD shocks). Persistence may be instead key, or GE effects (hence model).

Are magnitudes of effects macro-relevant?
- Can do external validation by sorting countries according to distribution along various LMI measures and compare their UR and inflation volatility with prediction.

Comments 3

Methodology:

○ Linear interaction terms is justified by first-order Taylor approximation. But this is valid for small variations in LMI, should not be used to evaluate prediction based on large delta in LMI (20 vs. 80 percentile).

○ Theory may predict different role of LMI for response to positive vs. negative shock (e.g. bargaining centralization should mute UR response in bad times, amplify UR response in good times). Model can estimate asymmetric response and test for it.

Conclusion

Interesting paper on a very policy-relevant topic, provides insights into complexity of LMI and how they potentially shape volatility

Can benefit greatly from having more theoretical underpinning to rationalize empirical findings and provide external validation

Empirical methodology can be supplemented with alternative identification schemes (reform episodes, test for over-identification).

Improvements can sharpen policy implications