

# **Discussion of: Sectoral Shocks, Reallocation, and Labor Market Policies**

## **by García-Cabo, Lipińska and Navarro**

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# Summary

- Paper studies the effect of different labor market policies to sector specific shocks
- Focus on the different policy responses to keep the *labor market* afloat in US and Europe at the outset of Covid-19
  - US: Unemployment Benefits (UB)
  - Europe: Wage Subsidies (WS)
- Unemployment benefits:
  - Increases reallocation towards productive sectors
  - Human capital destruction that results in unemployment
- Wage subsidies:
  - Preserves the job, no human capital destruction
  - Limit reallocation and lead to inefficiency
- Labor market flexibility –the *job finding rate* critical for the effect of the two policies

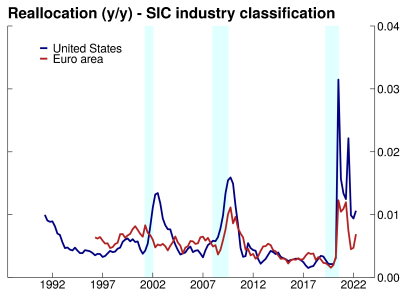
# Strengths and room for improvements

- Key strengths of the study
  - General equilibrium framework to evaluate different labor market policies. Comprehensive model with Covid policies like the 'furlough' scheme. Highly detailed model
  - It shows that the flexibility of the labor market critical for the tradeoffs of different policies
  - Pioneering application (computationally challenging) to study the policy response in the first quarter of the Covid-19 pandemic in the US and EA
- Room for improvements
  - VAR analysis: (i) is labor flexibility important? (ii) recursive identification not fully exploited
  - The wage protocol might be missing some important dynamics
  - Welfare differences not a clear cut
  - Fiscal policy and expectations might be critical to the policy tradeoffs

# Empirical evidence

- Initial observation: the dynamics of job reallocation

Figure 1: Reallocation Index: Euro Area and United States

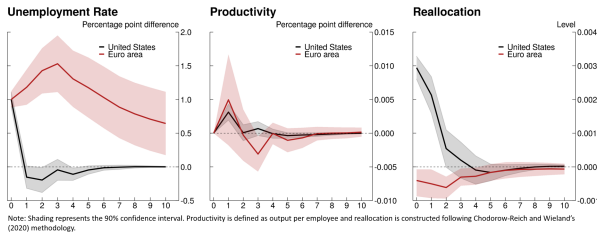


Note: The shading indicates recessions as determined by the NBER.  
Source: NBER, Statistical Office of European Communities, and Bureau of Labor Statistics.

- Timing, non-linearities and difference between US and EA

# Identification in the VAR model

- Cholesky identification. Variables order: productivity, unemployment, and reallocation
- Exogenous 1% increase in *unemployment*



- Result enhanced and more consistent if:
  - Exogenous 1% fall in *productivity* to exploit Cholesky, consistent with the theoretical model
  - Job finding rate is critical to assess the role of flexibility in the labor market
  - The wage will also help to assess the responses in the theoretical model. Does the sharply wage increase in the US and the increase less pronounced in Europe?—Productivity suggestive of no?

# The wage protocol

- Great to have forward-looking (sticky) wages
- Adoption of a simplified wage protocol for tractability

$$w_t^* = \omega \bar{\Pi}_t(z, s) + (1 - \omega) \bar{b}_t, \quad (1)$$

where

$$\bar{\Pi}_t(z, s) = \sum_{j=0}^n \mathbb{E}_t[\Omega_{t+j}(y_{t+j}(z_{t+j}, s) - c_0 | z)]$$
$$\bar{b}_t = \sum_{j=0}^n \Omega_{t+j} b_{t+j}$$

Compare it with the 'standard' Nash wage protocol:

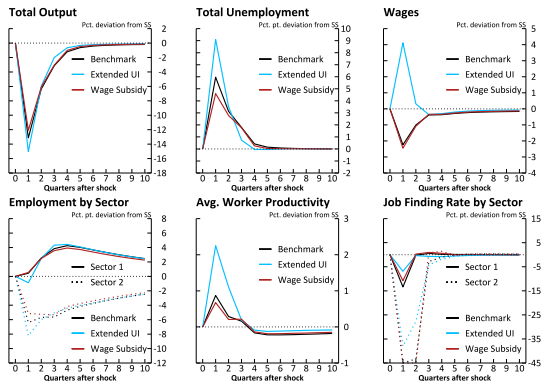
$$w^* = \omega [y(z, s) + c_0 \theta(s)] + (1 - \omega) \bar{b}$$

# The wage protocol and labor market tightness

- Features of the specific wage protocol
- No direct role for congestion in the labor market, but labor tightness relevant for:
  - Hiring/separation for firms
  - Working/non-working and searching while in furlough for workers
- Labor policies interplay with tightness and an efficient wage should account for it:
  - WS: firm retains workers, increasing labor market tightness  $\rightarrow$  hiring costly, firms rises  $w^*$
  - UB: firm dismiss worker, decreasing labor market tightness  $\rightarrow$  hiring cheap, firms offers low  $w^*$
- The wage abstracts from these effects of labor market tightness that are central to labor market flexibility

# Flexible economy and labor market policies

- Is the forward-looking wage magnifying the effect of unemployment benefits? Can  $\omega$  be informative on this?

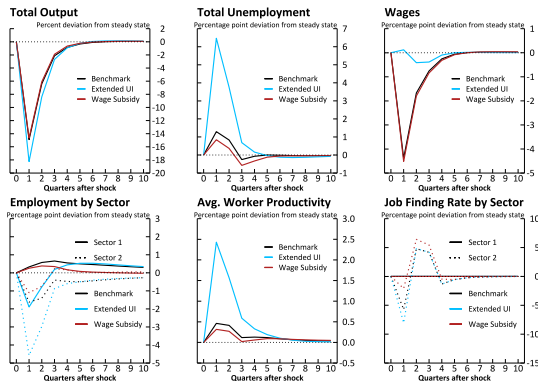


- UB (blue line):  $b \uparrow \implies w \uparrow, u \uparrow$ , Work. Prod.  $\uparrow$  (cleansing effect). JFR limited response
- WS (red line): Not much different from benchmark



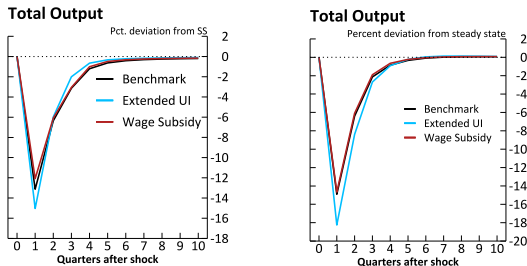
# Rigid economy and labor market policies

- Similar forces, but wage and JFR rigid



- UB (blue line):  $b \uparrow \implies w \leftrightarrow, u \uparrow$ , Work. Prod.  $\uparrow$  (cleansing effect). Aggregate JFR no response(?)
- WS (red line): Not much different from benchmark

# Welfare differences not a clear cut



- Flex labor market (left). UB (blue): unemployment fall attenuated by fast recovery
- Rigid labor market (right). UB (blue): unemployment fall *not* attenuated
- However, the overall effect is not a clear cut (especially in the flex labor market)
- Refocus the paper on unemployment and policy tradeoffs without welfare?

# Financing of the policies and expectations

- Limited discussion about the financing of the different schemes
  - Financing of WS critical for the firm
  - Expectations on the financing of UB critical for workers
- Can the study sheds light on the role of expectations about these scheme?

## Takeaways and conclusion

- Impressive analytical framework to assess the policy response to support the labor market in the outset of the Covid-19 pandemic
- Key lesson: the job finding rate (and labor market tightness) is central to policy evaluation
- Key implications:
  - In a flexible labor market with high absorption of job seekers, the rise in unemployment in the short-run is offset by the quick recovery, and the recovery faster the higher the job finding rate
  - In a rigid labor market with low job finding rate the recovery is slow and thus it is better to prevent the fall in unemployment
- The job finding rate needs to remain a prominent feature in the VAR and the theory (wage equation)
- Welfare differences across policies require further investigation or refocusing
- Financing details and expectations worth further scrutiny within the framework