WHAT IS NATURAL ABOUT UNEMPLOYMENT?

Policy sources and implications of labor market rigidities

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Jackson Hole, 23 August 2014
Not-so-natural unemployment:

- Shocks and wage rigidity
- Unavoidable and may be good in complicated imperfect markets

Macroeconomic policies:
- Stabilizing under nominal rigidities, coordination failures

Labor market flexibility can destabilize (aggregate shocks, liquidity constraints)

Figure 1. Unemployment and wage rigidity: negative shock, wage lower bound.

Figure 2. Aggregate demand effect of wage flexibility.
Employment
Current firing costs

Figure 3. Stabilizing effects of job security provisions and firing costs.

Pros and cons, depend:
• Distributional point of view
• Financial market imperfections
• Character of shocks, and structure:
  (less attractive when markets more elastic, e.g. international)

Policy sources of labor marked rigidity:
• Unemployment insurance
• Wage compression, job security

Good and bad, in time series and across firms/sectors/region.

Figure 4. Demand elasticity and labor market rigidity.
Stories of Western labor markets:

- Continental Europe’s used to do well: unemployment was relatively low (if long) and did not increase as much in recessions... but did not come back down.

- Globalization, moderation, financial development: labor market flexibility looks good, so rigid labor markets become more American.

Simple macroeconomic stability and income inequality indicators:

Figure 5: Long-run behavior of unemployment, long-term unemployment, and labor force participation in selected countries. Data source: OECD.
Figure 6: Changes of unemployment and GDP growth in selected countries and periods. Data source: OECD.
Different, changing relationship between unemployment and inequality.

Figure 7: Wage inequality (ratios of the 50th to the 10th and of the 90th to the 50th percentile) and unemployment, averaged for selected countries and periods. Source: OECD.

Figure 8: Gini coefficient of equivalized household income and unemployment, averaged for selected countries and periods.

Figure 9: Income share of top 1% tax returns and unemployment, averaged for selected countries and periods. Source: Solt (2009) SWIID database, summary point estimates from Version 4.0, September 2013; OECD.
Story of Europe’s EMU:

- One money: difficult when labor markets different. But useful.
- Deregulation of country-specific labor policies:
  - More inequality, productivity
  - Macroeconomic moderation
- Interestingly related to cross-country imbalances:
  - deregulation more attractive where effective capital intensity is reduced by financial integration

Figure 10: Labor market deregulation, income inequality changes (Gini coefficient of equivalized household income), and cumulated current accounts before the crisis in EMU. Sources: DG Ecfin LABREF database, elaborated as in Koltay et al (2009); Eurostat.
International integration, moderation, financial imbalances, labor market deregulation, inequality…

Crises.

- US more rigid:
  - Long-term unemployment, generous benefit extensions...
  - Not bad if controls inequality and supports aggregate demand in imperfect financial markets

- Some Europe more flexible:
  - Good if helps local reallocation to tradable sector
  - Way out of domestic demand contraction needs dynamic credibility...

Figure 11: Labor market deregulation before and after the crisis in EMU. Data source: DG Ecfin LABREF database (elaborated as in Koltay et al 2009).

Figure 12: Income inequality changes (Gini coefficient of equivalized household income) and cumulative current accounts after the crisis in 2008-2013.
Macro and labor policy in a dynamic world:

- labor market rigidity is good and bad like all things (and nominal price stickiness)

- How much and when?
  - financial market imperfections,
  - structure of labor demand and supply,
  - aggregate vs. allocative shocks.

Labor market policies matter for macro, do change...

Appropriately? Depends, also on point of view.

Minimal requirement: credibility, as labor markets think ahead.

Fostered by clear discussion of pros and cons,
commitment to sensible policy flexibility.
Hampered by simplistic dogmatic views.