Labor Market Reforms and the Cost of Business Cycles by T. Krebs and M. Scheffel

Discussion by

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The paper : an important issue

Welfare cost of business cycles, neglected issue since Lucas (1987)' paper:

- Lucas finds that the welfare gain from eliminating consumption risk is 0.005% of permanent consumption per capita
  - an annual consumption compensation as low as 17 US dollars per capita (Source : FRED database, 2014Q1, US, Real personal consumption expenditures per capita, 34 339 Chained 2009 Dollars)
- If Lucas is right, why shall we care about stabilizing policies analyzed in Neo-Keynesian DSGE models ?

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- In Lucas (1987)'s paper: linear world
  - deterministic and fluctuating economies have the same mean
  - the negative effects of recession are compensated by the positive effects of expansions

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- In Lucas (1987)'s paper: linear world
  - deterministic and fluctuating economies have the same mean
  - the negative effects of recession are compensated by the positive effects of expansions
- In a non-linear world
  - deterministic and fluctuating economies do *not* share the same mean
  - asymmetric effects of recessions and expansions : recessions are more harmful than expansion are beneficial (Mortensen Pissarides, 1994)

The paper : a rich model

- Bringing the data to the model : German labor market reforms
- Model :
  - search and matching model, endogenous search effort and wealth, aggregate and individual shocks, human capital depreciation, heterogeneous agents
  - endogenous interest rate r and tax rate τ

Main comments

1. Separation rate?
2. Understanding the results
3. Wage?

1. Separation rate

Source of non-linearity :
At the steady state, unemployment outflows equal unemployment inflows. U is then a convex function of the job finding rate f

$$U = \frac{s}{s+f}$$

Because of convexity,

$$\bar{u} = \frac{s}{s + \sum_i \pi_i f_i} < \sum_i \pi_i \tilde{u}_i = \tilde{u} \approx E(u)$$

The unemployment gap is

$$\tilde{u} - \bar{u} \approx u''(f) \frac{\sigma_f^2}{2} \approx \frac{s}{(s+f)^3} \sigma_f^2 \tag{1}$$

which increases with σ_f^2 and falls with f.

FIGURE : Non linearities in the labor market: the mean effect. The larger the business cycle fluctuations,the ↑ the average unemployment rate. A ↓ in business cycle volatility leads to ↓ unemployment, more C and welfare

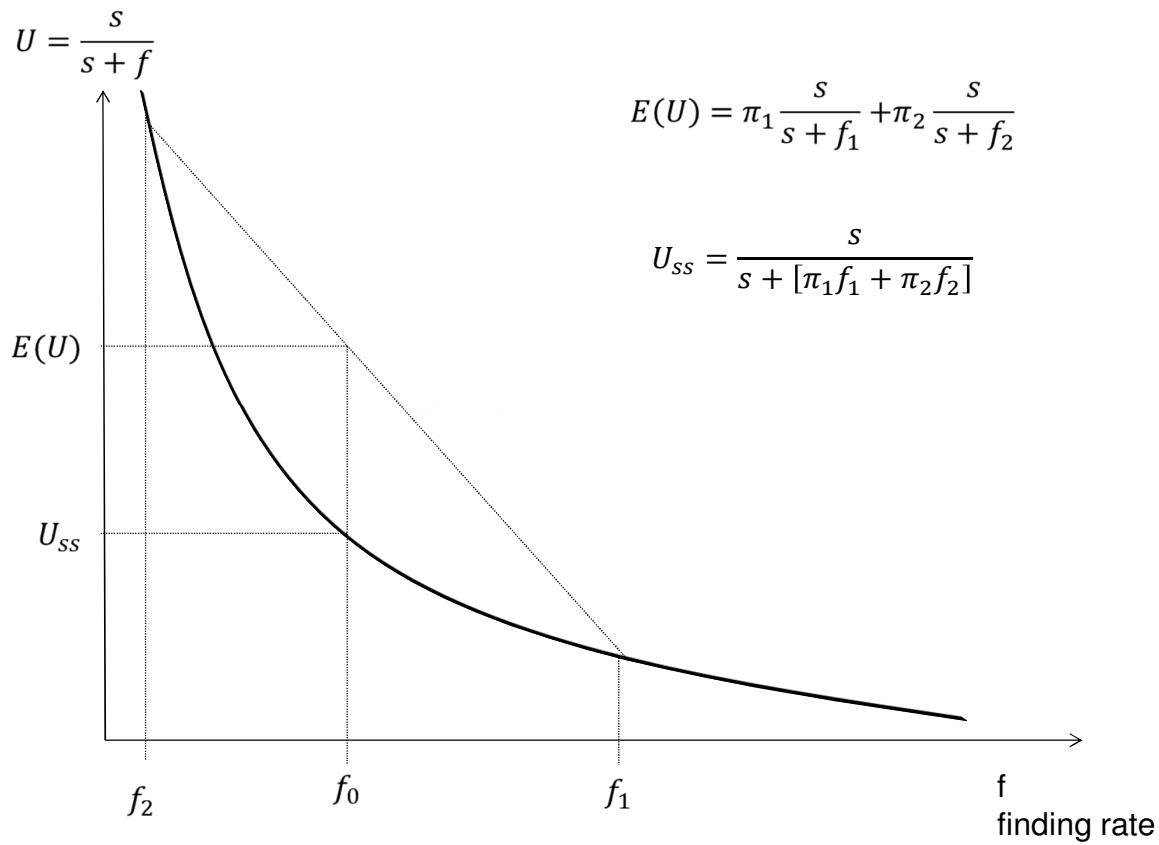


FIGURE : Non linearities in the labor market: Asymmetric effect of the business cycle

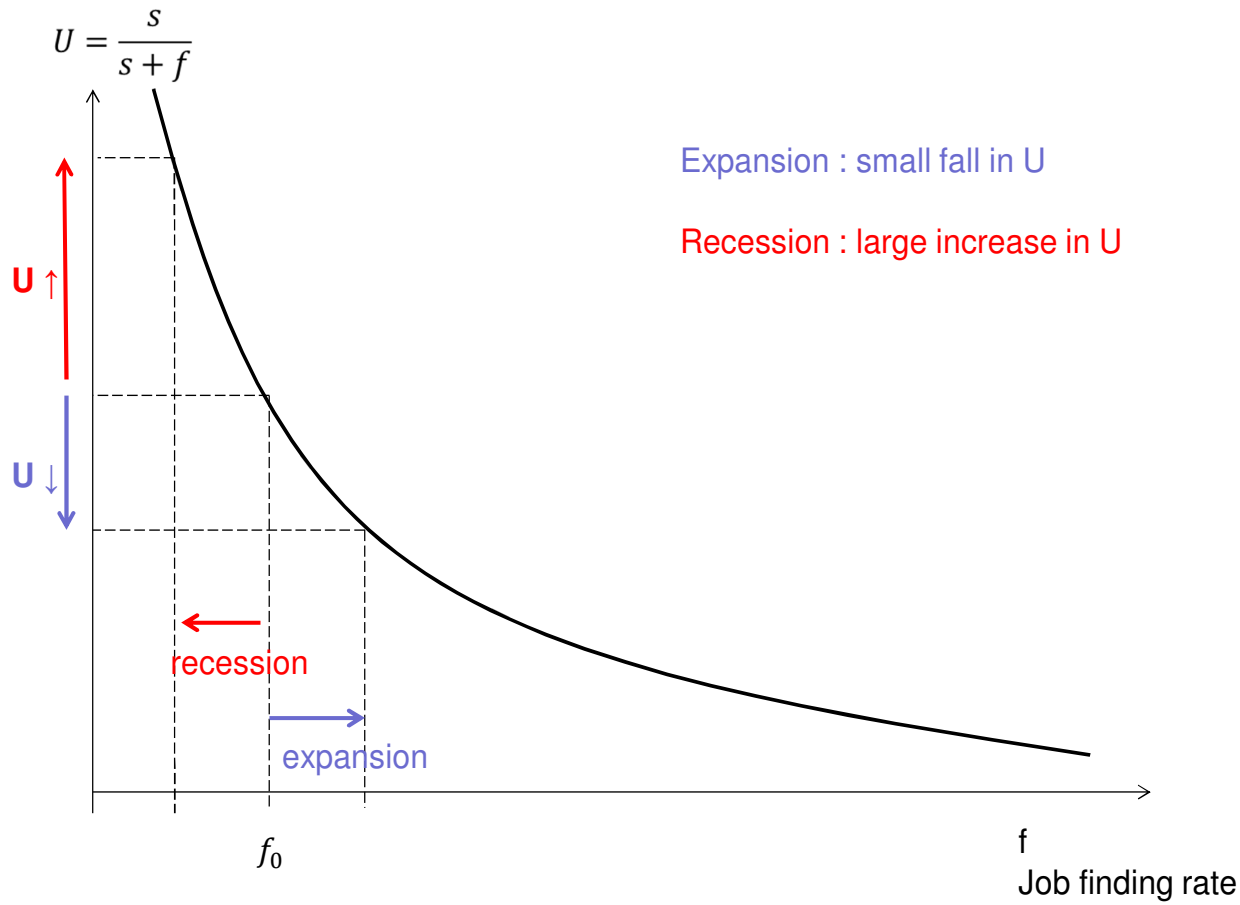
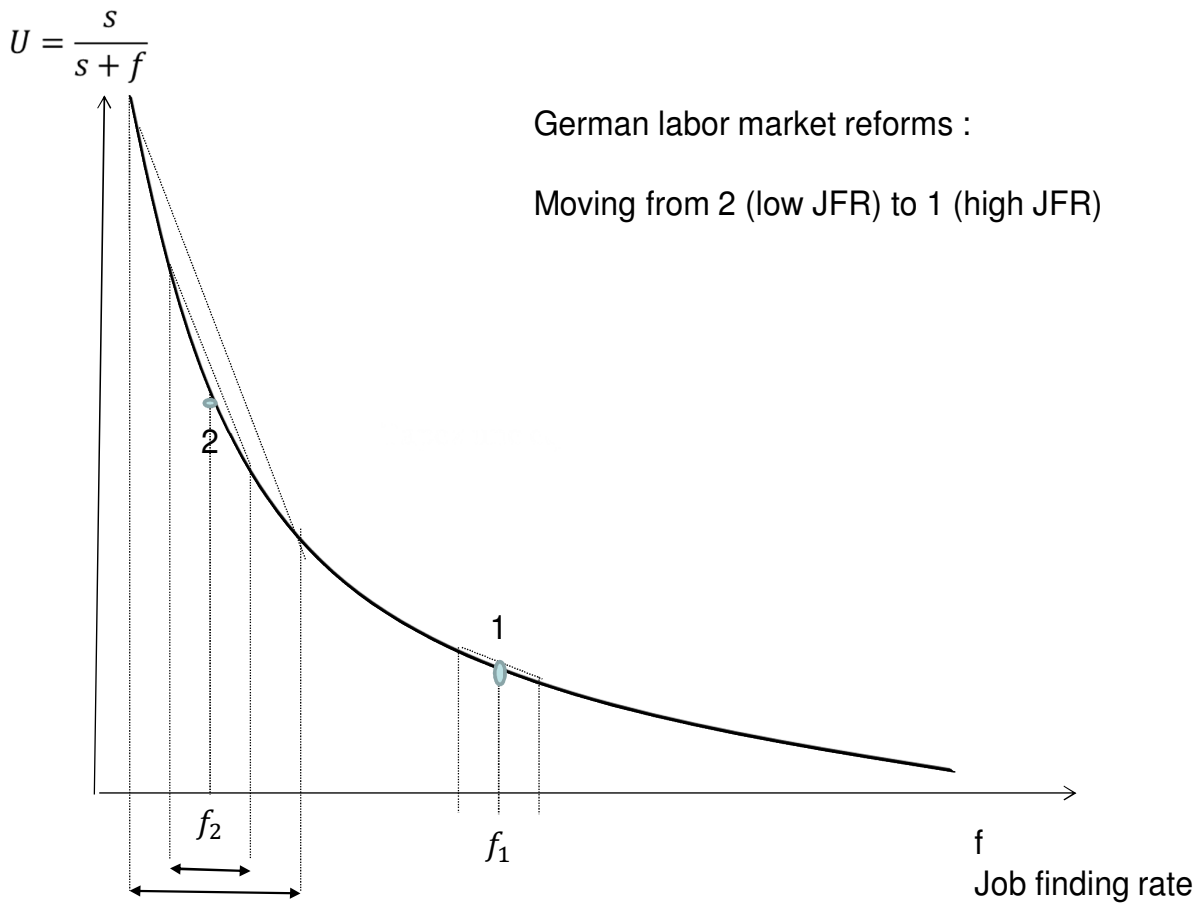


FIGURE : German labor market reforms



German labor market reforms :

Moving from 2 (low JFR) to 1 (high JFR)

1. Separation rate s

In US data, it seems reasonable to assume exogenous and constant s

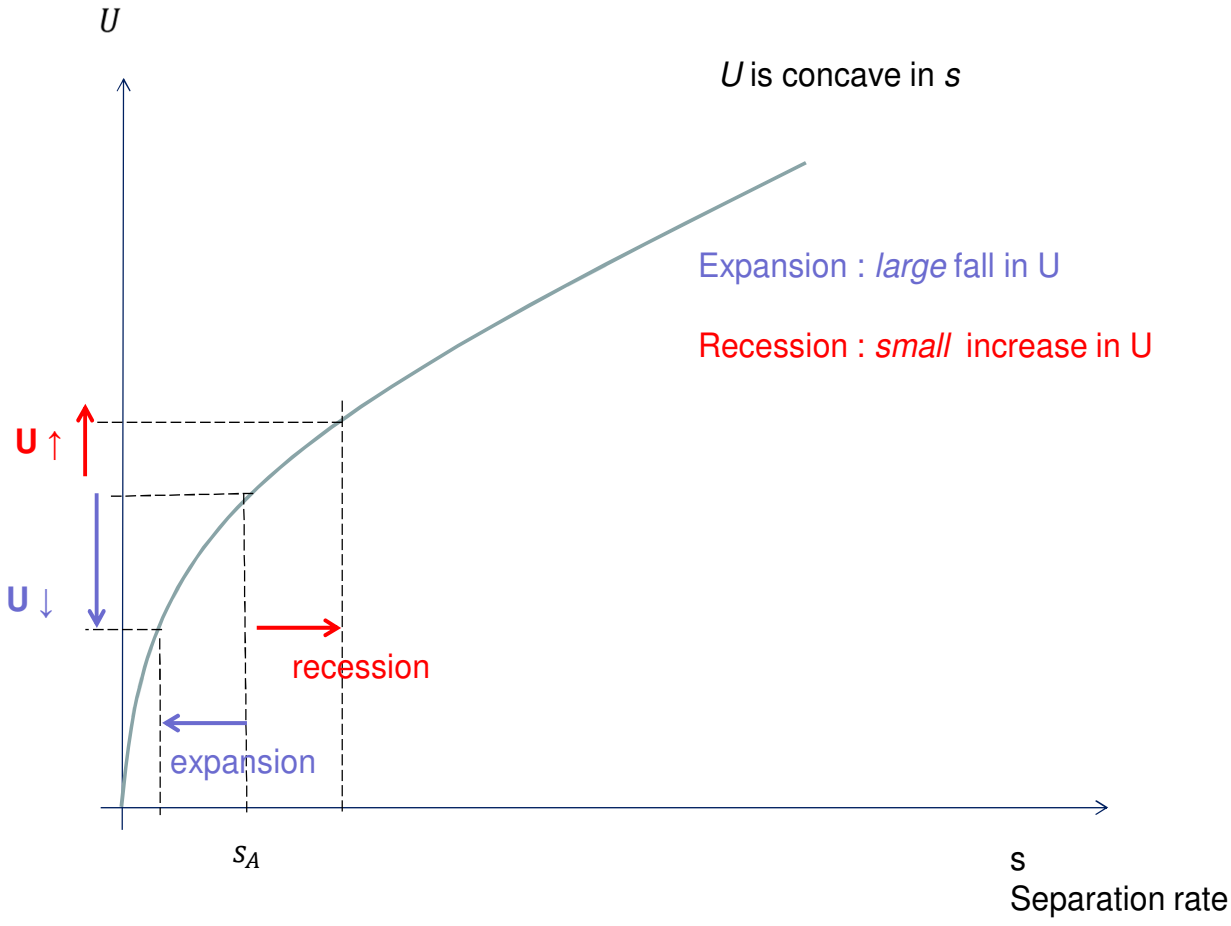
- Fluctuations in U are explained mainly by f (Shimer, 2012)
- U fluctuations are asymmetric (McKay and Reis, 2008; Petrosky-Nadeau and Zhang, 2013): contractions in economic activity ($\uparrow U$) are briefer and more violent than expansions.

1. Separation rate s

In Germany ?

- In German data :
  - Fluctuations in U are explained by s *and* f (Elsby, Hobijn and Sahin, 2012; $\beta^s = 0.47$ and $\beta^f = 0.56$)
  - U fluctuations are not asymmetric: contractions are neither shorter nor more violent than expansions (my calculations using McKay and Reis program on German unemployment data from OECD, MEI, 1991Q1-2013Q3)
- $U = \frac{s}{s+f}$ hence U is concave in s
- Story behind α ? $\alpha = 1$? Move Germany to a region in which U is more concave ?

FIGURE : U is concave in the job separation rate s



2. Understanding the results

- Full Characterization of the economy before / after the reforms:
  - Business cycle properties before/after the reform (model versus data)? Shimer puzzle? Gartner, Merkl and Rothe (2012) : more sclerotic labor market are more volatile so less business cycle labor market after the reform. Is that what you get ?
  - Composition of unemployment (short-term / long-term)? Inequality (endogenous savings)? Beveridge Curve?

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  - Composition of unemployment (short-term / long-term)? Inequality (endogenous savings)? Beveridge Curve?
- Very rich model: Do we need all this?
  - Endogenous savings? Labor market convexity is not enough?
  - Search effort? Magnifying effects of θ on labor market variables?
  - Results without these elements?

2. Understanding the results

- Understanding the impact of general equilibrium effects
  - Endogenous r: results with constant r (small open economy)? Impact on financial income for employed individuals? Inequality (financial income of the rich)?
  - Endogenous τ: results with constant τ ? Larger impact on low income groups ?

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- Model without capital (savings are not productive)
  - Krusell and Smith (1999): precautionary savings $\rightarrow$ "over-savings" $\rightarrow$ high level of capital and production $\rightarrow$ welfare cost of fluctuations is low
  - What happens with productive capital? Kuester and Jung (2011) (return to capital, marginal product of labor)

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- Desirability of the reforms? Desirable to lower the cost of fluctuations but does the cost of transition matter?

3. Wage

- Wage dynamics is crucial in labor market dynamics (understanding changes in quantity *and* price)
- Wage dynamics in the data before / after the reform ? Empirical evidence?
- In the paper, $w = A$
- Expected wage dynamics matter for business cycle costs:
  - Gomes, Greenwood and Rebelo (2001): search payoffs are convex in productivity (wage) so that more fluctuations in productivity may be preferred to less

Minor comments

- Present the distribution of welfare gains rather than the different weight in welfare function
- Job quantity versus job quality?
- Is that a desirable reform ... for France? Negative spillovers to France ? (Busl and Seymen, 2013)
- Which margins of labor matter? What about hours or labor participation?
- Suggested references: Challe and Ragot (2013), Iliopulos et al. (2014), Roulleau-Pasdeloup (2014)

Conclusion

Many questions that the paper can address
which makes it very appealing !

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