Capital Account Openness and Unemployment

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The general question

- How does capital mobility affect labor market outcomes?
- Relevant, Topical!

Outline

- A brief summary
- On the theory
- On the empirical work
- More on the interaction between capital flows and labor markets

The main idea

- Capital and Labor are complement in production
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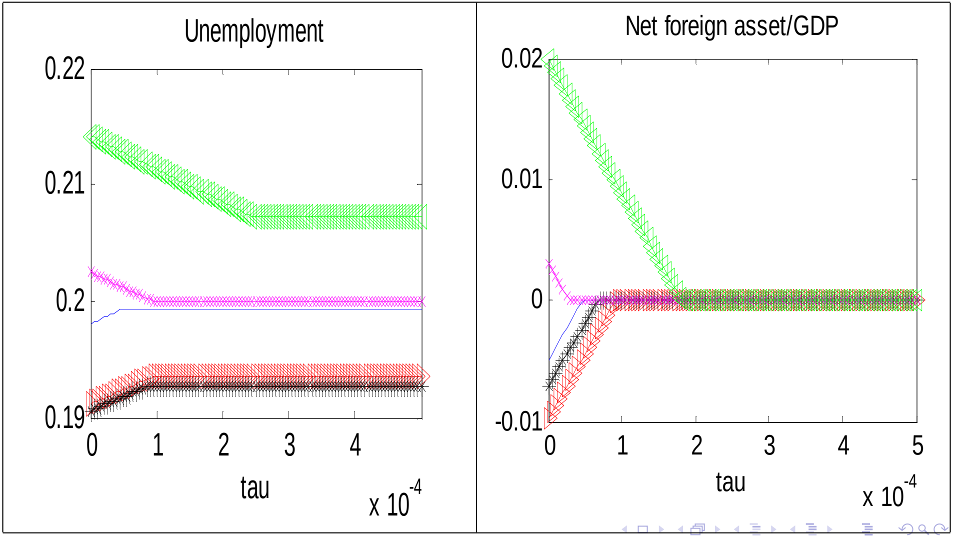
- Consider 2 countries: one with good (flex) and one with bad (rigid) labor markets
- With openness: capital flows from bad labor market to the good one, amplifying differences in LM outcomes
- Openness good for flex LM, bad for rigid LM

Theory

- Mortensen Pissarides model in a small open economy
- Comparative static wrt taxes on capital flows



Empirical work

- Regress U (5 years period) on KAOPEN and LMR*KAOPEN
- After controlling for country/time FE: KAOPEN signif. and negative, LMR*KAOPEN signif. and positive.
- For countries w/out rigidity: more openness ->less unemployment.
- For countries with rigidity: more openness -> more unemployment

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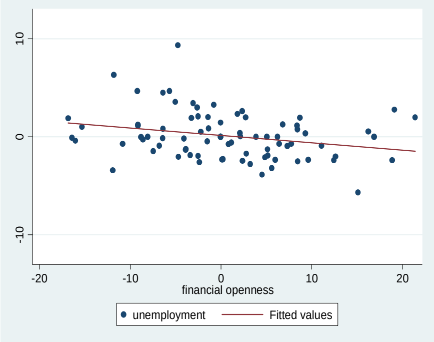
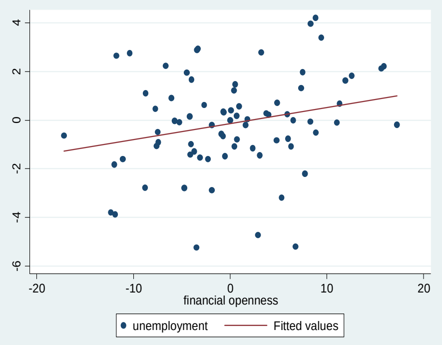


Flex countries



Rigid Countries

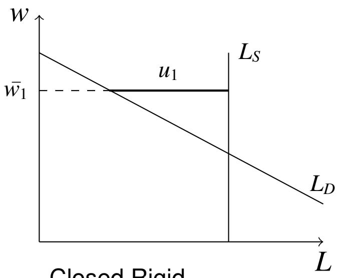
On the theory

- Is the MP machinery really necessary to make the point?
- Main advantage of MP is that it generates unemployment, but can generate unemployment in a simpler neoclassical model with sticky wages

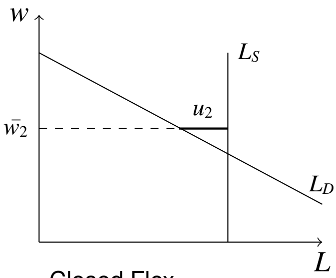
A static minimalist sticky wage model

- Each country endowed with K and inelastic labor supply $L = 1$
- Firms operate standard CRS $F(K, L)$
- Wages above the market clearing wage, with $w_1 > w_2 > w_{mc}$
- In closed economy capital is immobile (rental rate differential)
- In open economy capital is mobile hence rental rates (and wages) equalized across countries

Model solution

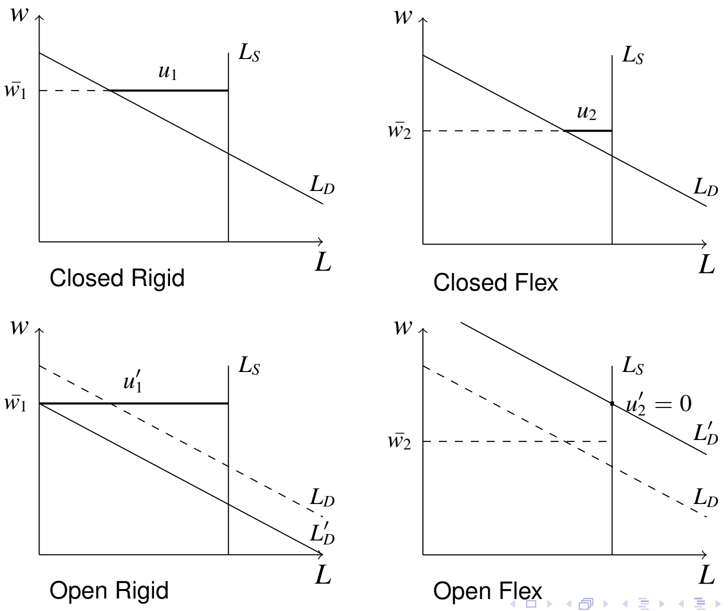


Closed Rigid

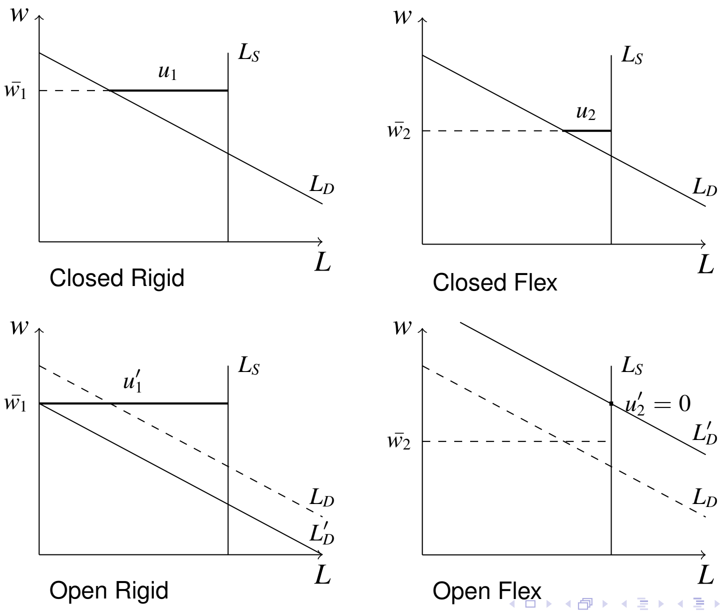


Closed Flex

Model solution



Model solution



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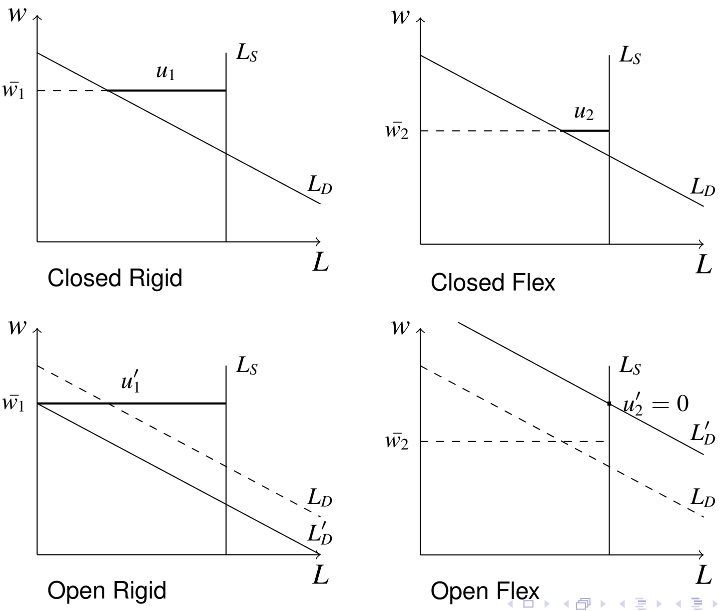

Results

- Opening up capital mkts reduce u in flex, increase u in rigid
- Welfare increases in flex, falls in rigid (overall pie smaller as there is more idle labor)
- Rigid loses labor income, and some of the returns from capital that is now shipped abroad are appropriated by workers in flex

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- Qualitative insights can be made with a much simpler (at least for me) model
- Model can easily be made quantitative

Two comments on the empirical work

- Evidence seems strong but there are no names on the dots, i.e. can you point to a few countries that drive these results? (relevant for policy advice!)
- Should look more carefully at evidence on current account/capital inflows

My attempt to put names on the dots

- Select countries/periods with largest changes in Chinn Ito index, and divide them in rigid/flex (using past unemployment)

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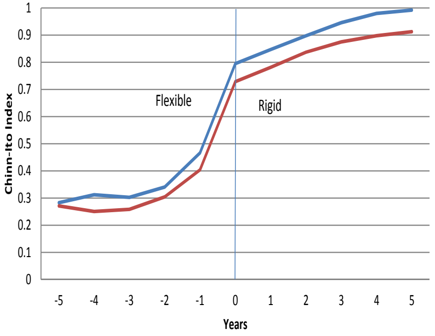
RIGID LIBERALIZERS

	Avg Unemp	Year Lib.
TTB	20.4	1993
BOL	17.68	1988
JAM	15.86	1997
SPA	17.22	1993
BUL	14.7	2006
DR	14.8	2003
SVK	17.14	2003
IRL	15.6	1993

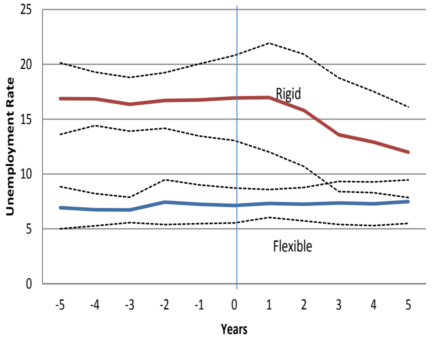
FLEX LIBERALIZERS

	Avg Unemp	Year Lib.
CHL	7.5	2001
DNK	7.7	1988
CZE	6.5	2001
AUS	7.62	1985
ISR	7.5	1999
CYP	4.4	2004
SLV	7.08	2000
HUN	7.96	2001

Not successfull..



Capital Openess



Unemployment

- Many reasons why unemployment fell in the rigid (possibly additional reforms associated with K liberalization), still the fact that unemployment did not fall in flex is puzzling..

The current account

- In the model fall in unemployment and capital inflows (increase in unemployment/capital outflows) go hand in hand
- Same exact evidence that hold for unemployment should hold for current account, i.e. rigid liberalizes should observe capital outflow, flex liberalizers capital inflow.
- Paper currently does not do that.. needed!!

Final thoughts on capital flows and employment

- Heathcote and Perri (2015) consider a different channel through which capital openness affect employment
- Capital inflows can drive up price of non tradables (housing)
- On impact positive impact on employment, as more work is used to produce those goods (construction boom): Spain/Italy in Euro integration phase
- As capital inflow ends, high price of non tradables (appreciated real exchange rate) stay, and that increase production costs
- If labor market not flexible enough (wages don't fall) tradable sector suffers, higher unemployment

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- If labor market not flexible enough (wages don't fall) tradable sector suffers, higher unemployment
- Degree of labor market flex is crucial for the desirability of capital inflows, but relation is more complex, and even capital inflows can be undesirable (through price effects)

Italy v/s Germany unemployment differential