Labor Market and Monetary Policy Reforms in the UK: a Structural Interpretation of the Implications

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DISCUSSANT'S COMMENTS

(very provisional)

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Summary:

An interesting attempt to introduce plausible labour market frictions into a DSGE model and to apply the model to a counterfactual exercise in appraising what would have happened had reforms to monetary policy and the labour market been introduced in the early 1970s rather than the 1980s and 1990s.

Questions/Comments

1. Have real output growth and inflation been more stable since the early 1990s than in the 1970s and 1980s if one takes what happened in 2008 and 2009 into account?

2. Is it plausible to think that the monetary authority (or government?) in the 1970s and 1980s conducted monetary policy using a modified Taylor rule (equation (22)) E.g. the UK had a fixed exchange rate in much of 1971, 1972 and 1990 – 92, and introduced monetary targeting in about 1975. There were massive policy changes within this period. Perhaps arguable that the authorities were implicit inflation targetters (with a time-varying inflation target). Less plausible to suggest they used interest rates to achieve these targets.

(3) Firm's surplus – 'given by the cost per hire, G_t'. Surely the firm's surplus is given by the difference between the extra revenue the worker produces for the firm and his wage, adjusted for hiring costs? Stock/flow issues arise – hiring costs are incurred just once (when the worker is hired) but

the benefits and other costs continue as long as the worker is employed. But perhaps there are other interpretations of the bargaining problem.

(4) Equation (14) on p. 10 gives the 'agreed wage' – presumably this is the wage a worker receives the period he is hired, but what wage does he receive in subsequent periods of his employment. Might it be that all workers are paid what new hires are paid in that period, but could this be made explicit?

Equation (14) suggests that wages are quite close to unemployment benefits. For example, if $\eta = 1$, the wage is less than unemployment benefits plus hiring costs (which are fairly small relative to unemployment benefits?) So how is it possible to explain the large increase in real wages in the 1980s with the fall in real unemployment benefits over the same period?

(5) Note that the model excludes investment, exports and imports, government expenditure, the housing market and assets markets like the stock market. Representative agent framework means no redistributional issues, no borrowing or lending.

(6) On p. 19, it is stated that the labour market reforms 'would have contributed to lower inflation but not a lowering of inflation and output growth volatility', but on p. 21 it is asserted that these changes 'would have unlikely produced a

different macroeconomic outcome'. So why was there the remarkable change in UK macroeconomic performance?

(7) 'A stronger reaction to inflation deviations from target would have lowered the volatility of inflation and output growth' (p. 21.) Surprising – one might expect this to increase the volatility of output growth.

(8) Are hiring costs estimated or calibrated?

(9) According to equation (25) on p. 13, output is either consumed, or used up in changing prices or hiring workers. The latter two uses are likely to be tiny compared with consumption, so we would expect consumption to be very similar to output in this economy. Does this cause any problems for the estimation, where consumption can presumably differ markedly from output because of changes in net exports, investment or government spending?

(10) Is it possible to evaluate the stabilising properties of (e.g.) monetary policy responding more vigorously to deviations of inflation from target in response to fluctuations caused by each specific shock?

(11) Would it be possible to evaluate the macroeconomic consequences of reducing firing costs by considering the effects on macroeconomic stability of an increase in δ?

Overall, a pioneering piece of work but more needs to be done!