Abstracts

Labor Demand, Labor Supply, and Employment Volatility

ROBERT E. HALL

If labor demand and labor supply are both flat, small shifts in either schedule bring substantial shifts in employment. Flatness of demand and supply seems the most promising explanation of observed aggregate employment volatility. Empirical work on labor demand in U.S. industries suggests flatness: When exogenous forces change the level of employment in an industry, the product wage in that industry changes relatively little. Other evidence corroborates this. For example, firms do not build inventories in anticipation of future higher levels of production; cost minimization would compel such production smoothing if the marginal product of labor was higher in slumps than in booms. Complementarities may be one of the reasons that labor demand is flat. With respect to labor supply, flatness occurs if the marginal value of alternative activities is not sensitive to the amount of time devoted to those activities. The paper focuses on reorganization as the primary alternative use of time. Empirical evidence on the relation between job matching and the volume of unemployment is consistent with the hypothesis of no decline in marginal effectiveness of job search as unemployment rises.

Markups and the Business Cycle

JULIO J. ROTEMBERG AND MICHAEL WOODFORD

As output and employment rise in business cycle booms, the marginal product of labor falls while real wages generally do not. So marginal cost, which equals the wage divided by the marginal product of labor, rises more than do prices. In this paper we examine this business cycle variation in the markup of price over marginal cost. We consider three leading theories of markup determination. The first is that firms are monopolistic competitors and that the elasticities of their demand curves vary over the business cycle. The second is the customer market model of Phelps and Winter (1970) where firms' markups also depend on the desirability of raising current market share in order to increase future sales. The third has markups depend on individual firms' incentives to deviate from an implicit collusive understanding, as in Rotemberg and Saloner (1986). We show that these three theories can be nested in a single specification that makes markups a function of current sales and of the expected present discounted value of future profits. However, the three theories make different predictions about the signs of the parameters relating the markup to its determinants. We thus estimate equations of this sort empirically to gauge the validity of the three models. This estimation is carried out both with aggregate data and with two-digit industry data. The two-digit data also allow us to see how the relationship between the markup and its determinants varies with the concentration of the industry. Finally, we also discuss in detail the causes of markup variation in two highly concentrated industries.

Pitfalls and Opportunities: What Macroeconomists Should Know about Unit Roots

JOHN Y. CAMPBELL AND PIERRE PERRON

This paper is an introduction to unit root econometrics as applied in macroeconomics. The paper first discusses univariate time series analysis, emphasizing the following topics: alternative representations of unit root processes, unit root testing procedures, the power of unit root tests, and the interpretation of unit root econometrics in finite samples. A second part of the paper tackles similar issues in a multivariate context where cointegration is now the central concept. The paper reviews representation, testing, and estimation of multivariate time series models with some unit roots. Two important themes of this paper are first, the importance of correctly specifying deterministic components of the series, and second, the usefulness of unit root tests not as methods to uncover some "true relation" but as practical devices that can be used to impose reasonable restrictions on the data and to suggest what asymptotic distribution theory gives the best approximation to the finite-sample distribution of coefficient estimates and test statistics.

Privatization in Eastern Europe: Incentives and the Economics of Transition

JEAN TIROLE

The paper discusses how incentives and market structure considerations ought to guide the choice of sequencing and institutions in the privatization of state industrial property in Eastern Europe. It first reviews some essential features of private incentives and government intervention in western economies. It then analyzes whether these features are likely to carry over to the Eastern European environment, characterized by a large amount of uncertainty and a nonstationarity in its level, and by the need for substantial efficiency—and competition-oriented restructuring. Finally it draws suggestions concerning the issues of the timing of privatization, that of the introduction of a stock market, the choice among governance structures, the structure of incentives within and outside productive units, and the evolution of industrial policy during the transition process.

The EMS, the EMU, and the Transition to a Common Currency

KENNETH A. FROOT AND KENNETH ROGOFF

When a central bank is about to relinquish control over its exchange rate and enter into a currency union, it faces very low reputational costs of devaluation. As with any finite-horizon game, the endpoint affects the earlier expectations of private agents, here causing them to demand higher interest rates and higher wages from countries whose currencies are relatively weak. In looking at the countries within the EMS, we find that Italian long-term interest rates as well as price and wage levels relative to those in Germany show evidence of growing gaps. We also find that the real appreciation of the lira appears to be partly due to increases in relative Italian government spending, and not just to rapid Italian productivity growth. Taken together, this evidence suggests that reputational considerations may not be enough to foster continuing convergence within the EMS. Furthermore, moving forward the date of currency union may in the short run increase both the rate of growth of the gaps and the need for exchange-rate realignment.

Growth, Macroeconomics, and Development

STANLEY FISCHER

The 1980s were both the lost decade of growth for much of Latin America and Africa and the period in which—through the new growth theory—macroeconomists returned to the study of growth and development. The new growth theory is production function driven and concerned primarily with steady states, and has paid little attention to the role of macroeconomic policy—as reflected for instance in the rate of inflation and the budget deficit—in determining growth. This paper presents a variety of evidence that macroeconomics policies matter for long-run growth. First, macroeconomic variables enter the typical new growth theory cross-country regressions with statistical significance and the expected signs. Second, evidence from large multicountry case studies, and from case studies of Chile and Côte d'Ivoire presented in the paper, shows that macroeconomic policy choices have had a significant impact on growth over periods of more than a decade. The conclusion is that macroeconomic policy choices, including the budget deficit, the exchange rate system, and those choices that determine the inflation rate, matter for long-term economic growth.