Comment on Ana Maria Loboguerrero and Ugo Panizza

Ansgar Belke

In my comment on the illuminating paper by Ana Maria Loboguerrero and Ugo Panizza I will proceed as follows. First, I will address its main questions and findings. Second, I am going to give a general assessment of the paper. Third, I will tackle some open issues left for further research.

1 Main Questions and Findings

This paper takes a tour d’horizon around issues of volatility transmission from macroeconomic variables to the labor market, i.e., involuntary unemployment. The authors estimate employment, unemployment, and wage Okun coefficients. They use these coefficients as a starting point and show that, compared with industrial countries, Latin American countries adjust more through wages than through employment. The main result of these exercises is that inflation plays a certain role in explaining the difference between employment elasticities in Latin America and industrial countries. However, there remains a significant difference between both regions which cannot be explained by inflation differentials. Within Latin America, inflation increases labor market flexibility in countries that are characterized by highly regulated labor markets and that enforce these regulations.

In the first part of their paper, the authors work out very clearly and in a systematic and persuading fashion that in Latin America wages instead of employment bear the main burden of adjustment. They argue that this is probably beneficial because, in the absence of an unemployment insurance, a situation characterized by a low employment elasticity and a high wage elasticity contributes to spreading out the cost of an economic crisis more evenly. However, the authors argue that a bad implication strictly following from their empirical analysis is that in Latin America crises are particularly costly for workers. Their estimations indicate that the share of labor income tends to change over the business cycle. Hence, let me just focus my comments on the most thought-provoking and disputable part of the paper, namely on the questions why Latin
American wages are so flexible and how labor market regulations and inflation can explain differences between employment elasticity in Latin American countries and industrial countries.

One of the main questions raised by the authors in Sections 3.2 and 4 refers to the impact of the interaction between inflation and labor market regulations on the employment response to output changes. With this focus, the paper is quite closely related to Blanchard and Wolfers (2000). Moreover, the authors complement the existing literature on the "grease/sand effects" of inflation in three ways. First, they place a special focus on labor market regulations when testing whether inflation increases real wage flexibility in general and, thus, reduces the sensitivity of employment to output changes. Second, they apply a wide range of econometric panel techniques. Third, they differentiate between industrialized countries with highly regulated labor markets (exception: the United States) and developing countries with a presumably lower degree of labor market rigidities, i.e. of the Giersch-type "eurosclerosis."

"Grease" dominates "sand" where labor markets are highly regulated, i.e., where wheels "squeak the most" as, for instance, in Italy and in Spain. "Sand" dominates "grease" where labor markets are more flexible as, for instance, in the United States. Most strikingly, net "grease effects" are only identified for a group of industrial countries, but not for a sample consisting of developing countries. The authors give the following explanations for this pattern of results by extending Bertola (1990): inflation enhances real wage flexibility/elasticity. In this sense, inflation allows real wages to fall faster in bad times. Hence, there is more employment than with lower inflation. Moreover, the impact of inflation is amplified by the existence of labor market regulations. As a special case, the authors consider a no-regulation scenario in which there is of course no inflation effect. Finally, they assume that labor markets in developing countries are less rigid in general. Seen on the whole, their contribution is an interesting and topical paper. It seems fair to say that it deserves the main merits for its empirics. Hence, the lack of a theoretical part is highly legitimised.

2 General Assessment

Underlying Theory

Unfortunately, there is no focus on the potential employment impacts of uncertainty which are induced by inflation (see Loboguerrero and Panizza in this conference volume, Footnote 8). Using their own terminology, the Tobin channel is over-emphasized compared to the Friedman channel, which emphasizes that uncertainty increases with inflation. This in turn implies that inflation has