Comments on

Resurrecting the Role of the Product Market Wedge in Recessions

by Bils, Klenow & Malin

Discussion by Susanto Basu

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Main messages of the paper

• The right (marginal, shadow, allocative) wage is really, really procyclical
  • From direct construction: for example, Kudlyak (2014) measure of user cost of labor
  • Inference from the assumption that marginal cost is the same on every margin
• Thus, the markup of price over marginal cost is really, really countercyclical (this is their PMW)
Why is a cyclical wedge important?

• Lots of recent models where the present is driven by expectations of the future
  • Beaudry & Portier (2006): News shocks
  • Bloom (2009), many others: Uncertainty shocks
  • Gourio (2012): Disaster risk
  • Veldkamp et al (2015): Learning about TFP growth
  • Financial frictions lowering expected capital returns
• All struggle with the Barro-King (1984) problem:
  \[ U_C(C, H) F_H(K, ZH) = -U_H(C, H) \]
• With standard preferences, no comovement of \( Y, C, H, I \)
Endogenous PMW can solve the problem

- With an endogenous markup, we get
  \[ U_C(C, H) \frac{1}{\mu} F_H(K, ZH) = -U_H(C, H) \]
- Changes in markups can make fears about the future translate to downturns today
- Substitute demand-driven model for full-employment model (Basu-Bundick, 2012)
  - As a logical matter, could drop additively time-separable preferences: e.g., E-Z utility with IES > 1
  - But we will need some nominal rigidity to match non-neutrality of money \( \Rightarrow \) comovement for free!

Basu discussion of Resurrecting the Product Market Wedge
Suggestions for improvement

• Important to find out whether the PMW changes are endogenous or only exogenous shocks
  • Medium-scale DSGE models have both
• Need to study *conditional* correlations of PMW—impulse responses to identified shocks
  • Example: In standard NK model, markup is countercyclical in response to monetary shocks but procyclical in response to technology (Galí, 1999; Basu-Fernald-Kimball, 2006)
• Follow Nekarda-Ramey (2013)
  • Extend to study intertemporal shocks
Some evidence

- Basu-House (2015) survey explores the idea that implicit wage contracts give rise to acyclical AHE but procyclical UCL (Becker, 1962; Barro, 1977)
- In our model, the UCL is the right allocative wage
- We show that UCL is very responsive to monetary policy shocks (while output prices are not)
  - Price markup/PMW strongly countercyclical
- In NK model, suggests important role for price rigidity, but not for *allocative* wage rigidity
  - Inertial AHE shows why we thought otherwise
Too much of a good thing?

- Countercyclical markups like salt in cooking
- Basu-House: Allocative wage (UCL) falls a lot in response to a contractionary monetary shock
- But these shocks still estimated to have persistent output effects (and small price effects)
- How can we get persistent real effects of money when monetary shocks change real marginal cost so much?
  - The CEE strategy of nearly-acyclical MC no longer matches the data
Conclusion

- A variety of ingenious tests suggest that marginal cost is very procyclical (i.e., price markups are countercyclical)
- If endogenous, then ideal propagation mechanism for an important class of shocks
- Medium-scale DSGE models will have a lot of difficulty matching this fact together with the fact that inflation fluctuates little
- Sticky-price models with countercyclical target markups may be able to match both facts