Comments on

Resurrecting the Role of the Product Market Wedge in Recessions

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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:

$$U_C\left(C,H\right)F_H\left(K,ZH\right) = -U_H\left(C,H\right)$$

- With standard preferences, no comovement of *Y, C, H, I*

Endogenous PMW can solve the problem

- With an endogenous markup, we get

$$U_C\left(C,H\right)\frac{1}{\mu}F_H\left(K,ZH\right)=-U_H\left(C,H\right)$$

- 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!

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