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On Okun's law in OECD countries: An analysis by age cohorts

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HIGHLIGHTS

- Okun's law for some sub-groups of the population might be not statistically significant.
- The youngest generations are most vulnerable to the business cycle.
- The coefficient becomes smaller up to a certain age cohort and then tends to stabilize.

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ABSTRACT

This study investigates Okun's law in OECD countries by examining estimates for male and female age cohorts for the period 1998–2012. We find that the estimated Okun coefficients are not always statistically significant for each subgroup of the population. Our results also highlight a general common pattern of higher Okun coefficients for the youngest cohorts. This suggests that the young population, and particularly the young male population, tends to be most exposed to the business cycle in both developed and emerging OECD countries.

1. Introduction

The global financial crisis that began in 2007 has led to one of the most significant economic shocks since World War II. The emergence of problems in the credit markets of developed countries primarily in the United States and Europe quickly led to a climate of extreme uncertainty among consumers and entrepreneurs and resulted in a slowdown of aggregate demand. In this scenario, many firms (particularly those in construction and manufacturing) revised their production schedules downward or even terminated production altogether. This contributed to a rapid increase in the unemployment rate (e.g., Edely, 2009 and Arechavala et al., 2014). In this study, we focus on the relationship between economic growth and the unemployment rate, which is well-known in the economic literature as Okun's law (Okun, 1962). In 1962, Arthur Okun suggested two approaches to study this relationship: the first difference model and the gap model. In the first approach, the model is defined as

$$\Delta y_t = \alpha + \beta(\Delta x_t / x_t) + \varepsilon_t, \quad t = 2, \ldots, T, \tag{1}$$

where T represents the number of time point observations, Δ is a difference operator, y_t represents the unemployment rate of a country, x_t is the country's real gross domestic product (GDP), α is the intercept of the model, and ε_t is a *i.i.d.* $N\left(0, \sigma^2\right)$ random variable. The parameter β is typically referred to as Okun's coefficient, which economic theory expects to be negative. Eq. (1) models the contemporaneous relationship between changes in the unemployment rate and real GDP in percentage terms. The second approach is based on the gap equation,

$$y_t - y_t^g = \beta(x_t - x_t^g) + \varepsilon_t, \tag{2}$$

where y_t^g and x_t^g represent the natural rate of unemployment and potential output, respectively. Note that y_t^g and x_t^g are not observable and must thus be determined by economists.

Scholars have documented the asymmetric relationship between economic growth and changes in the unemployment rate

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extensively, and this relationship exhibits higher effects during recessions than during economic expansions (e.g., Holmes and Silverstone, 2006). Other economists have emphasized that such a relationship is spatially heterogeneous and time-varying (e.g., Zanin and Marra, 2012 and references therein). Hutengs and Stadtmann (2013, 2014) focused on Okun's law as applied to age cohorts for both the Eurozone and a subset of eastern European countries; their main finding was that Okun's coefficient is highest for the youngest cohorts, particularly when compared with the oldest cohorts, which suggests that the youngest cohorts have the most exposure to the business cycle. However, Hutengs and Stadtmann (2013, 2014) limited their study to those countries for which a long time series of unemployment rates by age cohorts is available. Furthermore, a crucial issue in using a long historical period to estimate Okun's coefficient within the framework of a linear model is that inconsistent results might be obtained with respect to recent economic dynamics (see Zanin and Marra, 2012). The purpose of our study is to investigate Okun's law in subgroups of the population as determined by age cohorts (15–24, 25–34, 35–44, 45–54, and 55–64 years of age) and gender for a wide number of countries that are members of the Organization for Economic Co-operation and Development (OECD) and to focus the analysis on the last 15 years available. In contrast to Hutengs and Stadtmann (2013, 2014), we extend the Okun's law analysis in the following directions: first, we examine a much larger group of countries (both developed and emerging OECD countries); second, we use a common sampling period that allows results across countries to be compared; and third, we distinguish the analysis by male and female age cohorts (not provided by Hutengs and Stadtmann, 2013 for the Euro area countries).

The results can be a meaningful guide for macro-economists and policymakers interested in identifying and comparing countries and subgroups of populations regarding whether they are more or less sensitive to fluctuations in the business cycle.

2. Data

We investigated Okun's law with respect to the following OECD countries: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, The Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. The source for the annual real GDP and unemployment rate data for all countries (in constant 2005 prices) is the OECD (2014). For most of the selected countries, information regarding unemployment rates by gender and age cohort prior to 1998 is not available. Thus, we have restricted our analysis to the historical period that ranges from 1998 to 2012, which allows us to confidently compare results across countries.

Descriptive statistics by gender and age cohort highlight that unemployment in the youth cohort (15–24 years old) is a concern for many countries worldwide and that the great recession has exacerbated this problem in several cases. During the great recession, record high unemployment rates were recorded in Greece (48.4% and 63.2% for men and women, respectively), Ireland (38.9% and 26.7% for men and women, respectively), Italy (33.7% and 37.5% for men and women, respectively), Portugal (36.4% and 39.2% for men and women, respectively) and Spain (54.4% and 51.8% for men and women, respectively). The high unemployment rate for the youth cohort compared with older cohorts is attributable partly to a lack of work experience and partly to labor market policies that influence school-to-work transitions.

3. Estimating Okun's coefficient: the trade-offs among theory, available data, and methodology

A recent surge in both political and academic interest has focused on the great recession's negative effects on people's lives and on possible action-strategies that might lead to rapid economic recovery. Thus, some attention has focused on the relationship between GDP growth and the unemployment rate. In this sense, Okun's coefficient represents a simple indicator to quantify the magnitude and statistical significance of the relationship between fluctuations in real GDP and the unemployment rate, which are two relevant economic measures for economists and policymakers when aiming to monitor the economic health of a country. In this study, Okun's law is investigated using model (1). Calmfors and Holmlund (2000) identified the following features that might influence the relationship between economic growth and unemployment: "(a) exogenous changes of the rate of growth can affect unemployment; (b) exogenous changes of the type of growth can affect unemployment; (c) changes in labor-market institutions can affect the growth rate indirectly via changes in unemployment; (d) changes in labor-market institutions can affect both unemployment and growth directly but through different mechanisms". Population growth, labor market structure (rigid or flexible), tax policies, labor productivity, job specialization and the business cycle are among the factors that can affect such a relationship over time and space. From this theoretical perspective, Zanin and Marra (2012) suggested that Okun's coefficient should be estimated within a flexible time-varying framework using a penalized regression splines approach. Thus, we should let the data determine whether the relationship under investigation is linear or non-linear (i.e., stable or varying over time) and determine which countries or subgroups of the population are involved. However, such an approach requires lengthy historical series for which the applicable measurements are available; in our case, such historical series are generally not available for all the countries selected (see Section 2). For this reason, we estimate (1) using the traditional ordinary least squares (OLS) approach.

The size of the sampling period considered (1998–2012) is consistent with the choice of the temporal window used by Moosa (1997) and Zanin and Marra (2012) for estimating Okun's coefficient within a rolling regression framework. Accordingly, our results might be viewed as an estimation of the last point of a rolling regression approach. Although we recognize that the use of a linear model produces estimates that are constant within the sampling period, it is reasonable to assume that our findings are reliable and consistent with recent economic dynamics.

4. Results

We begin the discussion of the estimates of Okun's coefficients by focusing on the results for the working age population (ages 15–64) of men and women (see the last columns of Tables 1 and 2). Our main findings support those studies that are available in the literature regarding the existence of a significant inverse relationship between changes in unemployment rates and economic growth (excluding certain exceptions) and that demonstrate the manner in which the magnitude of Okun's coefficient is spatially heterogeneous (e.g., Zanin and Marra, 2012). As an additional insight, the analysis highlights that the absolute size of Okun's coefficient is higher for men than for women. One reason for this result is that men are predominantly employed in sectors that are more sensitive to economic cycles (such as manufacturing and construction) than women, who are typically concentrated in the service sectors (see also the Azmat et al., 2006; World Bank report, 2012). In general, the highest Okun's coefficients are found for Spain (−0.99 for both genders) and