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Introduction

Globalization and labor markets

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1. Introduction

The interaction between various forms of globalization and domestic labor markets has now become an active area of research in international economics. There is both empirical as well as theoretical work being done in this area, with the former guiding the latter and vice versa, something that is important for the progress of knowledge and the deepening of our understanding in any area. Another important feature of research on the topic of globalization and labor is that currently leading international trade economists from leading research institutions are heavily involved in it. In looking at this issue, researchers are paying special attention to frictions or imperfections in labor markets. While this is a recent development, some of the foundations for it were laid by a few scholars in the last couple of decades, working steadily on the topic of trade and labor-market frictions, when it was outside the mainstream of international trade that focused on full employment and perfect labor markets. Two most prominent among those pioneering researchers are Carl Davidson and Steven Matusz, who were kind enough to contribute an article to this special issue of *International Review of Economics and Finance*. By bringing in both established as well as emerging scholars in this area to write on diverse cutting-edge issues at the intersection of trade and labor, this special issue on globalization and labor markets celebrates the rise of this research topic to the center stage of mainstream international trade research.

In this special issue, we have aimed for a reasonable balance between theoretical and empirical research. In addition to this introductory article, there are seven papers, four of which are theoretical and the remaining three empirical. The theoretical papers are on the impact of trade on the quality of firm-worker matches in an environment with heterogeneous firms and workers, the very short-run to medium-run impact of trade on job creation and destruction and the rate of unemployment, the impact of offshoring on wages and wage inequality and the impact of trade, in interaction with country size, on unemployment insurance. The three empirical papers are on the role and importance of international and domestic market access in wage growth in China, the proportion of the increase in wage inequality in India that can be attributed to trade and services liberalization, and the impact of trade (both exports and imports) and trade policies, including those of partner countries, on labor–demand elasticities of Korean firms.

2. Theoretical analyses: The impact of globalization on search, matching, unemployment and wages

The lead article of this special issue is by Carl Davidson and Steven Matusz. In this paper, the authors study worker–firm matches in the presence of firm and worker heterogeneity in terms of their productivity levels. When matching every period is random, a firm has the option of rejecting a match if it is not optimal. However, in the presence of search frictions, a firm might prefer to accept a match even though the firm could do better employing a higher ability worker who commands a higher wage. That is because there is cost associated with forgoing current production and searching further. Thus, we get "mismatches" in equilibrium. It is important to note that a higher rejection rate of mismatches leads to a lower mismatch rate in equilibrium but a higher unemployment rate. Davidson and Matusz study in such a framework how globalization affects the propensity of firms and workers to be mismatched. The incentives for rejecting suboptimal matches depend on how responsive profits every period are to worker ability. That determines the difference to the firm between a good and a bad match. When this difference is large, it benefits the firm from waiting in that the benefits outweigh the costs of further search. Globalization,

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by affecting competition and the market size faced by firms, affects these incentives. The extent of mismatch in equilibrium is the result of a complex interplay between trade costs, the distribution of firm size, and magnitude of labor market frictions. This is a paper with several new insights and points to some new costs and benefits of globalization. The implication of these results is the need for some corrective domestic policies along with globalization.

The second article in this issue is by Priya Ranjan. The literature on trade and search unemployment takes the rate of job destruction to be exogenous, while the rate of job creation is endogenous. However, in the steady state the unemployment rate is constant, which means that the flow out of employment to unemployment should equal the reverse flow into employment. Thus, in the steady state even the job creation rate equals the exogenously given job destruction rate. This becomes a basic weakness of the standard model in the context of trade as it does not leave any scope for studying the effects of trade on job creation and destruction. Ranjan builds on the extended Pissarides (2000) model of endogenous job destruction by further extending it to a two-sector model with trade. Labor is assumed not to be mobile across sectors. In this model, new firms arrive with maximum productivity. However, in each subsequent point in time firms can get hit with a productivity shock with a certain probability. If not hit by this shock, they maintain their existing productivity. If hit with this shock, a firm draws a new productivity from a given distribution. Below a threshold productivity, a firm ceases to exist (effectively gets destroyed). The threshold productivity for destruction is decreasing in the price of the good the firm sells. A decrease in the threshold productivity means a lower endogenous rate of job destruction. Thus, trade liberalization leads to an increase in job destruction in the import-competing (comparative disadvantage) sector while it reduces job destruction in the export (comparative advantage) sector in the steady state. The sectoral job creation rates in the steady state also go in the same direction as the job destruction rates. The impact of trade liberalization, therefore, on steady-state economywide job destruction and creation rates and the overall steady-state unemployment rate are ambiguous. However, the immediate impact of trade liberalization, starting from the old steady state, on the aggregate unemployment rate and job destruction is not ambiguous. The reason is that in the import-competing sector certain jobs that were feasible are rendered infeasible (destroyed immediately) by this shock, as laying off workers does not require any time. However, in the export sector, there were jobs that were previously destroyed whose existence would have been feasible in the new scenario. But those jobs are already gone and the reduction in job destruction in this sector is not, therefore, immediately possible. These jobs will have to get created over time (this part of the productivity distribution will have to be built over time) before this reduction in job destruction in the export sector is realized (and note job creation takes time). Thus, the economywide immediate impact of trade liberalization is an increase in job destruction and unemployment. After this, the unemployment falls over time. These results are consistent with the cross-country evidence in Dutt, Mitra, and Ranjan (2009) and the evidence for India in Hasan et al. (2012). Ranjan also analyzes in his paper how inter- and intrasectoral wage inequality responds to trade liberalization in this context and how the impact of trade liberalization on job destruction depends on the generosity of the government with unemployment benefits. The paper makes important theoretical advances, with a large number of implications that future empirical work can explore.

The third article in this issue is by Gabriel Felbermayr, Mario Larch and Wolfgang Lechthaler. Within a framework that is a hybrid of the Melitz (2003) model of trade with firm heterogeneity and the Pissarides (2000) model of equilibrium search unemployment, the authors endogenize unemployment benefits. The key driving force here is what is called the “overhiring externality” in the literature. Since firms have some monopoly power, hiring an extra worker depresses marginal revenue. As a result the marginal revenue product of a worker falls. In multilateral bargaining in the presence of some monopsony power of each firm, this means the negotiated wage falls. Thus, there is an incentive to overhire. Unemployment is, therefore, less than optimal, which means unemployment benefits can be used to raise the unemployment rate to the optimal level. However, an increase in unemployment lowers product demand at both home and abroad. The authors in their paper split the effect of unemployment benefits on the partner country into a few intuitive channels. Important to note here is that the net effect turns out to be a negative externality on a country's trading partner. In the case of a relatively small country trading with a much larger country, a large part of the negative effect of unemployment benefits on output spills over to the partner country. Since this negative externality is not factored in by the small home country government, we will see relatively high unemployment benefits in a country that is relatively small and open. The authors motivate the paper empirically and tie it very well to the existing empirical and theoretical literature. The results of this paper have important policy implications, especially for trade agreements and domestic policy coordination.

The fourth article by Sasan Bakhtiari is also theoretical and he calibrates his model using parameters based on existing empirical work. He uses a Melitz-type model of firm heterogeneity but introduces offshoring into it. Note that unlike in the original Melitz model, there are two factors, namely skilled and unskilled labor here. Firms have a choice between hiring domestic unskilled labor and offshoring all their tasks to the South. In equilibrium, the author shows that both kinds of firms (offshoring and fully domestic) will exist. Adjusting offshoring costs such that offshoring is just 0.5 percent of unskilled jobs, which equals the actual extent of offshoring in the US economy in 2002, leads to a 0.3 percent rise in the real unskilled wage. This comes from the productivity effect of offshoring, which is now well known from the work of Grossman and Rossi-Hansberg (2008). Imperfect substitutability (some degree of complementarity) between skilled and unskilled labor also leads to an increase in skilled wage. However, the increase in skilled wage is proportionally higher than the increase in the unskilled wage, leading to an increase in wage inequality. The reason for this is that in the case of unskilled labor, there is both a positive productivity effect as well as an increase in the effective labor supply faced by Northern producers. These two effects are mutually opposing. In the case of skilled labor, there is only a positive productivity effect. This paper has very useful policy implications and belongs to the class of papers that destroy the myth that offshoring has only serious adverse effects on workers in the home country (country from where tasks are offshored).