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Banking crises, labor reforms, and unemployment

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Using a sample of 97 countries spanning the period 1980–2008, we estimate that banking crises have, on average, a large negative impact on unemployment. This effect, however, largely depends on the flexibility of labor market institutions: while in countries with more flexible labor markets the impact of banking crises is sharper but short-lived, in countries with more rigid labor markets the effect is initially more subdued but highly persistent. These effects are even larger for youth unemployment in the short term, and long-term unemployment in the medium term. Conversely, large upfront, or gradual but significant, comprehensive market reforms have a positive impact on unemployment, albeit only in the medium term. *Journal of Comparative Economics* **41** (4) (2013) 1202–1219. Department of Economics, University of Chicago, USA; Department of Economics, Bank of Mexico, Mexico; International Monetary Fund, USA; University of Palermo, Italy.
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1. Introduction

Although researchers have documented the impact of real shocks on overall unemployment in OECD countries (e.g. Bruno and Sachs, 1985; Nickell, 1997; Blanchard and Wolfers, 2000; Nickell et al., 2005), very little attention has been paid to the impact of banking crises on unemployment. Yet, like preceding crises (Reinhart and Rogoff, 2009), the 2008 banking crisis has resulted in a significant, and hitherto persistent, increase in unemployment in advanced economies (Fig. 1). While many emerging market economies have generally weathered the crisis well, youth unemployment has increased (or stopped declining) at least temporarily, in several regions, including Latin America, the Middle East, and North Africa.

Banking crises contribute to an increase in unemployment mainly through the decline in output and investment associated with heightened uncertainty, higher risk premia (Pindyck, 1991; Pindyk and Solimano, 1993), and tighter lending standards (Hall, 2009). Hysteresis effects related to the loss of attractiveness of the unemployed can also lead to an increase in long-term and structural unemployment (Ball, 2009). More vulnerable groups such as the youth and women with limited professional experience also become increasingly at risk, with their participation rate typically declining (Duval et al., 2011).[1]

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[1] For recent work on the real effect of banking crises see Fallon and Lucas (2002), Kroszner et al. (2007), Dell'Ariccia et al. (2008), Laeven and Valencia (2010, 2013), Furceri and Zdzienicka (2012a,b), Furceri and Mourougane (2012a).

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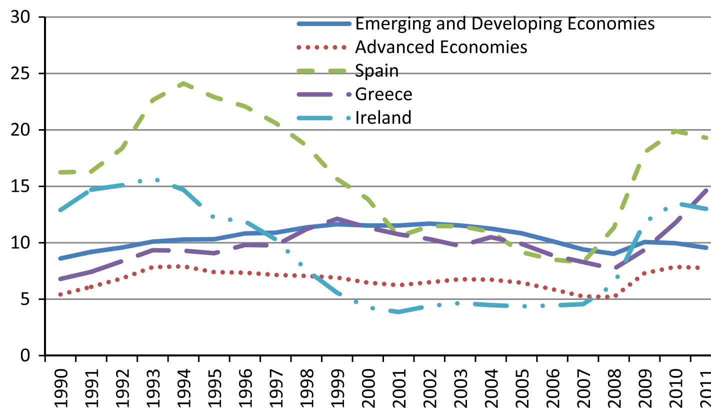

Fig. 1. Unemployment (1990–2010).

Recent studies in the literature suggest that, relative to other recessions, financial crises tend to have more detrimental effects on the labor market. For example, Calvo et al. (2012) find that compared to other recessions, banking crises hit the labor market by enhancing the degree of joblessness recoveries. Their paper also shows that this outcome is consistent with a simple model in which collateral requirements are higher the larger the share of labor force involved in the contract. Similarly, Boeri et al. (2012) find that financial recessions amplify labor market volatility and the Okun's elasticity over the business cycle. They argue that the peculiar labor market effect of financial crises can be explained by the fact that, in periods of financial distress, leveraged firms may find themselves in a position in which their liquidity is suddenly called back by the lender. This affects firms' ability to manage current jobs and may lead to the decision of shutting down part of their operations while destroying existing jobs.

This paper systematically measures the impact of banking crises on overall, long-term, and youth unemployment in 97 countries. While the graph in Fig. 1 is suggestive, we formally analyze the magnitude and persistence of the increase in unemployment resulting from banking crises, and we also compare it with other recessions. We also examine the extent to which the labor institutional and regulatory framework modulates the response of unemployment to banking crises. Following the work of Blanchard and Wolfers (2000), Nickell et al. (2005), and Bassanini and Duval (2009) on the role of institutions in explaining the unemployment response to macroeconomic or unobserved shocks, we look at the direct effect of labor market institutions on unemployment, as well as how the impact of crises varies depending on labor market institutions. We find that the flexibility of labor markets directly affects not only the magnitude but also the persistence of the impact of banking crises on unemployment.

We further test the impact of labor market institutions on unemployment by estimating the impact of both large-scale and gradual labor market reforms on unemployment. The endogeneity of labor market reforms is a potentially important issue in estimating their impact on unemployment. We attempt to address this issue by using a couple of methods, which uncover some interesting facts. In particular, we find that reforms are less likely to be adopted in more centralized political regimes, as well as in those whose chief executive's party has been in office for a long time. Overall, we find that large and comprehensive labor market reforms tend to reduce unemployment in the same magnitude that banking crises increased it, albeit only after several years.

2. Data and descriptive statistics

Our data set covers a panel of 97 countries from 1980 to 2008. Data for labor market flexibility are taken from the Fraser Institute's Economic Freedom of the World (EFW) database (Gwartney and lawson (2010)), which provides a composite measure of labor market flexibility and indicators of labor market flexibility on six policy areas: (i) minimum wage (M), (ii) hiring and firing regulation (H), (iii) centralized collective wage bargaining (C), (iv) mandated cost of hiring (MCH), (v) mandated cost of work dismissal (MCW), and (vi) conscription (CO). All indicators are standardized on a 0–10 scale, with higher values of indicating a more flexible labor market.

The sources of the data for the other variables used in the empirical analysis are the IMF's *World Economic Outlook* (WEO), the World Bank's *World Development Indicators* (WDI), the Penn World Table version 7.0 by Heston et al. (2001), the database constructed by Laeven and Valencia (2010) on banking crisis occurrences, and the database on political institutions by Keefer (2010). The full list of variables, definitions, and sources is provided in the Annex.

Table 1 presents descriptive statistics for the labor market flexibility indicators and the unemployment outcomes analyzed in the paper. For the composite labor market flexibility indicator we have a total of 1214 observations, ranging from a minimum of 1.8 to a maximum of 9.5. Among the unemployment outcomes, we can notice that unemployment is mostly concentrated among young people (aged between 15 and 24). Table 2 shows that the correlation between unemployment

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