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Employment and Firm Heterogeneity, Capital Allocation, and Countercyclical Labor Market Policies*

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Abstract

Developing and emerging economies have large employment shares in micro and small firms, which are characterized by limited access to formal financing and high reliance on input credit. These economies implemented a host of countercyclical labor market policies amid the Global Financial Crisis (GFC), but labor market data limitations prevent detailed empirical assessments of the effectiveness of these policies. We develop a business cycle model with frictional labor markets consistent with the employment and firm structure of these economies and assess the aggregate impact of key countercyclical labor market policies implemented amid the GFC. Improving job intermediation for large firms is particularly effective in aiding recoveries. Policies targeting smaller firms yield limited aggregate benefits. Differences in labor productivity and sectoral contribution to employment and output across firm categories are key in explaining the response to policy.

JEL Classification: E24, E32, J64

Keywords: Business cycles, search frictions, fiscal policy, self-employment, small firms, input credit.

*The views expressed in this paper are those of the authors and do not necessarily reflect the views of the Board of Governors of the Federal Reserve System or of any other person associated with the Federal Reserve System.

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