General Discussion*

In her response to Scott Hendry, Michelle Alexopoulos explained that many of his concerns had already been dealt with in a sensitivity analysis that had not been discussed in the paper. Addressing other issues raised by Hendry, Alexopoulos said that she prefers the partial over the full income insurance model, because it overstates the variation in unemployment. This is beneficial, since it captures several dynamics not accounted for in her model, such as adjustment costs in employment. She also commented that using indivisible labour would not change her results.

Referring to the author's model, Allen Head noted that the ability to punish workers strengthens during a boom, but this ability weakens in a search model. He then asked what is observed in actual micro labour market data. Alexopoulos confirmed that the data support her efficiency wage model.

Nicholas Rowe acknowledged that the model accounts for what is observed in short-run time series data. He added, however, that in long-run time series data and cross-country data, there is very little variation in the natural rates of employment, and the majority of the variation is observed in wages. Rowe asked whether her efficiency wage model accounts for this long-run phenomenon. Alexopoulos explained that the family structure in her model allows for growth and, consequently, the long-run predictions result in a natural rate of stable employment. Martin Eichenbaum joined the discussion by adding that since Alexopoulos is using a balanced-growth model, the wage rate is growing in the steady state and employment is not. He noted that in this model, monetary policy is represented by a Taylor rule and not by assuming a money-growth policy.

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Since the often-favoured sticky-price model provides better long-term predictions, Frank Smets questioned Alexopoulos's choice of the efficiency wage model. By changing the timing slightly, Alexopoulos explained, her model could obtain optimal nominal-wage rigidity, which would provide the same results as those derived using the other model.

James Nason wondered whether Alexopoulos had considered the case where the constant elasticity of substitution moved below one and noted that the cost of adjustment might appear different. He also asked whether she had contemplated incorporating habit formation into her model. Alexopoulos had not previously considered these suggestions and made note of them.