Adjustment to trade liberalization is associated with substantial reallocation of labor across firms within sectors. This salient feature of the data is well captured by models of international trade with heterogeneous firms. In this paper we reconsider the adjustment of firms and workers to changes in trade costs, explicitly accounting for labor market frictions and the entire adjustment path from an initial to a final steady-state. The transitional dynamics that emerge in this framework exhibit rich patterns, varying across firms that differ in productivity levels and across workers who are attached to these firms. Sunk costs of hiring slow down the adjustment process. High-productivity exporters expand employment on impact. Among lower productivity firms some close shop on impact, others fire on impact some workers and exit at a later date, and still other firms gradually reduce their labor force. In these circumstances jobs that pay similar wages ex ante are not equally desirable ex post, because after the trade shock high-productivity incumbents pay higher wages and provide more job security than low-productivity incumbents. After calibrating the model to match some key moments in the data, we provide a quantitative assessment of the various channels of adjustment. A main finding is that the gains from trade due to the decline in the price index of differentiated products overwhelm the losses that result from wage cuts, employment losses, and capital losses on incumbent firms.

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Abstract