Financial frictions and wages[†]

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Very preliminary and incomplete. Please do not circulate.

Abstract

This paper analyzes the interaction between financial frictions and wages. We use a large data set for Germany for 2006 to 2014 that combines administrative data on workers and wages with detailed information on firms' balance sheets. Controlling for firm characteristics and time fixed effects, we find that higher leverage (as a measure for financial frictions) implies on average lower wages. We build a theoretical model with labor market frictions and monitoring costs in the financial market. We show that wages react differently to financial frictions depending on whether and how they affect the relative costs of wages and hiring and the surplus of the job. We further show how employment volatility depends on these different mechanisms and document how higher employment volatility can be related to less rather than more rigid wages. Our empirical results then identify these different mechanisms in the data.

Keywords: financial frictions, wages, search and matching, unemployment

JEL-Codes: E32, E44, J63, J64

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