

# DISSERTATION PROPOSAL

## **The Effects of Contracting and Labor Search on Risks in Financial Markets**

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Tuesday, October 7<sup>th</sup>, 2014

1:30 pm

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My research is to understand how frictions such as contracting and labor search affect market outcomes in financial markets including systemic risk and asset prices.

Acquisitions of distressed firms by healthy firms are a prevailing policy approach to improve financial stability. The first essay characterizes conditions when these acquisitions are ineffective in reducing systemic risk. I develop a model in which financial firms face costly liquidation risks and strategically trade portfolios via bilateral contracts, thereby forming links. Specifically, an acquisition link that connects a liquid and a distressed firm can be socially costly because it increases system-wide liquidation risk. The model reveals that, when banks display high dispersion in financial distress, the equilibrium network features too many acquisition links and too few risk sharing links. This inefficiency results from an externality due to contract incompleteness in the bilateral trades. To forecast the level of this inefficiency and the implied systemic risk, I construct a novel indicator using the distress dispersion across financial firms. A tax based on the distress dispersion can prevent excess acquisitions and hence may improve financial stability.

The second essay studies asset prices in a two-agent production economy in which the worker has private information on her labor productivity. The shareholder offers a long-term labor contract that is incentive compatible, which partially insures the worker against the labor income risk. Compared to settings with competitive labor market and static labor contracts, my model matches both asset returns data and business-cycle features, which include a countercyclical and high equity premium, a low risk-free rate, procyclical labor input, and countercyclical labor share. The results highlight that the dynamic contracting feature in labor relations is relevant to asset prices.

In the third essay (with Lars-Alexander Kuehn and Mikhail Simutin), we show that labor search frictions are an important determinant of the cross-section of equity returns. Empirically, we find that firms with low loadings on labor market tightness outperform firms with high loadings by 6% annually. We propose a partial equilibrium labor market model in which heterogeneous firms make dynamic employment decisions under labor search frictions. In the model, loadings on labor market tightness proxy for priced time variation in the efficiency of the aggregate matching technology. Firms with low loadings are more exposed to adverse matching efficiency shocks and require higher expected stock returns.