

Blanchard and Wage Rigidity, Part I

Author : James Annable

Date : Jan 8, 2016

The most recent *Handbooks* of Macroeconomics and Monetary Economics, tasked to review the state of the art in each field, pay almost no attention to wage rigidity. The subject index of the former (at 1,745 pages) mentions fixed or rigid wages only once each. The index of the latter (1,520 pages) cites sticky wages twice, a sharp contrast with the 45 cites for sticky product prices. As the *Handbooks* indicate, wage rigidity and its repercussions are broadly ignored by mainstream macro theorists.

There are, of course, exceptions. A few New Keynesians (NK) carry on the Early Keynesian (EK) tradition of relying on meaningful wage rigidity (MWR) to repeal both Keynes's Second Classical Postulate and Say's Law, reversing neoclassical real-nominal causation to capture the evident capacity of nominal demand disturbances to induce same-direction movement in employment and output. Not sweeping wage rigidity under the rug is a big deal. MWR suppresses rational wage recontracting, a necessary condition for microfounded involuntary job loss. (Chapter 1) Only theories that feature rational labor-price rigidity can be both stabilization-policy relevant and acceptable under mainstream rules of engagement requiring micro-macro coherence.

Olivier Blanchard is among the most prominent of the dwindling subset of NK theorists seriously concerned with wages and involuntary job loss. This blog looks at his thinking on labor pricing, drawing from his 2010 *AJE:M* article (with Jordi Gali), "Labor Markets and Monetary Policy: A New Keynesian Model with Unemployment," and his 2009 textbook, *Macroeconomics*. He believes two model classes are capable of introducing useful wage rigidity into coherent market-centric macro modeling: bargaining theory (BT) and efficiency-wage theory (EWT). His take on EWT will be considered next week.

Bargaining theory. In his textbook, Blanchard narrowly defines bargaining power in terms of marketplace exchange, a common model-building misstep from which he cannot recover: "How much bargaining power a worker has depends on two factors. The first is how costly it would be for the firm to replace him, were he to leave the firm. The second is how hard it would be for him to find another job, were he to leave the firm. The more costly it is for the firm to replace the worker, and the easier it is for him to find another job, the more bargaining power he will have." (p.143)

The mechanics of his market-centric BT are elaborated upon in the 2010 *AEJ:M* article. The argument begins by positing labor-search imperfections that are rooted in job-applicant and job-vacancy idiosyncrasies. "As is well understood, frictions create a wage band, within which any real wage is consistent with private efficiency.... As emphasized by Hall (2005), the presence of a surplus associated with existing relations implies that many wages may be consistent with equilibrium. More specifically, existing employment relationships will be privately efficient so long as they generate a positive surplus to both parties involved." (pp.2-11)

Blanchard assumes a band of indeterminacy around the optimizing real wage, assumes that the band is significantly sized, and assumes how the indeterminacy is resolved. That's a lot of positing that produces a lot of problems. Practitioners, for example, would object to the inadequately motivated priors on matching applicants to routinized jobs, noting that the wage-indeterminacy band is in fact sufficiently small to make the effect on wage-setting for most hires trivial. They also note that wages for most entry jobs are posted, not bargained. Another class of objections, coming from mainstream theorists, are methodological and center on Blanchard's heavy reliance on free parameters that differs little from the discredited EK practice of simply (and incoherently) assuming wage rigidity.

Nominal MWR absent free parameters is, however, beyond the reach of Blanchard's "more realistic labor market". In his bargaining theory, nominal rigidities are not supplied by wages but instead by staggered product pricing. The latter is organized by the ubiquitous Calvo framework (1983). Setting aside the problematic claims for Calvo-model rationality, Blanchard ignores, or (less likely) is unaware, that product-price rigidities cannot suppress wage recontracting and therefore cannot support endogenous involuntary job loss. It is disappointing that Blanchard's foray into labor and product-price rigidities comes to very little. The resulting macro model cannot be both coherent and stabilization relevant.

Assessment. Had Blanchard been open to the generalization of rational exchange from the marketplace to the workplace, his work on wage rigidity could have mattered. As it stands, he is mired in the EK practice of critically relying on free parameters, partly to resolve labor-pricing indeterminacy and partly to justify

involuntary unemployment. His model is not acceptable in a macro mainstream governed by the Woodford (2009, p.270) rule: "What is important is having general-equilibrium models in the broad sense of requiring that all equations of the model be derived from mutually consistent foundations, and that the specified behavior of each make sense given the environment created by the behavior of the others."

Most critically, Blanchard's wage-rigidity class has little stabilization significance. Think about it. His bargained wage is downward flexible. Blanchard's BT cannot rationally suppress wage recontracting in the rational circumstances of worker choice between job loss or nominal wage cuts that do not violate opportunity costs. His "more realistic labor market" has returned to wage cuts, not layoffs, being the rational response in recession.

Pulling it all together, Blanchard's BT cannot support macro theory that is simultaneously coherent and stabilization-relevant. His fatal mistake is insisting on market centricity in his model-building. He is aware of modern work on the generalization of rational exchange from the marketplace to the large-establishment workplace but has yet to grasp the necessity of the innovation. When he does, his work will become important.

Blog Type: [New Keynesian Chicago, Illinois](#)