Generalized Exchange Theory

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This blog briefly summarizes the GEM Project. I feel good – downright cheerful – about the purpose and prospects for the endeavor. It is a pleasure to do coherent macroeconomics with powerful wage rigidities at your beck and call. Macro modeling can be done the way it was meant to be done.

That said, my immediate task is frankly a wonkish overview of generalized-exchange theory. Wonkishness probably comes with the territory in a weekly discourse on replacing mainstream macro thinking with an upstart coherent model that is uniquely consistent with the critical evidence.

Generalizing optimizing price-mediated exchange from the marketplace to the workplace microfounds a two-venue general-equilibrium (TVGE) macro model class. It features a distinctive approach to aggregate supply that captures consequential, typically ignored aspects of the modern production landscape. The GEM Project identifies the crucial misstep in the rigorous development of useful macro theory to be the assumption of a single representative firm, not of homogeneous households. Bifurcation of profit-seeking firms by size accommodates essential heterogeneity rooted in production specialization, the nature of workplace information, and routinized jobs. In the aftermath of the Second Industrial Revolution, preservation of organization diversity turns out to be a necessary condition for macro theory that is simultaneously coherent and stabilization-policy relevant. (Chapter 1)

In the introductory TVGE theory, labor is point-of-hire homogeneous; well-known Harris-Todaro transfer rationally governs inter-venue worker flows. Labor pricing for the large-establishment venue (LEV) is optimally relocated from the marketplace to the workplace, where profit-seeking firms construct their own exchange mechanisms that enable payment of the unit-cost-minimizing wage (W^n_J). In the theory's central derivation, self-interested workplace exchange microfounds meaningful wage rigidity (MWR) that is characterized by both nominal downward inflexibility over the business cycle and chronic labor rents. (Chapters 2, 3) Meanwhile, small-establishment-venue (SEV) firms, much less complex, can do no better than paying workers their opportunity cost, i.e., the market wage.

Macrodynamic modeling is crucially enriched by the microfounded MWR, which suppresses wage recontracting, uniquely motivates correspondingly-sized involuntary job (and income) loss in response to adverse nominal-demand disturbances, and pushes a large number of workers off their market-supply schedule. In LEV analysis, Keynes's Second Classical Postulate and Wicksell-Wicksteed income distribution must both be scrapped. The Project reconstructs labor supply on technological constraints inherent to large firms, the ubiquitous "new corporate forms" that enabled the Second Industrial Revolution. (Chapters 1, 8) Income and wealth are shown to be the primary determinants of consumption, while profit expectations exert the dominant influence on investment. Interest rates, so central in market-centric general-equilibrium thinking, are reduced to a secondary role in each spending category. (Chapters 3, 6) Adverse stationary and nonstationary demand disturbances induce two classes of continuous-equilibrium forced job loss. The former generates temporary lay-offs; the latter, permanent employment downsizing, eventually accompanied by wage givebacks. Recognizable unemployment follows a continuous decision-rule-equilibrium macrodynamic path. Deriving such important characteristics from axiomatic model primitives is clearly a substantial achievement. (Chapter 3) But there is more.

Point-of-hire homogeneous labor is employed in rent-paying (and therefore rationed) LEV jobs or market-wage (and thereby readily available) SEV jobs, involuntarily or voluntarily unemployed, or voluntarily out of the labor force. Voluntary job quits are procyclical and play little role in the stabilization narrative; job-matching efficiency in the hiring process also does not much matter. Both phenomena are happily freed from their unsuitable starring roles in the coherent market-centric modeling of employment fluctuations by mainstream theorists. (Chapter 5)

The GEM Project identifies, and provides solutions to, a range of problems that have long plagued consensus theorists. In a challenging difficulty, only weak nominal rigidities, e.g., menu-cost product pricing, have any hope of passing the central gatekeeping test of model coherence. Today's mainstream has no room for meaningful wage rigidity, involuntary job loss (neither layoffs nor job downsizing), recognizably-sized responses of output and jobs to nominal-demand disturbances, or recognizably-sized fluctuations in corporate profits. Profit expectations, despite being broadly understood by practitioners to be more significant than interest rates

in investment decision-making, must be severely downplayed in consensus thinking. Catch-up to past inflation, broadly understood by practitioners to be more significant than inflation expectations in the periodic adjustment of LEV wages, is also ignored, as is the obvious, consequential split between (rationed) good jobs and (plentiful) bad jobs. The generalization of exchange turns out to be an intuitive model-building innovation that solves an extraordinary range of problems that has damaged mainstream theory for more than a century. There is good reason to be cheerful.

Putting the pieces together, the GEM model class produces labor rents and job rationing that powerfully constrain optimization in the marketplace, reconciling continuous decision-rule equilibrium and supply-demand disequilibrium. (Chapters 5, 6) In the theory's simplest version, all rational exchange other than between LEV employers and employees occurs in the marketplace and is almost wholly governed by familiar textbook analysis. The analytic jump to two-venue modeling is not particularly difficult. But the fundamental message is definitive. Macroeconomics that is both coherent and stabilization-relevant is not feasible absent the continuous-equilibrium MWR channel and, consequently, the generalization of price-mediated exchange. Let's get on with it. It's new, it's powerful, it will be fun.

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