GOBBLEDYGOOK

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My choice for this morning's beach reading (with coffee) was William Fellner's 1976 essay, "Theoretical Foundations of the Failure of Demand-Management Policies" in the *Journal of Economic Literature.* I hoped that Fellner would provide some respite from consistently discouraging mainstream New Keynesians. He did, although I thought mostly about the unhappy need to go back decades to read serious analysis of the proper role of demand management in macroeconomics. How can it be that such an important subject is today largely ignored? The 2016 *Handbook of Macroeconomics* illustratively makes no mention of aggregate nominal demand in its survey of the modern literature on descriptive modeling. It is, of course, too significant in actual behavior to be ignored in empirical modeling.

I remember rarely agreeing with Fellner, a long-time Professor at Yale who died in 1983, on macro policy. But I also remember that he was a serious, interesting economist. That seriousness is reflected in his beginning the foundations essay with the twinned topics of involuntary unemployment and meaningful wage rigidity. The first is because the amelioration of significant involuntary joblessness was the primary objective of demand management for Keynes and the Early Keynesians; the second because wage rigidity's suppression of wage recontracting is a necessary condition for the existence of forced layoffs.

<u>Conclusions from Market-Centric Modeling</u>

It helps when considering the fundamental debates between Early Keynesians and their skeptics, initially monetarists and subsequently new classical, real-business-cycle, and New Keynesian theorists, to recall an important fact. All the combatants in the famous macro wars relied on the same market-centric general equilibrium model class. The shared analytic framework is why, beginning with Keynes's *General Theory* and running through modern macro theory, the treatment of involuntary unemployment and downward wage rigidity has bordered on gobbledygook.

Fellner summarized the relevant parts of the *General Theory*: "Keynes's distinction between involuntary and voluntary unemployment is basic to the analytic structure he built because it is the involuntary component that was to be reduced or eliminated by expansionary demand policies. He defined involuntary unemployment as the unemployment of workers who would accept work at lower real wage rates if the lowering were brought about by an increase in the price level, even if they would not accept a reduction of money wage rates." That accurately captures Keynes's argument. Upon first encountering the convoluted analysis, I remember thinking that if such reasoning is foundational to Keynesian macroeconomics there must be something deeply flawed about Keynesian macroeconomics.

Fellner further drew upon James Tobin, another Yale economist but one with whom I usually agreed, to make much the same foundational case: "Tobin [1972], setting for himself the task of placing Keynes's conception into the context of economic growth, suggesting a reformulation of the criterion of involuntariness. In Tobin's analysis the criterion of being involuntarily unemployed changes from a willingness to accept real-wage reduction in response to rising prices to a willingness to accept in response to rising prices a temporary shortfall of real-wage rates in relation to the normal trend, and this without subsequent 'making up'. Moreover, Tobin made the willingness to accept such real-wage moderation a definitional requirement of involuntariness only if productivity growth was slackening relative to its trend while the additional employment was occurring, that is, only if real-wage moderation was needed in this sense." At this point, I looked up the definition of gobbledygook.

After his framework for understanding demand management is set up, my interest in Fellner waned. His suggestions for improved theoretical foundations for the analysis of the crucial topic are the familiar, tired conclusions of market-centric, general-equilibrium thinking, the framework which Fellner admitted at the beginning of his essay is simply "taken for granted". Those "improvements" feature the preeminence policymakers should assign to the objective of low and stable inflation, the critical role of expected versus unexpected inflation in stationary business-cycle dynamics, and asserting the one-off idiosyncratic nature of the 1930s Great Depression.

It is, however, refreshing that he actually describes how market-centricity confines labor action to workers accepting or rejecting wage offers from firms. Nearly a hundred years into the Second Industrial Revolution, Fellner appears utterly innocent of how labor pricing is rationally done in large, highly specialized workplaces restricted by costly, asymmetric employer-employee information. He apparently did not know what rational workers know; they will accept a wage cut in lieu of losing their jobs unless the reduction violates opportunity costs. Given that it is well known that most forced layoffs in recessions occur in information-constrained workplaces, Fellner's innocence – and, more consequently, the deliberate version practiced by the modern New Keynesian mainstream – is unforgivable.

Conclusions from the GEM Project

The GEM Project recognizes that, after the advent of large, highly specialized firms that account for a substantial share of total output and employment and almost all of the involuntary job loss in cyclical contractions, relevant labor activity must not be confined to workers accepting or rejecting wage offers in the marketplace. Macro theorists taking that market-centric path can never explain the most crucial instability evidence; their macroeconomics can never be stabilization-relevant.

Once optimizing exchange is generalized from the marketplace to the information-challenged workplace, meaningful wage rigidity can be rooted in dynamic general decision-rule equilibrium; and the causality from nominal demand to involuntary job loss and evidence-sized movements in employment, output, and income is microfounded. The rest of the baseline macro-analytics are straightforward, firmly entrenching the importance of demand-management policy guided by *both* real (employment/output) and nominal (price-inflation) objectives. There is thankfully no need for labor-pricing gobbledygook.

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