Job Loss in Mainstream Macro Modeling, Part II

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Two weeks ago, the GEM Blog advised macro theorists, wishing to solve longstanding job-loss puzzles and satisfy their desire for stabilization-policy relevancy, to abandon Ptolemaic tinkering with endogenous market frictions. They must instead turn their attention to solving the fundamental problem of how to rationally model labor pricing that is capable of both suppressing recontracting and generating chronic wage rents. While economists have been reluctant to confront that analytic challenge, the problem is not insoluble. Moreover, resolution does not require abandonment of the powerful formal economic method organized around optimization and equilibrium but does require rethinking market centricity, which has long been the third tenet of consensus macroeconomics.

A useful guideline for that reassessment is the GEM Project's *two-venue theorem*: "The coexistence of continuous, optimizing economic equilibrium, providing analytic coherence, and wage market-rigidities, sufficient to support involuntary job loss, implies the existence of a dominant non-market equilibrium governing labor pricing."

Venues of economic exchange are defined by heterogeneity in optimizing decision rules, constraints, and mechanisms of exchange that implies boundaries of meaningful aggregation. The hard fact is that single-venue (marketplace) optimizing exchange cannot adequately microfound policy-relevant macro theory. Even prior to the progress in breaking away from market-centric analysis made in the GEM Project, that argument rang true. Forced layoffs imply the existence of wage rents, which in turn imply employment rationing, the suppression of work-leisure substitution, and spillover effects that disturb other markets. Such a macro environment is clearly more Keynesian than Walrasian.

The intuitive venue for the nonmarket class of equilibrium has always been the large, specialized workplace. Managers in large bureaucratic firms are broadly understood, outside university economics departments, to pay close attention to non-market factors in their wage policy-making. Employers learned early in the past century that, in circumstances of imperfect contracting and supervision, labor prices embody information that influences workplace, distinct from marketplace, incentives. The employee-management knowledge accumulated since Frederick Taylor's (1911) time-and-motion studies and the famous 1927-32 Hawthorne experiments indicates that the policy usefulness of the market-restricted macro model class, notably including Real-Business-Cycle (RBC) and New Keynesian analyses, is badly truncated. The effectiveness of modern macro theorists has been greatly damaged by their collective hubris, i.e., a belief that they could adequately model labor pricing and use while being largely innocent of the huge best-practices literature on modern workplace behavior and practices.

Innocence is also illustrated by mainstream theorists attempt to explain employment fluctuations as the result of fundamental shifts in technology or convenient changes in preferences about the consumption-leisure tradeoff. Exchange generalization easily incorporates what is useful in the textbook neoclassical model by providing a additional critical constraint on market exchange, i.e., rational, continuous-equilibrium labor pricing in the large-establishment workplace venue that dominates wage determination in marketplace venue.

A decade ago a prominent New Keynesian, Olivier Blanchard (2007), broke ranks by accurately assessing the dismal state of modern wage theory and thereby informing a superior research program to make mainstream macro theory more policy-relevant. He identifies three significant strands of research: search/matching models, efficiency wages, and collective bargaining. He observes that substantial progress has been made on the search/matching approach, while efficiency wages and collective bargaining have remained dormant. From Blanchard (p. 414): "… [the search/matching] line of modeling will not be able to do the job by itself, and the two other lines…, namely collective bargaining and efficiency wages, are very relevant. First, collective bargaining remains, at least in continental Europe, essential to wage determination and, I believe, essential to an understanding of differences in unemployment evolutions across European countries. Second, the formalization of bargaining in the standard DMP [Diamond-Mortensen-Pissarides search/match] model through Nash bargaining, while elegant and powerful, is a very poor description of reality. As a number of researchers have pointed out, real wages appear to move much less than is implied by Nash bargaining. Constraints coming from intra-firm efficiency-wage considerations look like plausible candidates to explain these wage rigidities."

Once properly informed by the GEM Project, efficiency-wage theory provides Blanchard's constraints by extending the formal economic method of optimizing, price-mediated exchange from the marketplace to the workplace, generating distinct venues of decision rules, constraints, and mechanisms of exchange. The existence and nature of derived rest points in the space of rational workplace decision rules, subject to costly, asymmetric intra-firm information and routinized jobs, solves the policy-relevancy conundrum implicit in the two-venue theorem. The coexistence of economic equilibrium (a condition of rigorous macro theory) and wage market-rigidities (sufficient to support involuntary job loss) is shown to require the existence of a dominant nonmarket equilibrium governing wages. Workplace labor pricing then constrains marketplace decision-rule optimization, and the two-venue macroeconomics usefully models the interaction of the inconsistent sectoral labor prices. Putting it all together, the GEM Project's intuitive generalization of rational exchange motivates a powerful alternative to mainstream market-centric thinking.

Powerful two-venue microfoundations permit the generalized-exchange model to feature rational wage-rigidities capable of supporting the existence of layoffs and job destruction. The stabilization-policy implications of the one- and two-venue theories also differ. Contractions produced in the former, relying on rational market frictions, are restricted to be exceptionally mild, involving no forced job or income loss. The inherently muted nature of market-centric cycles helps explain the lack of enthusiasm by many modern macro theorists for nominal-spending management and why they were chastised as useless in the 2008-09 Great Recession. By contrast, the full-bodied cycles accommodated in the GEM Project, reflecting its powerful revival of efficiency-wage theory, motivate the criticality of policymaker management of aggregate nominal demand. Macroeconomics becomes simultaneously micro-coherent and stabilization-relevant. That's a good thing.

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