Job Loss in Mainstream Modeling, Part I

Author : James Annable

Date : Jul 6, 2018

Modern macro theory is a quagmire of seemingly insoluble puzzles. A prime example is that the New Neoclassical Synthesis (NNS), the consensus macro framework organized around dynamic market-centric general equilibrium, produces much more mild recessions than is consistent with the cyclical evidence. Related is Robert Shimer's even better-known employment-volatility puzzle: The NNS generates much smaller increases in joblessness in recession than produced by actual downturns. Additional business-cycle characteristics that are out of the analytic grasp of NNS modelers include meaningful wage rigidities, involuntary job and income loss, chronic wage rents that motivate unemployment persistence, macro contractions that result from broad market failure, chronic market inefficiency, money non-neutrality sufficient to justify vigilant discretionary management of total nominal spending, an evidence-consistent trade-off between unemployment and inflation, rational explanation for depression, rational explanation for stagflation, and more. Simply put, the mainstream NNS framework does an embarrassingly shoddy job of explaining policy-relevant features of instability.

This GEM Project selective look at unresolved mainstream puzzles is divided into two parts. This post considers the adverse employment and production fluctuations generated in the market-centric, general-equilibrium model class, demonstrating that they can never qualify as a NBER-sanctioned recession. It also investigates the modern search/matching model class that is almost always attached to NNS analysis in order to provide behavioral content to the neoclassical treatment of labor-market behavior. Next week's post outlines an alternative, more policy-relevant labor-related research program. The alternative explains forced job loss as well as other significant cyclical characteristics while adhering to the consensus economic method of optimizing exchange organized around continuous general equilibrium.

Mainstream job-loss modeling. Mainstream, i.e., New Keynesian, research on downward nominal wage rigidity is fatally focused on identifying one or more market frictions that enable the rational suppression of labor-price recontracting. It has become clear hat the hoped-for super friction does not exist, helping to explain the chronic inability to endow mainstream NNS models with stabilization-policy relevancy. Illustrative is Blanchard and Gali (2010) relatively recent attempt to come up with a plausible super friction.

Blanchard-Gali's fate is sealed with their assignment of the central role to the familiar labor wedge, asserting that market frictions induce a wage band within which any real labor price is consistent with private efficiency: $MRS \leq W \leq MPL$. *MRS* denotes the marginal value of worker time; *W* is the wage paid; *MPL* is labor's marginal product. Blanchard-Gali manufacture a bit of wage indeterminacy by assuming away the bargaining power that informs determinate labor-wedge worker pricing.

Instead, their starring role is given to hiring costs that are increasing in labor-market tightness, which introduces a search/matching type of unemployment into the continuous-equilibrium model. It is their market friction of choice. This version of the labor wedge, however, captures relatively little of what is widely known about labor pricing in the modern NNS model class; and the Blanchard-Gali analysis suffers from inattention to that available knowledge. Most important, they simply ignore that rationally suppressing wage recontracting is a necessary condition of the rational existence involuntarily lost jobs (ILJ), which is known to account for most of the increase in unemployment in recession.

Constructing a mechanism that suppresses labor-price recontracting while preserving the optimizing, continuous-equilibrium economic method has proven to be the most durable problem in macroeconomics. Its resistance to solution eventually led to the expulsion of Early Keynesian thinking (Modigliani, Hicks, Samuelson, Okun, Solow, and many other really good economists) from graduate-school curriculums and cutting-edge journals. In setting aside recontracting problem, Blanchard and Gali follow standard modern model-building practice. The question then becomes why are New Keynesians allowed to get away with chronic malpractice. Setting it aside recontracting does not make its central role in actual behavior disappear. The Blanchard-Gali model cannot accommodate involuntary layoffs and is, therefore, fundamentally misaligned with the true nature of cyclical downturns.

Moreover, as noted, Blanchard-Gali follow standard practice by anchoring their analysis in the baseline Mortensen-Pissarides search/matching framework, which posits an exogenous constant job-separation rate and consequently makes their theory even more inappropriate for the coherent analysis of job loss. (Despite those fundamental limitations, they claim greater labor-market realism as an important model virtue.) Because of their exclusive focus on marketplace decision rules, search/match theorists never come close to providing useful explanations of forced job loss and, more generally, the cyclical behavior of production, employment, and unemployment.

Market-centric microfoundations imply that production fluctuations must be sufficiently small to ensure that they are never associated with forced job loss. Given such undersized output contractions, it is difficult to imagine how discretionary aggregate demand management could improve on market solutions, which is the RBC argument against activist monetary policy. It is interesting that the Blanchard-Gali simulations produce “large and inefficient movements in unemployment” resulting from monetary policy designed to stabilize inflation. They don’t appear to understand that their empirical conclusion cannot coherently follow from their NNS-class model. They remain caught in a familiar puzzle.

Really bad news. The job-loss problem for mainstream macro thinking is more general. The NNS-model class, despite efforts by Blanchard-Gali and other New Keynesians, can never be stabilization-policy relevant. That conclusion follows, to summarize, from the inherent inconsistency between (i) wage recontracting in lieu of being laid-off required by general market equilibrium and (ii) the endogenous involuntary job- and income-loss required by real-world stabilization-policy analysis. The successful New-Classical insurgency taught us that rigorous macro research was badly served by Early-Keynesian satisfaction with the use of free parameters to generate meaningful (i.e., capable of supporting forced job loss) wage rigidities. But New Keynesians do greater damage by refusing to acknowledge that recontracting forces meaningful labor-price rigidities in market-centric microfounded models always to require free parameters.

For reasons of convenience, reluctance to depreciate NNS-specific human capital, difficult-problem avoidance, devotion to incrementalism, or whatever, leading macro theorists continue to assert the dominance of NNS modeling that, absent free parameters, neither usefully supports stabilization policymaking nor recognizes the constructive management of aggregate nominal spending. Would any economist, reasonably informed and in good conscience, claim that the Blanchard-Gali model would have improved the Fed’s understanding and stabilization-management of the severe, not mild, 2007-09 recession that generated nearly six-million job losers?

Blog Type: New Keynesians Saint Joseph, Michigan