

New Keynesian Wage Rigidity

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The most recent *American Journal of Economics: Macroeconomics* arrived in my in-box last week. My interest was piqued by an article on wage rigidity, “Fixed-Wage Contracts and Monetary Non-Neutrality”, by Maria Björklund, Mikael Carlsson and Oskar Nordström Skans (hereafter BCS). Meaningful wage rigidity (MWR), defined by its capacity to rationally suppress wage recontracting, is a tricky subject for *AEJM* editors for at least two reasons. First, they have given up on the Early Keynesian (EK) expectation that MWR will eventually be microfounded in the consensus dynamic stochastic general-market-equilibrium macro model. It has been clear for some time that there is no market friction powerful enough to suppress wage recontracting. Second, and more problematic, they believe that DSGME model class is settled theory and, consequently, any search for MWR microfoundations outside its market-centric confines is a waste of space in their journal.

AEJM editors and other New Keynesian (NK) theorists quietly, and unsurprisingly, readily accept the assumption of wage rigidity; to do otherwise would doom their analysis to stabilization irrelevance. But that acceptance is not the whole story. In a concerted effort to protect the settled status of market-centric general-equilibrium macroeconomics, they reject nonmarket analysis capable of making MWR, with its downward labor-price inflexibility over stationary business cycles and its chronic labor rents, consistent with optimizing employee-employer exchange. As a result, their wage rigidity is always motivated by irrational behavior. That is the GEM Project’s fundamental objection to the nature and objectives of the mainstream macro research agenda. It relies, at its core, on irrational behavior, rejecting the powerful model-building guidance produced by optimization and equilibrium.

The *AEJM* wage-rigidity article illustrates the debilitating problems that result from New Keynesians’ giving up on the EK nonmarket research agenda – in particular, efficiency-wage theory. The authors describe their contribution as follows:

“We study the importance of wage rigidities for the monetary policy transmission mechanism. Using uniquely rich micro data on Swedish wage negotiations, we isolate periods when the labor market is covered by fixed-wage contracts. Importantly, negotiations are coordinated in time but their seasonal patterns are far from deterministic. Using a two-regime VAR model, we document that monetary policy shocks have a larger impact on production during fixed-wage episodes as compared to the average response. The results do not seem to be driven by the periodic structure, nor the seasonality, of the renegotiation episodes. The idea that nominal wage rigidities can give rise to persistent output movements in response to nominal shocks dates at least back to Keynes. It is also well established that wage contracts tend to be signed at coordinated points in time and last for at least a year; see, e.g., Druant et al. (2012) and references therein. But up until relatively recently, nominal wage rigidities have not featured as an element in standard New Keynesian models. Instead, nominal price rigidities were given the key role in connecting the real and the nominal side of the economy.”

The problems cited at the beginning of this post are illustrated by the BCS paper. Most critically, they provide no explanation supporting the rationality of their wage rigidity. Wage contracting exists on a sufficient scale that it is reasonable to suppose that it is indeed consistent with employer-employee mutual benefit, but figuring out how that benefit works would be useful in macro model-building. I am not arguing that the BCS work is wrong. But, since every macroeconomist worth his or her salt knows that the non-neutrality of monetary shocks must be substantially rooted in wage rigidity, the article is neither surprising nor particularly important. Given that research making progress on microfounding MWR would be surprising and important, my argument is that the settled-theory bias against such work must stop.

Readers of this blog are familiar with the *AEJM* editors’ careful inattention to the causes and consequences of meaningful wage rigidity. They must know that their wholesale rejection of the Early Keynesian research agenda has done great damage. A central message of the GEM Project is that, absent MWR, micro-coherent macroeconomics can accommodate neither involuntary job loss nor the evidence-consistent employment and output response to adverse nominal demand disturbances. It came as no surprise that prominent stabilization policymakers bitterly dismissed the practical relevance of mainstream market-centric general-equilibrium thinking when confronted with the 2008-09 Great Recession.

I have made the case before about the fundamental failure of the *AEJM*, which was founded in 2009 and would have been expected to emphasize the analysis of the greatest macro challenge since the 1930s Great Depression. My paper (“Why Has the *AEJM* Failed to Explain the Great Recession?” January 30, 2017) documents the inattention of the journal editors to the perilous extreme instability that occurred in 2008-09 (SSRN, <https://ssrn.com/abstract=2908495>). It explains in detail why the mainstream academy’s journal, largely founded on the profession’s responsibility to analyze and understand macro instability, has devoted such little space to MWR. Moreover, it explains why what has been published focuses on the analysis of voluntary unemployment produced in search/match modeling. The editors surely knew, and did not care, that their choice to push MWR aside substantially compromised the stabilization relevance of the infant journal.

It may be helpful, in closing, to reiterate the fundamental problem. Unlike their EK predecessors, New Keynesians insufficiently appreciate the importance of rational-behavior modeling in providing guidelines for the useful analysis of crucial macro issues. Put more provocatively, they have yet to give the New Neoclassical Synthesis the serious commitment it deserves.

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