The Alarming S/M/B Model, Part II

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In last week's blog, I vented my distress over the claims of stabilization-relevance for the ubiquitous Search/Match/Bargain theory. I pointed out that, as demonstrated in the GEM Project, modern search analysis coherently accommodates neither involuntary job loss (IJL) nor recognizable involuntary unemployment (IU), helping to explain why mainstream S/M/B conclusions are consistently misleading. Despite the drumbeat of claims, gussied-up search theory does not come close to adequately supporting macro policymaking.

This follow-up post poses two questions. First, why do mainstream macro theorists choose stabilization irrelevance? Most demonstrate admirable mastery of neoclassical market analysis and, consequently, must understand that Barro is correct: Robust IJL modeling requires suppression of rational wage recontracting, which in turn requires meaningful wage rigidity (MWR). The best of them must know that MWR is a necessary condition for causality from nominal demand disturbances to recognizable cyclical movements in employment and unemployment. They all know, from hard experience, that continuous-equilibrium MWR has been extraordinarily difficult to model. In large part, the modern breakdown in usable macroeconomics, illustrated by S/M/B prominence in business-cycle analysis, has resulted from the persisting failure to adequately capture the sort of labor pricing practiced in highly specialized economies. But deep frustration with the early Keynesian research agenda has led to a sharp decline in the search for rational explanations for readily apparent nominal wage rigidity.

The first question can be usefully restated. In the absence of microfounded MWR, why don't mainstream macro theorists choose the stabilization relevance available from simply positing their best guess about the nature of downward wage inflexibility? Since before Keynes, macro theorists have chosen between macro-micro coherence and the admittedly compromised stabilization relevance that comes from the use of free parameters rooted in conjecture about the true nature of MWR. (As described in Chapter 4, the early Keynesian design of the sticky-wage assumption was sufficiently off-base to prevent mainstream macro models from anticipating the consequences of the huge 1970s commodity-price terms-of-trade shift against labor, most critically including prolonged stagflation and subsequent job downsizing.) It was never a happy choice. The only lasting solution to recurring macro-methodology wars is to microfound MWR.

Here's what most modern theorists, struggling to make consensus theory stabilization-relevant, either do not understand or refuse to accept: *Insistence upon the nonintuitive convention that rational exchange must be restricted to the marketplace prevents the derivation of continuous-equilibrium MWR and the coherent accommodation of IJL.* Macro thinking confined market-centric modeling is inherently inadequate. In that box, labor-market analysis defaults to S/M/B modeling, producing the huge, frankly embarrassing effort to squeeze some cyclicality out of frictional joblessness. Civilians who inquire about the state of the art in macroeconomics are most interested in the profession's capacity to design policies that will prevent recurrence of the devastating 2008-09 extreme instability. They are befuddled to find the experts busy constructing models that substitute voluntary quits for forced layoffs and that focus on improving the efficiency of matching job applicants with available vacancies. Things get sticky when better-informed non-experts, having read headline BLS evidence, ask whether the problem in recession isn't the absence of job vacancies rather than inadequate hiring procedures.

My second question is more particular but still crucial. Why haven't the debilitating problems associated with the widespread misuse of the S/M/B model class been resolved with the advent of the GEM Project? Once rational exchange is generalized from the marketplace to the large-establishment (LE) workplace, the Project has little difficulty deriving MWR from axiomatic model primitives in the context of continuous general decision-rule equilibrium. Macro theory that is simultaneously coherent and stabilization-relevant is within easy reach of mainstream theorists, once a couple problems are resolved.

Macroeconomists must, of course, learn about the availability of powerful generalized-exchange modeling. That is the central task of the GEM Project and necessarily takes time. A more difficult roadblock is the academy's mainstream gatekeepers who must admit the new approach into active debate and dissemination. That is an inherently large hurdle for any model class that appears non-incremental. I believe, however, that the characterization of generalized-exchange theory as non-incremental is mistaken. The Project's workplace-marketplace synthesis is deeply rooted in rooted in the mainstream literature, especially the work of a once-dominant school of American labor economics. Clark Kerr, John Dunlop, and their many colleagues carefully modeled, from a neoclassical perspective, rational exchange in LE workplaces. (See Chapter 1.) They understood size-separation of firms to be critical, enabling the effective introduction of asymmetric, costly workplace information and routinized jobs into rational-exchange economics. Given the guidance of the close economic modeling of workplace behavior that already exists in the labor literature, mainstream gatekeepers are surely up to the challenge of recognizing the intuitive extension of rational exchange to employee-employer interaction in large firms.

Indeed, given that generalized-exchange modeling delivers the holy grail of macroeconomics, i.e. simultaneous coherence and stabilization-relevance, there is only one hurdle that really matters. The power of the GEM model class necessitates significant depreciation of existing mainstream human capital and, even worse, the implicit repudiation of a large chunk of what leading macro theorists have innovated and taught. Completing the circle, among the most prominent examples of the latter is the extraordinary development of labor-search theory in the ill-conceived effort to expand the reach of frictional unemployment to cyclical behavior. Reputational capital is typically the most intractable barrier in intellectual upheavals, no matter how badly the change is needed. If history is our guide, the bulk of the energy and effort needed to reconstruct mainstream macro theory will come from young macroeconomists less burdened with reputational capital. I invite them to join the GEM project and get on with it.

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