The Curse of Market-Centricity

Author : James Annable

Date : Jul 5, 2019

The GEM Blog's basic argument with mainstream macroeconomists concerns their market-centricity. The case is multidimensional but, at its core, is rooted in three facts. First, if rational-behavior macro theory cannot accommodate involuntary job loss (IJL), it cannot be stabilization-relevant. Forced layoffs are at the heart of any adequate description of dynamic macro instability. Second, meaningful wage rigidity (MWR), defined by its capacity to rationally suppress wage recontracting, does not exist in general market equilibrium. New Keynesian theorists, apparently conceding the point, have stopped looking for a market friction sufficiently powerful to rationally repress wage recontracting. Third, completing the circle, MWR is a necessary condition for the existence of involuntary job loss, particularly including the forced separations that result from weakening nominal demand. The three facts imply that NK market-centric theory is stabilization-irrelevant, a conclusion supported by its sorry performance in the 2008-09 Great Recession.

This post looks more closely at the debilitating damage done to mainstream model-building by its convenient assumption that rational exchange occurs wholly in the marketplace. Any prominent NK theorist could serve as this exercise's straw man. My pick is Michael Woodford (*Interest and Prices* (2003)) because he has been the profession's most influential proponent of the New Neoclassical Synthesis (NNS) that locked the academy into general-market-equilibrium analysis.

Woodford's reworking of Early Keynesian macro theory reflects the regression of mainstream thinking from EK stabilization relevancy. Understanding of that retreat begins with his badly misleading description of the overall analytic timepath of Keynesian thinking. He portrays relatively seamless progress from Keynes's fundamental break with the neoclassical business-cycle literature to the static modeling of the Early Keynesians and finally to the modern NK dynamic analysis of the simultaneous (microfounded) determination of prices, interest rates, employment, and output. The GEM Project, from the perspective of its marketplace-workplace generalization of rational exchange, provides a much more accurate description of the transition from Early to New Keynesianism, featuring two crucial facts omitted by Woodford. First is the EK explicit recognition of their keystone use of irrational downward wage inflexibility. Early theorists understood that MWR uniquely enables recognizable recessions and usefully drew attention to the fact that their macroeconomics was unfinished. MWR microfoundations were at the top of the EK research agenda.

Second, the NK phase of developing Keynesian macroeconomics has been deeply problematic, much more so than Woodford implies. In an important example new classical theorists, as their general-market-equilibrium framework was accepted by New Keynesians, pushed their advantage by insisting on the banishment EK theory from mainstream teaching and publications. The EK crime was harboring labor-pricing irrationality that made their unfinished model stabilization-relevant. The GEM Blog has documented how effective that banishment has been.

Woodford's rosy narrative pushes aside another deeply troubling fact. NK theorists eventually, after their huge investment in search/match modeling in the effort to get voluntary unemployment to behave counter-cyclically crashed and burned, accepted the need to assume some form of downward inflexible wages. The difference with EK theorists is largely that, embarrassed by MWR's incompatibility with general market equilibrium, New Keynesians used their gatekeeping power to divert the academy's attention from how wage rigidity actually occurs. This Blog has documented the remarkable extent to which research on MWR microfoundations has disappeared from mainstream publications. Disappearance is of course not surprising, given the increasingly frequent NK insistence that their market-centric general-equilibrium macroeconomics is settled theory. Contrary to Woodford, the GEM Project argues that the NK phase of the development of Keynesian analysis is best understood as a Ptolemaic regression to stabilization-irrelevance.

Interest and Prices illustrates how marginalizing the keystone EK role of MWR and research on the rational suppression of wage recontracting has damaged the development of useful macroeconomics. Woodford's argument that the NNS crucially and correctly mandated the "redefinition of the scope of Keynesian analysis as relating purely to the period before wages and prices were able to adjust" is especially damaging. Time-separation wage rigidity has turned out to be little more that another market-centricity barrier that helps doom stabilization-relevance in rational-behavior modeling. Such downward wage inflexibility has never been, and never can be, shown to be consistent with self-interested employer-employee labor-price recontracting. Early Keynesians struggled and failed to come up with a plausible transition from the short- to long-run wage determination at the center of their original Neoclassical Synthesis. Directing nominal rigidity analysis to exploration of short-term adjustment lags got mainstream thinking stuck on the irrational Calvo wage, which obviously cannot support recognizable recessions. The GEM Project is constructed on a fact that all Keynesians, except early efficiency-wage theorists, ignore. Progress to stabilization-relevant macro theory requires a non-market venue of rational exchange that enables the construction of enduring MWR. Workplace-centric labor pricing is consistent with both employee-employer optimization and continuous decision-rule equilibrium that easily coexists with market disequilibrium in the short- and long-runs.

Simply recognizing what everybody knows, i.e., that wage determination inside large complex firms differs substantially from pricing labor in the marketplace, permits modeling MWR that is the persisting, rent-paying phenomenon uniquely consistent with the full range of the evidence. Woodford’s commitment to restricting downward wage inflexibility to be a short-run phenomenon is implicated in a pile of consequential missteps that are familiar to readers of the GEM Blog, including:

- Woodford, largely by being imprecise about the boundaries between labor and product pricing, implies menu costs and other rational product-price downward stickiness are sufficient to motivate recognizable recessions. That is not true; it is an artless version of the sleight of hand that NK theorists typically use to obscure their convenient use of irrational-behavior wage rigidity.
- Woodford’s market-centric analysis eliminates pure profit and therefore the fact that expectations of such profit – not interest rates – is the central driver of investment spending. Pure-profit influence becomes almost singular in periods of contracting nominal demand. *Interest and Prices* problematically exaggerates the practical importance of interest rates,
- Woodford is forced into asserting dominance for stabilization authorities’ low-inflation objective. NK theorists are really stuck here. Doesn’t everybody who understands what happened in 2008-09 know that the real-side objective was almost exclusively important? When does stabilization-irrelevance begin to bother NK theorists?
- Woodford must pretend that labor search/match modeling will someday come up with an explanation for involuntary job loss. Market-centricity is thoroughly complicit in the huge waste of resources on the macro modeling of voluntary, instead of involuntary, unemployment.

Replacing market-centricity is hard, largely because of the self-interested devotion to the concept by mainstream theorists. It is in their bones. However, if stabilization-relevance is a fundamental goal, replacement is necessary. Professional integrity mandates that we get on with it.

Blog Type: Wonkish Saint Joseph, Michigan