Unapologetic Market Centricity

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Date : Oct 5, 2018

The GEM Blog argues that mainstream macroeconomics is stabilization-policy irrelevant, providing consistently bad advice to policymakers. Non-economist friends tell me I must be exaggerating. They cannot believe that well-known theorists reject the core message of the GEM Project: the necessary generalization of rational exchange from the marketplace to highly specialized, bureaucratic firms. Given their own experience, they cannot believe that what goes in such organizations, especially the pricing and management of employees, is simply ignored. But it is ignored. What goes on inside firms does not matter to macroeconomists.

Preference for market-centricity. The failure of mainstream modeling to explain the nature and consequences of significant instability is rooted in the profession's insistence that the proper modeling rational exchange must confined to the marketplace. That preference, rooted in the desire to protect existing human and reputational capital, suppresses the sort of wage determination that occurs in numerous workplaces that are restricted by asymmetric employer-employee information. As a result, useful explanation of instability is not possible mainstream macro thinking.

The GEM Blog has hammered away at two facts central to theorists' reliance on market-centricity. The first is a fundamental, albeit ignored, principle of general market equilibrium, the go-to model in the macro academy. In the circumstances of information-challenged workplaces, labor prices cannot be efficiently determined in the labor market. They must instead set inside rationally bureaucratic firms. Second, restrictions on the nominal wage flexibility crucially inform the nominal-real nexus at the heart of macroeconomics. Meaningful wage rigidity, defined by its capacity to rationally suppress wage recontracting, uniquely enables causality from nominal demand disturbances to involuntary job loss and recognizable movement in output, employment, and income. Those two facts are quietly understood in the academy, implying that the damaging truncation of macro modeling to the marketplace is a consensus choice. Mainstream theorists sacrifice stabilization-relevance for no better reason than they *prefer* the ease and self-interest of market centricity.

The following, from an otherwise admirable 1995 textbook by three obviously skilled theorists, Mas-Colell, Whinston, and Green, nicely illustrates my point: “Many aspects enter a full description of a firm: Who owns it? Who manages it? How is it managed? How is it organized? What can it do? Of all these questions, we concentrate on the last one. Our justification is not that the other questions are not interesting (indeed, they are), but that we want to arrive as quickly as possible at a minimal conceptual apparatus that allows us to analyze market behavior. Thus, our model of production possibilities is going to be very parsimonious: The firm is viewed merely as a ‘black box', able to transform inputs into outputs.” One cheer for Mas-Colell *et al,* for being unusually open about their overriding preference for market analysis. It would have been two cheers had they followed their open kimono with a paragraph or two about how that preference damages their ability to explain important economic phenomena and derive policy-relevant conclusions.

Costly preference. After decades of dominating the macro mainstream, New Keynesian theorists are clearly content to set aside the explanation of critical evidence if it requires generalizing rational exchange from the marketplace to the much less comfortable information-challenged workplace. It follows that NK macro theory, as demonstrated in the Great Recession, has becomes stabilization useless.

The unhappy state of affairs is well illustrated by Jordi Galí's recent restatement of the basic market-centric NK model, “The State of New Keynesian Economics: A Partial Assessment” (Summer 2018). The model is organized by general market equilibrium enriched by rational market frictions and is captured in three equations. In the first, *nominal output* at a point in time is determined by expected product-price inflation, the natural rate of interest (the interest rate that would occur if product prices were perfectly flexible), and potential real output (also defined as the hypothetical that would occur if product prices were perfectly flexible). Product prices are prevented from fully adjusting to market conditions by an assumption of a randomly rotating portion of firms being arbitrarily unable to change what they charge for goods and services. Labor prices are assumed to be perfectly flexible.

In the second, *product-price inflation* at the same point in time is determined by expected product-price inflation and the ratio of actual to potential output. In the third, the nominal interest rate is determined by

product-price inflation, actual output relative to its trend, and a monetary-policy shift factor that follows “some stochastic process”.

This is screwed-up model is stabilization-irrelevant in a multitude of ways. This post focuses on the first (nominal output) equation and its assumption of perfectly flexible wages. The biggest difference between this New Keynesian macro model and its Early Keynesian antecedent is the modern version’s absence of meaningful wage rigidity.

The difference is extraordinarily powerful. Here is a short-list of what MWR absence implies about mainstream macroeconomics. Wage recontracting is not rationally suppressed, making labor-pricing fully flexible. Given that rational employees will always accept a wage cut that does not violate their opportunity costs in lieu of losing their job, involuntary job loss cannot exist. Recessions must be small enough not to generate layoffs. Adverse nominal demand disturbances can generate neither involuntary job loss nor recognizable movement in employment and output. Aggregate-demand management no longer much matters to the real-side macro behavior. The proper objectives of stabilization authorities collapse to assuring low, stable product-price inflation. Everything else takes care of itself. Moreover, chronic, time-varying wage rents that are characteristic of an identifiable, substantial share of highly specialized economies must disappear in mainstream macro modeling. The implications of absent rents are powerful, including making the actual persistence of joblessness after being laid-off inexplicable.

Market-centric modeling broadly fails to explain the most important instability evidence. It is stabilization-irrelevant and its policy recommendations a sham. That is the model that dominates the macroeconomics academy. That is the model that the profession expects policymakers to take seriously. That is the model mainstream gatekeepers believe to be settled theory, insisting that research done outside its market-centric boundaries to be a waste of time.

Blog Type: New Keynesians Chicago, Illinois