Useful Advice from Lucas

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The GEM Project has figured out how to reconcile macroeconomic coherence and stabilization-relevance. The key is its microfounding of meaningful wage rigidity, comprised of downward inflexible nominal labor pricing over the business cycle and chronic labor rents. MWR enables causality from adverse nominal demand disturbances to involuntary job loss and joblessness.

Robert Lucas (1981a, p.4) showed the way to GEM theorists when he altered the course of macro thinking, as well as mainstream access to the practical macro core, by working through some implications of rational choice in the labor market. He dismissed Keynesian business cycles and the institutions thought to produce them, arguing that such arrangements must be designed “precisely in order to aid in matching preferences and opportunities.” Inspired by Lucas, the Project forswears free parameters, which arbitrarily restrict rational labor choice and dismayed anti-Keynesian theorists. Price-mediated exchange is now understood to be properly modeled in the workplace as well as the marketplace. Surely no serious scholar objects to removing subjective venue limits on self-interested behavior, especially when the expansion enables more complete analysis of rational employer-employee conduct and workplace mechanisms of optimizing exchange. A rich two-venue general-equilibrium (TVGE) class of institutional arrangements is identified that facilitates the heretofore badly incomplete matching of axiomatic preferences and opportunities. Exchange generalization rationally produces involuntary job- and income-loss in the aftermath of adverse nominal disturbances. That stabilization-critical outcome is not available in the caricature of matched preferences and opportunities featured in single-venue general-equilibrium (SVGE) theory.

The crucial message is that coherent market-centric modeling cannot be stabilization relevant in modern economies. Over the past century, SVGE modeling has increasingly got a great deal of labor-related activities wrong, a persistent error set rooted in the for-convenience suppression of workplace exchange. Labor-related problems have been accumulating and long ago became debilitating, implicated in a large portion of the contemporary predictive and explanatory failures of mainstream macro theory. Textbook aggregate supply, still featuring the universality of Keynes’s Second Classical Postulate, must be recognized as fundamentally misspecified.

Labor matters too much in the full range of economic activities for macro theorists to continue to ignore worker behavior. Yet a willful ignorance continues to be the norm, as little in consensus theory pays attention to what has been learned from a hundred years of investigating what goes on inside the large-establishment workplace. The evidence supports neither technologically fixed OJB nor endowing employees with a dominant preference to shirk. In their indifference to the facts and rejection of proper axioms upon which to build their models, mainstream theorists are not arguing that practitioners, in their unanimity, are wrong. That would be pretty stupid. Instead, most macroeconomists believe, conveniently, that practitioner knowledge is an unnecessary complication to an already robust market-centric theory.

The unnecessary-complication story is the surprising nub of the stabilization-relevance problem that beleaguers mainstream theory today. Incorporating dynamic-equilibrium workplace behavior (no matter how compatible with the evidence) into textbook price-mediated market exchange disturbs the *status quo*. Departing from convention is difficult, no matter how badly the break is needed. It is not 1:1 hours-output mapping or inherent laziness that motivates real-world employment relationships. Macro theorists must think through why large human-resource departments ubiquitously exist. HR specialists design and implement institutional arrangements that govern a significant portion of the alignment of preferences and opportunities in modern economies. Well-read economists must know that their SVGE models badly capture actual “matching preferences and opportunities” but, too frequently, do not care. Or, more generously, theorists are so thoroughly captive within the marketplace boundaries of mainstream thinking that they are simply unable to imagine breaking out.

Whatever its cause, the maintenance of the *status quo* with respect to workplace behavior has had outsized opportunity costs. In an important example, the Fed has never provided useful microfoundations for its aggressive policymaking, which was remarkably successful in taming the total-spending propagation of the 2008-09 financial crisis,. As a result, the central-bank actions have lacked mainstream academic support, especially on the existence of the rational MWR Channel through which nominal demand disturbances uniquely induce involuntary job- and income-loss. A better-informed consensus among macroeconomists would have helped contain the damaging, ill-informed criticism that followed the Fed's virtuoso performance as well as helped foster Congressional and investor/lender belief in the real-side stabilization credibility of the central bank's expanded toolkit. (Chapter 6)

Constructing policy-relevant macro theory, absent meaningful wage rigidities, is like attempting to put a suit on backwards and, once approximating that difficult task, wearing the backward suit out in the world. While the ingenuity and persistence required may in some way be admirable, the result must be understood as a failure to adequately accomplish the task of getting dressed. The failure is not much mitigated by any satisfaction derived from having acquired the relatively unique knowledge on how to put on a suit in such a complicated way.

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