What Bothers Jordi Galí

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When will New Keynesian theorists accept that the intuitive generalization of rational price-mediated exchange from the marketplace to workplaces restricted by asymmetric employee-employer information solves their thorniest problems? The best NK theorists are not innocent of the fundamental EK failure. Illustrative of that awareness is one of the best of the New Keynesians, Jordi Galí. In his 2010 Zeuthen Lectures, he focused on the mainstream market-centric general-equilibrium model's problematic "connection between economic fluctuations and efficiency":

- "The equilibrium allocation in that [New Keynesian] model is generally inefficient as a consequence of several imperfections embedded in it. Thus the market power enjoyed by firms and workers tends to bring about an inefficiently low level of activity, even in the absence of shocks and fluctuations."
- "In addition, the presence of nominal rigidities leads to endogenous variations in price and wage markups and, as a result, changes over time in the 'distance' between the actual equilibrium allocation and its efficient counterpart."
- "Finally, the assumption of staggered price and wage setting leads to a dispersion in prices and wages unwarranted by differences in fundamentals, with a consequent misallocation of resources across firms and workers."

Galí knows that the New Keynesian assumption of arbitrary restrictions on wage recontracting is a slender reeds that cannot effectively reconcile macro fluctuations and rational economic behavior.

Once continuous-equilibrium meaningful wage rigidity, producing rational downward labor-price inflexibility over stationary business cycles as well as chronic, time-varying labor rents, is substituted for empirically and theoretically unsatisfactory NK market imperfections, the embarrassing conflict between economic fluctuations and efficient behavior can be resolved. The key here is that the GEM Project identifies the difference between market and production efficiencies. Long ago, consensus macroeconomics assumed away consequential behavior in firms in order to focus wholly on optimizing exchange in the marketplace. As a result, NK theorists equate market efficiency and economic efficiency, a deeply misleading simplification. The generalized-exchange macro model recognizes that overall efficiency has both allocative and production roots, with the latter often playing the dominant role. Endowed with MWR, macro theory reconciles business cycles with efficient (rational) behavior. It also accommodates a rich variety of market inefficiency, including the greatly damaging market failure produced by contractions in total nominal demand. The Project demonstrates that such failure is a negative meta externality, requiring government remedial interventions in total spending. That identification cannot be made in market-centric general-equilibrium modeling.

Moreover, the GEM model identifies rent-paying jobs, which are shown to be both rational and necessarily rationed, as another important source of market inefficiency. If Galí wants to think of that failure as reflecting market power, he must recognize that it importantly results from optimizing employer-employee price-mediated exchange restricted by costly, asymmetric information and routinized jobs. In this consequential case, productive efficiency trumps market efficiency. It is more useful to understand that GEM market power is largely rooted effective wage cartelization. Industry, rather than firm, product-price elasticity is the operational constraint on the capacity to pass labor-cost increased on to consumers.

Once considered in the context of the two-venue macro model, Galí's three problematic phenomena (chronic wage rents, cyclical downward nominal rigidity, and wage-structure variation) are much more adequately understood. New Keynesianism, enriched with rational workplace exchange practiced in large, specialized establishments all over the world, becomes for the first time stabilization-relevant macroeconomics.

Why not simply designate MWR the missing New Keynesian "super friction" and be done with it? That easy solution is rejected largely because MWR, as derived in the Workplace Market-place Synthesis, is badly misunderstood as a market imperfection. Labor-price rigidity needs to be presented correctly, i.e., as an outcome of rational workplace exchange providing a powerful *constraint* on decision-rule optimization in the marketplace.

Mistaking the nonmarket MWR constraint for a market friction problematically invites mainstream theorists to give in to their model-building preferences and attempt to model labor pricing in large, specialized

establishments within the comfort zone of general market equilibrium. Given that profit-seeking labor pricing subject to asymmetric employee-employer information cannot be measured nor determined in the marketplace, the attempt to construct a market-centric version of MWR will be irreparably flawed. It is instructive to recall what happened to the original workplace-centric efficiency-wage theory that is at the core of the GEM Project analysis. (See Annable 1977, 1980.) Shapiro and Stiglitz (1984), among others, reconfigured the theory to fit within the market-centric framework and, given its greater familiarity, became recognized as the foremost example of efficiency-wage thinking.

Given market-centricity, Shapiro-Stiglitz must confine involuntary job loss to dismissal for cause, features downward flexible nominal wages in recession, provides no practical justification for the discretionary management of aggregate demand, and ultimately assumes all of its interesting results. It other words, it ignores meaningful wage rigidity. (See Chapter 9.) It is a stabilization-irrelevant theory that has little relation to the original efficiency-wage modeling of Solow and Annable. More to the point, it distorts the original message beyond recognition, illustrating the importance of properly identifying MWR as an outcome of rational workplace exchange that consequentially constrains market decision-rule optimization.

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