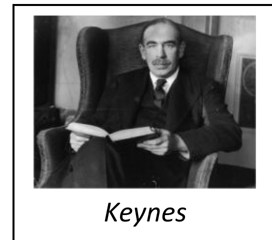
Keynes

Mitchell's Musings 7-22-2013: Keynesian Qualifications

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An interesting article has appeared on the San Francisco Federal Reserve Bank website comparing macro-level nominal wage behavior during and after the Great Recession with wage behavior in prior episodes.[1] The article looks at nominal wage change and finds – as have many others – that during recessions and soft labor markets, downward nominal wage rigidity retards explicit wage cuts that a drop in labor demand might otherwise cause. So the proportion of workers with zero wage increases rises for a time.

Earlier work in this field usually attributed such downward nominal wage rigidity to some combination of money illusion and worker resentment – if wages are cut explicitly – that could undermine morale and productivity. At one time, notably back in the days when John Maynard Keynes was writing, it was common to see the mechanism for such rigidity as related to union contracting and resistance. In modern American circumstances, however, the unionization rate is very low in the private sector so the more behavioral/psychological explanations tend to be favored more recently.

The chart below from the paper illustrates the effect of downward nominal wage rigidity. Each recession shown on the chart caused a rise in the proportion of workers with frozen wages. Then, with a lag, the proportion began to decline. In that respect, the Great Recession of 2008 was consistent with the past. However, as the chart also shows, the freeze effect was more pronounced in the most recent recession so that the percent of workers with zero wage increases became particularly high.

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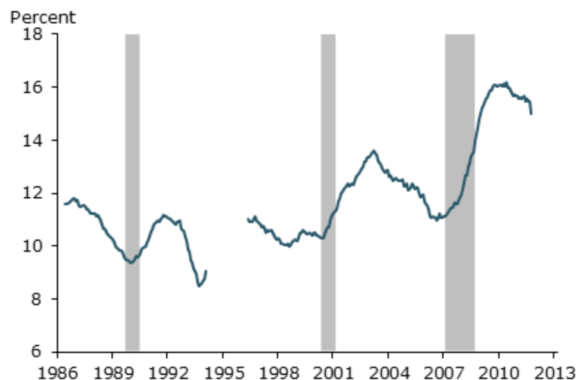
Proportion of Workers Experiencing Zero Wage Increases



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[1] Mary C. Daly, Bart Hobijn, and Timothy Ni, "The Path of Wage Growth and Unemployment," number 2013-20, July 15, 2013: http://www.frbsf.org/economic-research/publications/economic-letter/2013/july/wages-unemployment-rate/. At this writing, one figure in the paper (Figure 1) does not appear properly. Perhaps it will be corrected.

To this point, the analysis has been mainly descriptive – albeit with a rationale for the observed empirical observations – and essentially a micro story based on how workers and employers respond to a recession-related drop in labor demand. There is, however, a macro-level question. Given that many workers who might have experienced wage cuts in a "classical" labor market in fact had their wages in nominal terms frozen, what does that fact tell us about the pace of general labor market and economic recovery? We know that the recovery pace has been slow since 2008-2009. Is there any implication of the high proportion of workers with frozen wages for the speed of recovery? Does the high proportion explain the sluggish pace of recovery?

A quick reading of the paper might suggest that its authors think so, although what they actually think about that question is not clear. They state that *"inflation typically erodes the real wages of workers, relieving some of the pent-up demand of employers for wage cuts. This gradual process can continue long after the unemployment gap begins to narrow. At the same time, slower wage growth also means businesses are able to hire more workers, which stimulates the demand for labor and pushes the unemployment rate down further."* Put another way, if we think of labor demanded at the firm level – the number of workers or worker hours sought by employers – to be based on the real wage, the decline in real wages caused by frozen nominal wages and rising prices eventually cuts into unemployment. That is, the real wage decline shapes the labor-market recovery.

Note that there are at least some loose ends in that story, regardless of how you parse the statement in italics above. One of the major lessons that came out of Keynesian thinking in the period after the Great Depression of the 1930s was recognition that there was something called "macroeconomics" (the phrase didn't exist before) and that simple micro thinking was inadequate. The simple micro reasoning in pre-Keynesian economics was that ultimately the cause of large-scale unemployment was too-high wages, presumably too-high *real* wages, and that therefore cutting nominal wages would reduce overall unemployment. In that view, downward nominal wage rigidity was the problem.

One difficulty with that line of thinking that became apparent with the development of macro thinking was that prices were not independent of wages. At the macro level, if nominal wages generally fell, prices – if you think of them as cost markups over nominal wages – would also fall. So the real wage might end up unchanged if nominal wages and prices both declined. In fact, something along those lines seemed to happen as the U.S. fell into the Great Depression in the early 1930s. Note also that falling wages and prices can produce a rise in real interest rates (since you can always earn at least zero percent nominally just by holding cash). A rise in real interest rates might discourage both investment and consumption, particularly of durables. Thus, deflation of wages could be harmful rather than helpful when viewed from a macro perspective. The macro view produces different conclusions than what might be expected from a simple, static micro analysis.

Thus, if you were to assume that since the recent recession produced a sharp increase in frozen wages, the recession would have been less severe if only nominal wages had fallen, you would be going back to the era of pre-Keynesian thinking. All we know is that there was a large negative shock to the economy in 2008 that caused an unusually high proportion of workers to experience frozen wages. Similarly, it is

not evident that the sluggish pace of employment expansion that has occurred since the Great Recession ended is causally related to the abnormally high fraction of workers with frozen wages (which presumably also are too-high wages as the authors see it).

We know that due to the Great Recession of 2008, the post-recession starting employment level - once recovery got under way - was particularly low and that the post-recession starting unemployment rate was particularly high. It does not follow, however, that the *pace* of employment expansion or the *pace* of unemployment percentage point decline should be any slower than in earlier recoveries from recessions. Obviously, starting with a lower-than-normal employment level and with a higher-than-normal unemployment rate means that it will take longer to reach "full" employment *at any given pace of recovery* than it would with a more advantageous starting point. But the *starting point* is not necessarily causally rated to the subsequent *pace of change*.

Again, it's not clear what the authors of the article cited at the outset think about the pace issue. Thus, this Mitchell's Musing is not a critique of their article. Rather, this Musing should be viewed as taking off from that article and making some additional points. The larger issue he*re* is that when you think about the labor market or the economy at the macro level, there are limits to the simple application of micro modeling and static thinking. Such modeling and thinking can be useful in many contexts. But it is easy to fall into pre-Keynesian thought patterns if you don't keep in mind that macro reasoning is (and must be) different from micro.