## NOT YET USEFUL FOR STABILIZATION-POLICY ANALYSIS

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New Keynesian analysis of wage rigidities is notoriously deficient, helping to explain the chronic inability to endow the mainstream New Neoclassical Synthesis (NNS) with stabilization-policy relevancy. Blanchard and Gali attempt to rectify that problem. Their failure to do so can be traced to the inherent incapacity of NNS-endogenous market frictions to produce wage stickiness sufficient to support involuntary job- and income-loss in the aftermath of adverse shifts in aggregate nominal spending.

Blanchard-Gali assign a central role to the familiar labor wedge, asserting a friction-induced wage band within which any real labor price is consistent with private efficiency: MRS-W-MPL. [MRS denotes the marginal value of worker time; W is the wage paid; MPL is labor's marginal product. Blanchard-Gali wage indeterminacy, after rejecting the familiar Nash approach as counterfactual, requires ignoring the bargaining power that informs determinate Nash labor pricing. Wage indeterminacy assumed in lieu of deriving relative power should not be confused with the existence of wage indeterminacy.] Hiring costs increasing in labor-market tightness, which introduces a type of unemployment into the continuous-equilibrium model, is the friction of choice.

Much is known about the labor wedge and labor pricing in the modern NNS model class that the Blanchard-Gali analysis, to its detriment, ignores. Most importantly, wage market-rigidities that are consistent with general-market-equilibrium (GME) microfoundations are well understood to be unable to support involuntary job loss unless labor-price recontracting in lieu of employment loss is rationally suppressed. [Gains from trade implicit in the offer of wage recontracting in place of job loss are not eliminated by hiring costs or any other GME-consistent friction. See Barro (1979), "Second Thoughts on Keynesian Economics," American Economic Review (May), 69(2), pp. 54-59. Barro has long crusaded against formal economic models that leave dollar bills on the sidewalk.]

Constructing a mechanism that suppresses wage recontracting while preserving the optimizing, continuous-equilibrium economic method has proven to be the most durable problem in macroeconomics. Its resistance to solution eventually led to the expulsion of Early Keynesian thinking (Modigliani, Hicks, Samuelson, Okun, Solow, and many other really good economists) from graduate-school curriculums and cutting-edge journals. Blanchard and Gali follow the standard modern practice of simply setting aside the recontracting problem. However, since setting aside does not make it disappear, their search/marching model is both inconsistent with involuntary layoffs and restricted to exceptionally mild cyclical downturns. [Moreover, Blanchard-Gali's choice to anchor their analysis in the baseline Mortensen-Pissarides search/matching framework, which posits an exogenous constant job-separation rate, makes their theory even more inappropriate for the coherent analysis of job loss. Despite the problematic limitations, they claim greater labor-market realism as an important model virtue.]

GME microfoundations imply that production fluctuations must be sufficiently small to ensure that they are never associated with forced job loss. Given such meek output contractions, it is difficult to imagine how discretionary aggregate demand management could improve on market solutions, which is of course the RBC argument against activist monetary policy. It is interesting that the Blanchard-Gali simulations produce "large and inefficient movements in unemployment" resulting from monetary policy designed to stabilize inflation. That conclusion may or may not be true, but it cannot coherently follow from their NNS-class model, friction-augmented or not. [To be fair, Blanchard-Gali make no effort to calibrate the real-wage rigidity used in their simulations to be consistent with their labor-pricing theory. Also to be fair, the continued use of free parameters by New Keynesians to suppress wage recontracting in lieu of job loss badly blurs any meaningful distinction between them and the discredited Early Keynesians. Ever more ingenious burying of the same free parameters should never be confused with analytical progress and is a dubious strategy for achieving policy relevancy.]

The really bad news for mainstream macro thinking is more general. The NNS-model class, despite heavy lifting by Blanchard-Gali and other New Keynesians, can never be stabilization-policy relevant. That conclusion follows, to summarize, from the inherent inconsistency between (i) wage recontracting in lieu of being laid-off required by general market equilibrium and (ii) the endogenous involuntary job- and income-loss required by real-world stabilization-policy analysis.

The successful New-Classical insurgency taught us that rigorous macro research was badly served by Early-Keynesian satisfaction with the use of free parameters to generate meaningful (i.e., capable of supporting forced job loss) wage rigidities. But New Keynesians do greater damage by refusing to acknowledge that meaningful labor-price rigidities in GME-microfounded models will always require free parameters. For reasons of convenience, reluctance to depreciate market-specific human capital, difficult-problem avoidance, devotion to incrementalism, or whatever, leading macro theorists continue to assert the dominance of NNS modeling that, absent free parameters, neither usefully supports stabilization policymaking nor recognizes as constructive the discretionary management of aggregate nominal spending. [Would any economist, reasonably informed and in good conscience, claim that the Blanchard-Gali model would have improved the Fed’s understanding and stabilization-management of the severe, not mild, 2007-09 recession that generated nearly six-million job losers?]

Macro theorists, wishing to satisfy an urge for stabilization-policy relevancy, need to abandon Ptolemaic tinkering with endogenous market frictions and instead turn their attention to solving the fundamental problem of how to model rational labor pricing that is capable of suppressing Barro recontracting. The problem is not insoluble. Moreover, resolution does not require abandonment of the formal economic method but does require rethinking the New Neoclassical Synthesis. A productive place to begin that reassessment is the careful consideration of the following two-venue theorem:

The coexistence of continuous optimizing general economic equilibrium, provid-ing analytic coherence, and wage market-rigidities, sufficient to support involuntary job loss, implies the existence of a dominant nonmarket equilibrium governing labor pricing.

[Venues of economic exchange are defined by heterogeneities in optimizing decision rules, constraints, and mechanisms of exchange that imply boundaries of meaningful aggregation. It is not surprising that stabilization-policy-relevant macro theory requires careful attention to aggregation. A powerful non-market venue of optimizing exchange, replacing the reliance on labor wedges motivated by market choice, is modeled in Annable (2010), "Efficiency Wages and Policy-Relevant Macroeconomics," WEP Working Papers (Chicago: Workplace Equilibrium Project). Available at SSRN: http://ssrn.com/abstract=1595758.]