Paul Krugman - New York Times Blog

July 22, 2012

Sticky Wages and the Macro Story

A bit more methodology discussion. I’ve written quite a lot about sticky wages, aka downward nominal wage rigidity, which is one of those things that we can’t derive from first principles but is a glaringly obvious feature of the real world. But I keep running into comments along the lines of “Well, if you think sticky wages are the problem, why aren’t you calling for wage cuts?”

This is a category error. It confuses the question “What do we need to make sense of what we see?” with the question “What is the problem?” So let me talk about that.

When Keynes argued against the “classical economists”, he was to a large degree arguing against the view that there is no such thing as involuntary unemployment — a view often defended, then and now, by an appeal to the usual logic of supply and demand. If we’re looking at the market for, say, wheat, and there’s an excess supply — sellers want to sell more than buyers want to buy — we expect to see the price fall rapidly to clear the market. So if there were really a large excess supply of labor, shouldn’t we be seeing wages plummeting?

And the answer is no — wages (and many prices) don’t behave like that. It’s an interesting question why, one that has to be answered in terms of psychology and sociology, but it’s simply a fact that actual cuts in nominal wages happen only rarely and under great pressure. So wage stickiness is an essential part of a demand-side story about what’s going on with the economy; it’s how you answer the question of why wages aren’t falling.

But that’s not at all the same thing as saying that excessive wages are the problem. (I’m focusing here on a country with its own floating currency, like the US or the UK; for members of the euro zone, wages are part of the problem). To be fair, in IS-LM type models that don’t include balance sheet effects and also assume that we’re not in the liquidity trap, it is the case that the level of employment is determined by M/w — the ratio of the money supply to the wage rate. So in such models you could say that other things equal a wage cut would be expansionary. But even then it’s far easier to just increase M.

In any case, however, we are in a liquidity trap, and balance sheet effects are very important. So there is no reason to believe that cutting wages would be helpful; on the contrary, falling wages would worsen the balance-sheet problem, a point some of us have been making for quite a while.

So when I emphasize nominal wage rigidity, I am defending an analysis of how the economy works, which is not at all the same thing as saying that this rigidity is the problem. On the contrary, for the US (though not for countries like Spain), wage stickiness is if anything good for us right now, helping stave off destructive deflation.