CC IX: ECO-A-CC-4-9-TH-TU

Intermediate Macroeconomics II

AN OUTLINE OF NEW KEYENESIAN MACROECONOMICS

(NKM)

- The Keynesian model emphasize on involuntary unemployment and the

role of aggregate demand in determining output and employment.

- A key element of these models is wage rigidity
- In recent years , economists working within Keynesian tradition have pursued additional explanations of involuntary unemployment. The models emerging from this research are called New Keynesian Macroeconomic Models.
- Main contributors are N. Gregory Mankiw and David Romer
- Main focus of the above-mentioned two economists along with other advocates of *New Keynesian Macroeconomics (NKM)* is that the Keynesian macroeconomic model lacks a solid microeconomic foundation and these economists have tried to incorporate this microeconomic foundation in the Keynesian system.
- These economists have argued that as wage and price rigidities are central to explain Keynesian theory of involuntary unemployment there must be some microeconomic foundation which explain that these rigidities arise from the behaviour of optimizing agents.

Traditional Keynesian Models and NKM

- In NKM some form of imperfect competition is assumed for the product market. The traditional Keynesian models assume perfect competition.
- Traditional Keynesian models focus on rigidity of nominal wage whereas

NKM focus on nominal wage rigidity as well as on product price rigidity.

- Unlike traditional Keynesian models NKM also focuses on rigidity of real wage or firm’s relative price rigidity in the face of changes in aggregate demand.

- We consider here three types of NKM models :
- Sticky price (menu cost) models
- Efficiency wage models
- Rigidities in interest rates and credit rationing

NKM : Real Wage Rigidity Efficiency Wage Theory

- **Reasons for real wage rigidity**
- *Legal and institutional factors :* Example of such factors are minimum wage laws and union contracts. However, minimum wage laws are fixed usually in monetary terms.
- *The target to reduce turnover costs :* It involves the cost of hiring and training new workers. The firm can keep the wage rate at a high level to save the cost of hiring and replacement. If the wage rate is fixed at a low level workers may quit the job and the turnover costs may increase.
- *Efficiency wage :* Firms might pay real wages above market-clearing levels as the firm owners think that if the workers are paid well they may have greater incentive to work hard and effectively. The idea that a worker's productivity depends on the real wage rate received and that therefore firms may pay wages above the market clearing level. It is the essence of efficiency wage model. We shall focus mainly on efficiency wage model to explain real wage rigidity.

NKM : Real Wage Rigidity

The Efficiency Wage Theory

the efficiency wage model rests mainly on the model of Shapiro and Stiglitz (1984) it is always wise to start from Akerlof's (1982) concept of '*gift exchange motive*'.

- If better-paid workers are more productive, firms may gain by paying wages higher than the minimum wages necessary to attract workers. However, why productivity depend on the real wage rate is explained by the *'carrot and stick'* policy.
- The *'carrot'* or positive incentive is based on the idea that workers who feel well treated will work harder and more efficiently. The workers as a result of this incentive feel that they are treated fairly by the employer by paying a wage than what is required to retain them and they work harder due to this incentive. Akerlof (1982) called this motivation as the *'gift exchange motive'* because it is similar to the one that leads people to exchange gifts.

NKM : Real Wage Rigidity

The Efficiency Wage Theory : Shapiro and Stiglitz (1984) Model

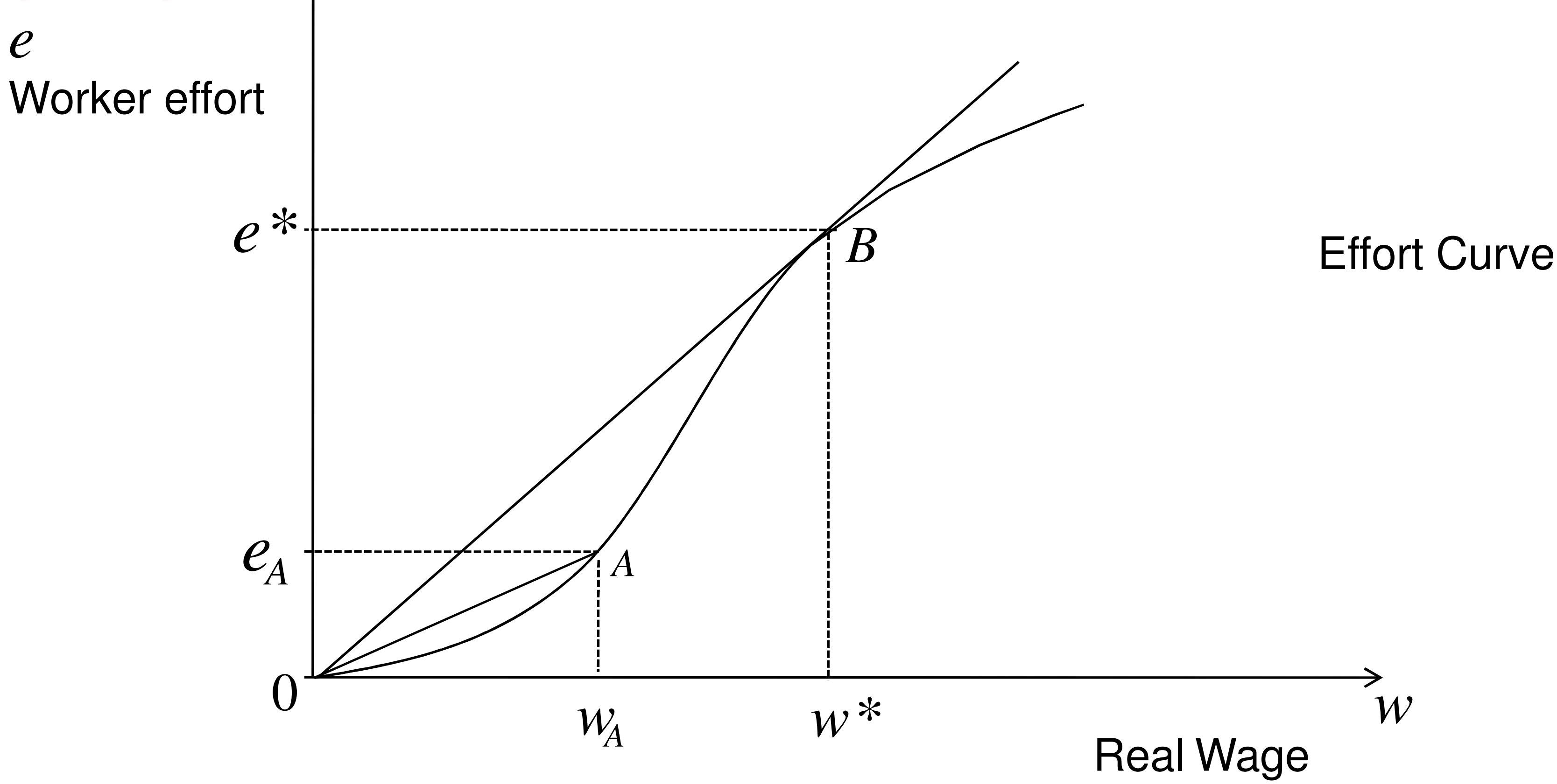

Figure 1

NKM : Real Wage Rigidity

Some Observations on Shapiro and Stiglitz (1984) Model

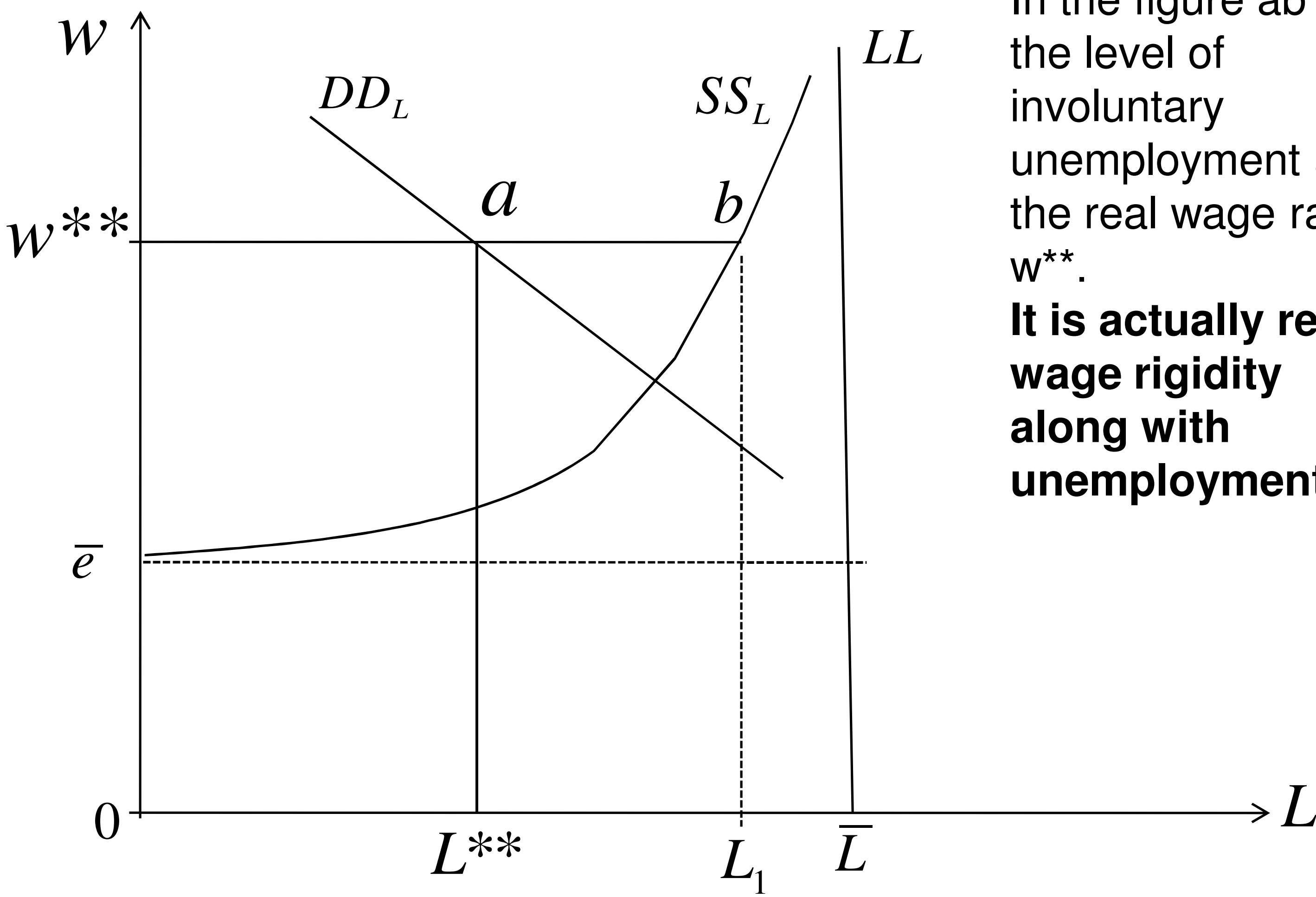

Figure 2/

In the figure ab is the level of involuntary unemployment at the real wage rate w**.

It is actually real wage rigidity along with unemployment

NKM : Rigidities in Interest Rates and Credit Rationing

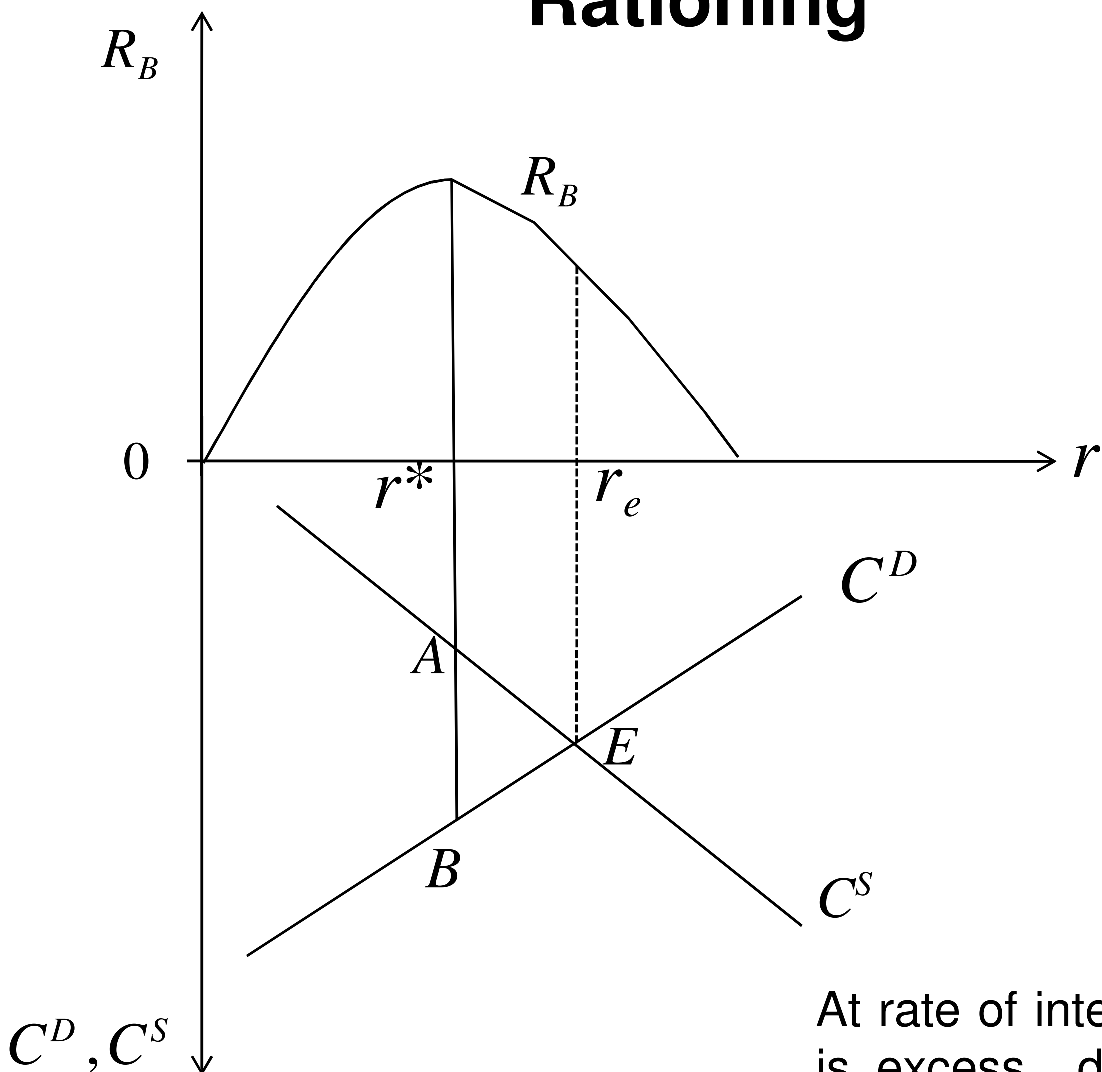

Figure 3

At rate of interest r* we find there is excess demand for credit of the amount AB which results in credit rationing.