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An intertemporal general equilibrium model with given real wage rates

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Abstract

The paper proposes a general equilibrium model based on the classical assumption that the real wage rate is determined from outside the system of production. In this model, the Walrasian auctioneer in the labor market is replaced by a flexible accumulation rate. Several equilibrium concepts are introduced and studied.
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1. Introduction

Models of general equilibrium, based on agent optimization, rational expectations, and market clearing, play a key role in neoclassical economic theory. In such models it is supposed that prices provide economic agents with all necessary information about the economy that they need in order to make efficient use of the available resources. From this premise neoclassicals typically draw (perhaps, implicitly) the conclusion that the prices provide an exhaustible list of variables through which a state of economic equilibrium can be established. This deduction looks plausible from a normative point of view: indeed, well-known theorems read that under more or less restrictive assumptions an equilibrium exists and, moreover, is Pareto-optimal. From a positive point of view the conclusion is

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less unambiguous, since the logical possibility of establishing equilibrium through varying prices does not imply the relevance of this possibility.

One of the features of real economies that catches eye is that labor markets do not behave like competitive commodity markets, where prices fall or even plunge when supply exceeds demand. The failure of pay rates to fall is termed wage stickiness, downward wage rigidity, or simply wage rigidity, and has puzzled economists for years.

Wage rigidity is central to intense controversy between Keynesian and neoclassical macroeconomists over whether government economic policy should be used to stabilize aggregate income and employment. Keynesians claim that wage rigidity is confirmed by statistical evidence that pay rates almost never fall. They say that labor markets do not automatically adjust to eliminate excess unemployment and that joblessness is a grave misfortune forced on people, most of whom want to work, even at wages lower than those earned previously.

Neoclassicals believe that wage rigidity is an illusion, that wages and salaries are flexible, and that labor markets always clear. Central tenets of those beliefs are that the existing rate of unemployment is the optimal outcome of market forces and should not or cannot be affected by government policy. The view is that during recessions pay rates fall below reservation levels, or the minimum at which people are willing to work. This decline causes employees to leave their jobs and become unemployed. Neoclassicists also assert that anyone can find some job quickly and that people remain unemployed because they seek for higher pay than available to them.

There are compelling reasons for wages to display much less flexibility than would be observed in Walrasian auction markets. Because wages are observed to be sticky, the assumption that at any point in time wages are a datum seems to be a more realistic basis on which to model the economy. Little is known about which theories are correct or under what conditions. The three theories that have been advanced to account for sticky wages are generally referred to as the implicit contracts theory, the efficiency wage hypothesis and the insiders–outsiders approach.

Two points should now be made. First, it is worth noting that Keynes himself assumed that nominal wages are ‘sticky’ downwards. He postulated that workers would accept a decrease in their real wages caused by a general increase in the price level, but would resist direct efforts to cut their wages. At the same time, two of the three mentioned approaches, the efficiency wage models and the implicit contracts theory, explain why the real wage rate (but not nominal wages) is rigid.

Secondly, changes in aggregate demand in Keynesian models are met with changes in quantities only in the short-run; over time, however, as output constraints become binding, adjustment occurs through prices. Keynesians will agree with the assertion that in the long-run nominal and real wages are flexible.

The conventional economic wisdom says that the real wage rigidity is not compatible with market clearance in the labor market. Since labor market clearance looks more satisfactory in the long run than in the short run, two possible conclusions can be drawn. Either in the long run the impersonal Walrasian auctioneer takes care of the labor market more successfully than in the short run or there exists a non-Walrasian mechanism of labor market clearance. Most economists would perhaps be inclined to make the first conclusion.

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