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Labor Force Participation, Wage Rigidities, and Inflation☆

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Abstract

The fall in the US labor force participation during the Great Recession stands in sharp contrast with its parallel increase in the euro area. In addition to structural forces, cyclical factors are also shown to account for these patterns, with the participation rate being procyclical in the US since the inception of the crisis and countercyclical in the euro area. We rationalize these diverging developments by using a general equilibrium business cycle model, which nests the endogenous participation decisions into a search and matching framework. We show that the "added worker" effect might outweigh the "discouragement effect" if real wage rigidities are allowed for and/or habit in consumers' preferences is sufficiently strong. We then draw the implications of variable labor force participation for inflation and establish the following result: if endogenous movements in labor market participation are envisaged, then the degree of real wage rigidities becomes almost irrelevant for price dynamics. Indeed, during recessions, the upward pressures on inflation stemming from the lack of downward adjustment of real wages are offset by an opposite influence from the additional looseness in the labor market, due to the higher participation associated with wage rigidities.

JEL Classification: E31, E32, E24

Keywords: labor force participation, great recession, wage rigidities, inflation.

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