

Monetary Policy When Wages Are Downwardly Rigid: Friedman Meets Tobin

(with Jinill Kim, Federal Reserve Board)

Abstract

This paper is concerned with the macroeconomic implications of downward nominal wage rigidity, in particular for monetary policy. To that end we build a small-scale, dynamic stochastic general equilibrium (DSGE) model where the cost of adjusting prices and wages may be asymmetric. We follow the Neo Keynesian literature in postulating a simple reduced-form mechanism to model nominal frictions in the goods and labor markets, but relax the assumption that frictions are symmetric around the current price or wage. Instead, we adopt an adjustment cost function based on the linex function due to Varian (1974), which includes the quadratic function in Rotemberg (1982) as a special case. Hence in our model, adjustment costs depend not only of the size but also on the sign of the adjustment. This project builds on, but makes a distinct contribution from, our previous work (Kim and Ruge-Murcia, 2009). In that paper, we carried out the analysis using a cashless economy and were primarily concerned with the optimal amount of "grease" inflation. In contrast, this paper studies the positive implications of downward wage rigidity, which were not examined in our earlier contribution, and do so in the context of a fully-fledged monetary economy.