Fair Wages in a New Keynesian Model of the Business Cycle*

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Abstract

We build a New Keynesian model of the business cycle with sticky prices and real wage rigidities motivated by efficiency wages of the gift exchange variety. Compared to a standard sticky price model, our Fair Wage model provides an explanation for structural employment and generates more plausible labor market dynamics – notably accounting for the low correlation between wages and employment. The fair wage induced real wage rigidity also significantly reduces the elasticity of marginal cost with respect to output. The smoother dynamics of real marginal cost increase both amplification and persistence of output responses to monetary shocks, thus remedying the well-known lack of internal propagation of standard sticky price models. We take these improvements as a strong endorsement of the addition of real wage rigidities to nominal price rigidities and conclude that the fair wage extension of this paper constitutes a promising platform for an enriched New Keynesian synthesis.

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