

JARGON ALERT

Sticky Wages

BY RENEE HALTOM

No, sticky wages aren't what happens when you do the payroll while eating a honey bun. Rather, sticky wages are when workers' earnings don't adjust quickly to changes in labor market conditions. That can slow the economy's recovery from a recession.

When demand for a good drops, its price typically falls too. That's how markets adjust to ensure that the quantity of willing suppliers equals the quantity of willing buyers. In theory, things are no different when the good in question is labor, the price of which is wages.

It is natural to think that wages should fall in a recession, when demand falls for the goods and services that workers produce. Assuming that the supply of labor does not change, reduced demand for labor should translate

into lower wages, until everyone willing to work at the going wage has found employment. Of course, what we tend to observe in a recession instead is unemployment, sometimes on a mass scale.

One possible explanation for why unemployment occurs is that wages are sticky; they are slow to produce equilibrium in the market for workers. The prices of some goods, like gasoline, change daily. But other prices appear to be sticky, perhaps because of menu costs — the resources it takes to gather information on market forces.

Wages are thought to be sticky on both the upside and downside. But economists have long observed that wages are especially unlikely ever to fall, even in very severe recessions, a phenomenon called “downward wage rigidity.” The reasons for downward wage rigidity are unclear. The prevalence of unions was once a common hypothesis — but unions have since declined, yet rigidity is still with us. Some economists thought employers might hold wages artificially high to encourage productivity. Others suggested that existing “insider” employees prevent unemployed “outsiders” from bidding down wages by threatening to disrupt the productivity of the competing workers. Evidence for these possible explanations is scant, however. In the 1999 book *Why Wages Don't Fall During a Recession*, Yale University economist Truman Bewley concluded, after hundreds of interviews with business insiders, that the key reason for downward rigidity might simply be that pay cuts are too damaging to morale, even more so than outright layoffs.

It's hard to say just how sticky wages actually are since it is impossible to know what the “correct” wage should be. Stickiness can be estimated, however, by looking at the number of workers who report no change in wages over the

course of a year. When there is an unusual spike in that number, especially if it occurs during a recession, a reasonable conclusion is that many employers would like to give a pay cut but are instead just keeping wages constant.

San Francisco Fed researchers Mary Daly, Bart Hobijn, and Brian Lucking looked at this measure of wage stickiness for 2011. They found that wage changes did not rest on a normal, bell-shaped distribution: Many workers experienced modest wage increases, while only a handful experienced wage declines. In addition, there was a large number who experienced a wage change of precisely zero. The number of workers with unchanged wages climbs in recessions; it reached 16 percent in 2011, according to the Census's

Current Population Survey, by far the highest proportion in 30 years. And unlike in previous recessions, the spike in downward wage rigidity occurred across a broad range of skill levels, suggesting that downward wage rigidity is especially prevalent today. (One caveat is that employers may not consider the current wage to be the true cost of labor. A 2009 study by Richmond Fed economist Marianna Kudlyak argued that the true cost of labor incorporates the future path of wages given the current state of the economy, and found that this broader measure of labor costs varies much more with economic cycles than seemingly sticky wages.)

Today's low rates of inflation exacerbate downward wage rigidity. Modest inflation gradually erodes nominal wages, and so is a way for employers to cut real wages without really having to cut them. Therefore, inflation can help the labor market achieve equilibrium. However, when inflation is very low, an employer might have to actually cut wages in dollar terms to reduce real wages. Since managers and workers alike appear to dislike wage cuts, sticky wages in an environment of low inflation means the employment recovery is likely to be slower. In fact, the recent recession's hardest-hit industries — manufacturing, finance, and especially construction — experienced the greatest increase in wage rigidity, according to Daly, Hobijn, and Lucking.

Wage stickiness is one of numerous explanations for unemployment. For example, economists believe there will always be some minimum level of joblessness because it takes time for workers to search for the best jobs. To the extent that unemployment results from sticky wages, there may be a role for policy to improve outcomes. That's one of the reasons why the degree of wage and price stickiness is an important and charged empirical question. **EF**

