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Efficiency Wage and Labor-Market Business Cycles: A New Keynesian Analysis

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ABSTRACT

This paper examines the cyclical implications of real wage rigidity for labor market and inflation dynamics in a New Keynesian model under the Mortensen-Pissarides (1994) search frictions. Shapiro and Stiglitz's (1984) efficiency wage framework is incorporated into the otherwise ordinary Nash bargaining wage determination, thereby generating downward wage rigidity over business cycles. Key findings are: first, real wage rigidity induced by the efficiency wage scheme significantly amplifies the volatilities of labor market quantities and dampens real wage fluctuations. Thus, it can address Shimer's (2005) volatility puzzle and explain the observed weak cyclicalities of real wages. Second, introducing downward wage rigidity can generate the asymmetric dynamics of inflation as well as labor market quantities observed in the data; the model exhibits a significantly left-skewed distribution for employment and vacancy but a highly right-skewed distribution for inflation along the business cycles.

KEYWORDS efficiency wage; moral hazard; downward real wage rigidity; volatility puzzle; cyclical asymmetry

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