A Theory of Wage Rigidity and Unemployment Fluctuations with On-the-Job Search

Masao Fukui (MIT)

Abstract

I develop a new theory of wage rigidity and unemployment fluctuations. The starting point of my analysis is a generalized version of Burdett and Mortensen's (1998) job-ladder model featuring risk-neutral firms, risk-averse workers, and aggregate risk. Because of on-the-job search, my model generates wage rigidity both for incumbent workers, through standard insurance motives, and for new hires, through novel strategic complementarities in wage setting between firms. In contrast to the conventional wisdom in the macro literature, the introduction of on-the-job search implies that: (i) the wage rigidity of incumbent workers, rather than new hires, is the critical determinant of unemployment fluctuations; (ii) fairness considerations in wage setting dampens, rather than amplifies, unemployment fluctuations; and (iii) new hire wages are too flexible, rather than too rigid, in the decentralized equilibrium. Quantitatively, the wage rigidity of incumbent workers caused by the insurance motive alone accounts for about one fifth of the unemployment fluctuations observed in the data.