Keynesian Dynamics and the Wage–Price Spiral: Identifying Downward Rigidities

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Abstract

We develop a constrained bivariate switching model to explore empirically the behavior of wage and price Phillips-curves for high- and low-inflation regimes. Using this switching regression technique with a structural simultaneous equations model of Phillips curves, we identify significant lower floors for wage and price inflation. We interpret these lower floors as the relevant downward rigidity for wages and prices. Such floors imply that the adverse real-wage adjustment mechanism that can be identified in the high-inflation regime may disappear in the low-inflation regime, where money-wage inflation and price inflation, and thus real-wage movements, may become rigid. Consequently, the economy may be stabilized then, but trapped in a long period of stagnation in such a low-inflation situation. Such properties of kinked wage and price Phillips-curves are thus important and could also be of help to break another important destabilizing feedback channel, the Fisher debt deflation mechanism, according to

which economies, in which highly indebted firms are unable to prevent price deflation, will experience severe crisis or even economic breakdown if the resulting deflationary spiral cannot be stopped.

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