

A Theory of How Workers Keep Up with Inflation

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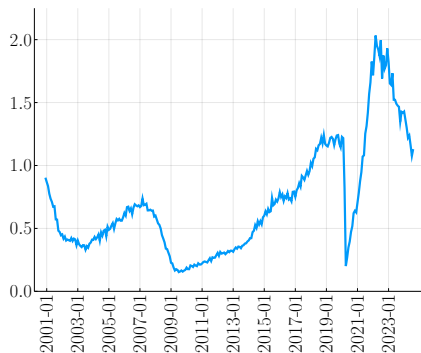
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Conference on Monetary Policy Trade-offs
Reserve Bank of Australia

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Recent Inflation Period: Market Tightness

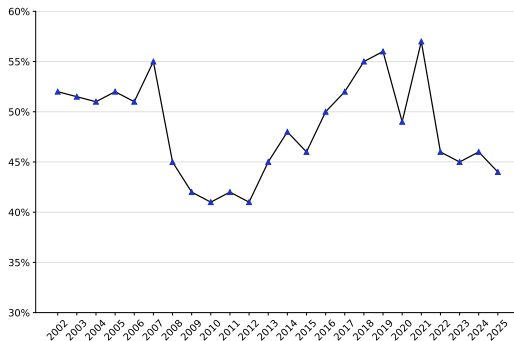


Vacancy-to-Unemployment

- Prevailing narrative: **High V-to-U ratio** $\Rightarrow$ “Hot” labor market $\Rightarrow$ Rising inflation

“The broader picture is of an overheated labor market where demand substantially exceeds supply”, Powell, 11/02/2022

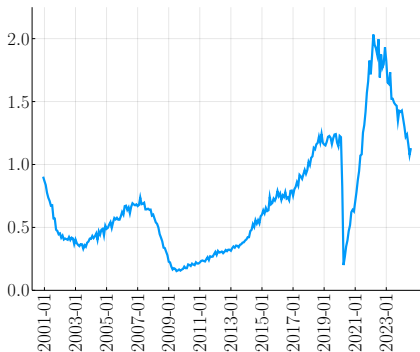
Reported Well-Being During the Inflation Period [Gallup]



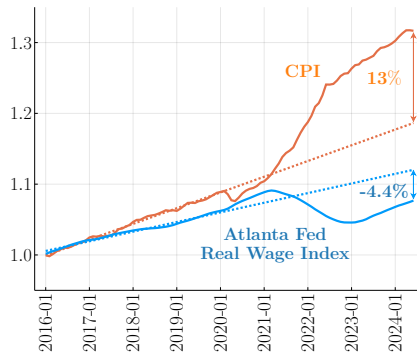
Excellent/Good Financial Situation Over Time

- Measures of subjective well-being fell sharply during the inflation period
- Why?

Recent Inflation Period: Market Tightness and Wage Growth



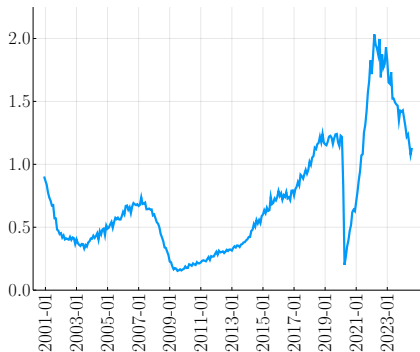
Vacancy-to-Unemployment



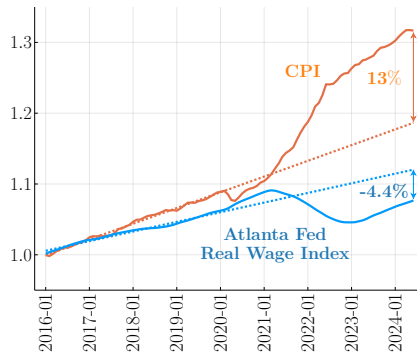
Real Wages: 2016-2024

- Real wages fell and remain below trend
- Observation: Around 2/5 of vacancies are for job-to-job transitions

Recent Inflation Period: Market Tightness and Wage Growth



Vacancy-to-Unemployment



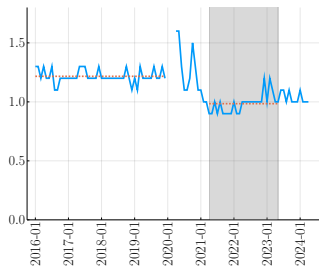
Real Wages: 2016-2024

- Our idea: Inflation lowers real wages, triggering on-the-job search (high V/U)

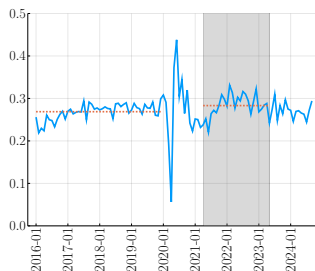
- **A new framework for frictional labor markets:**
 1. Costly nominal wage renegotiation
 2. Workers decide when to quit, look for another job, and renegotiate wages
 3. Firms decide when to lay off workers
- **Main result:** Higher labor market tightness from an isolated increase in inflation
 1. Inflation lowers real wages; workers escape low wages by:
 - (i) renegotiating wages with their employer
 - (ii) searching for a new job $\Rightarrow$ Higher labor market tightness
- Inflation reduces the median worker's welfare in 1K
- Document shifts in the Beveridge curve during inflationary episodes
- Within the model, “hot labor markets” struggle to match wages and flows

The U.S. Labor Market, 2021-2024

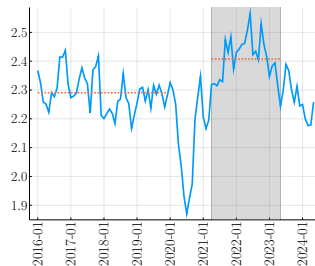
Aggregate Labor Market Flows



Layoff Rate



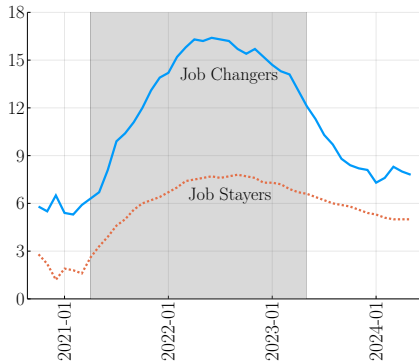
Job-finding Rate



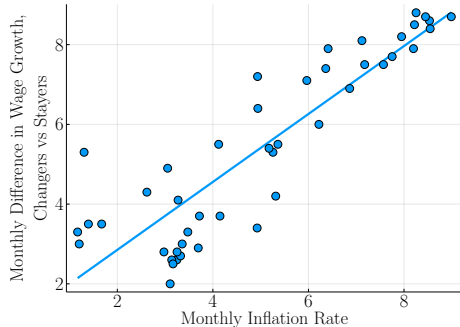
Job-to-Job Rate

- Decline in layoffs
- Small change in U-E flows
- Large increase in E-E flows

Nominal Earnings Growth: Switchers and Stayers



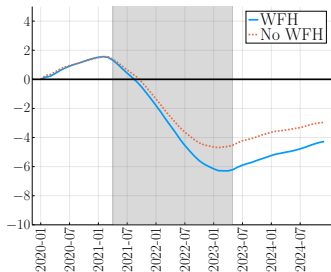
ADP Wage Growth,
By Switching Status



Changer-Stayer Difference
vs. Inflation Rate

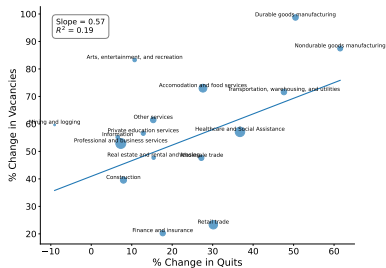
- Nominal wage growth rose sharply for job switchers compared to stayers

Heterogeneity across Occupations and Sectors



Real Wages by Occupation Type

Real wages fell in both WFH and non-WFH occupations



Industry-Level Changes: Quits vs. Vacancies

Positive correlation between quits and vacancies across industries

Model

Keeping Up with Inflation: Renegotiate, Search, or Quit

Three frictions

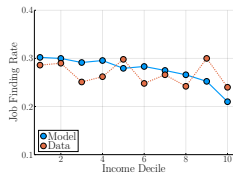
- Finding a job (or a worker) takes time and effort
- Nominal wages are sticky: changing them requires a costly renegotiation
- Lack of commitment of workers and firms

Inflation $\Rightarrow$ real wages fall. Then:

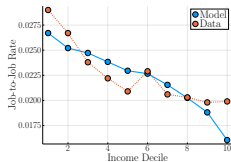
- **Workers** can escape low wages by
 - (i) renegotiating with their employer
 - (ii) **searching for a new job**
 - (iii) quitting to unemployment
- **Firms** lay off fewer workers (cheaper labor)

More on-the-job search $\Rightarrow$ firms post more vacancies $\Rightarrow$ higher V/U

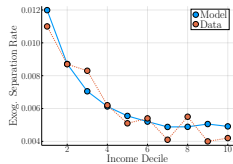
Target U.S. labor market 2016-2019



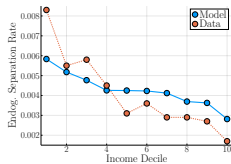
Job-finding Rate



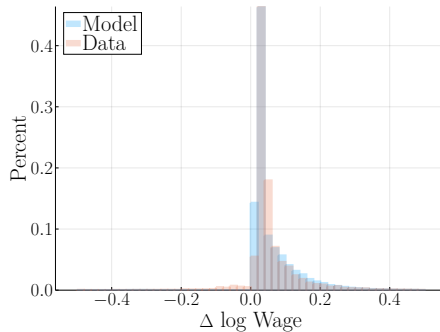
Job-to-job Rate



Exog. job-separation Rate



End. job-separation Rate



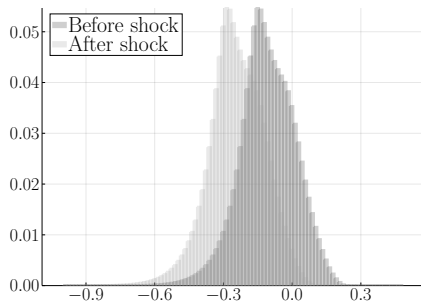
(Non-zero) Wage Changes

How Workers Respond to Temporary Changes in Inflation

Experiment I

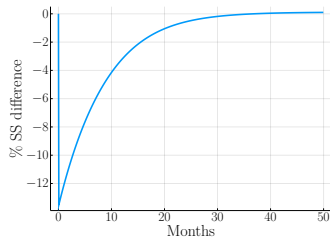
- From SS with 2% annual inflation, price level unexpectedly increases by 13.5%

Experiment II: sequence of MIT shocks that match realized inflation [in the paper]

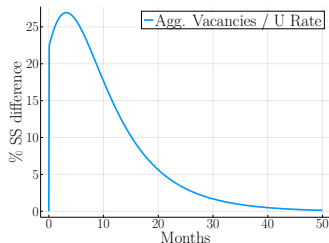


- Distribution of real wages shifts to the left after the inflation shock
- Workers move closer to the quit margin and farther from the layoff margin

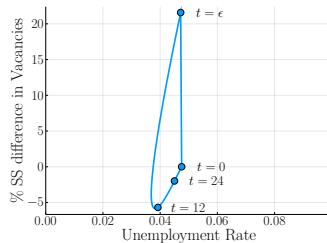
Aggregate Dynamics: Hot or Cold?



(a) Real Wage



(b) Market Tightness



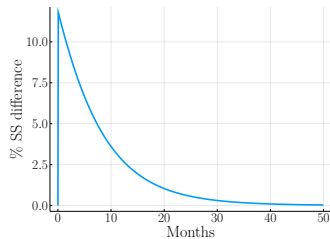
(c) Beveridge Curve Dynamics

Hot Surge in market tightness (vacancies-to-unemployment)

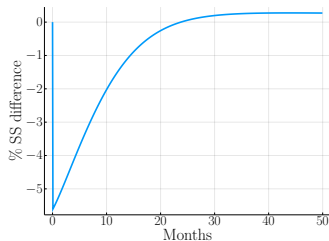
Hot Beveridge Curve shifts upward: vacancies increase with little effect on unemployment

Cold Real wages persistently lower

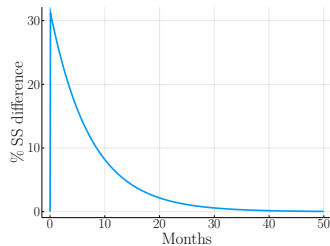
On-the-job Search and E-E Flows



(a) Search Intensity of Employed



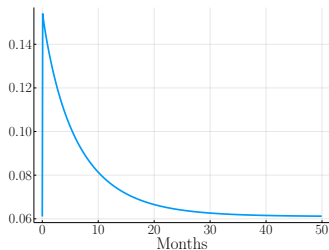
(b) Starting Wages of Job-Changers



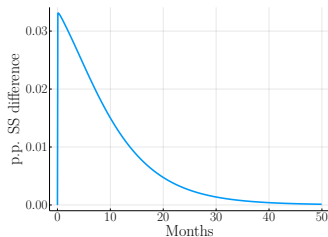
(c) Job-to-job Transition Rate

- Increase in search intensity
- Workers search for jobs positioned lower on the job ladder

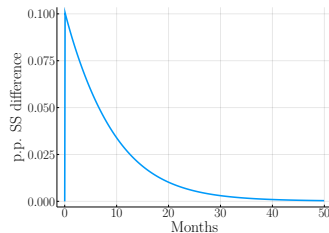
Wage Adjustment Within and Across Jobs



(a) Monthly Freq. of Wage Increases



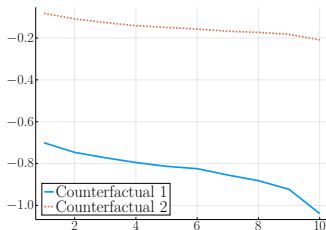
(b) Δw Stayers



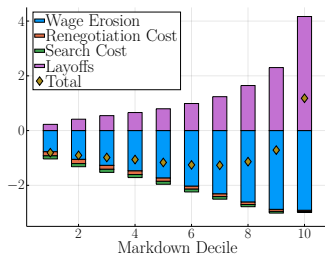
(c) Δw Changers

- Wage changes of job-changers are much larger than those of job-stayers

Welfare: No Wonder Workers Dislike Inflation



(a) Δ welfare by income

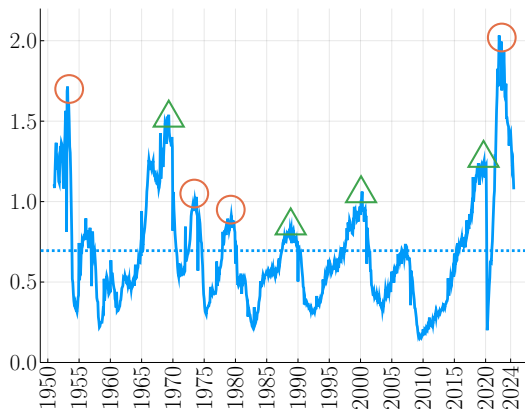


(b) Welfare decomposition

- Average welfare losses:
 - Experiment I: $\sim 80\%$ of monthly income
 - Experiment II: $\sim 20\%$ of monthly income (about \$1,000 for the median worker)
- Losses: real-wage erosion + search & renegotiation costs ($\sim 20\%$)
- Gains: fewer layoffs

Additional Historical Evidence

Vacancy-to-Unemployment Rate Over Time



- Vacancy data from Barnichon (2010) for 1951-2000

- 8 periods with spikes in the V/U rate since 1950

△: Traditional Beveridge curve periods (low inflation and declining unemployment)

○: Periods of very high inflation and non-declining unemployment

- Regressions: inflation is systematically associated with higher V/U and an upward shift of the Beveridge curve [in the paper]

- **Main Contribution:**

A model of frictional labor markets to study business cycles

- Reproduces quantitative labor market dynamics (2021-2024)
- Reconciles survey evidence from workers
- Highlights heterogeneity in welfare losses across worker types
- Decomposes welfare losses into distinct channels

- **Takeaway:**

Understanding how inflation distorts traditional labor market indicators (e.g., market tightness) is crucial for policy analysis