Sticky prices and their macroeconomic consequences

Economics, Macroeconomics

To understand the economic fluctuations, many economists have focused attention on economic coordination problems. Normally, the price system efficiently coordinates what goes on in an economy even in a complex economy. The price system provides signals to firms as to who buys what, how much to produce, what resources to use, and from whom to buy. For example, if consumers decide to buy fresh fruit rather than chocolate, the price of fresh fruit will rise and the price of chocolate will fall. More fresh fruit and less chocolate will be produced on the basis of these price signals. On a day-to-day basis, the price system works silently in the background, matching the desires of consumers with the output from producers.

•Flexible and Sticky Prices But the price system does not always work instantaneously. If prices are slow to adjust, then they do not give the proper signals to producers and consumers quickly enough to bring them together. Demands and supplies will not be brought immediately into equilibrium, and coordination can break down. In modern economies, some prices are very flexible, whereas others are not.

In the 1970s, U. S. economist Arthur Okun distinguished between auction prices, prices that adjust on a nearly daily basis, and custom prices, prices that adjust slowly. Prices for fresh fish, vegetables, and otherfoodproducts are examples of auction prices they typically are very flexible and adjust rapidly. Prices for industrial commodities, such as steel rods or machine tools, are custom prices and tend to adjust slowly to changes in demand. As shorthand, economists often refer to slowly adjusting prices as sticky prices (just like a door that won’t open immediately but sometimes gets stuck).

Steel rods and machine tools are input prices. Like other input prices, the price of labor also adjusts very slowly. Workers often have long-term contracts that do not allow employers to change wages at all during a given year. Union workers, university professors, high-school teachers, and employees of state and local governments are all groups whose wages adjust very slowly. As a general rule, there are very few workers in the economy whose wages change quickly. Perhaps movie stars, athletes, and rock stars are the exceptions, because their wages rise and fall with their popularity. But they are far from the typical worker in the economy.

Even unskilled, low-wage workers are often protected from a decrease in their wages by minimum-wage laws. For most firms, the biggest cost of doing business is wages. If wages are sticky, firms overall costs will be sticky as well. This means that firm’s product prices will remain sticky, too. Sticky wages cause sticky prices and hamper the economy’s ability to bring demand and supply into balance in the short run.