Babysitting and the Importance of Sticky Prices

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Reader Jess Austin noticed a critical feature of the Capitol Hill Baby-Sitting Co-op story I related in my last post:

Let me guess: the co-op had price controls too, didn't it? (I assume that is the meaning of Krugman's "equivalent to one hour of baby-sitting time" comment.) As a result, even though many couples wanted to babysit while few wanted their babies sat, enterprising babysitters weren't allowed to offer discounts? Which probably had a far larger negative effect than the "scrip" supply? Shockingly, arbitrary regulation is revealed here to cause recessions!

This is a smart observation, but I'm not sure "price controls" is the quite the right way to think about it. Krugman's story doesn't discuss the issue explicitly, but it seems unlikely that there's a formal rule against baby-sitting couples cutting their asking price. Rather, I suspect the co-op has an implicit social norm against doing so. After all, if they wanted to haggle over baby-sitting prices they could just pay each other in cash.

In any event, it's important to take the next step and ask: does the real economy have similar features? One obvious example is to the minimum wage, which may be contributing to unemployment at the low end of the labor market. Yet the recession clearly hasn't been limited to minimum-wage workers, so that can't be the whole story.

But the real economy *does* have a feature similar to the co-op's norm against price cutting. In the language of economics, wages exhibit "downward stickiness. When recessions hit, the result is often mass layoffs, resulting in high unemployment. This seems contrary to textbook economics; wages *should* simply fall until supply and demand are brought back into balance. But in practice this doesn't happen; instead we get persistent unemployment. This is largely because for a variety of complex reasons, wages tend not to fall fast enough to soak up the extra labor.

This is a key reason many economists consider mild inflation to be preferable to mild deflation. In an economy where prices are rising 2 percent a year, an employer that's having trouble making ends meet can cut employees' real wages by 2 percent simply by skipping a year's cost-of-living increase; that might be enough to forestall layoffs for the year. In contrast, if prices are *falling* by 2 percent, then the same 2 percent real wage cut translates to a nominal wage cut of 4 percent. Even though the effect on employees' purchasing power is identical, employees will get much angrier about the latter move. And so most employers don't bother and instead resort to layoffs.

And crucially, wage stickiness is asymmetrical. Workers are almost never asked to take nominal pay cuts, but when prices are rising, most employers *do* give their employees cost-of-living increases. So while inflation isn't harmless, it doesn't have the same kind of dramatic effect on output that deflation can produce.

And this is why Krugman's story can't easily be dismissed based on the fixed exchange rate between babysitting hours and scrip. True, wages in the real economy are more flexible than "wages" in the baby-sitting economy. But that's mostly true in the upward direction. In a contractionary economic environment, the two don't look so different. In both cases, it would be in everyone's interest for nominal wages to fall, but for complex social and psychological reasons, they don't—at least not fast enough to avoid unnecessary declines in output. And so in both cases, the monetary authority can help out by producing enough inflation to bring real wages down to a level where supply and demand are brought back into balance.