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Course

Date

**Price Wage Rigidity**

Price wage rigidity maintains that prices and wages are not flexible. This contradicts with what is stated in the classical theory, which means that it is impossible to reach an equilibrium level in the markets. Classical economists believe that unemployment results from mismatches. On the other hand, Keynesian economists believe that for adjustments of wages and prices in the market, then it is necessary for the government to intervene (Montgomery 2017). According to the Keynes’ theory, full employment would be maintained even with the drop in the aggregate demand if at all other workers are willing to have their wages reduced. In real life, employers are not always ready to ask workers to accept a reduction in their wages when the demand reduces since they know their workers would not take the idea positively. This makes them prefer firing workers. Those who are laid off respond by reducing consumption, which worsens the initial aggregate drop.

Keynes maintains that the key to restoring full employment when the economy is down is reducing wages by increasing aggregate demand. This, in turn, increased the prices relative to wages. They also believe that workers are normally willing to take reduced real wage in order to have full employment restored. But then this is only when the reduction is attained by increasing prices. Keynes theory is actually reasonable. Reducing real wages is one of the aspects that could not be easily accepted by most workers (Favilukis & Lin 2015). Few supporters of this theory are conversant with the central role of creating many efforts in order to reduce the real wages as a way of restoring full employment. Lastly, Keynes’ agreement on having government involved in the market is overstated. The economy is viewed by Keynes from a macroeconomic approach. The use of macro policy interventions is advocated as more or less fiscal policy expansion. The detailed intervention of the government is not advocated.

References

Favilukis, J., & Lin, X. (2015). Wage rigidity: A quantitative solution to several asset pricing puzzles. *The Review of Financial Studies*, *29*(1), 148-192.

Montgomery, H. B. (2017). *Energy price shocks and macroeconomic performance*. Routledge.