A Theory of How Workers Keep up With Inflation

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DC SAM Conference
Washington DC
April 25th 2025

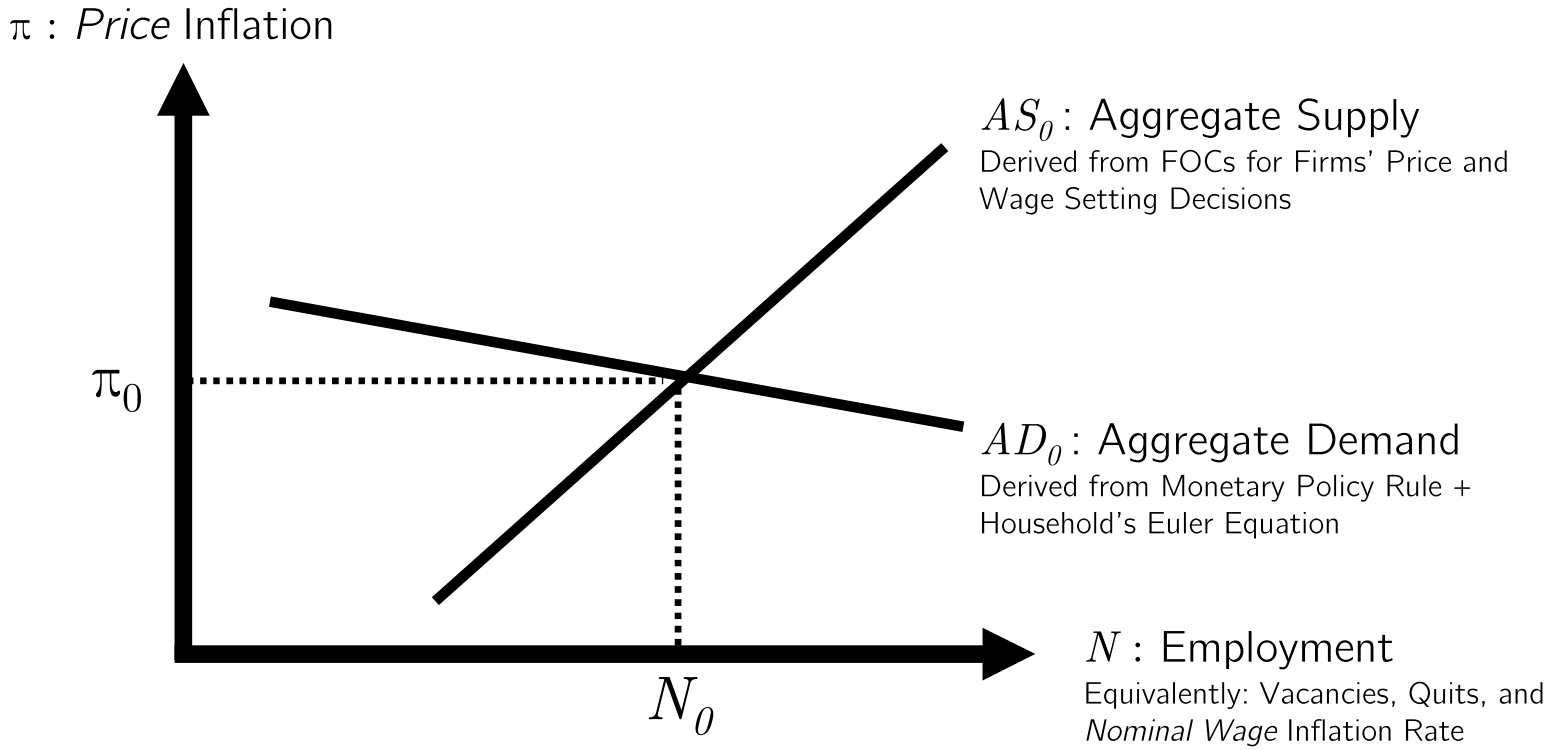
Big Question: Why do People Hate Inflation?

- Natural question!
- Difficult to answer: "inflations" are not all created equal!
- Re-framed: why does CB loss function include inflation and not just real wages/labor income/output?
- Do workers hate inflation *separately from* its effects on their income?
  - "Shoeleather" costs; information gathering costs; etc.

ABDH: Yes! Costly Search + Negotiation

- SMM calibration of a rich structural model where rigid wages within a match mean workers have to engage in costly search and/or renegotiation to raise wages if agg. conditions change
  - Calibration does NOT assume recent inflation driven by monetary shocks
- Application: decompose how inflation induced by monetary policy reduces worker welfare, and assess how that story fits recent data
- Paper is not "just" about monetary policy: provides calibrated microfoundations for costs in response to inflation of all sources.
- ...we should not understand ABDH as an attempt to "assess how inflation effects labor market dynamics, all else equal" (FN 3).

Flex-Price Sticky-Wage Model*



*Special case of Bloesch, Lee and Weber (2025): RANK DSGE model with OTJ Search

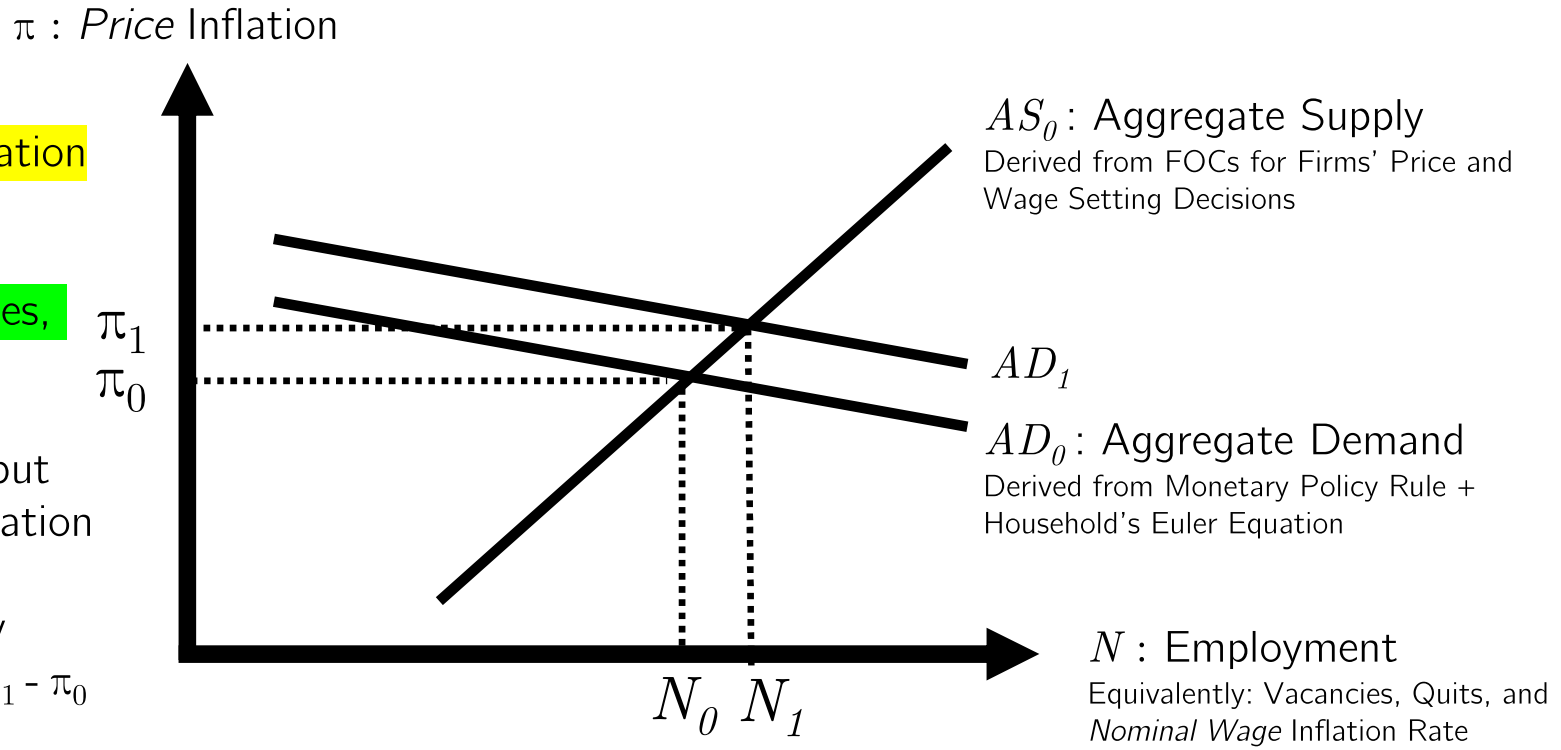
Flex-Price Sticky-Wage Model*: Monetary Shock

Unexpected Price Inflation "Shock" of size $\pi_1 - \pi_0$

Employment, Vacancies, Quits Rise

Wage inflation rises, but not as much price inflation

Real wages fall but by less than the shock, $\pi_1 - \pi_0$



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Flex-Price Sticky-Wage Model*: Bad TFP Shock

Unexpected Price Inflation "Shock" of size $\pi_1 - \pi_0$

Employment, Vacancies, Quits *Fall*

Wage inflation *Falls!*

Real wages fall by *more than* shock, $\pi_1 - \pi_0$

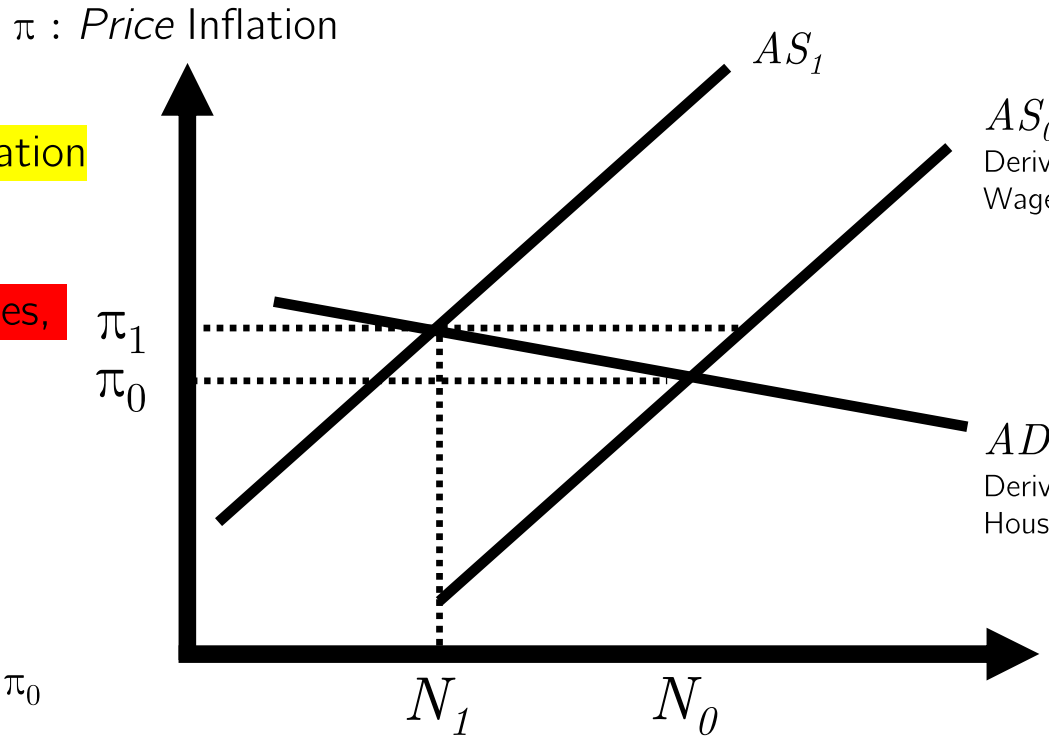

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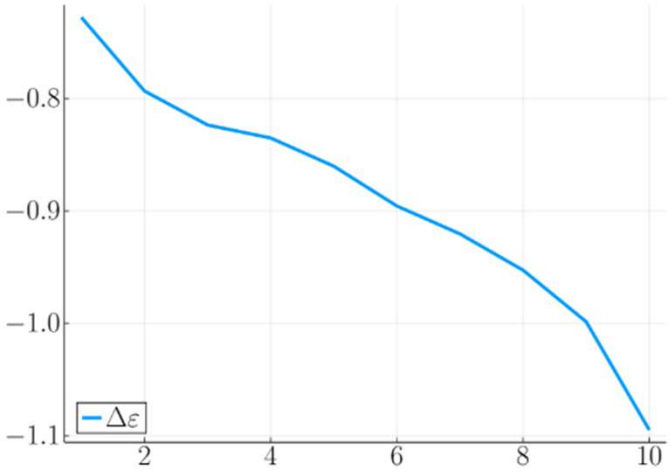
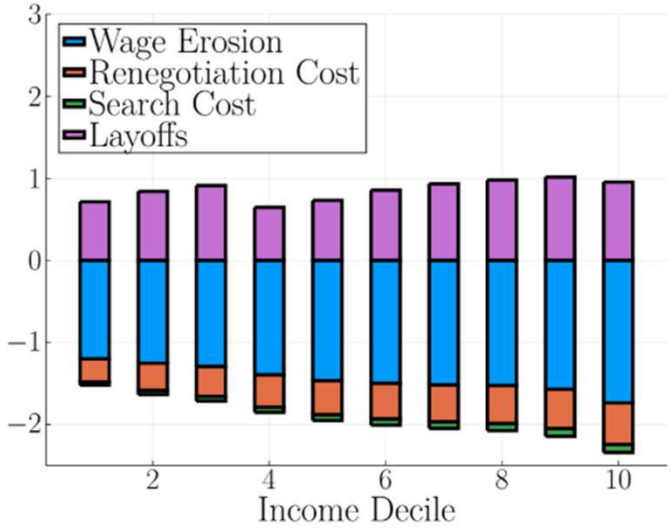
Figure 18: Employed Workers' Welfare Across the Distribution



PANEL A: CHANGE IN VALUES



PANEL B: WELFARE DECOMPOSITION

"unexpected *monetary* inflation shock"?

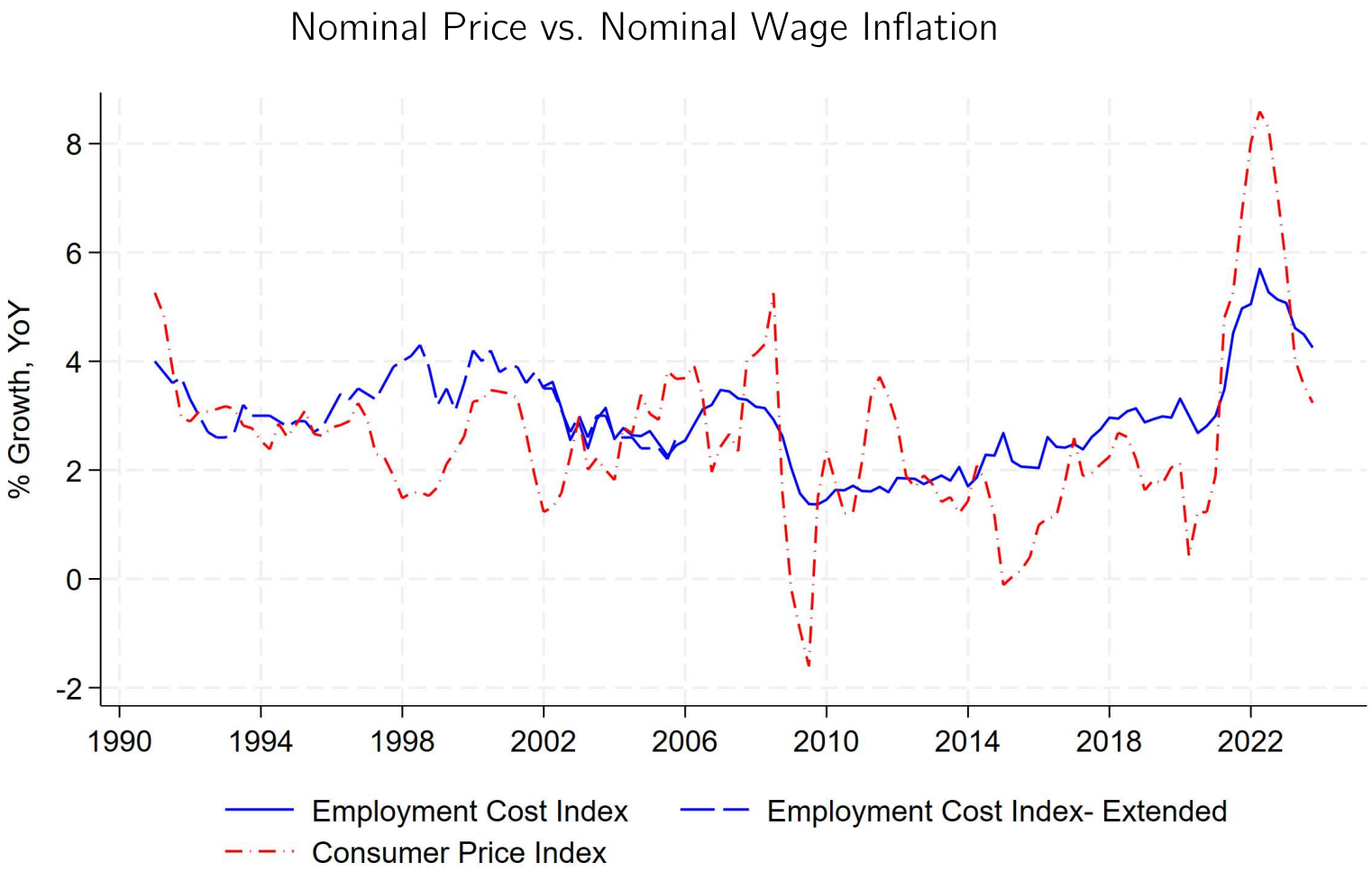
Notes: Panel A of the figure shows the welfare cost of the unexpected inflation shock for workers in different deciles of the worker income distribution. Results are shown in consumption equivalent units of monthly income. Panel B of the figure shows a decomposition of worker welfare into its various components.

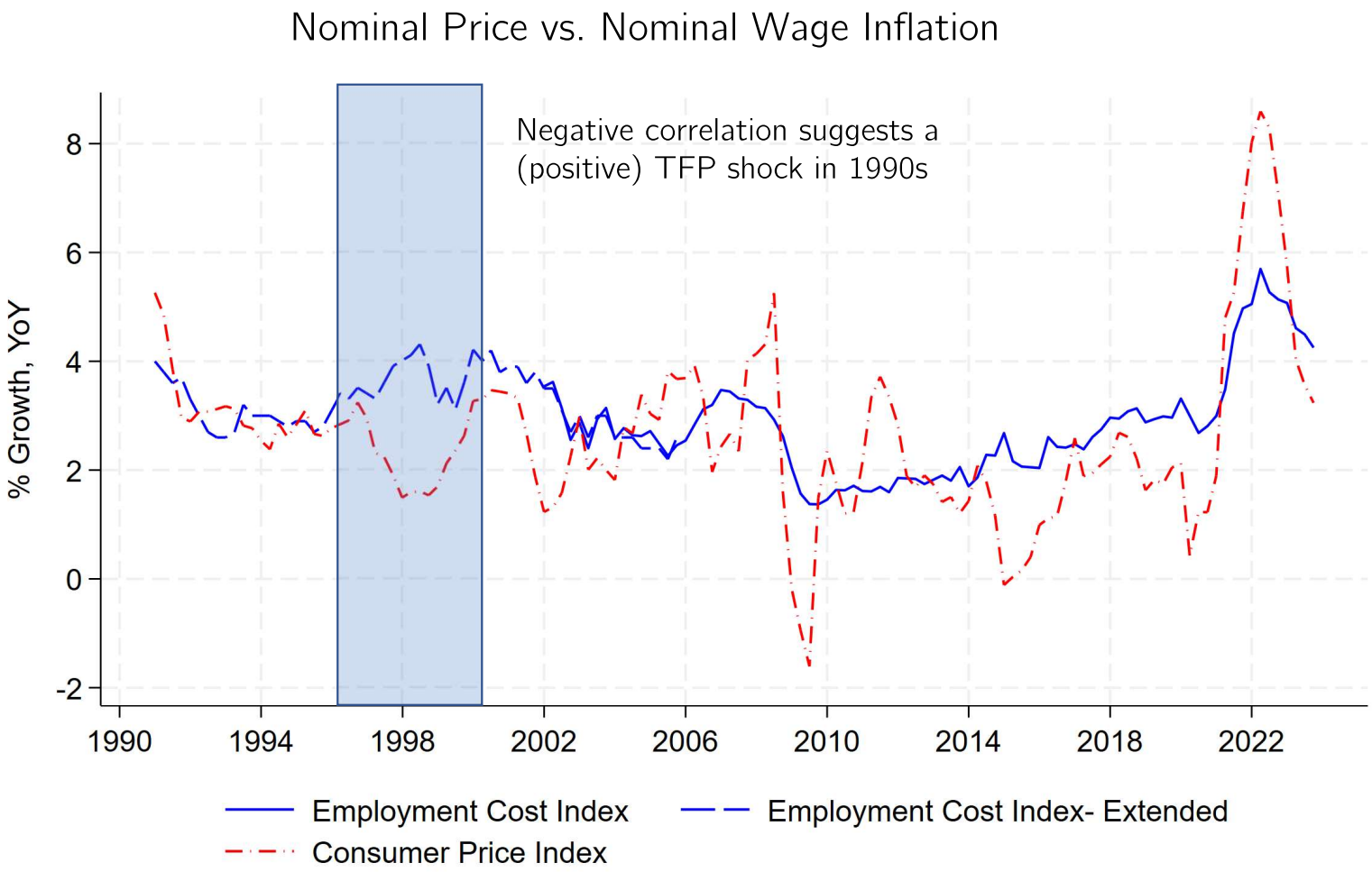
Presumably with a bad TFP shock, the blue bars would be even larger?

So we should understand this as a unexpected *monetary* inflation shock

Recap:

- In models with rigid wages but flexible prices, inflationary shocks tend to move *inflation* and *real wages* in opposite directions
- But for welfare, the source of the shock still matters! Not all "unexpected inflation shocks" are the same.
  - *Nominal wages* can move with inflation (driven by Monetary shocks) or against it (driven by TFP shocks)
- That is good, because it is a feature of the data!


Nominal Price vs. Nominal Wage Inflation
% Growth, YoY
8
6
4
2
0
-2
1990
1994
1998
2002
2006
2010
2014
2018
2022
Employment Cost Index
Employment Cost Index- Extended
Consumer Price Index


Nominal Price vs. Nominal Wage Inflation
Negative correlation suggests a
(positive) TFP shock in 1990s
% Growth, YoY
8
6
4
2
0
-2
1990
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1998
2002
2006
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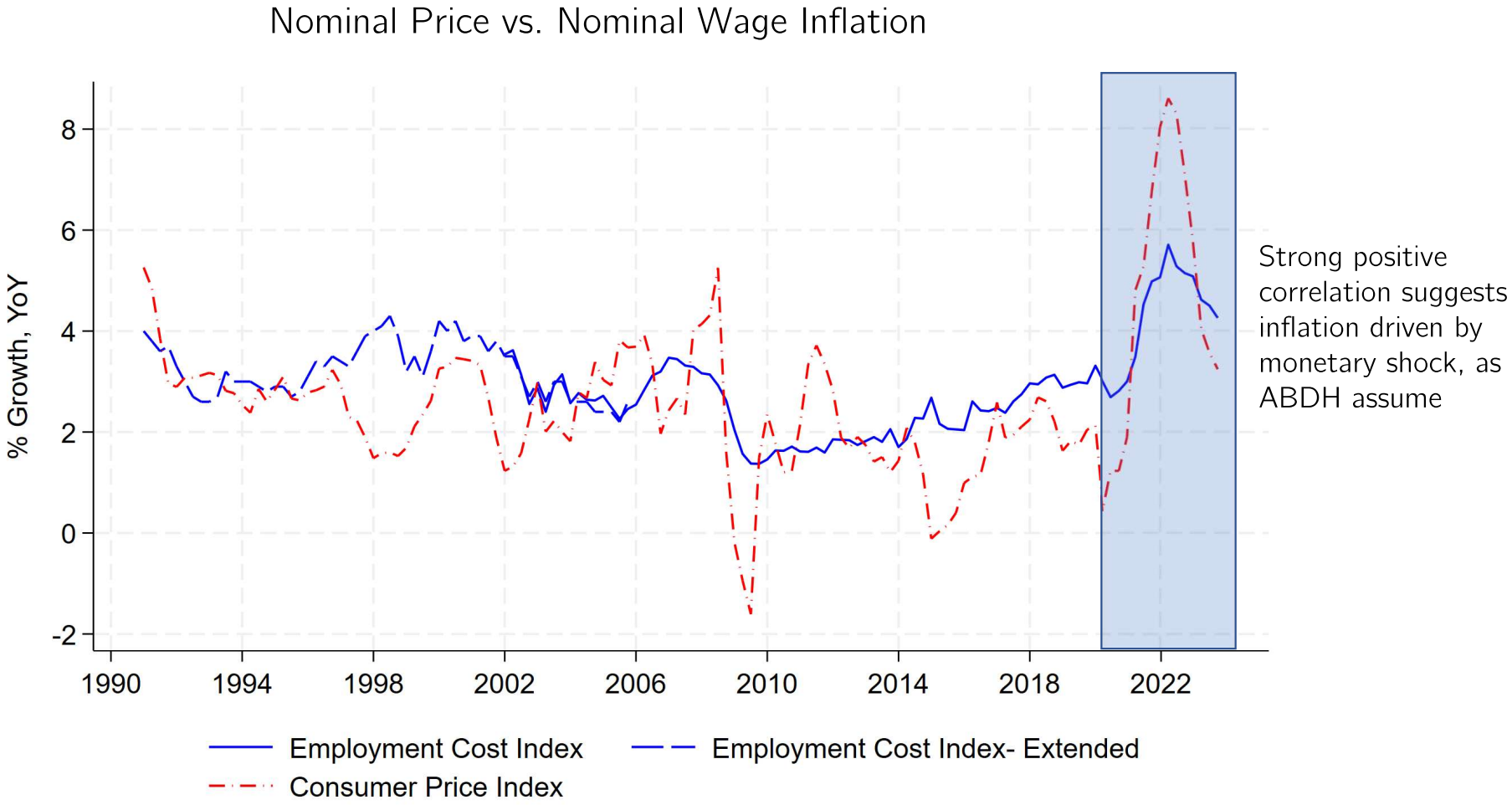
2018
2022
Employment Cost Index
Employment Cost Index- Extended
Consumer Price Index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Employment Cost Index- Extended
Consumer Price Index
Strong positive correlation suggests inflation driven by monetary shock, as ABDH assume

Recap Contribution:

- Estimates a rich model which *allows for quantifying* the contribution of search and negotiation costs to the welfare costs of inflation
  - This is what seems most exciting; claim generalizes to all inflationary shocks.
  - Currently small because of counterfactually large layoff margin; seems fixable
- Since welfare and labor market outcomes depend on shock choice, ABDH choose to study a *monetary shock*
  - Motivation being it explains *recent crisis* well; not necessarily inflation *generally*
- Implications for future research:
  - Are welfare costs of monetary inflation nonlinear and/or asymmetric?
  - Welfare costs of changing the Fed's inflation target?
  - Generalize model to allow for endogenous inflation/MP and look at other shocks