Bilateral Inefficiencies in Keynesian and New Keynesian Models

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Bilateral efficiency : Minimum amount of cooperation

- if a pair meets & can do something that generates a joint surplus
  → they do it
- if a pair meets & might do something that generate a negative joint surplus
  → they do not do it
- If bilateral efficiency is violated → there are Pareto improvements available.

Traditional models of price / wage rigidity do not satisfy bilateral efficiency :

- Barro (1977) critique of models with wage rigidity : firing workers b/c of wage rigidity violates bilateral efficiency
  → firm & worker could both be better off by renegotiating a lower wage [long-term relationship b/w worker & firm generates a positive surplus]

→ firm & worker can generate positive joint surplus by continuing to work together at lower wage

→ if there is a joint surplus to share → there is a price / wage such that both parties go home with positive surplus.

- <u>Huo & Rios-Rull (2020)</u> critique of New Keynesian models w/ Calvo pricing.
  - product market. sometimes $MU < MC$
    - → negative joint surplus
    - → firm & customer better off by not trading
  - labor market, sometimes $MPL < MRS$
    - → negative joint surplus
    - → firm & workers better off by not trading
  - ⇒ many Pareto improvements that are not implemented

<u>Conclusion:</u> in standard models of price/wage rigidity, bilateral inefficiencies occur

→ <u>problematic</u>