

Acceptance speech

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Traditionally, economists think of the labor market in terms of labor demand and labor supply, both depending on the real wage, and both firms and workers taking the real wage as given.

I thought that, when thinking about aggregate wage determination, this did not capture reality. Firms take the nominal wage largely as given, and then choose a price for their product, so implicitly setting a real (product) wage – the ratio of the nominal wage to the price they set. Symmetrically, workers take the price level as given and ask or settle for a nominal wage, thus setting the real (consumption) wage as well. Equilibrium is obtained when the two implied real wages are the same.

It may seem like a small change of perspective. It leads however to thinking about the role of imperfect competition and price setting in the goods market, and the nature of wage setting in the labor market. It leads one to explore what determines the degree of monopoly power of firms, the role of labor market institutions and the way they affect wage setting; factors altogether absent in the labor demand/labor supply approach. It gives a way of thinking about what determines the unemployment rate which is such that the two real wages are consistent – the so-called natural unemployment rate.

This is the approach I used, in my own work, then in work with Larry Summers and later, with Peter Diamond, to explore these issues. Why had unemployment rates increased so much in Europe over time? Why did Portugal and Spain have such different unemployment rates? How did similar unemployment rates in Portugal and the United States hide extremely different labor markets? Could institutions explain hysteresis, i.e., the long-lasting effects of temporary shocks? What implications did the approach have for the evolution of unemployment and the labor share over the medium run?

This way of thinking also gives a natural way of thinking about what happens when the economy is too hot or too cold, or put another way, when the unemployment rate deviates from the natural rate. If unemployment is very low, workers will be able to extract a higher nominal wage. This may be the result of a stronger hand in bargaining, or of firms wanting to do it anyway to attract workers and limit quits. Firms, now facing higher nominal wages, will

want to keep their profit margins and increase their prices. This however will lead workers in turn to ask for higher nominal wages, leading to higher prices, and so on. In other words, there will be inflation. And the hotter the economy, the stronger will be the pressure on inflation. Again, this leads one to think about the rich set of factors which affect this relation between unemployment and inflation, from the effect of unemployment on wage determination, to the effect of higher demand on firms' markups, to the role of expectations about future prices and future wages.

I was lucky, when reaching that point, to have a great student, Nobu Kiyotaki, who forced me to be more rigorous about these arguments than I had been, and this led to a joint paper, which can be seen as one of the foundational papers for the modern New Keynesian view of the economy. This view has been systematically explored and developed by my two fellow prize winners, Michael Woodford and Jordi Galí, with a focus on the implications for monetary policy. I have been more eclectic in my explorations, with more of a focus on fiscal policy. I shall mention just one line of research directly relevant in this context, in effect the empirical verification of the New Keynesian view of the economy I just sketched above.

While the various pieces of the model, price determination, wage determination, the effect of the price level and of monetary policy on demand and output, all seemed plausible, I worried whether their joint implications were fully consistent with the macroeconomic evidence. In a paper with Mark Watson, building on the work of Chris Sims, I introduced the notion of a "structural VAR", namely a just identified vector autoregression to interpret the data and check their consistency with theoretical priors. In a paper with Danny Quah, I showed how one could use long run restrictions to identify shocks coming from the demand side and the supply side of the economy. In a paper with Roberto Perotti, I used this approach to trace the effects of fiscal policy on activity. Based on those, I would argue that the New Keynesian model roughly fits the data. More generally, I believe the approach that all three of us have explored provides a basic structure to build on and is indeed here to stay.