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PII: S0304-4068(18)30072-7
DOI: https://doi.org/10.1016/j.jmateco.2018.07.003
Reference: MATECO 2255

To appear in: *Journal of Mathematical Economics*

Received date : 30 July 2017
Revised date : 29 June 2018
Accepted date : 5 July 2018

Please cite this article as: Camera G., Kim J., Equilibrium wage rigidity in directed search. *Journal of Mathematical Economics* (2018), https://doi.org/10.1016/j.jmateco.2018.07.003

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Equilibrium wage rigidity in directed search[†]

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June 29, 2018

Abstract

Matching frictions and downward wage rigidity emerge as equilibrium phenomena in a two-sided labor market where firms sustain variable wage adjustment costs. Firms post wages to attract workers and matches are endogenous. Reducing the wage relative to the wage previously posted is costly to the firm, where the cost is proportional to the size of the proposed cut. Shocks to the firm's profitability may yield an equilibrium wage above what the firm would offer absent proportional adjustment costs. Wage cuts can be partial or full, immediate or delayed, and are non-linear in the shock size. Importantly, wages are sticky even if firms have negligible costs for cutting wages.

Keywords: frictions; matching; sticky wages.

JEL: C70, D40, E30, J30

1 Introduction

A large body of empirical evidence suggests that real wages are not very flexible downward. Firms rarely push through wage cuts (e.g., Agell and Lundborg, 2003; Bewley, 1995; Holzer and Montgomery, 1993), in contrast with the equilibrium prediction of the typical directed search model of frictional labor markets. This kind

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