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 generates 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.

- Huo & Ríos-Rull (2020) 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

Conclusion: in standard models of price/wage rigidity, bilateral inefficiencies occur
-> problematic