

Inflation & Unemployment II

What is Unemployment?

- If we treat labour a factor of production needed to produce output then we can argue that unemployment is surplus capacity
 - Want to measure the 'potential labour force = all who could work
- Clearly this would be difficult and contingent on social structures and norms
- In the UK there was a clear definition up to 1979 "all those without work who are actively seeking work"
- Not the same thing but easy to measure and included
 - Those claiming unemployment benefit
 - Those registered at job centres not claiming benefits
 - Problems hidden unemployment –still people who would like to work but don't register
 - some countries have peasant subsistence agric sector/culture so being unemployed doesn't mean the same thing
 - even in Europe
- From 1979 there have been numerous changes to the measurement of unemployment. With the mass unemployment of the early 80s the Thatcher government made 20 changes all but three reduced unemployment and most of them
- Most marked since 1982 registered unemployment was only those who claim benefit
- Means unemployment stats became misleading when compared with past –some estimates suggested an underestimate of almost 1 million
- Unemployment rate is usually = $\text{Unemployment} / \text{Labour Force}$
- But definition changes affect both and changing participation rates change the size and composition of the labour force, so not completely consistent over time and care needed
- OECD:
 - unemployment definition = persons of working age without work, currently available for work, actively seeking work.
 - Standardised unemployment = persons of working age who are without work and have taken specific steps to find work
- Problems:
 - Meagre part time activities may include work

- The very recently laid off may be excluded
- Could increase it by increase women in LF if child care facilities available, day care facilities for elderly
- Not clear what qualifies as job search –is it reasonable to expect people who have very little chance of finding a job to search
- Should also recognise that talking about unemployment in aggregate tends to ignore the incidence/distribution of it
 - changes in the duration of unemployment
 - considerable regional variation –level and persistence
 - disproportionate effects on fringe groups –young, unskilled, minorities
- Partly in recognition of this research has also focussed on the dynamic nature of unemployment
 - Have to distinguish stocks and flows –slicing a cherry cake
 - Cant tell duration of the spells by cross section so need panel studies

Costs of Unemployment

If treat as part of means production then forgone output –opportunity cost

Marginal cost- incremental loss of output

Average cost-Total cost of reduction to lower level of U, but depends on defn of

FE

Government costs –maintaining the unemployed –loss of taxes

Other costs: -individual psychological and physical health –social effects when this generalises to communities –effects on the employed stress and insecurity

Inflation Costs –emphasised in the literature –historical reasons –have discussed before

Really NAIRU concept of little value when considering other costs

What is full employment?

1. When involuntary unemployment is zero. NB Keynes defined involuntary unemployment as existing when an increase in aggregate demand led to a decrease in unemployment
2. when unemployment = vacancies
3. when the rate of inflation is zero: natural rate vs NAIRU
4. when unemployment is at level necessary for optimal job search and placement

The different definitions have different implications.

Theories of Unemployment

Can distinguish 4 approaches to analysing unemployment –though distinctions have become rather blurred, with N-c, N-K orthodoxy taking on board analysis/aspects from other schools

1. Neoclassical

- All unemployment is voluntary
- Wages and prices are flexible so unemployment is a temporary/transitory phenomenon caused by imperfections, such as trade unions which prevent real wages falling to achieve equilibrium
- No role for govt
- Solution is not to interfere except to remove obstacles to decreasing real wages
- New classical type –Lucas supply function –argue need to remove benefits and state involvement

2. Keynesian

- All unemployment is involuntary caused by inadequate aggregate demand
- Market failure means markets don't clear and wages are rigid downwards – empirical observation
- So money wage is fixed –individuals and unions will not take nominal wage decrease
- Want to maintain differentials –norms social customs, fair play, implicit contract (more recent argument)
- If increase demand will increase prices and this could decrease the real wage to the market clearing value
- So expand out of unemployment – create jobs

3. New Keynesian –orthodoxy

- Jackman Layard and Nickell CLE approach influential and 1991 book has recently been reprinted with new intro
- Introduce number of imperfections into what is a N-C/GE view of the world
- Open to criticism that much is ad hoc, particularly in the way their models are operationalised in the empirical work.
- Focus on NAIRU –equil level of U is that at which inflation stabilises –not market clearing but stste to which system returns after a disturbance
- Arguments for wage and price setting close to the PKs
 - Wages are set relative to prices (real wage resistance and target real wage)
 - Prices set relative to wages –mark up
 - Level of unemployment effects mark up so unemployment ensures claims on national output are compatible
- Inverted Phillips curve
 - $p - w^e = \beta_0 - \beta_1 u$
 - $w - p^e = \gamma_0 - \gamma_1 u$
- Analogous to standard Phips curve relation
 - $\Delta p - \Delta p_{t-1} = -(\frac{1}{2})(\beta_1 + \gamma_1)(u - u^*)$
 - If Δp has no long run trend –is perceived as random walk
- Increase in unemployment in late 70s can be accounted for by
 - Decline in feasible real wages –OPEC price rise
 - Target real wage increased relative to labour productivity because of growing TU power
 - Jackman et al stress both
- This model has nominal inertia, the past has effect, but only surprises create fluctuation
- But also argue that:
 - in LR unemployment is determined only by LR supply factors and equals u^*
 - in SR intersection of Demand and supply
 - SRAS: $\Delta p - \Delta p_{t-1} = -(\frac{1}{2})(\beta_1 + \gamma_1)(u - u^*)$
 - SRAD: $\Delta p = \Delta q + \lambda(u - u_{t-1})$ with q log nominal GDP
 - So demand shock eg war ...
 - And supply shocks such as oil prices...
- Use to explain why unemployment and inflation moved in the same direction
- The persistence of unemployment means need to allow for hysteresis
 - $\Delta p = \Delta p_{t-1} - \theta_1(u - u^*) - \theta_1(u - u_{t-1})$
 - SR NAIRU $u_s^* = f(u^*, u_{t-1})$
 - Which means once unemployment has risen cannot bring back earlier LR NAIRU without a permanent increase in inflation
 - Note in short run have to consider effects of
 - Import prices
 - Taxes
 - Productivity

- Labour markets do not clear
 - but this is not like disequilibrium models where firms can't sell goods (quantity constrained).
 - They can't but wouldn't be able to at full employment as imperfect competition so set prices above MC to max profits
- So have to explain why labour markets do not clear and in good Neo Keynesian fashion focus on imperfections
 - Efficiency wages (Shapiro and Stiglitz)
 - prevent shirking by higher wages rather than police
 - Collective bargaining –insider outsider
 - Unions represent insiders, but restrained by fear of unemployment
 - Segmented labour markets and differential
 - Implicit contracts (Akerlof and Yellen)
 - Risk averse versus risk neutral
 - Fairness
 - Hysteresis
 - the long term unemployed have little effect on wage bargain
 - insider outsider
 - composition of unemployed important
 - but could reduce unemployment by increase AD
 - also strata of the reserve army!
 - Corporatism
 - Role of the state in wage bargains
 - Levels of employment part of the bargain
 - Effects of centralised vs decentralised bargaining
 - Rowthorn (1992) cooperation/centralisation better in bad times as fragmented structures vulnerable to shocks.
 - Job search –frictional unemployment
 - If unemployed search harder will need less unemployment to restrain wage pressure
 - Effect of mismatch
 - Effect of
 - Replacement ratio = benefit/income
 - Length of unemployment –as with hysteresis
 - Skills atrophy
 - Demoralised workers
 - Screening device by employers

4. Marxist/Radical

- Unemployment necessary consequence of the working of capitalism
- Labour market not same a market for other commodities –power relation; labour power vs labour
- Three types
 1. Unemployment associated with excess capacity and low profits
 2. Normal feature of capitalist system
 3. Combine 1 and 2 to give crisis theory
 - Dialectical process –contradictions eg increase surplus gives realisation crisis
 - Inherent endogenous contradiction
 - Crisis is cleansing removing inefficient
 - Role of IRAL in regulating –Francis Green tries to operationalise

5. Post Keynesian

- Market power of giant corporations: Kalecki
- Difference in savings propensities between workers and capitalists: Kaldor
- If monopoly power too high and inducement to invest too weak because MPC then equil level output is below potential ie below that required to achieve FE
- Sawyer in “Macroeconomics in question” gives more detail
- Also some focus on govt –evidence corporatist states have low unemployment where social cohesion keeps inflation down rather than draconian measures on demand

6. Other radical views

- a. Segmented labour market theory –Piore and Sabel: Fine critique
- b. Schumacher
- c. Schumpeter