

Macroeconomics Discussion Session Exercise #4

1. Using graphs and words, outline the self-adjusting mechanism that in the neoclassical view endows market systems with an automatic tendency to full employment. What are the conditions for the operation of the self-adjusting mechanism? What are the policy implications of the neoclassical theory?

When there is unemployment, $L_s > L_d$. In the labor market, the wage must be above w^* , at w_1 , with L_s at L_{s1} and L_d at L_{d1} . workers not able to obtain employment or as much as they would like will start to bid down the wage to undersell their competitors. As the wage falls, L_d increases and L_s contracts, until $w = w^*$ and $L_s = L_d$.

So, when $L_s > L_d \rightarrow w$ falls $\rightarrow L$ (employment) increases. This is because actual employment is determined by firms' hiring and that is L_d . So employment when the $w = w_1$ was L_{d1} and now that $w = w^*$, employment is at L^* .

More people are working, so more people are earning income. More people are working so more people are producing stuff. So when L increases $\rightarrow Y$ increases. (output and income rise by the exact same amount due to the national income accounting identity; there is a hidden assumption here that the wage elasticity of L_d is elastic).

The question then arises: who is going to purchase the additional output produced as a result of the higher level of employment brought on by the fall in the real wage?

(recall that with no government, income = 0 when one is out of work). Some of the new output will be purchased by the newly employed workers with their new income. And they could, hypothetically purchase all of it, but they probably will not, because there will probably be some positive level of savings.

Savings is income not spent; savings is production not purchased.

So when Y increases $\rightarrow S$ increases. And that corresponds to output left unsold. Unless firms have their new higher level of output validated and justified by real sales, they will not continue to produce at that level and will cut back production, laying off workers and the whole story will unwind.

That takes us to the loanable funds department, the market for savings and investment. Savings is a positive function of the rate of interest (interest is a reward for saving), and investment is a negative function of the rate of interest (interest is a cost of borrowing).

Higher savings due to an increase in income is shown on the loanable funds diagram as a shift out of the savings function, from S_1 to S_2 . at the old equilibrium rate of interest, i^*1 , that equated savings and investment when the savings function was S_1 , now that savings is depicted by S_2 , $S > I$. this will be the amount of production not purchased,

because some of the production not purchased as a result of consumption spending will be offset by investment purchases. But unless investment is high enough to fill the gap between output (income) and consumption, some production will still not be purchased, firms will cut back and lay off workers, income will fall, spending will fall, and the whole story will unwind.

Except that competition between and among the lenders and borrowers will result in banks with excess reserves to lend cutting their interest rate to try to attract borrowers. As i falls, investment demand will increase and savings will contract until $i = i^*$, and $S = I @ Y_f$.

So, perfectly flexible wages, prices, and interest rates constitutes the self-adjusting mechanism that endows market systems with a tendency to Y_f in the neoclassical view. Another way of saying the same thing is that all markets, including factor markets, must be perfectly competitive.

A perfectly flexible wage is a necessary but not sufficient condition for the self-adjusting mechanism: interest rates must also be perfectly flexible to stimulate the full employment level of investment.

The existence of a minimum wage or a union bargained wage does not mean that that is the cause of any unemployment that may exist. If the min wage or union wage is below w^* , then nothing is stopping the labor market from adjusting. It could be the loanable funds market where the problem is.

Policy implications of the neoclassical view? If there is unemployment, do nothing, let the market fix itself—government will only mess things up. Or, since we do not start from day one with no government, the ‘anti-policy’ policy implications are that government should promote the conditions under which the self-adjusting mechanism works most smoothly: so deregulate, anti-trust, etc.—promote free markets.