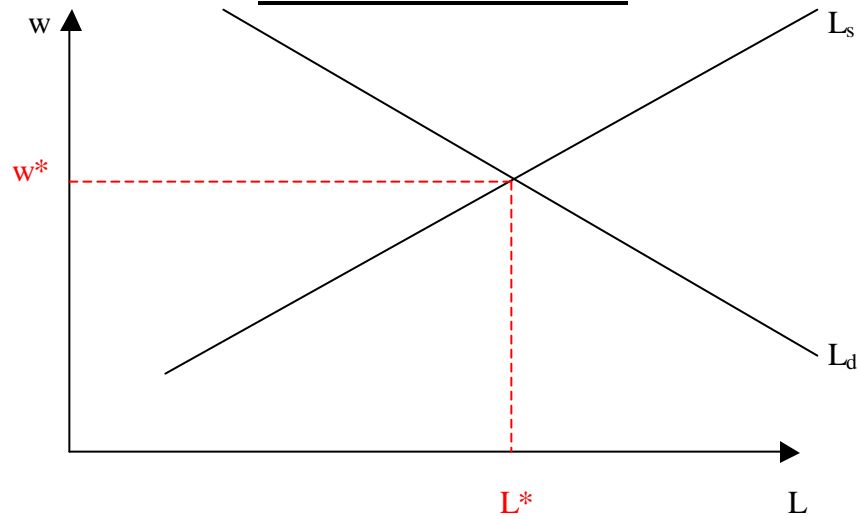


### Neoclassical Labor Market



w: Real Wage

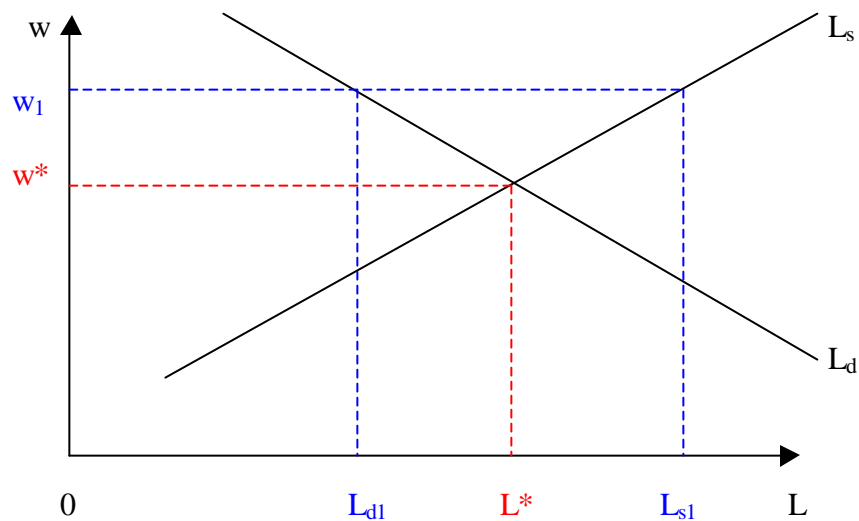
L: Labor or employment

$L_s$ : Labor Supply.

$L_d$ : Labor Demand

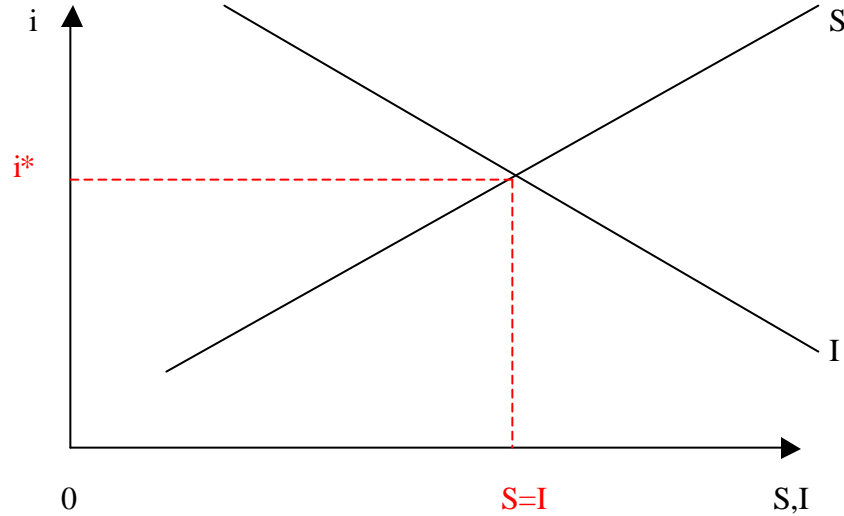
$w^*$ : equilibrium wage

$L^*$ : equilibrium (full) employment ( $L_s = L_d$ )



When  $w_1 > w^*$ ;  $L_s > L_d$  (unemployment), with perfectly competitive labor market (wage is perfectly flexible), unemployed workers will bid down the wage. As the wage rate decreases,  $L_d$  will increase and  $L_s$  will decrease until  $w = w^*$  and  $L_s = L_d$

### Neoclassical Loanable Funds Market



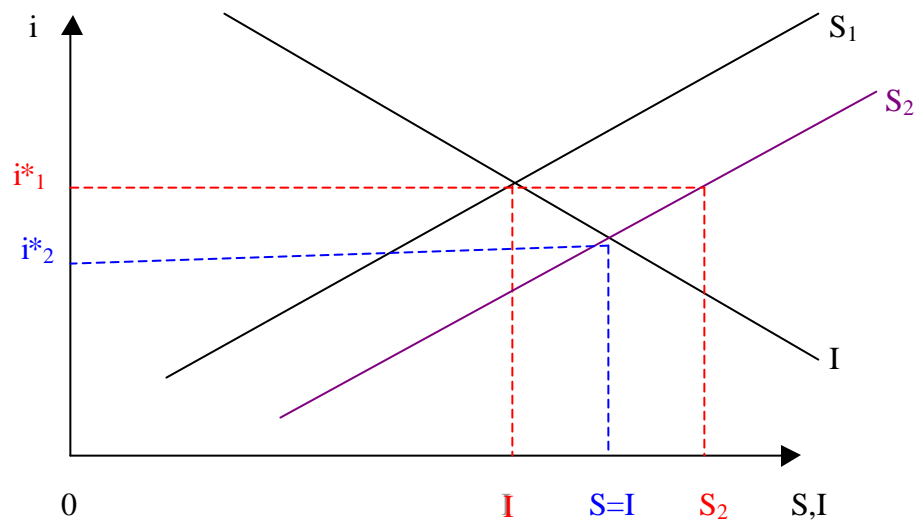
$i$  = real interest rate

$S$  = savings (Supply of Loanable Funds)

$I$  = investment (demand for Loanable funds)

$i^*$  = equilibrium rate of interest.

$S=I$  = savings = investment (supply and demand for Loanable Funds are equal), Macro equilibrium condition.



When  $L_s > L_d$ ,  $w$  goes down, then  $L$  increases, thus  $Y$  increase and  $S$  increases.

As a result of increase employment, aggregate output and income ( $Y$ ) increase, Increased income means increased savings (savings function shifts out). At old equilibrium, interest rate ( $i^*_1$ ), savings exceeds investment. Excess supply of loanable Funds will result in banks bidding down the interest rate (assuming loanable funds market is perfectly competitive). As the interest rate falls, investment will increase and savings will decrease until  $i=i^*_2$  and  $S=I$  at full employment ( $Y_f$ ).