Unemployment in a macroeconomic context essay sample

Economics, Macroeconomics

Unemployment is a macroeconomic phenomenon that directly affects an economy, its people and the society as a whole. The rise of unemployment in many developed countries has kept it in the limelight of macroeconomic research, and the underlying causes behind the existence of unemployment remain contentious. Given this divergence, the solutions presented by scholars and experts vary widely in scope and prescribed remedies. However, there is a general consensus that monetary policies and fiscal policies affect unemployment. But economists tend to agree that money has no effect on production and unemployment in the longer term. In this paper, I aim to review various competing theories of unemployment and consider whether they may be used to explain any of the rise in unemployment experienced globally during past and present economic cycles. I also examine the effectiveness of monetary and fiscal policy as a tool to drive out unemployment in an economy and the constraints these policies have in dealing with the most recent crisis we are experiencing.

Under the classical definition of unemployment, the unemployment rate could be broadly defined as the percentage of the labor force that is willing, able and actively seeking a job, but is unable to secure employment. The ILO standard for a person to be considered unemployed includes a clause that only encompasses persons who have been actively seeking a job in the last four weeks and are available to start work immediately if an opportunity presents itself. It assumes full employment of labor and other productive resources. Full employment is a situation where the economy’s resources are being used fully. There is zero deflationary unemployment i. e., a situation where the resources in the labor pool at that point in time will be willing to

work at the marginal wage rate being offered to them and will be employed. A worker is said to be voluntary unemployed when he refuses to work at the current wage rate.

According to classical economists, general over-production resulting in unemployment is impossible. There may be temporary instability in the economy but it is restored within a short period. They believe that there will always be a stable equilibrium at full employment. Any disturbance in the full employment situation may be due to government interference or any other causes in the free market economy.

For the purpose of this paper, the broad categories of unemployment must be identified, as I will allude to these in my argument:

- Structural unemployment: Typically arises for mismatching of skills as the skills required for jobs change with a growing economy, and is manifests itself typically in industries which undergo permanent or long term changes. This type of unemployment is typically prevalent in the long term.
- Frictional unemployment: Typically short term in nature, this type of unemployment occurs when a worker shifts jobs, or leaves one job for another. The period between the job search is when he experiences *frictional* This temporary hitch actually increases the workers long term welfare and economic efficiency, therefore being a productive part of the economy. This type of unemployment is a result of the imperfect system of information in the labor market. If a worker knew that he

would be employed immediately for a particular job opening, there would be no time lost getting the new job, thereby eliminating this form of unemployment. This type of unemployment coincides is not concerned with the number of jobs available and cannot be solved using aggregate demand simulation. The best solution for frictional unemployment is to provide better information asymmetry to job seekers and employers. It is important to understand that a small degree of frictional unemployment is helpful because it helps workers get the jobs that fit their wants and skills best and the managers to seek workers who advance their goals the most. ‘ Wait unemployment’ is a type of frictional unemployment which provides some of the workers in a particular sector receive a premium over the rate set by that segment. Workers from other sectors then wait to get into this sector to earn that premium. However, since these people are likely to have jobs while undergoing this waiting period, they would not be defined as being unemployed.

- Seasonal unemployment: This type of unemployment involves regular seasonal changes in labor demand, and affects industries such as construction, leisure, Agriculture etc.
- Cyclical unemployment: This type of unemployment is typically a result of inadequate effective aggregate demand that eventually leads to a loss of real GDP. It gets its name because it shifts with the business cycle, although it can also remain steady if the business cycle goes through a long slump, like it did in the 1930s depression. This type of unemployment is also often referred to as Keynesian unemployment

since the theory is attributed to J. M. Keynes. Under this theory, GDP stagnates due to economic slowdown, which is a direct result of pessimistic business expectations. As a result, the size of jobless people surpasses the amount of job opportunities, so that if even all open jobs were occupied, some workers would still remain unemployed.

Two other types of unemployment also deserve a mention: Classical and Marxian. Unemployment in the real context is a combination of different types of unemployment, and all of them can exist at one time. The scale of each is very hard to gauge, in part because they overlap and are they hard to disconnect from each other.

Economic cycles are undoubtedly a key driver of unemployment trends in any economy. Recent history has allowed economists to test theories in real world environments on many occasions. However, being the real world, the dynamics and underlying assumptions of constants is a challenge that cannot and will never be overcome. Up till the Great Depression in the 1930s, most macroeconomic research activity concentrated on individual firms and industries. With the great depression of the 1930s, and the development of the concept of national income and product statistics, the field of macroeconomics began to expand. Particularly influential were the ideas of John Maynard Keynes, who used the concept of aggregate demand to explain fluctuations in output and unemployment and coined the concept of cyclical unemployment.

In his work titled The General Theory of Employment, Interest and Money, Keynes concluded that certain types of unemployment, such as that witnessed in the 1930s in the U. S. was not of a short term nature, but rather was a long term issue and a major misconception in the classical theory actually led to the further deterioration of the crises. Classical economists believed that inflexible labor markets was a root cause of unemployment during the depression, where workers tended to price themselves out of the labor pool by not accepting jobs at available rates. The U. S. government did indeed try to impose pay cuts in government related jobs in their circle of influence, but Keynes surmised that this actually led to further deepening of the recession since consumer spending decreased as a result of less spending power and less money pumped into the economy (Porter, 2004, p. 397).

Keynes argued that while classical economists tended to focus on increased savings as a means of driving the economy through banks having more liquidity to lend to the business sector at a lower rate, this was a flawed assumption since the business environment was driven less by an attractive interest as it was on opportunities present at that specific point in time. Keynes proposed that given the sour business environment as seen in the depression would deter existing businesses and new businesses from taking new risk with borrowed capital, and would focus on conserving existing cash to last out the downturn. This in turn would lead to business owners curtailing the biggest part of their present expenses – their HR payroll, leading to a vicious circle of unemployment.

Based on his arguments, Keynes concluded that the recessions and depressions, while ultimately self correcting in the free market economy, would decrease drastically in length and depth if the government undertook timely corrective intervention. The government had to intervene with measures to generate sufficient aggregate demand for the economy.

Keynes went on to formulate how this increase in aggregate demand would help lower the unemployment rate by proposing his notion of a multiplier effect. When the government encourages firms to invest into higher production to cut the slack in production output, it would drive firms to increase the labor factor of production. This new labor or re-hired labor would result in a rise in new household incomes, which would trigger more spending. More spending would lead to higher demand for products, and contribute to a higher aggregate demand. This multiplier would work up to a certain degree until the marginal household incomes do not lead to marginal household spending.

Keynes offered the Monetary policy and the Fiscal policy as two tools that governments can use to drive aggregate demands and lower unemployment. Using the Monetary policy, governments can use interest rates to drive money supply into the system. This would have two effects – an increase in money supply would mean more liquidity for households who would spend more and drive up aggregate demand, and simultaneously, businesses wanting to cater to higher demand would have cheaper access to borrowed money to drive up supply of their product into the market. This would lead to the multiplier effect.

Keynes offers benefits to be derived from the multiplier by having the government manipulate the Fiscal policy as well. Under this model, Keynes proposed that the government should increase its spending on public projects and reduce taxes. Keynes argues that ordinarily, public spending on potential projects that could be done by private entities would crowd out the private entities and have an inefficient allocation of resources as well as a reduced amount of spending by private entities. However, in cases where there is unemployment, this public spending would in itself provide a multiplier effect as follows: The government would reduce taxes and therefore allow households to have higher disposable incomes and drive up aggregate demand and hence employment. Simultaneously, however, the government would have less capital at its disposal from tax revenues. Therefore, increase in government sending would come from the government borrowing from the public by issuing government bonds and accessing private savings that were depressed as a result of the business climate. The government spending on projects would lead to mopping up any unemployment in the system that remains after aggregate demand balances aggregate supply (Keyssar, 1986, p. 217).

The most recent global financial crisis and recession we face today has a different dynamic than the recession of the 1930s in the U. S. It is a crisis that has implications arising from the crisis that Japan faced in 1998. I cite economist Dr. Paul Krugman’s views on the potential ‘ liquidity trap’ scenario that Japan faced. Dr. Krugman points out that in 1998, Japan was stuck at a point where the Keynesian monetary policy theory could no longer be

applied since interest rates were already at zero and could not be negative. Any further money supply would accomplish nothing more than inflationary pressure on the local economy and depress spending power of the population even further. Even under these circumstances, however, Dr. Krugman hypothesizes that both the monetary and the fiscal policy can be used as positive tools (Krugman, 1998, p. 137-205). While decreasing taxes would not have helped restore any consumer spending as such, the Government of Japan did engage in many public works projects to boost employment and try to drive up aggregate demand (Crump, 2003, p. 153).

This shored up available labor from the unemployed labor pool and brought in more liquidity to the system to help drive local demand. Simultaneously, Dr. Krugman suggests that the Japanese central bank should in essence tried to use monetary policy such that the real interest rate is negative by declaring that inflation will be necessary for a certain amount of time before it is reigned in through natural market forces. The unemployment rate during this time, however, is likely to suffer. This is a particular example of where monetary policy will fail to act fully to resolve the unemployment problem on a timely basis.

The U. S. faces somewhat of a similar situation at the moment where the government has exhausted its use of effective monetary policy since interest rates are virtually zero now, and options for open market operations are extremely limited. Unemployment rates in the U. S. are at 8. 5% and at all time highs since the early 1980s. However, according to the Keynesian model, even in this liquidity trap situation, Dr. Krugman suggests that

government spending should increase up to a point where the labor pool is fully utilized again (Krugman, 2008, p. 1-3). He surmises that the social marginal cost of government spending is close to negligible, and the benefits will be that until full employment is restored are tremendous.

Despite means to mitigate the sort of structural unemployment based on the Keynesian model, it is hard to separate this type of unemployment empirically from frictional unemployment, except to say that it’s longer and more agonizing for the people involved as well as the regulators. Simple aggregated demand solutions will not suffice to eliminate this unemployment. Improving the quality of labor – for example continuing education and vocational training as well as providing mobility are some of the solutions that can tackle these issues. This means that this type of structural unemployment is a result of the dynamic changes of a capitalist economy such as technological change and capital flight. Labor skills get outdated and resources need to be allocated to cover costs of training and possible relocation since labor mobility becomes a key issue in overcoming structural employment.

A key change that has taken place between the time of the great depression in the early thirties and the global economic downturn we are witnessing today is the factor of Globalization. It was understood that free trade in essence meant a certain amount of unemployment for developed economies as companies shifted more basic and less value added manufacturing jobs to developing world nations in its search to maximize profits and minimize costs (Wingfield, Bishop & Porter, 2004, p. 410).

The argument in favor of globalization to counter this view was that developed world would move on to higher value added jobs, but would obviously require some level of re-training. Simultaneously, the lower wages in developing worlds have spilled over into most of the developed world as well where the same labor has to deal with growing unemployment from jobs that have moved overseas and compete harder for jobs that remain for which they would accept lower wages. Lower wages would mean less spending power, less aggregate demand, and hence even more unemployment with a negative multiplier. It remains to be seen how the world will react to the globalization trends and free trade agreements as nations come to terms with how to help their economies recover from this crisis.

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