

AGGREGATE DEMAND MANAGEMENT IN SEARCH EQUILIBRIUM

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RESEARCH QUESTION

- Effect of frictions in coordination of trade among individuals on unemployment in a many person economy.
- Introduces a novel (for 1981) channel- trade frictions in an economy with correctly perceived flexible prices and wages.
- Role of Government policy in manipulating employment.

CONTRIBUTION TO LITERATURE

- Back then fluctuations in unemployment were mostly attributed to misperceptions of prices and wages or the lag in adjustment of the same.
- Model has multiple steady state equilibria. Highlights the role of the government to direct the economy with the best natural rate of unemployment, not necessarily the lowest.

MAIN ELEMENTS OF THE PAPER

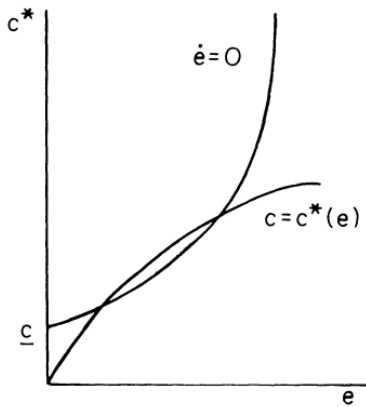
- Model is such that there are multiple steady state equilibria.

$$\dot{e} = a(1 - e)G(c^*) - eb(e) \dots (1)$$

$$rW_e = b(y - W_e + W_u) \dots (2)$$

$$rW_u = a \int_0^{c^*} (W_e - W_u - c) dG(c) \dots (3)$$

MULTIPLE EQUILIBRIA



ROLE OF GOVERNMENT POLICY

- In Steady state flow of utility per capita

$$Q(t) = eb(e)y - a(1 - e) \int_0^{c^*} cdG$$

- Welfare is given by $W = \int_0^{\infty} e^{-rt} Q(t) dt$. But $\frac{\partial W}{\partial c^*} > 0$
- But, optimal policy is given by

$$\text{Max}_{c^*} \int_0^{\infty} e^{-rt} Q(t) dt$$

subject to $\dot{e} = a(1 - e)G(c^*) - eb(e)$

- This gives optimal path of $\dot{c}^{**}(t)$ which, at steady state should be 0.
- Diamond shows that production subsidy can help achieve this level of c

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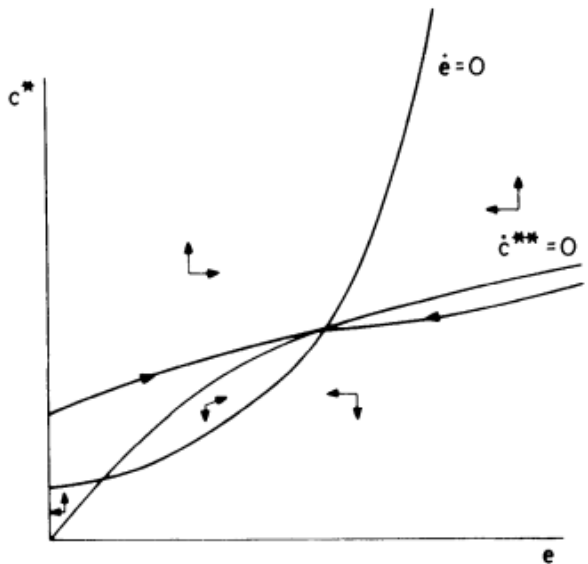
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OPTIMAL POLICY



LIMITATIONS

- Model is a very basic one- abstracts from the many good aspect of modern economics.
- Does not model (but provides a stepping stone) to introduce technological shocks
- Trade frictions and wage rigidities.