Economics 02.05.2016

The classical labour market

* Like all markets this has a demand side & a supply side
* D side represents all firms
* S side represents all workers
* AD for labour is an inverse function of the real wage

The lower the real wage the more labour is taken on by firms

Demand for workers

AS of labour is positively related to the real wage.

The higher the real wage the more workers offer themselves for employment

Any temporary displacement from equil. Is quickly eliminated through changes in the real wage.

AS supply

(w/p)e

Ne

AD demand

If the wage rate is higher or lower, it can break the equilibrium and either produce more supply or too little.

Persistent U was possible if *artificial restrictions* were placed on real wages.

E.g. trade union power raise money wages. (w)

Solution for classical economists: reduce w -> remove restriction -> workers should take a cut in their money wages.

* Cuts costs of production & raises employment

High wages can produce unemployment, if it’s above the equilibrium.

Classical view does allow for excess supply in certain sectors/industries.

Demand (D) may shift from some goods to others thereby creating temporary Unemployment(U)

Wages go down in declining sectors, and rise in expanding sectors.

Workers respond by moving to expanding sectors: U fails

This depends on:

* Degree of flexibility in wages
* Extent of worker mobility across sectors/industries

# Policy effectiveness – Public works

* Mass U in inter-war years
* Repeated calls for public works to create jobs: Keynes (1929)
* Treasury resisted: because increase in G(government spending) would be ineffective
* Why? Increase in G deprives private investors of funds
* I line includes G so we have I + G
* Rise in G shifts I+G line to the right (I + G2)
* This raises interest R.

Increase in supply of funds (Savings (s) rises)

Cost of borrowing goes up. Private sector investment falls (I)

* Rise in S = Fall in C
* Decrease in C and Decrease in I => Increase in G
* So, Y is unchanged.
* Rise in G crowds out private I

R

S

R2

R1

I + G2

I + G1

Change in Consumption and change in Interest rates.

S,I,G