Macroeconomics: BSc Year One

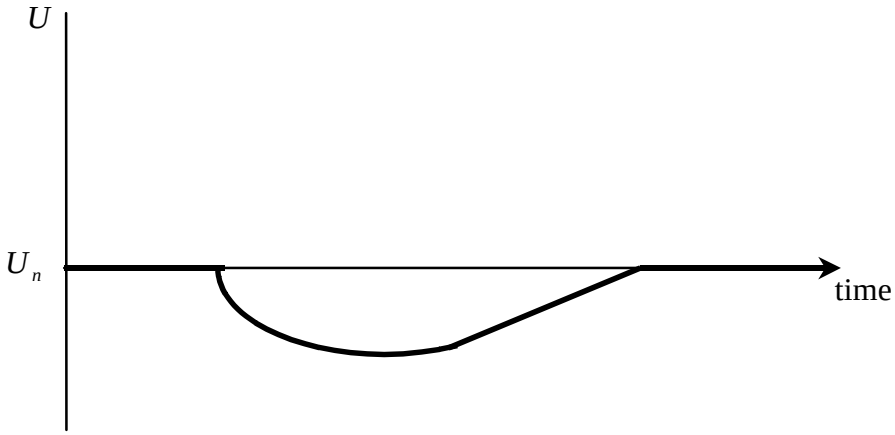
The Monetarist View of Unemployment

Monetarists give an expression for unemployment as:

$$U = U_n + [U - U_n],$$

where U_n is the natural rate of unemployment, and U is the actual rate. Monetarists express unemployment as such to distinguish between long-term changes and short-term fluctuations in unemployment; changes in U_n are likely to be long term.

The factors affecting the two different parts of unemployment are likely to be different. We have, so far, looked at deviation of unemployment about its natural rate, caused by movements in money supply leading to unexpected changes in prices. The deviation can be shown on a time diagram:

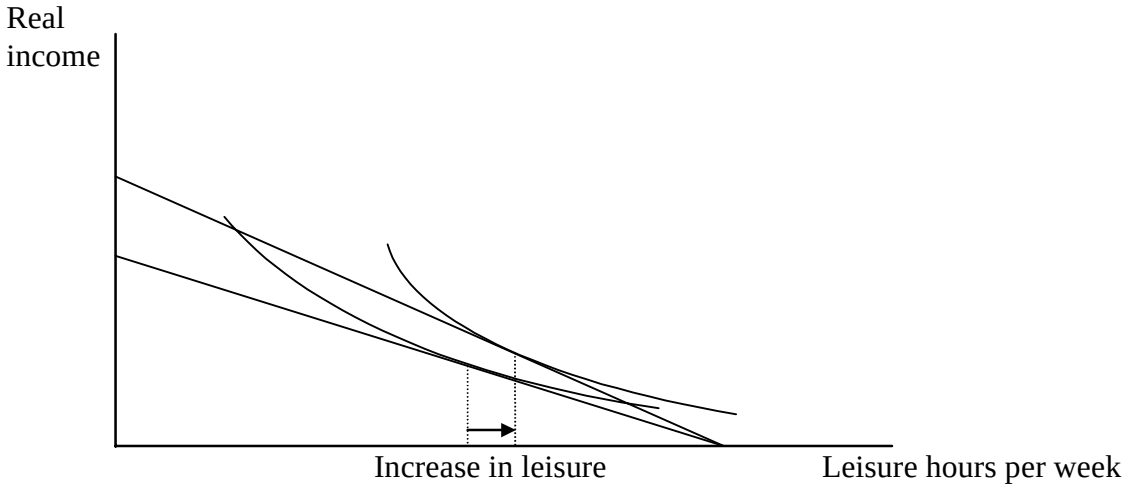


and so if there are constant shocks, the unemployment rate will deviate about its natural level. The rise in unemployment since 1950, however, is more likely to be explained by increases in U_n.

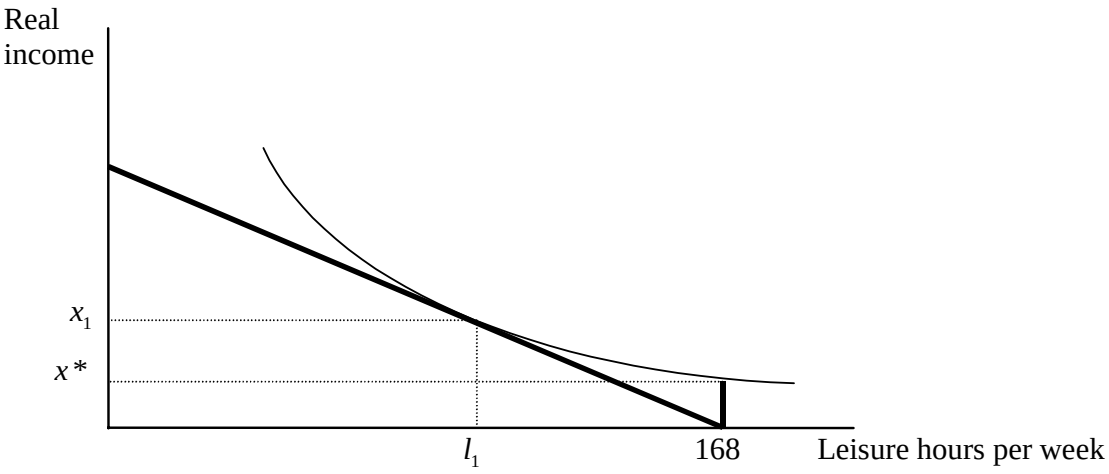
U_n is determined by choice; people sometimes choose to be unemployed as it is a better option than being employed. People want income, not a job for its own sake – we assume that the only reason people work is to accumulate income.

Voluntary Unemployment

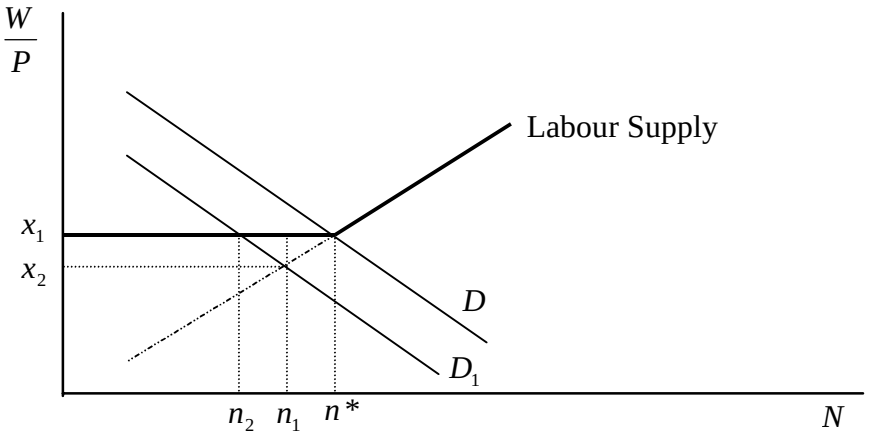
We look at a typical individual. On the graph below, we can use a standard indifference curve analysis (as used in microeconomics) to find the effect of a rise in the real income of a worker. It can be shown that as wage increases, the amount of time spent on leisure will also increase:



If there was a source of unemployment benefit, where the government agrees to give the wholly unemployed a benefit of x^* per week, the picture alters:



A person is indifferent between working at l_1 with income x_1, and not working at all with income x^*. If the budget line pivots down at all, the point at which benefits are received becomes the most attractive, and people choose to be unemployed. This can be represented on a labour supply and demand diagram:



If the demand for labour falls to D_1, $(n^* - n_2)$ people will register as unemployed rather than work. Monetarists claim that the high juvenile unemployment rate in the 1970s was due to the rise in the school leaving age, meaning people could claim unemployment benefit as soon as they left school. This analysis supports that argument.

Minimum Wages

If a minimum wage is set below the average rate, there is no effect, but if a wage is set above the general level, there will be an excess supply of labour in the market; at the minimum wage level, more people will wish to work than will be employed by firms (who now face a higher per unit cost), and thus unemployment is generated.

Government-imposed changes like these can have a permanent effect on unemployment, leading to a continual rise - as seen in Britain in the second half of the 20th century.