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Lecture 7, Parkin Chapter 6 continued

We have already looked at the difference between aggregate supply in the short & long run. We have also looked at the short run equilibrium of the economy. We now compare the short run to the long run.

- How does the short–run equilibrium level of RGDP compare to the potential long-run level of GDP for the economy?

Ans. The short–run equilibrium level of RGDP may be more, less, or equal to the potential long-run level of GDP for the economy.

(See Fig. 6.11, Panel (a), Pg. 141, Parkin Ch. 6)

- When is the economy in Long-Run Equilibrium?

Ans. The economy is in long-run equilibrium when the short-run equilibrium level of RGDP equals the potential GDP.

(See Fig. 6.9, Pg. 139, Parkin Ch. 6).

- Why do we need macroeconomic policy-making?

When you are off potential GDP in the short-run, resources (like labor) are either unemployed, or more than fully employed. This is due to the inflexibility of prices in the market for resources. However, in the long run prices are fully flexible, so the economy returns to its potential level of GDP, given a sufficient period of time.

First, let us consider the case where the short run GDP is less than the potential level. If adjustments in the economy take place quickly, that is price rigidity is a very temporary phenomenon (and we return to the long run state of the world shortly), then the economy might be left to a ‘self-adjustment’ process. However, if that is not so and it takes a long period of time for this self-adjustment process to work, then the government has to come forward with a policy to get the economy back to the potential level of GDP more quickly. As long as the economy is not at potential GDP there will be agents in the economy who will be worse off (as they might be facing unemployment).

In the case where short run GDP is above the potential long run level, the economy would face inflationary pressures in its automatic readjustment to long run potential GDP. Ultimately, the inflationary process would die out after a series of readjustments on both the demand and supply side, but in the meantime economic agents would suffer the
effects of inflation. If the government does not want this to happen, it can adopt anti-inflationary policies (like increasing taxes or lessening government expenditure, which would reduce the level of demand in the economy).

The basic macroeconomic debate between those who favor economic activism by the government versus those who do not arises from their difference of opinion regarding how long it takes to transition from the short state of the world, to the long run. In other words, the question really is ‘how long is the long-run’? Those who believe in less activism believe that the transition process is fast, while their opponents believe that the reverse is true.

Much of the remainder of this course will be spent studying models developed by economists subscribing to either of these viewpoints. *Before we do that, however, let us look at one of the other markets in the macro-economy that is of great interest to us for obvious reasons: the Labor Market.* As already stated, there is a strong connection between the labor market (the market for a productive input) and the market for goods & services (the market for productive output).

**Parkin Chapter 7: The Economy at Full Employment**

Q. Who demands labor?
Ans. Firms.

Q. Who supplies labor?
Ans. Households.

Q. How do firms decide how much labor to demand?
Ans. The firms decide how much labor to use in production (hence demand) through their profit maximization process, given prices in the market for goods & services and the price of labor (money wages).
(See Fig. 7.4, panel (b), Parkin page 162)

Q. How do households decide how much labor to supply?
Ans. The households decide how much labor to supply based on their utility maximization exercise, given prices in the market for goods & services and the price of labor (money wages).
(See Fig. 7.5, Parkin page 163)
Q. When is the labor market in equilibrium?

Ans. When quantity of labor demanded by firms equals the quantity of labor supplied by households. Diagrammatically, the intersection of the aggregate labor demand curve and the aggregate labor supply curve for the economy gives us the labor market clearing quantity of labor & real wage rate (i.e. money wages/price level).

(See Fig. 7.6, Panel (a), Parkin Pg. 165)

*Think about the following:*

1. How does an increase in population shift the labor supply curve? Why?
2. How does a more efficient technology shift the labor demand curve? Why?
3. While a change in W/P leads to movements along the labor demand & labor supply curves, think of factors that might shift these respective curves. How is the ‘full-employment’ equilibrium affected by the shift of these curves?

Q. When may the labor market not be in equilibrium?

Ans. The labor market may not be in equilibrium if money wages are sticky. For fully flexible money wages, the wages will adjust to guarantee labor market clearing (‘full-employment’ equilibrium). If initially demand is higher than supply, real wages will rise till demand reduces to equal supply. For supply being higher initially, the reverse will occur. However, for sticky wages this self-adjustment process may not occur & the labor market may be in a state of disequilibrium. If there is excess supply in the labor market, we would have underemployment in the economy at real wages greater than the equilibrium (market clearing) rate. On the other hand, if there were excess demand in the labor market, we would have over-employment in the economy at real wages less than the equilibrium rate.

(See diagram drawn in class)

Q. What is the relationship between the labor market & the market for goods and services?

Ans. The potential GDP for the economy is the amount of GDP that would be produced, using the equilibrium level of labor obtained when the labor market clears. We can calculate the potential GDP by plugging the market clearing quantity of labor, into the aggregate production function for the economy. For disequilibrium in the labor market, the actual GDP (obtained by plugging the actual amount of labor employed) is either
above or below potential GDP. For underemployment in the labor market, actual GDP is less than potential GDP. For over-employment in the labor market, actual GDP is above potential GDP.
(Refer back to Fig. 6.11, Panel (a), Pg. 141, Parkin Ch. 6)