UNIT - V

EMPLOYMENT THEORIES AND TRADE CYCLE

1. What do you mean by full employment?

Ans:- Full employment refers to a situation in the labour market where all available labour resources such as workers who are willing and able to work at prevailing wage rates are utilized. In a state of full employment, the unemployment rate is at its natural rate which means there is only frictional and structural unemployment present with no cyclical unemployment. Achieving and maintaining full employment is an important goal of macro economic policy. However, reaching full employment can be challenging due to factors such as technological changes, shifts in global markets and structural changes in industries

2. What do you mean by involuntary

unemployment?

Ans:- Involuntary unemployment refers to a situation where individuals who are willing and able to work at the prevailing wage rates are unable to find employment despite actively seeking it. In other words, involuntary unemployment occurs when individuals are unemployed due to factors beyond their control. Involuntary unemployment is considered as a significant economic problem as it leads to underutilization of human resources, lower economic output, etc.

3. What are the different types of unemployment?

Ans:- Following are the different types of unemployment:-

① Frictional Unemployment: This type of unemployment occurs when individuals are between jobs or transitioning from one job to another. It is often short-term and temporary, as individuals search for better employment opportunities or wait for suitable job matches. Frictional unemployment can result from factors such as changes in personal circumstances, job relocation, or graduating from school and entering the labor market.

(ii) Structural Unemployment: Structural unemployment arises from a mismatch between the skills possessed by workers and the skills demanded by employers or changes in the structure of the economy. It occurs when technological advancements, shifts in consumer preferences, or globalization render certain jobs or industries obsolete, leading to job losses. Workers in structurally unemployed sectors may require retraining or relocation to find employment in growing industries.

(iii) Cyclical Unemployment: Cyclical unemployment is closely tied to the business cycle and occurs when there is a downturn in economic activity, such as during recessions or periods of low demand. It results from decreased aggregate demand for goods and services, leading to layoffs, reduced production, and higher unemployment rates. Cyclical unemployment tends to rise during economic downturns and decline during periods of economic expansion.

(iv) Seasonal Unemployment: Seasonal unemployment is linked to seasonal fluctuations in demand for labor in certain industries or occupations. It occurs when businesses hire workers for specific seasons or periods of the year, such as agricultural workers during holiday seasons. Once the peak season ends, workers may become unemployed until the next season begins.

(v) Underemployment: Underemployment refers to a situation where individuals are employed but are not fully utilizing their skills, education, or availability for work. This includes part-time workers who desire full-time employment, workers in low-wage or low-skilled jobs despite having higher qualifications, and ~~indid~~ ~~indivi~~ individuals working in jobs below their skill level.

Understanding the different types of unemployment is crucial for policy-makers, economists, and individuals alike, as each type requires different policy interventions and strategies for mitigation. Effective labor market policies, education and training programs, and economic stimulus measures can help address the various forms of unemployment and promote sustainable job creation and economic growth.

4. What do you mean by natural rate of unemployment?

Ans:- The natural rate of unemployment also known as the non-accelerating inflation rate of ~~ue~~ unemployment refers to the ~~set~~ level of unemployment that exists in an economy when it is operating at its potential output and there is neither upward nor downward pressure on inflation. In other words, it represents the level of unemployment that is consistent with stable inflation over the long term.

5. What do you mean by trade cycle?

Ans:- The trade cycle also known as the business cycles, refers to the recurring pattern of economic expansion and contraction experienced by an economy over time. Understanding the trade cycle is important for policy maker, businesses and investors to anticipate and respond to changes in the economy.

6. What are the features of trade cycle/ ~~P~~ business cycle?

Ans:- Following are the features of

business cycle:

(i) Recurring Patterns: The business cycle consists of repetitive phases of expansion and contraction, characterized by changes in economic activity over time.

(ii) Four Phases: The cycle typically includes four phases: expansion, peak, contraction, and trough, each representing different stages of economic activity.

(iii) Duration: The length of each phase can vary, with expansions and contractions lasting from several months to several years, depending on various economic ~~activity~~ factors.

(iv) Impact on Employment and Output: During expansions, economic activity, employment and output generally increase, leading to growth and prosperity. In contrast, contractions are marked by declining economic activity, rising unemployment, and reduced output.

(v) Influence of Economic Indicators: Various economic indicators, such as GDP, employment rates, consumer spending, and business investment, reflect the different phases of the business cycle and provide insights into the heath of the economy.

(vi) Policy Response: Governments and central banks often implement monetary and fiscal policies to mitigate the negative effects of economic downturns and stimulate growth during periods of contraction.

(vii) Vulnerability to Shocks: External factors, such as changes in international trade, technological advancements, natural disasters, and financial crises, can disrupt the business cycle and impact economic performance.

(viii) Cyclical Industries: Certain industries, such as construction, manufacturing, and retail, are more sensitive to changes in the business cycle and may experience greater fluctuations in demand and profitability.

7. What are the components of business cycle?

Ans:- Following are the main components of business cycle:

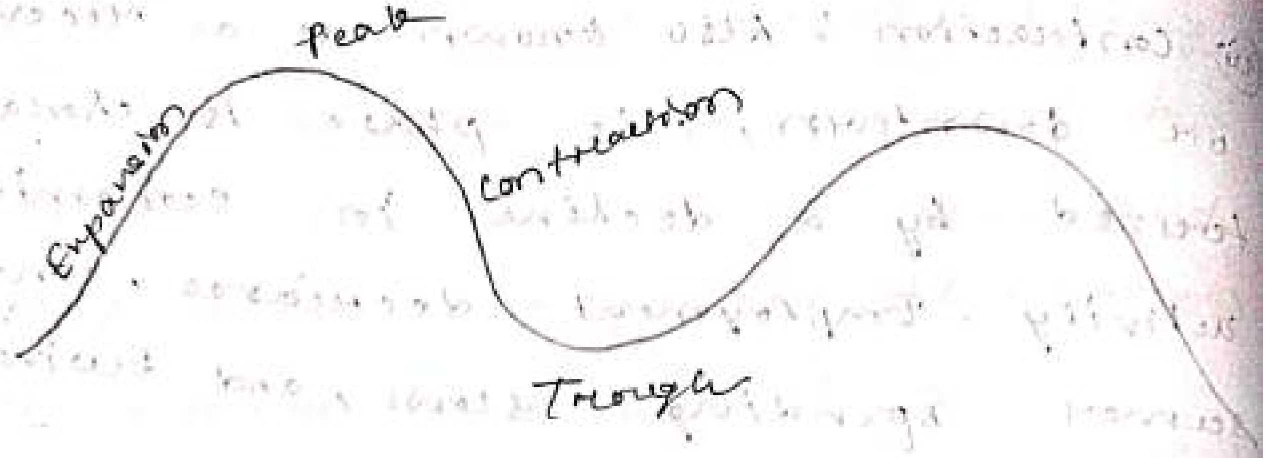
(i) Expansion: During this phase, economic activity, production, and employment levels increase. Consumer spending rises, and businesses invest in expansion.

(ii) Peak: The peak marks the highest point of economic activity in the cycle. Employment is high, and production levels are at their maximum. However, signs of strain may emerge, such as inflationary pressures.

(iii) Contraction : Also known as a recession or downturn, this phase is characterized by a decline in economic activity. Employment decreases, consumer spending slows, and businesses reduce production.

(iv) Trough : The trough represents the lowest point of the business cycle. Economic activity reaches its lowest level, and unemployment is high. However, it also signals the end of the contraction phase, as the economy begins to recover.

These components interact with each other to form the cyclical pattern of the business cycle. Economic indicators such as GDP growth, unemployment rates, consumer spending, and business investment help track the movements of these components and provide insights into the current phase of the cycle.



Business Cycle

8. ~~What~~ Explain the classical theory of employment.

Ans:- The classical ~~economy~~ ~~to~~ economists believed in the existence of full employment in the economy. According to them full employment was a normal situation and any deviation from this regarded as something abnormal.

The basis of the classical theory is Say's Law of Markets which was carried forward by classical economists like Marshall and Pigou. They explained the determination of output and employment divided into individual markets for labour, goods and money. Each market involves a built-in equilibrium mechanism to ensure full employment in the economy.

Assumptions

The classical theory of output and employment is based on the following assumptions:

(i) There is the existence of full employment without inflation.

(ii) There is a laissez-faire capitalist economy without government interference.

(iii) It is a closed economy without foreign trade.

(iv) There is perfect competition in labour and product markets.

(v) Labour is homogeneous.

Explanations of the theory

The determination of output and employment in the classical theory occurs in labour, goods and money markets in the economy.

Say's Law of Markets

Say's Law of markets is the core of the classical theory of employment. An early 19th century French Economist, J. B. Say, enunciated the proposition, that a supply creates its own demand. Therefore, there cannot be general overproduction and the problem of unemployment in the economy.

If there is general overproduction in the economy, then some labourers may be asked to leave their jobs. The problem of unemployment arises in the economy in the short run. In the long run, the economy will automatically tend toward full employment when the demand and supply of goods become equal.

When a producer produces goods and pays wages to workers, the workers, in turn, buy those goods in the market. Thus the very act of supplying goods implies a demand for them. It is in this way that supply creates its own demand.

Determination of output and Employment:

In the classical theory, output and employment are determined by the production function and the demand for labour and the supply of labour in the economy. Given the capital stock, technical knowledge and other factors, a precise relation exists between total output and amount of employment, i.e., number of workers. This is shown in the form of the following production function: $Q = f(K, T, N)$

Where total output (Q) is a function (f) of capital stock (K), technical knowledge (T), and the number of workers (N).

Given K and T, the production function becomes $Q = f(N)$ which shows that output is a function of the number of workers. Output is an increasing function of the number of workers, output increases as the employment of labour rises. But after a point when more workers are employed, diminishing marginal returns to labour start.

This shown in Fig. 1 where the curve $Q = f(N)$ is the production function and the total output OQ_1 corresponds to the full employment level N_F. But when more workers N_1N_2 are employed beyond the full employment level of output OQ_1, the increase in output Q_1Q_2 is less than the increase in employment N_1N_2.

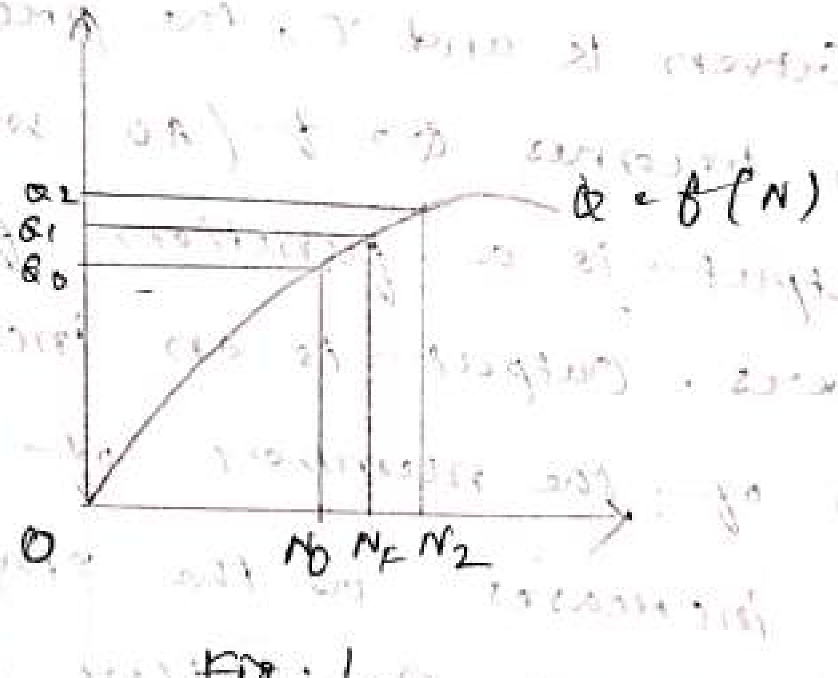


Fig. 1.

~~Source : Extern~~

Labour Market Equilibrium:

In the labour market, the demand for labour and the supply of labour determine the level of output and employment. The classical economists regard the demand for labour as the function of the real wage rate: $D_N = f(W/P)$.

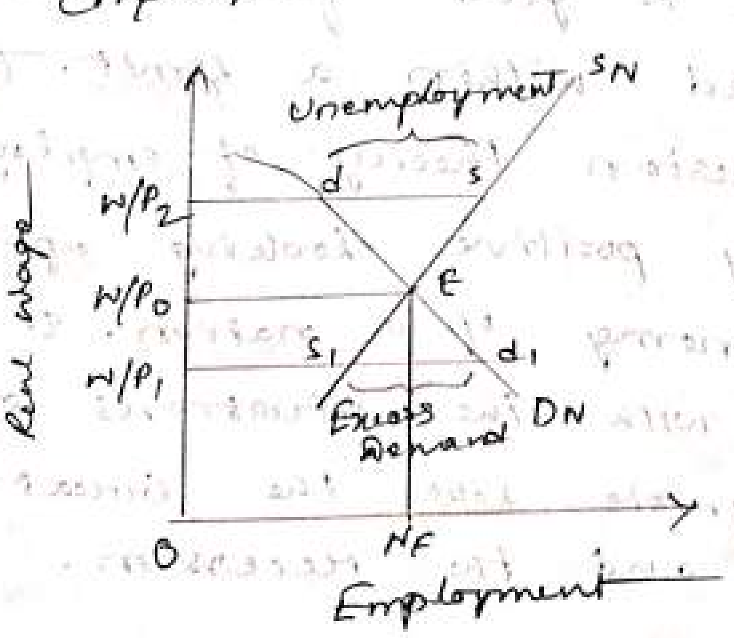
Where D_N = demand for labour

W = Wage rate

P = price level.

Dividing wage rate (W) by price level (P), we get the real wage rate (W/P).

The demand for labour is a decreasing function of the real wage rate, as shown by the downward sloping D_N curve in Fig. 2. It is by reducing the real wage rate that more workers can be employed.



9. Explain the keynessian theory of employment.

Ans:— It is also referred to as the effective demand theory of employment. Keynes developed this first systematic theory of employment states that the cause of unemployment is the deficiency of effective demand, and unemployment can be removed by raising effective demand. With the increase in effective demand, the production in the economy goes up. The increased production in the economy goes up. The increased production generates more jobs thus increasing the employment and giving a boost to the nation's economy. With the increase in inflation which is good for the economy if controlled within a limit. Therefore, keynesian theory of employment has a very positive looking approach for the economy of a nation. It helps in dealing with the situations of economic crisis like the Great Depression and the recession.

The Keynesian theory of employment, developed by British economist John Maynard Keynes during the Great Depression, provides a different perspective on economic fluctuations and unemployment compared to the classical theory. Key tenets of the Keynesian theory include:

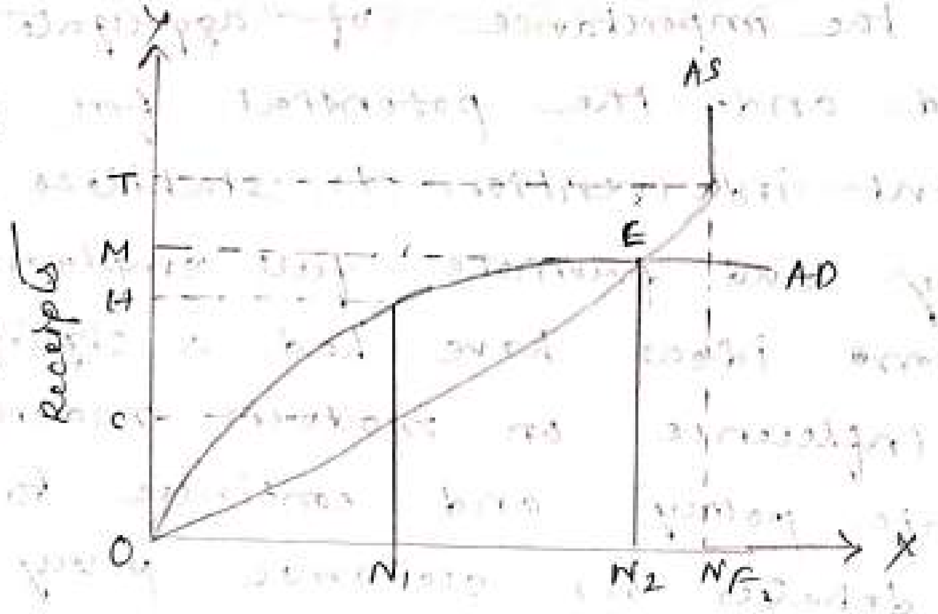
(i) Aggregate Demand: Keynesians emphasize the role of aggregate demand in determining the level of economic activity. They argue that fluctuations in aggregate demand, rather than supply-side factors, are the primary drivers of business cycles.

(ii) Involuntary Unemployment: Unlike classical economists, Keynesians believe that unemployment can persist even when wages are flexible. They posit that there can be involuntary unemployment, where individuals are willing to work at prevailing wage rates but cannot find employment due to insufficient demand for goods and services.

(iii) Role of Government Intervention: Keynesians advocate for active government intervention in the economy, particularly during times of economic downturns. They argue that fiscal and monetary policies, such as government spending increases, tax cuts, and monetary easing, can stimulate aggregate demand and reduce unemployment.

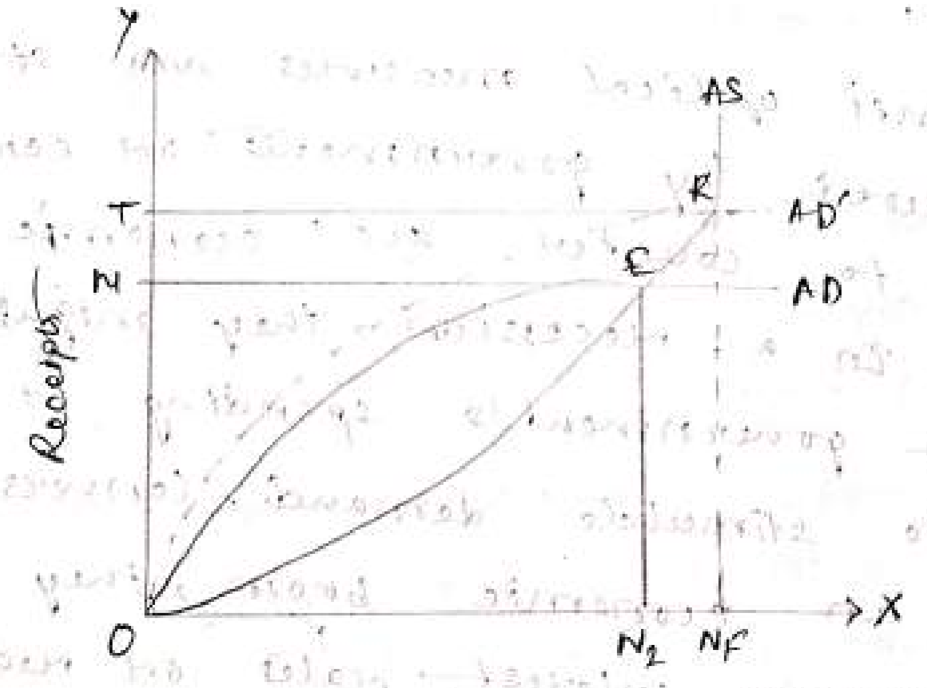
(iv) Sticky Prices and Wages: Keynesians recognize that prices and wages may not adjust quickly to clear markets, leading to wage and price rigidities. This can result in situations where changes in aggregate demand do not immediately translate into changes in output and employment.

(v) Multiplier Effect: Keynesians highlight the multiplier effect, where an initial increase in spending leads to a larger increase in national income and output through successive rounds of spending and re-spending.



Number of Persons employed

Fig. 1.1: Determination of Employment: Keynesian Theory.



Number of Persons Employed

Fig. 1.2

Overall, the Keynesian theory of employment represents a departure from classical economic thought by emphasizing the importance of aggregate demand and the potential for government intervention to stabilize the economy and promote full employment. Keynesians ideas have had a significant influence on modern macroeconomic policy and continue to shape debates on economic policy and ~~man~~ management.

10. Write a note on anti cyclical measures.

Ans:- Anti cyclical measures are strategies used by government or central banks to counter act economic cycles. In a recession, they might increase government's spending or cut taxes to stimulate demand. Conversely, during an economic boom, they might raise interest rates or reduce spending to prevent overheating. These measures aim to smooth out fluctuations in the economy and promote stability

11. What are the anti cyclical measures taken by the government?

Ans:- Government may take various anti cyclical measures to stabilize the economy. Some of the common anti cyclical measures include:

(i) Fiscal policy: Adjusting government spending and taxation levels to influence aggregate demand. During a recession, governments may increase spending on infrastructure projects or provide tax cuts to stimulate economic activity.

(ii) Monetary Policy: Central banks control interest rates and money supply to regulate economic activity. Lowering interest rates encourages borrowing and spending, while raising them can help curb inflation during periods of high growth.

(iii) Automatic stabilizers: Programs like unemployment benefits and progressive taxation automatically adjust during economic cycles, providing a buffer against downturns by increasing spending when incomes fall.

(iv) Reserve Requirements: Central banks may adjust reserve requirements for commercial banks, influencing the amount of money available for ~~lends~~ lending and spending in the economy.

(v) Exchange Rate Policy: Governments can intervene in currency markets to stabilize exchange rates, which can affect exports and imports, thus impacting overall economic activity.

These measures aim to smooth out fluctuations in the business cycle and promote sustainable economic growth.

4. Explain the Pigou's theory of trade cycle.

Ans:- Pigou's theory of the trade cycle, proposed by economist Arthur Cecil Pigou, focuses on the role of real wage adjustments in causing economic fluctuations.

Pigou argued that real wages tend to be inflexible downward during economic downturns due to factors such as labor market institutions, social norms, and wage contracts. When demand for goods and services falls, firms may cut prices, but they often find it difficult to lower nominal wages to adjust for decreased demand. As a result, real wages remain high relative to the decreased demand for labor, leading to higher unemployment.

According to Pigou, this mismatch between real wages and demand for labor creates a cyclical pattern in the economy. During expansions, rising demand for goods and services pushes up prices, leading to inflation. As a response, nominal wages increase, but real wages might not adjust downward as quickly when the economy contracts again, leading to unemployment.

Pigou's theory suggests that wage flexibility is crucial for minimizing the severity of economic fluctuations. However, he acknowledged that factors such as labor market rigidities and social considerations can hinder the adjustment process, contributing to the persistence of business cycles.

12. Explain the Keynes theory of trade cycle.

Ans:- Keynes' theory of the trade cycle, outlined in his seminal work "The General Theory of Employment, Interest, and Money," focuses on the role of aggregate demand in driving economic fluctuations.

Keynes argued that fluctuations in investment and consumption are the primary drivers of business cycles. He identified two main reasons for these fluctuations:

~~key~~

(i) Animal Spirits: Keynes emphasized the importance of psychological factors, or what he called "animal spirits," in influencing investment decisions. These include confidence, optimism, and pessimism among investors and consumers, which can lead to fluctuations in investment and spending.

(ii) The Paradox of Thrift: Keynes argued that individual attempts to save more during an economic down~~turn~~ turn can exacerbate the downturn by reducing aggregate demand. When households and businesses cut spending to increase saving, it reduces overall demand for goods and services, leading to further declines in income and employment.

Keynes advocated for active government intervention to stabilize the economy, particularly through fiscal policy measures such as increased government spending and tax cuts during downturns to stimulate demand. He also emphasized the importance of monetary policy in influencing interest rates and investment.

Overall, Keynes' theory provided a framework for understanding how fluctuations in aggregate demand drive business cycles and the role of government intervention in stabilizing the economy.