

Quadrant II - Notes

Paper Code : CEG 102

Module Name : Unemployment and Natural Rate of Unemployment

Module No : 13

Unemployment and the Natural Rate of Unemployment

Introduction to Unemployment

Unemployment is the most widely feared phenomenon that affects most people directly and severely. Due to unemployment, not only does the standard of living decrease, but the person also suffers from psychological stress. People get a sense of personal accomplishment from working. A job loss means a lower living standard in the present, anxiety about the future, and reduced self-esteem. All free market economies experience some unemployment, but the nature of unemployment differs. In underdeveloped countries, unemployment is a chronic problem. It is basically open and disguised but in developed countries, unemployment is basically involuntary and frictional. It is a key indicator of the performance of the country. It is also a measure to check the economic efficiency of a nation.

Concepts:

- **Unemployment**

A state of affairs where a large number of able-bodied persons of working age who are willing to work, but cannot find work at the current wage level.

- **Unemployed**

Persons are classified as unemployed if they do not have a job, have actively looked for work in the prior 4 weeks, and are currently available for work.

- **Labour force**

The total number of workers, including both the employed and the unemployed.

- **Unemployment Rate**

The percentage of the labour force that is unemployed.

Consequences of Unemployment

Unemployment creates huge costs for individuals and for the economy as a whole.

▶ Loss of income

Majority of the unemployed experience a decline in their standard of living, decline in their spending power and a rise of falling into debt problems resulting in an increase in inequality of income and wealth.

▶ Loss of national output

Unemployment results in a waste of scarce resources.

▶ Negative Multiplier Effect

One person's spending is another person's income. A loss of income can lead to a drop in demand for local services.

▶ Fiscal costs

Governments lose out because of a fall in tax revenues and higher spending on welfare payments

▶ Social costs

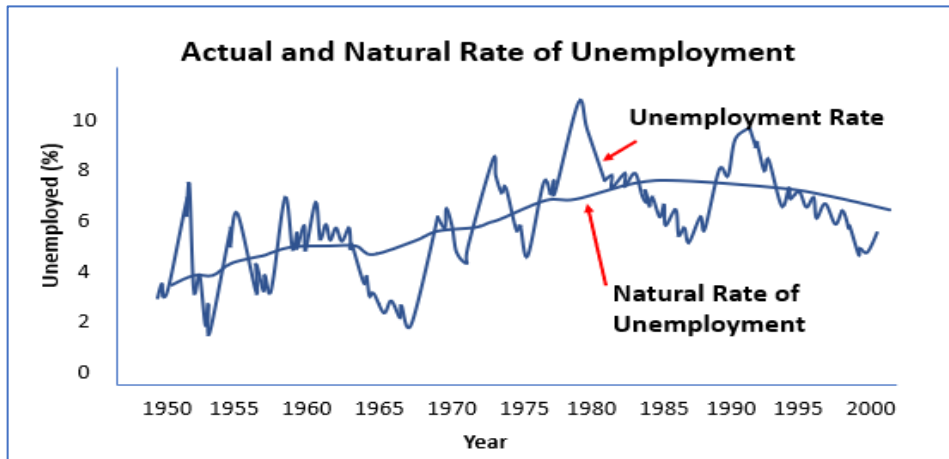
Rising unemployment is linked to social deprivation. Chronically unemployed persons are found to have more family problems, worsening health and lower life expectancy.

Full employment

- The condition in which virtually all who are able and willing to work are employed.
- At the point of full employment, the unemployment rate is going to be somewhere around 5%. This is the **natural rate of unemployment**.

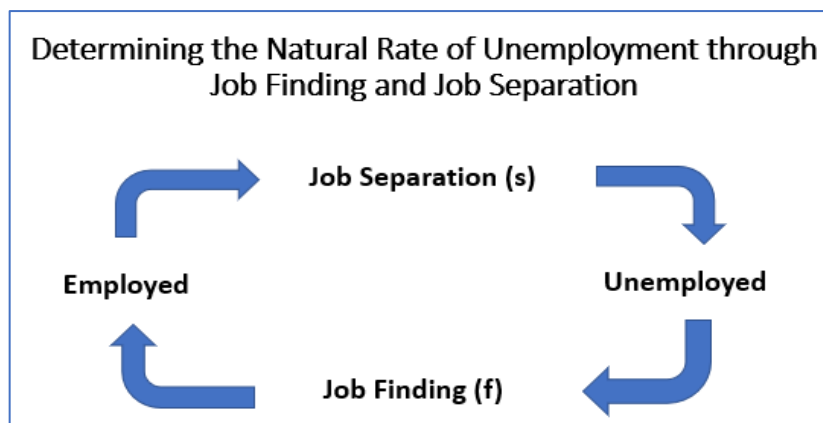
The Actual Rate of Unemployment (ARU) v/s the Natural Rate of Unemployment (NRU)

- ARU: Percentage of total labour force that is unemployed but seeking and willing to work.
- NRU: Average rate of unemployment around which the economy fluctuates in the long run.



Reasons for The Natural Rate of Unemployment

- Frictional unemployment: exists due to people being in the process of moving from one job to another.
- Structural unemployment: caused by a mismatch between the skills that workers in the economy can offer and the skills demanded by employers.



Determinants of the Natural Rate of Unemployment

- Labour force: $L = E + U$
- Unemployment Rate: U/L
- Rate of job separation = s and Rate of job finding = f
- Number of people finding jobs = fU
- Number of people losing jobs = sE
- Steady state labour market condition: $fU = sE$... Eq. 1

- We know that $L = E + U$. Therefore, $E = (L - U)$
- Substituting $(L - U)$ for E in Eq. 1 $\rightarrow fU = s(L-U) \dots$ Eq. 2
- $fU = sL - sU \rightarrow fU + sU = sL \rightarrow U(f + s) = sL$
- $$\frac{U}{L} = \frac{s}{s + f} \dots \text{Eq. 3}$$

Policy Implication

- Higher the rate of job separation, higher will be the unemployment rate.