Discussion of “A Model of Aggregate Demand, Idleness, and Unemployment”

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Franck Portier

10th Journée of the Fondation Banque de France
June 4, 2014, Paris
- **Beautiful paper**
  - Adresses the core questions in Macroeconomics:
    - Is unemployment caused by high wages, low demand or frictions?
    - What does move employment? demand shocks, supply shocks?
  - **My discussion**
    - The main mechanism in a nutshell
    - because “repetition is the mother of pedagogy”
    - Some random thoughts/comments
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In a nutshell

Supply

- Measure 1 of workers that produce on demand and consume (but not their own good)
- Each is endowed with one unit of time that can be allocated to
  - production: \( z \) units of time \( \rightarrow \) \( z \) units of good sold at price \( p \)
  - idleness
- Search: consumers make visits \( v \) at cost \( \rho v \) units of goods \( \rightarrow \) number \( f(v) \) of matches (= probability)
- A match implies the production of 1 unit that is sold at price \( p \)
- \( \frac{f(v)}{v} \) = number of matches (purchases) per visit (= probability)
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In a nutshell

Supply

search effort

\[ n \]

quantity
In a nutshell

Supply

search effort

capacity

quantity
In a nutshell
Supply

\[ \text{tightness } \sigma = \frac{\nu}{k} = \psi \]

1

Capacity

\text{search effort } \nu
In a nutshell

Supply

Output: $y = f(n)$
In a nutshell

Supply

- Consumption: \( c = f(w) - pv \)
- Output: \( y = f(w) \)
- Capacity: \( y' = f'(w) \)

Diagram:

- Vertical axis: search effort (\( w \))
- Horizontal axis: quantity
- Graphs:
  - Blue line: consumption
  - Orange line: output
  - Red line: capacity
In a nutshell

Supply

- Search effort: \( \nu \)
- Consumption: \( c = f(\nu) - p \nu \)
- Output: \( y = f(\nu) \)
- Matching cost: \( p \nu \)
- Capacity

\[ 1 \text{ quantity} \]
In a nutshell

Supply

\[ c = f(w) - pv \]
\[ y = f(w) \]
\[ p_v \]

Matching cost

\( r \)

Capacity

Quantity

Inefficiency
In a nutshell

Supply

consumption \( c = f(w) - p_v \)

output \( y = f(w) \)

matching cost \( p_v \)

employment

illness

capacity
In a nutshell

Supply

\[ c(\bar{w}) = f(\bar{w}) - p_w \]

Output
\[ y = f(\bar{w}) \]

Capacity

Search effort

Consumption

Matching cost

Employment

Happiness

\[ \text{Supply} : c(\bar{w}) = f(\bar{w}) - p_w \]
In a nutshell

Demand

- Max \( u(c, m) \)
- \( m \) is an outside good (money?)
- BC: \( m + p \times c + p \times \frac{1}{f(v)} \rho \leq \mu + pf(v) \)
- Solution: \( c^d(v, p) \), decreasing in \( v \) and \( p \)
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In a nutshell

\[ C = f(n) - \rho v \]

Output
\[ y = f(n) \]

Capacity

\[ v \]

Consumption
Note that the slope of demand depends on $p$. 
equilibrium is a triplet \((c, v, p)\) s.t.
\[
\begin{align*}
&c^e = c^s(v) \\
&c^e = c^d(v, p)
\end{align*}
\]
2 equations for 3 unknowns \(\iff\) pick up the price theory you want

- classic result in search models: \(p\) does not clear any market, put decides of the exposit sharing of the match surplus
- Note that this does not mean that fix price is one out of many possible choice for price setting
- Fix price means that a different mechanism is chosen every time the environment changes
In a nutshell

Equilibrium

- equilibrium is a triplet \((c, v, p)\) s.t.
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In a nutshell

Equilibrium

[Graph showing supply, demand, and output curves with axes labeled 'search effort' and 'quantity']
In a nutshell

Equilibrium
In a nutshell

Equilibrium

\[
\text{Consumption: } c = f(w) - pr
\]

\[
\text{Output: } y = f(r)
\]

Efficient
In a nutshell

Equilibrium

\[ \text{Consumption} \quad c = f(w) - p \nu \]

\[ \text{Output} \quad y = f(w) \]

\[ \text{Plaus} \]

\[ \text{Efficient} \]

\[ \text{Search effort} \quad \nu \]

Capacity

Quantity
In a nutshell

Equilibrium

\[ c = f(w) - pw \]

Output
\[ y = f(w) \]

Efficient

Search effort

Consumption

Capacity

\[ D_z \]

Tight

Quantity

1
Comparative statics

Table 1: Comparative statics in the basic model (Section 3)

<table>
<thead>
<tr>
<th>Increase in:</th>
<th>Effect on:</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Output y</td>
<td>Tightness x</td>
<td>Labor utilization f(x)</td>
<td>Consumption c</td>
</tr>
<tr>
<td><strong>A. Efficient pricing</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aggregate demand</td>
<td>0</td>
<td>0</td>
<td>0</td>
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</tr>
<tr>
<td>Aggregate supply</td>
<td>+</td>
<td>0</td>
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<td>+</td>
</tr>
<tr>
<td><strong>C. Rigid pricing</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aggregate demand</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>+ (slack)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0 (efficient)</td>
</tr>
<tr>
<td>Aggregate supply</td>
<td>+</td>
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</table>
In a nutshell

Comparative statics

- From that comparative statics and from data on labor utilization, search effort (recruiting sector), output,
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  - price rididity
  - the size of demand shocks
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- This is done in an extended version of that model with frictions on both goods and labor market
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Random Thoughts/Comments
Aggregate demand shocks

- The theory cries for a theory of demand shocks
  - that would not be preference shocks
  - that would not be shocks on $\mu$
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Aggregate demand shocks: monetary shocks?

- If $p$ is fixed, the model can be interpreted as a model with MIUF
- Then $p \times \mu$ is money supply
- The model looks pretty much like the good old fix price model
- In particular, there is an obvious monetary policy that can reach constrained efficient allocations at any time.
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Analogy with the 3-goods fix-price model

Different stories and microfoundations

- Is that such a different story?: not so much for business cycle analysis if $p$ is fixed.
- Lambert (1988) (also Sneessens): fix-price + micro markets + CES aggregation: very close to a model with matching frictions
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What I don't find in the model

- Diamond (1982) coconut model is (to me) capturing the (Keynesian) essence of search models
- trade depends on actions that depend on trade expectations
  - multiple equilibria are possible
  - but even with determinacy, multipliers exist:
  - which means that fluctuations are suboptimal
  - and not a “constant wedge" model
- I have not found a clear way to see this in the model when prices are not sticky
- (Something we are trying to do with Beaudry and Galizia in “Reconciling Hayek’s and Keynes’ views of recessions”)
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- In France, it almost always means that I am the more pro-market person at the table

- My example for why the *invisible hand* has some bite is the French bread market
  - Important market
  - Would be a nightmare to plan
  - Seems to work pretty well (?)

- It seems that I must find another example market: any suggestions?
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  - Should be read by any macroeconomist
  - Should be taught (the “Economical Business-Cycle Model” baby version)
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