Economic Gear-Changing

According to the textbooks of macroeconomic theory, it is axiomatic that, for a perfectly competitive economy in continuously market-clearing equilibrium, there can be no such thing as unemployment. The blind spot of Single-Gear Fundamentalism lies in its failure to recognise the possibility of deficiency of effective demand. When this blind spot is removed, it becomes clear that the economy is a multi-gear machine.

Adoption of the multi-gear view, however, implies a radical shift in economic policy. For a multi-gear economy to operate at its full employment potential, the lubricant of competition is necessary; but it is not sufficient. The machine must also be in top gear.

The Two Categories of Unemployment

Multi-gear theory recognises two distinct categories of unemployment:¹

1. the “disequilibrium rate of unemployment” – by which the actual disequilibrium volume of employment falls short of the market-clearing equilibrium volume of employment; and
2. the “equilibrium rate of unemployment” – by which the market-clearing equilibrium volume of employment falls short of the potential equilibrium volume of employment.

The disequilibrium rate of unemployment

The disequilibrium rate of unemployment includes the “natural rate of unemployment”. Otherwise known as the “Non-Accelerating Inflation

¹The logical flaw in the single-gear economic theory is exposed in Appendix B of the previous volume on Toxic Theory where a more detailed explanation of the alternative multi-gear theory is presented.
Rate of Unemployment” (or NAIRU), it is embedded in the structure of the economy by market imperfection and frictional resistances. For this reason, it is commonly known as “structural unemployment”. The only remedy for this category of unemployment is structural reform to improve the responsiveness of markets by reducing the imperfections and frictional resistances:

Only policies that reduce the NAIRU can reduce unemployment permanently.

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Competition has to be keener, information more widely and speedily available, and skills more readily transferable (by education and training). By these methods, the shortfall between the actual disequilibrium volume of employment and the market-clearing equilibrium volume can be made as small as possible; but, in the real world, the gap cannot be eliminated entirely (which is why it is called the “natural rate” of unemployment). Ultimately, it is necessary to live with whatever shortfall still remains.

The cause of the disequilibrium rate of unemployment is some form of market imperfection. The cure is removal of the imperfection (to make markets more flexible and responsive). If the machine is imperfectly lubricated, the only cure is better lubrication.

In that respect, the Fundamentalist single-gear slogan is sound:

you cannot spend your way out of market imperfection.

The equilibrium rate of unemployment

The cause of the equilibrium rate of unemployment is deficiency of effective demand. If some of the demand for future consumption takes the form of the accumulation of monetary claims, it is not revealed through spending: it bypasses the market and fails to be made effective.

The only remedy for this category of unemployment is to encourage the revelation of preferences through spending in the market place. Only in this way can the shortfall between the market-clearing equilibrium volume of employment and the potential equilibrium volume be made as small as possible.

The cause of the equilibrium rate of unemployment is deficiency of effective demand. The cure is removal of the deficiency. If the machine is in too low a gear, the only cure is an upward gear-change. Better lubrication can make no impression.