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Monopolistic Equilibrium and Involuntary Unemployment

by

Pierre DEHEZ

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Abstract:

This note provides a simple example of an economy in which involuntary unemployment may be the consequence of monopolistic behaviour on the product market.

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1. Introduction

In a recent paper [1], d'Aspremont, Dos Santos Ferreira and Gérard-Varet (ADG for short) have investigated the possibility of involuntary unemployment in the framework of a simple three commodity economy in which the production sector is an oligopoly *à la Cournot*. The firms take the wage rate as given and involuntary unemployment is defined as a situation where unemployment prevails whatever is the wage rate. It is therefore a situation where there is no way in which full employment could be achieved by acting on the wage rate. It is also a situation where the wage rate would be zero if it was determined competitively on the labour market.

The particularity of their model lies in the assumption that the firms know the objective demand curve and therefore take account of the effect of their employment decisions on the demand. This is at variance with a related paper by Hart [4] where the agents are assumed to be negligible relative to the size of the economy and therefore cannot affect aggregate income. The phenomenon of involuntary unemployment has also been studied by Grandmont and Laroque [3] in a model featuring imperfect competition, its occurence being due to pessimistic sale expectations held by the firms whose production process takes time. In ADG's model on the contrary production is instantaneous and it is the intertemporal behaviour of the consumers which generates involuntary unemployment.

The purpose of the present note is to provide an example illustrating ADG's results for the case of a *monopoly*. The example is restricted to a monopolistic situation because the existence of a Cournot-Nash equilibrium requires strong assumptions which obscures the main issue, involuntary unemployment.

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The example indicates that involuntary unemployment typically occurs when the initial wealth of the consumer is small relatively to the existing labour supply. It also leads to a stronger proposition: Unlike ADG's result, the possibility of involuntary unemployment can be shown to exist *whatever is the labour supply* and its occurrence does *not* require that the *"Ford effect"* on employment of a wage increase is always dominated. Furthermore, while in ADG the current profits are distributed at the end of the period and do not influence consumption decisions, here current profits are taken into account by assuming that consumers are either "rentiers" or workers, like for instance in the model of Glustoff [2].

The continuation of the paper is organized as follows. Section 2 is devoted to a discussion of the model and to the statement of the assumptions. The definition of a monopolistic equilibrium is given in Section 3. In Section 4, involuntary unemployment is formally defined and the conditions of its occurrence are given. Finally, concluding remarks are offered in the last Section.

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2. The Model

We consider a simple three commodity economy. There is an aggregate consumption good which is produced out of labour. Money is used as a medium of exchange and is the unique store of value. The price level and the wage rate are expressed in terms of money and denoted by p and w respectively. The economy is considered at a given period of time. Its past is given and enters into the agents' expectations about its future. At the beginning of the period, there is a given stock of money whose distribution among the agents results from past decisions.

The production sector of the economy consits of a single large firm whose technology is described by the *constant returns to scale* production function $y = z$.

In the consumption sector, the agents differ in the way in which their income is generated. There is a set A of workers selling their labour to the production sector and a set B of stockholders having shares in the profits. We assume that these two sets are disjoint and that, *within each set*, the agents have identical intertemporal preferences. All the agents have an horizon limited to the next period and the workers supply labour *inelastically*. The preferences are therefore defined over current and future consumption and we assume that they are strictly convex and *homothetic*. Furthermore, we assume that the agents take their current decisions *as if* they would receive no further income in the future.

Let p^e denote the price level expected to prevail in the next period. Then, if R_i denotes the current budget of a particular agent i, his or her demand for consumption

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goods can be written as

$$c_i = H_k\left(\frac{p^e}{p}\right)\frac{R_i}{p}$$

with k = a for a worker and k = b for a stockholder. Clearly, $0 \leqslant H_k(\theta) \leqslant 1$ for all $\theta \geqslant 0$, k = a,b.

The functions H_a and H_b are assumed to be continuous and non-decreasing over all $\mathbb{R}_+$, and to satisfy the following conditions:

(*i*) H_a is *strictly* increasing on $\mathbb{R}_+$;

(*ii*) $0 < H_a(\theta) < 1$ and $H_b(\theta) < 1$ for all $\theta > 0$;

(*iii*) $H_a(\theta) \geqslant H_b(\theta)$ for all $\theta > 0$;

(*iv*) $H_a(0) = H_b(0) = 0$.

Hence, current demand for consumption goods does not decrease when the future price increases and, for a worker, it must increase. Whatever the ratio between future and current prices, a worker always wants to consume in each period; for a stockholder, this requirement applies only to future consumption. The marginal propensity to spend of a stockholder never exceeds the one of a worker, a usual condition. Finally, the marginal propensities to spend go to zero when the ratio between future and current prices goes to zero. Intertemporal preferences yielding demand functions satisfying these assumptions are represented by the utility function $c_1^\beta + c_2^\beta$, $0 < \beta < 1$.

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For the sake of simplicity, we assume that all agents have the same expectations about the future price level. It is given by $p^e = \psi(p)$ where ψ is a continuous function on $\mathbb{R}_+$ satisfying the following two conditions:

(*i*) $\psi(p)/p$ has a maximum on $\mathbb{R}_+$ and all maxima are strictly positive;

(*ii*) $\lim_{p \to \infty} \frac{\psi(p)}{p} = 0.$

While excluding unit elastic price expectations, these conditions allow for a wide class of expectations functions.

We denote by $m_i \geq 0$ the initial money balances of agent i; by $\ell_i \geq 0$ the labour supply of worker i; and by α_i, $0 \leq \alpha_i \leq 1$, the share in profits of shareholder i. The total stock of money is then given by $M = \Sigma_{i \in A \cup B} m_i$; the aggregate labour supply is given by $L = \Sigma_{i \in A} \ell_i$; and by definition $\Sigma_{i \in B} \alpha_i = 1$. We assume that $M > 0$ and $L > 0$. The *initial* distribution of the stock of money between workers and stockholders is defined by

$$\Sigma_{i \in A} m_i = \mu M$$

and we assume that $0 < \mu \leq 1$.

The budget of agent i is given by $R = m_i + r$ if i is a worker, with $0 \leq r \leq w\ell_i$ depending on his or her current employment situation; it is given by $R = m_i + \alpha_i \Pi$ if i is a stockholder and Π are the profits.

Independently of the way in which employment is distributed among the workers, the aggregate demand for consumption goods, c, corresponding to an employment level z,

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$0 \leqslant z \leqslant L$, a price level $p > 0$ and a wage rate $w \geqslant 0$ is given by:

$$pc = G_a(p)(\mu M+wz)+G_b(p)((1-\mu)M+(p-w)z) \qquad (1)$$

where $G_k(p) = H_k(\psi(p)/p)$, $k = a,b$.

3. Monopolistic Equilibrium

Replacing c by z in the equation (1) and solving for z, we get

$$\zeta(p,w,M) = \frac{\mu G_a(p)+(1-\mu)G_b(p)}{p(1-G_b(p))+w(G_b(p)-G_a(p))} M \qquad (2)$$

The assumptions on H_a and H_b ensure that this expression is well defined for $p \geqslant w$.

Given some (w,M,L), the objective of the firm is to maximize $\Pi(p,w,M) = (p-w)\text{Max}(0,\zeta(p,w,M))$ subject to $p \geqslant 0$ and $\zeta(p,w,M) \leqslant L$. A *monopolistic equilibrium* is then defined as a solution of this problem. Here we will restrict our attention to solutions at which the labour supply constraint is not binding, i.e. to monopolistic equilibria at which there is no excess demand for labour.

Clearly, the set of prices which maximizes $\Pi(p,w,M)$ subject to $p \geqslant 0$ is independent of M and L. We denote it by $P(w)$ and we will show that for every $w \geqslant 0$, $P(w) \neq \emptyset$ and $p \in P(w)$ implies $p > w$.

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Let us consider first the case where $w > 0$. Then $\Pi(p,w,M) < 0$ whenever $p < w$; $\Pi(w,w,M) = 0$; and $\Pi(p,w,M) > 0$ whenever $p > w$. Furthermore, it is easily verified that

$$\lim_{p \to \infty} \Pi(p,w,M) = 0$$

Indeed, $p^e/p \to 0$ as $p \to \infty$ and therefore $G_k(p) \to 0$ as $p \to \infty$ for $k = a,b$. Hence, for any $w > 0$, $\Pi(w,p,M)$ has at least one maximum and all maxima satisfy $p > w$.

When $w = 0$, the objective of the firm becomes a strictly increasing function of $\psi(p)/p$. Therefore p maximizes $\Pi(p,0,M)$ if and only if it maximizes $\psi(p)/p$. Hence given the assumptions made on ψ, $\Pi(p,0,M)$ has at least one maximum and all maxima are positive.

4. Involuntary Unemployment

The question is the following. Given some aggregate labour supply $L > 0$, do there exist values of the stock of money $M > 0$, such that *for any* w, $w \geqslant 0$, the monopolistic equilibria *all* involve unemployment ? Formally, given $L > 0$, do there exist values of M, $M > 0$, such that for any $w \geqslant 0$, $p \in P(w)$ implies $\zeta(p,w,M) < L$?

The answer is yes: For every $L > 0$, there actually exists $b(L) > 0$ such that $0 < M < b(L)$ implies $\zeta(p,w,M) < L$ for all $p \in P(w)$ and all $w \geqslant 0$. Indeed $p \in P(w)$ implies $p > w$, and $G_a(p) \geqslant G_b(p)$; hence, using (2), we get:

$$\zeta(p,w,M) \leqslant \frac{\mu G_a(p) + (1-\mu) G_b(p)}{p(1-G_a(p))} M$$

Let w go to infinity; then $p \to \infty$ as well and $\psi(p)/p \to 0$. But $H_a(0) < 1$. Hence the demand for labour goes to zero.

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We can therefore conclude that, for any $M > 0$, the supremum of the labour demand over all (p,w) such that $p \in P(w)$ and $w \geq 0$ exists and is of the form γM, $\gamma > 0$. We then simply take $b(L) = L/\gamma$.

It is interesting to notice that the above result holds when $H_b(\theta)$ is identically zero and $\mu = 1$ which is the situation considered by ADG. The result also holds when $H_a(\theta) = H_b(\theta)$ identically, a situation where some of the workers could be stockholders as well.

A natural question is to ask whether the assumptions made are compatible with the existence of a *competitive equilibrium* with a *positive* wage rate. At a competitive equilibrium $p = w$ and p is the solution of the equation $\zeta(p,p,M) = L$, i.e.

$$\frac{\mu G_a(p)+(1-\mu)G_b(p)}{p(1-G_a(p))} = \frac{L}{M}$$

We denote by $\varphi(p)$ the left-hand side of this equation. If $p \to \infty$, then $p^e/p \to 0$ and $G_k(p) \to 0$ for $k = a,b$. Hence, we have

$$\lim_{p \to \infty} \varphi(p) = 0.$$

On the other hand if the expectation function ψ is such that $\psi(p)/p$ is *bounded away from zero*, then we also have

$$\lim_{p \to 0} \varphi(p) = \infty.$$

Hence, this further assumption ensures that, for all $M > 0$ and $L > 0$, a competitive equilibrium exists and any competitive equilibrium involves a positive wage rate.

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5. Conclusions

We have given an example of a class of economies in which whatever is the wage rate, possibly zero, the resulting monopolistic equilibria *all* involves unemployment.

The example is not trivial in the sense that, at an equilibrium, there is always a positive level of employment. The result requires neither satiation nor maximum capacity in production. The demand for labour must not necessarily decrease when the wage rate increases, i.e. the "Ford Effect" of a wage increase needs not be always dominated; it should only be dominated for large enough wage rates. The conditions under which the result holds are compatible with the existence of competitive equilibrium with a positive wage rate. Finally, involuntary unemployment is obtained either by considering low enough initial money balances at fixed labour supply, or alternatively by considering a high enough labour supply at fixed money stock; the result is not obtained by playing *simultaneously* on the money stock and on the labour supply, as ADG do.

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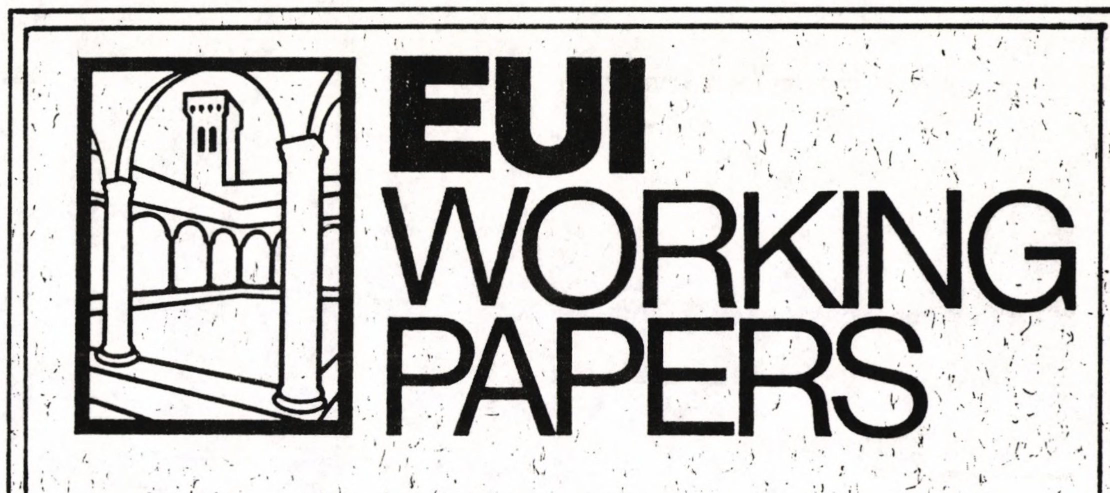

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