"It is important to understand the dependence of the marginal efficiency of a given stock of capital on changes in expectation, because it is chiefly this dependence which renders the marginal efficiency of capital subject to the somewhat violent fluctuations which are the explanation of the Trade Cycle."

Keynes (1936), The General Theory, Chapter 12.
Outline

► Introduction
► The Flows Approach
► Two sided Search Equilibrium
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Introduction

What are search frictions? What role do they play in the operations of markets.

Examples: Buying our apartment and selling our house. Investment in time and effort are required now in return for future benefits.

Lesson: An acceptable house, partner or job is one that offers an expected stream of benefits that has a value in excess of the option to search for an even better one.
The Flows Approach

► From the viewpoint of the classical “supply and demand” approach to markets, unemployment arises only when wages are “too high.”

► But in fact, large flows of workers are finding (losing) jobs...in both ‘good’ and ‘bad’ times.

► Unemployment (employment) is a stock that tends toward a level that balances inflows and outflows.
Figure 1: Labor Market Flows

Toward Search Equilibrium


The DMP Model

Figure 2: The Matching Function and the Beveridge Curve

Labor Market Equilibrium

► The ‘free entry’ condition: Jobs are created up to the point where the marginal vacancy has zero value. Implies that fewer vacancies are created per unemployed worker when the wages promised workers are higher.

► The bargaining outcome equation: Workers and employers share the surplus value of a match. Implies that wage demands are higher when the ratio of vacancies to unemployment is higher.

► As search equilibrium is a vacancy/unemployment and a wage promise pair that balances these two forces.
Figure 3: The BMP Model

Wage Promise

Vacancies/unemployment
Figure 4: The Great Recession
A Negative Expectations Shock

Wage Promise

Vacancies/unemployment
Figure 5: The Great Recession
US Beveridge Curve Dec 2000-June 2010