

A THEORY OF ECONOMIC SLACK

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Draft manuscript available at <https://pascalmichailat.org/18/>

SLACK IS ALMOST EVERYWHERE AT ALL TIMES







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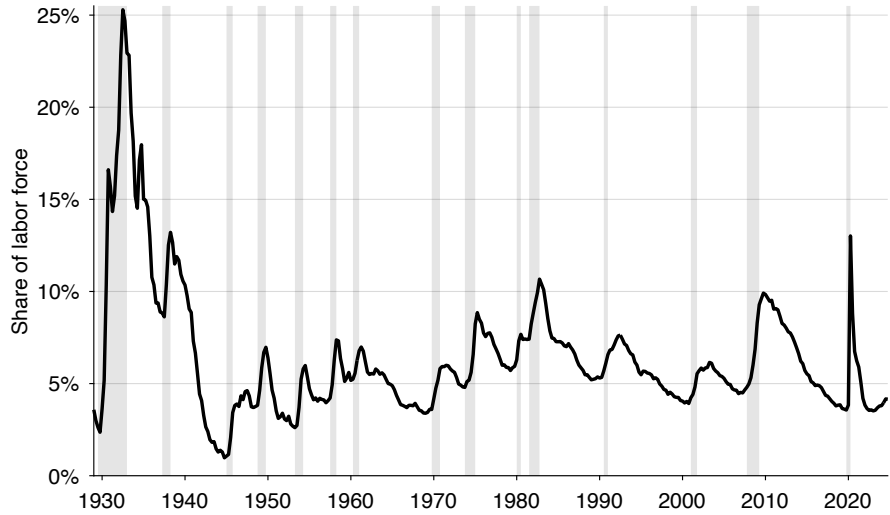




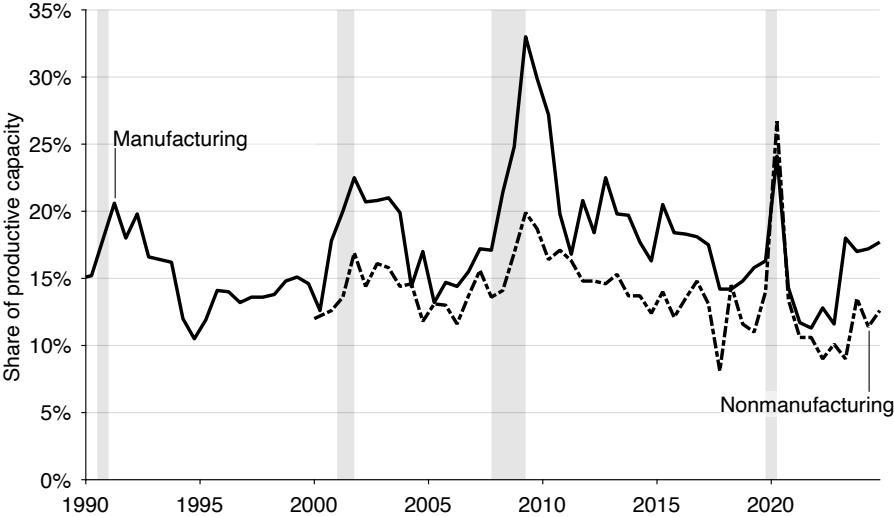




AVERAGE US UNEMPLOYMENT RATE = 6.4%

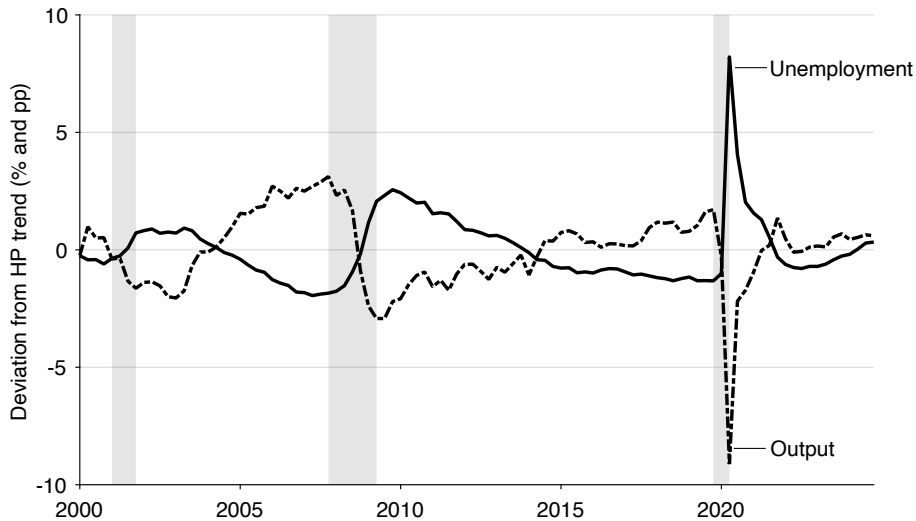


AVERAGE US IDLENESS RATE = 14⁰%–17⁰%

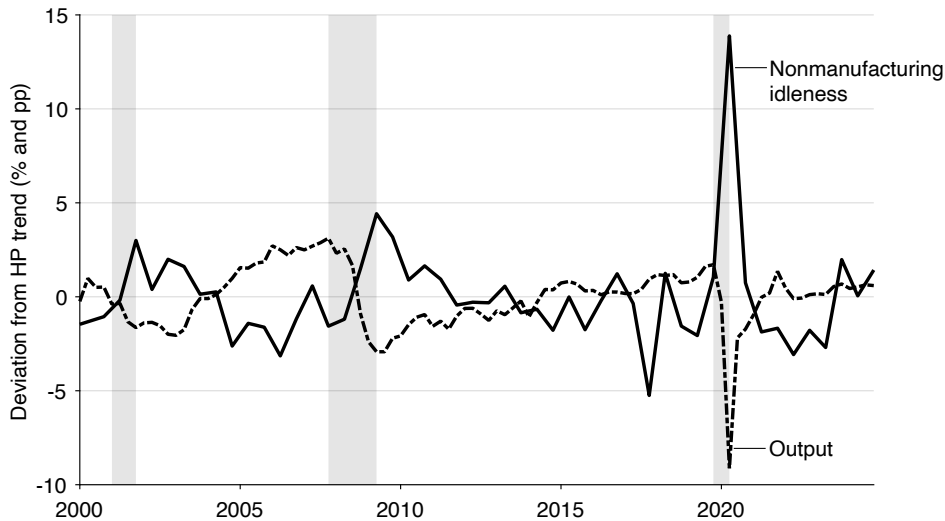


SLACK IS SHARPLY COUNTERCYCLICAL

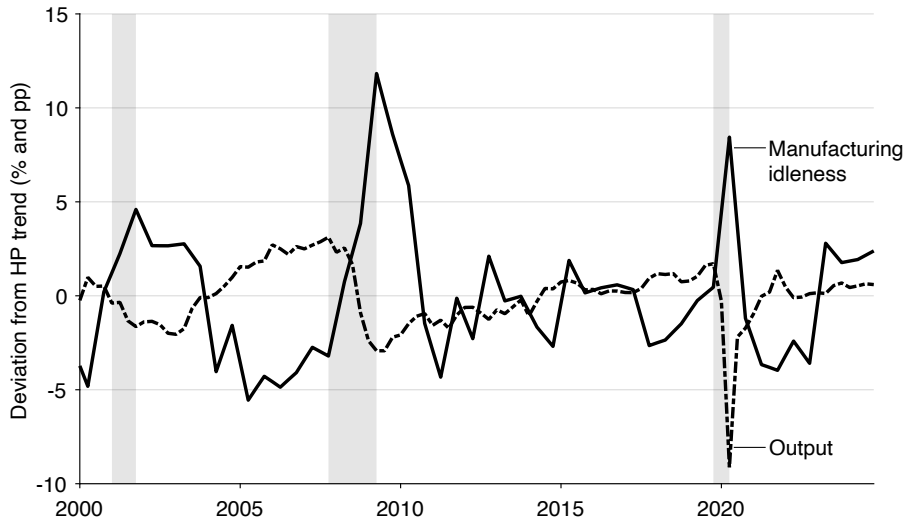
CORRELATION BETWEEN LABOR-MARKET SLACK AND OUTPUT = -0.90



CORRELATION BETWEEN NONMANUFACTURING SLACK AND OUTPUT = -0.72



CORRELATION BETWEEN MANUFACTURING SLACK AND OUTPUT = -0.65

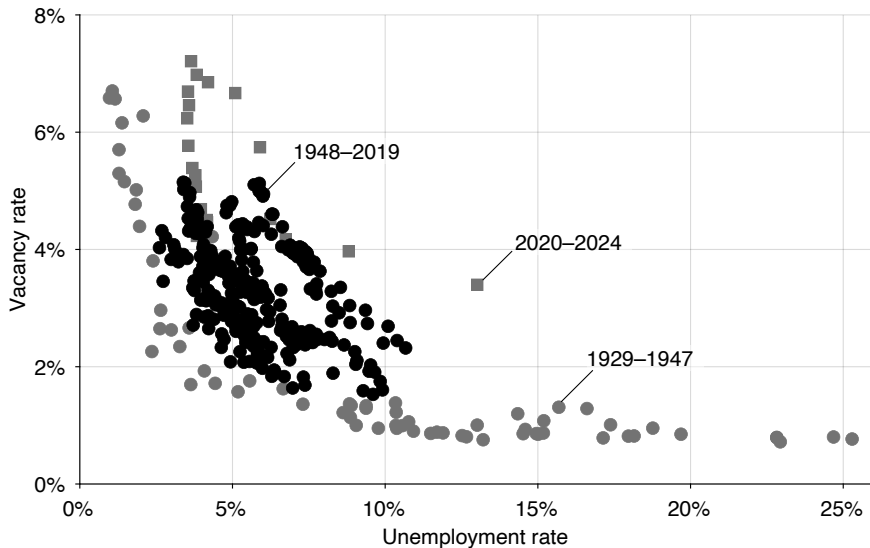


NEW KEYNESIAN MACROECONOMICS DRIFTED AWAY FROM SLACK

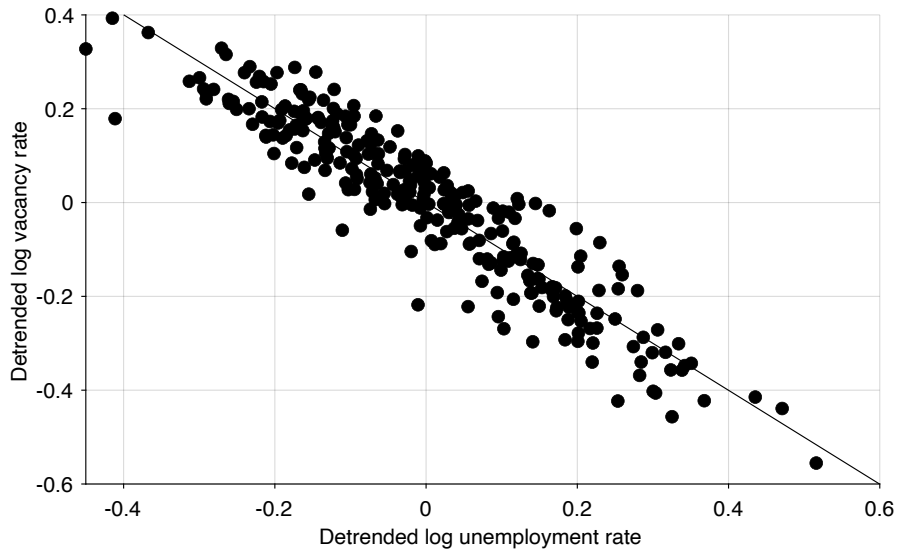
Textbook:	Keynes (1936)	Gali (2008)	Woodford (2003)
“Unemployment” in index	5–9, 13, 15, 16, 22, 109, 121, 128, 190, 235, 251, 274, 275, 278, 289, 334, 335, 346–349, 358, 359, 362–364, 381, 382	188	—
“Inflation” in index	119, 202, 207, 281, 291, 301, 303, 331, 332	1, 4, 11, 21–22, 31–32, 34, 37–38, 47, 49–52, 54–56, 60, 77, 79, 95–99, 103, 105, 107–108, 116, 120, 125– 127, 130, 133–135, 137– 139, 148, 155–156, 161– 164, 168–176, 179, 189	3–5, 13–14, 17, 19–21, 39, 43–44, 46, 49, 90– 101, 116–122, 126–138, 159–160, 176–177, 188, 203–205, 212–213, 215, 236, 248, 251, 262, 267, 272, 276–286, 289–295, 301–305, 317, 341, 347, 360–362, 381–382, 396–405, 408–409, 413–416, 418, 437, 440–441, 445– 446, 460, 462–463, 467–485, 493, 499–501, 522–527, 544, 559–565, 576–582, 590–604, 615, 619–623, 639–641, 694–695, 714–715, 724–727

IT IS DIFFICULT FOR BUYERS AND SELLERS TO MATCH

JOB SEEKERS AND VACANT JOBS ALWAYS COEXIST IN US LABOR MARKET

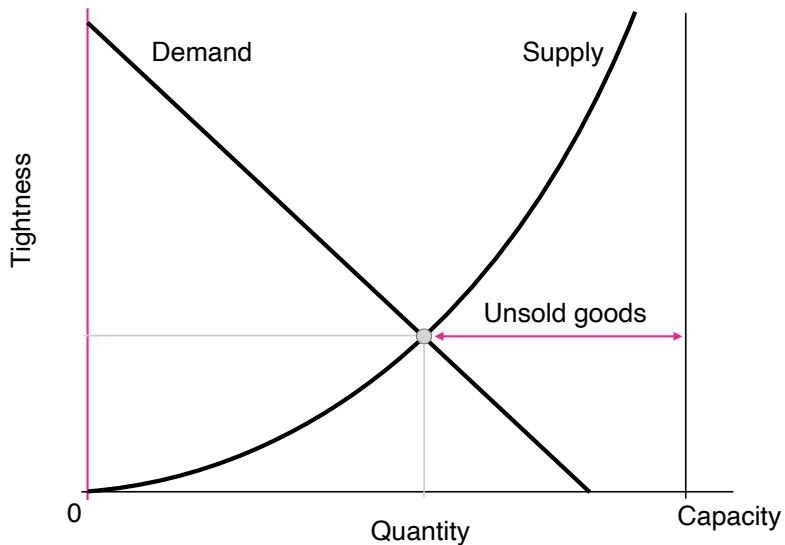


US BEVERIDGE CURVE = RECTANGULAR HYPERBOLA



SLACKISH MARKETS EQUILIBRATE THROUGH TIGHTNESS

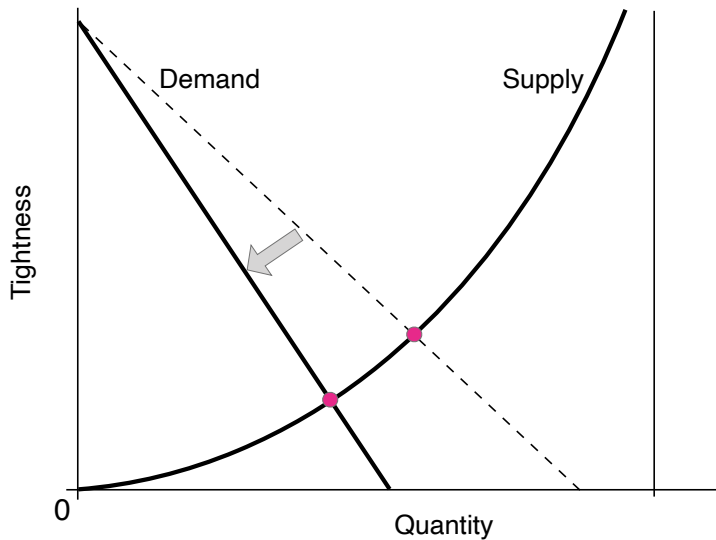
SUPPLY-DEMAND DIAGRAM FOR SLACKISH MARKET MODEL



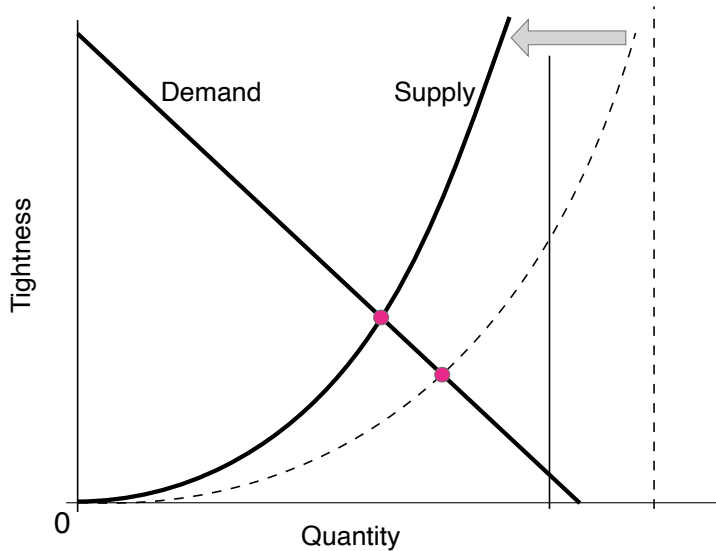
PRICES ARE DETERMINED BY SOCIAL NORMS

- Hicks (1946): “This assumption [that prices are perfectly flexible] must now be dropped, for it is of course highly unrealistic. In most communities there are a large number of prices which, for one reason or another, are fairly insensitive to economic forces.... This rigidity may be due to legislative control, or to monopolistic action ... It may be due to lingering notions of a just price.”
- Okun (1981): “Wage standards are conventional and habitual. They have their logic and take on a life of their own. They become entrenched because firms have incentives to get into step with other participants in the labor market. There may be more determinacy in the persistence of any reasonable convention than in its precise nature.”

DEMAND SHOCK: POSITIVE TIGHTNESS-OUTPUT CORRELATION

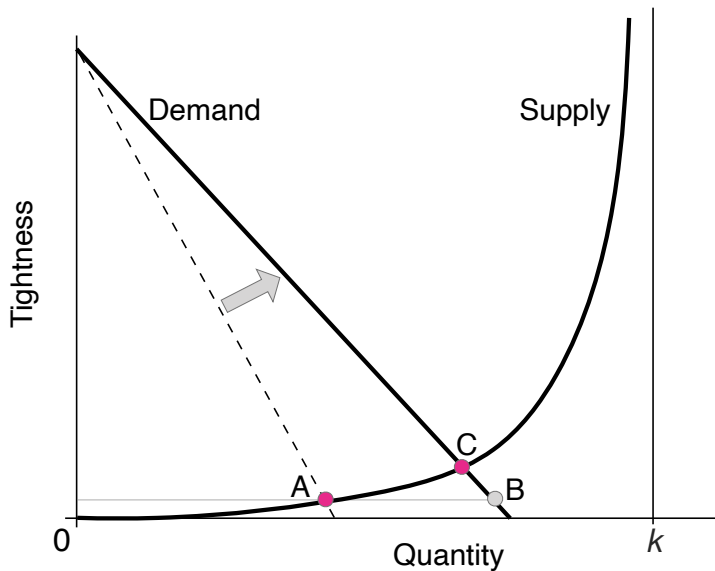


SUPPLY SHOCK: NEGATIVE TIGHTNESS-OUTPUT CORRELATION

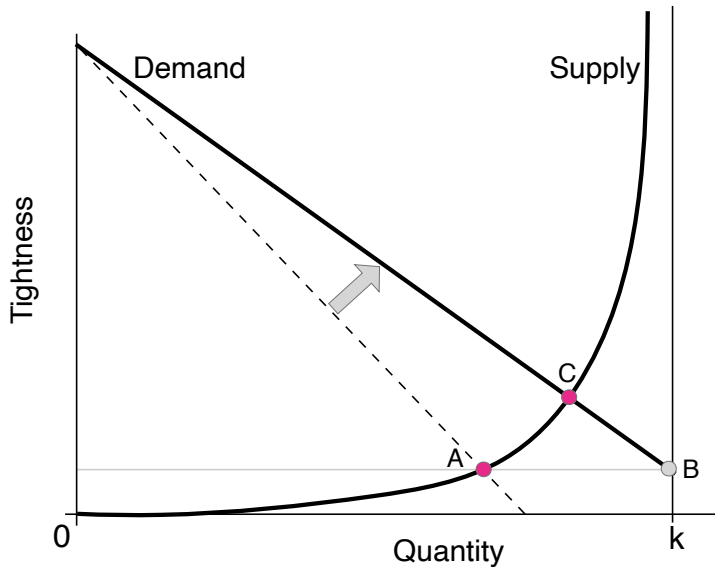


SLACKISH MARKETS ARE SHARPLY STATE DEPENDENT

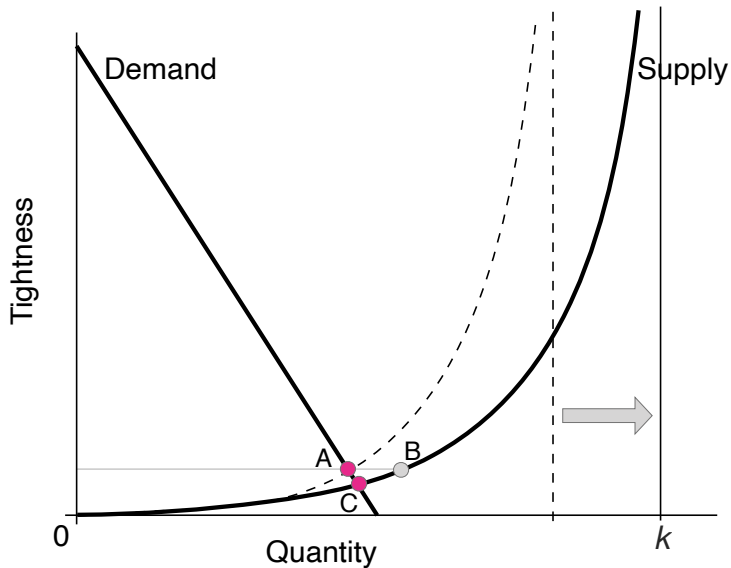
DEMAND SHOCK/POLICY: STRONG OUTPUT EFFECT IN SLACK TIMES



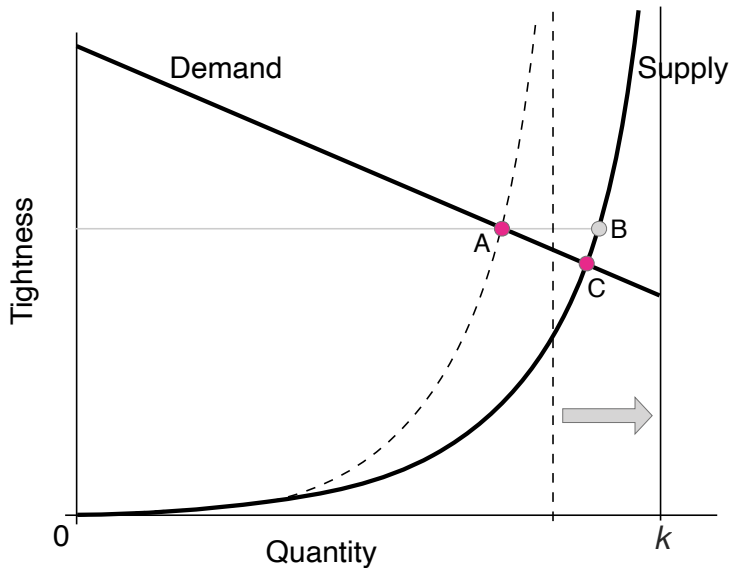
DEMAND SHOCK/POLICY: WEAK OUTPUT EFFECT IN TIGHT TIMES



SUPPLY SHOCK/POLICY: WEAK OUTPUT EFFECT IN SLACK TIMES

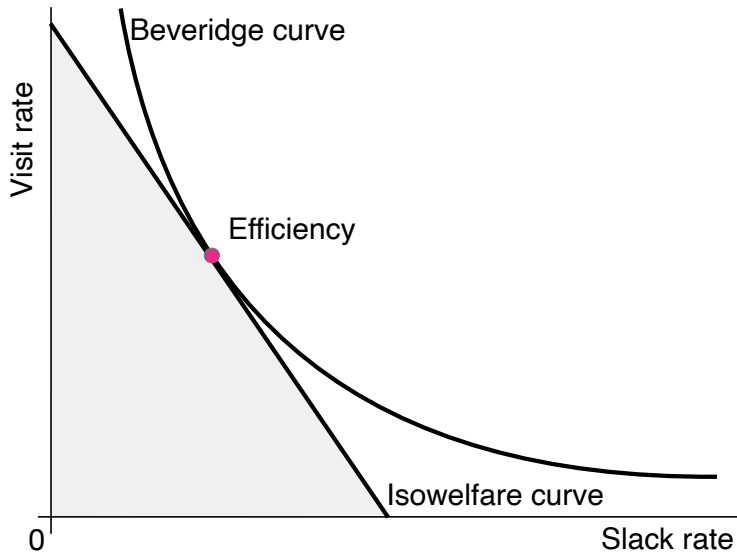


SUPPLY SHOCK/POLICY: STRONG OUTPUT EFFECT IN TIGHT TIMES

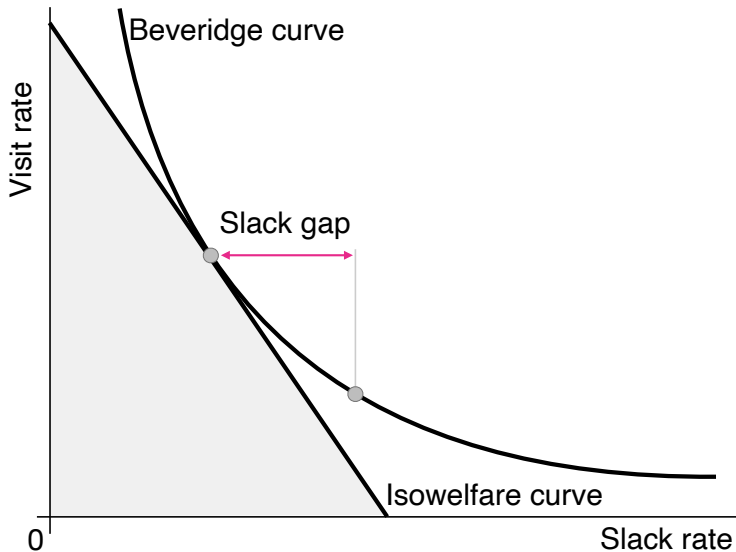


SLACKISH MARKETS ARE GENERALLY INEFFICIENT

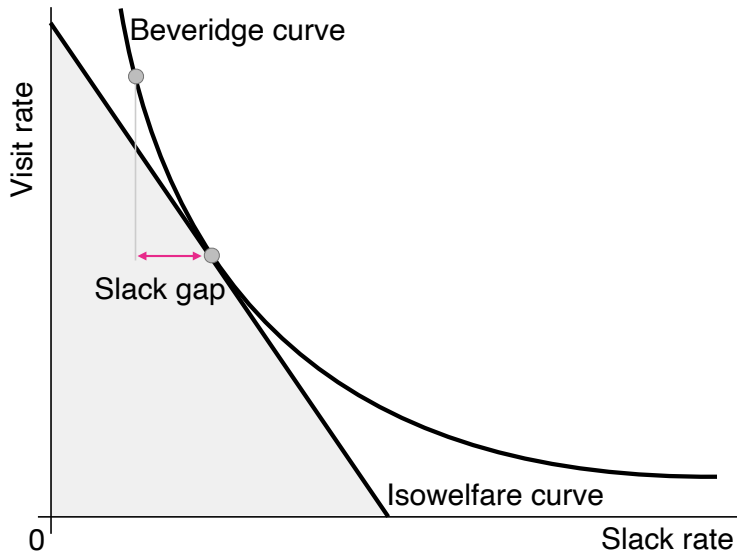
EFFICIENT MARKET ALLOCATION BALANCES SLACK COST & MATCHING COST



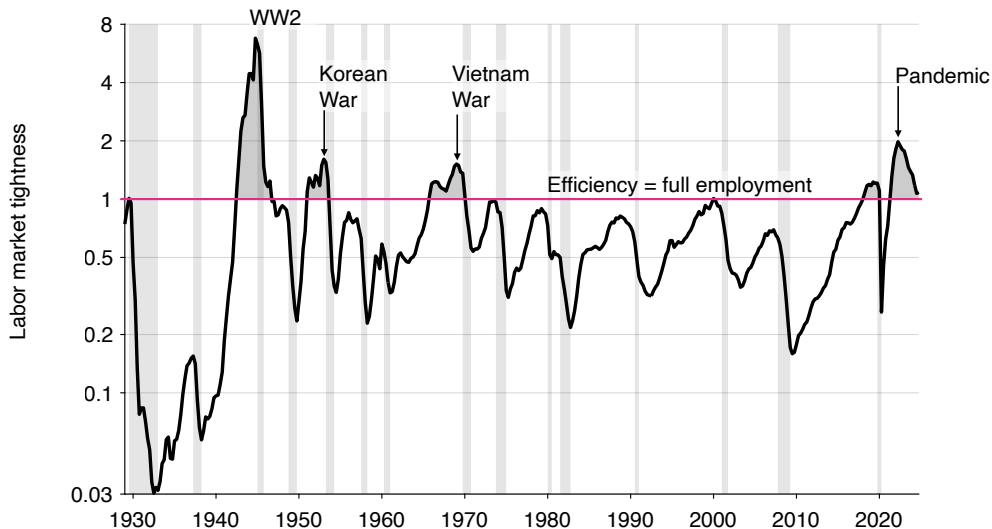
EFFICIENT MARKET ALLOCATION BALANCES SLACK COST & MATCHING COST



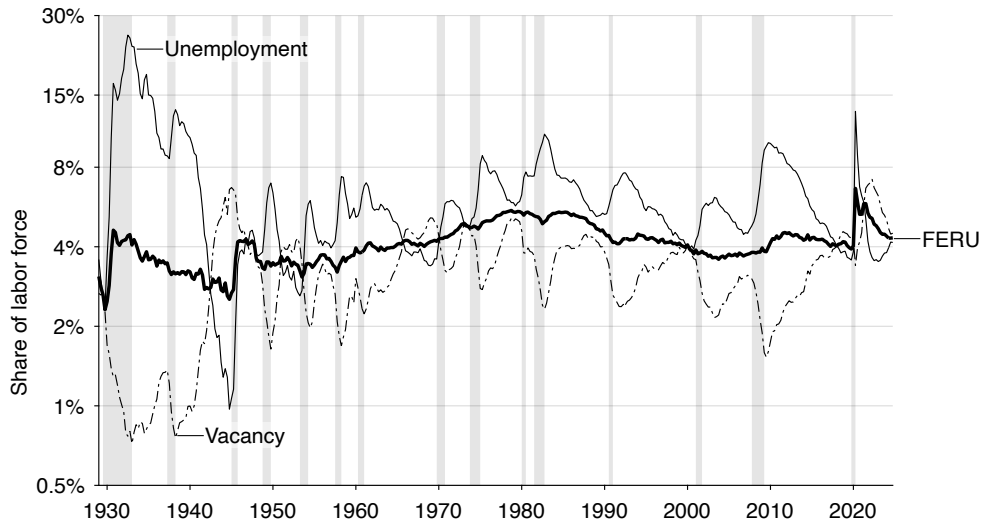
EFFICIENT MARKET ALLOCATION BALANCES SLACK COST & MATCHING COST



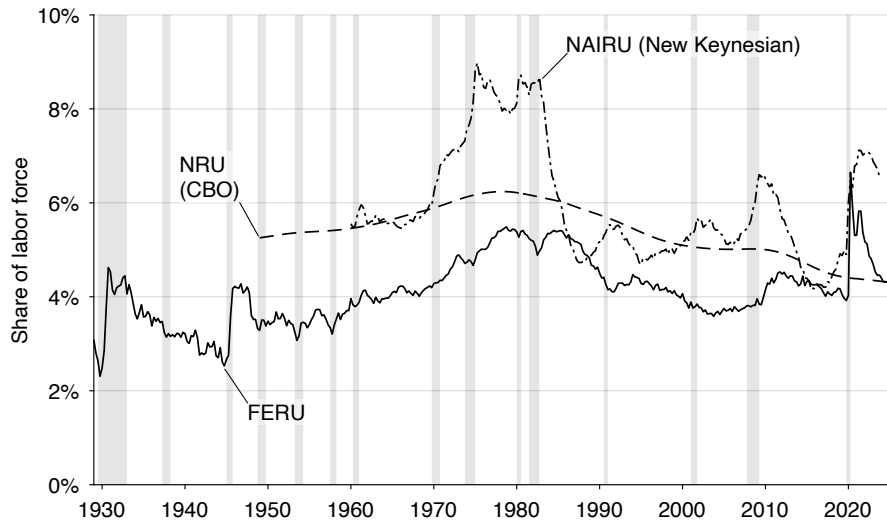
US LABOR MARKET IS GENERALLY INEFFICIENTLY SLACK: $v/u < 1$



FULL-EMPLOYMENT RATE OF UNEMPLOYMENT (FERU): $u^* = \sqrt{uv}$

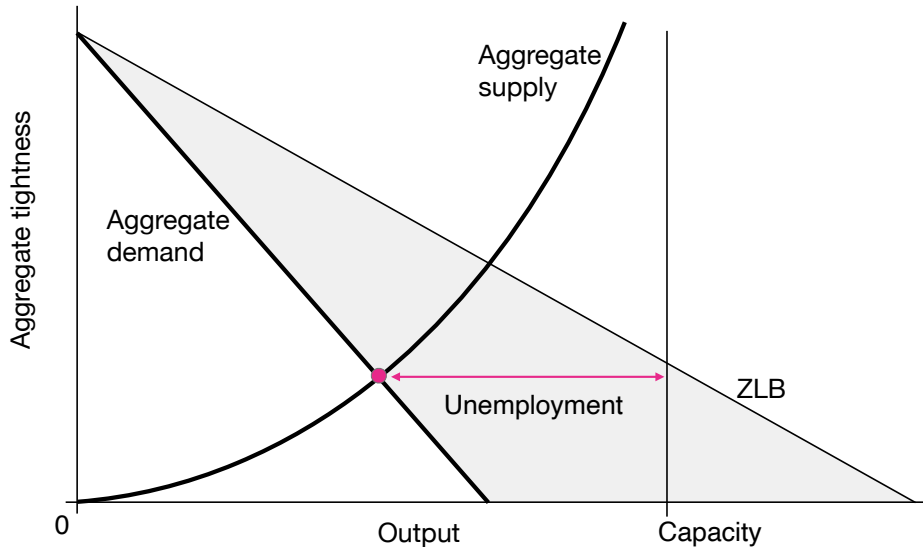


FERU AVERAGES 4.1%—BELOW OTHER UNEMPLOYMENT TARGETS

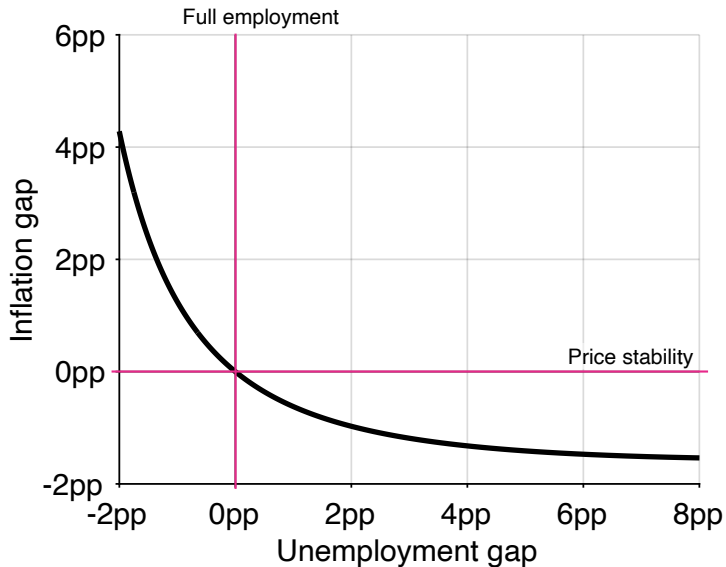


SLACK DETERMINES INFLATION TOO

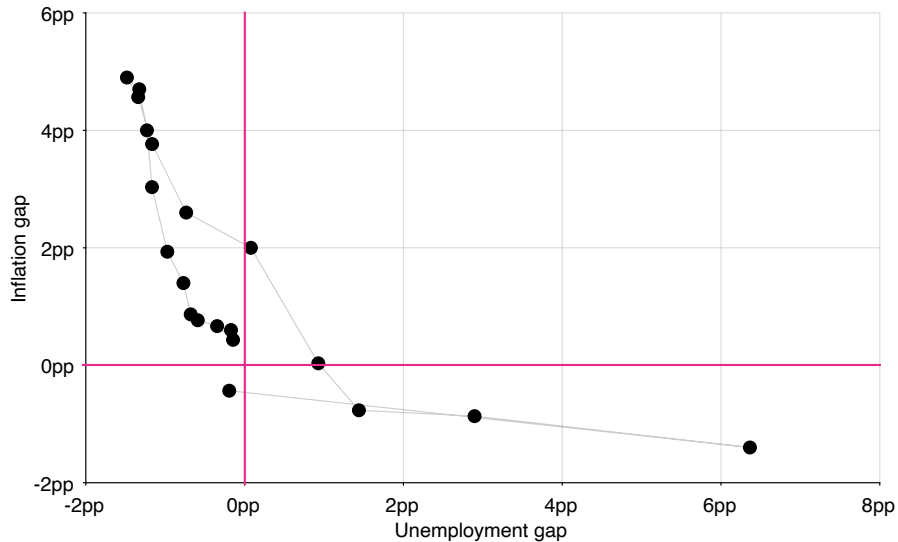
AGGREGATE DEMAND AND SUPPLY DETERMINE UNEMPLOYMENT ...



...AND UNEMPLOYMENT DETERMINES INFLATION

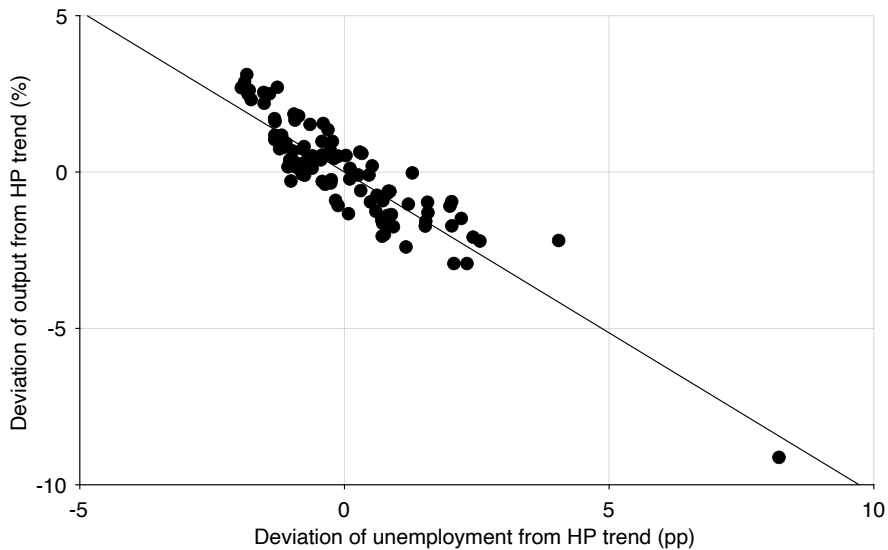


US PHILLIPS CURVE AFTER THE PANDEMIC

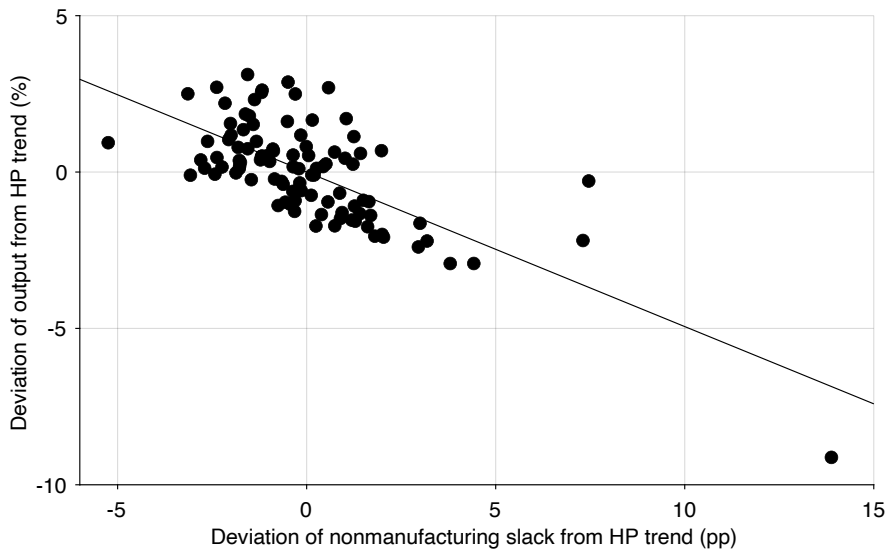


AGGREGATE DEMAND SHOCKS DRIVE BUSINESS CYCLES

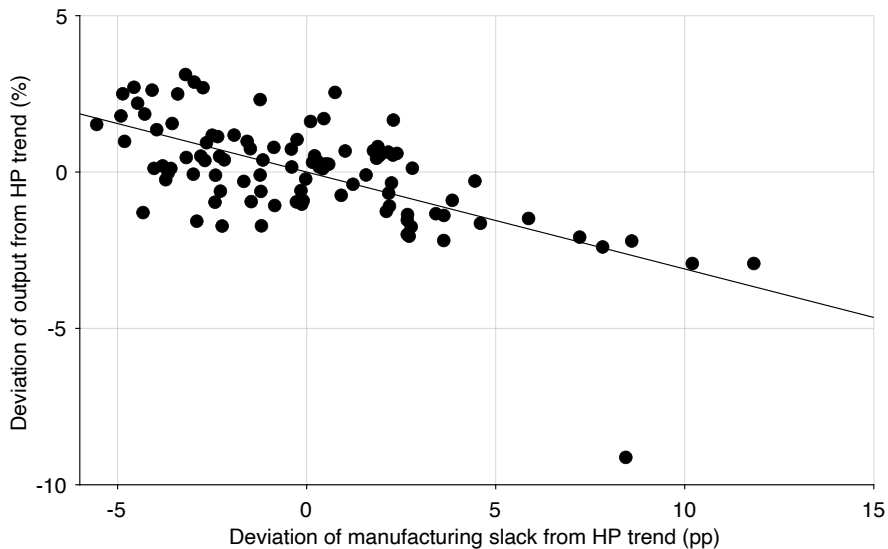
LABOR DEMAND (NOT SUPPLY) SHOCKS ARE PREDOMINANT



AGGREGATE DEMAND (NOT SUPPLY) SHOCKS ARE PREDOMINANT

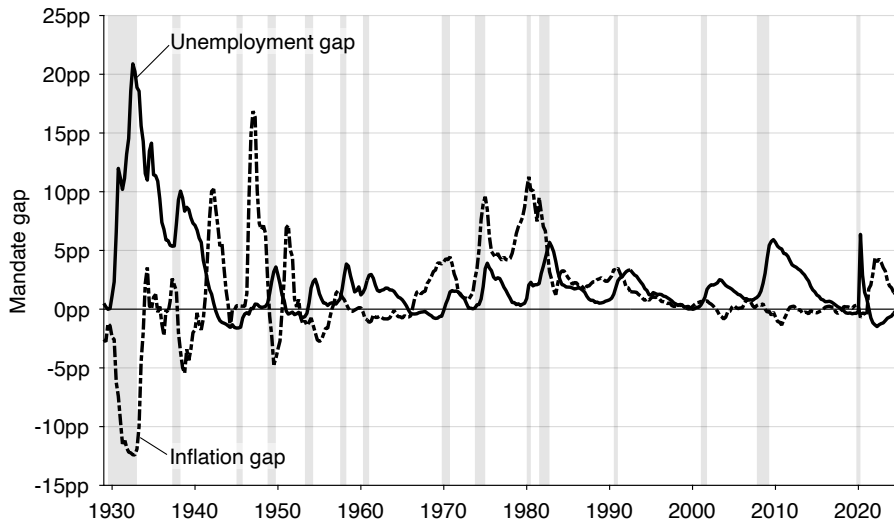


AGGREGATE DEMAND (NOT SUPPLY) SHOCKS ARE PREDOMINANT



SLACK DETERMINES OPTIMAL MONETARY POLICY

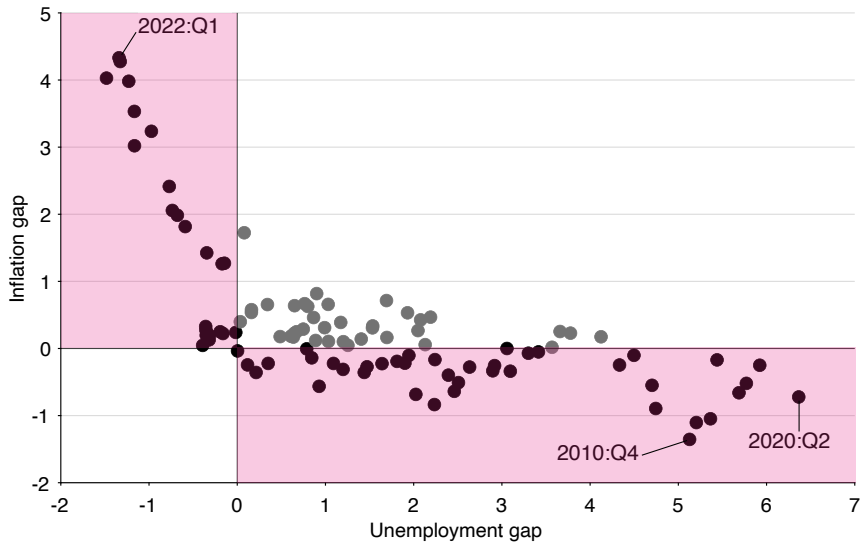
DEVIATION FROM DUAL MANDATE IN THE US, 1929–2024



1929–2024: MONETARY POLICY IS SUBOPTIMAL $> 47\%$ OF TIME

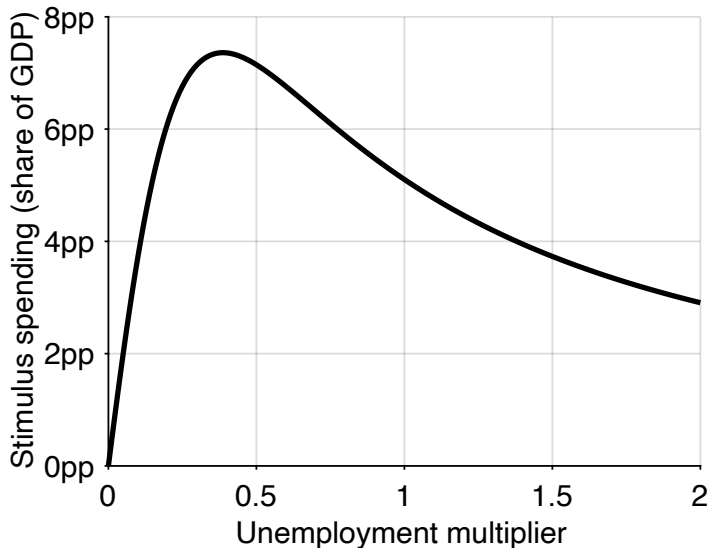


2000–2024: MONETARY POLICY IS SUBOPTIMAL > 63% OF TIME



SLACK DETERMINES OPTIMAL FISCAL POLICY

OPTIMAL STIMULUS SPENDING DURING GREAT DEPRESSION



UNEMPLOYMENT RATE UNDER OPTIMAL STIMULUS SPENDING

