Self-Fulfilling Unemployment Crises*

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Abstract

This paper proposes a theory of self-fulfilling unemployment fluctuations driven by an aggregate demand externality. Expectations of high unemployment, lead to low income and low aggregate demand. In turn, low aggregate demand leads to expectations of deflation and high unemployment. I show that this feedback between expectations and aggregate demand can lead to the emergence of self-fulfilling fluctuations in involuntary unemployment. Quantitative analysis calibrated to Spain shows that episodes of large unemployment are a result of pessimistic expectations. We discuss the policy implications of this novel source of multiplicity.

KEYWORDS: Multiple equilibria, sunspots, unemployment, secular stagnation
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