Asymmetric Unemployment Fluctuations and Monetary Policy Trade-Offs

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What this paper is about

A question: How much weight should policymakers place on inflation, and how much on employment?

Motivating evidence: Asymmetric unemployment dynamics in the US and recent spike in unemployment in certain Euro Area countries. This asymmetric nature of unemployment fluctuations may be very costly (Hairault et al. 2010, Jung & Kuester 2011).

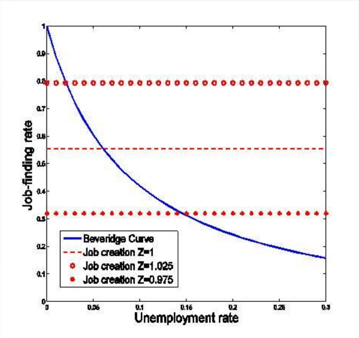
What I do: Use a theoretical model to study how the presence of asymmetries in unemployment dynamics shapes the optimal conduct of monetary policy.

Theoretical Framework

I develop a **standard** New Keynesian model with search and matching frictions in the labor market which has **three essential features**:

- Price stickiness gives monetary policy some leverage over aggregate demand and job creation
- Unemployment fluctuations are asymmetric (stems directly from the search frictions)
- There is some propagation of shocks to labor market activity

The model in a graph:



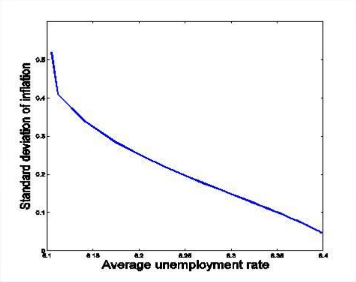
Comment: Shifts in technology lead to symmetric shifts in the job-finding rate and asymmetric fluctuations in unemployment.

The transmission mechanism of monetary policy:

- Not fully stabilizing inflation in response to shocks generates movements in firms' markups
- These movements in markups have an impact on job creation
- This implies that the monetary authority can influence unemployment volatility by allowing some inflation volatility in response to shocks

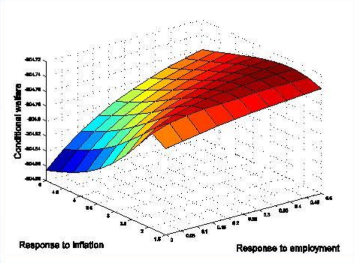
Results

Result 1: A long-run trade-off between inflation volatility and average unemployment arises in the presence of asymmetric unemployment fluctuations.



- Supply shocks move inflation and unemployment in opposite directions
- This creates a trade-off for the policymaker. Stabilizing inflation comes at the cost of higher unemployment volatility
- Since unemployment fluctuations are asymmetric, it also leads to higher **average unemployment**

Result 2: Large welfare gains can be obtained by stabilizing employment alongside inflation. Most of these gains are due to the decrease in average unemployment under that policy.



The final word

- **A clear policy implication:** A large weight on employment stabilization is warranted in countries which experience large asymmetric unemployment fluctuations.
- **Extension in the paper:** The welfare costs of price stability are even larger in the presence of imperfect consumption insurance.