‘Stabilisation Policy in a New Keynesian Model with Job Search, Skills Erosion and Growth Effects’ by Campbell Leith and Ioana Moldovan

Abstract:
This paper develops a sticky-price New Keynesian model where households engage in job search and accumulate both physical and human capital. The accumulation and erosion of human capital differ depending on the time spent in employment and unemployment, with a lower rate of skills erosion and greater positive spillovers for employed versus unemployed workers. Since unemployment affects human capital accumulation it also impacts on endogenous economic growth and hence this is an environment where the costs of unemployment are potentially high and may significantly influence the conduct of monetary policy. In the context of this economy, we explore the nature of optimal monetary policy and the trade-offs it faces in terms of stabilising inflation and output (unemployment). We also analyse the ability of optimal (linear and non-linear) simple policy rules both to deliver a determinate equilibrium and to mimic the fully optimal Ramsey policy.