The Labor Demand and Labor Supply Channels of Monetary Policy

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Introduction

This paper is about the transmission mechanism of monetary surprises through households' search behavior. It postulates that in the absence of a transient search status, employment would be more responsive to monetary policy shocks.

In these slides, I will briefly describe the authors' approach and results, and present my impressions on two aspects of their work:

- The choice of variables and VAR setup, particularly in connection with the behavioral model
- Whether the results can be rationalized in a general equilibrium environment

What they do

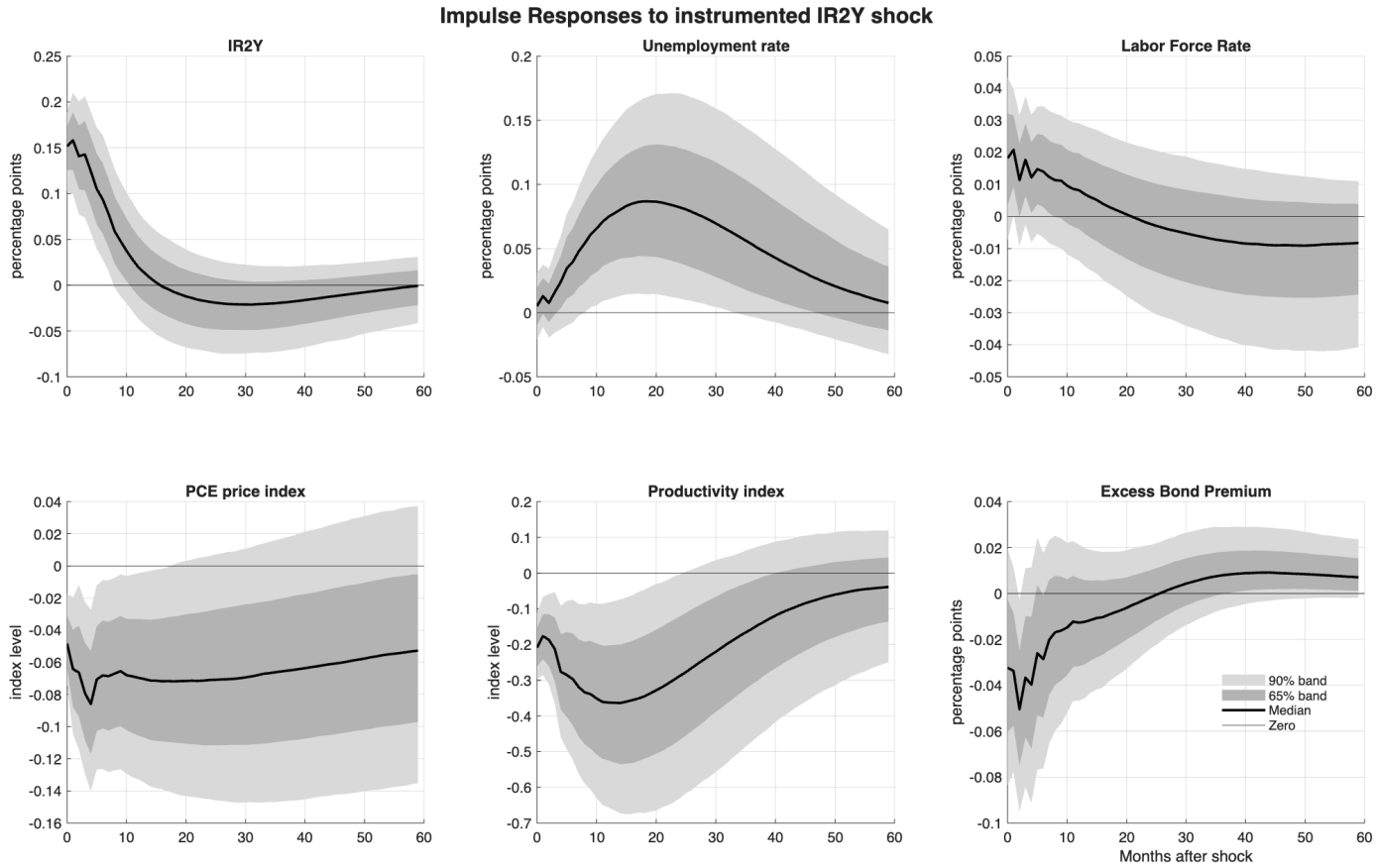
This paper can be divided into two blocks:

- **Empirical**: where present the best instrument for monetary policy surprises, and regress it on **supply-driven** labor market flows to get structural IRFs
- **Behavioral**: where they write a heterogeneous agent's decision model, successfully fitted to match empirical IRFs
- These parts are intertwined to show that the response of employment to an unexpected monetary contraction would be larger if we turned off the search channel

Empirical

There are two key elements to the empirical part:

1. The identification of monetary surprises using high frequency data
2. The definition of **supply-driven** labor market flows: NU and UN, and the "quit" component of EN
   - NU increases, UN and EN decrease under a monetary contraction
   - Therefore, an unexpected increase in interest rates seems to drive people into searching for a job in the short run
   - This drive seems to be more intense for people without a college education (what about older people?)


Impulse Responses to instrumented IR2Y shock
IR2Y
Unemployment rate
Labor Force Rate
PCE price index
Productivity index
Excess Bond Premium
percentage points
index level
Months after shock
90% band
65% band
Median
Zero

Empirical

The behavioral model includes idiosyncratic labor market risk, search costs, layoff risk, and job finding probabilities, that makes search effort an inevitable part of the allocation of the labor force over time.

The model is successfully fitted to the data and used to illustrate the importance of the search transient status, by not allowing decisions to adapt to effect of monetary surprises to the real interest rate and the wage path.

However, I believe the paper can sharpen its message by providing a coherent general equilibrium narrative of the responses of transitions and private consumption to a monetary surprise.

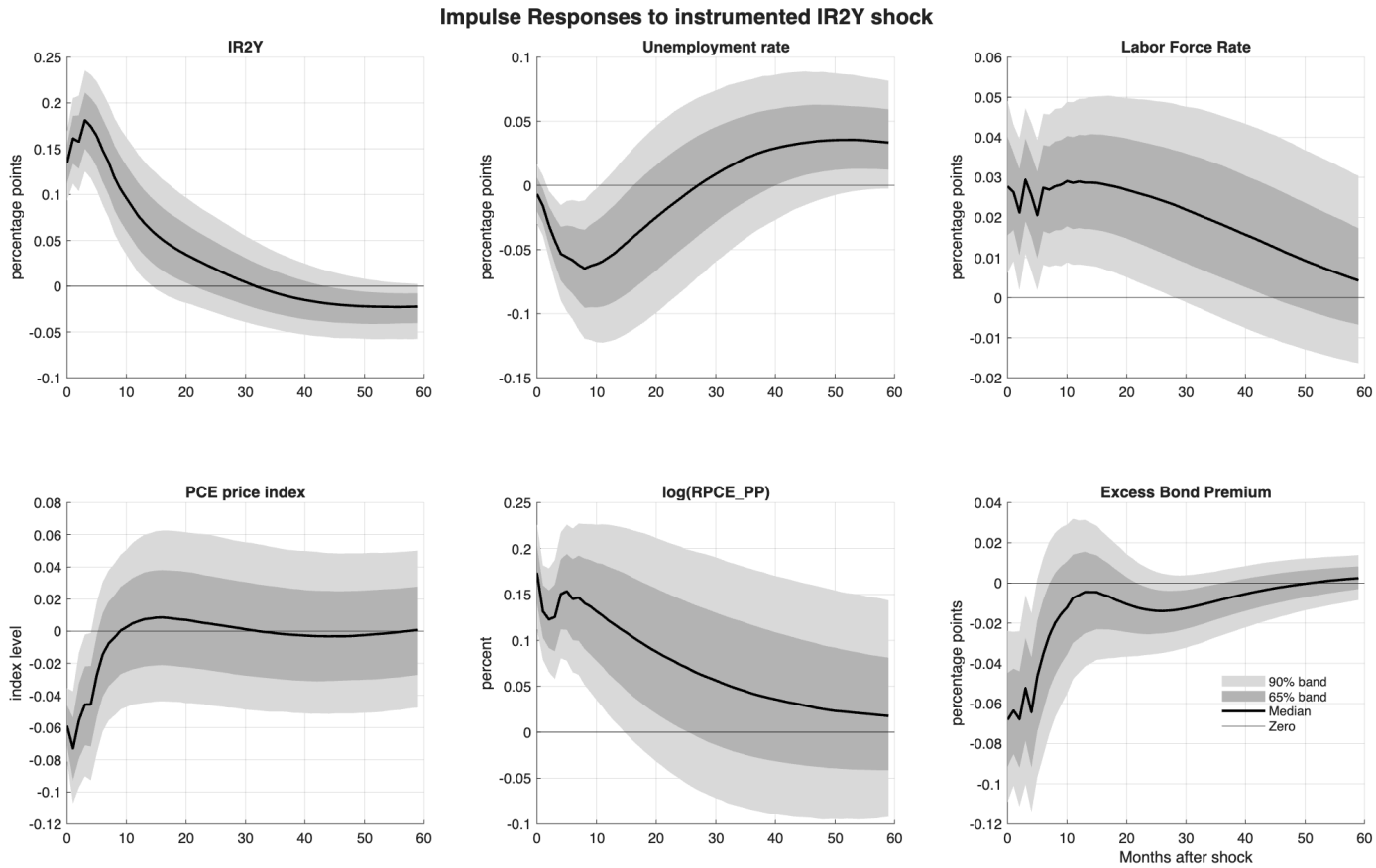


Figure: IR levels instrumented with surprises

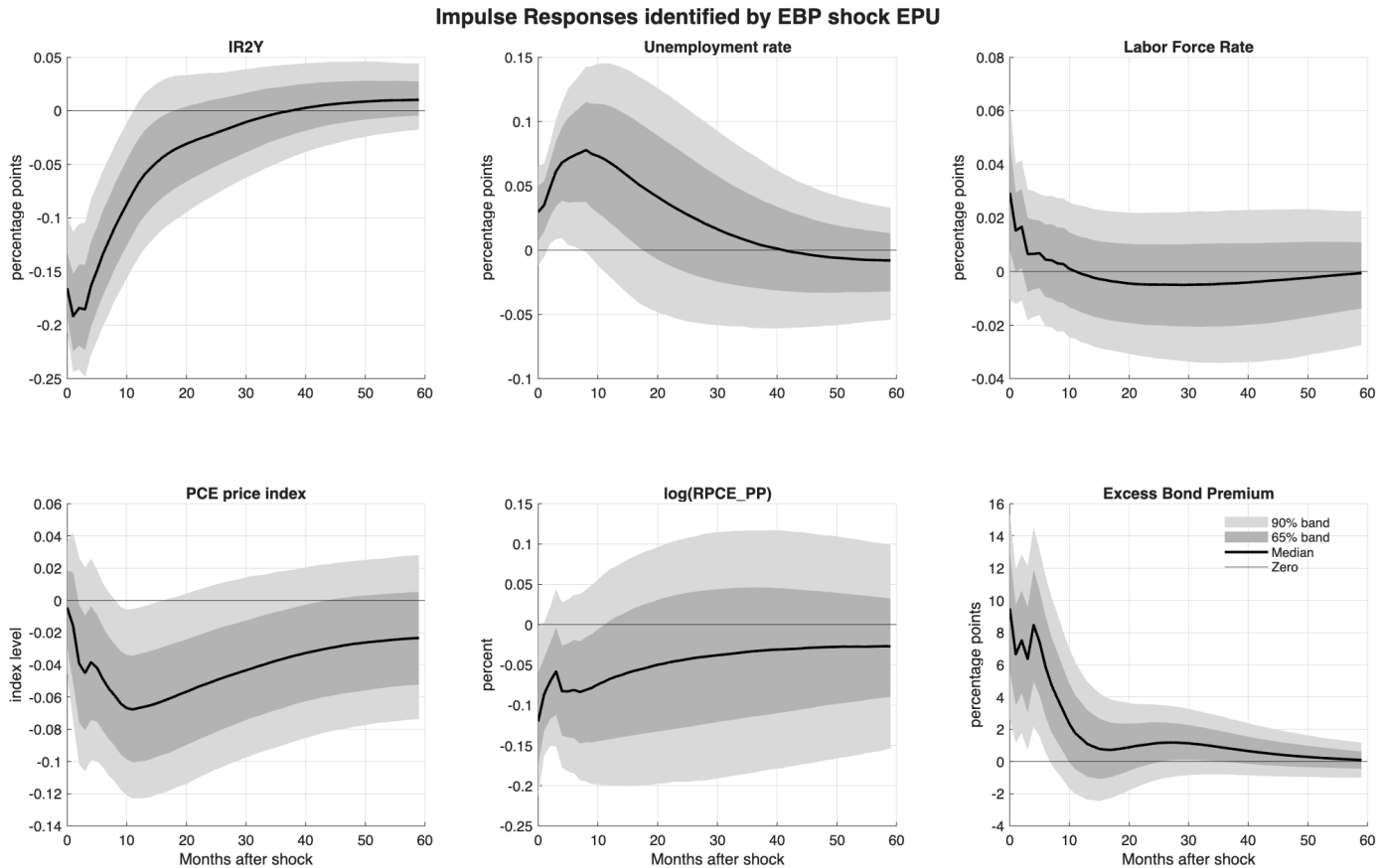


Figure: IR spreads instrumented with uncertainty

The equilibrium paths of the model should respect aggregate identities

$$P_t^* y_t^* = M_t^s v_t^*$$

and relations, like the fisher equation:

$$1 + R_t = E_t \left\{ (1 + r_{t+1}^*)(1 + \hat{P}_{t+1}^*) \right\}$$

or binding properties of neoclassical technologies:

$$w_t(r_t) \approx (1 - \alpha) \alpha^{\frac{\alpha}{1-\alpha}} A_t^{\frac{1}{1-\alpha}} r_t^{-\frac{\alpha}{1-\alpha}}$$

The results of the paper seem at odds with the last aggregate relationship, for their measure of wages

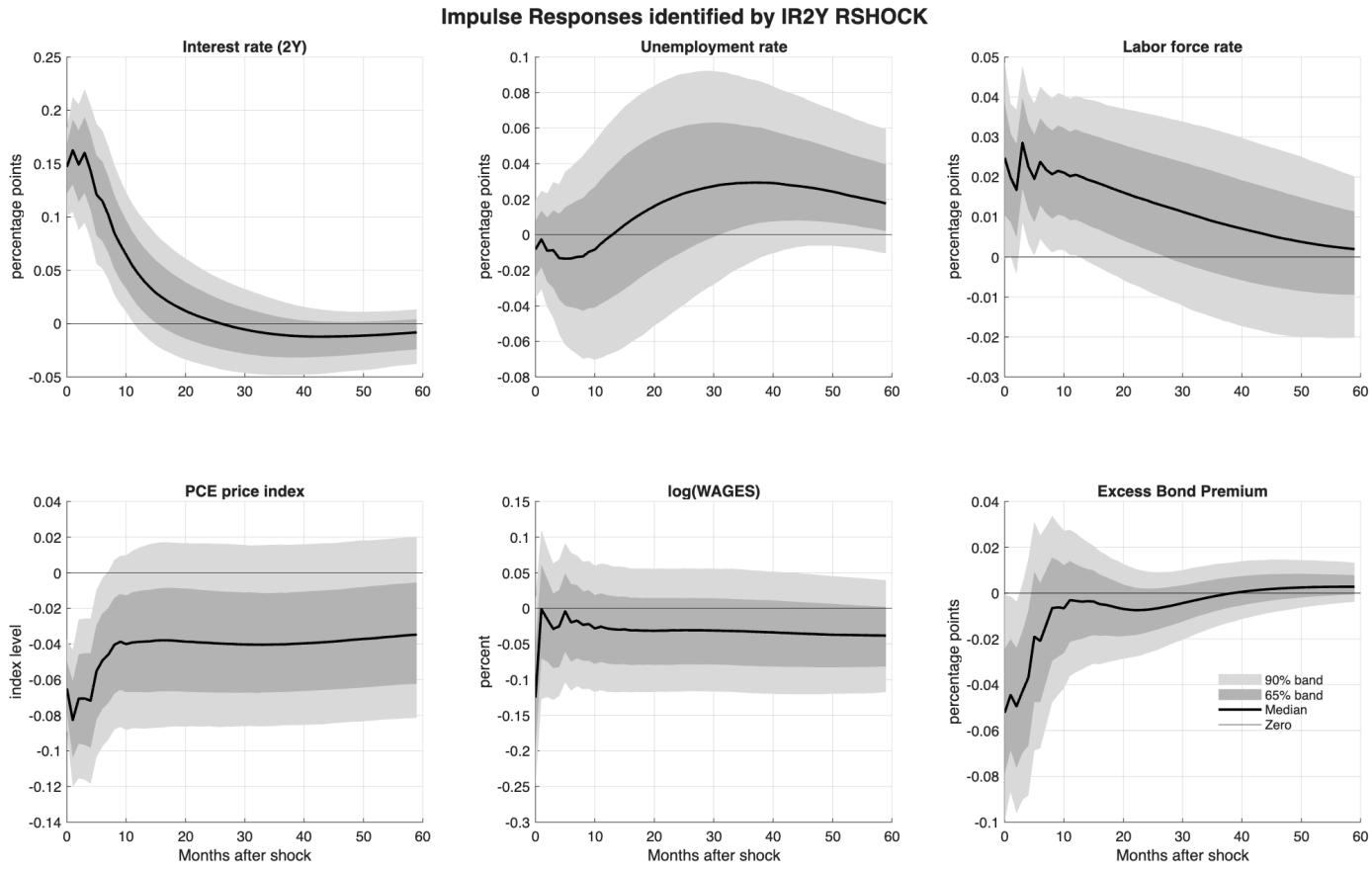


Figure: Monetary surprises on real wages