Labor Market Shocks and Monetary Policy

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Worker mobility played a key role in shaping inflation dynamics during the Great Recession and COVID-19 recoveries.

We study the positive and normative implications for inflation of employer-to-employer (EE) worker transitions by developing a heterogeneous agent New Keynesian model featuring a frictional labor market with on-the-job search. We find that EE dynamics played an important role in shaping the differential inflation dynamics observed during the Great Recession and COVID-19 recoveries. Despite both recoveries sharing similar unemployment dynamics, the recovery from the Great Recession exhibited subdued EE transitions and inflation dynamics. In our model, the optimal monetary policy involves a strong positive response to EE fluctuations, suggesting that central banks should distinguish between recovery episodes with different EE dynamics even if they have similar unemployment rates.

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