The Job Ladder: Inflation vs. Reallocation*

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Abstract

We introduce on-the-job search frictions in an otherwise standard monetary DSGE New-Keynesian model. Heterogeneity in productivity across jobs generates a job ladder. Firms Bertrand-compete for employed workers, as in the Sequential Auctions protocol of Postel-Vinay and Robin (2002). Outside job offers to employed workers, when accepted, reallocate employment up the productivity ladder; when declined, because matched by the current employer, they raise production costs and, due to nominal price rigidities, compress mark-ups, building inflationary pressure. When employment is concentrated at the bottom of the job ladder, typically after recessions, the reallocation effect prevails. As workers climb the job ladder, reducing slack in the employment pool, the inflation effect takes over. A quantitative version of the model generates endogenous cyclical movements in the Neo Classical labor wedge and in the New Keynesian wage mark-up. Because the average job-to-job transition probability in the US is low, the economy takes time to absorb cyclical misallocation, hence it features propagation in the response of job creation, unemployment and wage inflation to aggregate shocks. The ratio between job finding probabilities from other jobs and from unemployment, a measure of the "acceptance rate" of outside job offers to employed workers, is a better (and negative) predictor of inflation than the unemployment rate.

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1 Introduction

The Phillips curve, an inverse short-run relationship between the rates of unemployment and inflation, is a guiding principle of monetary policy. Microfoundations of this relationship build on price-setting frictions, due either to explicit costs of price adjustment or to incomplete information about the nature of demand shocks faced by producers. In this body of work, the labor market is typically modeled as competitive, and features no unemployment; the relevant measure of slack is an output gap. Nominal, thus real, wage rigidity can generate classical unemployment associated with such a gap (Erceg, Henderson and Levine (2000), Gertler and Trigari (2009)). But the canonical model of unemployment, supported by a vast arsenal of empirical evidence on labor market flows, builds on search frictions, a primitive feature of the trading environment, rather than on exogenously imposed sources of wage rigidity. In the so-called DMP framework, wages are set by Nash Bargaining, the value of unemployment being the worker’s outside option. When the economy is expanding and firms post many vacancies, the unemployed have an easy time finding a new job, hence unemployment declines, while employed workers have a strong threat and bargaining power, and real wages rise. This view seems to capture well the original idea behind the Phillips curve: low unemployment signals scarcity of labor, hence pressure on its price.

In this paper, we advocate shifting emphasis away from unemployment, as the relevant indicator of slack to predict inflation, and towards the (mis)allocation of employment on a “job ladder”. In Moscarini and Postel-Vinay (2017), using microdata from the Survey of Income and Program Participation to control for composition effects in employment, we provide empirical evidence that neither the unemployment rate nor the job-finding rate from unemployment have any significant comovement over time with nominal wage inflation. In

1Krause, Lopez-Salido and Lubik (2008) show that modeling the labor market according to this DMP tradition does not have much additional explanatory power for inflation dynamics in an otherwise standard monetary DSGE model, but Christiano, Eichenbaum and Trabandt (2016) find that it significantly improves the overall empirical fit the model.

2In a similar vein, Jager et al. (2018) find in administrative Austrian data that sudden and large changes in Unemployment Insurance benefit size and duration by age have no discernible effect on the continuing wages of eligible workers.
contrast, the rate at which workers move from job to job (or employer to employer, EE) has a significant positive relationship with nominal wage inflation, even wages of stayers who do not switch jobs. This is not surprising, in light of an alternative view of labor markets characterized by search frictions, one where wages are not subject to bargaining, but are offered unilaterally by firms, and workers’ bargaining power derives from their ability to receive outside offers. Such offers can either be accepted, moving the worker up a job ladder, or matched and declined, pushing wages closer to marginal product and representing, for the employer, a cost-push shock. The latter outcome is more likely after a sufficiently long aggregate expansion, when workers have been moving up the ladder for a while, hence are difficult to poach away. In this case, cost pressure builds and, with a lag due to nominal price rigidities, eventually manifests itself as price inflation.

Our claim is that competition for employed, not unemployed, workers transmits aggregate shocks to wages, and that the distinction is important, for two reasons. First, and foremost, these two types of competition point to two different observable proxies of slack to guide monetary policy. Our model features an endogenous Neoclassical labor wedge, which maps into an endogenous New-Keynesian wage mark-up, both measuring the deviation from the efficient benchmark where the marginal rate of substitution of consumption for leisure equal the marginal product of labor. This object matters to our firms because it captures the ex post profits from hiring an unemployed worker, necessary to cover upfront vacancy posting costs. High unemployment thus signals poor job creation, hence a large implicit “tax” on wages or wage mark-up, and no labor demand pressure. This is in line with the countercyclical labor wedge (tax) commonly measured in US data through the lens of a Neoclassical accounting framework. Accordingly, much of the literature aims to identify the origin and nature of the labor wedge.

In our model, however, the impact of aggregate shocks on employment or wages also depends on a new object, that we dub the productivity wedge. Because of frictions, employed workers are misallocated on the job ladder, relative to the competitive and efficient
benchmark where all employment is at the top of the ladder in the best possible matches. Misallocation reduces average labor productivity by a proportional amount, that we call the productivity wedge. Because workers can search on the job, they can upgrade their position, shifting the distribution up the ladder, and closing the productivity gap. The larger this gap, hence misallocation, the stronger job creation, even independently of unemployment, and the easier to poach employed workers with minimal wage pressure. Conversely, a small productivity gap predicts that most outside job offers will be either rejected or matched, causing little employment gains and large wage gains, which are cost-push shocks from the point of view of sticky-price firms. Therefore, unemployment is, at best, an incomplete measure of slack, which must be supplemented by measures of employment misallocation, or symptoms thereof, such as the average EE quit rate.

Second, although unemployment is just the bottom rung of a longer job ladder, these two forces, unemployment and the productivity gap, have different cyclical patterns. As Shimer (2012) showed, cyclical movements in the unemployment rate are driven to a large extent by those in the job-finding rate from unemployment, which in turn reflect closely the vacancy/unemployment rate, thus job creation. The latter is a very volatile variable, but the unemployment rate tracks it very closely, because the job finding probability in the US is high, over 25% per month, negating much propagation. In contrast, the EE transition probability is low, about 2% per month, so the reallocation of employment up the job ladder unfolds slowly, and the propagation of aggregate shocks through the poaching/outside offers channel can be strong. Because firms cannot perfectly target their pool of job applicants, they create more jobs and post more vacancies either when many job applicants are unemployed

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3 Ashley and Verbrugge (2018) show that, in a forecasting, reduced-form sense, the statistical relationship between the rates of inflation and unemployment is highly non linear, and characterized by two distinct measures of slack or unemployment gap, “bust” and “boom”, and three distinct phases. The first (“bust”) relationship is the one highlighted by Stock and Watson (2010): there is a sharp reduction in inflation that occurs as the unemployment rate is rising rapidly. The second (“null”) relationship occurs as the unemployment rate subsequently begins to fall; during this phase, inflation is unrelated to any conventional unemployment gap. The final (“overheating”) relationship begins once the unemployment rate drops below its natural rate. In our view, the transmission channel of aggregate demand to inflation is the productivity wedge, which is, in the last phase, small and highly correlated with the “boom” unemployment gap.
or when the employed are mismatched and easy to poach (or both). Thus, independently of the state of unemployment, the distribution of employment on the job ladder, a very slow-moving state variable, determines job creation and thus, ultimately, also the pace of job finding from unemployment. Wages do not respond, despite falling unemployment, for quite some time, until few workers are left at the bottom of the ladder, and competition for employed workers emerges. In terms of observables, monetary authorities should pay attention to the lagged EE transition probability, which predicts a falling productivity gap, hence cost-push inflation. The much stronger propagation of the productivity gap makes it a more plausible source of inflation persistence than the unemployment rate.

To formalize and quantitatively investigate this hypothesis, we introduce search in the labor market, both on- and off-the job, and endogenous job creation into an otherwise standard monetary DSGE model with complete financial markets, a representative risk-averse household, Calvo pricing. Wages are set by Postel-Vinay and Robin (2002)’s Sequential Auctions protocol: firms make unilateral offers that can be renegotiated only by mutual consent, when outside offers arrive. We are interested in business cycles and monetary shocks, hence we must move from the steady state analysis that is common in search models to allow for aggregate uncertainty. Accordingly, we allow firms to offer and commit to contracts that are state-contingent wages, and to Bertrand-compete in such contracts for already employed workers. In Moscarini and Postel-Vinay (2018) we analyze in great detail, also quantitatively, the risk-neutral real version of this model, a business cycle search model with Sequential Auctions. Here we introduce on-the-job search and ex post competition in a business cycle, g.e. macro model with risk-averse agents and nominal price rigidities, which requires significant modifications both to the model and to the methodology to compute equilibrium. Essentially, we replace the household neoclassical labor supply of the standard DSGE models, where the labor market is perfectly competitive, with a search model of the labor market, where (un)employment is a state variable and labor demand determines its change, through endogenous job creation. We review the literature in the paper.
To evaluate the quantitative properties of the model, we calibrate it in steady state, log-linearize the dynamic equations, and simulate time series subject to various combinations of demand and supply side aggregate shocks. We find that the model provides modest propagation of Average Labor Productivity (ALP), due to employment movement on the job ladder, and significant amplification of aggregate shocks on job finding probability from unemployment and unemployment rate. Nominal price stickiness dampens the response of ALP, but amplifies the response of unemployment. Most notably, we study in simulated data the lead/lag relationship of various labor market variables with the inflation rate. Besides the conventional unemployment rate, we also study the UE job finding probability from unemployment, as well as the “acceptance probability” of outside offers to employed workers. In the model, the acceptance probability can be directly measured by taking the ratio between EE and UE probabilities, because the latter measures the frequency of contacts with open vacancies, thus the two probabilities diverge only because employed workers do not accept all job offers, to an extent that varies with the misallocation of employment on the job ladder. The lagged acceptance probability has a strong and negative correlation with inflation: when employment is misallocated, and employed workers are more likely to accept outside offer, the economy features more slack, and output can expand more easily, without putting pressure on marginal cost and inflation. Importantly, the acceptance probability swamps the unemployment rate and the UE probability as a predictor of future inflation.

Section 2 describes the model, Section 3 its equilibrium, Section 4 quantitative results, the Appendix additional details.
2 The Economy

Agents, goods, endowments and technology. Time $t = 0, 1, 2, \cdots$ is discrete. Two vertically integrated sectors produce each a different kind of non-storable output: an intermediate input, that we call Service, and differentiated varieties of a final good.

Firms in the Service sector produce with linear technology using only labor. Each unit of labor ("job match") produces $y$ units of the Service, which is then sold on a competitive market at price $\omega_t$. Productivity $y$ is specific to each match and is drawn, once and for all, when the match forms, in a iid manner from a cdf $\Gamma$ with $\Gamma(y) = 0$, $\Gamma(\bar{y}) = 1$ for some $\bar{y} > y > 0$, and mean $\mathbb{E}_\Gamma[y] := \mu$.

Each variety $i \in [0, 1]$ of the Final good is produced by a single firm, also indexed by $i$, with a linear technology that turns $y$ units of the homogeneous Service into $z_t y$ units of variety $i$, which are then sold at unit price $p_t(i)$ in a monopolistic competitive market. TFP $z_t$ follows a first-order Markov process.

A representative household is a collection of agents $j \in [0, 1]$. Each household member has an indivisible unit endowment of time per period, and the household is collectively endowed with ownership shares of all firms in both sectors. We indicate whether household member $j$ is employed at time $t$ by $e_t(j) \in \{0, 1\}$.

Preferences. The household has preferences

$$U(C_t) + b \int_0^1 (1 - e_t(j)) \, dj$$

over consumption of Final good varieties, where, for $\eta > 1$

$$C_t = \left( \int_0^1 c_t(i)^{\frac{\eta - 1}{\eta}} \, di \right)^\frac{\eta}{\eta - 1}$$

and leisure, with $U' > 0 > U''$, $b \geq 0$. For simplicity, we assume that $b$ is low enough that all matches are preferable to unemployment at all points in time, and separations into unemployment are only exogenous\footnote{In Moscarini and Postel-Vinay (2018) we allow for endogenous separations in the flexible price, risk-neutral version of this economy.}.

\footnote{In Moscarini and Postel-Vinay (2018) we allow for endogenous separations in the flexible price, risk-neutral version of this economy.}
The household maximizes the present value of expected utility discounted with factor $\beta_t \in (0, 1)$. The subjective discount factor $\beta_t$ follows an exogenous stationary first-order Markov stochastic process with support in $(0, 1)$. We denote the total discount factor between times $t$ and $t + \tau$ by $B_{t+\tau}^t = \prod_{\tau' = 0}^{\tau-1} \beta_{t+\tau'}$, with the convention $B_t^t = 1$.

**Search frictions in the labor market.** Service sector producers can advertise vacancies which randomly meet jobseekers. Advertising a vacancy entails a flow cost of $\kappa_v$ in units of the utility aggregator $C_t$. Once a vacancy and a jobseeker meet, the employer has to pay an additional one-off utility cost equal to $\kappa_s$ units of $C_t$, which we interpret as a screening/training cost, to learn match productivity $y$ and to make the match viable. If the match is also acceptable, production can begin in the following period.

Previously unemployed workers search for open job vacancies. Previously employed workers are separated from their jobs with probability $\delta \in (0, 1]$ and become unemployed, in which case they have to wait until next period to search; if not, they also receive this period, with probability $s \in (0, 1]$, an opportunity to search for a vacant job (a new match). Let

$$\theta = \frac{v}{u + s(1 - \delta)(1 - u)}$$

be effective job market tightness, the ratio between vacancies and total search effort by (previously) unemployed and (remaining) employed. A homothetic meeting function determines the probability $\phi(\theta) \in [0, 1]$, increasing in $\theta$, that a searching worker locates an open vacancy, thus the probability $\phi(\theta)/\theta$, decreasing in $\theta$, that an open vacancy meets a worker. Therefore, the output of the Service sector can be thought of as a bundle of efficiency units of labor, assembled by Service sector firms in a frictional labor market, and leased to Final good producers in a competitive market at unit price $\omega_t$. Service sector firms are essentially labor market intermediaries, solving the hiring problems of Final good producers.

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5Note that we specify hiring costs — i.e. advertising and screening costs — as utility (or “effort”, or “psychic”) costs, rather than costs to be paid in units or Services or Final goods. That is, adjustment costs do not appear in resource constraints and market-clearing equations. While this is not essential, we explain the reason, and alternatives, in Section 3.4.
**Price determination.** Each Final good variety producer \( i \in [0, 1] \) is a monopolistic competitor for its variety \( i \), and draws every period with probability \( \nu \in (0, 1) \) in an i.i.d. fashion an opportunity to revise its price \( p_t(i) \). Given the price, either newly revised or not, the firm serves all the resulting demand \( q_t(i) \) by buying the required quantity \( q_t(i)/z_t \) of Service in a competitive market at nominal unit price \( \omega_t \).

Finally, we describe wage setting. A Service-producing firm can commit to guarantee each worker a state-contingent expected present value of payoffs in utility terms (a “contract”), including wages paid directly to the worker, wages paid by future employers, and value of leisure during unemployment spells. This contract can be implemented by state-contingent wage payments while the relationship lasts. The contract can be renegotiated by mutual consent only. The firm’s commitment is limited, in that it can always unilaterally separate, so firms’ profits cannot be negative (in expected PDV). Same for the worker: if the utility value from staying in the contract falls below the value of unemployment, the worker will quit. When an employed worker contacts an open vacancy, the recruiting firms and the worker’s incumbent employer observe each other’s match qualities with the worker and engage in Bertrand competition over contracts. The worker chooses the contract that delivers the larger value. When indifferent, the worker stays.

**Financial assets.** The monetary authority issues numéraire liabilities worth \( B_t \). For simplicity, we will refer to these liabilities as “bonds”. All prices, of goods and other assets, must be expressed in these units: in particular, when a final good producer receives randomly the opportunity to revise the price for its variety, it must choose and commit to a price expressed in units of these bonds. Households can invest in these bonds, by paying \((1 + R_t)^{-1} \leq 1\) units of numéraire in exchange for the promise to receive one unit of it for sure one period later. The monetary authority is the monopolist of the unit of account and controls the nominal interest rate \( R_t \) on its bonds according to some (typically Taylor) rule. The consolidated government levies on households a lump-sum tax, or rebates a lump-sum subsidy, equal to
$T_t$ units of account to repay the redemption of outstanding bonds net of the revenues from issuing new bonds, and thus balances its budget every period: $T_t = B_t - B_{t+1}/(1 + R_t)$.

Households trade, in competitive financial markets, ownership shares of all producers, of Final good (F) and Service (S). Producers of Final good varieties earn, due to product differentiation, pure profits (or losses), which change randomly with infrequent Calvo pricing. Service producers also earn pure profits ex post, to cover hiring costs due to search frictions in the labor market. These profits also fluctuate randomly depending on the outcome of job posting. Both flows of profits are rebated to shareholders as net dividends. To eliminate idiosyncratic risk in these dividends, the household combines these shares in mutual funds that own a representative cross-section of all firms.

**Timing of events within a period.**

1. all agents observe innovations to subjective discount factor, TFP in the Final good sector, and monetary policy;

2. the monetary authority chooses the nominal interest rate;

3. each producer of a Final good variety receives with some probability an opportunity to change its price, independent over time and across varieties;

4. previously unemployed workers receive utility from leisure;

5. some existing job matches break up exogenously, and those workers become unemployed;

6. firms in the Service sector post vacancies;

7. previously unemployed and (still) employed workers search for those vacancies;

8. upon meeting a job applicant, a vacancy-posting firm pays the screening costs to learn the idiosyncratic match productivity draw, and then makes the worker a new offer; if the worker is already employed, his current employer makes a counteroffer;
9. if the worker is employed, receives and accepts an outside offer, he becomes employed in the new match, otherwise he remains in his current state, either unemployed or employed in the current match;

10. firms and employed workers produce; firms and households trade Final good and Service; firms in the Service sector pay their workers wages to fulfill the current contracts they are committed to; firms in all sectors pay dividends to mutual fund owners;

11. households trade nominal bonds with the monetary authority and mutual fund shares with each other, and pay taxes.

3 Equilibrium

3.1 Household optimization

The household chooses stochastic processes for Final good consumption varieties $c_t(i)$, holdings of bonds $B_t$ and ownership shares of (mutual funds of) firms in both sectors $(h_t^F, h_t^S)$, given their prices, resp. $p_t(i)$, $R_t$, $\vartheta_t^F$, $\vartheta_t^S$. The household does not freely choose its member $j$’s labor supply $e_t(j)$, because of search frictions: rather, the household chooses the probability $a_t(j)$ that member $j$ accept any new job offer they might receive at the end of period $t$. The household then solves:

$$
\max \left\{ c_t(i), B_t, h_t^F, h_t^S, a_t(j) \right\} \mathbb{E}_0 \left[ \sum_{t=0}^{+\infty} B_0^t \left( U(C_t) + b \int_0^1 (1 - e_t(j)) \, dj \right) \right]
$$

subject to:

- the utility aggregator ($\Pi$)
- the budget constraint (in nominal terms)

$$
\int_0^1 p_t(i) c_t(i) \, di + \frac{B_{t+1}^t}{1+R_t} + \sum_{i=S,F} h_{t+1}^T \vartheta_t^T \leq \sum_{i=S,F} h_t^T (\Pi_t^T + \vartheta_t^T) + \int_0^1 e_t(j) w_t(j) \, dj + B_t - T_t
$$

where $\Pi_t^F = \int_0^1 \Pi_t^F(i) \, di$ are the total nominal profit flows earned by all Final good producers, $\Pi_t^F(i)$ by the only firm producing Final good variety $i$, and $\Pi_t^S$ by each
Service producer (after paying any hiring costs ex ante), while \( \int_0^1 e_t(j) w_t(j) dj \) are the household’s nominal earnings, the sum of wages \( w_t(j) \) paid to those workers \( j \in [0, 1] \) within the household who are currently employed by Service producers; because of search frictions, different workers receive different wages;

- the stochastic processes for each member \( j \)'s employment status...

\[
e_{t+1}(j) = \begin{cases} e_t(j) & \text{with prob. } e_t(j)(1 - \delta) + [1 - e_t(j)] \phi(\theta_t) a_t(j) \\ 1 - e_t(j) & \text{otherwise} \end{cases}
\]

- ... and wage \( w_t(j) \), to be determined;

- the No Ponzi Game condition

\[
\Pr \left( \lim_{t \to \infty} B_t \prod_{\tau=0}^{t-1} (1 + R_\tau)^{-1} = 0 \right) = 1
\]

We solve the household’s maximization problem in steps: consumption and financial portfolio allocation first, then labor market turnover decisions.

The demand for each Final good variety is standard

\[
c_t(i) = C_t \left( \frac{p_t(i)}{P_t} \right)^{-\eta}
\]

where the ideal price index is

\[
P_t = \left( \int_0^1 p_t(i)^{1-\eta} di \right)^{1-\eta}
\]

and minimum expenditure equals \( P_tC_t = \int_0^1 p_t(i)c_t(i)di. \)

Divide the time-\( t \) budget constraint by \( P_t \) and attach to it a Lagrange multiplier \( \lambda_t \), which then equals \( U'(C_t) \), so it converts units of the consumption aggregator \( C_t \) into utils. The demand for bonds gives rise to the standard Euler equation

\[
(1 + R_t) \beta_t \mathbb{E}_t \left[ \frac{U''(C_{t+1})}{U''(C_t)} \frac{P_t}{P_{t+1}} \right] = 1
\]

which discounts the real interest rate \( (1 + R_t) \mathbb{E}_t [P_t/P_{t+1}] \) with the pricing kernel \( D_t^{t+1} \), where we define the pricing kernel \( \tau \) periods forward:

\[
D_t^{t+\tau} = \prod_{s=t}^{t+\tau-1} \left( \frac{\lambda_{s+1}}{\lambda_s} \right) = \left( \prod_{s=t}^{t+\tau-1} \beta_s \right) \left( \prod_{s=t}^{t+\tau-1} \frac{\lambda_{s+1}}{\lambda_s} \right) = \left( \prod_{s=t}^{t+\tau-1} \beta_s \right) \frac{\lambda_{t+\tau}}{\lambda_t} = B_t^{t+\tau} \frac{U''(C_{t+\tau})}{U''(C_t)}
\]
For each sector $I = S, F$, optimal portfolio allocations and market clearing, ruling asset price bubbles out, imply a standard asset pricing formula:

$$\frac{\partial \pi^I}{P_t} = \mathbb{E}_t \left[ \sum_{\tau=0}^{+\infty} D_{t+\tau} \Pi_{t+\tau} \right]$$

Firms maximize the value to their owners, or utility value of the share price of each mutual fund, which is the present value of real profits, discounted by the pricing kernel, the representative household’s stochastic discount factor.

We now turn to labor market turnover decisions $a_t(j)$. The only objects in the household’s maximization problem that depend on those decisions are the total value of leisure $b \int_0^1 (1 - e_t(j)) \, dj$ and nominal labor income $\int_0^1 e_t(j) w_t(j) \, dj$ through the stochastic laws of motion of each member’s employment status $e_t(j)$, namely [2], and nominal wage $w_t(j)$. Thus, when deciding upon $a_t(j)$, the household solves the sub-problem:

$$\max \mathbb{E}_0 \left[ \sum_{t=0}^{+\infty} \mathcal{B}_t \left( b \int_0^1 (1 - e_t(j)) \, dj + \lambda_t \int_0^1 e_t(j) \frac{w_t(j)}{P_t} \, dj \right) \right] \quad (6)$$

subject to (2) and the stochastic process for equilibrium wages $w_t(j)$.

Job acceptance decisions are taken independently by different household members, because they do not affect each other’s employment prospects: the household is one of many, and does not internalize congestion externalities in the search labor market, not even the externalities that its own members create on each other. The only interaction between household members is through income pooling, which explains the common weight $\lambda_t$ on earnings, independent of each member’s identity $j$ and employment status $e_t(j)$. Therefore, the household maximizes the integrand of (6) separately for each member $j$. The household’s labor turnover problem (6) thus separates into two types: one for each currently unemployed member ($e_t(j) = 0$), which can be written in recursive form as

$$\lambda_t V_{u,t}^j = b + \max_{\{a_t(j)\}} \mathbb{E}_t \left[ \sum_{\tau=1}^{+\infty} \mathcal{B}_t \left( (1 - e_{t+\tau}(j)) b + e_{t+\tau}(j) \lambda_{t+\tau} \frac{w_{t+\tau}(j)}{P_{t+\tau}} \right) \mid e_t(j) = 0 \right]$$

$$= b + \beta_t \max_{\{a_t(j)\}} \mathbb{E}_t \left[ (1 - \phi(\theta_t) a_t(j)) \lambda_{t+1} V_{u,t+1}^j \right.$$

$$\left. + \phi(\theta_t) a_t(j) \lambda_{t+1} V_{e,t+1}^j \left( w_{t+1}(j), y_{t+1}(j) \right) \mid e_t(j) = 0 \right]$$
and one for each employed member \( j \) (\( e_t(j) = 1 \)) paid \( w_t(j) \) in a match of quality \( y_t(j) \),

\[
\lambda_t V_{e,t}^j (w_t(j), y_t(j)) = \lambda_t \frac{w_t(j)}{P_t} + \max_{\{a_{e(j)}\}} E_t \left[ \sum_{\tau=1}^{+\infty} \mathcal{B}_t^{t+\tau} (b (1 - e_{t+\tau}(j)) + \lambda_{t+\tau} w_{t+\tau}(j) e_{t+\tau}(j)) \middle| e_t(j) = 1, w_t(j), y_t(j) \right] \\
= \lambda_t \frac{w_t(j)}{P_t} + \beta_t e_t \max_{\{a_{e(j)}\}} E_t \left[ \delta \lambda_{t+1} V_{u,t+1}^j + (1 - \delta) \lambda_{t+1} V_{e,t+1}^j (w_{t+1}(j), y_{t+1}(j)) \middle| e_t(j) = 1, w_t(j), y_t(j) \right]
\]

In this notation, \( V_{u,t}^j \) and \( V_{e,t}^j (w_t(j), y_t(j)) \) represent the household’s value, in units of the consumption aggregator \( C_t \), of having its \( j \)th member at date \( t \) (resp.) unemployed or employed in a match of quality \( y = y_t(j) \) and at wage \( w_t(j) \), with \( \lambda_t V_{u,t}^j \) and \( \lambda_t V_{e,t}^j (w_t(j), y_t(j)) \) representing the corresponding utility values. The time index \( t \) subsumes the dependence of the value on payoff-relevant variables that are exogenous to the employment relationship but endogenous to the economy, such as job market tightness \( \theta_t \) and price level \( P_t \).

We can now represent those two problems in the recursive form that is common in equilibrium models with on-the-job search:

\[
V_{u,t}^j = \frac{b}{\lambda_t} + E_t \left\{ \mathcal{D}_t^{j+1} \left[ \phi (\theta_t) a_t(j) V_{e,t+1}^j (w_{t+1}(j), y_{t+1}(j)) + (1 - \phi (\theta_t) a_t(j)) V_{u,t+1}^j \right] \right\} \\
V_{e,t}^j (w_t(j), y_t(j)) = \frac{w_t(j)}{P_t} \\
+ E_t \left\{ \mathcal{D}_t^{j+1} \left[ \delta V_{u,t+1}^j + (1 - \delta) V_{e,t+1}^j (w_{t+1}(j), y_{t+1}(j)) \right] \middle| e_t(j) = 1, w_t(j), y_t(j) \right\}
\]

### 3.2 Final good producers’ optimization

The producer of Final good variety \( i \) chooses its price \( p_t(i) \) and produces quantity \( q_t(i) \) to serve the resulting demand \( c_t(i) \) from the consumers’ isoelastic demand function \( z_i \), and maximizes profits, given the technology that turns one unit of the homogeneous Service, purchased at given unit price \( \omega_t \), into \( z_t \) units of Final good variety \( i \). Serving the demand \( c_t(i) \) thus requires \( q_t(i) = c_t(i) \) and paying a nominal input cost \( \omega_t q_t(i)/z_t = \omega_t c_t(i)/z_t \).

Dropping the variety index and using \( z_i \), this producer earns nominal profits from quoting price \( p \)

\[
\tilde{\Pi}_t^F (p) = C_t \left( \frac{p}{P_t} \right)^{-\eta} \left( p - \frac{\omega_t}{z_t} \right)
\]
Each producer \(i\) is allowed to revise its price with probability \(\nu\) each period. When this opportunity arises at time \(t\), firm \(i\) chooses a price, that will be in effect until the future random time \(t + \tau > t\) of the next opportunity, to maximize the expected PDV of real profits:

\[
\max_{p(i)} \mathbb{E}_t \left[ \sum_{\tau=0}^{+\infty} (1 - \nu)^{\tau} D_t^{t+\tau} \frac{\tilde{\Pi}_t^F(p(i))}{P_{t+\tau}} \right].
\]

The optimal reset price, \(p_t^*\), is the same for all firms \(i\):

\[
p_t^* = \frac{\eta}{\eta - 1} \frac{\mathbb{E}_t \left[ \sum_{\tau=0}^{+\infty} (1 - \nu)^{\tau} D_t^{t+\tau} C_{t+\tau} P_t^{\eta-1} \frac{\omega_{t+\tau}}{z_{t+\tau}} \right]}{\mathbb{E}_t \left[ \sum_{\tau=0}^{+\infty} (1 - \nu)^{\tau} D_t^{t+\tau} C_{t+\tau} P_t^{\eta-1} \frac{p_t^* - \tau}{P_t} \right]},
\]

(7)

Because the selection of firms that get to reset their prices is random, using (4) the Final good price index \(P_t\) then solves:

\[
P_t^{1-\eta} = \nu (p_t^*)^{1-\eta} + (1 - \nu) P_{t-1}^{1-\eta}
\]

(8)

This price adjustment technology causes dispersion in the prices of Final good varieties. Specifically, in each period \(t\) prices are geometrically distributed across inputs, with a fraction \(\nu(1 - \nu)\) of the varieties priced at \(p_{t-\tau}^*\), for \(\tau \in \mathbb{N}\). Total demand for the Service is then:

\[
\frac{1}{z_t} \int_0^1 c_t(i) di = \frac{C_t \nu}{z_t} \sum_{\tau=0}^{+\infty} (1 - \nu)^{\tau} \left( \frac{p_t^* - \tau}{P_t} \right)^{-\eta}.
\]

The total profits that this firm rebates to its shareholders at time \(t\) equal \(\Pi_t^F(i) = \tilde{\Pi}_t^F(p_{t-\tau(i)}^*)\) where \(\tau(i)\) is the age of firm \(i\)’s price.

### 3.3 Service producer’s optimization and labor market equilibrium

**Match values.** In the Service sector, firms hire workers in a frictional labor market to assemble a (labor) Service that they sell in a competitive market to downstream Final good producers. Service sector firms can commit to pay their workers streams of wages, and can only renegotiate the deal by mutual consent, which only occurs if either the worker receives a better outside offer or if an aggregate shock makes one of the two parties’ participation
constraint bind, causing that party to want to walk away from the relationship, while the other disagrees. Because we assumed that the value of leisure $b$ is small enough to rule out any endogenous separations under any history of aggregate shocks, only outside offers can trigger renegotiation.

We now drop the individual-member superscript $j$ from labor market values and investigate said values further. Because employers extract the full match rent from unemployed workers, the value they offer them as of the beginning of period $t$, after aggregate shocks are observed, is $V_{e,t}(w_t(j), y_t) = V_{u,t}$, and converted in utils it solves

$$
\lambda_t V_{u,t} = b + \lambda_t \mathbb{E}_t \left[ D^t_{t+1} V_{u,t+1} \right] = b + \beta_t \mathbb{E}_t \left[ \lambda_{t+1} V_{u,t+1} \right] = b \mathbb{E}_t \left[ \sum_{\tau=0}^{\infty} B^t_{t+\tau} \right]
$$

so that the real value of unemployment simplifies to

$$
V_{u,t} = \frac{b}{\lambda_t} \sum_{\tau=0}^{\infty} \mathbb{E}_t \left[ B^t_{t+\tau} \right]
$$

(9)
a known multiple of $b$. Hence, if $b$ is small enough, for example equal to zero, no match will ever break up endogenously, so all separations will be exogenous, with probability $\delta$.

Next, let $V_{e,t}(y)$ denote the maximum value that a firm is willing to pay at the time offers are made (i.e. at stage 8 of the within-period timing outlined in Section 2) to a worker with whom it can produce a flow $y$ of Service, without violating its participation constraint (remember, the firm has a zero outside option by free entry). In auction theory parlance, this is the firm’s willingness to pay for a match $y$.

When a worker who is currently employed in a match of quality $y$ and is promised an expected continuation value $V_{e,t}(w_t, y)$, namely a wage $w_t/P_t$ today and then a continuation contract, meets an open vacancy and draws a new match quality $y'$ in period $t$, Bertrand competition produces one of three possible outcomes: (i) $V_{e,t}(w_t, y) \geq V_{e,t}(y')$, in which case the incumbent employer needs to do nothing to retain the worker, and the offer is irrelevant as the poacher cannot profitably match the worker’s current value; (ii) $V_{e,t}(w_t, y) < V_{e,t}(y') \leq V_{e,t}(y)$, in which case the incumbent employer profitably retains the worker by raising its offer from $V_{e,t}(w_t, y)$ to $V_{e,t}(y')$; (iii) and finally $V_{e,t}(w_t, y) \leq V_{e,t}(y) < V_{e,t}(y')$, in which
case the worker is poached with an offer worth $V_{e,t}(y)$. In any case, the worker moves if and only if $V_{e,t}(y) < V_{e,t}(y')$, and turnover decisions depend solely on the full-rent extraction value function $V_{e,t}(y)$. Thus, in period $t$, the maximum value $V_{e,t}(y)$ that the worker can receive in a type-$y$ match includes a wage, as well as a continuation value which equals the discounted expected value of unemployment $\mathbb{E}_t[D_{t+1}V_{u,t+1}]$ in case the worker is laid off at stage 6 of period $t$ (probability $\delta$), and otherwise equals the (expected future) willingness to pay $\mathbb{E}_t[D_{t+1}V_{e,t+1}(y)]$ of the current employer, received either from the incumbent employer itself, as part of the current contract, or from a poacher. This is because the incumbent firm is already promising the maximum it can in period $t + 1$, so it will not match any outside offers: the worker either stays at the same value or leaves and receives the same value from a more productive poacher. Hence, the only remaining choice is the flow wage, and the maximum the firm can pay without making a loss is full revenues. Therefore:

$$V_{e,t}(y) = \frac{\omega_t}{P_t} y + \delta \mathbb{E}_t[D_{t+1}V_{u,t+1}] + (1 - \delta) \mathbb{E}_t[D_{t+1}V_{e,t+1}(y)]$$

Since households value a marginal dollar of profit as much as a dollar of labor income (namely, $\lambda_t P_t$), value is perfectly transferable between individual workers and firms. Therefore, a worker’s value $V_{e,t}(y)$ of extracting full rents from a type-$y$ job is also the value of said job to the firm-worker pair under any sharing rule, and we can define a type-$y$ job surplus $S_t(y) = V_{e,t}(y) - V_{u,t}$ at the offer-making stage of period $t$. Subtracting (9) from both sides of the last equation and solving forward:

$$S_t(y) = V_{e,t}(y) - V_{u,t} = \frac{\omega_t}{P_t} y - \frac{b}{\lambda_t} + (1 - \delta) \mathbb{E}_t[D_{t+1}S_{t+1}(y)]$$

$$= \mathbb{E}_t \left[ \sum_{\tau=0}^{+\infty} (1 - \delta)^\tau D_{t+\tau} \left( \frac{\omega_{t+\tau}}{P_{t+\tau}} y - \frac{b}{\lambda_{t+\tau}} \right) \right]$$

$$= W_t y - \frac{b}{U'(C_t)} \mathbb{E}_t \left[ \sum_{\tau=0}^{+\infty} (1 - \delta)^\tau B_{t+\tau} \right]$$

where we define recursively the expected PDV of a unit flow of Service, namely of the “average real wage rate” $\omega_t/P_t$, until match separation, in units of the consumption aggregator $C_t$:

$$W_t = \frac{\omega_t}{P_t} + (1 - \delta) \mathbb{E}_t[D_{t+1}W_{t+1}] \quad \text{(10)}$$
Crucially, the surplus \(S_t(y)\) is affine increasing in \(y\). Because the willingness to pay in the auction can be written as \(V_{e,t}(y) = V_{u,t} + S_t(y)\), this too is affine increasing in \(y\), with intercept and slope that vary stochastically over time. Therefore, the firm with the higher match quality \(y\) wins the auction, and we draw the main conclusion of this subsection: the equilibrium is Rank Preserving (RPE), and the direction of reallocation is efficient, always from less to more productive matches.

Note that worker compensation depends on the expected PDV \(W_t\) of the real price \(\omega_t/P_t\) of the Service he produces, while the pricing decision \(\text{(7)}\) of the Final good producers who buy that Service and can reset their prices today depend on the expected PDV of the marginal cost, which is \(\omega_t/(P_t z_t)\), adjusted for TFP.

**Evolution of worker stocks.** Let \(\ell_{t+1}(y)\) denote the population density of employment at match quality \(y\), at the end of time \(t\), after separations and hiring, when production takes place. (Equivalently, \(\ell_t(y)\) is the density of employment at the beginning of period \(t\).) Due to the RP property of equilibrium, this evolves according to:

\[
\ell_{t+1}(y) = (1 - \delta) \left\{ [1 - s\phi(\theta_t) \Gamma(y)] \ell_t(y) + s\phi(\theta_t) \gamma(y) \int_y^y \ell_t(y') dy' \right\} + \phi(\theta_t) \gamma(y) u_t \tag{11}
\]

Defining the associated cumulative density \(L_t(y) = \int_y^y \ell_t(y') dy'\) and integrating w.r.t. \(y\):

\[
L_{t+1}(y) = (1 - \delta) \left[ 1 - s\phi(\theta_t) \Gamma(y) \right] L_t(y) + \phi(\theta_t) \Gamma(y) u_t
\]

Finally, combining with the definition of the employment rate, \(L_t(\bar{y}) = 1 - u_t\), yields the familiar law of motion of unemployment:

\[
u_{t+1} = [1 - \phi(\theta_t)] u_t + \delta (1 - u_t) \tag{12}\]

**Free entry and labor demand.** By the time a firm and a worker who have met on the search market must decide whether or not to consummate the match, they know the quality of the potential match, \(y'\), which yields surplus \(S_t(y')\). The surplus in the worker’s previous
situation is known, too: it is zero if the worker was unemployed, and $S_t(y)$ if the worker was employed in a type-$y$ match.

The free entry condition equates the flow cost of vacancy posting to the vacancy contact probability times the expected return from a successful contact, net of screening costs. The firm appropriates the entire surplus $S_t(y)$ from unemployed job applicants and the difference in surplus between own match $y$ and existing match $y'$, namely $S_t(y) - S_t(y') = \overline{V}_t(y) - \overline{V}_t(y')$, from employed job applicants. Assuming that the parameters are such that in equilibrium firms are always willing to post vacancies and, ex post, pay the screening cost (meaning that $\kappa_s$ is small enough), and using the previous expression for the match surplus, the free entry condition then writes as:

$$\kappa_v \frac{\theta_t}{\phi(\theta_t)} + \kappa_s = \frac{u_t}{u_t + (1 - \delta)s(1 - u_t)} \left\{ W_t \mu - \frac{b}{U'(C_t)} \sum_{\tau=0}^{\infty} (1 - \delta)^\tau \mathbb{E}_t \left[ \mathcal{B}_t^{t+\tau} \right] \right\}$$

$$+ \frac{(1 - \delta)s(1 - u_t)}{u_t + (1 - \delta)s(1 - u_t)} W_t \int_y^\gamma \gamma(y) \int_y^y (y - y') \frac{\ell_t(y')}{1 - u_t} dy' dy \quad (13)$$

On the LHS are vacancy posting costs times the expected duration of a vacancy, plus the screening cost, on the RHS are the expected profits earned by Service sector producers, namely the expected PDV of $\Pi_{t+s}^S/P_{t+s}$, all in units of the aggregator of Final goods. This is the average of the expected profits from hiring an unemployed and an employed job applicant, weighted by the respective shares of the two types of job applicants in the pool of job searchers. Unemployed hires are homogeneous, while employed hires are distributed, at the time of vacancy posting, according to the probability density $\ell_t(y')/(1 - u_t)$ of match quality $y'$ in their current jobs, which gives them bargaining power in wage negotiations.

### 3.4 Market-clearing

**Financial markets.** The representative household holds all shares of all firms, $h_t^F = h_t^S = 1$. The government balances its budget, so the household pays back to the government in taxes all the net surplus of bonds redemptions (including interest) minus new bond purchases, neither borrows nor saves, but spends all income on the Final good.
**Good markets.** Hiring costs are in utils and do not absorb any physical resources, so they do not enter any market-clearing condition. Market-clearing in the Service market requires the supply by its producers to equal its demand by Final good producers:

$$\int_0^\infty y \ell_{t+1}(y) dy = \int_0^1 \frac{q_t(i)}{z_t} di.$$ 

Market-clearing in each Final good variety requires the supply $q_t(i)$ to equal the isoelastic demand in (3). Therefore

$$\int_0^\infty y \ell_{t+1}(y) dy = \frac{C_t}{z_t} \int_0^1 p_t(i)^{-\eta} di$$

Denoting $\tilde{P}_t = \left( \int_0^1 p_t(i)^{-\eta} di \right)^{-1/\eta}$, we obtain a consolidated market-clearing condition:

$$\int_0^\infty y \ell_{t+1}(y) dy = \frac{C_t}{z_t} \left( \frac{P_t}{\tilde{P}_t} \right)^\eta.$$  \(14\)

### 3.5 General Equilibrium

The economy enters period $t$ with a set of pre-determined aggregate objects: the employment distribution $\ell_t(\cdot)$, hence unemployment $u_t = 1 - \int_0^\infty \ell_t(y) dy$, the distribution of Final good variety prices $p_{t-1}(\cdot)$ and, at the beginning of the period, the new realizations of TFP $z_t$, discount factor $\beta_t$, and interest rate $R_t$. The first two are endogenous, infinitely-dimensional state variables. TFP and the discount factor have exogenous laws of motion. Monetary policy is assumed to follow a rule that makes $R_t$ a stochastic function of the other four.

A key observation is that the price distribution $p_{t-1}(\cdot)$ enters equilibrium conditions only through the two price indexes $P_{t-1}, \tilde{P}_{t-1}$, which have known laws of motion: $P_t$ follows (8) and, by the same reasoning, $\tilde{P}_t$ follows

$$\tilde{P}_t^{-\eta} = \nu \left( p_t^* \right)^{-\eta} + (1 - \nu) \tilde{P}_{t-1}^{-\eta}$$  \(15\)

\(^6\)An alternative specification of hiring costs is in units of the Service, essentially using workers to hire and recruit other workers. Since the nominal Service price $\omega_t$ is flexible, so is the real price $\omega_t/P_t$, which determines the incentives to create jobs. As aggregate recruiting activity rises in response to a shock, and the demand for Service with it, its price $\omega_t/P_t$ rises, raising real hiring costs and curbing the job creation response.
where we note that the reset price $p^*_t$ that updates these two price indexes only depends on the processes of $C_t$, $P_t$ and $\omega_t$ through (7).

**Definition 1** A **Recursive Rational Expectations Equilibrium** is a collection of measurable functions $\{C, \theta, \omega\}$ of the state vector $\langle P_{t-1}, \bar{P}_{t-1}, \ell(\cdot), \beta, z \rangle$, and a monetary policy rule $R$, a given function of the same state vector, that solve the consumption Euler equation (5), the optimal reset price equation (7), the free entry condition (13), and market-clearing (14), and which induce a Markov process for each endogenous component of the state vector: (8) for $P$, (15) for $\bar{P}$, (11) for $\ell(\cdot)$. The exogenous components $z$ and $\beta$ evolve according to predetermined Markov processes.

**3.6 Discussion: Two Wedges**

The Neoclassical labor wedge and the New Keynesian wage mark-up. From the free entry condition (13), vacancy creation $\theta_t$ depends on the average of two expected returns, from unemployed and employed hires, weighted by the shares of these two groups in the job searching pool. The expected returns from an unemployed hire equal the expected PDV

$$W_t \mu - \frac{b}{U'(C_t)} \mathbb{E}_t \left[ \sum_{\tau=0}^{\infty} (1 - \delta)^\tau B_i^{t+\tau} \right] = \mathbb{E}_t \left[ \sum_{\tau=0}^{+\infty} (1 - \delta)^\tau D_i^{t+\tau} (MPL_{t+\tau} - MRS_{t+\tau}) \right]$$

(16)

of the difference between the Marginal Product of Labor in units of the Final good

$$MPL_{t+\tau} = \frac{\omega_{t+\tau}}{P_{t+\tau}}$$

and the Marginal Rate of Substitution between consumption of the Final good and leisure:

$$MRS_{t+\tau} = \frac{b}{U'(C_{t+\tau})}$$

Indeed, the term labeled $MPL_t$ is the average flow Service output of an extra unit of work $\mu$, converted into consumption goods by the relative price $\omega_t/P_t$, an expected Marginal Product of Labor. The term labeled $MRS_t$ is the ratio between the additional utility $b$ from one less unit of work and the marginal utility of consumption of the Final good, namely the MRS between consumption and leisure.
Chari, Kehoe and McGrattan (2007) define the “labor wedge” as the ratio between the MRS and the MPL. Measured in the data through the lens of a neoclassical growth model with balanced growth preferences, this labor wedge is procyclical, that is, the implicit “tax” rate on labor income is countercyclical, and plays the central role in amplifying business cycle fluctuations. In our model, the expected returns to hiring an unemployed worker in (16) equal the expected present value of the MPL times one minus the labor wedge. A procyclical labor wedge makes the returns to hiring unemployed workers procyclical. The MRS, however, contributes a countercyclical component to the labor wedge: in recessions, when consumption is low, workers value income more, so they are willing to work for less. So the procyclical movement in the labor wedge required to account for business cycle must originate from a strongly procyclical MPL, or relative price $\omega_t/P_t + \tau$.

An alternative interpretation of the “Service” in our model is a composite quantity of labor, with Service producers acting as labor market intermediaries, or temp-agencies, that hire workers in a frictional labor market and sell their services to good producers in a competitive market. Therefore, $\omega_t/P_t + \tau$ is the average cost of efficiency units of labor to good producers, and the firm discounts the difference between this real wage index (scaled by average efficiency units $\mu$) and the MRS between consumption and leisure.

Estimated New-Keynesian models (Smets and Wouters 2007) define the “wage markup” as the ratio between the real wage and the MRS, and find that changes in this mark-up are key to explain inflation and output dynamics. Lacking a mechanism to generate endogenous changes in the wage mark-up, they attribute them to shocks, that they estimate to be procyclical. Erceg, Henderson and Levine (2000) generate wage mark-ups by assuming sticky nominal wages. Gali (2011) calls for a theory of an endogenous wage mark-up. Our model delivers just that. The expected returns to hiring an unemployed worker in (16) equal the expected present value of the MRS times the wage mark-up minus one. Thus, in our model the labor wedge is the reciprocal of the wage mark up. If the markets for both input (labor) and output (Service) were competitive, both the labor wedge and the wage mark-up
would be identically equal to one, with workers on their labor supply curve and firms on their labor demand curve. If the labor market was competitive but the output (Service) market was monopolistically competitive, with Service providers charging a constant mark-up over the marginal cost of labor, the labor wedge would be less than one (i.e., the implicit tax rate on labor earnings would be positive) and the wage mark-up larger than one, but both would be constant over time. With our frictional labor market, the labor wedge is smaller than one and the wage mark-up is larger than one, to compensate for hiring costs, and, crucially, both are endogenous and time-varying.

**The Productivity Gap: A new source of propagation and inflation.** Our model contains an additional, novel transmission mechanism of aggregate shocks to job creation, absent in either of those two strands of the literature. Service providers, when posting vacancies, also mind the expected return from an *employed* hire, the double integral in (13). This is independent of the MRS, and depends entirely on the distribution of employment \( \ell_t(\cdot) \), which is a slow-moving aggregate state variable. We call this object the “productivity gap”, because it is zero in the frictionless limit, where every worker is always in the best possible match, and it is larger the more misallocated is employment on the ladder.

This term introduces an additional component to labor demand, with a complex cyclical pattern. At a cyclical peak, workers have had time and opportunities to climb the ladder, so it is both difficult and expensive to poach employees from other firms, and the expected returns from hiring employed workers are weak. After a recession, as the unemployed regain employment, they restart from random rungs on the match quality ladder, which are worse than the employment distribution at the cyclical peak. Hence, early in a recovery, many recent hires are easily “poachable”. The transition of cheap unemployed job applicants into low-quality jobs makes these workers only slightly more expensive, and still quite profitable, to hire. As time goes by, and unemployment declines, employment reallocation up the ladder through job-to-job quits picks up, employed workers grow more and more expensive to hire,
ultimately putting pressure on wages, until we are back to a cyclical peak. The productivity gap implies a procyclical wage mark-up, or countercyclical labor wedge, as long as employment is still misallocated and “poachable”.

In the US economy, the transition probability from job to job is fairly small, of similar magnitude to the separation rate into unemployment, and both are an order of magnitude smaller than the transition probability from unemployment to employment. Therefore, movements in the employment distribution up the job ladder are slow. An important implication is that, in our model, job market-tightness, thus the unemployment rate, have sluggish transitional dynamics. This stands in contrast to the canonical model with only search from unemployment, where tightness is a jump variable, with no transitional dynamics, and the unemployment rate converges very quickly to its new steady state. This is important, because the slow but prolonged decline in the U.S. unemployment rate after 2009 can only be explained in the canonical model by a long (and implausible) sequence of small, consecutive, positive aggregate shocks. A slowly mean-reverting process for the aggregate driver of business cycles will not do, because the free entry condition is forward-looking and would incorporate the expected recovery. In contrast, our model has a built-in, slow-moving, endogenous propagation mechanism of temporary aggregate shocks. Even more notably, the propagation is also transmitted to real wages, thus, ultimately, to inflation, amplifying the classic propagation that derives from staggered price-setting.

DSGE models with search frictions (Andolfatto 1996, Merz 1996, Krause and Lubik 2007, Gertler and Trigari 2009, Christiano, Eichenbaum and Trabandt 2016) typically focus on unemployment and abstract from on-the-job search. Within the linear-utility labor market search tradition, Robin (2011) adopts the Sequential Auction model of a labor market with on-the-job search, but stresses permanent worker heterogeneity. Firms are identical, thus the job ladder has only two steps. Only unemployed hires generate profits for firms. An employed job searcher extracts all rents from both incumbent and prospective employer. Therefore, in Robin’s model no productivity gap appears in the returns to job creation. The full
stochastic job ladder mechanism, which gives rise to a positive and time-varying productivity gap, appears in two recent business cycle models with on the job search: Moscarini and Postel-Vinay (2013)’s assume wage-contract posting without renegotiation, but cannot easily accommodate nominal price stickiness; Lise and Robin (2017) allow for ex ante worker and firm heterogeneity and sorting within the more tractable renegotiation framework. The latter model, although still cast in a linear utility framework, is the closest comparison. We assume a much simpler model of the job ladder, based on ex post match quality draws rather than ex ante two-sided heterogeneity, in order to flesh out the propagation mechanism of aggregate shocks that poaching introduces, and to be embed it in a full-fledged general equilibrium framework, with sticky prices and savings, where we can study monetary policy.

3.7 Special cases

Our model features three important “frictions”: risk aversion in consumer preferences for Final goods, nominal price rigidity in Final good markets, and search frictions in the labor market. Barring search frictions in the labor market (e.g., the distribution of match qualities is a mass point at the upper bound $y$, all workers receive offers every period, and $\delta = 0$ so no worker falls off the job ladder), employment concentrates at $y$, the Service price $\omega_t$ is the nominal wage, and the model reduces to a standard New Keynesian model.

To gain understanding about the response of the economy to aggregate shocks, we now shut down price rigidity and then risk aversion. In the next section, we will compute numerically a calibrated version of the full model. Note that the steady state equilibrium of the economy, that we illustrate in the Appendix, is the same with sticky and flexible prices, because in steady state there is no need to change prices.

3.7.1 Flexible prices

Barring nominal rigidities, namely assuming $\nu = 1$, we obtain the most interesting benchmark, the flexible price economy. Since optimal mark-ups are constant, monopoly power turns out to have no impact on the business cycle properties of the model. Therefore, any
conclusions that we reach in this particular case will extend, with minor modifications, to the economy with both flexible prices and perfectly competitive input producers.

Final good producers that face no pricing frictions all choose the same optimal static mark-up price, so that
\[ p_t = P_t = \frac{\eta}{\eta - 1} \frac{\omega_t}{z_t} \]  
(17)
and supply the same quantity, which then equals also the consumption aggregator \( C^n_t \). The subscript “\( n \)” stands for “natural”, thus \( C^n_t \) is the natural rate of output, the quantity of final goods produced in the absence of nominal price rigidities.\(^7\) A flex-price equilibrium is a collection of stochastic processes for Final good consumption \( C^n_t \), job market tightness \( \theta^n_t \), risk-adjusted value of services \( W^n_t \) and employment distribution \( \ell^n_t(\cdot) \) (with implied natural rate of unemployment \( u^n_t \)) which solve the same equilibrium conditions of the sticky price model, except (17) replacing pricing equations (7) and (8).

We can easily show that money is neutral and nominal variables are determined by monetary policy. From the Euler equation, given the equilibrium process for \( C^n_t \) and a nominal interest rate policy rule that generates a process for \( R_t \), the inflation rate \( \pi_{t+1} = P_{t+1}/P_t - 1 \) is a process that satisfies
\[ \beta_t \mathbb{E}_t \left[ \frac{U'(C^n_{t+1})}{U'(C^n_t)} \frac{1+R_t}{1+\pi_{t+1}} \right] = 1. \]

### 3.7.2 Risk neutral households

Further removing consumer risk aversion, the model boils down to the standard case analyzed in search model of the labor market, linear utility and competitive output market, a business cycle version of the Sequential Auction model of Postel-Vinay and Robin (2002) as analyzed in Moscarini and Postel-Vinay (2018) in the case of fixed discount factor \( \beta_t = \beta \) for all \( t = 0, 1, 2 \cdots \). Equilibrium computation in that case is very simple. Accounting for OJS yields a much higher estimated elasticity of the matching function with respect to vacancies, in US data from about .31 to .5. The reason is that employment is procyclical, hence so

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\(^7\) In the canonical New Keynesian model, this level of economic activity is not first-best only because of the monopoly distortion, which can be and usually is undone with an appropriate tax and subsidy scheme. In our model, there is a second, unavoidable distortion due to search frictions, and no presumption that the natural rate is constrained efficient. Nonetheless, we maintain the nomenclature for ease of comparison.
is the congestion created by the employed on the unemployed job searchers. In order to match the same observed cyclical volatility of the job finding probability from unemployment, vacancies have to be much more “important”, and workers unimportant, in generating meetings. This effect amplifies aggregate shocks. A composition effect in the search pool works in the opposite direction: employed job searchers are more expensive to hire and less profitable than unemployed ones, and are relatively more prevalent in good economic times, thus they tame the response of job creation through the free entry condition. Finally, within employment, procyclical movements in the contact rate generate countercyclical misallocation of employment on the job ladder, which moves slowly, but affects job creation through free entry, hence propagates aggregate shocks.

This flex price, risk-neutral benchmark is especially important to the present exercise, because much of the steady state calibration strategy does not depend on price rigidity (which is irrelevant in steady state) and risk aversion. Therefore, we follow the calibration strategy in Moscarini and Postel-Vinay (2018) and refer to that for details and robustness checks.

4 Equilibrium computation

In any version of this model with labor market frictions, independently of price rigidities, monopoly power, and risk aversion, the distribution of employment $\ell_t(\cdot)$ is a state variable, which makes equilibrium computation difficult in the presence of aggregate shocks. To compute stochastic equilibrium paths, we log linearize the system around its deterministic steady state, and assume that match quality has finite support, so we treat employment on each of the $K$ rungs as a scalar variable in the linearization. We describe the equations, including steady state, in Appendix B. We calibrate the model at a monthly frequency. Unless otherwise noted, the calibration strategy follows Moscarini and Postel-Vinay (2018), to which the reader is referred for details. We then simulate the model, and report implied

\footnote{We also explored a nonlinear approximation algorithm based on parameterized expectations}
aggregate statistics after aggregating them at the quarterly frequency, which is the only one available in the data for many relevant variables.

### 4.1 Functional forms and Steady State calibration

We begin with production technology. Log TFP is described by the following AR(1) process:

$$\ln(z_t) = (1 - \varpi)\mu_z + \varpi \ln(z_{t-1}) + \varepsilon_t^z, \quad \varepsilon_t^z \overset{i.i.d.}{\sim} \mathcal{N}(0, \sigma_z^2)$$

Because Average Labor Productivity is endogenous and depends on employment allocation on the ladder, we treat TFP as a latent variable that drives ALP. To calibrate $\varpi = .95$ and $\sigma_z = .0067$, in Moscarini and Postel-Vinay (2018) we targeted a quarterly standard deviation of filtered log ALP equal to 1.9% in the stochastic simulation of a risk-neutral, flex price version of this model. We approximate this AR(1) as a discrete 51-point Markov chain.

We specify the distribution $\Gamma$ of match quality draws as a Pareto with slope coefficient equal to 1.1 and mean normalized to 1. We approximate it over a 100-point discrete grid.

We assume a Calvo parameter $\nu = 1/10$, implying a 10-month average duration of prices. While this is higher than the corresponding empirical duration of about 7 months, heterogeneity across sectors in $\nu$ that we ignore is sizable and tends to raise price stickiness.

Next, we move to preferences. We set the value of leisure $b = 0$ so that no existing job is ever destroyed endogenously. Importantly, once we allow for OJS, the amplification properties of the model are much less dependent on the value of $b$. This value determines the returns to hire unemployed job applicants, while the returns from hiring employed job applicants depend on their current wages, which may have been renegotiated multiple times and thus no longer retain any memory of the opportunity cost $b$. So OJS allows to sidestep the debate on the opportunity cost of time that originated from Hagedorn and Manovskii (2008). We choose a value $\eta = 6$ for the elasticity of substitution between final good varieties, implying a 20% optimal net mark-up of price over marginal cost in steady state. The utility function over the CES consumption aggregator of final good varieties is CRRA: $U(C) = \sigma C^{1-1/\sigma}/(\sigma - 1)$, and we choose IES $\sigma = .5$. 

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For the discount factor, we assume $\beta_t = 1/(1 + \varrho_t)$ where $\varrho_t > 0$ follows an AR(1) process in logs: $\ln (\varrho_{t+1}) = (1 - \varpi) \ln \frac{1-\beta}{\varrho} + \varpi \ln (\varrho_t) + \frac{1}{1-\beta} \varepsilon_{t+1}$ for some $\beta \in (0, 1)$, $\varpi \in (0, 1)$ and $\varepsilon_{t+1}$ i.i.d. In the Appendix, we show that this implies, up to a log-linear approximation:

$$\ln \beta_{t+1} = (1 - \varpi) \ln \beta + \varpi \ln \beta_t - \varepsilon_{t+1}$$

To calibrate the discount factor process, we downloaded from FRED monthly time series for the yield on 1-year Treasury bonds and CPI, and quarterly time series for chain-weighted aggregate private consumption and population size. We use 1-year bonds, rather than 3-month Bills, because the latter series is available only since 1982. We compute one-year ahead CPI inflation, every month, and average the inflation rate and the yield on Treasuries over quarters. Subtracting the former from the latter we obtain at quarterly frequency a time series of the ex post annual real interest rate, that we convert to quarterly real interest rate by taking its fourth root. We then compute the quarterly growth rate of per capita real consumption growth from NIPA. We end up with quarterly time series of per capita consumption growth and ex post real interest rate from 1962:Q1 to 2018:Q3. We multiply consumption growth by the calibrated value of $\sigma$, the inverse Intertemporal Elasticity of Substitution, and subtract the real interest rate. This residual variation in consumption growth unexplained by real interest rate movements is an estimate of changes in the discount factor. We take the log of that residual and subtract one, to obtain an empirical counterpart of $\varrho_t$. To eliminate volatility in this latter series, due for example to expectation errors that contaminate actual vs expected inflation, we MA-smooth it with a two-sided window of one quarter on each side. To this smoothed series we fit an AR(1). The estimated persistence and standard deviation of innovations imply monthly values of $\varpi = .947$ and standard deviation of innovations $\sigma = .00284$. Finally, we calibrate the mean discount factor to $\beta = .9957$ per month, corresponding to .95 per year, and we approximate this AR(1) process as a discrete 11-point Markov chain.
We specify monetary policy as a Taylor rule with contemporaneous timing:

$$\ln (1 + R_t) = \varpi R \ln (1 + R_{t-1}) + (1 - \varpi R) \left[ \psi_\pi \ln (1 + \pi_t) + \psi_C \ln \left( \frac{C_t}{C} \right) - \ln (\beta) \right] + \varepsilon R$$

where $C$ is steady state output of the final good, which is also total value added, $\varepsilon R \sim \mathcal{N}(0, \sigma^2_R)$. We ignore the Zero Lower Bound. To calibrate its parameters, we assume high interest rate smoothing $\varpi R = .95$ and standard values for the Taylor rule coefficients, $\psi_\pi = 1.5$, $\psi_C = .5$ and small shocks $\sigma_R = .0024$.

Finally, we specify matching frictions. Since for now all separations into unemployment are exogenous, we set $\delta$ equal to the average monthly transition probability from employment into unemployment (EU). Since all new matches are acceptable to the unemployed, we set the job contact probability in steady state equilibrium $\phi(\theta)$ equal to the average monthly transition probability from unemployment into employment (UE). We estimate these two probabilities from unemployment duration stocks (Shimer 2012) in the monthly CPS, respectively the number of workers who report being unemployed for 5 weeks or less divided by employment a month before (EU), which averages 2.4%, and one minus the ratio between the number of workers who report being unemployed for more than 5 weeks and unemployment a month before (UE), which averages 41%. The implied steady-state unemployment rate is $u = .024/(.024 + .41) = .055$.

Given these parameter values, we identify the relative efficiency of OJS $s$ from the pace of EE reallocation. Because of the Rank-Preserving property of equilibrium, in steady state this is independent of the specific match quality distribution $\Gamma$: when given the opportunity, workers move up the job ladder, no matter how steep it is, at a speed that depends only on $s\phi(\theta)$. Given values of $\phi(\theta)$ and $\delta$, hence $u$, we solve for the value of $s$ that equates the model-implied steady state EE probability to the average monthly transition probability from job to job, which is about 2% in the monthly CPS after its 1994 survey re-design. This yields $s = .176$, in line with existing estimates.

---

9A potentially interesting alternative rule to look at would be an interest rate peg, where the Central Bank simply keeps the interest rate constant. However, as it generically the case in the simple NK model, the steady state of our model is locally indeterminate under such a monetary policy rule.
For the job finding probability we use the unemployment-duration based measure described above, which has standard deviation (in log deviations from HP trend) equal to .147 over the post-war period. For vacancies we use the monthly Composite Help-Wanted Index of Barnichon (2010), updated by the author to cover 1955-2016, and very close to JOLTS vacancies since its 2001 inception. For \( u_t \) we use the civilian unemployment rate from the monthly CPS, 1948-2018. We filter the log of each series separately using the longest time span available for each. We then run regressions of the job-finding probability on vacancies and unemployment rate for the time period where the series overlap, 1955-2016. We cannot reject empirically the hypothesis of constant returns to scale in matching. Hence, we assume a Cobb-Douglas matching function, with elasticity \( \alpha \), so that the job finding probability is \( \phi(\theta) = \phi_0 \theta^\alpha \). We estimate the value of \( \alpha \) at \( \hat{\alpha} = .510 \).

We calibrate the values of vacancy posting cost \( \kappa_v \) and screening cost \( \kappa_s \) so that \( \kappa_s \) equals 80% of the total hiring cost per hire \( \kappa_v \theta / \phi(\theta) + \kappa_s \) in steady state equilibrium. In turn, the average hiring cost per hire equals, by free entry, the expected return from a random hire, whether unemployed or employed, which can be calculated based entirely on parameter values set above. The resulting values yield screening cost of about five months, and therefore an average advertising cost of about a month, of average output, per hire.

4.2 Results

The linearized system of equations solved by a Rational Expectations Equilibrium can be reduced to two jump variables and three predetermined variables. Details are in the appendix. The calibration generates a determinate equilibrium: the resulting matrix has five

---

As argued in Moscarini and Postel-Vinay (2018), the scale \( \phi_0 \) of the matching function only reflects the units in which vacancies are measured and has no impact on the model’s dynamic properties. The only constraint on \( \phi_0 \) in a discrete-time model like ours is that it must be such that both the job finding probability \( \phi(\theta) \) and the vacancy filling probability \( \phi(\theta) / \theta \) are less than one at all dates. But for the results that follow, we only need to specify the value of the matching function elasticity \( \alpha \). When we estimate a standard matching function ignoring OJS, i.e. when we identify the search pool with just unemployment \( u_t \), we obtain a lower elasticity \( \hat{\alpha} = .32 \). The reason is simple: this standard method incorporates a term equal to \( \alpha \) times the log of relative search effort by the unemployed vs the employed \( u_t / [u_t + (1 - \delta)s (1 - u_t)] \), into the residual, which is then negatively correlated with \( \ln (v_t / u_t) \), creating a downward bias in the estimated elasticity \( \hat{\alpha} \).
<table>
<thead>
<tr>
<th>Parameter</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\omega_z$</td>
<td>0.95</td>
</tr>
<tr>
<td>$\sigma_z$</td>
<td>0.067</td>
</tr>
<tr>
<td>$\mu_z$</td>
<td>0</td>
</tr>
<tr>
<td>Monetary policy rule/pricing frictions</td>
<td></td>
</tr>
<tr>
<td>$\omega_R$</td>
<td>0.975</td>
</tr>
<tr>
<td>$\sigma_R$</td>
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</tr>
<tr>
<td>$\psi_{\pi}$</td>
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</tr>
<tr>
<td>$\psi_C$</td>
<td>0.5</td>
</tr>
<tr>
<td>$\nu$</td>
<td>0.1</td>
</tr>
<tr>
<td>Discount factor</td>
<td></td>
</tr>
<tr>
<td>$\omega_\beta$</td>
<td>0.947</td>
</tr>
<tr>
<td>$\sigma_\beta$</td>
<td>0.00284</td>
</tr>
<tr>
<td>$\beta$</td>
<td>0.9957</td>
</tr>
<tr>
<td>Preferences and match quality</td>
<td></td>
</tr>
<tr>
<td>$\sigma$</td>
<td>0.5</td>
</tr>
<tr>
<td>$\eta$</td>
<td>6</td>
</tr>
<tr>
<td>$b$</td>
<td>0</td>
</tr>
<tr>
<td>Pareto slope</td>
<td>1.1</td>
</tr>
<tr>
<td>Matching/hiring/job destruction</td>
<td></td>
</tr>
<tr>
<td>$\alpha$</td>
<td>0.5</td>
</tr>
<tr>
<td>$s$</td>
<td>0.176</td>
</tr>
<tr>
<td>$\delta$</td>
<td>0.024</td>
</tr>
<tr>
<td>$\kappa_v$</td>
<td>2.6</td>
</tr>
<tr>
<td>$\kappa_s$</td>
<td>4.3</td>
</tr>
</tbody>
</table>

Table 1: Parameter values

real eigenvalues, of which two are outside the unit sphere.

We simulate the model’s equilibrium monthly time series over a period of fifty years, after an initial longer burn-in period. We then study the properties of various macroeconomic variables of interest. We aggregate their time series to quarterly frequency by averaging, we take logs of the quarterly time series, and we HP-filter them with parameter 1,600.

Table 2 reports standard deviations of some variables of interest. Average Labor Productivity in the Final good sector equals

$$ALP = \frac{\omega_t}{P_t} \int_0^u y dL_t(y) \frac{dL_t(y)}{1 - u_t}.$$ 

Its standard deviation is about 1%, half as much as in the data, smaller than that of TFP alone (1.1%), despite the presence of other shocks. Unemployment and job finding rate from unemployment vary about four time as much, a significant degree of amplification. Aggregate consumption varies as much as ALP, which also falls somewhat short of the data (1.6%). Inflation exhibits significant quarterly variability. The Beveridge-curve negative correlation between unemployment and vacancies observed in the data is well replicated.

Our main focus is on the predictive power of labor market indicators on inflation, in a reduced-form sense, from these model-generated data. In Table 2 we also report the es-
Table 2: Results

<table>
<thead>
<tr>
<th>Shocks ⇒</th>
<th>TFP</th>
<th>Monetary Policy</th>
<th>Discount Factor</th>
<th>All</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Standard Deviations</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Factor Productivity</td>
<td>.012</td>
<td>0</td>
<td>0</td>
<td>.012</td>
</tr>
<tr>
<td>Average Labor Productivity</td>
<td>.01</td>
<td>.0014</td>
<td>.0036</td>
<td>.01</td>
</tr>
<tr>
<td>U to E transition prob.</td>
<td>.043</td>
<td>.032</td>
<td>.075</td>
<td>.1</td>
</tr>
<tr>
<td>E to E transition prob.</td>
<td>.042</td>
<td>.033</td>
<td>.075</td>
<td>.1</td>
</tr>
<tr>
<td>U rate</td>
<td>.029</td>
<td>.021</td>
<td>.054</td>
<td>.07</td>
</tr>
<tr>
<td>Consumption</td>
<td>.01</td>
<td>.002</td>
<td>.005</td>
<td>.012</td>
</tr>
<tr>
<td>Inflation rate</td>
<td>.01</td>
<td>.004</td>
<td>.011</td>
<td>.016</td>
</tr>
<tr>
<td><strong>Correlations</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U rate and Vacancies</td>
<td>-.63</td>
<td>-.51</td>
<td>-.52</td>
<td>-.52</td>
</tr>
<tr>
<td><strong>Estimated elasticities (std errors)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dependent variable: inflation rate</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lagged U rate</td>
<td>-.05</td>
<td>-.09</td>
<td>-.05</td>
<td>-.01</td>
</tr>
<tr>
<td>(0.017)</td>
<td>(0.01)</td>
<td>(0.018)</td>
<td>(0.019)</td>
<td></td>
</tr>
<tr>
<td>Lagged U to E transition prob.</td>
<td>.09</td>
<td>.05</td>
<td>-.01</td>
<td>.048</td>
</tr>
<tr>
<td>(0.011)</td>
<td>(0.008)</td>
<td>(0.013)</td>
<td>(0.012)</td>
<td></td>
</tr>
<tr>
<td>Lagged acceptance prob. outside offers</td>
<td>-1.48</td>
<td>.45</td>
<td>-.54</td>
<td>-.8</td>
</tr>
<tr>
<td>(0.08)</td>
<td>(0.08)</td>
<td>(.1)</td>
<td>(.1)</td>
<td></td>
</tr>
</tbody>
</table>

Estimated elasticities from a regression of (log) inflation on a constant and various combinations of last quarter (log) unemployment rate, UE job finding probability from unemployment, EE probability, and a new variable, the ratio between EE and UE probabilities. In the model, this ratio equals the average “acceptance probability” of outside offers, namely

$$\text{Acceptance Probability} := \int_{y}^{\pi} \Gamma(y) \frac{dL_t(y)}{1 - u_t}.$$

Unlike UE and EE in isolation, which reflect demand and productivity shocks, their ratio is a direct measure of “misallocation” of employment on the job ladder, and of “poachability” of employed workers. In simpler words, it is a measure of aggregate labor supply elasticity.

If employment is misallocated, many workers are unhappy about their jobs, and are easy to poach in new matches that are likely to beat their existing ones. Then, an increase in the demand for the intermediate input (Service), thus in the returns to hiring are met by an easy expansion in employment, because many job applications result in a hire, and generate a large surplus. Hence, quantity responds much more than the marginal production cost of
the Final good. Conversely, if most employment is up the job ladder, most outside offers will be either ignored or matched, creating a bottleneck that limits the expansion of Service input and amplifies that of its price, the marginal cost. So we observe an apparent “marginal cost shock”, which is the response to a garden-variety shock to labor demand, and has the usual impact on inflation of a standard DSGE New Keynesian model.

Consistently with this view, the results show that the (lagged) acceptance probability is a much stronger (in a statistical and economic sense) predictor of inflation than the more traditional unemployment rate, the UE probability, and the EE probability. The regression coefficient is systematically large, negative and significant. This result is qualitatively robust across calibrations and simulation runs. Figure 1 shows, for the case where all shocks are activated, that this negative correlation between acceptance rate and future inflation starts building a few quarters in advance. The estimated regression coefficient is positive only in case of Monetary Policy shocks alone, but this result is not robust to changes in calibration.
This result suggests to exploit the relative behavior of job-to-job transitions and unemployment-to-employment transitions in the data to forecast marginal cost, thus inflation. Faccini and Melosi (2018) study a version of our model with two possible match qualities, bad and good jobs, and extend it to allow for endogenous search effort by the employed. They use data on EE and UE transition probabilities and a few equilibrium equations to extract the implied time series for on-the-job search effort and marginal cost $\omega_t/(P_tz_t)$. They show that the latter is much more in line with observed post-2008 inflation that estimates of marginal costs derived from either the labor share, as typically done in standard New Keynesian models with competitive labor market, or from that and the UE transition rate, as typically done in versions of the New Keynesian model that introduce search frictions and unemployment in the labor market, but no on-the-job search. Simply put, both the EE transition rate and the inflation rate in the US exhibited a profound decline and lack of recovery following the 2008-2009 recession, much slower than even the slow recovery of employment. What caused the persistently low propensity to search on the job remains to be investigated. In our structural model, where on the job search effort is fixed by assumption, the action is all loaded on the the acceptance probability, which in turn originates from cyclical mismatch.
References


APPENDIX

A Steady state

An important benchmark for stochastic equilibrium computation is the steady state equilibrium. Absent aggregate shocks to the discount factor $\beta_t$, TFP $z_t$ and nominal interest rate $R_t$, price rigidity is irrelevant, because prices never need to change. Therefore, the steady state of the full, frictional economy closely resembles the stochastic equilibrium of the flex price benchmark.

Let $L(y) = \int_y^\bar{y} \ell(y')dy'$. This stationary employment distribution solves the following ordinary linear differential equation:

$$L'(y) = (1 - \delta) \left[ 1 - s\phi(\theta)\Gamma(y) \right] L'(y) + s\phi(\theta)\gamma(y)L(y) + \phi(\theta)\gamma(y)u$$

The solution can be found in closed form:

$$L(y) = \frac{\phi(\theta)\Gamma(y)u}{\delta + (1 - \delta)s\phi(\theta)\Gamma(y)}$$

Using this expression and integrating by parts, total Service output equals:

$$\int_y^\bar{y} ydL(y) = \bar{y}(1 - u) - \int_y^\bar{y} \frac{\phi(\theta)\Gamma(y)u}{\delta + (1 - \delta)s\phi(\theta)\Gamma(y)}dy.$$ 

Normalizing to one the steady state levels of prices and TFP, steady state equilibrium solves:

$$P = \tilde{P} = p^* = 1$$

$$R = \frac{1 - \beta}{\beta}$$

$$z = 1$$

$$u = \frac{\delta}{\delta + \phi(\theta)}$$

$$C = \bar{y}(1 - u) - \int_y^\bar{y} \frac{\phi(\theta)\Gamma(y)u}{\delta + (1 - \delta)s\phi(\theta)\Gamma(y)}dy$$
\[
\frac{\omega}{P_z} = \frac{\eta - 1}{\eta} \\
W = \frac{1}{1 - \beta (1 - \delta)} \frac{\omega}{P}
\]

\[
\kappa_v \frac{\theta}{\phi(\theta)} + \kappa_s = \frac{u \left[ W \mu - \frac{b}{U'(C)} [1 - \beta (1 - \delta)] \right] + W (1 - \delta) s \int_y \Gamma(y) \frac{\phi(\theta) \Gamma(y) u}{\delta + (1 - \delta) s \phi(\theta) \Gamma(y)} dy}{u + (1 - \delta) s (1 - u)}
\]

\section{Log linearization with discrete match types}

\subsection{Notation}

We will carry out our linearization and numerical exercises under the assumption that the support of match quality \(y\) is discrete, i.e. that the support of \(y\) consists of the finite set of values \(\underline{y} = y_1 < y_2 < \cdots < y_K = \overline{y}\), with \(K \geq 2\), and with corresponding probability masses \(\gamma(y_1), \ldots, \gamma(y_K)\) in \(\gamma\) (and likewise in \(\ell\)). We propose a modified linearization and computation procedure to accommodate the case of a continuous match quality support in Appendix C.

Then, CDFs and survivor functions are:

\[
\Gamma(y_k) = \sum_{i=1}^{k} \gamma(y_i) \quad \text{and} \quad \Gamma(y_k) = 1 - \Gamma(y_k) = \sum_{i=k+1}^{K} \gamma(y_i)
\]

and similarly for \(\ell\). This implies \(\Gamma(y_1) = \gamma(y_1) > 0\) and \(L(y_1) = \ell(y_1) > 0\). In what follows, we expand the notation by introducing a “dummy” \(y_0\) such that \(\Gamma(y_0) = L(y_0) = 0\). We also define, for every \(n = 0, 1, 2, \ldots\)

\[
I_{n,t} := \sum_{k=1}^{K-1} [\Gamma'(y_k)]^n L_t(y_k) (y_{k+1} - y_k).
\]

With this notation, total Service output equals:

\[
\sum_{k=1}^{K} y_k \ell_t(y_k) = \sum_{k=1}^{K} y_k [L_t(y_k) - L_t(y_{k-1})]
\]

\[
= y_K L_t(y_K) - \sum_{k=1}^{K-1} L_t(y_k) (y_{k+1} - y_k) = \overline{y}(1 - u_t) - I_{0,t},
\]
and the expected returns from an employed hire equal:

\[
\sum_{k=1}^{K} \gamma(y_k) \sum_{i=1}^{k} \ell_t(y_i) (y_k - y_i) = \sum_{k=1}^{K} \left[ \Gamma(y_{k-1}) - \Gamma(y_k) \right] \sum_{i=1}^{k} \ell_t(y_i) (y_k - y_i)
\]
\[
= \sum_{k=1}^{K-1} \Gamma(y_k) \left( \sum_{i=1}^{k+1} \ell_t(y_i) (y_{k+1} - y_i) - \sum_{i=1}^{k} \ell_t(y_i) (y_k - y_i) \right)
\]
\[
= \sum_{k=1}^{K-1} \Gamma(y_k) L_t(y_k) (y_{k+1} - y_k)
\]
\[
= I_{1,t}
\]

Finally, we introduce the notation \( x_t \) for the real marginal cost of production of any variety of intermediate inputs:

\[
x_t = \frac{\omega_t}{P_t z_t}
\]

**B.2 Recap of equilibrium conditions**

**Pre-determined variables.**

*Discount factor*

\( \beta_{t+1} = 1/(1 + \varrho_{t+1}) \) where

\[
\ln(\varrho_{t+1}) = (1 - \omega \beta) \ln \frac{1 - \beta}{\beta} + \omega \beta \ln(\varrho_t) + \frac{1}{1 - \beta} \varepsilon_{t+1}^\beta
\]

*TFP*

\[
\ln(z_{t+1}) = z_t \ln(z_t) + \varepsilon_{t+1}^z
\]

*Nominal interest rate: Monetary Policy Rule*

\[
\ln(1 + R_{t+1}) = \omega R \ln (1 + R_t) + (1 - \omega R) \left[ \psi\pi \ln (1 + \pi_{t+1}) + \psi_C \ln \left( \frac{C_{t+1}}{C_t} \right) - \ln(\beta) \right] + \varepsilon_{t+1}^R
\]

*Unemployment*

\[
u_{t+1} = [1 - \phi(\theta_t)] u_t + \delta (1 - u_t)
\]

*Employment distribution dynamics*

For each \( k \in \{1, \cdots, K - 1\} \) (note that \( L_t(y_K) = 1 - u_t \) duplicates the unemployment equation above):

\[
L_{t+1}(y_k) = (1 - \delta) \left[ 1 - s \phi(\theta_t) \Gamma(y_k) \right] L_t(y_k) + \phi(\theta_t) u_t \Gamma(y_k)
\]

39
"Static" equations, where no \((t + 1)\)-dated variables appear, either directly or in expectation.

**Market-Clearing**

\[
C_t \left( \frac{P_t}{\tilde{P}_t} \right)^\eta = \bar{y}(1 - u_{t+1}) - I_{0,t+1}
\]

**Free-Entry Condition**

\[
\kappa_v \frac{\theta_t}{\phi(\theta_t)} + \kappa_s = \frac{u_t \left( W_t \mu - \frac{b}{U'(C_t)} \sum_{\tau=0}^{\infty} (1 - \delta)^\tau \mathbb{E}_t [B_t^{t+\tau}] \right) + W_t (1 - \delta) s I_{1,t}}{u_t + (1 - \delta) s (1 - u_t)}
\]

where \(B_t^{t+\tau} = \prod_{\tau'=0}^{\tau-1} \beta_{t+t'}\).

**Price indices**

\[
P_t^{1-\eta} = \nu p_t^{1-\eta} + (1 - \nu) P_{t-1}^{1-\eta}
\]

\[
\left( \frac{\tilde{P}_t}{P_t} \right)^{-\eta} = \nu \left( \frac{p_t}{P_t} \right)^{-\eta} + (1 - \nu) \left( \frac{P_t}{P_{t-1}} \right)^\eta \left( \frac{\tilde{P}_{t-1}}{P_{t-1}} \right)^{-\eta}
\]

Dynamics of non-predetermined, forward-looking variables.

**Consumption: Euler Equation**

\[
\beta_t (1 + R_t) \mathbb{E}_t \left[ \frac{U'(C_{t+1})}{U'(C_t)} \frac{1}{1 + \pi_{t+1}} \right] = 1
\]

**Present value of Service relative price**

\[
W_t = x_t z_t + (1 - \delta) \mathbb{E}_t [D_t^{t+1} W_{t+1}]
\]

**Optimal reset price**

\[
p_t^* = \frac{\eta}{\eta - 1} \frac{\mathbb{E}_t \left[ \sum_{\tau=0}^{+\infty} (1 - \nu)^\tau D_t^{t+\tau} C_{t+\tau} P_t^{\eta} x_{t+\tau} \right]}{\mathbb{E}_t \left[ \sum_{\tau=0}^{+\infty} (1 - \nu)^\tau D_t^{t+\tau} C_{t+\tau} P_t^{\eta-1} \right]}
\]
B.3 Log-linearizing the equilibrium conditions

We use hats to denote log deviations from steady state, such as \( \hat{\theta}_t = \ln(\theta_t) - \ln(\theta) \). For inflation, since we cannot take logs of \( \pi = 0 \), we use a linearization in levels: \( \hat{\pi}_t = \pi_t - \pi = \pi_t \).

Moreover, in steady state, from the Euler equation \( R = -\ln(\beta) \) and we define \( \hat{R}_t = R_t + \ln \beta \).

**Discount factor.**

\[
\ln (\beta_{t+1}) = -\ln(1 + \varrho_{t+1}) \simeq -\ln(1 + \varrho) - \frac{\varrho}{1 + \varrho} (\ln (\varrho_{t+1}) - \ln (\varrho))
\]

\[
= \ln (\beta) - (1 - \beta) (\ln (\varrho_{t+1}) - \ln (\varrho))
\]

\[
= \ln (\beta) - (1 - \beta) (\varpi (\ln (\varrho_t) - \ln (\varrho)) + \frac{1}{1 - \beta} \varepsilon_{t+1}^\beta)
\]

where \( \ln (\varrho) = 1/\beta - 1 \). At time \( t \), \( \ln (\beta_t) = \ln (\beta) - (1 - \beta) (\ln (\varrho_t) - \ln (\varrho)) \), so we solve for

\[
-(1 - \beta) (\ln (\varrho_t) - \ln (\varrho)) = \ln (\beta_t) - \ln (\beta)
\]

and replace into the equation at time \( t + 1 \):

\[
\ln (\beta_{t+1}) - \ln (\beta) = \varpi (\ln (\beta_t) - \ln (\beta)) - (1 - \beta) \frac{1}{1 - \beta} \varepsilon_{t+1}^\beta
\]

so in log deviations from steady state

\[
\hat{\beta}_{t+1} = \varpi \hat{\beta}_t - \varepsilon_{t+1}^\beta
\]

**TFP.** This is already linear in logs:

\[
\hat{z}_{t+1} = \varpi \hat{z}_t + \varepsilon_{t+1}^z
\]

**Monetary Policy Rule.** This is already linear in logs:

\[
\hat{R}_{t+1} = \varpi R_t + (1 - \varpi) \left[ \psi_\pi \pi_{t+1} + \psi_C \hat{C}_{t+1} \right] + \varepsilon_{t+1}^R
\]

**Employment distribution.** With a finite support of match quality \( \{y_k\}_{k=1}^K \), the employment distribution \( L_t(\cdot) \) is a finitely-dimensional vector which is part of the state variable. In log-linear form, for each \( y_k \) in the support:

\[
\hat{L}_{t+1}(y_k) = (1 - \delta) \left[ 1 - s\phi(\theta) \Gamma(y_k) \right] \hat{L}_t(y_k) + \frac{\phi(\theta) u\Gamma(y_k)}{L(y_k)} \hat{u}_t + \alpha(\theta) \phi(\theta) \left[ \frac{u\Gamma(y_k)}{L(y_k)} - (1 - \delta) s\Gamma(y_k) \right] \hat{\theta}_t
\]

where \( \alpha(\theta) \) is the elasticity of the matching function w.r. to vacancies.
Unemployment. The log-linearized version of the law of motion of unemployment can be obtained either by direct log-linearization of (12), or by noticing that \( \hat{L}_t (y) = -\frac{u}{1-u} \hat{u}_t \) and applying the derivation above. Either way:

\[
\hat{u}_{t+1} = [1 - \delta - \phi(\theta)] \hat{u}_t - \phi(\theta) \alpha(\theta) \hat{\theta}_t
\]

Consumption Euler Equation. Standard derivations produce:

\[
\mathbb{E}_t \left[ \tilde{C}_{t+1} \right] - \tilde{C}_t = \sigma \left( \hat{R}_t - \mathbb{E}_t [\pi_{t+1}] + \hat{\beta}_t \right)
\]

Free-entry condition.

\[
\kappa_v \frac{\theta_t}{\phi(\theta_t)} + \kappa_s = \frac{u_t \left( W_t \mu - \frac{b}{U''(C_t)} \sum_{\tau=0}^{+\infty} (1-\delta)^\tau \mathbb{E}_t \left[ \prod_{\tau'=0}^{\tau-1} \beta_{t+\tau'} \right] \right) + W_t (1-\delta) s I_{1,t}}{u_t + (1-\delta) s (1-u_t)}
\]

This log-linearizes as:

\[
\frac{(1-\alpha(\theta)) \kappa \theta / \phi(\theta) \hat{\theta}_t}{\kappa s} = \left[ \frac{\mu - m}{u (\mu - m) + (1-\delta) s I_1} - \frac{1 - s(1-\delta)}{u + (1-\delta) s (1-u)} \right] u \cdot \hat{u}_t
\]

\[
+ \frac{u \mu + (1-\delta) s I_1}{u (\mu - m) + (1-\delta) s I_1} \hat{W}_t - \frac{1}{\sigma u (\mu - m) + (1-\delta) s I_1} \hat{C}_t
\]

\[
- \frac{um}{u (\mu - m) + (1-\delta) s I_1} \sum_{\tau=0}^{+\infty} (1-\delta)^{\tau+1} \beta^{\tau+1} \mathbb{E}_t \left[ \hat{\beta}_{t+\tau} \right]
\]

\[
+ \frac{(1-\delta)s}{u (\mu - m) + (1-\delta) s I_1} \sum_{j=1}^{K-1} (y_{j+1} - y_j) [1 - \Gamma(y_j)] L(y_j) \hat{L}_t (y_j)
\]

where we denote

\[
m := \frac{b}{WU''(C)} \frac{1}{1 - \beta (1-\delta)} = \frac{b}{U''(C)} \frac{\eta}{\eta - 1}
\]

for ease of notation. Now, from the stochastic process of the discount factor:

\[
\hat{\beta}_{t+\tau} = \varphi_{\beta} \hat{\beta}_t + (1-\beta) \sum_{\tau' = 0}^{\tau-1} \varphi_{\beta} \varepsilon_{t+\tau-\tau'} \Rightarrow \mathbb{E}_t \left[ \hat{\beta}_{t+\tau} \right] = \varphi_{\beta} \hat{\beta}_t
\]
Substituting into the log-linearized FEC (and reordering terms slightly):

\[
\begin{align*}
(1 - \alpha(\theta))\kappa\theta\hat{\theta}_t &= \left[ \frac{\mu - m}{u(\mu - m) + (1 - \delta)sI_1} - \frac{1 - s(1 - \delta)}{u + (1 - \delta)s(1 - u)} \right] u \cdot \hat{u}_t \\
+ \frac{u\mu + (1 - \delta)sI_1}{u(\mu - m) + (1 - \delta)sI_1} \hat{W}_t + \frac{(1 - \delta)s}{u(\mu - m) + (1 - \delta)sI_1} \sum_{j=1}^{K-1} (y_{j+1} - y_j) \left[ 1 - \Gamma(y_j) \right] L(y_j) \hat{L}(y_j)
\end{align*}
\]

Present value of Service relative price.

\[
W_t = x_t z_t + \beta_t(1 - \delta)E_t \left[ \frac{U'(C_{t+1})}{U'(C_t)} W_{t+1} \right]
\]

hence:

\[
W \hat{W}_t = xz (\hat{x}_t + \hat{z}_t) + \beta(1 - \delta)W E_t \left[ \hat{\beta}_t - \frac{1}{\sigma} \hat{C}_{t+1} + \frac{1}{\sigma} \hat{C}_t + \hat{W}_{t+1} \right]
\]

Using the steady state expression \( W = \frac{xz}{1 - \beta(1 - \delta)} \):

\[
\hat{W}_t = [1 - \beta(1 - \delta)] (\hat{x}_t + \hat{z}_t) + \beta(1 - \delta)E_t \left[ \hat{\beta}_t - \frac{1}{\sigma} \hat{C}_{t+1} + \frac{1}{\sigma} \hat{C}_t + \hat{W}_{t+1} \right]
\]

Prices. The law of motion of the final good price:

\[
P_t^{1 - \eta} = \nu (p_t^*)^{1 - \eta} + (1 - \nu)P_{t-1}^{1 - \eta}
\]

log-linearizes as:

\[
\hat{P}_t = \nu \hat{p}_t^* + (1 - \nu)\hat{P}_{t-1}
\]

where we used the fact that in steady state, \( P_t = p_t^* = P_{t-1} = P \). Similarly, the dynamics of

\[
P_t^{-\eta} = \nu p_t^{*-\eta} + (1 - \nu)\hat{P}_{t-1}^{-\eta}
\]

log-linearize as:

\[
\hat{P}_t = \nu \hat{p}_t^{*-\eta} + (1 - \nu)\hat{P}_{t-1}^{-\eta}
\]

Combining those two log-linear equations \( \hat{P}_t = (1 - \nu)\hat{P}_t \). Thus \( \hat{P}_t - \hat{P}_t \) converges to zero deterministically. Near steady state, prices are close to their steady-state benchmark, there is little price dispersion. This implies that \( \hat{P}_t \) and \( \hat{P}_t \) are approximately the same:

\[
\hat{P}_t \approx \hat{P}_t \]
Market-Clearing. Taking logs at time $t$, evaluating at steady state, using $z = \tilde{P} = P = 1$ and $\tilde{P}_t \approx \tilde{P}_t$, and subtracting the two equations:

$$C \tilde{C}_t \simeq C \tilde{z}_t - u \tilde{\Pi}_t + \mathbf{I}_t \tilde{I}_t$$

Substituting the components of $\tilde{I}_t$:

$$\tilde{C}_t = \tilde{z}_t - \frac{u \Pi}{C} \tilde{u}_t + \mathbf{I}_t \tilde{I}_t$$

Note that we can further substitute the laws of motion of $\tilde{u}_t$ and $\tilde{L}_t(y_k)$ to obtain:

$$\tilde{C}_t = \tilde{z}_t - \left\{ \frac{[1 - \delta - \phi(\theta)] u}{C} + \frac{\phi(\theta) u}{C} \sum_{k=1}^{K-1} (y_{k+1} - y_k) L(y_k) \tilde{L}_t(y_k) \right\} \tilde{u}_t$$

$$+ \frac{\alpha(\theta) \phi(\theta)}{C} \left\{ u \frac{y}{C} - \sum_{k=1}^{K-1} (y_{k+1} - y_k) \left[ u \Gamma(y_k) - (1 - \delta) s \tilde{\Gamma}(y_k) L(y_k) \right] \tilde{L}_t(y_k) \right\}$$

$$- (1 - \delta) \sum_{k=1}^{K-1} \left[ 1 - s \phi(\theta) \tilde{\Gamma}(y_k) \right] \frac{(y_{k+1} - y_k) L(y_k)}{C} \tilde{L}_t(y_k)$$

Noticing that $\sum_{k=1}^{K-1} (y_{k+1} - y_k) \Gamma(y_k) = y - \mu$, this becomes:

$$\tilde{C}_t = \tilde{z}_t - \frac{(1 - \delta) \Pi u}{C} - u \phi(\theta) \mu \tilde{u}_t + \frac{\alpha(\theta) \phi(\theta)}{C} \left[ u \mu + (1 - \delta) s \mathbf{I}_t \right] \tilde{\theta}_t$$

$$- (1 - \delta) \sum_{k=1}^{K-1} \left[ 1 - s \phi(\theta) \tilde{\Gamma}(y_k) \right] \frac{(y_{k+1} - y_k) L(y_k)}{C} \tilde{L}_t(y_k)$$

Optimal reset price. To log linearize (7), we log linearize the FOC. We proceed as follows. Recall that $\Pi_t^F(i)$ denotes the flow dividends/profits rebated by producer $i$ to the household, which, in equilibrium, is the result of the firm’s optimization. Let

$$\Pi_t^F(p) = \left( \frac{p}{P_t} \right)^{-\eta} \left( p - \frac{\omega_t}{z_t} \right)$$

so that the price-resetting Final good producer solves

$$\max_{p_t} \mathbb{E}_t \sum_{\tau=0}^{+\infty} (1 - \nu)^{\tau} D_{t+\tau} C_{t+\tau} \frac{\Pi_t^F(p_t)}{P_{t+\tau}}.$$
We now drop the $F$ superscript. The FOC for an optimal reset price $p_t^*$ is

$$0 = \mathbb{E}_t \sum_{\tau=0}^{+\infty} (1 - \nu)^\tau D_t^{t+\tau} C_{t+\tau} \frac{\Pi_{t+\tau}(p_t^*)}{P_{t+\tau}}$$

and we log-linearize it near steady state, where

$$\Pi'(p) = \left( \frac{p}{P} \right)^{-\eta} \left( 1 - \eta + \eta \frac{\omega}{zp} \right) = 0$$

by the optimal static mark-up, and $D_t^{t+\tau} = \beta^\tau$, $C_{t+\tau} = C$, $p_t = p = P_{t+\tau} = P$:

$$0 = \mathbb{E}_t \sum_{\tau=0}^{+\infty} (1 - \nu)^\tau \beta^\tau \frac{C}{P} \eta (\hat{\omega}_{t+\tau} - \hat{p}_t^* - \hat{z}_{t+\tau})$$

and finally we can solve for $\hat{p}_t^*$ as the expected present value of nominal marginal costs:

$$\hat{p}_t^* = [1 - \beta(1 - \nu)] [\mathbb{E}_t \sum_{\tau=0}^{+\infty} \beta^\tau (1 - \nu)^\tau (\hat{\omega}_{t+\tau} - \hat{z}_{t+\tau})]$$

Note that this is a recursive formula

$$\hat{p}_t^* = [1 - \beta(1 - \nu)] (\hat{\omega}_t - \hat{z}_t) + \beta(1 - \nu) \mathbb{E}_t [\hat{p}_{t+1}]$$

using the log linearized law of motion of the price level, $\hat{P}_t = \nu \hat{p}_t^* + (1 - \nu) \hat{P}_{t-1}$, note that

$$\hat{p}_t^* = \hat{P}_{t-1} + \nu^{-1} \pi_t$$

substituting in the above recursion, subtracting $\hat{P}_t$ from both sides and using $\pi_t = \hat{P}_t - \hat{P}_{t-1}$:

$$-\pi_t + \nu^{-1} \pi_t = [1 - \beta(1 - \nu)] (\hat{\omega}_t - \hat{z}_t - \hat{P}_t) + \beta(1 - \nu) \mathbb{E}_t [\nu^{-1} \pi_{t+1}]$$

using $\hat{x}_t = \hat{\omega}_t - \hat{z}_t - \hat{P}_t$, we finally obtain a standard New-Keynesian Phillips curve

$$\pi_t = \nu \frac{1 - \beta(1 - \nu)}{1 - \nu} \hat{x}_t + \beta \mathbb{E}_t [\pi_{t+1}]$$

The system of “boxed” equations comprises $9 + (K - 1)$ linear stochastic difference equations in the 9 variables $\left( \hat{C}_t, \hat{\theta}_t, \pi_t, \hat{x}_t, \hat{\omega}_t, \hat{R}_t, \hat{z}_t, \hat{\beta}_t, \hat{u}_t \right)$ and the $K - 1$ variables $L_t(y_k)$ for $k = 1, 2, \cdots, K - 1$. Price indices $P_t$ and $\hat{P}_t$ no longer appear, only their growth rate $\pi_t$ is relevant to equilibrium.
Market-clearing and free entry are contemporaneous, i.e. contain only variables dated at \( t \). Three equations are forward-looking, i.e. also contain time-\( t \) expectations of variables dated at \( t+1 \). The last \( 4+(K-1) \) equations are backward-looking, i.e. only contain variables dated at \( t+1 \) as function of variables dated \( t \), but without any expectation. The system only contains variables dated \( t \), \( t+1 \), and expectations thereof conditional on information available at time \( t \). Here the “contemporaneous” variables \( \hat{\theta}_t, \hat{x}_t \) only appear at time \( t \), the “predetermined” variables \( \hat{R}_t, \hat{z}_t, \hat{\beta}_t, \hat{u}_t, L_t(y_k) \) can be solved at \( t+1 \) as a function of variables at time \( t \) and exogenous innovations, and the “jump” variables \( \hat{C}_t, \pi_t, \hat{W}_t \) appear both at time \( t \) and as time-\( t \) conditional expectations of their values at time \( t+1 \).

We stack variables in a column vector of dimension \( 9+(K-1) = 8+K \geq 10 \)

\[
\hat{\xi}_t = \left( \hat{C}_t, \hat{\theta}_t, \pi_t, \hat{x}_t, \hat{W}_t, \hat{R}_t, \hat{z}_t, \hat{\beta}_t, \hat{u}_t, L_t(y_1), \ldots, L_t(y_{K-1}) \right) ^\top
\]

with \( K \geq 2 \) the finite cardinality of the support of match quality. Also, we let \( \varepsilon_t = (\varepsilon^x_t, \varepsilon^R_t, \varepsilon^\beta_t) \). The linearized system has the matrix representation:

\[
A\hat{\xi}_t + B\hat{\xi}_{t+1} + C\mathbb{E}_t \left[ \hat{\xi}_{t+1} \right] + D\varepsilon_{t+1} = 0_{(8+K) \times 1} \tag{18}
\]

where \( A, B, C \) are \( (8+K) \times (8+K) \) coefficient matrices, \( D \) is \( (8+K) \times 3 \).

To further simplify the system, we can use the two “static” equations to solve for \( \left( \hat{W}_t, \hat{\theta}_t \right) \) as (linear) functions of \( \left( \hat{z}_t, \hat{\beta}_t, \hat{u}_t, L_t(y_k), \hat{C}_t \right) \). Doing so means that we can also write \( \mathbb{E}_t \left[ \hat{W}_{t+1} \right] \) as a linear function of \( \mathbb{E}_t \left[ \hat{z}_{t+1} \right] \), which only depends on \( \hat{z}_t \), of \( \mathbb{E}_t \left[ \hat{\beta}_{t+1} \right] \), which only depends on \( \hat{\beta}_t \), of predetermined variables \( \mathbb{E}_t \left[ \hat{u}_{t+1} \right] = \hat{u}_{t+1}, \mathbb{E}_t \left[ \hat{L}_{t+1}(y_k) \right] = \hat{L}_{t+1}(y_k) \), which depend on \( \left( \hat{z}_t, \hat{u}_t, L_t(y_k), \hat{C}_t, \hat{\beta}_t \right) \) both directly and through \( \hat{\theta}_t \), and finally of \( \mathbb{E}_t \left[ \hat{C}_{t+1} \right] \). Substituting those partial solutions to the top two equations into the remaining \( 6+K \) equations leaves us with a system of \( 6+K \) equations into the \( 6+K \) variables \( \left( \hat{C}_t, \pi_t, \hat{x}_t, \hat{R}_t, \hat{z}_t, \hat{\beta}_t, \hat{u}_t, L_t(y_1), \ldots, L_t(y_{K-1}) \right) \).

Next, we can solve for \( \hat{x}_t \) between the third equation (the New Keynesian Phillips Curve) and the fourth equation (the definition of \( \hat{W}_t \)). This eliminates \( \hat{x}_t \) from the system entirely, as \( \hat{x}_t \) only appears at date \( t \) in those two equations.
We are now left with a system of \(5 + K\) equations into the \(5 + K\) variables, two of which, \((\tilde{C}_t, \pi_t)\), being “jump” variables which appear also in expectation one period forward, and \(3 + K\) pre-determined: \((\tilde{R}_t, \tilde{z}_t, \tilde{\beta}_t, \tilde{u}_t, \tilde{L}_t(y_1), \cdots, \tilde{L}_t(y_{K-1}))\).

C Linearization with a continuum of match types

In the continuous match quality case, similarly to the discrete case, we define

\[
I_{n,t} := \int_y^\gamma \left[ \Gamma(y) \right]^n L_t(y) dy
\]

Integrating by parts:

\[
\int_y^\gamma y \ell_t(y) dy = \gamma (1 - \epsilon) - I_{0,t}
\]

and

\[
\int_y^\gamma \ell_t(y') (y - y') dy' = L_t(y) (y - y) - L_t(y) (y - y) + \int_y^\gamma L_t(y') dy' = \int_y^\gamma L_t(y') dy'
\]

\[
\int_y^\gamma \gamma(y) \int_y^\gamma \ell_t(y') (y - y') dy' dy = \int_y^\gamma \gamma(y) \int_y^\gamma L_t(y') dy' dy
\]

\[
= \Gamma(\gamma) \int_y^\gamma L_t(y) dy - \Gamma(\gamma) \int_y^\gamma L_t(y) dy - \int_y^\gamma \Gamma(y) L_t(y) dy = \int_y^\gamma \Gamma(y) L_t(y) dy = I_{1,t}
\]

so the expected returns from an employed hire at time \(t\) equals \(I_{1,t}\), because the firm posting vacancies at \(t\) meets a distribution of employment pre-determined at \(t\). Finally, multiply the law of motion of the employment distribution on both sides by \(\left[ \Gamma(y) \right]^n\) and integrate over \([y, \gamma]\) to obtain

\[
I_{n,t+1} = (1 - \delta) I_{n,t} - (1 - \delta) \sigma \phi(\theta_t) I_{n+1,t} + \phi(\theta_t) \epsilon u_t \int_y^\gamma \left[ \Gamma(y) \right]^n \Gamma(y) dy
\]

Therefore, \(I_{0,t+1}\) depends on the values of \(I_{0,t}\) and \(I_{1,t}\); \(I_{1,t+1}\) on the values of \(I_{1,t}\) and \(I_{2,t}\); and so on. Hence, this is still an infinitely-dimensional, albeit countable, system. Also, for every \(t\) the sequence \(I_{n,t}\), \(n = 0, 1, 2, \cdots\) is decreasing and converges to 0.
One possible approximation truncates the sequence at some \( n = N = 0, 1, 2, \ldots \) and replaces \( I_{N+1,t} \) on the RHS of the last equation with \( I_{N,t} > I_{N+1,t} \), so that the \( N \)-th equation fully determines the dynamics of \( I_{N+1,t} \):

\[
I_{N,t+1} = (1 - \delta)(1 - s\phi(\theta_t))I_{N,t} + \phi(\theta_t)u_t \int_y [\Gamma(y)]^N \Gamma(y)dy
\]

and then \( I_{n,t+1} \) is calculated recursively backwards for \( n = N - 1 \) to \( n = 0 \). The system of equations describing stochastic equilibrium, whether the original one or the log-linearization, only contains the first two integrals \( I_{0,t}, I_{1,t} \), so \( I_{n,t} \) for \( n \geq 2 \) only serve to determine the dynamics of the first two integrals.