

Author's Accepted Manuscript

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www.elsevier.com

PII: S0927-5371(17)30234-8
DOI: <http://dx.doi.org/10.1016/j.labeco.2017.04.005>
Reference: LABECO1551

To appear in: *Labour Economics*

Received date: 15 November 2015
Revised date: 21 February 2017
Accepted date: 25 April 2017

Cite this article as: Carlos Carrillo-Tudela, Michael Graber and Klaus Waelde
Unemployment and Vacancy Dynamics with Imperfect Financial Markets
Labour Economics, <http://dx.doi.org/10.1016/j.labeco.2017.04.005>

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Unemployment and Vacancy Dynamics with Imperfect Financial Markets *

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April 27, 2017

Abstract

This paper proposes a simple general equilibrium model with labour market frictions and an imperfect financial market. The aim of the paper is to analyse the transitional dynamics of unemployment and vacancies when financial constraints are in place. We model the financial sector as a monopolistically competitive banking sector that intermediates financial capital between firms. This structure implies a per period financial resource constraint which has a closed form solution and describes the transition path of unemployment and vacancies to their steady state values. We show that the transition path crucially depends on the degree of wage flexibility. When wages do not depend on the unemployment rate the transition path is always downward sloping. This implies unemployment and vacancies adjust in opposite directions as observed in the data. When calibrating the model to the Great Recession and its aftermath we find that the lack of an improvement in the financial sector's effectiveness to intermediate resources played a crucial role in the slow recovery of the labour market.

Keywords: Job search, unemployment, financial markets.

JEL: J63, J64, G10.

*We would like to thank a referee and the Editor for their useful comments that have helped improve the paper. We also would like to thank Pedro Gomes, Claudio Michelacci, Lawrence Uren, Gianluca Violante and Ludo Visschers for their useful comments and insights. The usual disclaimer applies. Carlos Carrillo-Tudela acknowledges financial support from the UK Economic and Social Research Council (ESRC), award reference ES/I037628/1.

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