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Labor Force Participation, Interest Rate Shocks, and Unemployment Dynamics in Emerging Economies*

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Abstract

Emerging economies (EMEs) have highly volatile unemployment and real wages. Standard models with interest rate shocks can generate higher unemployment volatility, but still fall quantitatively short of matching the empirical volatility of unemployment. A small open economy search model with endogenous participation and self-employment—a feature of EMEs—generates 90 percent of the volatility of unemployment in the data, highly volatile wages, and quantitatively-consistent cyclical aggregate dynamics amid productivity and interest rate shocks of plausible magnitudes. Endogenous participation amplifies shocks and plays a critical role in overcoming a key limitation of standard search models for EMEs.

JEL Classification: E24, E32, E44, F41, J6

Keywords: Emerging economies, business cycles, unemployment volatility, search frictions, labor force participation.

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