Optimal monetary policy with imperfect unemployment insurance

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Abstract

We analyze optimal monetary policy in an economy with sticky prices and efficiency wages. Unemployment exists because of indivisibility of labor. Unemployment insurance is not perfect so that the existence of unemployment introduces an additional source of distortions. We focus on the case in which the zero-inflation steady-state is (conditionally) efficient. In such a case, with perfect risk sharing, there would be no tradeoff between output and inflation even in the presence of exogenous disturbances: keeping zero inflation would be the sole objective of the monetary authority. We show, however, that imperfect unemployment insurance introduces a tradeoff between inflation and output even when the zero-inflation steady state is (conditionally) efficient. We then characterize how inflation and output should respond to different kinds of exogenous shocks under optimal policy.

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