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**MONETARY POLICY AND INEQUALITY
UNDER LABOR MARKET FRICTIONS
AND CAPITAL-SKILL
COMPLEMENTARITY**

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JEL Classification: E24, E25, E52, J64

Keywords: monetary policy, Search and Matching, capital-skill complementarity, inequality

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MONETARY POLICY AND INEQUALITY UNDER LABOR MARKET FRICTIONS AND CAPITAL-SKILL COMPLEMENTARITY

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February 13, 2018

Abstract

Contrary to previous beliefs, recent empirical work has found that the effects of monetary policy on inequality are far from modest. In order to improve our understanding of the channels through which monetary policy has distributional consequences, we build a New Keynesian model with incomplete asset markets, asymmetric search and matching (SAM) frictions across skilled and unskilled workers and, foremost, capital-skill complementarity (CSC) in the production function. Our main finding is that an unexpected monetary easing increases labor income inequality between high and low-skilled workers, and that the interaction between CSC and SAM asymmetry is crucial in delivering this result. This is so since the increase in labor demand driven by a monetary expansion leads to larger wage increases for high-skilled workers than for low-skilled workers since the former have smaller matching frictions (SAM-asymmetry channel). Moreover, the increase in capital demand amplifies this wage divergence due to skilled workers being more complementary to capital than substitutable unskilled workers are (CSC channel). Strict inflation targeting is often the most successful rule in stabilizing measures of earnings inequality even in the presence of shocks which introduce a trade-off between stabilizing inflation and aggregate demand.

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1 Introduction

During the last two decades growing inequality has become one of the most discussed topics in the public debate, mainly pointing to long-term trends driven by technological change and globalization. However, following the financial crisis and the extreme measures central banks took to fight it, questions have also arisen about how monetary policy might affect inequality over the business cycle. There are contrasting views on this issue. On the one hand, there are concerns that the highly accommodative monetary policy stance in advanced economies, as with unconventional quantitative easing, favors richer households disproportionately, thereby contributing to a more unequal income and wealth distribution. On the other hand, there are opinions supporting the opposite view, namely, that expansionary monetary policy reduces inequality because borrowers become better off than savers.

Of course, central banks consider the economy *as a whole* when setting monetary policy, their objectives being price stability and the stabilization of aggregate real economic activity over the business cycle. As [Bernanke \(2015\)](#) points out, distributional issues should not be the concern of unelected monetary policymakers but rather be addressed by other policy tools, such as fiscal policy. Monetary policy is a blunt tool which is ill-equipped to target various measures of inequality even if it does have an impact on them. Given that inequality has been growing over a much wider horizon than the one over which monetary policy typically operates, it is thought that its influence on inequality should be transitory, canceling out over the course of the business cycle. In addition, [Bivens \(2015\)](#) and [Bell et al. \(2012\)](#) have argued that any distributional consequence of monetary policy actions should be assessed in light of a counterfactual scenario in which central banks would abstain from stabilizing the economy. For instance, even if some population groups have benefited more than others from the exceptional monetary easing following the financial crisis, it is generally acknowledged that society as a whole is possibly better off as a result of such active policies. A corollary to this way of thinking is therefore that the most monetary policy can contribute to social welfare is by promoting aggregate economic stability which is also likely to be beneficial from an inequality perspective.

Notwithstanding the above, it is increasingly acknowledged that the short-run effects of monetary policy on inequality could be relevant for its optimal design. Taking these effects into consideration might influence the welfare implications of various systematic monetary strategies, while inequality might also interact with the different channels of the monetary transmission mechanism. As a result, there has been a recent body of literature dealing with how both issues are related. Our paper aims to contribute to this literature by introducing some new features in a New Keynesian model with incomplete markets; in particular, we focus on capital-skill complementarity (CSC hereafter) and labor market heterogeneity in the form of asymmetric search-and-matching (SAM) frictions.

The channels through which monetary policy affects inequality are complex. First, it might

matter whether one looks at income, wealth, earnings, or consumption inequality, since these variables behave differently in the monetary transmission. [Bell et al. \(2012\)](#) categorize these channels in the following way. Monetary policy directly affects interest rates received by savers on deposits and paid by borrowers on loans (*income effect*), as well as assets such as bonds, equities and real estate (*wealth effect*). A change in real interest rates influences the intertemporal consumption-saving choice of households (*substitution effect*), which is the main channel of monetary transmission in mainstream representative-agent New Keynesian models, through changes in aggregate demand followed by changes in employment, wages and profits.

Second, the way these channels interact with inequality depends on how households are distributed along certain dimensions of heterogeneity (e.g. borrowers *vs.* lenders, or workers *vs.* rentiers), and how these characteristics correlate with income or wealth levels (e.g. borrowers and workers tend to be poorer). The same monetary policy action can have different (and potentially offsetting) effects on inequality along these different dimensions of heterogeneity, which is why the overall effect can be considered a priori ambiguous. Combining the categorization of [Amaral \(2017\)](#) and [Coibion et al. \(2012\)](#) the main dimensions can be summarized as follows.

- First, households differ with respect to their net wealth: through the **savings redistribution channel** the income effect of a monetary expansion makes borrowers better off by reducing their interest payments on debt, while deposit holding savers face lower returns. Higher inflation also reduces the real value of nominally fixed debts, which favors borrowers at the expense of creditors. As long as savers are richer on average, this reduces income inequality. Conversely, the wealth effect pushes up the prices of assets which are mainly owned by the richer, therefore pushing wealth inequality up.
- Second, the **interest-rate sensitivity channel** concerns the maturity structure of assets and liabilities as their duration determines how much their value increases in response to a fall in the discount rate.
- Third, households differ in their **income composition**. Some receive a larger share of their income from business and financial dividends than others (relative to labor income), and they also tend to be richer. Thus, insofar as a monetary expansion (stimulating demand through the intertemporal substitution effect) leads to a steeper rise in profits than in wages, this channel contributes to a rise in income inequality. The same holds in relation with middle-income households (who rely more on rising wages) and poorer ones (who rely on unchanging transfers). Rising inequality is mitigated by the fact that the wealthy also receive a larger share of their income from falling interest payments.
- Fourth, households might differ in how their labor earnings react to a monetary expansion and this **earnings heterogeneity** can affect income inequality. There can be many factors here: different unemployment risk, asymmetric wage rigidities and labor market institutions, or different complementarity with capital across the skill distribution which, as mentioned above, is one of the main mechanisms we focus on here. For instance, [Heathcote](#)

[et al. \(2010\)](#) show that labor earnings at the bottom of the distribution are the ones most exposed to business cycle fluctuations, leading to larger fluctuations in working hours and employment than at the top of the distribution (i.e. unemployment falls disproportionately on the poor). Hence, a monetary expansion which decreases unemployment (more so than it increases wages) will reduce income inequality.

- Fifth, households can exhibit "**intertemporal substitution heterogeneity**" either with respect to their preferences (patient vs impatient), or as regards their access to financial markets (Ricardian vs hand-to-mouth consumers, or credit constraints). This will influence their labor supply and savings decisions (i.e. their wages and financial income) which might interact with a monetary policy loosening in affecting inequality.

As mentioned above, the balance of all these forces is ambiguous and thus can only be determined by quantitative methods. Yet, while "empirically it is hard to control for all the sources of endogeneity, theoretically it is cumbersome to include all the relevant heterogeneity" ([Amaral, 2017](#), p.5). Therefore, our main goal in the present paper is to focus on the earnings heterogeneity channel, leaving aside other sources of heterogeneity (like the wealth distribution). More specifically, we wish to investigate how CSC interacts with monetary policy in affecting inequality between high and low-skilled workers. Skill-biased technological change has been traditionally considered as one of the main driving factors behind the growing trend of income inequality, as reflected in an increasing skill wage premium. However, to the best of our knowledge, no theoretical model has yet analyzed the business-cycle effects of this production feature with the aim of studying its implications for monetary policy.

If high-skilled labor is a complementary input to capital while low-skilled labor can be substituted by a combination of high-skilled labor and capital, then cyclical changes induced by monetary policy can have markedly different effects on the relative income shares of these labor inputs than when CSC is ignored. This is especially the case when these two types of workers are also subject to different labor-market frictions which damage low-skilled workers' prospects of finding or keeping jobs. In particular, to the extent that a monetary expansion leads to a fall in the relative cost of capital through lower nominal interest rates, which translate into lower real interest rates given price stickiness, it might stimulate demand for complementary skilled labor relatively more than for substitutable unskilled labor. This could show up in a combination of larger wage (*skill*) premium and larger employment gains for skilled workers, and could even push the income shares of skilled and unskilled workers in opposite directions ([Koczan et al., 2017](#)). Given that high-skilled workers are already richer, the monetary expansion is then *increasing* inequality through this specific channel, which contrasts with how most researchers interpret the effects of the earnings heterogeneity channel.

To illustrate our previous reasoning, we build a New Keynesian model which combines CSC and asymmetric SAM frictions as its two key ingredients. We include these frictions to account for other potential sources of earnings heterogeneity which could interact with CSC. As regards

their asymmetric nature, one rationalization could be that, while low-skilled workers are only able to undertake simple tasks, high-skilled workers can undertake both complex and simple tasks, so that they experience lower job-separation rates. Furthermore, to the extent that high-skilled workers have more stable jobs than less-skilled workers, they are likely to have larger networks helping them to find jobs when unemployed, therefore leading to more efficient search intensity. Finally, it is also plausible that high-skilled workers have larger bargaining power than less-skilled ones since they are more valuable for the firm. Notice that we do not explicitly model these mechanisms here but rather use them as motivation devices for heterogeneous SAM frictions by worker-type. With regard to CSC, it is assumed that the elasticity of substitution between skilled labor and capital is below unity (making them complements), while it is above unity between unskilled labor and capital or skilled labor (making them substitutes). Under incomplete markets the idiosyncratic effect of unemployment or earnings risk on the consumption of these heterogeneous workers cannot be fully insured. First, we look at the effect of *unexpected* expansionary monetary policy shocks on the relative income shares of high and less-skilled labor, which we use as a measure of inequality. We then compare this setting against the benchmark cases without CSC and with symmetric SAM frictions in order to identify the role of different sources of heterogeneity. Finally, we also look at the effect of various other shocks under different rules for *systematic* monetary stabilization in order to examine the implications of different monetary policy strategies for inequality.

Related Literature

In carrying out the above exercises, we relate to several strands in the literature. First, our model is one in the family of **New Keynesian models with SAM friction** à la Mortensen-Pissarides in the labor market. We have endogenous participation choice as in [Ravn \(2006\)](#), [Campolmi and Gnocchi \(2016\)](#) and [Christiano et al. \(2016\)](#). Labor market heterogeneity is captured by asymmetric SAM frictions across various groups of workers as in [Brückner and Pappa \(2012\)](#), and [Pappa et al. \(2015\)](#). The implications of SAM frictions for optimal monetary policy are derived by [Ravenna and Walsh \(2011\)](#). Second, we rely on the literature which looks at the relationship between **capital-skill complementarity** and inequality. [Krusell et al. \(2000\)](#) were the first to model the effects of skill-biased technological change on the U.S. skill premium in the medium and long run by introducing CSC via a two-level CES production function, a formulation that we rely on for our analysis. [Lindquist \(2004\)](#) showed that CSC is crucial in explaining the behavior of the skill premium and wage inequality at business cycle frequencies. [Angelopoulos et al. \(2017\)](#) use the same production function and SAM frictions to investigate the effects of policies supporting on-the-job-learning. However, none of these studies consider nominal rigidities which are crucial for monetary policy analysis. Third, this paper is part of the recently growing literature on **monetary policy and inequality**. Most of these studies combine an incomplete market Aiyagari-type heterogeneous agent framework with New Keynesian nominal rigidities, resulting in what is now referred to as HANK models ([Kaplan et al., 2016](#)) and ([Ravn and Sterk, 2016](#)). This allows for a rich analysis of distributional issues, as the model yields

wealth and income distributions over a wide range of values. [Gornemann et al. \(2012\)](#) use this framework, augmented by SAM frictions to make unemployment risk endogenous to monetary policy. They show that contractionary monetary shocks increase income inequality –via a rise in precautionary savings by poorer households which leads to a higher value of the assets held by the wealthy rich – and therefore have larger welfare costs than thought before. [Gornemann et al. \(2016\)](#) show that a systematic monetary policy rule which puts larger weight on stabilizing unemployment (shifting from "hawks" to "doves"), is relatively more beneficial for poorer than for rich households, as it provides partial insurance against unemployment risk. However, they do not account for CSC and their SAM frictions are symmetric across skills (even if idiosyncratic risk generates labor market heterogeneity ex post). The HANK framework is crucial to analyze the above mentioned savings redistribution and income composition channels through which monetary policy influences inequality, since asset and income distribution are needed to address these issues. However, since our focus here lies only in the earnings heterogeneity channel, it suffices to use a less rich setting of heterogeneity, already present in the form of CSC and asymmetric SAM frictions.

The main contribution of our paper is to *combine* these three strands of literature, which proves to be crucial to derive our results. Introducing CSC to the relationship between monetary policy and inequality, and analyzing its interaction with heterogeneity in the labor market is something that, to the best of our knowledge, is novel in this area of research.

On the empirical side, the evidence on the effects of monetary policy on inequality is also mixed. [Coibion et al. \(2012\)](#) find that contractionary monetary policy shocks (identified as in [Romer and Romer \(1998\)](#)) systematically increase inequality as rising unemployment falls disproportionately on low-income workers. [Furceri et al. \(2016\)](#) also argue that unexpected monetary tightening increases inequality, but the effect depends on the labor share of income and the degree of redistributive policies. In addition, they show that increases in interest rates that *systematically respond to* an economic upturn actually reduce inequality. [O’Farrell et al. \(2016\)](#) conduct a simple theoretical exercise (in a partial equilibrium framework) based on empirical income and wealth distributions and find that the effects are small, and that a monetary expansion reduces inequality in Canada and the U.S., but increases it in most European countries. [Saiki and Frost \(2014\)](#) found that aggressive monetary easing in Japan has contributed to higher income inequality. [Bivens \(2015\)](#) finds that the overall effect on inequality of the Fed’s policies after the financial crisis was very modest, with most of the different channels offsetting each other. He instead emphasizes that without the exceptional monetary stimulus all groups would have been worse-off. [Bell et al. \(2012\)](#) achieve a similar result for the UK.

Our main finding is that an unexpected expansionary monetary policy shock *increases* earnings inequality by lowering the labor share of income for low-skilled workers and raising it for high-skilled workers. This is mainly driven by an increase in the wage premium for the high skilled, who also fare better in terms of employment rates. Relative to the benchmark cases without

CSC or with symmetric SAM frictions, we find that introducing CSC in itself is not enough to generate these results, but it is its *interaction* with asymmetric SAM frictions which leads to a larger rise in inequality compared to a standard Cobb-Douglas production function. It is important to stress that these results are not specific to monetary policy shocks but are similar for any positive aggregate demand shock leading to higher investment. Yet, since monetary shocks have a stronger impact on the relative price of capital than government expenditure shocks, we show that their effect on income inequality via capital accumulation is much larger. Our results are in line with our initial hypothesis about how CSC works, but differ from several empirical and theoretical findings discussed earlier (Coibion et al. (2012) or Gornemann et al. (2012)), which do not consider CSC, or SAM asymmetry explicitly.

Looking at the performance of alternative monetary policy rules in the face of various other shocks we find that strict inflation targeting is more successful in stabilizing the economy than a more flexible Taylor-rule by managing expectations in a way which improves potential trade-offs and limits variations in relative income shares of skilled workers. However, increasing the Taylor-reaction parameter to unemployment or output (i.e. making inflation targeting "less strict") has the same effect (although at the cost of higher inflation), suggesting that unemployment fluctuations are also important for inequality and it might be worth limiting them. In contrast, *absent* CSC and asymmetric SAM, the optimal monetary policy rule might put less weight on unemployment, even in the face of cost-push shocks, confirming the results of Coibion et al. (2012) or Gornemann et al. (2012)).

Finally, we analyze the welfare effects of monetary policy shocks for the different groups of individuals in our economy and in the aggregate. In the absence of CSC and asymmetric SAM, a monetary expansion is beneficial for both types of agents. However, with SAM and CSC a monetary expansion reduces aggregate welfare by increasing inequality. The high skilled gain 2.06 percent of steady state consumption while the low skilled lose 0.17 percent of their steady state consumption.

The rest of the paper is organized as follows. We use Section 2 to motivate our further analysis, by estimating the dynamic effects of monetary policy shocks on the wage premium and the relative employment of skilled and unskilled workers in structural VAR (SVAR) models. Section 3 lays out the theoretical model, while Section 4 shows our calibration strategy. Results are presented and discussed in Section 5. Finally, Section 6 concludes.

2 Monetary Policy and Earnings Inequality

To motivate the research question addressed in this paper, we start by identifying the impact of a monetary policy shock on the relative wages (*skill premium*) and the employment rates of skilled and unskilled workers (*employment rates ratio*) in a conventional SVAR model. Our SVAR consists of six variables: log industrial production, unemployment rate, the log of the

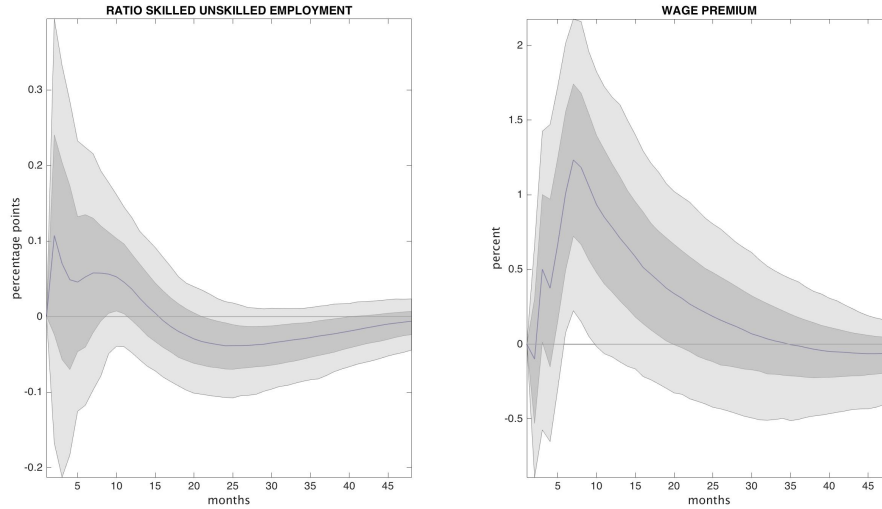


Figure 1: IRFs of employment rates ratio and skill premium to a one percentage point unexpected reduction in the FF interest rate

skill premium, the relative employment rate ratio, the consumer price index inflation, and the federal funds rate (FFR). Data for the unemployment rate and consumer price index for all urban consumers are both produced by the Bureau of Labor Statistics; data for industrial production index and the effective federal funds rate are produced by the Board of Governors of the Federal Reserve System. For the relative wage and employment data we construct the series using the NBER extracts of the Current Population Survey (CPS) Merged Outgoing Rotation Groups, including in the sample only individuals in working age 15-64 and excluding part-time workers, self-employed and military employees. CPS provides monthly information from 1979:1 until 2016:6 on the participants' employment status, level of education, weekly earnings, and weekly hours of work.

We classify workers as high-skilled and low-skilled depending on whether they have a college degree or not. Low-skilled workers are defined as all those employed with a lower educational attainment.¹ Employment is defined as number of monthly hours of work per employee times the number of salaried workers in each skill category.² We obtain hourly wages for both types of workers using weekly wage and dividing by the corresponding weekly hours worked for each group. These derived wages are used to compute the skill premium, which is defined as the ratio between the weighted average of hourly wages of the high-skilled and low-skilled workers. All variables except for the FFR are seasonally adjusted and detrended by a fourth order polynomial

¹Defining high-skilled workers as those with some college education using the NBER harmonization of education in CPS over time leads to a break in the series from 1991 to 1992. To avoid this break we opted to split workers depending on whether or not they have completed a college degree.

²The weighted average of the weekly earnings and hours worked last week for each skill group are calculated using the proper weights ERNWGT. These weights are computed each month such that, when applied, the resulting counts are representative of the national counts. Thus, the proper application of weights enables the results to be representative of the US population as a whole, instead of just the participants in the survey.



Figure 2: IRFs of employment rates ratio and skill premium to a one percentage point unexpected reduction in the FF interest rate

trend. Using information criteria, we include 4 lags of each variable in the VAR.

Given the high frequency of the data, the identifying assumption is that the FFR is allowed to respond contemporaneously to shocks in all remaining variables, while real variables and prices do not react to FFR shocks within a month. Hence, we consider a lower triangular Cholesky decomposition using the aforementioned ordering of the variables.

The right-hand side of Figure 1 displays the skill- premium impulse response function (IRF) to a one percentage point (100 b.p) unexpected cut in the FF rate, while the left-hand side shows the corresponding IRF for the skilled-unskilled employment rate ratio. Confidence intervals at 68% (darker bands) and 95% levels (lighter bands) are depicted. As can be observed, both variables increase during the first 12-15 months as a result of the expansionary monetary policy shock and their IRFs exhibit a hump-shaped pattern, especially in the case of the skill premium. Although the IRF of the employment ratio is only marginally significant at 68% level, both IRFs seem to suggest that inequality between high and low-skilled workers (in terms of pay and employment rates) is positively related with an unexpected reduction in interest rates.³ At the peaks of the IRFs, the employment rate ratio increases by about 0.1 percentage points while the skill premium goes up more substantially, by 1.3 percent.

In Figure 2, we plot similar IRFs as those above, this time using an external instrument to identify the monetary policy shock. In particular, we use the proxy-SVAR approach proposed by Mertens and Ravn (2013), where the extended time series of the Romer and Romer's (2004) narrative/ Greenbook shocks constructed by Tenreiro and Thwaiter (2015) is used as a noisy measure of the

³In the Online Appendix we present the complete set of responses of the SVAR as well as robustness checks. Results are insensitive if we stop the sample in 2007, if we use 2 instead of 4 lags, or if we use a shorter set of variables in the VAR.

true shocks⁴. By assuming that the narrative monetary policy shocks are contemporaneously correlated with the structural policy shock and that it is contemporaneously uncorrelated with the other structural shocks, we recover the shocks to monetary policy.⁵ As can be inspected, the IRFs of the skill premium and the employment rate ratio to an expansionary monetary shock are larger than those in Figure 1, though their hump shapes are fairly similar, indicating that these measures of labor market inequality, if anything, grow together when unexpectedly monetary policy becomes laxer.

3 Model

Our model belongs to the family of New Keynesian models with SAM frictions in the labor market. The New Keynesian feature of nominal rigidities ensures that monetary policy has real effects in the economy, while SAM frictions allow us to model unemployment. Heterogeneity in the population manifests itself along two dimensions, with three different households (high and low skilled workers, and entrepreneurs) and three different labor-market status for workers. Skill types differ in their labor market frictions (*"asymmetric" SAM*) and also in their role in production, with high-skilled workers having a lower elasticity of substitution with capital than low-skilled workers do (*CSC*). Different households can trade with each other in a single risk-free bond market but the incomplete market setup does not provide full insurance against the idiosyncratic effects of shocks, leading to fluctuating consumption inequality.

Perfectly competitive intermediate good firms produce a homogeneous output by renting capital and the two types of labor from the households. Hiring and firing are subject to SAM frictions and wages are set by Nash bargaining. Intermediate output is then differentiated by monopolistically competitive retail firms who face Calvo-type nominal rigidities in the price of the final good. Final output is used for consumption, investment and (wasteful) government spending. Fiscal policy finances exogenous expenditures, unemployment benefits and production subsidies by lump sum taxes. Monetary policy sets the short term nominal interest rate.

3.1 Labor market search and matching

There are three different types of households: high and low-skilled workers and entrepreneurs, all of whom have constant masses φ^k , $k \in \{H, L, E\}$. It is assumed that no transition is possible across those types. The population size is normalized to one, i.e. $\sum_k \varphi^k = 1$. For each worker belonging to household $k \in \{H, L\}$ there are three possible labor market status at any period

⁴The Romer and Romer series pass the weak instrument test at 10 percent significance level.

⁵In the Online Appendix we also present the complete set of responses of the SVAR as well as robustness checks. The optimal lag criteria suggest higher lags for this specification in the baseline model. Results are insensitive if we stop the sample in 2007, if we use 4 or 12 instead of 6 lags, or if we use a shorter set of variables in the VAR.

of time: employment n_t^k , unemployment u_t^k , and inactivity (enjoying leisure) l_t^k . Entrepreneurs use all of their time endowment enjoying leisure.

$$1 = n_t^k + u_t^k + l_t^k \quad k \in H, L \quad (1)$$

Intermediate good firms post vacancies v_t^k requiring different skills, which are then matched by unemployed job-searchers U_t^k according to the following matching technology:

$$m_t^k(v_t^k, U_t^k) = \rho_m^k (v_t^k)^{\alpha^k} (U_t^k)^{1-\alpha^k} \quad k \in \{H, L\} \quad (2)$$

where ρ_m^k is the matching efficiency parameter for a k skilled unemployed. Aggregate measures of employment and unemployment in each household are $N_t^k = \varphi^k n_t^k$ and $U_t^k = \varphi^k u_t^k$.

Labor market tightness θ_t^k , vacancy filling probabilities $\gamma_{f,t}^k$ and hiring probabilities $\gamma_{h,t}^k$ are defined as follows:

$$\theta_t^k = \frac{v_t^k}{U_t^k} \quad k \in H, L \quad (3)$$

$$\gamma_{f,t}^k = \frac{m_t^k}{v_t^k} \quad k \in H, L \quad (4)$$

$$\gamma_{h,t}^k = \frac{m_t^k}{U_t^k} = \rho_m^k \left(\frac{v_t^k}{U_t^k} \right)^{\alpha^k} \quad k \in H, L \quad (5)$$

An exogenous separation rate σ^k signals the fraction of employed workers losing their job, who then become unemployed. Unemployed agents either find a job, stay unemployed or exit the labor force. As a result, the transition dynamics between different labor market statuses can be expressed as:

$$N_{t+1}^k = (1 - \sigma^k)N_t^k + \underbrace{\gamma_{h,t}^k U_t^k}_{m_t^k} \quad k \in H, L \quad (6)$$

Participation in the labor force is chosen by a given-skilled household (from (1), we have: $1 - l_t^k = u_t^k + n_t^k$). However, while the household can only decide to start *searching* for a job (transiting from inactive to unemployed), *getting* a job is constrained by search and matching frictions. Therefore, n_t^k are pre-determined (state) variables at time t , so the participation margin can only be adjusted through choosing u_t^k .⁶ Then, the choice of u_t^k can affect future employment through the hiring probabilities in (5). Similarly, the intermediate firm cannot decide directly how many workers to employ in a given period, but it can only affect future employment levels through its current posted vacancies v_t^k (as it also affects hiring probabilities $\gamma_{h,t}^k$ through (5)). Once these choices are made by households and firms, and given the pre-determined levels of

⁶Notice that through the time endowment constraint, and once employment and unemployment are accounted for, leisure becomes just a residual. So in effect, the endogenous participation choice is equivalent to choosing u_t^k , which is why leisure is not included in the transition matrix. Flows into U_{t+1}^k are not to be interpreted, since it can be reoptimized at the beginning of each period.

n_t^k , future flows into employment are governed by the laws of motions (6), which will act as constraints on the household's and firm's problems.

This also shows that labor market status endogenously interact in this setup with the rest of the economy through two channels. One is the participation choice of the household through u_t^k and the other is the vacancy posting decision of intermediate firms v_t^k , both taking into account future desired levels of employment n_{t+1}^k , which in turn are subject to constraints imposed by SAM frictions.

The potential asymmetry in SAM frictions across skills $k \in \{H, L\}$ are captured by k -specific parameters $\sigma^k, \alpha^k, \rho_m^k$ (see below for further discussion on this issue).

3.2 Households

The three different household types (i.e. high and low-skilled workers and entrepreneurs, $k \in \{H, L, E\}$) have some common features. They all maximize lifetime utility which is a separably additive function of consumption c_t^k and leisure l_t^k . The three households can trade with each other through incomplete financial markets, i.e., in a single risk-free nominal bond B_t^k , which pays a gross nominal return of R_t . All households exhibit external habits in consumption, i.e. their utility depends on past levels \hat{c}_{t-1}^k with a parameter of h , but this is taken as given when choosing consumption. The intertemporal elasticity of substitution is $\frac{1}{\eta}$ for everyone. Lump-sum taxes t^k are collected from the households by the government. The aggregate price level of final consumption goods is p_t .

Households discount future utils from any period t to $t = 0$ by using a time varying discount factor $\tilde{\beta}_t \equiv \beta^t \prod_{s=0}^{t-1} \psi_s$, which is subject to exogenous shocks. From this we can define the discount factor between any two consecutive periods as

$$\beta_t \equiv \frac{\tilde{\beta}_{t+1}}{\tilde{\beta}_t} = \beta \psi_t \quad (7)$$

$$\ln \psi_t = \rho_\psi \ln \psi_{t-1} + \varepsilon_t^\psi \quad (8)$$

3.2.1 Entrepreneurs

Entrepreneurs do not participate in the labor market, and for simplicity their utility from leisure is normalized to zero. In addition to trading in a non-state contingent nominal bond B_t^E , as the workers, they can save by investing in physical capital k_t , too. Investment i_t also has to cover depreciation and capital adjustment costs, the latter being governed by parameter, ω . Entrepreneurs then rent capital out to intermediate firms at a rental rate r_t . It is possible to adjust the intensity of capital utilization z_t which boosts the return on capital but also raises depreciation costs according to $\delta(z_t) = \delta z_t^\phi$, $\phi > 1$, $\delta > 0$. Entrepreneurs own the firms in the economy, so they receive all profits π_t^f as dividends. The main reason why they

appear in our model is to avoid further asymmetries, beyond those existing in the labor market, between high and low-skilled workers that could originate from firm ownership and dividends. Thus, entrepreneurs maximize utility subject to their budget constraint and the capital law of motion.

$$\begin{aligned}
& \max_{\{c_t^E, i_t, k_{t+1}, B_t^E, z_t\}} E_0 \sum_{t=0}^{\infty} \tilde{\beta}_t \left[\frac{(c_t^E - h c_{t-1}^E)^{1-\eta}}{1-\eta} \right] \\
& c_t^E + \Delta_t i_t + t_t^E + \frac{B_t^E}{p_t} \leq r_t(z_t k_t) + \frac{R_{t-1} B_{t-1}^E}{p_t} + \pi_t^f \\
& i_t = k_{t+1} - (1 - \delta(z_t)) k_t + \frac{\omega}{2} \left(\frac{k_{t+1}}{k_t} - 1 \right)^2 k_t
\end{aligned} \tag{9}$$

The relative price of investment Δ_t is assumed to follow an exogenous AR(1) process, with the innovation to this process representing an investment-specific shock.

$$\ln \Delta_t = \rho_{\Delta} \ln \Delta_{t-1} + \varepsilon_t^{\Delta} \tag{10}$$

Substituting investment out (by plugging the capital law of motion (9) into the budget constraint), and defining gross inflation as $\Pi_t = p_t/p_{t-1}$ we can take first-order conditions:

$$c_t^E : (c_t^E - h c_{t-1}^E)^{-\eta} = \lambda_t^{c,E} \tag{11}$$

$$k_{t+1} : \lambda_t^{c,E} \Delta_t \left[1 + \omega \left(\frac{k_{t+1}}{k_t} - 1 \right) \right] = \beta_t E_t \lambda_{t+1}^{c,E} \left\{ r_{t+1} z_{t+1} + \Delta_{t+1} \left(1 - \delta(z_{t+1}) + \frac{\omega}{2} \left[\left(\frac{k_{t+2}}{k_{t+1}} \right)^2 - 1 \right] \right) \right\} \tag{12}$$

$$B_t^E : \lambda_t^{c,E} = \beta_t E_t \lambda_{t+1}^{c,E} \frac{R_t}{\Pi_{t+1}} \tag{13}$$

$$z_t : r_t = \Delta_t \delta'(z_t) = \Delta_t \delta \phi z_t^{\phi-1} \tag{14}$$

3.2.2 Workers

We have two separate worker households, $k \in \{H, L\}$. In addition to the intertemporal consumption-saving choice, workers also need to decide on intratemporal labor-market participation. The inverse Frisch-elasticity of labor supply is ζ , while Φ^k governs the weight of the leisure of each skill type in their utility. On top of being able to save in risk-free nominal bonds B_t^k , they can get additional insurance through inflation-indexed unemployment benefits b^k . Labor earnings depend on the real wage w_t^k and employment levels n_t^k for each skill type k .

The utility maximization problem is subject to the budget constraint and constraints on employment flows imposed by SAM frictions (6).⁷

⁷The law of motion for employment (6) is expressed here in *per capita* terms, i.e. divided by the mass of workers φ^k .

$$\begin{aligned}
\max_{\{c_t^k, B_t^k, u_t^k, n_{t+1}^k\}} \quad & E_0 \sum_{t=0}^{\infty} \tilde{\beta}_t \left[\frac{(c_t^k - h c_{t-1}^k)^{1-\eta}}{1-\eta} + \Phi^k \frac{(l_t^k)^{1-\zeta}}{1-\zeta} \right] \quad k \in H, L \\
c_t^k + t_t^k + \frac{B_t^k}{p_t} + \underbrace{\frac{\xi}{2} \left(\frac{B_t^k}{p_t} - \bar{b}^k \right)^2}_{f_t^k} & \leq w_t^k n_t^k + \frac{R_{t-1} B_{t-1}^k}{p_t} + b^k u_t^k + f_t^k \quad k \in H, L \\
n_{t+1}^k & = (1 - \sigma^H) n_t^k + \gamma_{h,t}^k u_t^k \quad k \in H, L
\end{aligned}$$

As discussed before, current employment n_t^k is a state variable pre-determined by previous labor market conditions, and each household can only choose their next period value taking into account the constraints imposed by SAM frictions. The participation margin today can only be adjusted through unemployment u_t^k . Using the laws of motion for employment (6) in their form above means that the household does not take the number of matches as given, but takes into account the effect of its unemployment decisions on matches, at least partially.⁸

A well-known issue with incomplete market models is that the non-stochastic steady state suffers from indeterminacy, while equilibrium dynamics around it are non-stationary ([Schmitt-Grohé and Uribe, 2003](#)) because consumption growth does not depend on asset holdings. In order to get around this problem, we introduce a small portfolio adjustment cost (governed by ξ), which penalizes workers in case their real bond holdings deviate from some benchmark level \bar{b}^k . To rule out any wealth effects, all of these costs are rebated to the households as a lump-sum f_t^k , but the latter is not taken into account when making the saving/borrowing decision.

Substituting leisure out using (1) we can take first-order conditions for $k \in \{H, L\}$:

$$c_t^k : \quad (c_t^k - h c_{t-1}^k)^{-\eta} = \lambda_t^{c,k} \quad (15)$$

$$B_t^k : \quad \lambda_t^{c,k} \left[1 + \xi \left(\frac{B_t^k}{p_t} - \bar{b}^k \right) \right] = \beta_t E_t \lambda_{t+1}^{c,k} \frac{R_t}{\Pi_{t+1}} \quad (16)$$

$$u_t^k : \quad \lambda_t^{n,k} = \frac{\Phi^k (l_t^k)^{-\zeta} - b^k \lambda_t^{c,k}}{\gamma_{h,t}^k} \quad (17)$$

$$n_{t+1}^k : \quad \lambda_t^{n,k} = \beta_t E_t \left[\lambda_{t+1}^{c,k} w_{t+1}^k + (1 - \sigma^k) \lambda_{t+1}^{n,k} - \Phi^k (l_{t+1}^k)^{-\zeta} \right] \quad (18)$$

where $\lambda_t^{c,k}, \lambda_t^{n,k}$ are Lagrange-multipliers on the budget constraint and the employment laws of motion, respectively. Then cancelling the portfolio adjustment costs with the lump sum rebates f_t^k , and defining *real bonds* as $b_t^k \equiv \frac{B_t^k}{p_t}$, we will use the budget constraints as:

$$c_t^k + t_t^k + b_t^k \leq w_t^k n_t^k + \frac{R_{t-1}}{\Pi_t} b_{t-1}^k + b^k u_t^k \quad k \in \{H, L\} \quad (19)$$

⁸It ignores, however, the full effect of its decisions on matches. In particular, its unemployment decisions also affect hiring probabilities $\gamma_{h,t}^{j,k}$ through (5), which the household takes as given in the above formulation; see [Brückner and Pappa \(2012\)](#). The full effect would be taken into account only if we substituted (2) into (6), instead of using the formulation with hiring probabilities.

3.2.3 Financial markets

Trading in non-state contingent bonds means that financial markets are incomplete, implying that different households cannot fully insure against idiosyncratic risk or against the part of aggregate shocks which affect them in an asymmetric way.⁹ In other words, there is no perfect risk sharing among them, which can give rise to *fluctuating* consumption inequality. Imperfect risk-sharing can be seen through the fact that the ratio of different households' marginal utilities is not constant *ex post*, and stays fixed only in *expectation*. Hence, unanticipated shocks with an idiosyncratic aspect will lead to fluctuations in this ratio. In other words, *expected* consumption growth is equalized across agents, but *actual* consumption growth is not.

This is in contrast to the complete market case which is practically equivalent to using only a representative household. In that case, perfect risk-sharing would create a much tighter link between the consumption of different households and keep their ratio of marginal utilities constant at all times due to the ability to insure against all idiosyncratic shocks by means of a complete set of state-contingent securities.¹⁰

Our model framework nests different financial market setups in the following way:

- a) **financial autarky** can be approximated by $\xi \rightarrow \infty$. Another way is by replacing the Euler equations of the workers (16) with $b_t^k = 0$ for $k \in \{H, L\}$. In essence we have to impose that workers are hand-to-mouth, and they cannot have a savings decision. Then the Euler equation of the entrepreneurs (13) will be used to price the bond (which is not traded in equilibrium).¹¹
- b) intermediate case of **incomplete markets** is any value of $\xi > 0$. Note that, $\xi = 0$ is still the incomplete market case, but then we have non-stationarity and indeterminacy.
- c) **complete markets** can be obtained by replacing the Euler equations¹² of the workers (16) with the perfect risk-sharing condition across agents, which keep the ratio of their

⁹Even aggregate shocks can have idiosyncratic effects if they influence different households in different ways. For instance, an aggregate demand shock will lead to changes in the skill premium.

¹⁰Note however, that even under complete markets there would be consumption inequality, since, even in the steady state, different households would enjoy different consumption *levels* (through different wages, rent, benefits, initial wealth). Likewise, even complete markets cannot insure against *aggregate* risk, but only against the *idiosyncratic* component, so the *level* of consumption would change. It is just the *ratio* of marginal utilities which would stay constant. Under incomplete markets, this ratio is constant only in expectation terms, and this allows unanticipated idiosyncratic shocks to give rise to fluctuating relative consumption and fluctuating inequality.

¹¹With financial autarky, the bond price is meaningless anyway since there are no financial markets, and the entrepreneurs will also end up being de facto hand-to-mouth. But this is the bond price which makes it an optimal decision for them.

¹²Under complete markets the budget constraints will have to be adjusted as well since now we have a full set of state-contingent securities, and not a single bond b_t . In this case however, the budget constraint is only used to recover the value of this portfolio as a residual, and so it can be omitted.

marginal utilities constant at the steady- state value (labeled by bars) :

$$\frac{\lambda_t^k}{\lambda_t^E} = \frac{\bar{\lambda}^k}{\bar{\lambda}^E} \quad k \in \{H, L\}$$

3.3 Intermediate goods firms

A continuum of perfectly competitive firms produce a homogeneous intermediate good y_t , using high and low skilled labor N_t^k and *effective* aggregate capital K_t . Just like in the case of the household, N_t^k are state variables, given by matches and employment levels from the previous period. It is only next period's employment levels N_{t+1}^k which can be influenced by choosing how many vacancies v_t^k to post. This influence is subject to the same SAM frictions as in the case of the household, however, (6) is now reformulated by plugging in (4) to reflect how vacancies are affecting the number of matches.¹³ Therefore, the firm's problem becomes dynamic.

$$\begin{aligned} V^F(N_t^H, N_t^L, \mathbf{s}_t) &= \max_{K_t, N_{t+1}^H, N_{t+1}^L, v_t^H, v_t^L} x_t F(K_t, N_t^H, N_t^L) - r_t K_t - w_t^H N_t^H - w_t^L N_t^L - \kappa^H v_t^H - \kappa^L v_t^L + \\ &\quad + E_t \Lambda_{t+1} V^F(N_{t+1}^H, N_{t+1}^L, \mathbf{s}_{t+1}) \\ \Lambda_{t+1} &= \beta_t \frac{\lambda_{t+1}^{c,E}}{\lambda_t^{c,E}} \\ N_{t+1}^H &= (1 - \sigma^H) N_t^H + \gamma_{f,t}^H v_t^H \\ N_{t+1}^L &= (1 - \sigma^L) N_t^L + \gamma_{f,t}^L v_t^L \end{aligned}$$

where Λ_{t+1} is the stochastic discount factor of the entrepreneurs, reflecting the ownership of the firm. The real price of intermediate goods x_t is taken as given by the firm – this constitutes real marginal costs for retails firms. Posting vacancies has a unit cost of κ^k . Substituting in the constraints and taking derivatives, the first-order conditions yield the capital and labor demand equations:

$$K_t : \quad r_t = x_t F_{k,t} \quad (20)$$

$$N_{t+1}^H : \quad \frac{\kappa^H}{\gamma_{f,t}^H} = \beta_t E_t \frac{\lambda_{t+1}^{c,E}}{\lambda_t^{c,E}} \left[x_{t+1} F_{n,t+1}^H - w_{t+1}^H + (1 - \sigma^H) \frac{\kappa^H}{\gamma_{f,t+1}^H} \right] \quad (21)$$

$$N_{t+1}^L : \quad \frac{\kappa^L}{\gamma_{f,t}^L} = \beta_t E_t \frac{\lambda_{t+1}^{c,E}}{\lambda_t^{c,E}} \left[x_{t+1} F_{n,t+1}^L - w_{t+1}^L + (1 - \sigma^L) \frac{\kappa^L}{\gamma_{f,t+1}^L} \right] \quad (22)$$

where $F_{k,t}$ and $F_{n,t}^k$ are the marginal products of respective inputs. Aggregate capital K_t and the production function are defined as

$$K_t = \varphi^E z_t k_t \quad (23)$$

$$y_t = F(K_t, N_t^H, N_t^L) \quad (24)$$

¹³Also, as in the case of the household, the firm does not take into account the full effect of its vacancy choices on the number of matches. In particular, it disregards the effect on vacancy filling probabilities through (4).

Our baseline production function is a nested CES composite of production factors, where we can separately control the elasticity of substitution between capital and high skilled labor, ϱ_{k,n^H} on the one hand, and between capital and low skilled labor ϱ_{k,n^L} on the other.¹⁴ This follows [Krusell et al. \(2000\)](#) and [Lindquist \(2004\)](#).

$$F(K_t, N_t^H, N_t^L) = A_t \left[a^k \left[\lambda K_t^\gamma + (1 - \lambda)(N_t^H)^\gamma \right]^{\frac{\alpha}{\gamma}} + (1 - a^k)(N_t^L)^\alpha \right]^{\frac{1}{\alpha}}$$

The capital intensity of the "skilled input bundle" is controlled by λ , while a^k represents the "skill intensity" of total production. The elasticities of substitution are governed by γ and α , and can be defined as $\varrho_{k,n^H} = \frac{1}{1-\gamma}$, and $\varrho_{k,n^L} = \varrho_{n^H,n^L} = \frac{1}{1-\alpha}$. We restrict these elasticities to be positive in order to preserve strict quasi-concavity of the production function. This means that $\alpha, \gamma \leq 1$.

CSC is captured in the following way:

- $0 < \varrho_{k,n^H} < 1$ represents CSC ($\gamma < 0$, with larger absolute values corresponding to a higher degree of complementarity)
- $1 < \varrho_{k,n^L}$ shows the substitutability of low-skilled labor with the skilled inputs ($0 < \alpha \leq 1$ with larger values corresponding to a higher degree of substitutability and $\alpha = 1$ meaning perfect substitutes)
- $\varrho = 1$ would be the Cobb-Douglas case with a unit elasticity of substitution ($\gamma, \alpha = 0$)

This follows the definition of [Koczan et al. \(2017\)](#), who define production factors as complements when their elasticity of substitution is below unity. In that case a fall in the relative price of one factor should increase the income share of the other factor, and vice versa for substitutes.¹⁵ [Lindquist \(2004\)](#) uses a less strict definition: based on the following formula, he shows that as long as $1 \geq \alpha > \gamma$, we get that a rise in the stock of capital will *ceteris paribus* raise the relative marginal product of skilled labor,¹⁶ and this is what they call *CSC effect*. It can also be seen that a rise in low-skill employment relative to high-skill employment raises the marginal product of high-skill workers, which is called the *relative supply effect*.

$$\frac{F_{n,t}^H}{F_{n,t}^L} = (1 - \lambda) \frac{a^k}{1 - a^k} \left[\lambda \left(\frac{K_t}{N_t^H} \right)^\gamma + (1 - \lambda) \right]^{\frac{\alpha - \gamma}{\gamma}} \left(\frac{N_t^L}{N_t^H} \right)^{1 - \alpha}$$

In order to gauge the effects of CSC relative to the case of no CSC, we can change parameters γ and α , but we also need a different benchmark production function, the structure of which allows for controlling the elasticity of substitutions separately between capital and any labor,

¹⁴The structure of the nesting implies that the elasticity of substitution between high and low skilled labor must be the same as between capital and low skilled labor $\varrho_{n^H,n^L} = \varrho_{k,n^L}$.

¹⁵Although in these authors' model there is only one type of labor and no SAM frictions (which put a wedge between the wage and the marginal product of labor), so this might not carry straight over to our model.

¹⁶In our model SAM frictions put a wedge between the wage and the marginal product of labor, but they are still closely related. Therefore the above argument can be applied to the skill premium as well.

and between the two different types of labor.

$$\tilde{F}(K_t, N_t^H, N_t^L) = A_t K_t^\sigma \left[\mu (N_t^H)^\nu + (1 - \mu) (N_t^L)^\nu \right]^{\frac{1-\sigma}{\nu}}$$

where, as is well known, the Cobb-Douglas (CD hereafter) structure between capital and labor is a special case of CES, with the elasticity of substitution between them being unity – i.e. capital and labor are neither complements, nor substitutes, and the income shares are supposed to be constant and independent of relative prices, with σ being the share of capital. The two different types of labor are perfect substitutes when $\nu = 1$, i.e. their elasticity of substitution is $\frac{1}{1-\nu} = \infty$. With equal intensity $\mu = 0.5$ labor is basically homogeneous.

Aggregate TFP follows an exogenous AR(1) process:

$$\ln A_t = \rho_a \ln A_{t-1} + \varepsilon_t^a \quad (25)$$

3.4 Wage bargaining

Workers and intermediate firms split the surplus of a match by Nash-bargaining. Wages are negotiated separately in the high and low-skill labor markets.

$$\begin{aligned} \max_{w_t^k} (1 - \vartheta^k) \ln(V_t^{E,k}) + \vartheta^k \ln(V_t^{F,k}) \quad k \in H, L \\ V_t^{E,k} = \frac{\partial \mathcal{L}}{\partial n_t^k} = \lambda_t^{c,k} w_t^k - \Phi^k(l_t^k)^{-\zeta} + (1 - \sigma^k) \lambda_t^{n,k} \\ V_t^{F,k} = \frac{\partial V^F(N_t^k)}{\partial N_t^k} = x_t F_{n,t}^k - w_t^k + (1 - \sigma^k) \frac{\kappa^k}{\gamma_{f,t}^k} \end{aligned}$$

where $V_t^{E,k}$ is the marginal value for the household of being employed, and $V_t^{F,k}$ is the expected value for the firm of filling a vacancy. \mathcal{L} is the Lagrangian of the household, while V^F is the value function of the firm. During Nash-bargaining they maximize the weighted sum of log surpluses, with the weights ϑ^k representing the bargaining power of the firm in each labor market. The solution to this problem yields the *desired* wage w_t^{k*} :

$$w_t^{k*} = (1 - \vartheta^k) \left[x_t F_{n,t}^k + (1 - \sigma^k) \frac{\kappa^k}{\gamma_{f,t}^k} \right] + \frac{\vartheta^k}{\lambda_t^{c,k}} \left[\Phi^k(l_t^k)^{-\zeta} - (1 - \sigma^k) \lambda_t^{n,k} \right] \quad (26)$$

Actual wages w_t , however, will be subject to an exogenous constraint which is meant to be a shortcut for wage rigidities, controlled by parameter ρ_w^k . Under this formulation, and unlike the case of Calvo-type frictions, the presence of rigidities is not taken into account in a forward-looking manner either by firms or by households during their bargaining. However, this allows for a much simpler setup.

$$w_t^k = \rho_w^k w_{t-1}^k + (1 - \rho_w^k) w_t^{k*} \quad k \in H, L \quad (27)$$

3.5 Retail firms

We have a continuum $i \in [0, 1]$ of monopolistically competitive retail firms, each of which buys $y_t(i)$ amount of the homogenous intermediate good y_t , and produces a differentiated product $y_t^r(i)$ with a linear technology, i.e. $y_t^r(i) = y_t(i)$. These differentiated products are then assembled to become final goods y_t^r according to a CES aggregator:

$$y_t^r = \left[\int_0^1 y_t^r(i)^{\frac{\epsilon-1}{\epsilon}} di \right]^{\frac{\epsilon}{\epsilon-1}} = \left[\int_0^1 y_t(i)^{\frac{\epsilon-1}{\epsilon}} di \right]^{\frac{\epsilon}{\epsilon-1}} =! y_t$$

where the last equality is just a scaling assumption, so that we can drop the r superscript, i.e., in the end we have as much final goods as much intermediate goods. ϵ is the elasticity of substitution between different products.

Retail firms take the relative price x_t of the intermediate good as given, which is basically their real marginal cost. This depends neither on i (since intermediate goods are homogenous, so retail firms are competitive *buyers*), nor on the amount of goods used (since all the retail firms have an infinitesimally small size). Due to differentiation, retailers have pricing power in setting the price of their own product $p_t(i)$, but take the aggregate price level p_t as given. The latter is defined as $p_t = \left[\int_0^1 p_t(i)^{1-\epsilon} di \right]^{\frac{1}{1-\epsilon}}$.

In setting their price, retailers are constrained by Calvo-type nominal rigidities, meaning that in every given period a fraction χ of them cannot adjust prices. The $(1 - \chi)$ fraction of firms, who are able to adjust prices in a given period, will choose them $(p_t^*(i))$ so as to maximize the real present value of expected future profits, taking into account nominal rigidities and also the price elastic demand of households.

$$p_t^*(i) \equiv \arg \max_{p_t(i)} E_t \sum_{s=0}^{\infty} \chi^s \Lambda_{t+s} \left[\frac{p_t(i)}{p_{t+s}} - (1 - \tau)x_{t+s} \right] y_{t+s}(i)$$

$$y_{t+s}(i) = \left(\frac{p_t(i)}{p_{t+s}} \right)^{-\epsilon} y_{t+s}$$

where τ is a production subsidy used by the government to eliminate the static distortion coming from monopolistic competition. Due to symmetry across retailers, all of them will choose the same price $p_t^* \equiv p_t^*(i)$. The solution to this problem yields:

$$p_t^* = \underbrace{\frac{(1 - \tau)\epsilon}{\epsilon - 1}}_{(1-\tau)\mathcal{M}} E_t \frac{\sum_{s=0}^{\infty} \chi^s \Lambda_{t+s} y_{t+s}(i) \overbrace{p_{t+s} x_{t+s}}^{MC_t}}{\sum_{s=0}^{\infty} \chi^s \Lambda_{t+s} y_{t+s}(i)}$$

Calvo-rigidities imply that evolution of the aggregate price level will follow

$$p_t = \left[(1 - \chi)(p_t^*)^{1-\epsilon} + \chi p_{t-1}^{1-\epsilon} \right]^{\frac{1}{1-\epsilon}}$$

Manipulating the previous expression and the FOC of the retailers, we can derive a non-linear

substitute for the New Keynesian Phillips Curve,¹⁷ expressed by the following three equations:

$$\frac{K_t}{F_t} = \left[\frac{1 - \chi \Pi_t^{\epsilon-1}}{1 - \chi} \right]^{\frac{1}{1-\epsilon}} \quad (28)$$

$$K_t \equiv y_t (c_t^E - h c_{t-1}^E)^{-\eta} x_t \frac{(1 - \tau)\epsilon}{\epsilon - 1} + \chi \beta_t E_t [\Pi_{t+1}^\epsilon K_{t+1}] \quad (29)$$

$$F_t \equiv y_t (c_t^E - h c_{t-1}^E)^{-\eta} + \chi \beta_t E_t [\Pi_{t+1}^{\epsilon-1} F_{t+1}] \quad (30)$$

where $\Pi_t = \frac{p_t}{p_{t-1}}$ is the gross inflation rate.

3.6 Monetary and fiscal policies

Monetary policy sets short term nominal interest rates following a standard Taylor rule with interest rate smoothing and potential reaction to the deviations of output and unemployment from their steady states.

$$\frac{R_t}{\bar{R}} = \left(\frac{R_{t-1}}{\bar{R}} \right)^{\zeta^R} \left[\left(\frac{\Pi_t}{\bar{\Pi}} \right)^{\zeta^\pi} \left(\frac{y_t}{\bar{y}} \right)^{\zeta^y} \left(\frac{u_t}{\bar{u}} \right)^{\zeta^u} v_t^R \right]^{1-\zeta^R} \quad (31)$$

$$\ln v_t^R = \rho_R \ln v_{t-1}^R + \varepsilon_t^R \quad (32)$$

where v_t^R captures a (persistent) monetary policy shock which follows an AR(1) process.

Fiscal policy is described by an exogenous and wasteful government consumption G_t , production subsidy τ to retailers, and unemployment benefits b^k , all of which are financed by lump-sum taxes T_t so that the government runs a balanced budget in every period.

$$T_t = b^H U_t^H + b^L u_t^L + G_t + \tau x_t y_t \quad (33)$$

$$\ln G_t = (1 - \rho_g) \ln(\bar{y}\Gamma) + \rho_g \ln G_{t-1} + \varepsilon_t^g \quad (34)$$

where Γ is the steady state share of government consumption out of output. The distribution of lump-sum taxes is assumed to be equal, i.e. $t_t^k = T_t$ for $k \in \{H, L, E\}$, so that we have $T_t = \sum_k \varphi^k t_t^k = T_t \sum_k \varphi^k$.

3.7 Market clearing

Since households can only trade bonds with each other, and not with the government or foreign agents, the bond market clears as follows:

$$\varphi^E b_t^E + \varphi^H b_t^H + \varphi^L b_t^L = 0 \quad (35)$$

Combining the budget constraints of the households and the government (and using the bonds market clearing condition) we get the goods market clearing condition. Final output is used for

¹⁷For detailed derivations, refer to the online appendix.

consumption, investment, government expenditures and posting vacancies.

$$y_t = C_t + \Delta_t I_t + G_t + \kappa^H v_t^H + \kappa^L v_t^L \quad (36)$$

where $C_t = \sum_{k \in (H,L,E)} \varphi^k c_t^k$ and $I_t = \varphi^E i_t$.

Equilibrium is described by equations (1) through (36).

This completes the description of the model.

4 Calibration

In parameterizing the model we use the following strategy. First, we consider the model period to be one quarter. Second, we set targets to the steady state values of participation and unemployment rates – separately for high and low-skilled labor markets. In doing this, we set values so that they track the pre-crisis averages for the U.S. As mentioned earlier, high-skilled workers are regarded to have college degrees or higher¹⁸. In terms of the model variables, these correspond to

$$\begin{aligned} partic_t^k &\equiv \frac{N_t^k + U_t^k}{\varphi^k} \\ unemp_t^k &\equiv \frac{U_t^k}{N_t^k + U_t^k} \end{aligned}$$

Parameters Φ^k, ϑ^k are calibrated so as to match the above targets.¹⁹ The exact values can be seen in Table 1, with blue color for targeted steady states and with red color for calibrated parameters.

The asymmetry in SAM frictions is captured by skill-specific parameters. We set separation rates $\sigma^H < \sigma^L$ and matching efficiencies $\rho_m^L < \rho_m^H$, which all result in larger frictions for the low skilled workers, making their steady state vacancy filling and hiring probabilities lower than that of the high skilled: $\gamma_h^L < \gamma_h^H, \gamma_f^L < \gamma_f^H$. This makes it relatively more costly for firms to post low-skill vacancies and for low-skilled households to increase their participation. The non-equal share of different skill types in the population φ^k and our skill-specific steady state targets for employment variables result in further asymmetries for calibrated parameters. In particular, the weight of leisure (inactivity) in the households' utility function will be higher for low-skilled workers $\Phi^H < \Phi^L$, while the bargaining power of the firm will be higher in the low-skill labor market $\vartheta^H < \vartheta^L$. The latter feature mitigates the relative costliness of low-skilled workers as the firm is able to capture a larger share of the surplus created by filling a low-skill vacancy. So does the slightly higher unit cost of posting a high-skill vacancy $\kappa^L < \kappa^H$. In addition, we have asymmetry also in the wage replacement rate of unemployment benefits b^k/w^k .

¹⁸According to this classification, 18 percent of our households are high-skilled workers, while 72 percent are low-skilled workers and the share of entrepreneurs in the economy is set to 10 percent.

¹⁹The details of on how the steady state is calculated can be found in the Online Appendix.

Parameters							
σ^H	0.0299	β	0.9900	κ^H	0.1400	ϵ	6.0000
σ^L	0.0505	η	2.0000	κ^L	0.1300	χ	0.8500
ρ_m^H	0.8630	ζ	4.0000	a^k	0.4300	τ	0.1667
ρ_m^L	0.3835	Φ^H	0.8529	λ	0.3500	Γ	0.2000
α^H	0.5000	Φ^L	21.1374	α	0.4000	ζ^R	0
α^L	0.5000	ξ	0.0010	γ	-0.4902	ζ^π	1.5000
ρ_w^H	0.0000	ω	4.0000			ζ^y	0
ρ_w^L	0.0000	δ	0.0100	ϑ^H	0.2515	ρ_ψ	0.7000
φ^H	0.1800	ϕ	2.0101	ϑ^L	0.6983	ρ_a	0.8500
φ^L	0.7200	h	0.8000	b^H	0.2818	ρ_g	0.7000
φ^E	0.1000	\bar{b}^k	0.0000	b^L	0.2432	ρ_R	0.7000
Steady state values							
w^H/w^L	1.6242	$partic^H$	0.7100	b^H/w^H	0.4000	K/y	3.0845
$(w^H n^H)/(w^L n^L)$	0.5242	$partic^L$	0.5700	b^L/w^L	0.5500	I/y	0.0308
$(w^H n^H)/(y - \kappa v)$	0.3215	$unemp^H$	0.0340	κ^H/w^H	0.1901	$(\kappa^H v^H + \kappa^L v^L)/y$	0.0417
$(w^L n^L)/(y - \kappa v)$	0.6132	$unemp^L$	0.0680	κ^L/w^L	0.2867	$partic$	0.6382
$(rK)/(y - \kappa v)$	0.0653			z	1.0000	$unemp$	0.0505
$skilled/(y - \kappa v)$	0.3868			x	1.0000		

Table 1: Parameters and selected steady-state values. 8 blue steady states are targeted by 8 red parameters.

Heterogeneity across high and low-skilled workers does not only come from the labor market, but, as captured by CSC, it also has to do with their different roles in production. We set elasticities of substitution based on the estimation of our production function by [Krusell et al. \(2000\)](#). This means $\frac{1}{1-\gamma} = 0.67$ and $\frac{1}{1-\alpha} = 1.67$, which makes high-skilled labor complementary to capital, while low-skilled labor becomes substitute.

Other parameters are set to standard values as common in the literature. In particular, the production subsidy is set to eliminate the static distortion coming from monopolistic competition $\tau = 1/\epsilon$, which makes the steady state real marginal cost (markup) x equal to one. ϕ is calibrated so as to have a steady state capital utilization rate z of unity.

As a result, under our baseline parameterization we get a steady state wage premium of 62%. The low- skilled labor market is much tighter $\theta^H < \theta^L$, as a result of its lower matching efficiency.

5 Theoretical results

We approximate the model by log-linearizing it around the deterministic steady state, and look at impulse responses to various shocks under different scenarios and parameterizations.

5.1 The effect of expansionary monetary policy shocks

An expansionary monetary policy shock (100 basis point cut in the nominal interest rate) stimulates aggregate demand, which leads to expanding output and inflationary pressures. Reacting to a higher relative price of the intermediate good x_t , firms increase their demand for capital and labor, which leads to rising investment and higher employment, together with higher wages and larger rent on capital. What happens in our labor market with SAM frictions is that firms start posting more vacancies while households raise their labor market participation in response to better job finding prospects. However, employment cannot suddenly react much (it is not a jump variable) being subject to SAM frictions according to (6), which is why most of the adjustment will take place through higher wages.²⁰

Heterogeneity in our labor market (asymmetric SAM) and different roles in production due to CSC imply that high and low-skilled workers will not experience the same increase in wages and employment. Under our baseline scenario an expansionary monetary policy shock leads to a rise in the skill premium $\frac{w_t^H}{w_t^L}$ of about 30%. As shown in the left panel of Figure 3, this also implies an increase in the income share $\frac{w_t^H n_t^H}{y_t - \kappa v_t}$ for the high skilled at the expense of a *decreasing* income share for low-skilled labor. This means that the benefits of a monetary easing are not evenly distributed, with high-skilled workers getting *relatively* more of the increase in real income than do low-skilled workers – even though both types are better off in absolute terms. To the extent that the low skilled are poorer to begin with (which is confirmed by a steady-state skill premium of 62%), a monetary expansion raises inequality. The right panel of Figure 3 shows that the increase in the relative income share of high skilled labor $\frac{w_t^H n_t^H}{w_t^L n_t^L}$ is driven mainly by different increases in wages, while changes in employment have a negligible effect.

At this stage a brief note of warning to the reader is due on the much larger responses of the skill premium in the calibrated model than in the estimated SVAR. The insight is that it is a common feature of SAM models is that, since employment (i.e. quantities) is a state variable whose current value is restricted due to SAM frictions, most of the adjustment to a shock takes place through wages (i.e. prices), whose changes can be quite large. This is the so-called "Shimer puzzle" and a popular attempt to overcome it is to assume ad-hoc wage rigidities which constrain these excessive wage movements. We do this in the sensitivity analysis and the responses of the skill premium to an unexpected interest rate reduction becomes much more muted. Thus, we do not really try to match the empirical SVAR results to the theoretical predictions, but only use them as a motivation device towards building a model which qualitatively points in the same direction.

It is not clear, however, where lies the source of the increase in inequality. In order to separately identify the effects of asymmetric SAM frictions on the one hand, and CSC on the other, we

²⁰This is a standard result in SAM models: as demand pressures run up against SAM frictions, the surplus coming from a match increases a lot. In other words, firms are willing to agree to a much higher wage during the Nash bargaining, since they are compensated by higher revenues.

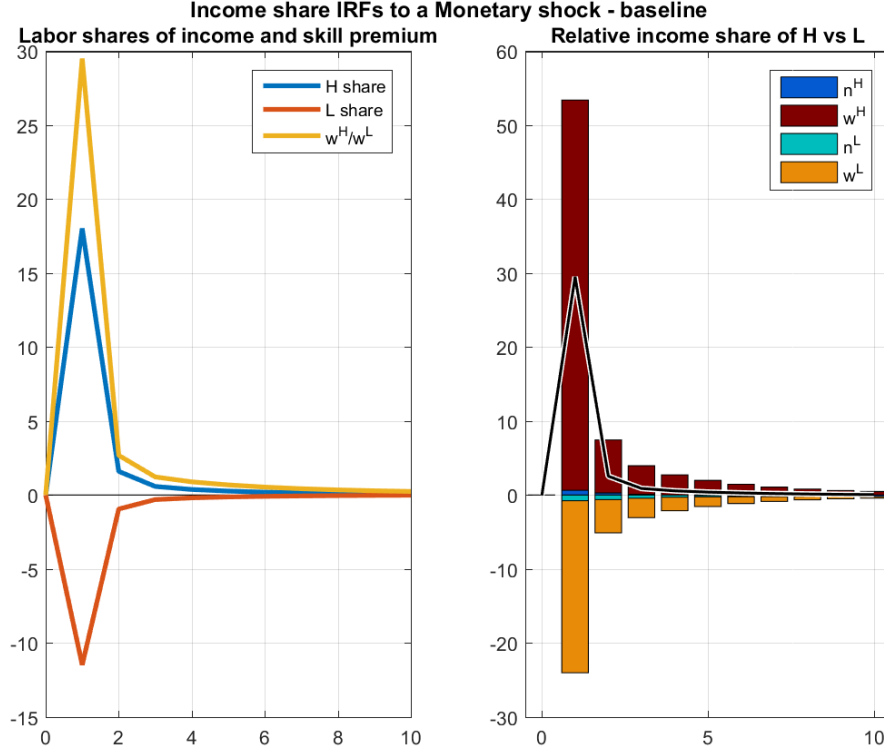


Figure 3: Income shares of labor types

construct a benchmark case with *symmetric* SAM frictions and a standard Cobb-Douglas (CD) production function where high and low- skilled labor are perfect substitutes (as defined by $\tilde{F}(\tilde{k}_t, n_t^H, n_t^L)$ above). Then we add either SAM asymmetry only or CSC only in order to compare the effect of each of these features against our benchmark. Finally, we add both sources of heterogeneity together to get back our original (baseline) scenario. The results of this exercise are shown in Figures 4 and 5.

Blue lines represent our symmetric benchmark. The results after introducing CSC are displayed in red lines. It can be observed that, by changing the characteristics of the production function, an expansionary monetary policy shock affects aggregate variables to a larger extent than it does affect relative variables. In particular, output now expands by much less, and there is a smaller fall in the non-employment rate $\frac{u_t + l_t}{n_t + u_t + l_t}$.²¹ However, looking at relative measures between high and low-skilled workers in Figure 5 we see almost negligible changes. The relative income share of high-skilled workers hardly changes. This would be contrary to our expectation that the increased demand for capital induced by a monetary expansion will benefit complementary high-skilled labor relatively more than substitutable unskilled labor. In fact, however, the relative marginal product of high-skilled labor $\frac{F_{n,t}^H}{F_{n,t}^L}$ does increase (though little) in line with the CSC effect discussed by Lindquist (2004) – we just still have some asymmetry in ϑ^k and Φ^k which

²¹The steady state share of investment is smaller in the CSC scenario which is why a similar proportional increase in investment leads to a smaller increase in output.

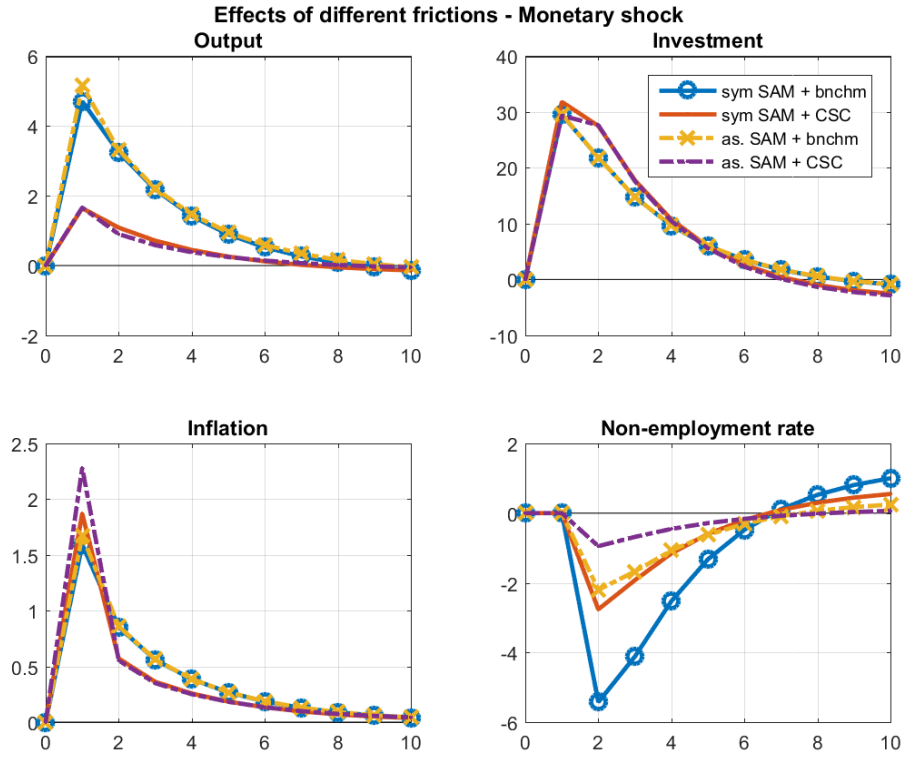


Figure 4: Effects of SAM asymmetry and CSC – aggregate variables

puts a wedge between marginal products and wages.²² At any rate, the overall conclusion of this exercise is that introducing CSC *only* on its own does not seem to have large effects on inequality.

The effects of introducing only SAM asymmetries (and keeping the benchmark CD production function) is plotted with yellow lines. In terms of *aggregate* variables the IRFs to an expansionary monetary shocks are essentially identical to the benchmark case, which suggests that labor market heterogeneity does not have significant effects at the macro level, provided we have the same production technology. In contrast, high versus low-skilled *relative* variables are affected significantly. As discussed in the calibration section, larger SAM frictions in the low-skill sector make it relatively more costly for firms to open low-skill vacancies and for households to enter the low-skill labor market. Likewise, the value of an unskilled match is relatively lower since the resulting job is more likely to be terminated and a subsequent match is less likely to take place. This results in a nearly 8% increase in the skill premium. The picture for employment is more mixed: the non-employment rate of skilled workers falls more initially, but later on becomes slightly higher than the non-employment rate of unskilled workers. The participation

²²This is an artifact of the way we engineered SAM symmetry. Recall from our calibration strategy that ϑ^k and Φ^k are not free parameters but residuals of our steady state targets. Even with symmetric steady-state employment targets, CSC introduces a non-zero steady-state skill premium, which then leads to different values for the above parameters. Fixing these parameters symmetrically instead of our employment targets would force us to abandon our steady-state calculation strategy.

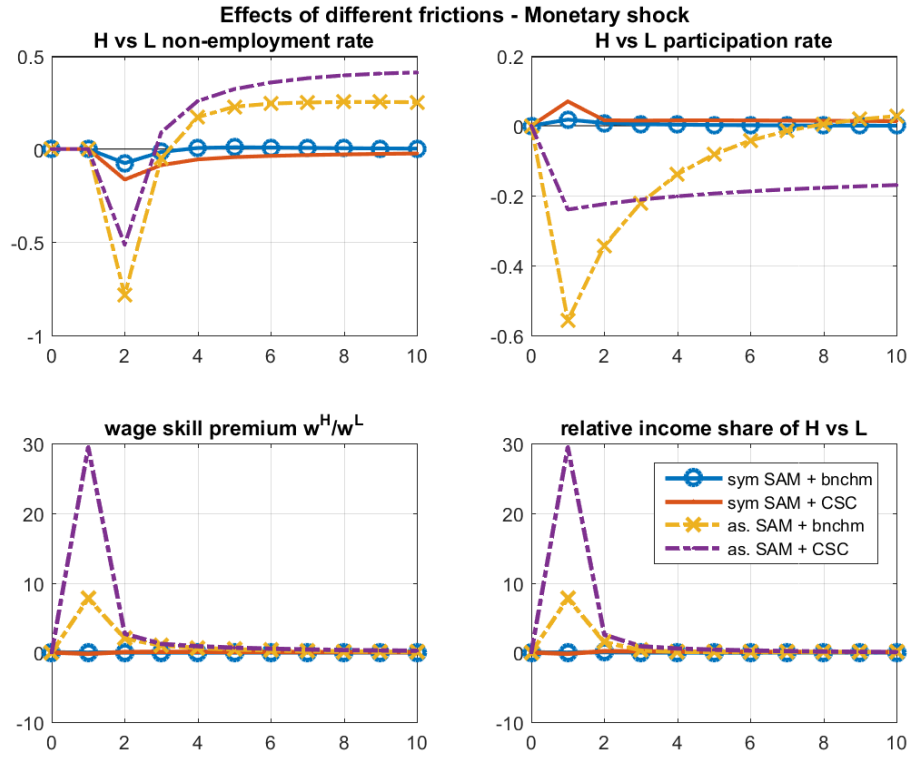


Figure 5: Effects of SAM asymmetry and CSC – relative variables

rate also rises less for high-skilled workers (i.e., their leisure consumption drops by less). In any case though, the magnitudes of these employment changes are small, and most of the increase in the relative income share of high-skilled workers is driven by the skill premium in wages. This leads to the conclusion that a monetary expansion increases inequality under asymmetric SAM frictions.

Finally, we introduce CSC on top of SAM asymmetry, where this scenario is plotted with purple lines. In contrast to introducing CSC in a symmetric labor market environment (blue *vs.* red lines), this time one can observe sizeable changes in the responses of relative variables between the yellow and purple lines (while aggregate variables change by a similar amount as before). Both the responses of non-employment and participation rates change in favor of high-skilled workers, while their wage premium rises even more, driving the 30% increase in the relative income share for skilled labor. Therefore, under a heterogenous labor market CSC makes the effect of a monetary expansion more beneficial for high-skilled workers, contributing to increasing inequality.

The *interaction* of CSC with asymmetric SAM frictions, however, is crucial for this result. Introducing CSC on its own has little effect on the relative income share, while SAM asymmetry alone leads to a modest rise only. In fact, CSC more than triples the effect of SAM asymmetry, amplifying the rise in inequality. This indicates that SAM asymmetries are required for CSC to exert its effect in full. The insight for this result is that the increase in labor demand induced by

an unexpected monetary expansion leads to larger wage increases for high-skilled workers who have smaller matching frictions (SAM-asymmetry channel). In addition, the increase in capital demand amplifies this wage divergence due to high-skilled workers being more complementary to capital than substitutable unskilled ones are (CSC channel)

5.2 Different monetary policy strategies

In addition to analyzing the effects of an *unexpected* monetary policy shock on inequality, it is also important to know how different kinds of *systematic* monetary policy strategies perform in the response to other shocks that could be a source of cyclical fluctuations. To this end, we analyze the impulse responses of the economy to shocks in: (i) TFP, (ii) government spending, (iii) cost-push, and (iv) investment specific and (v) discount factor shocks. Our baseline monetary policy strategy is described by a standard Taylor rule, as in (31), where $\zeta^\pi = 1.5$ and the rest of the reaction parameters are set equal to zero. For the sake of brevity, we do not report these results (available upon request) but just our main findings. These are that, while aggregate variables might react differently to these shocks, relative labor market variables tell basically the same story conditional on whether the shock strengthens or weakens aggregate demand²³. Another noticeable feature is that a shock to government expenditure increases the skill premium but by much less (around 3 percent) than a monetary shock since it crowds out investment. The rise in inequality, however, is larger under shocks lowering the discount rate and the price of investment which lead to larger investment. In other words, the effects of CSC on inequality are qualitatively similar under a monetary easing than under any other shock which leads to an expansion in demand: inequality rises more CSC than in its absence.

Given these effects, a monetary policy rule which can stabilize demand could also prevent the distributional consequences of these shocks. It has been shown that, in a basic New Keynesian model, some of the above mentioned shocks exhibit the so called *divine coincidence*, whereby the central bank does not face any trade-off between stabilizing inflation and the welfare-relevant output gap (Blanchard and Galí, 2007). In such cases, strict inflation targeting (IT) is the optimal policy, which also stabilizes aggregate demand.²⁴ Based on the above considerations, in our setup this also means that the relative income share of high-skilled labor would be stabilized under a strict IT regime in the face of divine coincidence shocks. Indeed, approximating strict IT by setting $\zeta^\pi = 100$ in our Taylor rule, monetary policy manages to almost completely stabilize output (hence demand) and the income shares of both types of labor in the face of positive TFP, government expenditure or other demand shocks.

²³This is especially true for shocks that increase substantially investment demand such as monetary policy shocks, shocks to the price of investment and discount factor shocks.

²⁴Blanchard and Galí (2010) and Ravenna and Walsh (2011) show that, in the presence of labor market frictions, the divine coincidence vanishes, but delivering price stability remains very close to the optimal policy. This is also the in our model with SAM frictions where the divine coincidence does not hold either but strict IT still does a good job in stabilizing the economy in response to these shocks.

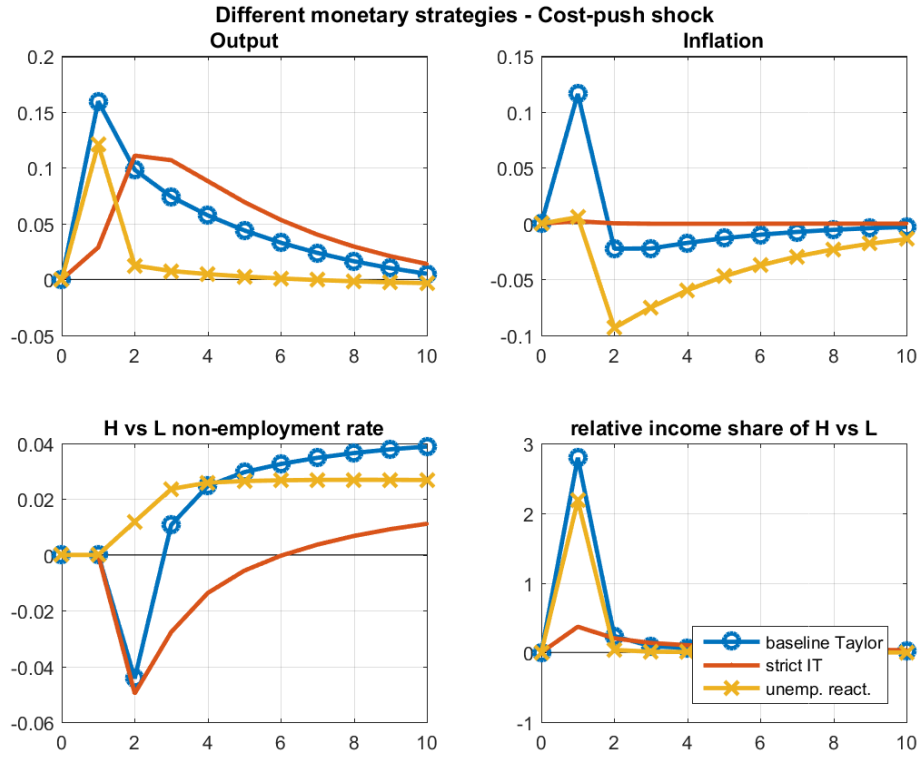


Figure 6: IRFs to a favourable cost push shock under different monetary policy rules – case of capital-skill complementarity

Some shocks, however, are not subject to the divine coincidence, meaning that a monetary policy rule focused solely on price stability might lead to large output fluctuations, and thereby deviations in the relative income share of high-skilled labor. To examine this, we look at the IRFs of a favourable *cost-push shock*, which introduces a trade-off between inflation and output stabilization.²⁵ In Figure 6 we compare these responses under various monetary policy regimes. The baseline policy rule features $\zeta^\pi = 1.5$, while with strict IT it becomes $\zeta^\pi = 100$. We also introduce another regime under which the central bank explicitly reacts to the deviation of unemployment from its steady state, i.e. in terms of (31) we set $\zeta^u = 0.5$ together with the baseline $\zeta^\pi = 1.5$ – we can call this strategy *flexible* inflation targeting.

As Figure 6 shows, following a favorable cost-push shock, strict IT stabilizes inflation almost fully, but it cannot prevent output from rising above its steady-state value. However, even with a much more aggressive stance against inflation than in our baseline Taylor rule, strict IT leads to a smaller increase in output.²⁶ This is because the strict commitment to price stability helps the central bank manage inflation expectations more efficiently, and this improves the trade-off along the Phillips Curve. This is why a given change in the inflation rate requires

²⁵For simplicity, cost-push shocks are included as an ad-hoc term in the pricing equation (29).

²⁶Under our baseline monetary policy regime, inflation *rises* on impact in response to a favourable cost-push shock, which is unusual. The reason for this move is that the expansionary effects of the shock set off such a large increase in demand that it outweighs the initial deflationary pressure. The latter can dominate, however, if monetary policy becomes relatively less focused on inflation, as is the case with $\zeta^u = 0.5$.

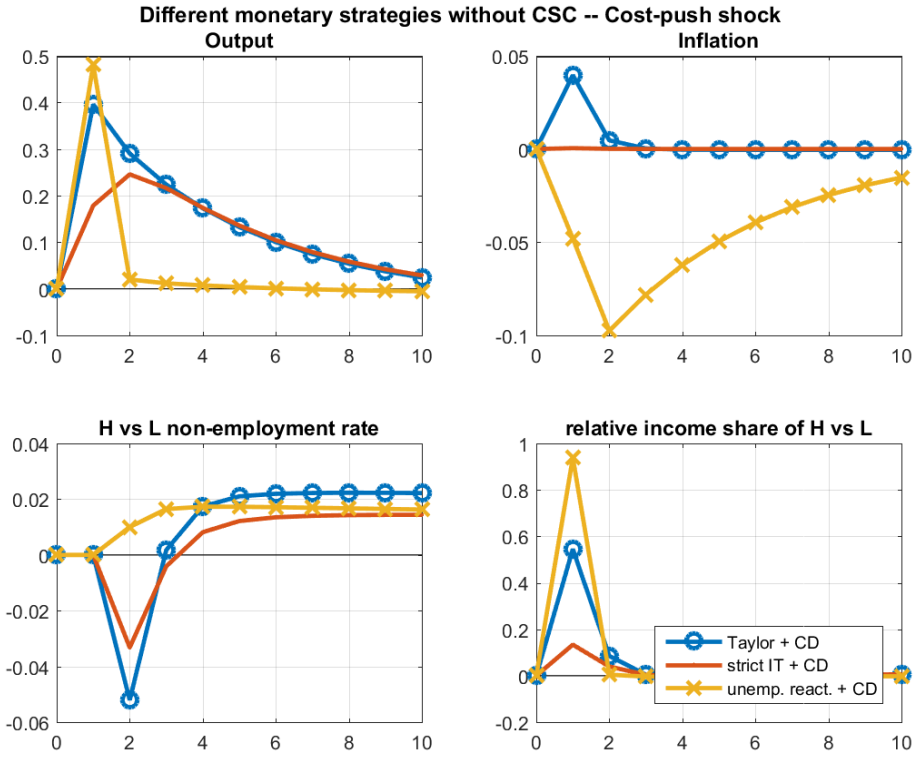


Figure 7: IRFs to a favourable cost push shock under different monetary policy rules – *without* capital-skill complementarity (i.e. standard Cobb-Douglas production functions)

a smaller sacrifice in terms of output deviation. In contrast, when monetary policy becomes relatively more lenient on inflation, by explicitly reacting to unemployment as well, the trade-off gets worse. As can be seen from Figure 6, although output rises less than in the baseline, this comes at the cost of inflation lower below target. Compared to strict IT, output even rises *more* on impact (despite the explicit reaction), although later on flexible IT manages to almost completely end the expansion.

These different demand stabilization properties of our alternative policy rules also carry over to their ability to offset the distributional consequences of the cost-push shock. In this respect, our baseline Taylor rule performs the worst. The regime with unemployment reaction delivers slightly more stable paths for the relative income share, while strict IT prevents most of the deviation on impact even though later on it fares a bit worse than flexible IT.

The above ranking of different monetary policy rules in terms of their efficacy in muting the distributional effects of cost-push shocks is derived under CSC. Hence, it is interesting to check how this ranking would change were CSC absent. To do so, we plot impulse responses under our alternative monetary policy regimes using the benchmark CD production function instead of CSC. The results are presented in Figure 7.

The main difference between Figure 6 and Figure 7 is that in the latter flexible IT, i.e. the policy rule with $\zeta^u = 0.5$ (in yellow), now leads to the largest increase in output as well as the largest

deviation in the relative income share of high-skilled labor. This is in contrast to the case with CSC in Figure 6, where an explicit reaction to unemployment deviation slightly *improved* the performance of monetary policy in stabilizing inequality compared to the baseline Taylor rule. Therefore, from an inequality point of view, the presence of CSC seemingly favors a monetary policy rule which explicitly reacts to unemployment as well.

5.3 Sensitivity analysis

5.3.1 Elasticities of substitution

CSC is captured in our model through the elasticity of substitution between capital and high skilled labor, $\frac{1}{1-\gamma}$. This elasticity is below unity in our baseline parameterization signaling the complementary relationship between the two. Given the above effects of CSC, increasing complementarity through this parameter should lead to similar changes as the switch from the benchmark Cobb-Douglas production function to the one in our baseline scenario with CSC (and vice versa when decreasing it).

As Figure 8 shows, the results of this exercise confirm our previous conclusions. A larger degree of complementarity (i.e. lower elasticity of substitution, with yellow lines) favors high-skilled workers even more after an expansionary monetary policy shock. As demand for capital increases, firms need even more skilled labor relatively to unskilled workers. This is reflected in a larger skill premium which in turn drives the relative income share higher.²⁷ Conversely, decreasing complementarity (red lines) results in the opposite changes. Notice, that in the latter scenario we still maintain the relation $\frac{1}{1-\alpha} = 1.67 > \frac{1}{1-\gamma} = 1.33$, which captures CSC in the sense defined by Lindquist (2004), even though capital and high-skilled workers are now substitutes (but less so than capital and unskilled workers are). If we went up to the point where $\frac{1}{1-\gamma} > \frac{1}{1-\alpha}$, then the CSC channel would switch sign and it would actually *reduce* the increase in the relative income share compared to the case with only asymmetric SAM frictions and a Cobb-Douglas production function, instead of amplifying it.

Notice also the similar change in the responses of output in Figure 8 compared to Figure 4. Increasing CSC (either through γ or through switching from the benchmark CD to our baseline production function) mutes the expansion of aggregate demand after a monetary easing. This is because the production function is becoming "more restrictive" in the sense that the same inputs can be combined in fewer ways, or equivalently, most combinations will yield lower output (just think about the isoquants). In contrast, increasing the degree of substitutability in the production function will allow output to react more flexibly – in this case even more than with the benchmark Cobb-Douglas.

²⁷Non-employment *rate* differences, however, do not change in favor of high skilled workers. This might only be some base effect, as differences in high and low- skilled employment *levels* change in favor of the skilled workers.

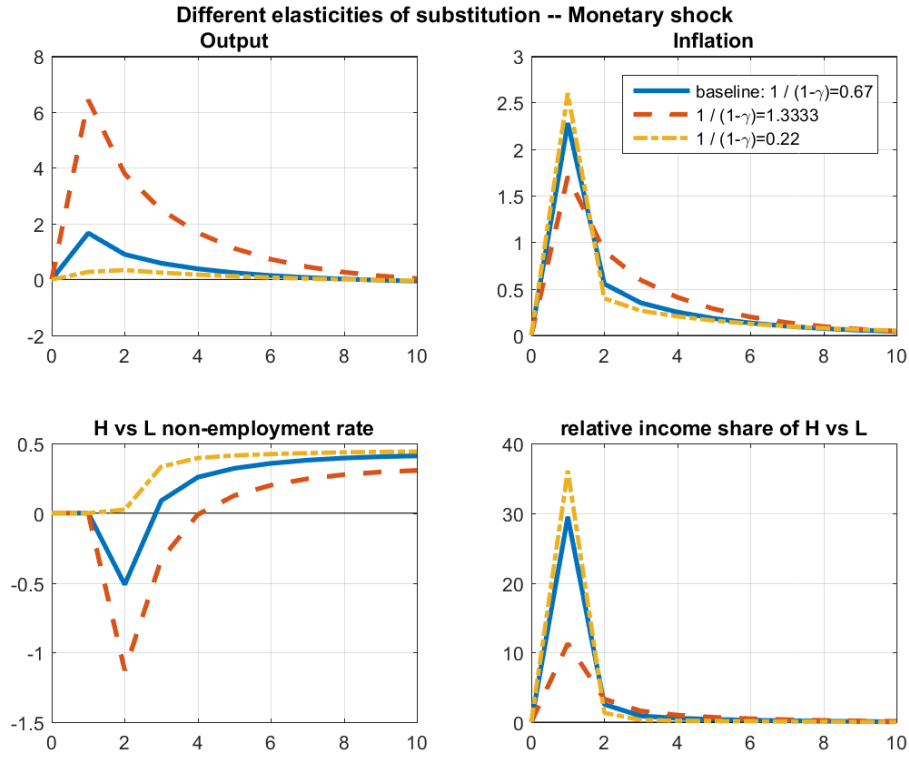


Figure 8: The effects of different elasticities of substitution $\frac{1}{1-\gamma}$ between capital and skilled labor – expansionary monetary policy shock, asymmetric SAM frictions, capital-skill complementarity

5.3.2 Wage rigidities

All the above results about inequality are driven mainly by large (and unrealistic) changes in wages, as is often the case in SAM models. Therefore it is important to check whether they still hold in the presence of wage rigidities. We do this by considering positive values for ρ_w^k in equation (27) capturing (in an admittedly ad-hoc way) higher wage persistence. After introducing symmetric wage rigidities by setting $\rho_w^H = \rho_w^L = 0.8$, the signs of the effects of CSC and asymmetric SAM frictions in response to an unexpected monetary easing (as identified by the bottom right panel of Figure 5) do not change, although their magnitude is mitigated. The same holds in the case of asymmetric wage stickiness where $\rho_w^L = 0.8 > \rho_w^H = 0.6$. However, wage rigidities do overturn our previous result regarding monetary policy strategies, namely, that from an inequality perspective the presence of CSC makes it slightly more beneficial to have a policy rule which explicitly reacts to unemployment after a cost-push shock – compared to the baseline Taylor rule without such reaction. As it happens with wage rigidities and a Taylor-rule with unemployment reaction, a cost-push shock is much more destabilizing than without such reaction, independently of whether CSC is present or not.

If we only deviate from the baseline scenario in allowing for wage rigidity, then the effects of an unexpected monetary easing change according to what is shown in Figure 9. Symmetric wage stickiness (with red lines) mitigates the deviation in the relative income share of high-skilled

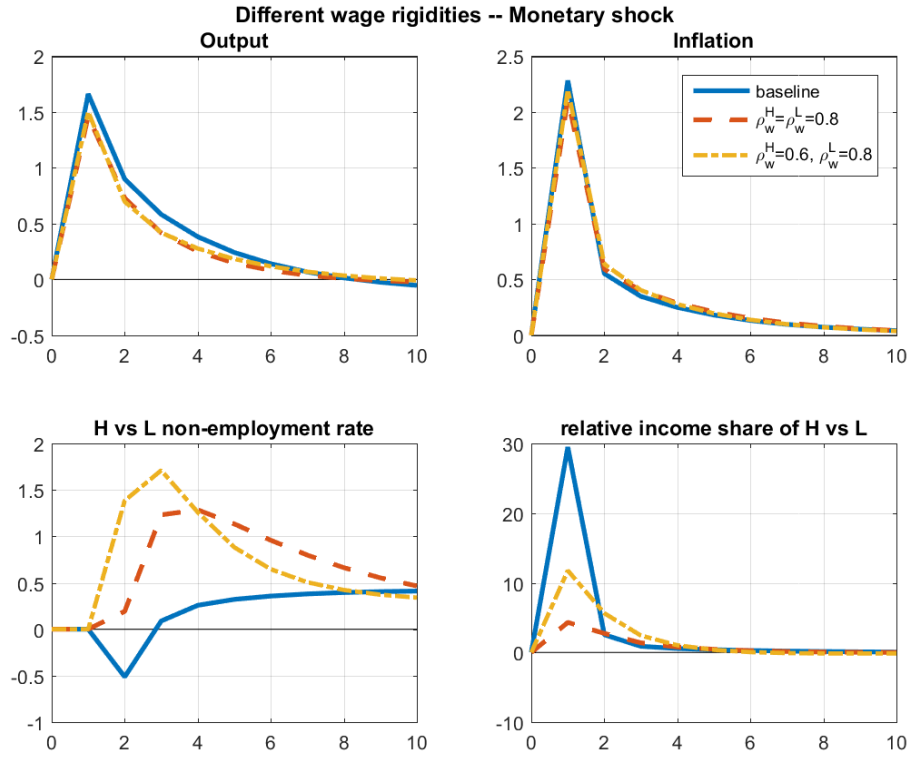


Figure 9: The effects of wage rigidities under an expansionary monetary policy shock – asymmetric SAM frictions, capital-skill complementarity

workers. However, if we increase the stickiness of low- skill wages further (asymmetric case, with yellow lines), then we retrieve the original effect. This is not surprising, since it is now relatively easier to increase the wages of high- skilled workers, and a rise in the skill premium would be exactly what economic forces would push for in the absence of wage rigidities. Meanwhile, aggregate variables are not affected much.

5.3.3 Effect of financial market structure

In general, the incomplete financial market structure of our baseline scenario prevents perfect risk sharing in consumption among different households. In particular, the idiosyncratic effects of aggregate shocks cannot be fully insured against, leading to fluctuations in the ratio of marginal utilities $\frac{\lambda_t^{c,i}}{\lambda_t^{c,j}}, j \neq i$. In other words, we observe fluctuating consumption inequality under incomplete markets. In contrast, complete markets would prevent any such fluctuations, and keep consumption ratios constant across households.²⁸

This can be inspected in Figure 10. Even though the skill premium and relative income shares change in a similar way under our baseline incomplete (blue lines) and complete markets setup (yellow lines), in the former case we see that the rise in the skill premium leads to a higher consumption path for skilled workers relative to their unskilled peers. By contrast, under complete

²⁸For further details we refer back to Section 3.2.3.

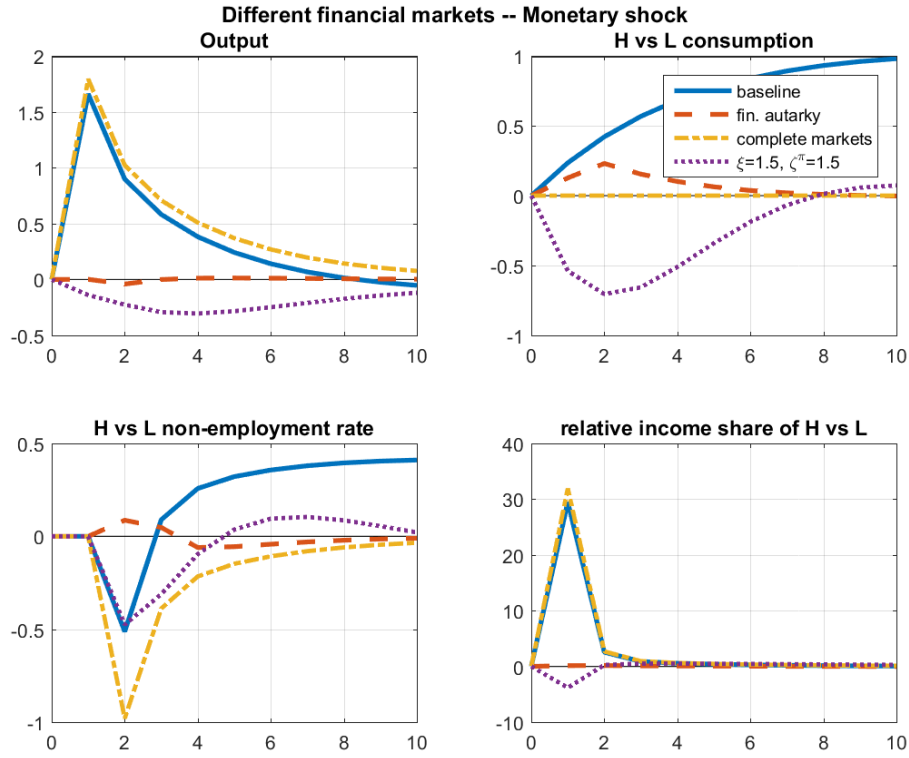


Figure 10: The effects of different financial market structures under an expansionary monetary policy shock – asymmetric SAM frictions, capital-skill complementarity. Baseline scenario is incomplete markets with $\xi = 0.001$ and $\zeta^\pi = 1.5$, while the financial autarky case features $\zeta^\pi = 27$ in order to impose a unique stable solution.

markets there is no such fluctuation in consumption inequality despite leading to a similar rise in the skill premium. This points to the fact that, while an expansionary monetary policy shock can have the same effects on wage inequality, its effect on consumption inequality can differ starkly, depending on the financial market structure. This is why the latter is important from a welfare point of view.

Notice that aggregate variables and prices move very similarly under complete and incomplete markets. This is to be expected, as the main difference is the lack of insurance against the *idiosyncratic* aspect of shocks under incomplete markets, while even complete markets cannot insure against *aggregate* shocks. Consequently, it is individual variables which differ noticeably across the two cases, as can be seen from the consumption and non-employment rate responses of different workers. Recall, that complete markets provide insurance for *consumption*, but not for *leisure*, which is why even under this setup we see fluctuating differences in the non-employment rate of skilled versus unskilled workers (bottom left panel).²⁹

²⁹High- skilled workers do not increase their participation as much as low- skilled workers (i.e. they consume relatively more leisure), as they feel wealthier. Notwithstanding, their non-employment rate still drops more because of their better employment prospects. This is the case throughout the complete markets responses, while under incomplete markets the participation effect will dominate in the long run due to persistence in leisure demand.

Another relevant result to notice is how persistent the IRFs of individual variables are under incomplete markets. By introducing portfolio-adjustment costs ξ only slightly higher than zero, we ensured stationarity of the model, but only barely so. The ratio of marginal utilities still behaves close to a random walk process, so the effect of any idiosyncratic shock will be highly persistent. High-skilled workers can save the unexpected temporary increase in their wages which makes them persistently richer allowing them to consume more goods and leisure for a long time. The complete-markets model does not feature this kind of non-stationarity or persistence due to the perfect risk-sharing property, whereby a full set of securities provide insurance against any type of unexpected idiosyncratic contingency.³⁰

Increasing portfolio adjustment costs ξ does not make markets "more incomplete" (as we still have the same single financial instrument), but it does make financial trade more difficult. However, this does not only make risk-sharing across households less effective, but also affects aggregate outcomes because financing investment becomes costlier. Under the scenario depicted in purple lines, entrepreneurs can borrow less from workers, since the latter do not save as much from their wage increases due to higher saving costs. This has such an adverse effect on investment that aggregate demand actually declines, pushing relative income shares and consumption inequality in the opposite direction to what was observed before.

Finally, consider the case of financial autarky (depicted with red lines) which can be approximated by $\xi \rightarrow \infty$. This scenario is not directly comparable to the ones above because in order to ensure a stable unique equilibrium, the Taylor-coefficient of the monetary authority had to be increased to 27. In fact, increasing ξ beyond 1.5 requires to increase the Taylor-coefficient as well³¹. This is an important result, as it shows that, in the absence of financial markets, monetary policy might not be able to pin down the path of prices unless it reacts very aggressively to inflation deviations from its target. The reason is that with less access to financial instruments agents become less responsive to interest rate changes when making their consumption-saving decisions, i.e. they start behaving more like hand-to-mouth households. This unresponsiveness to changes in interest rates compromises the stabilizing effect of the Taylor principle which is needed to prevent sunspot equilibria.

³⁰The incomplete markets model would not exhibit non-stationarity either if we solved it globally in a non-linear way – instead of by local approximation around the non-stochastic steady state. In that case consumption growth would depend on asset holdings even without imposing portfolio adjustment costs. This is due to the combination of idiosyncratic uncertainty and the presence of a borrowing constraint, where the risk of hitting the latter would constrain individual borrowing (precautionary saving motive). Therefore, assets would become an important state variable in the agent's decision problem, providing a feedback into consumption and inducing stationarity.

³¹The Taylor coefficient needs to be increased by gradually less, converging to 27 under current parameterization – see online appendix for details

5.4 Welfare analysis

5.4.1 Monetary expansion

The above discussion has shown how monetary policy might affect wage inequality in the presence of CSC and asymmetric SAM frictions. We have also seen how this wage inequality might translate into consumption and leisure inequalities under different financial market structures. In this section we explore the welfare consequences of these fluctuations in inequality.

We consider the effects of an expansionary monetary policy shock for $T = 20$ periods (after which the shock fades away) and calculate the following consumption equivalent welfare measures.

$$\begin{aligned}
\sum_{t=0}^T \beta^t \sum_k \varphi^k u(\mu c^k, l^k) &= \underbrace{\sum_{t=0}^T \beta^t \sum_k \varphi^k u(c_t^k, l_t^k)}_{W_{0,T}} \\
\sum_{t=0}^T \beta^t \sum_k \varphi^k u(\mu^{\text{level}} c^k, l^k) &= \underbrace{\sum_{t=0}^T \beta^t \sum_k \varphi^k u\left(c^k \frac{C_t}{C}, l^k \frac{L_t}{L}\right)}_{\tilde{W}_{0,T}} \\
\sum_{t=0}^T \beta^t \sum_k \varphi^k u(\mu^{\text{ineq}} c^k \frac{C_t}{C}, l^k \frac{L_t}{L}) &= \underbrace{\sum_{t=0}^T \beta^t \sum_k \varphi^k u(c_t^k, l_t^k)}_{W_{0,T}} \\
\sum_{t=0}^T \beta^t u(\mu_k c^k, l^k) &= \underbrace{\sum_{t=0}^T \beta^t u(c_t^k, l_t^k)}_{W_{0,T}^k} \quad \text{for } k \in H, L, E
\end{aligned}$$

where μ is a measure of aggregate welfare comparing the $T = 20$ periods under the monetary shock consisting of a cut of 100bp in the interest rate with the case of shock (i.e. the steady state). This can be decomposed into contributions of a change in the average level of consumption and leisure on the one hand (μ^{level}), and of a change in the dispersion of consumption and leisure across different households (μ^{ineq}) on the other hand. For this decomposition we have constructed a synthetic case where the distribution of individual variables mimics that of the steady state but everything is scaled up to reflect average levels in the actual shock scenario. Finally, μ_k shows how individual households' welfare is affected as a result of the shock.

As Table 2 shows, in our baseline scenario a monetary expansion actually *reduces* aggregate welfare by 0.07 % of steady state consumption. The change in average consumption (which increases) and leisure (which falls due to higher participation rates) are such that they exactly offset each other in terms of welfare. Therefore, the whole reduction in welfare is driven by higher inequality across households. The last two columns show that high-skilled workers are better off by 2.06 % of their steady state consumption, while low- skilled workers are worse off by

100*	$\mu - 1$	$\mu^{\text{lev}} - 1$	$\mu^{\text{ineq}} - 1$	$\mu_H - 1$	$\mu_L - 1$
baseline	-0.07	0.00	-0.07	2.06	-0.17
$\zeta = 100$	0.33	0.07	0.26	1.26	0.35
complete markets	-0.82	-0.91	0.08	-0.57	-0.88
sym SAM + CD	3.15	1.72	1.38	3.15	3.18
asym SAM + CD	1.20	0.46	0.74	2.02	1.12
$\gamma = 0.25$	0.34	-0.12	0.46	1.79	0.23
$\gamma = -3.5$	-0.10	0.08	-0.17	2.27	-0.19

Table 2: Consumption equivalent welfare measures shown in percentages, i.e. in the form $(\mu - 1) * 100$. These compare the effects of an unexpected monetary expansion in the following $T = 20$ periods relative to the no shock scenario.

0.17 %.³² This is driven by the aforementioned rise in consumption inequality, driven in turn by an increase in the relative income share. Yet, these measures also include different fluctuations in leisure, which initially falls less, then increases persistently higher for high skilled than for low skilled workers.

To filter out the effects coming from leisure (and focus only on consumption), we next examine a scenario with nearly inelastic labor supply ($\zeta = 100$), so that leisure and participation changes become negligible. This shows that now both types of workers are better off as a result of a rise in their consumption, but this effect is larger for high-skilled workers since they can afford even more consumption due to the rise in the skill premium.³³ In contrast, complete markets prevent any fluctuations in consumption inequality (even with an increasing relative income share of the skilled workers), while both types of workers have to work more which makes them both worse off. This negative effect is again larger for unskilled workers, but they started from a higher leisure level to begin with. Thus, in terms of "leisure-inequality" this actually improves on aggregate welfare (hence the positive μ^{ineq}).

In line with our earlier results, an expansionary monetary policy shock leads to negative welfare effects through its adverse effects on inequality under CSC and SAM asymmetry. Similarly to the ranking in the responses of relative income shares of high *vs.* low-skilled workers (which translate into similar differences in consumption inequality), it can be seen that the contribution of inequality to welfare (μ^{ineq}) follows a similar pattern. In the case with symmetric SAM frictions and no CSC, the skill premium remains constant, consumption and leisure inequality do not change, and both types of workers become better off by approximately the same amount (due to increasing consumption levels and persistently falling participation).³⁴ As we introduce SAM asymmetry, we see that the rise in the skill premium leads to larger inequality also in consumption which is why μ^{ineq} drops. Finally, when we add CSC on top of asymmetric SAM

³²Entrepreneurs are also worse off due to falling profits, and therefore falling consumption. The countercyclicity of profits is a well-known feature of New Keynesian models.

³³This rise in consumption inequality across workers is offset by a fall in entrepreneurs' consumption, which is why μ^{ineq} is positive, i.e., overall consumption inequality falls.

³⁴The fact that $\mu^{\text{ineq}} > 0$ is again due to the fall in entrepreneurs' consumption, which improves consumption inequality.

frictions (our baseline scenario), μ^{ineq} drops even further, just like when we further increase the degree of CSC by making high-skilled workers even more complementary to capital ($\gamma = -3.5$). This illustrates the effect of CSC in making a monetary expansion contribute to rising inequality and decreasing welfare.

5.4.2 Favourable cost-push shock

In Section 5.2 we have already seen how the effects of cost-push shocks on the macroeconomy and inequality can be different under various monetary policy strategies. Table 3 shows how these policy rules perform in terms of welfare and how they interact with CSC.

100*	$\mu - 1$	$\mu^{\text{lev}} - 1$	$\mu^{\text{ineq}} - 1$	$\mu_H - 1$	$\mu_L - 1$
baseline (Taylor)	-0.02	-0.03	0.01	0.21	-0.03
unemp. react	-0.05	-0.08	0.03	0.07	-0.05
strict IT	0.01	0.02	-0.01	0.14	0.00
CD (Taylor)	0.10	0.01	0.09	0.19	0.09
CD + unemp.react.	0.06	-0.02	0.08	0.12	0.05
CD + strict IT	0.10	0.08	0.02	0.14	0.10

Table 3: Consumption equivalent welfare measures shown in percentages, i.e. in the form $(\mu - 1) * 100$. These compare the effects of a favourable cost-push shock in the following $T = 20$ periods relative to the no shock scenario.

Under CSC, an explicit reaction to unemployment by the central bank leads to more favourable welfare outcomes with respect to inequality (μ^{ineq} being higher). In contrast, the relation is reversed in the absence of CSC (with a standard CD production technology). This is in line with what Figures 6 and 7 suggest, namely, that flexible inflation targeting stabilizes the skill premium (and therefore consumption inequality) more than the baseline Taylor rule only under CSC, but otherwise it does not. Moreover, both with and without CSC, flexible IT delivers lower aggregate welfare since lower average levels of consumption and/or leisure (μ^{lev} being lower) dominate differences in μ^{ineq} . Therefore, in spite of its slightly more favourable inequality features, it is not the preferred policy rule even in the presence of CSC.

Strict inflation targeting performs the best in terms of aggregate welfare both under CSC and CD production technology (highest μ). However, this is mainly due to its ability to deliver higher average levels of consumption and/or leisure but not because it fares well in terms of inequality – which is higher (lower μ^{ineq}). This is somewhat in contrast to what we would expect based on Figures 6 and 7, where strict IT was the most successful rule stabilizing the skill premium, and hence consumption inequality, in the face of a favourable cost-push shock. The reason is that even though consumption inequality is better under strict IT, "leisure inequality" worsens considerably. As output expands, high-skilled workers increase their labor force participation more than under other policy rules (without actually earning that much more), which affects inequality adversely since they consumed less leisure than their low-skilled peers to begin with.

6 Conclusions

In order to improve our understanding of the channels through which monetary policy might affect inequality, we have built a New Keynesian model with capital-skill complementarity (CSC) in the production function and asymmetric search and matching (SAM) frictions in the labor market between high and low-skilled workers. Our main result is that an unexpected monetary easing increases earnings inequality by raising the relative income share of high skilled workers. Disentangling the effects of different sources of heterogeneity we find that the *interaction* of CSC and SAM asymmetry is crucial in delivering this result. In effect, while the increase in labor demand induced by an unexpected cut in interest rates leads to larger wage increases for high-skilled workers with smaller matching frictions (SAM-asymmetry channel), the increase in capital demand amplifies this wage divergence due to these workers being more complementary to capital than substitutable unskilled ones are (CSC channel). These findings are not qualitatively specific to monetary policy shocks but turn out to be similar for any other type of shock which stimulates aggregate demand, although to a lesser degree. The reason is that an unexpected easing of monetary policy stimulates investment, while, say, an unexpected expansionary fiscal shock crowds it out. These results are robust to including wage rigidities.

Our second main result is that, in the face of shocks which introduce a trade-off between stabilizing inflation and aggregate demand, a systematic monetary policy rule focusing on price stability (*aka* strict inflation targeting) is the most successful rule in terms of stabilizing measures of earnings inequality – while, for shocks with the *divine coincidence* property, strict IT manages to completely stabilize the whole economy. A more unusual finding is that the presence of CSC alters the ranking of policy rules as regards their ability to stabilize the relative income share of high skilled labor: unlike the case of no CSC, reacting explicitly to unemployment slightly improves upon the performance of a basic Taylor rule which only reacts to inflation. The latter result, however, is not robust to different parameterizations, such as higher capital intensity or wage rigidities.

Our findings are not to be taken as suggestions for what optimal monetary policy should be, nor as proposals that central banks should consider reacting to measures of inequality. Issues of inequality might be best dealt with by other policy areas led by elected officials. Nonetheless, it is worth being aware of the potential distributional consequences of monetary policy actions even if it is not among the objectives in the mandate of central banks. We aimed to contribute to a deeper understanding of these forces.

That said, our main result that monetary easing increases earnings inequality should also be interpreted with caution. We have focused in this paper only on one particular channel, namely the joint effect of CSC and asymmetric SAM frictions, while in reality the channels through which monetary policy affects inequality are more complex than what our model is capable of capturing. For example, as pointed out in the Introduction, an unexpected cut in interest rates

should increase inflation which harms lenders and benefits borrowers, and conversely with an unexpected rise in interest rates. As a result, this alternative channel, which is not accounted for in this paper, would operate the other way around: inequality goes down (up) when the interest rate is subject to a negative (positive) shock, whereas our mechanism implies that it goes up (down). However, the alternative mechanism impinges on capital/ debt income whereas ours operates through wages and employment, which constitute the two key variables we have focused on here to highlight a channel which, to our knowledge, is novel. For a more complete picture and a more comprehensive welfare study, further analysis and different models are needed.

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