UNEMPLOYMENT (FEARS) AND DEFLATIONARY SPIRALS

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Abstract
The *interaction* of incomplete markets and sticky nominal wages is shown to magnify business cycles even though these two features – in isolation – dampen them. During recessions, fears of unemployment stir up precautionary sentiments which induces agents to save more. The additional savings may be used as investments in both a productive asset (equity) and an unproductive nominal liquid asset. The desire to hold the nominal liquid asset puts deflationary pressure on the economy which, provided that nominal wages are sticky, increases labor costs and reduces firm profits. Lower profits repress the desire to save in equity, which increases (the fear of) unemployment, and so on. This mechanism causes the model to behave differently from its complete markets version and is quantitatively important even if monetary policy counteracts the desire to hold more of the liquid asset by lowering the interest rate. The deflationary pressure yields a mean-reverting reduction in the price level, which implies an increase in expected inflation and a *decrease* in the expected real interest rate even if the policy rate does not adjust. Thus, our mechanism is different from the typical zero lower bound argument. Due to the deflationary spiral our model also behaves differently from its incomplete market version without aggregate uncertainty, especially in terms of the impact of unemployment insurance on average employment levels. (JEL: E12, E24, E32, E41, J64, J65)

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