This paper models the liquidity effects after a contractionary open market operation in a framework that highlights the frictions of limited participation in financial markets and search frictions in labor markets. It is shown that Lucas rigidities, with the aid of labor market rigidities, could generate more persistent liquidity effects even in a context of flexible prices. In addition, the simulation results show that this adapted liquidity and labor search model does a reasonable good job in explaining the observed labor market dynamics in response to shocks of a plausible magnitude, and deliver substantial movements along a downward-sloping Beveridge curve.

1. INTRODUCTION

What the liquidity effect is and how to model it are two frequently debated questions among monetary economists, which have received extensive attention in recent years. Evidence based on a structural VAR shows that when the Fed surprises financial markets by suddenly decreasing the rate of money growth through an open-market sale, the nominal interest rate rises on impact, in company with a drop in aggregate employment, output, and prices. In contrast, when the money growth rate increases due to an open-market purchase, the opposite economic phenomena will appear. This is the so-called liquidity effect (see Figure 1 for an illustration). Therefore, any plausible model of monetary policy should account for this behavior. Several competing monetary models currently exist, with each employing a different mechanism of transmission of monetary policy.

Two of the most popular transmission mechanisms of monetary shocks in the recent literature are price stickiness and financial-market frictions. In a sticky price environment, such as described by Christian (1989) and Christiano et al. (1997),...