

Unemployment in a Balassa-Samuelson Model with Heterogeneous Job Separations

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Abstract: A small open economy model with tradeable and nontradeable sectors is used to examine how unemployment and the real exchange rate are affected by productivity growth. While labour is mobile, unemployment occurs due to search frictions. The nontradeable sector includes the public sector. Sectors have different separation rates, which gives rise to compensating wage differentials. Productivity growth leads to both sectors expanding or to one sector expanding and the other contracting. Moreover, depending on the sector in which productivity grows relatively more, unemployment may rise or fall. We also find that the effect of relative productivity growth on the real exchange rate, i.e. the Balassa-Samuelson effect, is mitigated or amplified by relative expansion of both sectors. Simulations suggest that introducing intersectoral differences in separation rates can improve the predictive ability of the Balassa-Samuelson model.

Keywords: Unemployment, compensating wage differential, job matching, Balassa-Samuelson

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