Abstract

Data-consistent involuntary unemployment is introduced into an otherwise standard New Keynesian model with search frictions. In the model, the unemployed pay costs to search for a job and they are better off if matched with one. Hence, any resulting unemployment is involuntary and satisfies the official definition of unemployment in the United States. I find that allowing for endogenous labor force participation greatly improves the model fit for U.S. data. It appears that the price markup and matching efficiency shocks are the two key driving forces of unemployment fluctuations. Monetary policy that stabilizes the participation gap can be welfare improving.