Research question and motivation

- Majority of dynamic general equilibrium models: Firm (scale) heterogeneity does not matter.
- Because some firms are so large, decisions of individual firms can have aggregate implications
  - 2004Q4: Microsoft issues $24 billion one-time dividend. Accounts for 2.1% boost in personal income growth.
  - 2000: Nokia accounts for half of Finish private R&D, 1.6 percentage points of GDP growth.
- Are these anecdotes exceptional or common?
- Question: To what extent are firm-level shocks responsible for aggregate fluctuations?
Outline

- Some data
  - Compustat: 1960 to present.

- Theoretical results and calibration
  - The Central Limit Theorem is irrelevant when firm sizes are fat-tailed
  - The herfindahl index is a summary statistic for the importance of firm-specific shocks.

- The granular residual
The firm size distribution in 1960

![Graph showing the firm size distribution in 1960 with sales on the x-axis and the complementary cumulative distribution function (1-CDF) on the y-axis. The graph compares GM, ATT, Ford, and GE, with points indicating the distribution of sales across different firms.]
The firm size distribution in 1970
The firm size distribution in 1980

\[ \text{Sales (Billions)} \]
The firm size distribution in 1990
The firm size distribution in 2000
The firm size distribution in 2010
Sales Herfindahl of firms in Compustat

\[ h = \left[ \sum_i \left( \frac{S_i}{S} \right)^2 \right]^{1/2} \]
Overview of the theoretical results

- If the firm size distribution is Pareto, we can show how the dispersion of GDP growth decreases in economies with more and more firms.

- Even if the firm size distribution is not Pareto, we can relate the dispersion of GDP to:
  - $\sigma$: the standard deviation of firm productivity growth rates.
  - $h$: the HHI of firm sales
  - a combination of other model parameters.
"Islands Economy"

What is the relationship between micro productivity growth and aggregate output growth?

- Economy is made up of \( n \) units (firms or industries)
- Utility = log \( C \), where \( C \equiv \prod_{i=1}^{n} \left( \frac{c_i}{\xi_i} \right) \)
- \( L \equiv \sum_i L_i \) is fixed at 1
- Set \( C \) as the numeraire good: \( P \equiv \prod_i (P_i)^{\xi_i} = 1 \)
- Production: \( C_i = A_i L_i \)
  - \( \sigma = \text{SD of productivity shocks, which are i.i.d. across units.} \)
- One can show:
  - \( \frac{P_i C_i}{C} = \xi_i \)
  - \( \log C = \sum_i \frac{P_i C_i}{C} \log (A_i) \)
- Thus:
  - \( \text{Var}(\log C) = \sum \frac{P_i C_i}{C} \sigma^2 \)
  - \( \sigma_{\log C} = \text{SD}(\log C) = \left[ \sum \left( \frac{P_i C_i}{C} \right)^2 \right]^{1/2} \cdot \sigma \)
    - \( \equiv h \)
The Pareto Distribution

Let $S_i \equiv P_i C_i$ be a Pareto($\zeta, x_0$) random variable. 

\[ P(S > x) = \left( \frac{x}{x_0} \right)^{-\zeta}. \]

Some useful facts about the Pareto distribution:

- $\mathbb{E}[S] = x_0 \frac{\zeta}{\zeta - 1}$ if $\zeta > 1$, $\infty$ otherwise
- $\mathbb{E}[S^2] = (x_0)^2 \frac{\zeta}{\zeta - 2}$ if $\zeta > 2$, $\infty$ otherwise
- $S^\alpha$ is Pareto $\left( \frac{\zeta}{\alpha}, (x_0)^\alpha \right)$ distributed.
- $\alpha S$ is Pareto $(\zeta, \alpha x_0)$ distributed.
- $r^{th}$ moment of the $k^{th}$ largest value in a sample of $N$:
  \[ \mathbb{E}[S_{k:N}^r] = (x_0)^r \frac{\Gamma[k - \frac{r}{\zeta}]}{\Gamma[k]} \frac{\Gamma[N+1]}{\Gamma[N+1 - \frac{r}{\zeta}]}, \text{ if } r > \zeta. \]
- Many other facts in Gabaix (2009, Section 2)
Suppose $S_1, S_2, \ldots, S_N$ is a sequence of i.i.d. random variables with $\mathbb{E}[S_i] = \mu$ and $\text{Var}[S_i] = \sigma^2 < \infty$. Then, as $N$ approaches $\infty$, 

$$
\frac{\sqrt{N}}{\sigma} \left( \frac{\sum S_i}{N} - \mu \right) \rightarrow_d \mathcal{N}(0, 1)
$$

"Compared to an economy with 10 firms, an economy with 10 million firms will have GDP growth with a standard deviation 0.1% as large".

What if $\text{Var}[S_i] = \infty$?
Central Limit Theorem with infinite variances

Suppose $S_1, S_2, \ldots, S_N$ is a sequence of i.i.d. nonnegative random variables with $P(S_i > x) = x^{-\zeta}L(x)$ (where $L(x)$ is a slowly-varying function, and $\zeta < 2$). Then

$$
\left( \frac{\sum_i S_i - b_N}{a_N} \right) \to \mathcal{L}(\zeta),
$$

where

$$
a_n = \inf \left\{ x : P(S_i > x) \leq \frac{1}{N} \right\} \quad \text{and} \quad b_n = N\mathbb{E} \left[ S_i \cdot 1(x_i \leq a_n) \right]
$$

and $\mathcal{L}(\zeta)$ is a Levy distribution with exponent $\zeta$.

- PDF of Levy distribution: $\sqrt{\frac{\zeta}{2\pi}} \exp \left\{ -\frac{\zeta}{2x} \right\} x^{-3/2}$

- A slowly-varying function, $L(x)$ is one that satisfies

$$
\lim_{x \to \infty} \frac{L(tx)}{L(x)} = 1 \quad \forall \ t > 0.
$$

- If $P(S_i > x) = \left( \frac{x}{x_0} \right)^{-\zeta}$, then

$$
a_n = \inf \left\{ x : \left( \frac{x}{x_0} \right)^{-\zeta} \leq \frac{1}{N} \right\} = x_0 N^{1/\zeta}, \ b_N = 0
$$

- Thus $\frac{N^{1-1/\zeta}}{x_0} \sum S_i \to \mathcal{L}(\zeta)$
Proposition 2

"Consider a series of island economies indexed by \( N \). Economy \( N \) has \( N \) firms whose growth rate volatility is \( \sigma \) and whose sizes \( S_1, \ldots, S_N \) are independently drawn from a power law distribution."

\[
P(S > x) = ax^{-\zeta}, \text{ with } \zeta \geq 1.
\]

As \( N \to \infty \), GDP volatility follows

\[
\sigma_{GDP} \sim \frac{v_\zeta}{\log N} \sigma \text{ for } \zeta = 1
\]

\[
\sigma_{GDP} \sim \frac{v_\zeta}{N^{1-1/\zeta}} \sigma \text{ for } \zeta \in (1, 2)
\]

\[
\sigma_{GDP} \sim \frac{v_\zeta}{N^{1/2}} \sigma \text{ for } \zeta \geq 2
\]

When \( \zeta \geq 2 \), \( v_\zeta \) is a constant; when \( \zeta < 2 \), \( v_\zeta \) is the square root of a Levy distributed (with exponent \( \zeta/2 \)) random variable.
Intuition for Proposition 2

In our islands economy, $\sigma_{GDP} = \sigma h$. Looking across economies with different numbers of firms, how does $h$ change as $N$ changes?

Take $P(S > x) = ax^{-\zeta}$, and consider the case in which $\zeta \in (1, 2)$, and $a = 1$.

$$\frac{\mathbb{E}[X_{k:N}]}{N\mathbb{E}[X]} = \frac{\Gamma \left[k - \frac{1}{\zeta} \right] (\zeta - 1) \Gamma[N]}{\Gamma[k] \zeta \Gamma(N + 1 - \frac{1}{\zeta})}$$

$$\implies _{N \to \infty} \frac{\Gamma \left[k - \frac{1}{\zeta} \right] (\zeta - 1) \Gamma[k] \zeta}{\Gamma[N]} N^{-(1-1/\zeta)}$$

Share of top $K$ firms is proportional to $N^{-(1-1/\zeta)} \Rightarrow h$ is proportional to $N^{-(1-1/\zeta)}$. 
Proof of Proposition 2, Part 1

If $\zeta \geq 2$, the variance of $S_i$ is finite. Can apply the formula

$$\sigma_{GDP} = \sigma h$$

$$h = \frac{1}{N^{1/2}} \left[ N^{-1} \sum (S_i)^2 \right]^{1/2}$$

$$\sigma_{GDP} \rightarrow \frac{\sigma}{N^{1/2}} \cdot \frac{\left( \mathbb{E} [S^2] \right)^{1/2}}{\mathbb{E} [S]}$$
Proof of Proposition 2, Part 2

When $\zeta > 1$, $N^{-1} \sum S_i \rightarrow \mathbb{E}[S]$

$S_i^2$ has a power law exponent $\zeta/2$

$$P \left( (S_i)^2 > x \right) = ax^{-\zeta/2}$$

Use the CLT with infinite variances, if $\zeta > 1$

$$N^{-2/\zeta} \sum S_i^2 \rightarrow_d \mathcal{L}(\zeta/2)$$

$$N^{1-1/\zeta}h = N^{1-1/\zeta} \frac{\left[N^{-2/\zeta} \left( \sum S_i^2 \right) \right]^{1/2}}{N^{-1} \sum S_i} \rightarrow_d \frac{(\mathcal{L}(\zeta/2))^{1/2}}{\mathbb{E}[S]}$$

Putting the pieces together

$$\sigma_{GDP} N^{1-1/\zeta} = \sigma h N^{1-1/\zeta} \rightarrow_d \sigma \frac{(\mathcal{L}(\zeta/2))^{1/2}}{\mathbb{E}[S]}$$

If $\zeta \approx 1.05 \Rightarrow N^{1-1/\zeta} \approx N^{0.05} \Rightarrow$ Compared to an economy with 10 firms, an economy with 10 million firms will have GDP growth with a standard deviation about half as large.
Digression: Is the firm size distribution Pareto?

- With moderate sample size it’s difficult to distinguish between Pareto distribution (which has finite variance) and something like a lognormal distribution (for which regular CLT applies).
- Find best fit, assuming firm sizes are distributed either Pareto or lognormal.

\[
f(x) = \frac{\zeta x_0^\zeta}{x^{\zeta+1}} \Rightarrow \log f(x) = \log \zeta + \zeta \log x_0 - (\zeta + 1) \log x
\]

\[
\frac{\partial \log L}{\partial \zeta} = \sum_{i=1}^{n} \frac{1}{\hat{\zeta}} + \log \left( \frac{x_0}{x} \right) = 0 \Rightarrow \hat{\zeta} = \left[ \frac{1}{N} \sum \log \left( \frac{x}{x_0} \right) \right]^{-1}
\]

<table>
<thead>
<tr>
<th>Sample</th>
<th>( \hat{x}_0 )</th>
<th>( \hat{\zeta} )</th>
</tr>
</thead>
<tbody>
<tr>
<td>80</td>
<td>2.32</td>
<td>0.87</td>
</tr>
<tr>
<td>90</td>
<td>5.62</td>
<td>1.00</td>
</tr>
<tr>
<td>95</td>
<td>11.96</td>
<td>1.10</td>
</tr>
<tr>
<td>99</td>
<td>60.75</td>
<td>2.52</td>
</tr>
</tbody>
</table>
Digression: Is the firm size distribution Pareto?
Digression: Is the firm size distribution Pareto?
The dispersion of growth rates decreases with size

\[ \log(\sigma^\text{Grow}) = \kappa_0 - \kappa_1 \log(\text{size}); \]

\[ \kappa_1 \in [0.15, 0.25], \text{ compare to benchmark of perfect correlations of shocks within firms (} \kappa_1 = 0) \text{ or no correlation (} \kappa_1 = \frac{1}{2} \). \]
The dispersion of growth rates decreases with size

Lee et al. (1998)
We can extend Proposition 2 to allow for firm size and firm volatility to be related.

Consider a series of island economies indexed by $N$. Economy $N$ has $N$ firms whose growth rate volatility is $\sigma^{\text{firm}}(S) = \sigma \left( \frac{S}{x_0} \right)^{-\alpha}$ and whose sizes $S_1, \ldots, S_N$ are independently drawn from a power law distribution.

$$P(S > x) = x^{-\zeta}, \text{ with } \zeta \geq 1.$$ 

If $\zeta > 1$, the volatility of GDP, $\sigma(Y)$, is proportional to $N^{-\min\left\{\frac{1}{2}, 1 - \frac{1-\alpha}{\zeta}\right\}}$.

If $\zeta \approx 1.05$ and $\alpha \approx \frac{1}{6}$, then $N^{1-\frac{1-\alpha}{\zeta}} \approx N^{0.21}$, so Compared to an economy with 10 firms, an economy with 10 million firms will have GDP growth with a standard deviation about 5% as large.
Hulten (1978)

What is the relationship between micro productivity growth and aggregate output growth?

- Economy is made up of \( n \) units (firms or industries)
- Utility = \( \log C - \frac{\phi}{\phi+1} L^{\phi+1} \), where \( C \equiv \prod_i \left( \frac{C_i}{\xi_i} \right)^{\xi_i} \)
- Production: \( Q_i = A_i \left( \left( \frac{L_i}{\alpha b} \right)^{\alpha} \left( \frac{K_i}{(1-\alpha)b} \right)^{1-\alpha} \right)^{b} \left( \frac{M_i}{1-b} \right)^{1-b} \)
- Intermediate input bundle: \( M_i = \prod_j (M_{j\rightarrow i})^{\gamma ji} \)
- Market clearing: \( Q_i = C_i + \sum_j X_{i\rightarrow j} + M_{i\rightarrow j} \)
  - Version 1: Capital is fixed across time.
  - Version 2: \( K_i = \prod_j (X_{j\rightarrow i})^{\theta ji} \)
- Write
  - \( P_i \) as the Lagrange multiplier for the good \( i \) market-clearing condition, and \( S_i \equiv P_i Q_i \).
  - \( \mathcal{W} \) as the Lagrange multiplier for the labor market clearing condition.
  - Set \( C \) as the numeraire good: \( P \equiv \prod_i (P_i)^{\xi_i} = 1 \)
Consider the problem of the representative consumer who is trying to maximize:

$$\log C - \frac{\phi}{\phi + 1} L^{\phi + 1} \quad \text{s.t.} \quad C = WL$$

Equilibrium $C$ and $L$ satisfy:

$$L = W^\phi$$

$$C = W^{\phi+1} = L^{\phi + 1}$$

(1)
Hulten (1978)

Step 2: Solve for Prices

Consider the cost-minimization problem of firm/industry $i$.

Version 1:

$$\log P_i = -\log A_i + (1 - \alpha) b \log (K_i / [(1 - \alpha) b]) + \alpha b \log W$$
$$+ (1 - \alpha) b \log S_i + (1 - b) \sum_j \gamma_{ji} \log P_j$$

$$\overrightarrow{\log P} = (I - (1 - b) \Gamma')^{-1} \left\{ -\overrightarrow{\log A} - (1 - \alpha) b \overrightarrow{\log (K / [(1 - \alpha) b])} + \alpha b \log W + (1 - \alpha) b \overrightarrow{\log S} \right\}$$

Version 2:

$$\log P_i = -\log A_i + \alpha b \log W + \sum_j [(1 - \alpha) b \theta_{ji} + (1 - b) \gamma_{ji}] \log P_j$$

$$\overrightarrow{\log P} = (I - (1 - b) \Gamma' - (1 - \alpha) b \Theta')^{-1} \left( -\overrightarrow{\log A} + \alpha b \log W \right)$$ (2)
Hulten (1978)

Step 3: Write out sales in each industry

Using the market clearing conditions (Version 1)

\[ S_i = P_i Q_i = P_i C_i + \sum_j P_i M_{i \to j} \]

Plugging in customers’ factor demand curves and re-arranging:

\[ S_i - (1 - b) \sum_j \gamma_{ij} S_j = \xi_i C \]

\[ \overrightarrow{S} = (I - (1 - b) \Gamma)^{-1} \overrightarrow{\xi} C \]

In Version 2:

\[ S_i = P_i C_i + \sum_j P_i M_{i \to j} + P_i X_{i \to j} \]

which eventually yields

\[ \overrightarrow{S} = (I - (1 - b) \Gamma - (1 - \alpha) b \Theta)^{-1} \overrightarrow{\xi} C \quad (3) \]
Hulten (1978)

Step 4: Write out total consumption and labor in terms of productivity

In Version 2: Plug Equation (2) into Equation (1)

\[
\log P = (l - (1 - b) \Gamma' - (1 - \alpha) b\Theta')^{-1} \left(-\log A + \alpha b \log W\right)
\]

\[
= (l - (1 - b) \Gamma' - (1 - \alpha) b\Theta')^{-1} \left(-\log A + \frac{\alpha b}{\phi + 1} \log C\right)
\]

Use the fact that \( \xi' \log P = 0 \)

\[
(\phi + 1) (l - (1 - b) \Gamma' - (1 - \alpha) b\Theta')^{-1} \log A = \log C
\]

Remember the equation for sales

\[
\frac{\bar{S'}}{C} = \xi' (l - (1 - b) \Gamma' - (1 - \alpha) b\Theta')^{-1}
\]

Thus

\[
\log C = (\phi + 1) \frac{\bar{S'}}{C} \log A \quad \text{and} \quad \log L = \phi \frac{\bar{S'}}{C} \log A
\]

For version 1, you can do something similar.
Hulten (1978)

The Main Results

1. Aggregate productivity is a weighted average of productivity of the individual units:

   \[ A_{agg} \equiv \log \frac{C}{L} = \frac{\sum S_i}{C} \log \hat{A} \]

   The sum of the weights is bigger than 1.

2. Total output and labor inputs each depend on aggregate productivity and the labor supply elasticity

   \[ \log C = (\phi + 1) A_{agg} \text{ and } \log L = \phi A_{agg} \]

3. Combining (1) and (2)

   \[ \sigma_{\log C} = (\phi + 1) \frac{\sum S_j}{C} \left[ \sum_i \left( \frac{S_i}{\sum S_j} \right)^2 \right]^{1/2} \]

   \[ \sigma = \mu \cdot h \cdot \sigma, \]

   where \( \mu \equiv (\phi + 1) \cdot \sum \frac{S_i}{C} \)

   - Calibration: \( h = 6\%, \ \sigma = 12\%, \ \mu = 2 \Rightarrow \sigma_{\log C} = 1.4\% \)
Partial summary

- $h = 6\%$ and $\sigma = 12\% \Rightarrow$ A calibration of a simple "islands" model implies that independent firm shocks can potentially meaningfully contribute to GDP volatility
- Rest of the paper:
  - Construct a measure of productivity shocks to individual firms
  - Regress GDP growth against productivity shocks of the largest firms.
Defining the granular residual

From before

$$\log \frac{Y_t}{Y_{t-1}} \propto \sum_i S_{i,t-1} \log \left( \frac{A_{it}}{A_{i,t-1}} \right)$$

Define

$$\Gamma_t \equiv \sum_{i=1}^{100} \frac{S_{i,t-1}}{Y_{t-1}} \hat{\varepsilon}_{it},$$

$$\hat{\varepsilon}_{it} \equiv z_{it} - z_{i,t-1} - (\bar{z}_{lt} - \bar{z}_{I,t-1})$$

where $z_{it} = \log \left( \frac{\text{sales of } i \text{ in year } t}{\text{employees of } i \text{ in year } t} \right)$, and $\bar{z}_{lt}$ is the corresponding average labor productivity in firm $i$'s industry, $I$. 
On the granular residual

$log \left( \frac{A_{it}}{A_{i,t-1}} \right)$ measures changes in TFP, not in labor productivity.

- For plants in the manufacturing sector these productivity measures have pretty different patterns (Syverson 2004):
  - 90-10 (75-25) difference of log labor productivity is roughly 1.4 (0.66)
  - 90-10 (75-25) difference of log TFP is 0.7 (0.29)
GDP growth and the granular residual

<table>
<thead>
<tr>
<th>Sample</th>
<th>1952-2008</th>
<th></th>
<th>1952-2014</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$\Gamma_t$</td>
<td>2.8</td>
<td>2.9</td>
<td>3.7</td>
<td>2.9</td>
</tr>
<tr>
<td>$\Gamma_{t-1}$</td>
<td>3.1</td>
<td>3.4</td>
<td>3.1</td>
<td>3.4</td>
</tr>
<tr>
<td>$\Gamma_{t-2}$</td>
<td>2.1</td>
<td></td>
<td>2.3</td>
<td></td>
</tr>
<tr>
<td>Intercept</td>
<td>0.02</td>
<td>0.02</td>
<td>0.02</td>
<td>0.02</td>
</tr>
<tr>
<td>N</td>
<td>57</td>
<td>56</td>
<td>55</td>
<td>63</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.14</td>
<td>0.32</td>
<td>0.40</td>
<td>0.12</td>
</tr>
<tr>
<td>$\tilde{R}^2$</td>
<td>0.12</td>
<td>0.29</td>
<td>0.36</td>
<td>0.10</td>
</tr>
</tbody>
</table>
GDP growth and the granular residual

Granular events

- 1970 Strike at GM (labor productivity down 18%)
- 1972 Ford and Chrsyler have a rush of subcompact sales
- 1983 Launch of IBM PC (labor productivity up 10%)
Predictive power of the granular residual

<table>
<thead>
<tr>
<th></th>
<th>( \Gamma_{t-1} )</th>
<th>( \Gamma_{t-2} )</th>
<th>( \text{Monetary}_{t-1} )</th>
<th>( \text{Monetary}_{t-2} )</th>
<th>( \text{Oil}_{t-1} )</th>
<th>( \text{Oil}_{t-2} )</th>
<th>( 3\text{-month t(-)bill}_{t-1} )</th>
<th>( 3\text{-month t(-)bill}_{t-2} )</th>
<th>( \text{Term Spread}_{t-1} )</th>
<th>( \text{Term Spread}_{t-2} )</th>
<th>( \tilde{R}^2 )</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>0.015</td>
<td>0.019*</td>
<td>0.021*</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>( \Gamma_{t-1} )</td>
<td>3.5**</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>( \Gamma_{t-2} )</td>
<td>1.2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>( \text{Monetary}_{t-1} )</td>
<td>-0.04</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>( \text{Monetary}_{t-2} )</td>
<td>-0.02</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>( \text{Oil}_{t-1} )</td>
<td>-8.7 \cdot 10^{-5}</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>( \text{Oil}_{t-2} )</td>
<td>-6.9 \cdot 10^{-5}</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>( 3\text{-month t(-)bill}_{t-1} )</td>
<td>-0.45</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>( 3\text{-month t(-)bill}_{t-2} )</td>
<td>0.43</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>( \text{Term Spread}_{t-1} )</td>
<td>0.38</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>( \text{Term Spread}_{t-2} )</td>
<td>0.27</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>( \tilde{R}^2 )</td>
<td>0.19</td>
<td>0.19</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Oil: (Hamilton 2003): current vs. last year’s max oil price.
- Monetary policy shock: Residuals from FOMC decisions vs. FOMC forecasts (Romer and Romer 2004)
- Term spread: 5 year bond yield - 3 month bond yield.
Notes on Carvalho and Gabaix (2013): "The Great Diversification and its Undoing"
The Great Moderation
The Great Moderation and its Undoing
Motivation and question

- Why did volatility of GDP growth decrease beginning around 1980? And why did volatility increase beginning around 2005?
- Previous answers to the first question:
  - Stock and Watson (2003): It *doesn’t* seem to have to do with better inventory management or more aggressive monetary policy.
  - Arias, Hansen, and Ohanian (2007): Aggregate TFP shocks have become less volatile.
  - Jaimovich and Siu (2009): Fewer young people (those with more elastic labor supply) in the work force.
- New answer in this paper: Industry composition affects aggregate volatility.
Industries differ in their volatility
Fundamental Volatility

Reminder from our islands economy

- Suppose economy is made up of $n$ units (firms or industries)
- \[ \log GDP_t = \sum_i \frac{S_{it}}{GDP_t} \log (A_{it}) \]
- \[ \log \left( \frac{GDP_{t+1}}{GDP_t} \right) \approx \sum_i \frac{S_{it}}{GDP_t} \log \left( \frac{A_{i,t+1}}{A_{it}} \right) \]

Suppose \( \frac{A_{i,t+1}}{A_{it}} \) are i.i.d. across time and industries, with standard deviation \( \sigma_i \)

\[
\text{SD} \left[ \log \left( \frac{GDP_{t+1}}{GDP_t} \right) \right] \approx \left[ \sum_i \left( \frac{S_{it}}{GDP_t} \right)^{\frac{1}{2}} (\sigma_i)^2 \right]^{1/2}
\]

Potentially

- productivity shocks are correlated, have volatilities that change over time.
- things besides industries’ TFP change from one period to the next
Fundamental Volatility

\[ \sigma_{Ft} = \left[ \sum_i \left( \frac{S_{it}}{GDP_t} \right)^2 (\sigma_i)^2 \right]^{1/2} \]
Definitions and data sources
  - TFP in each industry
    - $\sigma_{GDP}$
  - Fundamental volatility accounts for the break in GDP volatility.
  - Sources of fundamental volatility
  - Fundamental volatility and GDP volatility in other countries
Industry TFP Volatility

- KLEMS data from Dale Jorgenson (http://hdl.handle.net/1902.1/11155)
- For each industry×year define TFP growth as:

\[
\Delta TFP_{it} = \log \left( \frac{y_{it+1}}{y_{it}} \right) \\
- \frac{1}{2} \left( s_{it}^k + s_{it+1}^k \right) \log \left( \frac{k_{it+1}}{k_{it}} \right) \\
- \frac{1}{2} \left( s_{it}^l + s_{it+1}^l \right) \log \left( \frac{l_{it+1}}{l_{it}} \right) \\
- \frac{1}{2} \left( s_{it}^m + s_{it+1}^m \right) \log \left( \frac{m_{it+1}}{m_{it}} \right)
\]

where \( s_{it}^l \) (\( s_{it}^m \), \( s_{it}^k \)) is industry \( i \)'s cost share of labor (intermediate inputs, capital) at time \( t \).

- \( \sigma_i \equiv \text{SD}(\Delta TFP_{it}) \)
GDP Volatility

Three measures:
1) Rolling standard deviation

\[ \sigma_t^{\text{roll}} = \text{SD} \left( y_{t-10}^{HP}, \ldots y_{t+10}^{HP} \right) , \text{ where} \]

\[ y_t^{HP} \text{ is deviation of log GDP from trend} \]

2) Instantaneous standard deviation

\[ \Delta y_s = \psi + \phi \Delta y_{s-1} + \epsilon_s \]

\[ \sigma_t^{\text{Inst}} \equiv \frac{1}{2} \sqrt{\frac{\pi}{2}} \sum_{q=1}^{4} \left| \hat{\epsilon}_{t,q} \right| \]

3) \( \sigma_t^{HP} \) is the HP smoothed version of \( \sigma_t^{\text{Inst}} \)
Fundamental Volatility accounts for the break in GDP volatility.

\[ LR_T = \frac{\prod_{t=1960}^{T} f_1(\eta_t) \prod_{T+1}^{2008} f_2(\eta_t)}{\prod_{1960}^{2008} f_0(\eta_t)} \]

| \( \sigma_{Y_t}^{\text{inst}} = a + \eta_t \) | \( \sigma_{Y_t}^{\text{inst}} = a + b\sigma_{F_t} + \eta_t \) |
|---|---|---|---|
| \( H_0 \) | No break in \( a \) | No break in \( b \) | No break in \( a \) or \( b \) |
| \( \max_T LR_T \) | 26.50 | 8.32 | 8.64 | 8.91 |
| Reject null? | Yes | No | No | No |
| Estimated break date | 1983 | NA | NA | NA |
Fundamental Volatility

\[ \sigma_{Ft} = \left[ \sum_i \left( \frac{S_{it}}{GDP_t} \right)^2 (\sigma_i)^2 \right]^{1/2} \]
Sales weights: motor vehicles and petroleum

\[ \sigma_{Ft} = \left[ \sum_i \left( \frac{S_{it}}{GDP_t} \right)^2 (\sigma_i)^2 \right]^{1/2} \]
Contribution to fundamental volatility: motor vehicles and petroleum

\[ \sigma_{Ft} = \left[ \sum_i \left( \frac{S_{it}}{\text{GDP}_t} \right)^2 (\sigma_i)^2 \right]^{1/2} \]
Sales weights: depository and nondepository financial institutions

\[
\sigma_{Ft} = \left[ \sum_{i} \left( \frac{S_{it}}{GDP_t} \right)^2 (\sigma_i)^2 \right]^{1/2}
\]
Contribution to fundamental volatility: depository and nondepository financial institutions

\[
\sigma_{Ft} = \left[ \sum_i \left( \frac{S_{it}}{GDP_t} \right)^2 \sigma_i^2 \right]^{1/2}
\]
Fundamental volatility tracks GDP volatility in other countries
Fundamental volatility tracks GDP volatility in other countries.
Conclusion

Summary:
- GDP volatility changes over time.
- Volatility changes reflect changes in the importance of different types of firms in the economy.
  - Implies that firm/industry-level shocks are important for aggregate volatility.

Next steps:
- To what extent are the economy’s shocks independent across firms (or industries)?
"Real Business Cycles"
Model

► From the board:

\[ X_{j\rightarrow i,t} = \beta \frac{\gamma_i}{\gamma_j} a_{j\rightarrow i} Y_{jt} \]

\[ L_{it} = \frac{\beta \gamma_i b_i}{\theta_0 + \beta \sum \gamma_j b_j} H \]

► Plug these expressions into the production function:

\[ Y_{i,t+1} = \lambda_{i,t+1} (L_{it})^{b_i} \prod_j (X_{j\rightarrow i,t})^{a_{j\rightarrow i}} \]

\[ = \lambda_{i,t+1} \left( \frac{\beta \gamma_i b_i}{\theta_0 + \beta \sum \gamma_j b_j} H \right)^{b_i} \prod_j \left( \beta \frac{\gamma_i}{\gamma_j} a_{j\rightarrow i} \right)^{a_{j\rightarrow i}} \prod_j (Y_{jt})^{a_{j\rightarrow i}} \]

\[ \equiv \exp\{k_i\} \]

\[ \log Y_{i,t+1} = \log (\lambda_{i,t+1}) + k_i + \sum_j a_{j\rightarrow i} \log Y_{jt} \]

\[ \equiv y_{i,t+1} + \eta_{t+1} \]
Theoretical predictions

- Writing the previous equation in vector form:

\[ y_{t+1} = A' y_t + k + \eta_{t+1} \]

- Define \( \tilde{y}_{t+1} \equiv y_{t+1} - (I - A')^{-1} k \)

\[ \tilde{y}_{t+1} = A' \tilde{y}_t + \eta_{t+1} \]

\[ \tilde{y}_t = \sum_{j=0}^{\infty} (A')^j \eta_{t-j} \]

- Assume \( \text{Var}(\eta_t) = I \). Then:

\[ \text{Var} (\tilde{y}_t) = \sum_{j=0}^{\infty} (A')^j A^j \]

\[ \text{Cov} (\tilde{y}_t, \tilde{y}_{t-1}) = \sum_{j=0}^{\infty} (A')^j A^{j+1} \]
Data

- BEA: 1992 Input/Output Table & Capital Flows Table.
- Dale Jorgenson: Annual data on industries’ production.
  - Agriculture (5%)
  - Construction (6%)
  - Durable Manufacturing (16%)
  - Nondurable Manufacturing (16%)
  - Transportation (10%) Wholesale/Retail (14%)
  - Finance, Insurance, and Real Estate (13%)
  - Personal and Business Services (20%).
## Intermediate Input and Capital Flows

<table>
<thead>
<tr>
<th>Sector</th>
<th>0.25</th>
<th>0.01</th>
<th>0.01</th>
<th>0.09</th>
<th>0.03</th>
<th>0.00</th>
<th>0.0</th>
<th>0.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>0.04</td>
<td>0.02</td>
<td>0.02</td>
<td>0.03</td>
<td>0.10</td>
<td>0.04</td>
<td>0.32</td>
<td>0.03</td>
</tr>
<tr>
<td>Construction</td>
<td>0.12</td>
<td>0.16</td>
<td>0.40</td>
<td>0.10</td>
<td>0.17</td>
<td>0.08</td>
<td>0.04</td>
<td>0.08</td>
</tr>
<tr>
<td>Durable Manf.</td>
<td>0.08</td>
<td>0.03</td>
<td>0.04</td>
<td>0.31</td>
<td>0.04</td>
<td>0.04</td>
<td>0.01</td>
<td>0.08</td>
</tr>
<tr>
<td>Nondurable</td>
<td>0.05</td>
<td>0.02</td>
<td>0.04</td>
<td>0.07</td>
<td>0.20</td>
<td>0.06</td>
<td>0.03</td>
<td>0.03</td>
</tr>
<tr>
<td>Transport</td>
<td>0.07</td>
<td>0.28</td>
<td>0.08</td>
<td>0.08</td>
<td>0.04</td>
<td>0.09</td>
<td>0.02</td>
<td>0.03</td>
</tr>
<tr>
<td>Whole/Retail</td>
<td>0.11</td>
<td>0.03</td>
<td>0.02</td>
<td>0.03</td>
<td>0.05</td>
<td>0.10</td>
<td>0.26</td>
<td>0.06</td>
</tr>
<tr>
<td>FIRE</td>
<td>0.04</td>
<td>0.06</td>
<td>0.07</td>
<td>0.07</td>
<td>0.10</td>
<td>0.12</td>
<td>0.08</td>
<td>0.15</td>
</tr>
<tr>
<td>Capital + Materials Share</td>
<td>0.78</td>
<td>0.60</td>
<td>0.69</td>
<td>0.77</td>
<td>0.73</td>
<td>0.52</td>
<td>0.76</td>
<td>0.46</td>
</tr>
</tbody>
</table>
## Theoretical Predictions

### Correlations and autocorrelations

<table>
<thead>
<tr>
<th>Sector</th>
<th>1</th>
<th>0.09</th>
<th>0.11</th>
<th>0.13</th>
<th>0.11</th>
<th>0.08</th>
<th>0.10</th>
<th>0.07</th>
<th>0.31</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.31</td>
</tr>
<tr>
<td>Construction</td>
<td>1</td>
<td>0.12</td>
<td>0.09</td>
<td>0.09</td>
<td>0.07</td>
<td>0.06</td>
<td>0.06</td>
<td>0.07</td>
<td></td>
</tr>
<tr>
<td>Durable Manf.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.42</td>
</tr>
<tr>
<td>Nondurable</td>
<td>1</td>
<td>0.11</td>
<td>0.08</td>
<td>0.08</td>
<td>0.08</td>
<td>0.36</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transport</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.08</td>
<td>0.11</td>
<td>0.26</td>
</tr>
<tr>
<td>Whole/Retail</td>
<td>1</td>
<td>0.08</td>
<td>0.06</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.12</td>
</tr>
<tr>
<td>FIRE</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.07</td>
<td>0.30</td>
</tr>
<tr>
<td>Other Services</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.17</td>
</tr>
</tbody>
</table>

Average correlation: 0.20
Average autocorrelation: 0.23
Empirical counterparts

Correlations and autocorrelations:

<table>
<thead>
<tr>
<th>Department</th>
<th>1</th>
<th>0.34</th>
<th>-0.09</th>
<th>0.55</th>
<th>-0.16</th>
<th>0.08</th>
<th>0.10</th>
<th>0.07</th>
<th>0.34</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>1</td>
<td>0.43</td>
<td>0.28</td>
<td>0.78</td>
<td>0.43</td>
<td>-0.13</td>
<td>0.05</td>
<td></td>
<td>0.25</td>
</tr>
<tr>
<td>Construction</td>
<td>1</td>
<td>0.00</td>
<td>0.59</td>
<td>0.03</td>
<td>0.01</td>
<td>0.68</td>
<td></td>
<td>-0.02</td>
<td></td>
</tr>
<tr>
<td>Durable</td>
<td>1</td>
<td>0.79</td>
<td>0.06</td>
<td>-0.41</td>
<td>-0.05</td>
<td></td>
<td></td>
<td></td>
<td>0.21</td>
</tr>
<tr>
<td>Nondurable</td>
<td>1</td>
<td>0.41</td>
<td>-0.46</td>
<td>0.14</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.30</td>
</tr>
<tr>
<td>Transport</td>
<td>1</td>
<td>0.22</td>
<td>-0.09</td>
<td></td>
<td></td>
<td>-0.07</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Whole/Retail</td>
<td>1</td>
<td>1</td>
<td>-0.04</td>
<td></td>
<td></td>
<td>0.53</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FIRE</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Serv.</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.28</td>
</tr>
</tbody>
</table>

Average correlation: 0.28 (theoretical=0.20)
Average autocorrelation: 0.25 (theoretical=0.23)
Intermediate Input and Capital Flows

![Graph showing intermediate input and capital flows between different industries. The graph is a scatter plot with color coding indicating the percentage of flows. The x-axis represents the originating industry (Primary+ Construction, Manufacturing, Transport + Utilities), and the y-axis represents the destination industry (Primary+, Construction, Manufacturing, Transport + Utilities, Services). The color bar on the right indicates percentages: 2%, 4%, 8%, 16%, 32%. The data points show varying degrees of flow between the industries.](image-url)
Theoretical Prediction

Average correlation: 7%
Average autocorrelation: 22%
Average correlation: 26% (theoretical=0.07)
Average autocorrelation: 64% (theoretical=0.22)
Two common characteristics of business cycles: co-movement and persistence

Input-output linkages can spread industry-specific shocks over time, across industries.

With data on many industries, the amplification seems not to be "strong enough" ⇒ residual cross-industry correlation of productivity shocks.

\[ \Delta \tilde{y}_{t+1} - A' \Delta \tilde{y}_t = \log \left( \frac{\lambda_{t+1}}{\lambda_t} \right) \] ⇒ Can use data on \( \Delta \tilde{y}_{t+1} - A' \Delta \tilde{y}_t \) to infer correlation of productivity shocks.
Notes on Foerser, Sarte, Watson (2011) "Sectoral vs. Aggregate Shocks: A Structural Factor Analysis of Industrial Production"
Research questions

1. How correlated are shocks to industries’ productivities?
2. What fraction of industrial production volatility is due to common shocks? Industry-specific shocks?
3. Are the answers to (1) and (2) different for different points in the sample? Were common shocks or industry-specific shocks less volatile during the Great Moderation (after 1983)?
Outline

- Data
- Statistical factor analysis
- Model and structural factor analysis
Data

- BEA: Input/Output Table & Capital Flow Table, from 1997.
- Federal Reserve Board: Quarterly data on industrial production, from 1972 to 2011.
  - Quarterly data
  - 117 industries in manufacturing, mining, energy, and publishing.
Industrial production and its components

![Graph showing growth over previous quarter for different components from 1975 to 2005. The graph includes lines for IP, Power Gen, Semiconductors, and MV Parts. The x-axis represents the years from 1975 to 2005, and the y-axis shows the growth over the previous quarter ranging from -1 to 0.5.](image-url)
Industrial production tracks GDP
Principal component analysis

- Define \( g_t \) as the vector of sectoral growth rates, \( \log \left( \frac{Y_{t+1}}{Y_t} \right) \), and \( w_t \) as the weight of each industry within the industrial sector.

- How can we best measure the fraction of variation in \( w_t' \cdot g_t \) that is due to "common shocks"?

- Suppose that

\[
g_t = \Lambda \cdot F_t + u_t
\]

where \( F_t \) is some small (e.g., two) number of common factors, and \( u_t \) are idiosyncratic shocks (the covariance matrix of \( u \) has zero off-diagonal terms), and \( F_t \) and \( u_t \) are uncorrelated.

- Use principal component analysis to choose \( \Lambda, F_t \) so that \( \Lambda F \) explains the maximum possible variance of the \( g_t \) vector. These columns of \( F \) will represent the common shocks.
Principal component analysis

- From the last slide

\[ g_t = \Lambda \cdot F_t + u_t \]

- Note that \( \Lambda \) and \( F_t \) are not separately identified.

\[ \Lambda F_t = \tilde{\Lambda} \tilde{F}_t = \Lambda \tilde{\nu} \nu^{-1} F_t. \]

We will normalize \( \Lambda \) so that the lengths of each column equal equal 1.

- Useful formulas:

\[ \Sigma_{gg} = \Lambda \Sigma_{FF} \Lambda' + \Sigma_{uu} \]
\[ \sigma_g^2 = \bar{w}' \Lambda \Sigma_{FF} \Lambda' \bar{w} + \bar{w}' \Sigma_{uu} \bar{w} \]
\[ R^2(F) = \frac{\bar{w}' \Lambda \Sigma_{FF} \Lambda' \bar{w}}{\sigma_g^2} \]
Principal component analysis: 2-d to 1-d
Principal component analysis: 2-d to 1-d
Principal component analysis

The idea is to find the linear combination of the data that explains the greatest possible variance

$$\max_{\lambda_1} \lambda_1' \Sigma_{\text{Animal,Grain}} \lambda_1$$

subject to

$$||\lambda_1|| = 1$$

$$= \max_{\lambda_1} \lambda_1' \Sigma_{\text{Animal,Grain}} \lambda_1 + \mu_1 \left(1 - \lambda_1' \lambda_1\right)$$

First order conditions:

$$2 \Sigma_{\text{Animal,Grain}} \lambda_1 = 2 \mu_1 \lambda_1$$

$$\Sigma_{\text{Animal,Grain}} \lambda_1 = \mu_1 \lambda_1$$

Note that

$$\lambda_1' \Sigma_{\text{Animal,Grain}} \lambda_1 = \lambda_1' \mu_1 \lambda_1 = \mu_1$$

To maximize the left hand side, choose the unit-length eigenvector associated with the largest eigenvalue of $\Sigma_{\text{Animal,Grain}}$. 
Principal component analysis

Can extend this idea to many (say 117) data series and multiple (say 2) factors.

Suppose we have 117 data series and we have computed the first factor \( F_1 = g' \cdot \Lambda_1 \). The problem is now to find a vector \( \Lambda_2 \) that is orthogonal to \( \Lambda_1 \) and explains the greatest possible variance:

\[
\max_{\Lambda_2} \Lambda_2' \Sigma_{gg} \Lambda_2 + \mu_2 (1 - \Lambda_2' \Lambda_2) + \kappa \Lambda_2' \Lambda_1
\]

First order conditions:

\[
\Sigma_{gg} \Lambda_2 = \mu_2 \Lambda_2
\]

The solution to this maximization problem, \( \Lambda_2 \) will be the eigenvector associated with the second largest eigenvalue of \( \Sigma_{gg} \)

Side note: See Bai and Ng (2003) on how to choose the number of factors (similar to minimizing Mallows's \( C_p \))
The two columns of Λ

Loadings: First Factor
-0.1  0   0.1  0.2  0.3

Loadings: Second Factor

Logging
Copper
Coffee/Tea
Animal Food
Sawmills
Plywood
Iron
Nonferrous Metal
Heavy Trucks
MV Bodies
MV Parts
Plywood
Sawmills
Coffee/Tea
Animal Food
Logging
Industrial production and its factor component

\[ R^2 (F) \approx 0.9 \]
Partial summary

- The story so far: there is a strong common component to industrial production.
- Is this because there are common shocks? Or because there are independent shocks transmitted via input-output relationships?
- Rest of the paper: Use a model with input-output linkages to back out productivity shocks for each industry-quarter. Perform factor analysis on the productivity shocks.
  - $N$ perfectly competitive sectors, which produce using capital, labor, and the output of other sectors.
  - Consumers have preferences over leisure and consumption of the goods produced by the $N$ industries.
  - Productivity growth is distributed $\mathcal{N}(0, \Sigma_{\omega\omega})$; $\omega$ will admit an factor representation.
Model: Market Clearing

- Output can be used for consumption, as an intermediate input, or to increase one of the $N$ capital stocks:

$$Y_{tj} = C_{tj} + \sum_{i=1}^{N} M_{t,j\rightarrow i} + \sum_{i=1}^{N} X_{t,j\rightarrow i} \quad \forall j \in \{1, \ldots, N\}$$
Model: Preferences

- Consumers’ lifetime utilities are given by:

\[ U = \sum_{t=0}^{\infty} \beta^t \left[ \sum_{i=1}^{N} \left( \frac{(C_{ti})^{1-\sigma} - 1}{1-\sigma} - \psi L_{ti} \right) \right] \]

- \( \psi \): disutility from work
- \( \sigma \): preference elasticity of substitution, intertemporal elasticity of substitution.
The production technology of each sector is given by:

\[ Y_{tj} = A_{tj} (K_{tj})^{\alpha_j} M_{tj} (L_{tj})^{1-\alpha_j - \sum_i \gamma_{ij}} \]

The intermediate input bundle of sector \( j \) consists of the purchases from the other sectors:

\[ M_{tj} = \prod_i X_{t,i \rightarrow j}^{\gamma_{ij}} \]

\( \gamma_{ij} \) is the share of good \( i \) used in the production of the good-\( j \) intermediate input.
Model: Evolution of Capital, Productivity

- Industry-\(j\)-specific capital evolves according to:

\[
K_{t+1,j} = (1 - \delta) K_{tj} + Z_{tj}
\]

where \(Z_{tj} = \prod_i X_{t,i \rightarrow j}^{\theta_{ij}}\)

- \(\theta_{ij}\) is the share of good \(i\) used in the production of the good-\(j\) capital input.

- Productivity in each sector evolves according to a random walk:

\[
\log A_{t+1,j} = \log A_{tj} + \omega_{t+1,j}, \quad \omega_{t+1} \sim \mathcal{N}(0, \Sigma_{\omega\omega})
\]
Solution

- The model yields the following (log-linear-approximate) expression for the evolution of output:

\[
\begin{pmatrix}
\Delta \log Y_{t+1,1} \\
\Delta \log Y_{t+1,2} \\
... \\
\end{pmatrix}
= Q
\begin{pmatrix}
\Delta_{t,1} \\
\Delta_{t,2} \\
... \\
\end{pmatrix}
+ R
\begin{pmatrix}
\omega_{t1} \\
\omega_{t2} \\
... \\
\end{pmatrix}
+ S
\begin{pmatrix}
\omega_{t+1,1} \\
\omega_{t+1,2} \\
... \\
\end{pmatrix}
\]

- Q, R, and S are specified, given \((\beta, \delta, \psi, \sigma, \alpha_i, \theta_{ij}, \gamma_{ij})\).

- Given these parameters, one can back out innovations to productivity (setting \(\omega_0 = 0\)):

\[
\begin{pmatrix}
\omega_{t+1,1} \\
\omega_{t+1,2} \\
... \\
\end{pmatrix}
= S^{-1}
\left[
\begin{pmatrix}
\Delta \log Y_{t+1,1} \\
\Delta \log Y_{t+1,2} \\
... \\
\end{pmatrix}
- Q
\begin{pmatrix}
\Delta \log Y_{t1} \\
\Delta \log Y_{t2} \\
... \\
\end{pmatrix}
- R
\begin{pmatrix}
\omega_{t1} \\
\omega_{t2} \\
... \\
\end{pmatrix}
\right]
\]

- Next step: Calibrate model’s parameters, which will allow us to back out \(\omega_{tj}\).
### Calibration

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Value/Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\beta$-discount factor</td>
<td>0.99</td>
</tr>
<tr>
<td>$\delta$-capital depreciation rate</td>
<td>0.025</td>
</tr>
<tr>
<td>$\psi$-disutility from work</td>
<td>1</td>
</tr>
<tr>
<td>$\sigma$-consumers’ elasticity, across goods</td>
<td>1</td>
</tr>
<tr>
<td>$\alpha_i$-capital share in production of $i$</td>
<td>1997 BEA I.O. Tables</td>
</tr>
<tr>
<td>$1 - \alpha_i - \sum_j \gamma_{ij}$-share of</td>
<td>1997 BEA I.O. Tables</td>
</tr>
<tr>
<td>capital/labor in production of $i$</td>
<td></td>
</tr>
<tr>
<td>$\gamma_{ij}$-share of good $i$ in production of j’s intermediate input</td>
<td>1997 BEA I.O. Tables</td>
</tr>
<tr>
<td>$\theta_{ij}$-share of good $i$ in production of j’s capital input</td>
<td>1998 Capital Flow Tables</td>
</tr>
</tbody>
</table>
Calibration of $\Sigma_{\omega\omega}$

- Given the other parameters, we know $\omega_{tj}$ for all time periods and industries.
- Two calibrations:
  - $\Sigma_{\omega\omega}$ is diagonal, with the $j, j^{th}$ entry equal to the sample variance of $\omega_{tj}$
  - Perform principal component analysis on the $\omega_{tj}$:
    $\Sigma_{\omega\omega} = \Lambda_S \Sigma_{SS} \Lambda_S + \Sigma_{uu}$, with a 2-dim. common factor, $S_t$
- With $\Sigma_{\omega\omega}$ in hand, we compute the following statistics:
  - $\bar{\rho}_{ij}$: average correlation in the growth rates for two industries
  - $\sigma_g$: standard deviation of the growth rate of industrial production
  - $R^2(S)$: fraction of the variation in industrial production growth explained by the common factors.
### Results

<table>
<thead>
<tr>
<th></th>
<th>Period</th>
<th>$\bar{\rho}_{ij}$</th>
<th>$\sigma_g$</th>
<th>$R^2(S)$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Data</strong></td>
<td>72-83</td>
<td>0.27</td>
<td>8.8</td>
<td></td>
</tr>
<tr>
<td></td>
<td>84-07</td>
<td>0.11</td>
<td>3.6</td>
<td></td>
</tr>
<tr>
<td><strong>Uncorrelated Shocks</strong></td>
<td>72-83</td>
<td>0.05</td>
<td>5.1</td>
<td></td>
</tr>
<tr>
<td></td>
<td>84-07</td>
<td>0.04</td>
<td>3.1</td>
<td></td>
</tr>
<tr>
<td><strong>2 Common Factors</strong></td>
<td>72-83</td>
<td>0.26</td>
<td>9.5</td>
<td>0.81</td>
</tr>
<tr>
<td></td>
<td>84-07</td>
<td>0.10</td>
<td>4.1</td>
<td>0.50</td>
</tr>
</tbody>
</table>
Comparison to other models

- Foerster et al.:
  \[ g_{t+1} = Qg_t + S\omega_{t+1} - R\omega_t \]

- Long and Plosser: Materials arrive with a one-period lag, no capital, log preferences for consumption and leisure.
  \[ g_{t+1} = \Gamma' g_t + \omega_{t+1} \]
  \[ \Sigma_{gg} = \sum_{i=0}^{\infty} (\Gamma')^i \Sigma_{\omega \omega} \Gamma' \]

  \[ g_{t+1} = (I - \Gamma') \omega_{t+1} \]
  \[ \Sigma_{gg} = (I - \Gamma') \Sigma_{\omega \omega} (I - \Gamma) \]
## Model performance with independent productivity shocks

<table>
<thead>
<tr>
<th></th>
<th>$\bar{\rho}_{ij}$</th>
<th>$\sigma_g$</th>
<th>$\sigma_g$(diag)</th>
<th>$\frac{\sigma_g$(scaled)}{\sigma_g,bench$(scaled)$}</th>
</tr>
</thead>
<tbody>
<tr>
<td>Data</td>
<td>0.19</td>
<td>5.80</td>
<td>1.85</td>
<td></td>
</tr>
<tr>
<td>Benchmark</td>
<td>0.04</td>
<td>3.87</td>
<td>1.88</td>
<td>1.00</td>
</tr>
<tr>
<td>Long-Plosser</td>
<td>0.01</td>
<td>2.66</td>
<td>2.07</td>
<td>0.39</td>
</tr>
<tr>
<td>Carvalho</td>
<td>0.04</td>
<td>3.15</td>
<td>1.64</td>
<td>0.87</td>
</tr>
<tr>
<td>Benchmark, $\theta = I$</td>
<td>0.02</td>
<td>3.86</td>
<td>2.43</td>
<td>0.59</td>
</tr>
<tr>
<td>Benchmark, $\Sigma_{\omega\omega} = \sigma^2 I$</td>
<td>0.04</td>
<td>5.72</td>
<td>2.99</td>
<td>0.86</td>
</tr>
<tr>
<td>Benchmark, $\Gamma, \alpha$: average</td>
<td>0.05</td>
<td>3.30</td>
<td>1.71</td>
<td>0.87</td>
</tr>
</tbody>
</table>

$\sigma_g$(scaled) is defined as the $\sigma_g$ computed in an alternative calibration in which $\Sigma_{\omega\omega}$ is chosen so that "model-implied variance of IP growth associated with the diagonal elements of $\Sigma_{gg}$ correspond to the value in the data."
Do the industry definitions matter?

<table>
<thead>
<tr>
<th></th>
<th>Period</th>
<th>2-digit 26 inds.</th>
<th>3-digit 88 inds.</th>
<th>4-digit 117 inds.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Data $\bar{\rho}_{ij}$</strong></td>
<td>72-83</td>
<td>0.38</td>
<td>0.29</td>
<td>0.27</td>
</tr>
<tr>
<td></td>
<td>84-07</td>
<td>0.22</td>
<td>0.13</td>
<td>0.11</td>
</tr>
<tr>
<td><strong>Independent Error $\bar{\rho}_{ij}$</strong></td>
<td>72-83</td>
<td>0.09</td>
<td>0.05</td>
<td>0.05</td>
</tr>
<tr>
<td></td>
<td>84-07</td>
<td>0.07</td>
<td>0.05</td>
<td>0.04</td>
</tr>
<tr>
<td><strong>$R^2 (S)$</strong></td>
<td>72-83</td>
<td>0.76</td>
<td>0.85</td>
<td>0.81</td>
</tr>
<tr>
<td></td>
<td>84-07</td>
<td>0.53</td>
<td>0.53</td>
<td>0.50</td>
</tr>
</tbody>
</table>
Conclusion

Summary:

- Industry-specific shocks explain about 40% of the variation in industrial production
- Lower (20%) in the pre-Great Moderation period; higher (50%) in the Great Moderation. Common shocks became less volatile during the great moderation

Extensions:

- Apply this model to the whole economy, not just the goods-producing sectors (Ando 2014)
- Decompose output variation into firm-specific, industry-specific, and common shocks.