Entry, Exit, Firm Dynamics, and Aggregate Fluctuations[*]

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This version: September 4, 2010
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Abstract

How important are firm entry and exit in shaping aggregate dynamics? We address this question by characterizing the equilibrium allocation in Hopenhayn (1992)'s model of equilibrium industry dynamics, amended to allow for investment in physical capital and aggregate fluctuations. We find that entry and exit propagate the effects of aggregate shocks. In turn, this results in greater persistence and unconditional variation of aggregate time–series. In the aftermath of a positive productivity shock, the number of entrants increases. The new firms are smaller and less productive than the incumbents, as in the data. As the common productivity component reverts to its unconditional mean, the new entrants that survive become progressively more productive, keeping aggregate efficiency higher than in a scenario without entry or exit. We also find that both the mean and variance of the cross–sectional distribution of firm–level productivity are counter–cyclical, in spite of the assumption that innovations to firm–level productivity are i.i.d. and orthogonal to aggregate shocks. This happens because of selection: the idiosyncratic productivity of the marginal entrant is lower in expansion than during recessions. Since idiosyncratic productivity is mean–reverting, mean and variance of the distribution of productivity growth are pro–cyclical.

Key words. Selection, Propagation, Persistence, Survival, Reallocation.

JEL Codes: D21, D92, E32, L11.

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1 Introduction

During the last 25 years or so, the empirical research in industrial organization has pointed out a tremendous amount of between–firms and between–plants heterogeneity, even within narrowly defined sectors. Yet, for most of its young life the modern theory of business cycles has completely disregarded such variation. What is the loss of generality implied by this methodological choice?

There are many reasons why heterogeneity may matter for aggregate fluctuations, some of which have received a substantial attention in the literature.[1] Our goal is to contribute to the understanding of the role played by entry and exit. What are, if any, the costs of abstracting from firm entry and exit when modeling aggregate fluctuations?

We address this question by characterizing the equilibrium allocation in Hopenhayn (1992)'s model of industry dynamics, amended to allow for investment in physical capital and for aggregate fluctuations. We assume that firms' productivity is the product of a common and an idiosyncratic component, which are driven by persistent stochastic processes and orthogonal to each other. Differently from Hopenhayn (1992), potential entrants are in finite mass and face different probability distributions over the first realization of the idiosyncratic shock.

When parameterized to match a set of empirical regularities on investment, entry, and exit, our framework replicates well–documented stylized facts about firm dynamics. To start with, the exit hazard rate declines with age. The growth rate of employment is decreasing with size and age, both unconditionally and conditionally. The size distribution of firms is skewed to the right. When tracking the size distribution over the life a cohort, the skewness declines with age. Furthermore, the entry rate is pro–cyclical, while the exit rate is counter–cyclical.

The mechanics of entry is straightforward. A positive shock to the common productivity component makes entry more appealing. Entrants are more plentiful, but of lower average idiosyncratic efficiency. This is the case because firms with lower prospects about their productivity find it worth to enter. Aggregate output and TFP are lower than they would be in the absence of this selection effect. However, given the small output share of entering firms, the contemporaneous response of output is not very different from the one that obtains in a model that abstracts from entry and exit.

It is the evolution of the new entrants that causes a sizeable impact on aggregate

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[1]This is the case for the possibility that the occasional synchronization in the timing of establishments' investment may influence aggregate dynamics when nonconvex capital adjustment costs lead establishments to adjust capital in a lumpy fashion. See Veracierto (2002) and Khan and Thomas (2003, 2008).

dynamics. As the common productivity component declines towards its unconditional mean, there is a larger–than–average pool of young firms that increase in efficiency and size. While the exogenous component of TFP falls, the distribution of firms over idiosyncratic productivity improves. It follows that entry propagates the effects of aggregate productivity shocks on output and increases its unconditional variance.

For a version of our model without entry or exit to generate a data–conforming persistence of output, the first–order autocorrelation of aggregate productivity shocks must be 0.775. In the benchmark scenario with entry and exit, it needs only be 0.65. As pointed out by Cogley and Nason (1995), many Real–Business–Cycle models have weak internal propagation mechanisms. In order to generate the persistence in aggregate time–series that we recover in the data, they must rely heavily on external sources of dynamics. Our work shows that allowing for firm heterogeneity and for entry and exit can sensibly reduce such reliance.

The propagation result clearly depends on the pro–cyclicality of the entry rate, for which evidence abounds,[2] and on the dynamics of young firms. According to our theory, the relative importance of a cohort is minimal at birth and increases over time. Is there evidence in support of this prediction?

The dynamics of young firms is reflected in the contribution of net entry to aggregate productivity growth. A productivity decomposition exercise along the lines of Haltiwanger (1997) reveals that on average the contribution of net entry to productivity growth is positive, as entering firms tend to be more productive than the exiters they replace. Its magnitude is small when the the interval between observations is one period (equivalent to one year). However, it increases with the time between observations. In part, this is due to the mere fact that the output share accounted for by entrants is larger, the longer the horizon over which changes are measured. However, it is also due to the fact that entrants grow in size and productivity at a faster pace than incumbents. Not surprisingly, the contribution of net entry is pro–cyclical, mostly as a result of the cyclical behavior of entry and exit rate.

The results of our decomposition are consistent with the evidence illustrated by Foster, Haltiwanger, and Krizan (2001). Their own findings, as well as those of several other scholars, lead them to conclude that *"studies that focus on high–frequency variation tend to find a small contribution of net entry to aggregate productivity growth while studies over a longer horizon find a large role for net entry."* They go on to add that *"Part of this is virtually by construction... Nevertheless, ... The gap between productivity of entering*

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[2]See Campbell (1998) and Lee and Mukoyama (2009).

and exiting plants also increases in the horizon over which the changes are measured since a longer horizon yields greater differential from selection and learning effects." The contribution of the selection effect to the evolution of aggregate efficiency and output emerges with full clarity from the analysis of our model.

Recently, Eisfeldt and Rampini (2006) and Bachman and Bayer (2009b) have documented a negative correlation between the cross–sectional standard deviation of firm–level TFP growth and detrended output. Because of the systematic variation in entry and exit selection highlighted by our theory, inferring properties of firm–level uncertainty from such result is not immediate. In principle, their result could simply reflect a selection bias.

Our simulations show that the selection bias exists, but reinforces their results. With an homoscedastic process for idiosyncratic productivity, the cross–sectional standard deviation of firm–level TFP growth is greater during expansions than during recessions.

This is not a theory of the firm. That is, we do not provide an explanation for why single–plant and multi–plant business entities coexist. In our setup, firms (or plants) are decreasing–returns–to–scale technologies that produce an homogeneous good by means of capital and labor.

Our analysis is in partial equilibrium. We assume that the demand for firms' output and the supply of physical capital are infinitely elastic at the unit price, while the supply of labor services has finite elasticity. The wage rate fluctuates to ensure that the labor market clears. This is crucial, as it is often the case in economics that effects of shocks on endogenous variables are muted or reversed by the ensuing adjustment in prices.

For given wage, our theory predicts that a positive innovation in the common component of productivity raises the value of entering. It follows that the entry rate increases, while entrants' average idiosyncratic productivity declines. Whether this is a feature of the equilibrium allocation depends on the adjustment of the wage rate.

A hike in productivity increases the marginal product of labor for all incumbents. The labor demand schedule shifts, leading to an increase in the wage rate and to a corresponding decline in the value of entering the industry. With a labor supply elasticity calibrated to match the standard deviation of employment relative to output, the equilibrium response of the wage rate is not large enough to undo the impact of the positive shock to aggregate productivity.

Given the complexity of the model, most of our analysis is numerical. Our methodology, common to many macroeconomic studies, calls for choosing some parameters based on direct evidence. The others are selected in such a way that a set of moments computed

on simulated data are close to their empirical counterparts. The algorithm used for the approximation of the equilibrium allocation is described in Appendix A.

It will be shown that the vector of state variables in the firm optimization problem consists of the distribution of firms over the two dimensions of heterogeneity, along with the realization of the aggregate shock. Knowledge of the distribution is necessary in order to form expectations about the evolution of the wage rate. Faced with the daunting task of working with an infinite–dimensional state space, we follow the lead of Krusell and Smith (1998) and assume that firms form expectations by means of a simple forecasting rule. We posit that the wage is an affine function of the wage in the previous period and the aggregate productivity shock in the current and previous period. An exhaustive battery of tests shows that the forecasting rule is very accurate.

We have already pointed out that our framework builds on the seminal work of Hopenhayn (1992). This is the case for most competitive equilibrium models with aggregate fluctuations and firm heterogeneity.[3] Some of these contributions abstract from entry and exit. See for example the business cycle theories of Veracierto (2002), Khan and Thomas (2003, 2008) and Bachman and Bayer (2009a,b), as well as the asset pricing model by Zhang (2005). Others do not.

The predictions for the dynamics of entry and exit rates that obtain in Campbell (1998) are very close to ours. However, Campbell (1998) focuses on investment–specific technology shocks and makes a list of assumptions with the purpose of ensuring aggregation. In turn, this leads to an environment that has no implications for most features of firm dynamics. Cooley, Marimon, and Quadrini (2004) and Samaniego (2008) characterize the equilibria of stationary economies with entry and exit and study their responses to zero–measure aggregate productivity shocks.

Lee and Mukoyama (2009)'s framework, in which selection also leads to counter–cyclical variation in the idiosyncratic productivity of entering firms, is perhaps the closest to ours. Their study, however, differs in key modeling assumptions. In particular, Lee and Mukoyama (2009) do not model capital accumulation and let the free–entry condition pin down the wage rate.

The remainder of the paper is organized as follows. The model is introduced in Section 2. In Section 3 we characterize firm dynamics in the stationary economy. The analysis of the scenario with aggregate fluctuations begins in Section 4, where we describe the impact of aggregate shocks on the entry and exit margins. In Section 5 we characterize the cyclical

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[3]A somewhat different strand of papers, among which Devereux, Head, and Lapham (1996), Chatterjee and Cooper (1993), and Bilbiie, Ghironi, and Melitz (2007), model entry in general equilibrium models with monopolistic competition, but abstract completely from firm dynamics.

properties of entry and exit rates, as well as the relative size of entrants and exiters. We also gain insights into the mechanics of the model by describing the impulse responses to an aggregate productivity shock. In Section 6 we illustrate how allowing for entry and exit strengthen the model's internal propagation mechanism and generates a pro–cyclical cross–sectional standard deviation of productivity growth. Section 7 concludes.

2 Model

Time is discrete and is indexed by $t = 1, 2, ...$ The horizon is infinite. At time t, a positive mass of price–taking firms produce an homogenous good by means of the production function $y_t = z_t s_t (k_t^\alpha l_t^{1-\alpha})^\theta$, with $\alpha, \theta \in (0, 1)$. With k_t we denote physical capital, l_t is labor, and z_t and s_t are aggregate and idiosyncratic random disturbances, respectively.

The common component of productivity z_t is driven by the stochastic process

$$\log z_{t+1} = \rho_z \log z_t + \sigma_z \varepsilon_{z,t+1},$$

where $\varepsilon_{z,t} \sim N(0, 1)$ for all $t \geq 0$. The dynamics of the idiosyncratic component s_t is described by

$$\log s_{t+1} = \rho_s \log s_t + \sigma_s \varepsilon_{s,t+1},$$

with $\varepsilon_{s,t} \sim N(0, 1)$ for all $t \geq 0$. The conditional distribution will be denoted as $H(s_{t+1}|s_t)$.

Firms hire labor services on the spot market at the wage rate $w_t \geq 0$ and discount future profits by means of the time–invariant factor $\frac{1}{R}$. Adjusting the capital stock by x requires firms to incur a cost $g(x, k)$. Capital depreciates at the rate $\delta \in (0, 1)$.

We assume that the demand for the firm's output and the supply of capital are infinitely elastic and normalize their prices at 1. The supply of labor is given by the function $L_s(w) = w^\gamma$, with $\gamma > 0$.

All operating firms must pay a fixed cost $c_f > 0$ per period. Those that quit producing cannot re–enter the market at a later stage and obtain a value 0. The timing is summarized in Figure 1.

Every period there is a constant mass $M > 0$ of prospective entrants, each of which receives a signal q about their productivity, with $q \sim Q(q)$. Conditional on entry, the distribution of the idiosyncratic shock in first period of existence is $H(s'|q)$, decreasing in q.[4] Entrepreneurs that decide to enter the industry pay an entry cost $c_e \geq 0$.

At all $t \geq 0$, the distribution of operating firms over the two dimensions of heterogeneity is denoted by $\Gamma_t(k, s)$. Finally, let $\lambda_t \in \Lambda$ denote the vector of aggregate state variables and $J(\lambda_{t+1}|\lambda_t)$ its transition operator. In Section 4, we will show that $\lambda_t = \{\Gamma_t, z_t\}$.

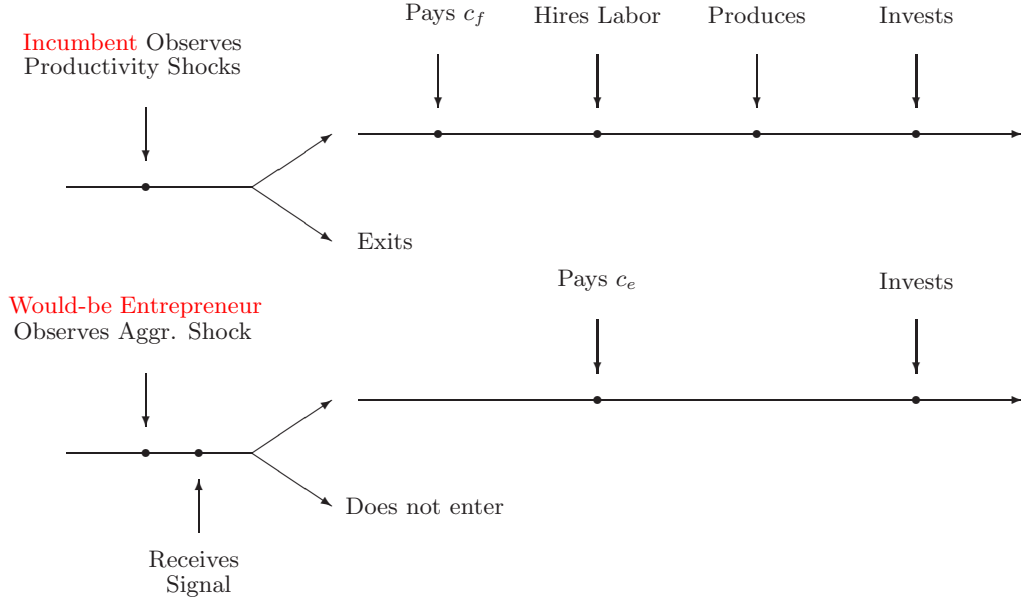[4]The distribution of year–1 idiosyncratic productivity is equal to incumbents' conditional distribution.

Figure 1: Timing in period t.

2.1 The incumbent's optimization program

Given the aggregate state λ, capital in place k, and idiosyncratic shock s, the employment choice is the solution to the following static problem:

$$\pi(\lambda, k, s) = \max_{l} \ sz[k^{\alpha}l^{1-\alpha}]^{\theta} - wl$$

Then, the incumbent's value function $V(\lambda, k, s)$ is the fixed point of the following functional equation:

$$V(\lambda, k, s) = \max\left[0, \max_{x} \ \pi(\lambda, k, s) - x - g(x, k) - c_f + \frac{1}{R}\int_{\Lambda}\int_{\Re}V(\lambda', k', s')dH(s'|s)dJ(\lambda'|\lambda)\right],$$

$$\text{s.t. } k' = k(1 - \delta) + x$$

2.2 Entry

The value of a prospective entrant that obtained a signal q when the aggregate state is λ is

$$V_e(\lambda, q) = \max_{k'} -k' + \frac{1}{R}\int V(\lambda', k', s')dH(s'|q)dJ(\lambda'|\lambda)$$

She will invest and start operating if and only if $V_e(\lambda, q) \geq c_e$.

2.3 Recursive Competitive Equilibrium

For given Γ_0, a recursive competitive equilibrium consists of (i) value functions $V(\lambda, k, s)$ and $V_e(\lambda, q)$, (ii) policy functions $x(\lambda, k, s)$, $l(\lambda, k, s)$, $k'(\lambda, q)$, and (iii) bounded sequences

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of wages $\{w_t\}_{t=0}^{\infty}$, incumbents' measures $\{\Gamma_t\}_{t=1}^{\infty}$, and entrants' measures $\{\mathcal{E}_t\}_{t=0}^{\infty}$ such that, for all $t \geq 0$,

1. $V(\lambda, k, s)$, $x(\lambda, k, s)$, and $l(\lambda, k, s)$ solve the incumbent's problem;

2. $V_e(\lambda, q)$ and $k'(\lambda, q)$ solve the entrant's problem;

3. The labor market clears: $\int l(\lambda_t, k, s) d\Gamma_t(k, s) = L^s(w_t) \ \forall \ t \geq 0$,

4. For all Borel sets $\mathcal{S} \times \mathcal{K} \in \Re \times \Re^+$ and $\forall \ t \geq 0$,

$$\mathcal{E}_{t+1}(\mathcal{S} \times \mathcal{K}) = M \int_{\mathcal{S}} \int_{\mathcal{B}_e(\mathcal{K}, \lambda_t)} dQ(q) dH(s'|q),$$

where $\mathcal{B}_e(\mathcal{K}, \lambda_t) = \{q \text{ s.t. } k'(\lambda_t, q) \in \mathcal{K} \text{ and } V_e(\lambda_t, q) \geq c_e\}$;

5. For all Borel sets $\mathcal{S} \times \mathcal{K} \in \Re \times \Re^+$ and $\forall \ t \geq 0$,

$$\Gamma_{t+1}(\mathcal{S} \times \mathcal{K}) = \int_{\mathcal{S}} \int_{\mathcal{B}(\mathcal{K}, \lambda_t)} d\Gamma_t(k, s) dH(s'|s) + \mathcal{E}_{t+1}(\mathcal{S} \times \mathcal{K}),$$

where $\mathcal{B}(\mathcal{K}, \lambda_t) = \{(k, s) \text{ s.t. } V(\lambda_t, k, s) > 0 \text{ and } k(1 - \delta) + x(\lambda_t, k, s) \in \mathcal{K}\}$.

3 The Stationary Case

We begin by analyzing the case in which there are no aggregate shocks, i.e. $\sigma_z = 0$. In this scenario, our economy converges to one in which all aggregate variables are constant.

Investment adjustment costs are the sum of a fixed portion and of a convex portion:

$$g(x, k) = \chi(x)c_0 k + c_1 \left(\frac{x}{k}\right)^2 k, \quad c_0, c_1 \geq 0,$$

where $\chi(x) = 0$ for $x = 0$ and $\chi(x) = 1$ otherwise. Notice that the fixed portion is scaled by the level of capital in place and is paid if and only if gross investment is different from zero.

The distribution of signals for the entrants is Pareto. We posit that $q \geq \underline{q} \geq 0$ and that $Q(q) = (\underline{q}/q)^{\xi}$, $\xi \in \mathbb{N}$, $\xi > 1$. The realization of the idiosyncratic shock in the first period of operation follows the process $\log(s) = \rho_s \log(q) + \sigma_s \eta$, where $\eta \sim N(0, 1)$.

3.1 Entry and Exit

In Hopenhayn (1992), the solution to the optimal exit problem can be described by a threshold on the productivity dimension. Firms exit if and only if their productivity draw is lower than the threshold. The reason, very simply, is that value of continuing operations

is strictly increasing in the idiosyncratic productivity shock, while the value of exiting is constant. In our scenario, the continuation value is strictly increasing in both the shock and the capital stock. It follows that there exists a decreasing schedule, call it $\underline{s}(k)$, such that a firm equipped with capital k will exit if and only if its productivity is lower than $\underline{s}(k)$.

Since an incumbent's value is weakly increasing in the idiosyncratic productivity shock and the conditional distribution $H(s'|q)$ is decreasing in q, the value of entering is a strictly increasing function of the signal. In turn, this means that there will be a threshold for q, call it q^*, such that prospective entrants will enter if and only if they received a better draw.

Let $k^*(q)$ denoted the optimal entrants' capital choice conditional on having received a signal q. the At age 1, every cohort will consists of the prospective entrants that received a signal q such that $q \geq q^*$, followed by a first–period shock s such that $s \geq \underline{s}(k^*(q))$.

Our treatment of the entry problem is different from that in Hopenhayn (1992). There, prospective entrants are identical. The selection in entry is due to the fact that firms that paid the entry cost start operating only if their first productivity shock is greater than the exit threshold. In our framework, prospective entrants are heterogeneous. Some obtain a greater signal than others and therefore face better short–term prospects. A larger fraction of them will indeed start operating. Our modeling assumption introduces a further selection effect.

The entry threshold q^* is strictly increasing in the wage rate. Everything else equal, the higher the wage the higher must be the signal in order to ensure that the expected value of entering is higher than the cost of entry. This will play an important role in the analysis of the scenario with aggregate shocks.

3.2   Calibration

Before we plunge into the description of our calibration procedure, it is worth noticing that there are uncountably many pairs (M, γ) which yield stationary equilibria that differ only in scale. That is, they only differ in the volume of entrant and operating firms. All the statistics of interest for our study will be the same.

To see why this is the case, start from a given equilibrium and consider raising γ. The original equilibrium wage will elicit a greater supply of labor. Now it is easy to find a new, greater entry volume such that demand for labor in stationary equilibrium will equal supply at the original wage.

Table 1 lists the values assigned to the parameters. One period is assumed to be one

year. Consistent with most macroeconomic studies, we assume that $R = 1.04$, $\delta = 0.1$, and $\alpha = 0.3$. We set θ, which governs returns to scale, equal to 0.8. This value is on the lower end of the range of estimates recovered by Basu and Fernald (1997) using aggregate data. Using plant–level data, Lee (2005) finds that returns to scale in manufacturing vary from 0.828 to 0.91, depending on the estimator.

Description	Symbol	Value
Capital share	α	0.3
Span of control	θ	0.8
Depreciation rate	δ	0.1
Interest rate	R	1.04
Labor supply elasticity	γ	5.0
Persist. idiosync. shock	ρ_s	0.55
Variance idiosync. shock	σ_s	0.215
Fixed cost of operation	c_f	0.00533
Fixed cost of investment	c_0	0.0002
Variable cost of investment	c_1	0.036
Pareto exponent	ξ	15.0
Entry cost	c_e	0.0015

Table 1: Parameter Values.

We have no direct information about M, the mass of prospective entrants. Given all other parameters, a choice of M pins down the equilibrium wage rate w. Since we do not have a suitable calibration target for it, we decided to replicate our analysis for different values of w. In the scenario described here, M is set in such a way that the equilibrium wage is 3. However, we have taken care of showing that the results described below are not particular to this value of the market clearing wage.

As long as we are not interested in the economy' scale, the choice of the supply elasticity γ is immaterial. Given what argued above, for any increase in the elasticity of supply there exists an increase in M that results in an equilibrium that differs from the initial one only in the scale of the economy. We let $\gamma = 5.0$, the value that emerges from the calibration of the model with aggregate fluctuations. In that scenario, γ is pin down by the volatility of employment with respect to output. See Section 4.

The remaining parameters were chosen in such a way that a number of statistics computed using a panel of simulated data are close to their empirical counterparts. Since the model is highly non–linear, it is not possible to match parameters to moments. However, the mechanics of the model clearly indicates what are the key parameters for each set of moments.

The parameters of the process driving the idiosyncratic shock, along with those governing the adjustment costs, were chosen to match the mean and standard deviation of the investment rate, the autocorrelation of investment, and the rate of inaction. The targets of our calibration are the moments computed by Cooper and Haltiwanger (2006) using a balanced panel from the LRD from 1972 to 1988.[5]

Finally, the parameters ξ, c_e, and c_f were chosen to match the entry rate and the size of entrants and exiters, relative to survivors. The targets are the statistics obtained by Lee and Mukoyama (2009) using the LRD. Notice that entry and exit rate must be the same in stationary equilibrium. Table 2 shows that the model is able to hit all the targets, with the exception of exiters' relative size.

Statistic	Model	Data
Mean investment rate	0.136	0.122
Std. Dev. investment rate	0.306	0.337
Investment autocorrelation	0.062	0.058
Inaction rate	0.085	0.081
Entry rate	0.062	0.062
Entrants' relative size	0.59	0.60
Exiters' relative size	0.23	0.49

Table 2: Calibration Targets.

3.3 Firm Dynamics

In this section, we describe the model's implications for firm growth and survival, and compare them with the empirical evidence. Unless otherwise noted, size is proxied by employment.

The left panel of Figure 2 illustrates the unconditional relation between exit hazard rate and age. Consistent with Dunne, Roberts, and Samuelson (1989) and all other studies we are aware of, the exit hazard rate decreases with age. This is the case because on average entrants are less productive than incumbents. As a cohort ages, the survivors' productivity and value increase, leading to lower exit rates. See the right panel of Figure 2.

A similar mechanism is also at work in Hopenhayn (1992). In his framework, however, there exists a size threshold such that the exit rate is 100% for smaller firms and identically

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[5]Following Cooper and Haltiwanger (2006), we define as periods of inaction those in which the investment rate is less than 1%.
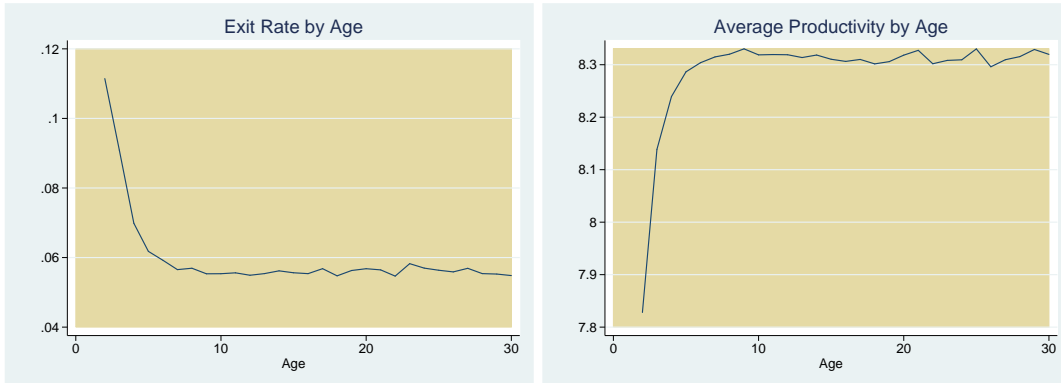
Figure 2: The exit hazard rate

zero for larger firms. This feature is at odds with the evidence.[6] In our model, same–employment firms will be characterized by different combinations of (k, s) and therefore will have different continuation values. Firms with relatively low capital and relatively high productivity will be less likely to exit.

Dunne, Roberts, and Samuelson (1989) also found that in the US manufacturing sector, establishment growth is unconditionally negatively correlated with both age and size. This finding has been confirmed for a variety of sectors and countries.[7] Evans (1987) and Hall (1987) found evidence that firm growth declines with size even when we condition on age, and viceversa.

Hopenhayn (1992) is consistent with these facts, with the exception of the conditional correlation between growth and age. In his model, idiosyncratic productivity is a sufficient statistics for firm size and growth. Conditional on age, smaller firms grow faster because the stochastic process is mean–reverting. However, firms of the same size behave identically. The model generates the right unconditional relation between age and growth, simply because age and size are positively correlated in the stationary distribution. When controlling for size, age is uncorrelated with growth.

Our version of the model is consistent with all the facts about growth listed above. Figure 3 illustrates the unconditional correlations. In our setup, the state variables are productivity and capital. Conditional on age, employment growth declines with size because larger firms tend to have higher productivity levels. Given that productivity is mean–reverting, their growth rates will be lower.

Now consider all the firms with the same employment. Since adjustment costs prevent

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[6]See Dunne, Roberts, and Samuelson (1989) and Lee and Mukoyama (2009).
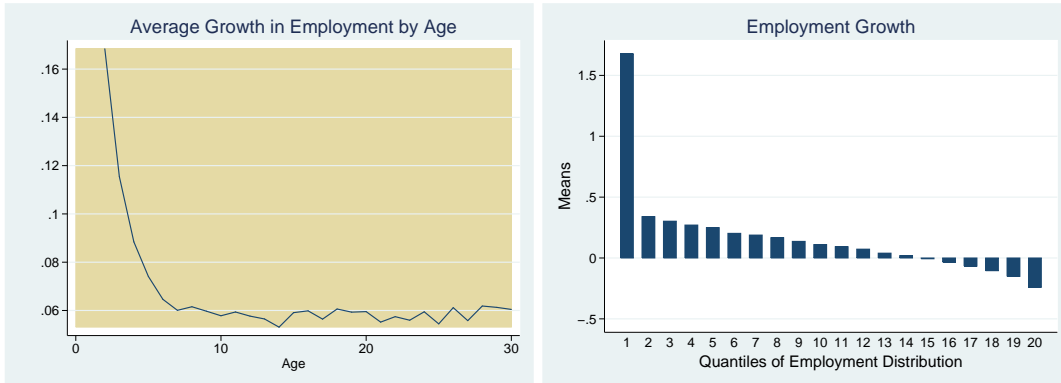[7]See Coad (2009) for a survey of the literature.

Figure 3: Unconditional Relationship between Growth, Age, and Size.

the instantaneous adjustment of capital to the first–best size implied by productivity, some of the firms will be characterized by a relatively low capital and high shock, and others by a relatively high capital and low shock. The former will grow faster, because investment and employment are catching up with the optimal size dictated by productivity. The latter will shrink, as the scale of production is adjusted to the new, lower level of productivity. This implies a conditional negative association between age and size because, on average, firms with relatively high k and low s will be older than firms with low k and high s.

This feature is driven by relatively young firms. For those among them which are shrinking, productivity must have declined. For this to happen, they must have had the time to grow in the first place. On average, they will be older than those that share the same size, but are growing instead.

Notice that the model is consistent with the evidence on firm growth even when we proxy size with capital rather than employment. Conditional on age, capital will be negatively correlated with growth for the same reason as above. It will still be the case that larger firms will have higher productivity on average. Another mechanism contributes to generating the right conditional correlation between growth and size. Because of investment adjustment costs, same–productivity firms will have different capital stocks. The larger ones are those whose productivity has been declining, while the smaller ones are those whose productivity has been increasing. The former are in the process of shrinking, while the latter are growing.

We just argued that firms with the same capital will have different productivity levels. For given capital, firms with higher shocks are growing, while firms with lower shocks are shrinking. Once again, the negative conditional correlation between growth and age follows from the observation that, on average, firms with higher shocks are younger.

It is worth emphasizing that, no matter the definition of size, the conditional relation between age and growth is driven by relatively young firms. Age matters for growth even when conditioning on size, because it is (conditionally) negatively associated with productivity. To our knowledge, only two other papers present models that are consistent with this fact. The mechanism at work in D'Erasmo (2009) is similar to ours. Cooley and Quadrini (2001) obtain the result in a version of Hopenhayn (1992)'s model with financial frictions and exogenous exit.[8]

The left panel of Figure 4 shows the firm size distribution that obtains in stationary equilibrium. Noticeably, it displays skewness to the right. The right panel illustrates the evolution of a cohort size size distribution over time. Skewness declines as the cohort ages. Both of these features are consistent with the evidence gathered by Cabral and Mata (2003) from a comprehensive data set of Portuguese manufacturing firms.
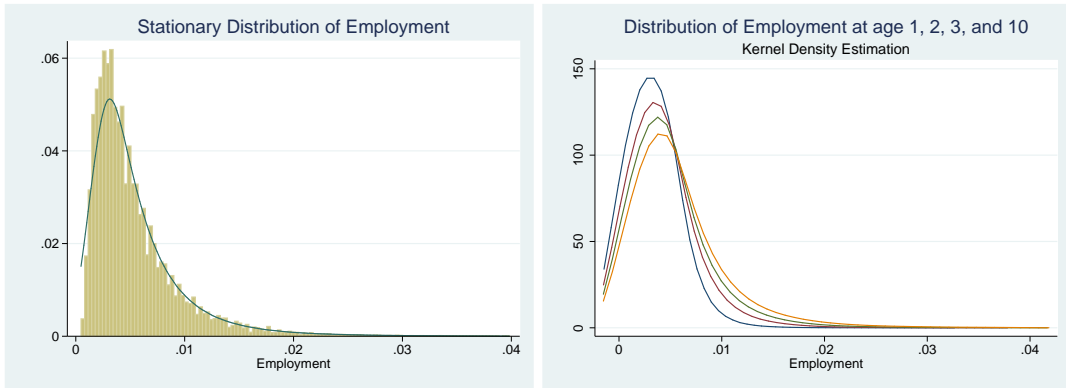

Figure 4: Evolution of a Cohort's Size Distribution

4 Aggregate Fluctuations – Mechanics

We now move to the scenario with aggregate fluctuations. In order to formulate their choices, firms need to forecast the wage in the next period. The labor market clearing condition implies that the equilibrium wage at time t satisfies the following restriction:

$$\log w_t = \frac{\log[(1-\alpha)\theta z_t]}{1+\gamma[1-(1-\alpha)\theta]} + \frac{1-(1-\alpha)\theta}{1+\gamma[1-(1-\alpha)\theta]}G_t, \tag{1}$$

with $G_t = \log\left[\int \left(sk^{\alpha\theta}\right)^{\frac{1}{1-(1-\alpha)\theta}} d\Gamma_t(k,s)\right]$. The log–wage is an affine function of the logarithm of aggregate productivity and of a moment of the distribution.

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[8]In Cooley and Quadrini (2001), a necessary condition for the result to hold is that young firms are relatively more productive. It is not clear whether, allowing for endogenous exit, this would lead to a counterfactual negative relation between age and exit hazard rates.

Unfortunately, the dynamics of G_t depends on the evolution of Γ_t. It follows that the vector of state variables λ_t consists of the distribution Γ_t and the aggregate shock z_t. Faced with the formidable task of approximating an infinitely–dimensional object, we follow Krusell and Smith (1998) and conjecture that G_{t+1} is an affine function of G_t and $\log z_{t+1}$. Then, (1) implies that the equilibrium wage follows the following law of motion:

$$\log w_{t+1} = \beta_0 + \beta_1 \log w_t + \beta_2 \log z_{t+1} + \beta_3 \log z_t + \varepsilon_{t+1}. \tag{2}$$

When computing the numerical approximation of the equilibrium allocation, we will impose that firms form expectations about the evolution of the wage assuming that (2) holds true. This means that the aggregate state variables reduce to the pair (w_t, z_t). The parameters $\{\beta_0, \beta_1, \beta_2, \beta_3\}$ will be set equal to the values that maximize the accuracy of the prediction rule. The definition of accuracy and its assessment are discussed in Section 4.2. The algorithm is described in detail in Appendix A.

4.1 Calibration

With respect to the stationary case, we need to calibrate three more parameters. These are ρ_z and σ_z, which shape the dynamics of aggregate productivity, and the labor supply elasticity γ. We set them in order to generate certain values for the standard deviation and auto–correlation of industry output, as well as the standard deviation of employment (relative to output).

The targets for the first two are standard deviation and autocorrelation of (linearly de–trended) non–farm private value added from 1947 to 2008, from the Bureau of Economic Analysis. The third target is the standard deviation of (linearly de–trended) employment, also in the non–farm private sector and for the same period, from the Bureau of Labor Statistics.

The mass of entrants M is chosen in such a way that the mean unconditional wage is equal to 3, the value we used in the calibration of the stationary model.

4.2 The Forecasting Rule

The forecasting rule for the equilibrium wage turns out to be

$$\log(w_{t+1}) = 0.32732 + 0.70195 \log(w_t) + 0.31232 \log(z_{t+1}) - 0.06759 \log(z_t) + \varepsilon_{t+1}.$$

The wage is persistent and mean–reverting. A positive aggregate shock increases the demand for labor from both incumbents and entrants. This is why the coefficient of $\log(z_{t+1})$ (β_2) is estimated to be positive. For the same reason, the coefficient of $\log(z_t)$

Description	Symbol	Value
Capital share	α	0.3
Span of control	θ	0.8
Depreciation rate	δ	0.1
Interest rate	R	1.04
Labor supply elasticity	γ	5.0
Persist. idiosync. shock	ρ_s	0.55
Variance idiosync. shock	σ_s	0.215
Persist. aggregate shock	ρ_z	0.65
Variance aggregate shock	σ_z	0.008
Fixed cost of operation	c_f	0.00533
Fixed cost of investment	c_0	0.0002
Variable cost of investment	c_1	0.036
Pareto exponent	ξ	15.0
Entry cost	c_e	0.001

Table 3: Parameter Values.

Statistic	Model	Data
Std. dev. output	0.040	0.040
Autocorrelation output. investment rate	0.894	0.782
Std. dev. employment (rel. to output)	0.833	0.923

Table 4: Additional Calibration Targets.

(β_3) is negative. The larger the aggregate shock in the previous period, the smaller is going to be the expected increment in aggregate productivity, and therefore the lower the wage increase.

In the literature with heterogeneous agents and aggregate risk it has become standard to evaluate the accuracy of the forecasting rule by assessing the R^2 of the regression, which in our case is 0.9991. However, as pointed out by Den Haan (2010), this choice is questionable on at least three grounds. To start with, the R^2 considers predictions made conditional on wages generated by the true law of motion. In this sense, it only assesses the accuracy of one–period ahead forecasts. Second, the R^2 is an average. In the numerical literature, it is standard to report maximum errors instead. Last, but not least, the R^2 scales the error term by the variance of the dependent variable. The problem here is that it is often not clear what the appropriate scaling is. The root mean squared error (0.00021 in our case) does not suffer from the latter shortcoming, but is affected by the first two.

Here we follow Den Haan (2010)' suggestion to assess the accuracy of our forecasting

rule by calculating the maximum discrepancy (in absolute value) between the actual wage and the wage generated by the rule *without* updating. That is, we compute the maximum pointwise difference between the sequence of actual market–clearing wages and that generated by our rule, when next period's predicted wage is conditional on last period's prediction for the current wage rather than the market clearing wage. The value of that statistics over 24,500 simulations is 0.296%.

The frequency distribution of percentage forecasting errors is illustrated in the left panel in Figure 5. The right panel is a scatter plot of equilibrium wages and their respective forecasts. The points are aligned along the 45° line. More diagnostics is reported in Appendix.
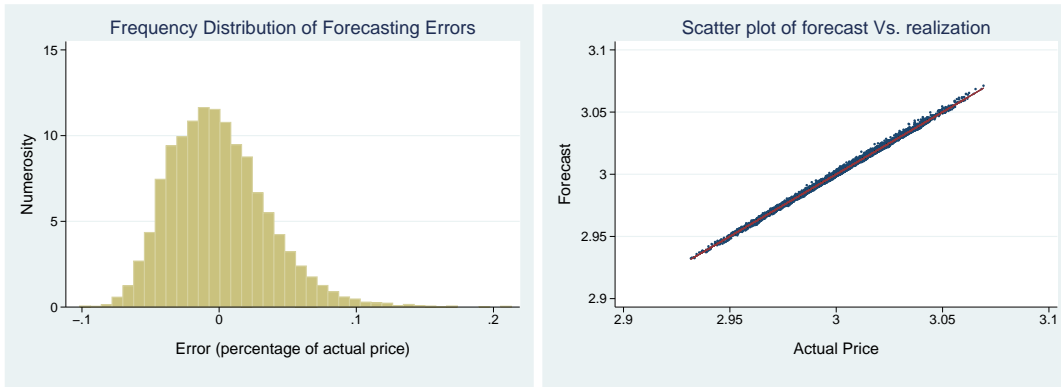

Figure 5: Accuracy of the Forecasting Rule.

4.3 Entry and Exit

The value of an incumbent is strictly increasing in aggregate productivity and strictly decreasing in the wage. Given that the cost of entry is constant, the entry threshold will be greater the lower is aggregate productivity and the greater is the equilibrium wage. See the left panel in Figure 6 for an illustration.

Everything equal, a rise in productivity will lead to an increase in the number of entrants. Given that the distribution of idiosyncratic shocks is stochastically increasing in the value of the signal, such a rise will also lead to a decline in entrants' average idiosyncratic efficiency. However, wether periods of high aggregate TFP will be characterized by high entry volumes and low entrants' average productivity will depend on the dynamics of the wage.

The right panel of Figure 6 illustrates the effect of changes in aggregate productivity on the optimal exit decision. The two lines represent the loci in the (k, s) space that make
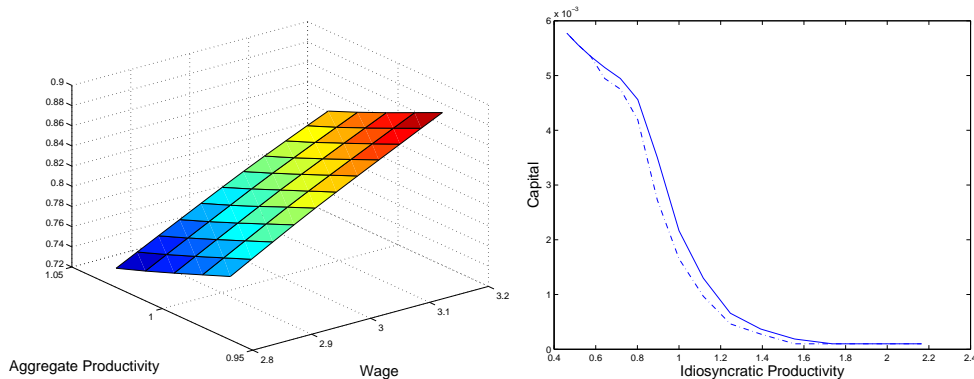
Figure 6: Left: Entry Threshold on the Signal Space. Right: Exit Threshold.

firms indifferent between staying and exiting. The dashed line is associated with a higher aggregate productivity. Given that the outside value is invariant at zero, everything else equal a greater aggregate productivity will lead to a lower productivity of the marginal exiter, for all levels of the capital stock. In other words, the average idiosyncratic productivity of non-exiting firms will be lower. Since variations in the wage rate have the opposite effects on the exit locus and higher productivity episodes will be characterized by high wages, a priori it cannot be established whether this will also be a feature of equilibrium dynamics.

5   Aggregate Fluctuations – Results

5.1   Cyclical Behavior of Entry and Exit

Table 5 reports the raw correlations of entry rate, exit rate, and the size of entrants and exiters (relative to incumbents) with industry output. Consistent with the evidence presented by Campbell (1998), the entry rate is pro–cyclical and the exit rate is counter–cyclical.

Entry Rate	Exit Rate	Entrants' Size	Exiters' Size
0.222	-0.351	-0.150	-0.478

Table 5: Correlations with industry output.

Interestingly, Campbell (1998) also provides evidence on the correlations between entry rate, exit rate, and future and lagged output growth. He finds that the correlation of entry with lagged output growth is greater than the contemporaneous correlation and that the

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exit rate is positively correlated with future output growth.

Our model is consistent with both features. While the correlation of entry rate with contemporaneous output growth is 0.1124, that with one–period lagged output growth is 0.899. The reason is that the entry decision is taken contingent on the information available one period before the start of operations. The correlation between exit rate and one–period ahead output growth is 0.12. The correlation with two–period ahead output growth is 0.09. The reason is that periods of low exit tend to be periods of high output. Given the mean–reverting nature of the process, on average such periods will be followed by times of low output growth.

Analyzing data from the LRD, Lee and Mukoyama (2009) find that selection at entry is quantitatively very important. Entering plants tend to be more productive when the industry is in recession than when it is in expansion. Our model shares this feature of the data, as the correlation between the average size of entering firms and output is negative. This result obtains because when the common productivity component is low, only firms with a relatively high level of idiosyncratic productivity find it worthwhile to enter.

The banking literature also found evidence in support of the claim that aggregate conditions have an impact on selection at entry. A number of papers, among which Cetorelli (2009), find that when credit market conditions are relatively favorable, entering firms are less productive on average.

The relative size of exiters is also higher during recession. A drop in the common productivity component leads to a lower value of all incumbents. It follows that the marginal exiter will have a higher value of the idiosyncratic productivity component.

5.2   Impulse Responses

The objective of this section is to describe the impulse response functions in order to gain some more intuition about the model's dynamics. We initialized the system by assuming that the distribution of firms is equal to the point–wise mean on the ergodic set. The common productivity component is set at its mean value. At time $t = 1$, we impose that the aggregate shock jumps to its highest value and we compute the evolution of the size distribution over the next 20 periods. We repeated this experiment for 3,000 times and depicted the averages of selected variables in Figures 7 and 8.

The left–most panel on the top of Figure 7 simply reports the deviation of the common productivity component from its unconditional mean. Not surprisingly, output, the wage rate and employment display similar dynamics. The contemporaneous response to the shock is almost entirely due to the expansion in hiring by incumbents.
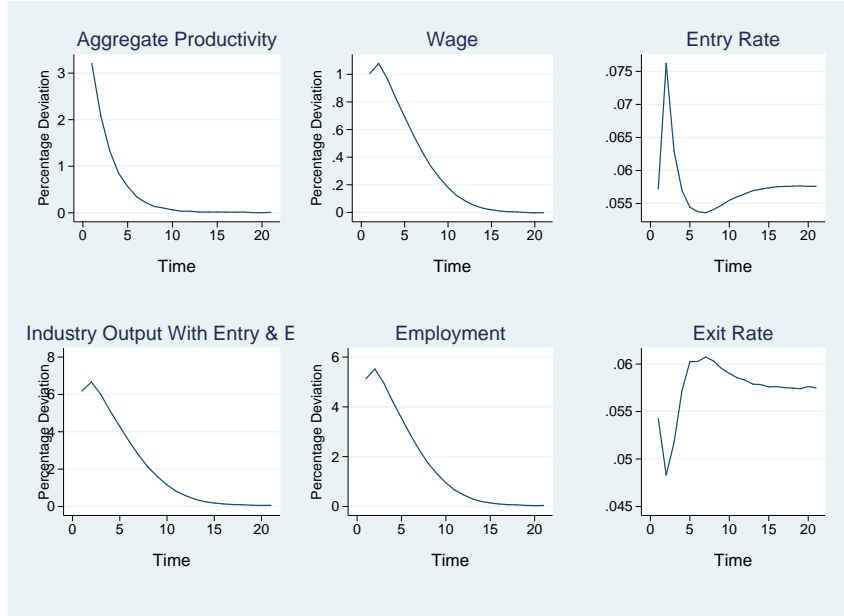
Figure 7: Response to a positive productivity shock.

Given our timing assumptions, entry reacts to aggregate shocks with one period lag. Exit also reacts with delay, because it is optimal for entrepreneurs to disinvest before closing down shop. In period 2, exit drops dramatically, while entry rises. This is why output and employment peak.

The number of operating firms peak in period 3. In the following periods, the exit volume is greater than entry. Therefore, the number of operating firms declines.

The two right–most panels show that the convergence of both exit and entry rates to their unconditional means is not monotone. The exit rate overshoots its long–run value. The entry rate undershoots. These features stem from the fact that the wage decays at a lower pace than aggregate productivity.

A few periods after the positive shock hits, the aggregate component of productivity is back close to its unconditional mean. However, the wage is still relatively high. The reason is that the volume of entry is finite and firms are born relatively small. As the survivors become more efficient, their labor demand increases, keeping the wage from falling faster. With a relatively high wage and relatively low aggregate productivity, the selection effect changes sign. Entry falls below its long–run value, while exit is higher than that.

Figure 8 shows that, following the hike in the aggregate component, the average idiosyncratic productivity of both entrants and exiters declines. In turn, this leads to a fall in the industry's average idiosyncratic efficiency. The relative size of entrants and
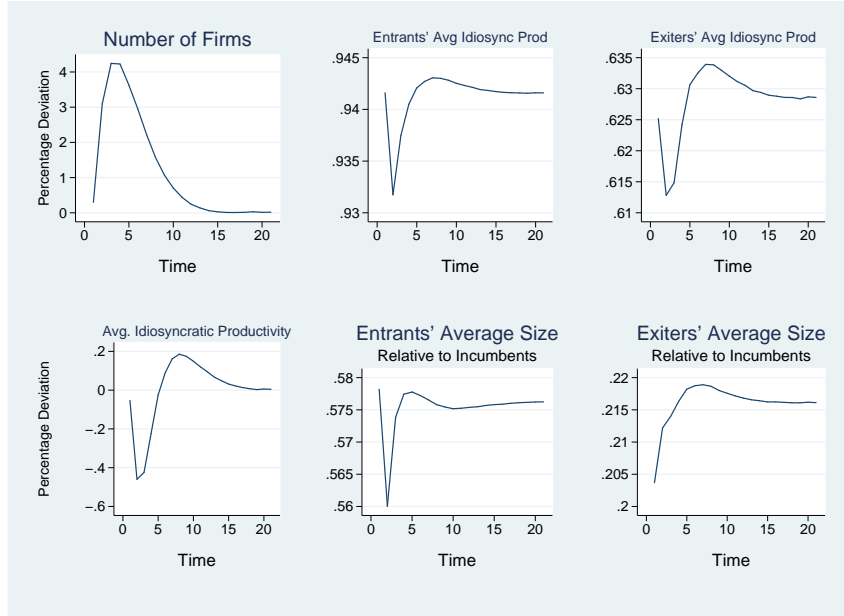
Figure 8: Response to a positive productivity shock.

exiters also decreases, since it is uniquely determined by the differences between their and the incumbents' idiosyncratic productivity. Consistent with the above discussion, the convergence of average idiosyncratic productivity levels to their unconditional means is not monotone.

6 The importance of entry and exit

In this section we show that allowing for entry and exit enhances the model's internal propagation mechanism. It follows that measuring the aggregate Solow residual as it is customary done in macroeconomics results in an upward bias in its persistence's estimate.

This is the outcome of two forces. One is the pro–cyclicality of the entry rate. The other is the fact that firms start out relatively unproductive, but quickly grow in size and efficiency. This dynamics is reflected in the contribution of net entry to aggregate productivity growth. As it is the case in the data, the contribution of new entrants is small in their first year, but grows disproportionably faster than their number.

Finally, we describe our model's implications for the cyclicality of the cross–sectional standard deviation of productivity growth.

6.1 Propagation

Think of the economy considered in Section 5, but abstract from entry and exit. At every point in time, there is a mass of firms whose technology is exactly as specified above. However, firms never exit. As the purpose is to compare such economy with our benchmark, let's assume that the number of operating firms is equal to unconditional average number of incumbents in the benchmark.
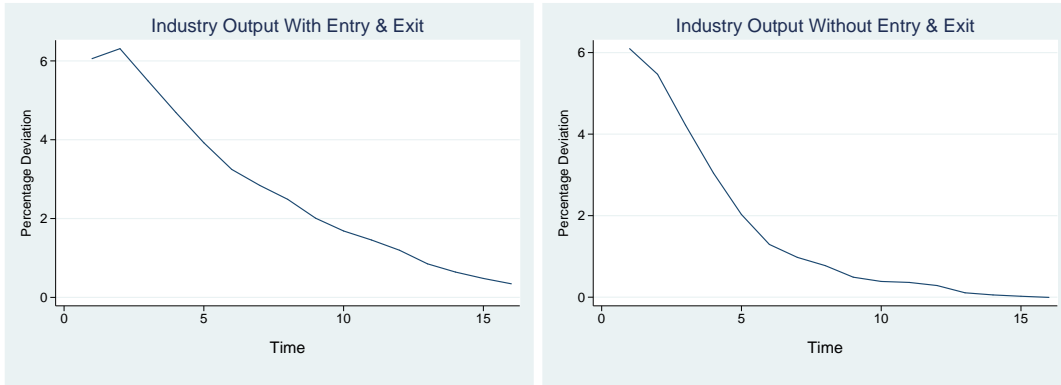

Figure 9: Accuracy of the Forecasting Rule.

In the right panel of figure 9 we plotted the impulse response of industry output to a positive aggregate shocks. For comparison, the left panel reports the impulse response in the benchmark scenario.

Since entry and exit are essentially determined one period ahead, it is not surprising that the contemporaneous response of the two economies is about the same. In either case, the increase in output is due the rise in hiring by incumbents. In period 2, output increases in the benchmark economy, while it decreases in the scenario without entry or exit. This is expected, as entry increases.

What is perhaps less expected is that the process of output mean–reversion is slower when we allow for entry and exit. In other words, the aggregate output is more more persistent. The difference is driven by the dynamics of firms born during the expansion. Firms that entered in the wake of positive shocks are initially very small and therefore account for a rather small fraction of total output. Over time, however, they grow in efficiency and size. This process takes place at the same time in which the aggregate productivity component regresses towards its unconditional mean. As a result, aggregate output and efficiency fall at a slower pace.

A confirmation that this mechanism is indeed at work comes from the inspection of
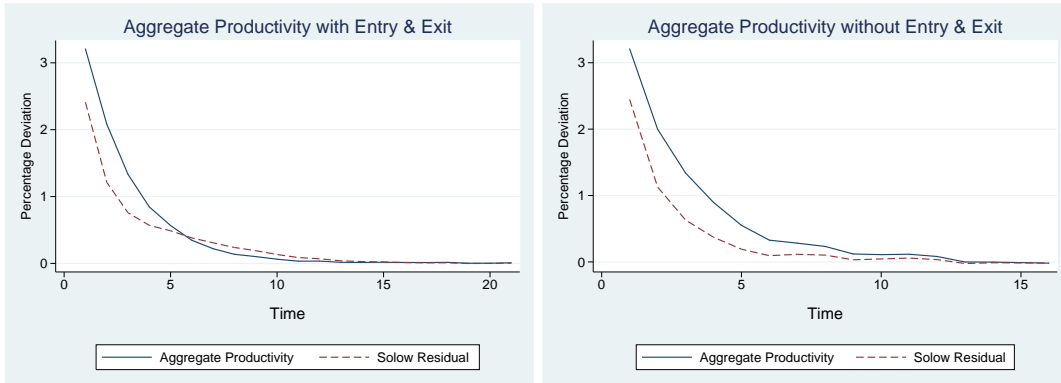
Figure 10: Accuracy of the Forecasting Rule.

Figure 10. The solid lines depict the impulse responses of the aggregate productivity component z_t. They are identical by construction. The dashed lines depict the Solow residuals in the two economies, computed by assuming an aggregate production function of the Cobb–Douglas form with capital share equal to 0.3. That is, we plotted $\log(Y_t) - \alpha \log(K_t) - (1-\alpha) \log(L_t)$. The evolution of the residual depends on the dynamics of both z_t and the distribution of the idiosyncratic component s_t. In the benchmark economy, the latter improves over time. In the case without entry and exit, it is time–invariant.

The simple exercise just conducted hints that trying to infer information about the process of aggregate productivity using a model without entry or exit will inevitably give the wrong answer. Such model will interpret changes in aggregate efficiency that results from the reallocation of output shares towards more efficient firms as changes in the exogenous aggregate component.

We also conducted the alternative experiment of setting the parameters in the economy without entry and exit in such a way that it generates the same values of the target moments as the benchmark economy. To generate an autocorrelation of output equal to 0.89, we had to set $\rho_z = 0.775$, much higher than the value of 0.65 assumed in Section 4.

6.2 Productivity Decomposition

Necessary conditions for the increase in propagation that we have just described are that entry is pro–cyclical and that entrants' productivity grows faster than the incumbents'. Is there any evidence that the latter claim holds true in the data?

Foster, Haltiwanger, and Krizan (2001) conducted a thorough and comprehensive review of the literature that exploits longitudinal establishment data in order to understand the determinants of aggregate productivity growth. One of their findings is that the con-

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tribution of net entry to productivity growth tends to be small in high–frequency studies, while it is much larger in lower–frequency analyses. To a large extent, this is due to the fact that because of selection and/or learning, the productivity gap between entrants and exiters is greater, the longer the time between observations.

Conducting a standard productivity decomposition on simulated data generated by our model leads to the same conclusion. In our case, selection and mean-reverting productivity are the assumptions that are responsible for the result.

Define total factor productivity as the weighted sum of firm–level Solow residuals, where the weights are the shares of output. Let $\mathcal{C}_t$ denote the collection of plants active in both periods $t - k$ and t. The set $\mathcal{E}_t$ includes the plants that entered between the two dates and are still active at time t. In $\mathcal{X}_{t-k}$ are the firms that were active at time $t - k$, but exited before time t.

Following Haltiwanger (1997), the growth in TFP can be decomposed into five components, corresponding to the addenda in equation (3). They are known as (i) the *within* component, which measures the changes in productivity for continuing plants, (ii) the between–plant portion, which reflects the change in output shares across continuing plants, (iii) a covariance component, and finally an (iv) entry and (v) exit components.[9]

$$\Delta \log(TFP_t) = \sum_{i \in \mathcal{C}_t} \phi_{i,t-k} \Delta \log(TFP_{it}) + \sum_{i \in \mathcal{C}_t} [\log(TFP_{i,t-k}) - \log(TFP_{t-k})] \Delta \phi_{it} +$$
$$\sum_{i \in \mathcal{C}_t} \Delta \log(TFP_{it}) \Delta \phi_{it} + \sum_{i \in \mathcal{E}_t} [\log(TFP_{it}) - \log(TFP_{t-k})] \phi_{it} +$$
$$\sum_{i \in \mathcal{X}_{t-k}} [\log(TFP_{i,t-k}) - \log(TFP_{t-k})] \phi_{i,t-k} \tag{3}$$

Table 6 reports the results that obtain when we set k equal to 1 and 5, respectively. In the last column, labeled Net Entry, we report the difference between the entry and exit components. Recall that in our model the unconditional mean of aggregate productivity growth is identically zero.

k	Within	Between	Covariance	Entry	Exit	Net Entry
1	-8.8477	-3.3663	11.9392	-0.5584	-0.8337	0.2753
5	-15.0994	-10.6881	24.4110	-0.9062	-2.2832	1.3770

Table 6: Productivity Decomposition (percentages).

The between and within components are necessarily negative, because of mean rever-

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[9]With ϕ_{it} and TFP_{it} we denote firm i's output share and measured total factor productivity at time t, respectively. TFP_t is the weighted average total factor productivity across all firms active at time t.

sion in the process driving idiosyncratic productivity. Larger firms, which tend to be more productive, shrink on average. Smaller firms, on the contrary, tend to grow. The covariance component is positive, because firms that become more productive also increase in size.

On average, both the entry and exit contributions are negative. This reflects the fact that both entrants and exiters are less productive than average. However, entrants tend to be more productive than exiters. The contribution of net entry to productivity growth is positive regardless of the horizon.

What's most relevant for our analysis is that for $k = 5$ the contribution of net entry is one order of magnitude larger than for $k = 1$. In part, this is due to the fact that the share of output produced by entrants increases with k. However, this cannot be the whole story. The contribution of entry is roughly -0.56% for $k = 1$ and goes to -0.9% for $k = 5$. If entrants' productivity did not grow faster than average, the contribution of entry for the $k = 5$ horizon would be much smaller.

6.3   Cyclical Variation of Cross–sectional Moments

A recent literature has documented that idiosyncratic risk faced by economic agents is strongly counter–cyclical. For example, Storesletten, Telmer, and Yaron (2004) find that individual labor income is riskier during recessions.

Eisfeldt and Rampini (2006) and Bachman and Bayer (2009b) argue that firm–level uncertainty is also counter–cyclical. Their conclusion is based on the finding that the cross–sectional standard deviation of firm–level TFP growth in an unbalanced panel is negatively correlated with detrended GDP. Recognizing the possibility that systematic cyclical variation in entry and exit selection may bias their results, Bachman and Bayer (2009b) estimate a selection model, where lagged Solow residuals determine selection.

According to our theory, the concern of Bachman and Bayer (2009b) is justified. Time–varying selection in entry and exit does generate systematic compositional changes in the cross–sectional distribution of idiosyncratic productivity, suggesting that particular care should be placed in inferring the properties of the process of firm–level productivity from information on cross–sectional moments. If the process responsible for generating their data was consistent with our theory, there would be systematic cyclical sample selection.

The good news is that the selection bias reinforces their results. With an homoscedastic process for idiosyncratic productivity, the cross–sectional standard deviation of firm–level TFP growth is larger during expansions than during recessions. This rules out the possibility that, in spite of finding a counter–cyclical variation in the cross–sectional standard

deviation of firm–level TFP growth, idiosyncratic uncertainty faced my firms is indeed acyclical.

In our framework, expansions are times in which the volume of entry is relatively high and their average productivity is relatively low. As a result, the firm distribution over idiosyncratic productivity is more skewed to the right, i.e. it will have relatively more mass on low values of the shock.

This is illustrated in Figure 11. For each level of idiosyncratic shock, it plots the difference between the (average) fraction of firms associated with it in expansion and in recession, respectively. In expansions we record a larger fraction of firms with less than average idiosyncratic productivity.
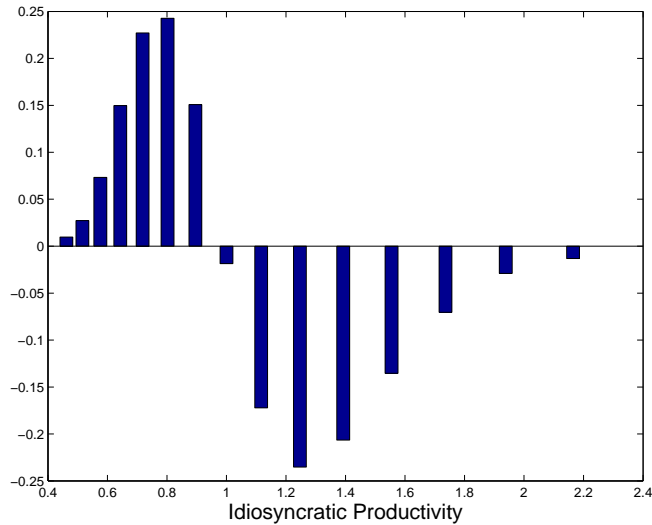

Figure 11: Change in the Cross-Sectional Distribution.

This immediately implies that the mean idiosyncratic productivity is counter–cyclical. As it turns out, the standard deviation is also counter–cyclical. Given that the expected growth of productivity is monotonically decreasing in its level, both the cross–sectional mean and standard deviation of productivity growth are pro–cyclical.

Since the conditional survival rate is higher during expansions, there will be firms that, following a drop in idiosyncratic productivity, will exit in a recession (when aggregate TFP is low) but will keep operating in an expansion. For such firms, recorded productivity growth will be higher during a recession. In our simulations this effect is dominated by the one described above.

7 Conclusion

This paper provides a framework for the study of the dynamics of the cross–section of firms and its implications for aggregate dynamics. When calibrated to match a set of moments of the investment process, our model delivers implications for firm dynamics and for the cyclicality of entry and exit that are consistent with the evidence.

The survival rate increases with size. The growth rate of employment is decreasing with size and age, both unconditionally and conditionally. The size distribution of firms is skewed to the right. When tracking the size distribution over the life a cohort, the skewness declines with age.

The entry rate is positively correlated with current and lagged output growth. The exit rate is negatively correlated with output growth and positively associated with future growth.

We show that allowing for entry and exit enhances the internal propagation mechanism of the model. This obtains because of four features of the equilibrium allocation: (i) entry is pro–cyclical, (ii) entrants are smaller than the average incumbent, and (iii) particularly so during expansions. Finally, (iv) idiosyncratic productivity is mean reverting.

A positive shock to aggregate productivity leads to an in increase in entry. Consistent with the empirical evidence, the new entrants are smaller and less efficient than incumbents. The skewness of the distribution of firms over the idiosyncratic productivity component increases. As the exogenous component of aggregate productivity declines towards its unconditional mean, the new entrants that survive grow in productivity and size. That is, the distribution of idiosyncratic productivity improves.

For a version of our model without entry or exit to generate a data–conforming persistence of output, the first–order autocorrelation of aggregate productivity shocks must be 0.775. In the benchmark scenario with entry and exit, it needs only be 0.65.

Even though idiosyncratic productivity is homoscedastic by assumption, systematic time–varying selection in entry implies that both mean and standard deviation of the cross–sectional distribution of firm–level Solow residual are counter–cyclical. Since idiosyncratic productivity is also mean–reverting, the cross–sectional mean and standard deviation of productivity growth are pro–cyclical. This is important, because it identifies the sign of the bias that is implicit in the estimates of these cross–sectional moments in unbalanced panels.

A   Numerical Approximation

Our algorithm consists of the following steps.

1. Guess values for the parameters of the wage forecasting rule $\hat{\beta} = \left\{ \hat{\beta}_0, \hat{\beta}_1, \hat{\beta}_2, \hat{\beta}_3 \right\}$;

2. Approximate the value function of the incumbent firm;

3. Simulate the economy for T periods, starting from an arbitrary initial condition (z_0, Γ_0);

4. Obtain a new guess for $\hat{\beta}$ by running regression (2) over the time–series $\{w_t, z_t\}_{t=S+1}^T$, where S is the number of observation to be scrapped because the dynamical system has not reached its ergodic set yet;

5. If the new guess for $\hat{\beta}$ is close to the previous one, stop. If not, go back to step 2.

A.1   Approximation of the value function

The incumbent's value function is approximated by value function iteration.

1. Start by defining grids for the state variables w, z, k, s. Denote them as Ψ_w, Ψ_z, Ψ_k, and Ψ_s, respectively. The wage grid is equally spaced and centered around the equilibrium wage of the stationary economy. The capital grid is constructed following the method suggested by McGrattan (1999). The grids and transition matrices for the two shocks are constructed following Tauchen (1986). For all pairs (s, s') such that $s, s' \in \Psi_s$, let $H(s'|s)$ denote the probability that next period's idiosyncratic shock equals s', conditional on today's being s. For all (z, z') such that $z, z' \in \Psi_z$, let also $G(z'|z)$ denote the probability that next period's aggregate shock equals z', conditional on today's being z.

2. For all triplets (w, z, z') on the grid, the forecasting rule yields a wage forecast for the next period (tildes denote elements not on the grid):

$$\log(\tilde{w}') = \hat{\beta}_0 + \hat{\beta}_1 \log(w) + \hat{\beta}_2 \log(z') + \hat{\beta}_3 \log(z).$$

In general, $\tilde{w}'$ will not belong to the grid of wages. There will be contiguous grid points (w_i, w_{i+1}) such that $w_i \leq \tilde{w}' \leq w_{i+1}$. Now let $J(w_i|w, z, z') = 1 - \frac{\tilde{w}' - w_i}{w_{i+1} - w_i}$, $J(w_{i+1}|w, z, z') = \frac{\tilde{w}' - w_i}{w_{i+1} - w_i}$, and $J(w_j|w, z, z') = 0$ for all j such that $j \neq i$ and $j \neq i + 1$. This will allow us to evaluate the value function for values of the wage which are off the grid, by linear interpolation;

3. For all grid elements (w, z, k, s), guess values for the value function $V_0(w, z, k, s)$;

4. The revised guess of the value function, $V_1(w, z, k, s)$, is determined as follows:

$$V_1(w, z, k, s) = \max\left[0, \max_{k' \in \Psi_k} \pi(w, z, k, s) - x - c_0 k\chi - c_1\left(\frac{x}{k}\right)^2 k - c_f + \right.$$

$$\left. \frac{1}{R}\sum_j\sum_i\sum_n V_0(w_i, z_j, k', s_n)H(s_n|s)J(w_i|w, z, z_j)G(z_j|z)\right],$$

$$\text{s.t. } x = k' - k(1 - \delta),$$

$$\pi(w, z, k, s) = \frac{1 - (1 - \alpha)\theta}{(1 - \alpha)\theta}w^{-\frac{\theta(1-\alpha)}{1-\theta(1-\alpha)}}[(1 - \alpha)\theta szk^{\alpha\theta}]^{\frac{1}{1-\theta(1-\alpha)}},$$

$$\chi = 1 \text{ if } k' \neq k \text{ and } \chi = 0 \text{ otherwise}.$$

5. Keep on iterating until $\sup\left|\frac{V_{t+1}(w, z, k, s) - V_t(w, z, k, s)}{V_t(w, z, k, s)}\right| < 10.0^{-6}$. Denote the latest value function as $V_\infty(w, z, k, s)$.

A.2 Entry

1. Define a grid for the signal. Denote it as Ψ_q. Let also $W(s_n|q)$ indicate the probability that the first draw of the idiosyncratic shock is s_n, conditional on the signal being q.

2. For all triplets (w, z, q) on the grid, compute the value of entering as

$$V_e(w, z, q) = \max_{k' \in \Psi_k} -k' + \frac{1}{R}\sum_j\sum_i\sum_n V_\infty(w_i, z_j, k', s_n)W(s_n|q)J(w_i|w, z, z_j)G(z_j|z)$$

3. For all grid points z, construct a bi-dimensional cubic spline interpolation of $V_e(w, z, q)$ over the dimensions (w, q). For all pairs $\tilde{w}, \tilde{q}$, denote the value of entering as $\tilde{V}_e(\tilde{w}, z, \tilde{q})$.

4. Define $\tilde{q}_e(\tilde{w}, z)$ as the value of the signal which makes prospective entrants indifferent between entering and not. That is, $\tilde{V}_e(\tilde{w}, z, \tilde{q}_e(\tilde{w}, z)) = c_e$.

A.3 Simulation

1. Given the current firm distribution Γ_t and aggregate shock z_t, compute the equilibrium wage $\tilde{w}_t$ by equating the labor supply equation $L^s(w) = w^\gamma$ to the labor demand equation

$$L_t^d(w) = \left(\frac{z_t\theta(1 - \alpha)}{w}\right)\sum_m\sum_n\left[s_n k_m^{\alpha\theta}\right]^{\frac{1}{1-\theta(1-\alpha)}}\Gamma_t(s_n, k_m)$$

2. For all $z' \in \Psi_z$, compute the conditional wage forecast $\tilde{w}_{t+1}(z')$ as follows:

$$\log[\tilde{w}_{t+1}(z')] = \hat{\beta}_0 + \hat{\beta}_1 \log(\tilde{w}_t) + \hat{\beta}_2 \log(z') + \hat{\beta}_3 \log(z_t).$$

For every z', there will be contiguous grid points (w_i, w_{i+1}) such that $w_i \leq \tilde{w}_{t+1}(z') \leq w_{i+1}$. Now let $J_{t+1}(w_i|z') = 1 - \frac{\tilde{w}_{t+1}(z') - w_i}{w_{i+1} - w_i}$, $J_{t+1}(w_i|z') = \frac{\tilde{w}_{t+1}(z') - w_i}{w_{i+1} - w_i}$, and $J_{t+1}(w_j|z') = 0$ for all j such that $j \neq i$ and $j \neq i+1$;

3. For all pairs (k, s) on the grid such that $\Gamma_t(k, s) > 0$, the optimal choice of capital $k'(\tilde{w}_t, z_t, k, s)$ is the solution to the following problem:

$$\max_{k' \in \Psi_k} \pi(\tilde{w}_t, z_t, k, s) - x - c_0 k \chi - c_1 \left(\frac{x}{k}\right)^2 k - c_f +$$

$$+ \frac{1}{R} \sum_j \sum_i \sum_n V_\infty(w_i, z_j, k', s_n) H(s_n|s) J_t(w_i|z_j) G(z_j|z_t),$$

s.t. $x = k' - k(1 - \delta)$,

$$\pi(\tilde{w}_t, z_t, k, s) = \frac{1 - (1-\alpha)\theta}{(1-\alpha)\theta} \tilde{w}_t^{-\frac{\theta(1-\alpha)}{1-\theta(1-\alpha)}} [(1-\alpha)\theta s z_t k^{\alpha\theta}]^{\frac{1}{1-\theta(1-\alpha)}},$$

$\chi = 1$ if $k' \neq k$ and $\chi = 0$ otherwise .

4. There will be contiguous elements of the signal grid (q^*, q^{**}) such that $q^* \leq \tilde{q}_e(\tilde{w}_t, z_t) \leq q^{**}$.

   - For all $q \geq q^{**}$, the initial capital of entrants $k'_e(\tilde{w}_t, z_t, q)$ solves the following problem:

   $$\max_{k'_e \in \Psi_k} -k_m + \frac{1}{R} \sum_j \sum_i \sum_n V_\infty(w_i, z_j, k'_e, s_n) W(s_n|q) J_t(w_i|z_j) G(z_j|z_t)$$

   - We can easily compute the distribution of the idiosyncratic shock conditional on $\tilde{q}_e \equiv \tilde{q}_e(\tilde{w}_t, z_t)$, denoted as $\tilde{W}(s_n|\tilde{q}_e)$ and then compute the optimal capital $k'_e(\tilde{w}_t, z_t, \tilde{q}_e)$ as the solution to:

   $$\max_{k'_e \in \Psi_k} -k_m + \frac{1}{R} \sum_j \sum_i \sum_n V_\infty(w_i, z_j, k'_e, s_n) \tilde{W}(s_n|\tilde{q}_e) J_t(w_i|z_j) G(z_j|z_t)$$

5. Draw the aggregate productivity shock z_{t+1};

6. Determine the distribution at time $t+1$. For all (k, s) such that $V_\infty(\tilde{w}_{t+1}(z_{t+1}), z_{t+1}, k, s) = 0$, then $\Gamma_{t+1} = 0$. For all other pairs,

$$\Gamma_{t+1}(k, s) = \sum_m \sum_n \Gamma_t(k_m, s_n) H(s|s_n) \Upsilon_{m,n}(w_t, z_t, k) + \mathcal{E}_{t+1}(k, s)$$

where

$$\Upsilon_{m,n}(w_t, z_t, k) = \begin{cases} 1 & \text{if } k'(w_t, z_t, k_m, s_n) = k \\ 0 & \text{otherwise.} \end{cases}$$

and $\mathcal{E}_{t+1}(k, s) = M \sum_{i:q_i \geq q^{**}} H(s|q_i)Q(q_i)\Xi_{m,i}(w_t, z_t, k) + M\tilde{H}(s|q^e)\tilde{Q}(q^e)\tilde{\Xi}_{m,i}(w_t, z_t, k)$

where

$$\Xi_{m,i}(w_t, z_t) = \begin{cases} 1 & \text{if } k'(w_t, z_t, q_i) = k \\ 0 & \text{otherwise.} \end{cases}$$

A.4   More Accuracy Tests of the Forecasting Rule

Forecasting errors are essentially unbiased – the mean error is -0.00017% of the forecasting price – and uncorrelated with the price (the correlation coefficient between the two series is -0.0456) and the aggregate shock (-0.0045).

Figure 12: Accuracy of the Forecasting Rule.

In the left panel of Figure 12 is the scatter plot of the forecasting errors against the market clearing price. In the right panel is the time series of the forecasting error. The good news is that errors do not cumulate.

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