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ABSTRACT

We model worker heterogeneity in the rents from being employed in a Diamond-Mortensen-Pissarides model of matching and unemployment. We show that heterogeneity, reflecting differences in match quality and worker assets, reduces the extent of fluctuations in separations and unemployment. We find that the model faces a trade-off--it cannot produce both realistic dispersion in wage growth across workers and realistic cyclical fluctuations in unemployment.

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1. Introduction

Shimer (2005), Hall (2005), Costain and Reiter (2008), and Gertler and Trigari (2009) each argue that matching models with flexible wages fail to explain business cycle fluctuations—the models generate much more procyclical wages and much less cyclical unemployment and job finding rates than observed. But, as discussed by Costain and Reiter, Mortensen and Nagypal (2007), and Hagedorn and Manovskii (2008), this negative conclusion rests on an assumption that employment renders substantial economic rents relative to the monetary, home production, and leisure benefits to not being employed in the market. For example, Hagedorn and Manovskii, by allowing the payout to unemployment to replace 95% that of employment, are able to rationalize the cyclical volatility of unemployment under the matching model with flexible wages and exogenous separations. So establishing the rents from employment is key to judging how well the matching model captures cyclical fluctuations. Judging the size of these rents a priori is problematic as they reflect, not only direct payments, but also individuals' valuations of leisure and home production.

We shed light on this question by considering endogenous separations. We introduce heterogeneity in reservation wages into a business cycle model of separations, matching, and unemployment. As in Mortensen and Pissarides (1994), we allow workers to face shocks to their employment matches, with bad draws possibly leading to endogenous separations. We depart from Mortensen and Pissarides by allowing for diminishing marginal utility in consumption—necessary for wealth to affect labor supply—and for imperfect insurance as in Aiyagari (1994)—which affects workers' reservation wages. As a result, willingness to trade work for search depends on the worker's wealth. Workers with lower savings, reflecting bad past earnings shocks, are less willing to separate. The heterogeneity in match quality and assets jointly determine the distribution of rents to being employed. In turn, this distribution drives both the level and cyclical nature of unemployment.

We find a trade-off between generating realistic dispersion in wage growth across

workers and generating realistic cyclical fluctuations in unemployment. For instance, with a high replacement rate, such as suggested by Hagedorn and Manovskii, the model can generate reasonable average rates of separation and unemployment only if shocks to match quality are extremely small; so small that wages changes within jobs are an order of magnitude smaller than suggested by empirical studies. With Shimer's calibrated replacement rate of 40%, by contrast, substantial shocks to match quality are required to match average turnover and unemployment rates. We find that match shocks on this order of magnitude are much more consistent with the estimated behavior of cross-sectional dispersion of wages and wage growth found in micro data. With reasonable match quality shocks, selection through endogenous separations yields few matches with quality near the threshold for destruction. In turn, this reduces the responses in separations and unemployment to aggregate shocks. Thus we conclude that the search and matching model, calibrated to reasonable match shocks and separation rates, fails to capture the cyclical nature of unemployment.

The model is presented in the next section then calibrated in Section 3. In Section 4 we examine the model's steady-state features. We show that both a high replacement rate and little heterogeneity, in match quality and assets, are key for producing an economy with many workers with low rents from employment—the scenario that generates a large response of unemployment to aggregate shocks. We require our benchmark economy to exhibit realistic separation and unemployment rates and reasonable dispersions in wage rates of wage growth. In turn, this requires a relatively low replacement rate and significant match quality shocks. We consider an alternative economy that matches the average unemployment with a high replacement rate, but it requires extremely small shocks to match quality.

The model's cyclical predictions are presented in Section 5. The model can generate a very cyclical unemployment rate, but only if there is little dispersion in match quality. With little cross-sectional dispersion there is an important spike up in separations at the onset of a downturn. Secondly, again for low dispersion, the rents to vacancy creation are highly procyclical. Thirdly, the model generates a new avenue for

cyclicality in unemployment—in response to higher expected unemployment duration, separations become skewed toward workers with higher assets and higher reservation match qualities. Because these workers generate smaller expected surplus to employers, this acts to further depress vacancy creation in a recession. However, for our benchmark model that displays reasonable dispersions in match wages and wage growth, we find that separations, vacancies, and unemployment all exhibit much less cyclicality than seen in the data.

Besides Mortensen and Pissarides (1994), an antecedent to our model is Chang and Kim (2006, 2007). They show that the cross-sectional distributions of wealth and worker productivity play a critical role in determining the elasticity of aggregate labor supply in a competitive equilibrium. Nakajima (2007), Shao and Silos (2007), and Krusell, Mukoyama, and Sahin (2008) have also recently adopted diminishing marginal utility in consumption and imperfect risk sharing into the Mortensen-Pissarides model.¹ However, only Shao and Silos allow for heterogeneous productivity; and none of these authors allows for endogenous separations.

Our finding on the trade-off between the cross-sectional wage dispersion and the cyclicality of unemployment is in the same spirit as Hornstein, Krusell, and Violante (2007) who show that, with substantial dispersion in wage offers, the Diamond-Pissarides-Mortensen model implies unemployment durations that are far higher than seen in the data. While both Hornstein, Krusell, Violante (2007) and our work highlight the importance of wage dispersion in a matching model setting, we, as in Mortensen and Pissarides (1994), abstract from dispersion in initial match qualities and any effect of that dispersion on unemployment duration. We focus on the shocks to productivity and wages within matches, which is central for separations, whereas Hornstein, Krusell

¹Other papers that entertain wealth effects in modeling search include Pissarides (1987), Gomes, Greenwood, and Rebelo (2001), and Hall (2006). Haefke and Reiter (2006) generate dispersion in reservation wages, while maintaining linear utility and no match-specific productivity, by assuming heterogeneity in individuals' value of home production. Several papers (Darby, Haltiwanger, and Plant, 1985, Baker, 1992, and Pries, 2007) have argued that lower job-finding rates during recessions may reflect a compositional shift toward workers who display lower job-finding rates. But these papers impose this shift exogenously, whereas our model, by allowing for wealth effects, predicts such a shift in recessions toward unemployed workers with high reservation match qualities.

and Violante (2007) focus on the dispersion in initial match offerings.²

2. Model

We build on the model of cyclical unemployment in Mortensen and Pissarides (1994). We depart from Mortensen and Pissarides by letting workers be risk averse—necessary for wealth effect to affect labor supply, face a borrowing constraint, and value leisure, distinct from goods consumption, from being unemployed.

2.1. Environment

There is a continuum of infinitely-lived workers with total mass equal to one. Each worker has preferences defined by

$$E_0 \sum_{t=0}^{\infty} \beta^t \left\{ \frac{c_t^{1-\gamma} - 1}{1-\gamma} + B \cdot l_t \right\},$$

where $0 < \beta < 1$ is the discount factor, and $c_t (> 0)$ is consumption. The parameter B denotes the utility from leisure when unemployed. l_t is 1 when unemployed and otherwise zero. In Mortensen and Pissarides (1994), and many extensions, there is no valuation of leisure; so a marginal rate of substitution between leisure and consumption is not defined. Here the marginal rate of substitution ($c^{-\gamma}/B$) is decreasing in c . This provides the basis for a worker's reservation match quality to be increasing in consumption and thereby savings.

Each period a worker either works (employed) or searches for a job (unemployed). A worker, when working, earns wage w . If unemployed, a worker receives an unemployment benefit b . Each can borrow or lend at a given real interest rate r by trading the asset a . But there is a limit, \underline{a} , that one can borrow; that is $a_t > \underline{a}$. Real interest

²An advantage of our focus, we would argue, is that it is easier to identify that movements in wages within matches (jobs) are empirically important, than to identify the importance of dispersion in initial match offerings, separate from individual effects.

rate r is determined exogenously to fluctuations in this particular economy (small open economy).

There is also a continuum of identical agents we refer to as entrepreneurs (or firms). Entrepreneurs have the ability to create job vacancies with a cost κ per vacancy. Entrepreneurs are risk neutral, diversifying ownership of their investments across many vacancies and across economies, and maximize the discounted present value of profits

$$E_0 \sum_{t=0}^{\infty} \left(\frac{1}{1+r} \right)^t \pi_t.$$

There are two technologies in this economy, one that describes the production of output by a matched worker-entrepreneur pair and another that describes the process by which workers and entrepreneurs become matched. A matched pair produces output

$$y_t = z_t x_t,$$

where z_t is aggregate productivity and x_t is idiosyncratic match-specific productivity, i.e., match quality. Both aggregate productivity and idiosyncratic productivity evolve over time according to Markov processes, respectively $Pr[z_{t+1} < z' | z_t = z] = D(z'|z)$ and $Pr[x_{t+1} < x' | x_t = x] = F(x'|x)$. For newly formed matches, idiosyncratic productivity starts at the mean value of the unconditional distribution, which is denoted by \bar{x} .³

The number of new meetings between the unemployed and vacancies is determined by a matching function

$$m(v, u) = \eta u^{1-\alpha} v^\alpha,$$

where v is the number of vacancies and u is the number of unemployed workers. The matching rate for an unemployed worker is $p(\theta) = m(v, u)/u = \eta\theta^\alpha$, where $\theta = v/u$ is

³With dispersion in initial match quality, then workers will turn down some new matches. This would, everything else equal, increase unemployment duration and the average rate of unemployment. Hornstein, Krusell, and Violante, 2007, examine the tension between generating reasonable wage dispersion and average unemployment duration in a calibrated Diamond-Mortensen-Pissarides model. Therefore, to maintain the target rate of unemployment, this extension would require a lower value of unemployment (parameter B) for our calibrated model. We expect this would further reduce the model's ability to produce cyclical fluctuations in unemployment.

the vacancy-unemployment ratio, the labor market tightness. The probability that a vacant job matches with a worker is $q(\theta) = m(v, u)/v = \eta\theta^{\alpha-1}$.

A matched worker-firm constitutes a bilateral monopoly. We assume the wage is set by bargaining between the worker and firm over the match surplus. This is discussed in the next subsection. The match surplus reflects the value of the match relative to the summed worker's value of being unemployed and the entrepreneur's value of an unmatched vacancy, which is zero in equilibrium. There are no bargaining rigidities; separations are efficient for the worker-firm pair, occurring if and only if match surplus falls below zero.

The timing of events can be summarized as follows.

1. At the beginning of each period matches from the previous period's search and matching are realized. Also, aggregate productivity z and each match's idiosyncratic productivity x are realized.
2. Upon observing x and z , matched workers and entrepreneurs decide whether to continue as an employed match. Workers breaking up with an entrepreneur become unemployed. There is no later recall of matches.
3. For employed matches, production takes place with the wage reflecting worker-firm bargaining. Also at this time, unemployed workers and vacancies engage in the search/matching process.

2.2. Value functions

Consider a recursive representation, where W , U , J , and V denote respectively the values for the employed, unemployed, a matched entrepreneur, and a vacancy. All value functions depend on the measures of workers. Two measures capture the distribution of workers: $\mu(a, x)$ and $\psi(a)$, respectively, represent the measures of employed workers and unemployed workers during the period.⁴ The evolution of these measures is given

⁴Let \mathcal{A} and \mathcal{X} denote sets of all possible realizations of a and x , respectively. Then $\mu(a, x)$ is defined over σ -algebra of $\mathcal{A} \times \mathcal{X}$ while $\psi(a)$ is defined over σ -algebra of \mathcal{A} .

by \mathbf{T} , i.e., $(\mu', \psi') = \mathbf{T}(\mu, \psi, z)$. For notational convenience, let $\mathbf{s} = (z, \mu, \psi)$.

From the model discussion, it follows that the worker's value of being employed is

$$W(a, x, \mathbf{s}) = \max_{a'_e} \left\{ u(c_e) + \beta E [\max\{W(a'_e, x', \mathbf{s}'), U(a'_e, \mathbf{s}')\} | x, \mathbf{s}] \right\}, \quad (1)$$

subject to

$$\begin{aligned} c_e &= (1+r)a + w - a'_e, \\ a'_e &\geq \underline{a}. \end{aligned}$$

The value of being unemployed, recalling that $p(\theta)$ is the probability that an unemployed worker matches, is

$$U(a, \mathbf{s}) = \max_{a'_u} \left\{ u(c_u) + \beta(1-p(\theta(\mathbf{s})))E[U(a'_u, \mathbf{s}') | \mathbf{s}] + \beta p(\theta(\mathbf{s}))E[W(a'_u, \bar{x}, \mathbf{s}') | \mathbf{s}] \right\}, \quad (2)$$

subject to

$$\begin{aligned} c_u &= (1+r)a + b - a'_u, \\ a'_u &\geq \underline{a}, \end{aligned}$$

where $u(c_u)$ includes the leisure value B from being unemployed.

For an entrepreneur the value of a matched job is:

$$J(a, x, \mathbf{s}) = zx - w(a, x, \mathbf{s}) + \beta E [\max\{J(a'_e, x', \mathbf{s}'), V(\mathbf{s}')\} | x, \mathbf{s}]. \quad (3)$$

The value of a vacancy is:

$$V(\mathbf{s}) = -\kappa + \frac{1}{1+r}q(\theta(\mathbf{s})) \int E[J(a'_u, \bar{x}, \mathbf{s}') | \mathbf{s}] d\tilde{\psi}(a'_u) + \frac{1}{1+r}(1-q(\theta(\mathbf{s})))V(\mathbf{s}'), \quad (4)$$

where recall that κ is the vacancy posting cost and $q(\theta)$ is the probability that a vacancy is filled. $\tilde{\psi}(a'_u)$ denotes the measure of unemployed workers at the end of a period after decisions on asset accumulation are made.

2.3. Wage Bargaining

The setting allow for bilateral bargaining between a matched vacancy and worker. We follow much of the literature in assuming that wages reflect a Nash bargaining solution,

such that

$$\operatorname{argmax}_w (W(a, x, \mathbf{s}; w) - U(a, \mathbf{s}; w))^{\frac{1}{2}} (J(a, x, \mathbf{s}; w) - V(\mathbf{s}; w))^{\frac{1}{2}} \quad (5)$$

for all (a, x, \mathbf{s}) .⁵

The Nash solution generates a wage that is increasing in a worker's assets, reflecting that being unemployed is less painful for a worker with greater assets. (Below see Figure 1.) In turn, this makes the vacancy creation decision depend on the assets of the unemployed. We believe these features potentially generalize to settings with wage posting by firms and directed search by workers. For instance, Acemoglu and Shimer (1999) model directed search by risk averse workers. They show that the distribution of posted wages exhibits a higher mean, with longer queues, if workers are less risk averse, as then workers are less willing to take lower wages in order to raise the probability of employment. We would expect increased assets for the unemployed, for given risk aversion, to exhibit comparative statics in this same direction in their setting.

2.4. Evolution of measures

The measures for workers employed and unemployed, $\mu(a, x)$ and $\psi(a)$, evolve as follows.

$$\begin{aligned} \mu'(A^0, X^0) &= \int_{A^0, X^0} \int_{\mathcal{A}, \mathcal{X}} \mathbf{1}_{\{x' \geq x^*(a', \mathbf{s}'), a' = a'_e(a, x, \mathbf{s})\}} dF(x'|x) d\mu(a, x) da' dx' \\ &+ p(\theta(\mathbf{s})) \int_{A^0} \int_{\mathcal{A}} \mathbf{1}_{\{x' = \bar{x}, a' = a'_u(a, \mathbf{s})\}} d\psi(a) da' dx' \end{aligned} \quad (6)$$

$$\begin{aligned} \psi'(A^0) &= \int_{A^0} \int_{\mathcal{A}, \mathcal{X}} \mathbf{1}_{\{x' < x^*(a', \mathbf{s}'), a' = a'_e(a, x, \mathbf{s})\}} dF(x'|x) d\mu(a, x) da' \\ &+ (1 - p(\theta(\mathbf{s}))) \int_{A^0} \int_{\mathcal{A}} \mathbf{1}_{\{a' = a'_u(a, \mathbf{s})\}} d\psi(a) da' \end{aligned} \quad (7)$$

for all $A^0 \subset \mathcal{A}$ and $X^0 \subset \mathcal{X}$.

⁵Rubinstein (1982) demonstrates in a stationary environment that the Nash solution can be interpreted as the outcome of a noncooperative game with sequential offers. In our stochastic setting without linear utility this interpretation does not literally hold (Coles and Wright, 1998.) We adopt the Nash solution, however, partly for comparability with the related literature.

2.5. Equilibrium

The equilibrium consists of a set of value functions, $W(a, x, \mathbf{s})$, $U(a, \mathbf{s})$, $J(a, x, \mathbf{s})$, a set of decision rules for consumption $c_e(a, x, \mathbf{s})$, $c_u(a, \mathbf{s})$, asset holdings $a'_e(a, x, \mathbf{s})$, $a'_u(a, \mathbf{s})$, and separating $x^*(a, x, \mathbf{s})$, the wage schedule $w(a, x, \mathbf{s})$, the labor-market tightness $\theta(\mathbf{s})$, and a law of motion for the distribution, $(\mu', \psi') = \mathbf{T}(\mu, \psi, z)$. Equilibrium is defined by the following.

1. (Optimal Savings): Given θ , w , μ , ψ , and \mathbf{T} , a' solves the Bellman equations for W , U , J and V in (1), (2), (3), and (4).
2. (Optimal Separation): Given W , U , J , V , μ , ψ , and \mathbf{T} , x^* satisfies $J(a, x^*, \mathbf{s}) = 0$.
3. (Nash Bargaining): Given W , U , J and V , w satisfies $J(a, x, \mathbf{s}) = (W(a, x, \mathbf{s}) - U(a, \mathbf{s})) \times u'(c_e(a, x, \mathbf{s}))^{-1}$.
4. (Free Entry): Given w , x^* , J , μ , ψ , and \mathbf{T} , the vacancies are posted until $V = 0$.
5. (Rational Expectations): Given a'_e , a'_u and x^* , the law of motion for distribution $(\mu', \psi') = \mathbf{T}(\mu, \psi)$ is described in (6) and (7).

3. Model Calibration

We calibrate our model in order to present its predictions for business cycle fluctuations. But, prior to considering business cycles, in Section 4 we display the model's steady-state features, in particular showing how the heterogeneity of worker's match quality and assets determine the distribution of rents to employment.

3.1. The benchmark economy

We consider two calibrated models that yield the same steady-state rates of separations and unemployment, but differ sharply in their predictions for the average level, and

dispersion, in match rents. Our benchmark calibration reflects nontrivial rents to employment that reflect dispersion in wages due to differences in match quality. These rents are roughly consistent both with the dispersion observed for wage growth within matches (e.g., Topel and Ward, 1992) and with the dispersion for wage levels that has been attributed to match effects estimated on matched employer, employee data (Woodcock, 2008). We also describe an alternative calibration that is designed to generate sizable cyclical fluctuations—large enough to match the observed volatility of aggregate unemployment in the data. But this calibration hinges on having almost no dispersion in match quality, which requires extremely small dispersion in wage growth within matches.

Starting with preferences, we assume a relative risk aversion parameter γ equal to one. We choose a monthly discount factor β of 0.995 and an annualized real interest rate of 6%. These together generate average assets equal to 18 months of labor earnings, which is about the median ratio of net worth to family earnings we calculate from the Survey of Income and Program Participation (SIPP) data. (See Bills, Chang, and Kim, 2007, for more details on statistics derived from the SIPP.) We set the borrowing constraint to six, so approximately six month labor income, as we see few households in the SIPP with unsecured debt exceeding this amount.

The key outcomes we target are the average rates of unemployment and separations. We target an average unemployment rate of 6% and a monthly separation rate of 2%. (A separation rate of 2% is consistent with what we see for the SIPP data.) These rates for unemployment and separations imply a steady-state job finding rate, of 31%, a rate consistent with transition hazards reported by Meyer (1990). The vacancy posting cost κ is chosen so that the vacancy-unemployment ratio (θ) is normalized to 1 in the steady state. The matching technology is Cobb-Douglas; $m(v, u) = .31 v^\alpha u^{1-\alpha}$ hits the steady-state finding rate. We set the matching power parameter α to 0.5.

Remaining to calibrate are the payouts to being unemployed, which are unemployment insurance b and leisure utility B , and the magnitude of match-specific shocks. These are key determinants of rates of separations and unemployment. If unemploy-

ment is made more attractive, everything else equal, this clearly leads to higher separation and unemployment rates. We calibrate our benchmark economy to generate rents to employment comparable to that in Shimer (2005). To do so, we first considered a special case of our model that, like Shimer’s, has linear utility and no match-quality shocks or endogenous separations—separations occur exogenously at a rate of 2% monthly. We follow Shimer by calibrating unemployment insurance to $b = 0.4$, with $B = 0$. That economy generates capitalized value of a matched job (J) of 1.65, that is, a little over one and half months of match output. This in turn directly implies a vacancy creation cost κ of 0.52 (half of a month’s output). We calibrate our benchmark economy to exhibit the same size of values, $J = 1.65$ and $\kappa = 0.52$. Keeping $b = 0.4$, we find this requires a value for leisure of $B = 0.15$. That is, a consumer views this leisure comparably, in terms of flow utility, to 15% higher consumption.

Greater match-quality shocks, like higher replacement rates, create more separations and higher average unemployment. We set the persistence of the match-specific shock to be quite high, $\rho_x = 0.97$, to accord with the high persistence typically estimated for individual wage earnings.⁶ Finally, we set the standard deviation of these match-quality shocks in order to achieve the target separation and unemployment rates of 2 and 6%. This dictates $\sigma_x = 0.13$. These shocks to match quality produce a plausible match to individual earnings data. In particular, they are consistent with the dispersion in the growth rate of wages within job matches reported by Topel and Ward (1992). Topel and Ward examine quarterly wages for full-time workers based on earnings reported to Social Security for the primary job. We highlight the Topel and Ward study because of its use of administrative data, which should minimize the impact of measurement error. They report a cross-sectional standard deviation of wage-growth relative to four quarters prior, *within job matches*, of 19%. We calculate the growth rate in the same fashion, that is quarterly wages relative to four quarters earlier for the

⁶For example Topel and Ward (1992), discussed in the text to follow, estimate an annual autocorrelation for the growth rate in wage earnings within job matches of -0.33 . When we produce the same statistic, based on wage growth within matches, our calibrated models (all versions) generate a value of -0.27 .

same employer match, for our calibrated model economies. For our benchmark economy the standard deviation of this growth rate is 18%, quite close to that reported by Topel and Ward.

Our benchmark model generates a standard deviation of wage *levels* across workers, reflecting differences in match quality, that also equals 18%. This figure is more difficult to relate directly to the empirical literature. Woodcock (2008) allows for individual, employer, and match components in explaining dispersion in earnings for a matched employer-employee sample and finds an important match component. Woodcock’s estimated standard deviation for the match component in earnings is 28%. This figure is larger than wage dispersion of 18% for our benchmark model with important match shocks.⁷ But, more to the point, it is far, far greater than the dispersion in wages produced by the high-volatility economy that we describe next.

3.2. The high-volatility economy

For contrast, we consider a cyclically sensitive economy calibrated so that, in response to aggregate shocks to productivity, it exhibits a standard deviation of quarterly unemployment rate that is 9.5 times that in productivity—where 9.5 reflects the ratio of these standard deviations reported by Shimer (2005).

To achieve this targeted cyclicity, while maintaining an average rate of 6% unemployment, we free up the leisure value of unemployment B and the variability of match-quality shocks σ_x , keeping other parameters at their benchmark values.⁸ The economic payoffs while unemployed are key, not only to the average rate of unemployment, but also to its cyclical volatility (Hagedorn and Manovskii, 2008, and Mortensen and Nagypal, 2007)—less surplus to employment increases cyclical volatility of vacancies and unemployment. By contrast, greater volatility of match-specific productivity

⁷The dispersion in wages for our model partially reflects dispersion in assets, as wages are increasing in assets. But most of the wage dispersion for the model reflects differences in match quality.

⁸It requires a very slightly different discount factor ($\beta = 0.9949$, versus 0.9948 for the benchmark) to hit average asset holding of 18 months earnings.

(higher σ_x) has opposite impacts on the level versus cyclical volatility of unemployment. Greater match-quality shocks create more separations and higher average unemployment, but actually reduce the cyclical volatility of separations and unemployment. With greater match-quality shocks, workers become sorted over time into matches with significant match surplus. This makes their separations less responsive to cyclical fluctuations in productivity. Because the level of unemployment is increasing in both B and σ_x , but its cyclicality responds oppositely to the two parameters, we can maintain unemployment's average rate of 6%, while increasing its cyclicality, by appropriately increasing B in conjunction with decreasing σ_x . We find that the combination $B = 0.51$, $\sigma_x = 0.014$ produces a standard deviation of unemployment that is 9.5 times that for productivity. We show that this economy, though generating realistic cyclical volatility, yields implausibly little cross-sectional dispersion for wage growth within matches.

Table 1 summarizes the calibrated parameters with values employed for both the benchmark and high-volatility economies.

4. Steady-state Statistics and the Distribution of Match Rents

We present statistics for the model's steady state to illustrate how a worker's assets and match quality determine his wage, reservation match quality, and the surplus from employment. We focus on the distribution of surplus from employment because this is key in determining cyclical volatility of separations, vacancy creation, and unemployment for the model. We contrast the distribution of rents to employment from our benchmark model to those for the economy calibrated to generate high cyclical volatility in unemployment.

Starting with the benchmark economy, Figure 1 displays the values of the wage, $W - U$, and J as functions of a worker's assets. These relations are illustrated for three different values for match quality x . Higher values of match quality are directly associated with higher wages and capitalized value of employment W , while irrelevant

for U . So both $W - U$ and J correspondingly increase with match quality. Focusing on assets, both W and U increase with assets. But having low assets particularly lowers the value of being unemployed, resulting in a lower bargained wage. Figure 1 displays this positive relation between assets and wages. Both $W - U$ and J (reflecting the higher wage) decrease in worker assets. The sharpest positive relation of the wage to assets, and opposite reaction in J , is concentrated at the very low end of assets, near or below zero.⁹ Focusing on firm rents J , we see that high assets lessens the expected rents of hiring a worker. In turn this provides a channel from assets, specifically the assets of the unemployed, to vacancy creation—high assets among the unemployed, everything else equal, reduces desired vacancies. This implies the cyclicity of assets for the unemployed will influence (oppositely) the cyclicity of vacancy creation.

The top panel of Figure 2 presents the distribution of assets separately for employed and unemployed workers. The model succeeds in generating a fairly wide dispersion in assets, given workers differ only in the history of the quality of employment matches and history of unemployment durations. Because the unemployed draw down assets to maintain consumption, they exhibit average assets of 21% less than the employed (14.7 compared to 18.1). The unemployed exhibit lower consumption, by 9%, than the employed. The bottom panel of Figure 2 displays how a worker's critical value for match quality x^* depends positively on assets—the critical match quality increases with assets throughout the range of relevant asset holding. Projecting this policy for x^* on the distribution for assets in the top panel of Figure 2 yields the distribution for x^* . This distribution exhibits a standard deviation of 3.3%.

Statistics for unemployment, turnover, and assets for the benchmark economy are presented in Table 2. The table reports that the cross-sectional standard deviation of (ln)wages is 18%. As discussed under calibrating, the standard deviation of annual wage growth within a match (calculated to parallel the treatment in Topel and Ward)

⁹The assumptions of Nash bargaining and a coefficient of risk aversion of one imply that J equals $W - U$ times the worker's consumption. For this reason J decreases less than $W - U$ with worker assets. This is more relevant at low asset levels, where consumption responds more to assets. For instance, for $x = 1$, an increase in assets from 0 to 5 yields a drop in J of about two-thirds that in $W - U$.

also equals 18%.

Figure 3 presents the distribution of workers' $\ln(\text{wages})$ relative to the critical wage, $\ln(w^*)$, at which the worker is indifferent to separating. (w^* is the bargained wage associated with critical match quality x^* .) This difference, $\ln(w) - \ln(w^*)$, reflects the flow rents associated with the employment match. These rents are significant for the benchmark economy, averaging 26%. If we consider a drop in match quality sufficient to reduce the wage by 10%, holding w^* unaffected, this would induce only about 16% of workers to separate. The standard deviation across workers of the differential $\ln(w) - \ln(w^*)$ equals 17.8%. This dispersion is largely driven by dispersion in the wage, not the reservation wage (w^*), and in turn reflects the dispersion in match quality, x . Recall that $\ln(\text{wages})$ has a standard deviation of 18.0%. By contrast $\ln(w^*)$ has standard deviation of only 1.5%.

The magnitude of the differential $\ln(w) - \ln(w^*)$ is key to the economy's cyclical volatility. A negative aggregate shock induces only a small response in separations if few workers display wages close to the reservation wage w^* . Greater dispersion in $\ln(w) - \ln(w^*)$, absent search frictions, implies a less elastic aggregate labor supply response to aggregate shocks—in a search and matching model this is manifested by less response in separations. Secondly, a drop, say of one percent, in aggregate productivity represents a much smaller percentage hit to the expected payout to filling a vacancy if the average rents to employment are large. Therefore, considerable rents, such as depicted for the benchmark economy in Figure 3, will act to reduce the cyclicity of both separations and vacancy creation.

By contrast, the high-volatility economy displays much less dispersion in match quality and smaller rents to employment. Results for this model economy are given in Figures 4 and 5. The top panel of Figure 4 presents the distribution of assets separately for employed and unemployed workers; the bottom panel displays how a worker's critical match quality x^* depends on assets. Compared to the benchmark economy, the high-volatility economy generates a smaller dispersion of assets and, as a result, a smaller dispersion of x^* —the standard deviation of x^* is 0.8% for this economy,

compared to 3.3% for the benchmark.

Statistics for the high-volatility economy are presented in the right-most column of Table 2. For the high volatility economy assets and consumption differ little between the employed and unemployed. Reflecting the small shocks to match quality, this economy exhibits a cross-sectional standard deviation for (\ln) wages of only 1.9%, which we view as unreasonably small. Similarly, the high-volatility economy displays very little dispersion for rates of wage growth within matches. The simulated model data display a cross-sectional standard deviation for wage growth within matches (calculated to parallel Topel and Ward’s treatment) also of only 1.9%. That is a full order of magnitude smaller than reported by Topel and Ward.

Figure 5 presents the distribution of workers’ $\ln(\text{wages})$ relative to reservation wage $\ln(w^*)$. In order to match cyclical volatility of employment, this economy must exhibit a highly elastic aggregate labor supply. This is reflected in a distribution for the differential $\ln(w) - \ln(w^*)$ that is limited to near zero—it averages only 3.0% for workers, with a standard deviation equal to only 1.8%.¹⁰ A drop in match quality sufficient to reduce the wage by 10%, holding w^* unaffected, would induce nearly 100% of workers to separate. Thus, while we are able to generate large cyclical fluctuations with this model, we highlight that there is a severe tradeoff—achieving high cyclical volatility requires implausibly little dispersion in wages from match quality.

5. Business cycle predictions

We next characterize the business cycles properties of the model in response to exogenous shifts in aggregate productivity, contrasting results for the benchmark and high-volatility economies. For aggregate monthly productivity shocks we use $\rho_z = 0.95$ and $\sigma_z = 0.0077$. This yields a time series for (logged) TFP, after quarterly averaging and HP filtering, with autocorrelation of 0.84 and standard deviation of 2%. These

¹⁰As with the benchmark economy, this dispersion is driven by dispersion in the wage, not w^* . The standard deviation of $\ln(w^*)$ is only 0.6 percent. The correlation between $\ln(w)$ and $\ln(w^*)$ is 0.24. For the benchmark economy that correlation is 0.14.

coincide with the statistics reported by Shimer (2005) for U.S. quarterly labor productivity. We focus on discussing relative volatilities and correlations in describing the model results.

With aggregate fluctuations, productivity z and the measures of workers, μ and ψ , are state variables for agents' optimization problems, as separation decisions depend on subsequent matching probabilities. These, in turn, depend on the next period's measures of workers. Because it is not possible to keep track of the evolution of these measures, we employ Krusell and Smith's (1998) "bounded rationality" method which approximates the distribution of workers by a limited number of its moments. In particular, we assume that agents make use of the average asset holdings of the economy and the fraction of workers who are employed. (The computational appendix gives more detail.). We generate 12,000 monthly periods for a model economy. After dropping the first 3,000 observations, we compute quarterly values, take logs, and apply Hodrick-Prescott filter to produce the business cycle statistics.¹¹

Key statistics are highlighted in Table 3. In addition to our benchmark and high-volatility economies, for comparison the table provides results for a model with linear utility, exogenous separations, and no shocks to match quality. We refer to this, in Column 2, as the Shimer model because it is similar to the model calibrated in Shimer (2005). Also for comparison, the first column reports the comparable statistics reported by Shimer for quarterly U.S. data for 1951-2003, where note that all standard deviations are expressed relative to that for labor productivity. Shimer points out that the natural log of the unemployment series exhibits volatility, measured by standard deviation, that is 9.5 times that in labor productivity, whereas for his calibrated model unemployment displays lower volatility by a factor of about one half. Comparing results for our Shimer model in Column 2 to the data essentially replicates this finding—here the relative standard deviation of unemployment to productivity falls short of the data by a factor of 16.

The cyclical results for our benchmark economy are given in Column 3. The volatil-

¹¹We use H-P smoothing parameter of 10^5 to be comparable to Shimer's treatment.

ity of unemployment falls very far short of that in the data; its standard deviation is only one-eighth that observed for the data. Although unemployment is twice as volatile as for the Shimer economy, this increased volatility largely reflects the impact of fluctuations in separations. Volatility of the finding rate, as with the Shimer economy, falls far short of that for the data. Vacancies are actually less volatile for our model than for the Shimer economy. This reflects the model's predicted increase in separations during contractions which, in turn, encourages vacancy creation. The standard deviation of vacancies is only 0.6 for the model, compared to the data's 10.1, and the correlation with the unemployment rate is only -0.39 , compared to -0.89 for the data. Thus the model generates only a weak Beveridge curve relative to the Shimer model, and especially relative to the data.

Separations are both volatile and countercyclical for the model: the standard deviation for separations is nearly equal that for unemployment, while the correlation between the rates of separations and unemployment is 0.54. (Separations lead the cycle for the model economy, and so are more highly correlated, 0.85, with the change in unemployment rate.) The correlation between Shimer's data measure of separations and unemployment is even higher at 0.71; but separations for the data show a considerably lower standard deviation than that for unemployment.

We turn now to our high-volatility model, with results given in the last column of Table 3. The model by construction generates observed volatility in unemployment. Its standard deviation for unemployment is eight times that produced by our benchmark model. Because it exhibits many workers with little employment surplus, separations are much more volatile than for the benchmark model—the standard deviation of separations is 9 times higher. This model also generates much more cyclical vacancies. This primarily reflects that expected surplus of matches is only about one-tenth that for the benchmark economy. In other words, workers are highly concentrated at the margin. Therefore, a shock to aggregate productivity yields a much bigger percentage impact on expected surplus of matching. The high-volatility economy also generates a considerable skewing of separations during downturns toward workers with higher

assets. This shift toward workers with higher assets and higher reservation wages in recessions further drives down the value of vacancy creation. (This channel for volatility is distinctive to our model having both risk aversion and endogenous separations.) To separately quantify the impact of this channel, we constructed a version of our high-volatility model where separations are exogenous, but display the same time series properties as the economy with endogenous separations.¹² We find that the selection of workers into the unemployment pool by assets increases the volatility of unemployment by about 12%.

Despite matching cyclical volatility of unemployment, the high-volatility economy displays the qualitative shortcomings of our benchmark model. In particular, separations are far too cyclical relative to vacancies. This model generates an even weaker Beveridge curve correlation between unemployment and vacancies, -0.16 , than the benchmark economy. Finally, we repeat that this model can achieve its cyclicity for unemployment only by displaying a cross-sectional dispersion for wages of just 1.9%. Related to this, it generates a cross-sectional standard deviation in wage growth within matches (calculated as in Topel and Ward) of only 1.9%. We view this as implausible as it is an order of magnitude less than reported by Topel and Ward.¹³

6. Conclusions

We have introduced worker heterogeneity, in worker assets and match quality, into a model of separations, matching, and unemployment. We emphasize the trade-off between producing realistic dispersion in wages or realistic cyclical fluctuations in un-

¹²We first estimate a two-variable VAR for productivity and the separation rate on data simulated from our model with endogenous separations, where the separation rate depends on current and lagged productivity as well as its own lag. We then employ the estimated VAR to generate shocks for separations as well as productivity for the model simulations.

¹³We also considered an intermediate calibration employing a value for B that generates a replacement rate for the unemployed of 70%. This replacement rate is comparable to that employed by Hall (2005b) and by Costain and Reiter (2008). For this intermediate case, the cross-sectional standard deviation of wage growth within matches is still only 7.8%, so well below that reported by Topel and Ward. More importantly, the standard deviation for unemployment only rises modestly compared to the benchmark case, and falls short of that in the data by a factor of five.

employment. We can generate very high cyclical unemployment, comparable to U.S. data, if shocks to match quality are extremely small and payouts to unemployment are high. But we find this simultaneously implies very little cross-sectional dispersion in wage growth within matches. We consider this implausible, given estimates from micro data of dispersion in wage growth within jobs (especially Topel and Ward). With lower payouts to unemployment, comparable to Shimer's calibration, and considerable match productivity shocks, we can generate a realistic dispersion in rates of wage growth. But then the model falls drastically short in capturing cyclical fluctuations in unemployment of the magnitude displayed by the data.

How might the model be extended to overcome this conflict between realistic wage dispersion and realistic unemployment cyclical, while maintaining wage flexibility? This requires that the model produce little dispersion in the rents to employment, despite considerable dispersion in wages due to shocks to match productivity. One way to achieve this would be to modify the environment to generate a strong inverse relationship between a worker's match quality and the worker's marginal utility of consumption. Our model, because it assumes no insurance and limited borrowing, does generate higher consumption, and lower marginal utility of consumption, for workers who exhibit higher match wages. But we anticipate that breaking the link between match productivity and rents to employment would require extreme assumptions on preferences and/or the availability of asset markets.

A. Computational Algorithm

A.1. Steady-State Equilibrium

In steady state, the aggregate productivity z is constant at its mean and the measures of workers μ and ψ are invariant over time. Computing the steady-state equilibrium amounts to finding *i*) the value functions $W(a, x)$, $U(a)$ and $J(a, x)$, *ii*) the decision rules $a'_e(a, x)$, $a'_u(a)$ and $x^*(a)$, *iii*) the wage schedule $w(a, x)$, *iv*) the labor market tightness θ , *v*) the time-invariant measures $\mu(a, x)$ and $\psi(a)$ that satisfy the equilibrium conditions given in subsection 2.5. The detailed computational algorithm for steady state equilibrium is as follows.

1. Discretize the state space $\mathcal{A} \times \mathcal{X}$ over which the value functions and wages are computed. The stochastic process for the idiosyncratic productivity is approximated by the first-order Markov process of which transition probability matrix is computed using Tauchen's (1986) algorithm.
2. Assume an initial value of θ^0 .
3. Given θ^0 , we solve the Nash bargaining and individual optimization problems to approximate wages, value functions, and decision rules in the steady state, which will be used to compute the time-invariant measures.
 - (a) Assume an initial wage schedule $w^0(a, x; \theta^0)$ for each (a, x) node.
 - (b) Given $w^0(a, x; \theta^0)$, solve for the worker's value functions, $W(a, x; w^0)$ and $U(a; w^0)$, using equations (1) and (2) in the text. The value functions are approximated using the iterative method. The utility maximization problems in the worker's value functions are solved through the Brent method. The decision rules $a'_e(a, x; w^0)$, $a'_u(a; w^0)$ and $x^*(a; w^0)$ are obtained at each iteration of the value functions.
 - (c) Compute wages that satisfy the definition of $J(a, x, w^0)$ in (3) and the Nash bargaining solution in (5) in the text. Specifically, we solve for $w^1(a, x; \theta^0)$

for each (a, x) node that satisfies

$$w^1(a, x; \theta^0) = zx - J(a, x; w^0) + \beta(1 - \lambda)E [\max\{J(a'_e, x'; w^0), 0\}|x],$$

where $J(a, x; w^0)$ is computed using the first order condition for the Nash bargaining problem in (5):

$$J(a, x; w^0) = \left(\frac{1 - \alpha}{\alpha}\right) [W(a, x; w^0) - U(a; w^0)] c_e(a, x; w^0).$$

- (d) If $w^1(a, x; \theta^0)$ and $w^0(a, x; \theta^0)$ are close enough to each other, then move on to the step 4 to compute invariant measures and the corresponding labor market tightness, θ^1 . Otherwise, go back to the step 3a with a new guess for the wage schedule:

$$w^0(a, x; \theta^0) = \zeta_w w^1(a, x; \theta^0) + (1 - \zeta_w) w^0(a, x; \theta^0).$$

4. Using the converged decision rules $a'_e(a, x; w^0)$, $a'_u(a; w^0)$ and $x^*(a; w^0)$ given the converged wage schedule $w^0(a, x; \theta^0)$ from the step 3b and 3a, compute the time-invariant measures $\mu(a, x; \theta^0)$ and $\psi(a; \theta^0)$ by iterating the laws of motion for measures given in (6) and (7). Then, compute the labor market tightness θ^1 that satisfies the free-entry condition using equation (4) and the converged measures:

$$\kappa = \beta q(\theta^1) \int J(a'_u, \bar{x}; \theta^0) d\tilde{\psi}(a'_u; \theta^0).$$

5. If θ^1 and θ^0 are close enough to each other, then we found the steady state. Otherwise, go back to the step 3 with a new guess for the labor market tightness:

$$\theta^0 = \zeta_\theta \theta^1 + (1 - \zeta_\theta) \theta^0.$$

A.2. Equilibrium with Aggregate Fluctuations

Approximating the equilibrium in the presence of aggregate fluctuations requires us to include the aggregate productivity, z , and the measures of workers, μ and ψ , as

state variables for agents' optimization problems. In order to make match separation decisions at the end of a period, agents need to know their matching probabilities in the next period, $p(\theta_{t+1})$ and $q(\theta_{t+1})$, which in turn depends on the next period's measures of workers, $\mu_{t+1}(a, x)$ and $\psi_{t+1}(a)$. The laws of motion for the measures are given in equations (6) and (7). It is impossible to keep track of the evolution of these measures. We employ Krusell-Smith's (1998) "Bounded Rationality" method which approximates the distribution of workers by a number of its moments. We assume that agents in the economy make use of two first moments of the measures: the average asset holdings of the economy, $K = \int a d\mu(a, x) + \int a d\psi(a)$, and the number of employed workers, $E = \int d\mu(a, x)$. Let $\hat{\mathbf{s}}$ denote a vector of aggregate state variables in the approximation of equilibrium with fluctuations. Then $\hat{\mathbf{s}} = (K, E, z)$. In addition we assume that the agents use log-linear rules in predicting the current θ , the future K and the future E .

1. Guess a set of prediction rules for the equilibrium labor market tightness (θ) in the current period, the average asset of the economy (K') and the number of employed workers (E') in the next period. This step amounts to setting the coefficients of the log-linear prediction rules:

$$\begin{aligned}\log \theta &= b_{\theta,0}^0 + b_{\theta,1}^0 \log K + b_{\theta,2}^0 \log E + b_{\theta,3}^0 \log z \\ \log K' &= b_{K,0}^0 + b_{K,1}^0 \log K + b_{K,2}^0 \log E + b_{K,3}^0 \log z \\ \log E' &= b_{E,0}^0 + b_{E,1}^0 \log K + b_{E,2}^0 \log E + b_{E,3}^0 \log z.\end{aligned}$$

As is the case in the steady state computation, we approximate the stochastic process for the aggregate productivity by the first-order Markov process of which transition probability matrix is computed using Tauchen's (1986) algorithm.

2. Given these prediction rules, we solve the individual optimization and wage bargaining problems. This step is analogous to step 3 in the steady state computation, so we omit the detailed description of computational procedure. However, the dimension of state variables is now much larger: $(a, x, \hat{\mathbf{s}})$. Computation of the conditional expectations involves the evaluation of the value functions not on

the grid points along K and E dimensions since K' and E' are predicted by the log-linear rule above. We polynomially interpolate the value functions along the K dimension when necessary.

3. We generate a set of artificial time series data $\{\theta_t, K_t, E_t\}$ of the length of 9,000 periods. Each period, these aggregate variables are calculated by summing up 50,000 workers' decisions on asset accumulation and match separation, which are simulated using the converged value functions, $W(a, x, \hat{\mathbf{s}})$, $U(a, \hat{\mathbf{s}})$, and $J(a, x, \hat{\mathbf{s}})$, the decision rules, $a'_e(a, x, \hat{\mathbf{s}})$, $a'_u(a, \hat{\mathbf{s}})$ and $x^*(a, \hat{\mathbf{s}})$ from the step 2, and the assumed prediction rules for θ , K' and E' from the step 1.
4. We obtain the new values for the coefficients (b^1 's) in the prediction functions through the OLS using the simulated data from the step 3. If b^0 and b^1 are close enough to each other, then we find the (limited information) rational expectations equilibrium with aggregate fluctuations. Otherwise, go back to the step 1 with a new guesses for the coefficients in the prediction functions:

$$b_{i,j}^0 = \zeta_b b_{i,j}^1 + (1 - \zeta_b) b_{i,j}^0,$$

where $i = \theta, K, E$ and $j = 0, \dots, 3$.

The converged prediction rules and their accuracy, measured by R^2 , for the benchmark calibration with $h = 1$ are as follows.

- Prediction for labor market tightness in the current period:

$$\log \theta = 1.934 - 0.05810 \log K + 0.4220 \log E + 0.14804 \log z, \quad R^2 = 0.9971$$

- Prediction for average asset holdings in the next period:

$$\log K' = 0.0096 + 0.9965 \log K - 0.0071 \log E + 0.0457 \log z, \quad R^2 = 0.9999$$

- Prediction for number of employed workers in the next period:

$$\log E' = -0.0182 - 0.0015 \log K + 0.6361 \log E + 0.0276 \log z, \quad R^2 = 0.9538$$

Overall, the estimated prediction rules are fairly precise as R^2 's are close to 1, while the prediction rule for average asset holdings provides the highest accuracy.

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Table 1: Parameter Values for Benchmark and High-Volatility Economies

| Parameter | Description | Benchmark | High-volatility |
|-----------------|--|-----------|-----------------|
| γ | Relative risk aversion | 1 | same |
| r | Real interest rate (annualized) | 6% | same |
| β | Discount factor | 0.9948 | 0.9949 |
| \underline{a} | Borrowing constraint | -6.0 | same |
| θ | Steady state v/u ratio (normalized) | 1 | same |
| α | Matching technology $m(v, u) = .313 v^\alpha u^{1-\alpha}$ | 0.5 | same |
| κ | Vacancy posting cost | 0.522 | 0.0785 |
| b | Unemployment benefit | 0.4 | same |
| B | Utility from leisure | 0.15 | 0.506 |
| ρ_x | Persistence of idiosyncratic productivity $\ln x$ | 0.97 | same |
| σ_x | Standard deviation of innovation to $\ln x$ | 13.0% | 1.38% |

Table 2: Steady-state Statistics for Benchmark and High-Volatility Economies

| | Benchmark | High-volatility |
|------------------------------------|-----------|-----------------|
| Unemployment rate | 6% | Same |
| Separation rate | 2% | Same |
| Finding rate | 31% | Same |
| Average assets for employed | 18.1 | 17.9 |
| Average assets for unemployed | 14.7 | 18.1 |
| Standard deviation, assets | 15.1 | 8.6 |
| Average consumption for employed | 1.19 | 1.07 |
| Average consumption for unemployed | 1.09 | 1.056 |
| Standard deviation, ln(wage) | 18.0% | 1.9% |

Notes: See Table 1 for parameter values for two calibrations.

Table 3: Business Cycles for Benchmark and High-Volatility Economies

| | U.S. Data | Shimer | Benchmark | High-volatility |
|---|-----------|--------|-----------|-----------------|
| Standard deviation (relative to productivity) for | | | | |
| – Unemployment rate | 9.5 | 0.6 | 1.2 | 9.6 |
| – Separation rate | 3.8 | 0 | 1.0 | 8.4 |
| – Finding rate | 5.9 | 0.7 | 0.5 | 3.8 |
| – Vacancy rate | 10.1 | 1.0 | 0.6 | 3.1 |
| Correlation with unemployment rate for: | | | | |
| – Separation rate | 0.71 | 0 | 0.54 | 0.50 |
| – Finding rate | -0.95 | -0.83 | -0.89 | -0.93 |
| – Vacancy rate | -0.89 | -0.60 | -0.39 | -0.16 |

Notes: Variables are in natural log form, e.g., unemployment rate refers to $\ln(\text{unemployment rate})$. Standard deviations are relative to productivity. Statistics for U.S. data are from Shimer (2005) which reflects the deviations from the H-P trend with smoothing parameter of 10^5 for 1951 to 2003. See Table 1 for parameter values for the two calibrations. The simulated data are also based on the deviation from the H-P trend with smoothing parameter 10^5 . The productivity shock used in the simulation exhibits the same persistence and standard deviation to the U.S. quarterly data reported in Shimer (2005).

Figure 1: Benchmark Economy: Wages and Value Functions

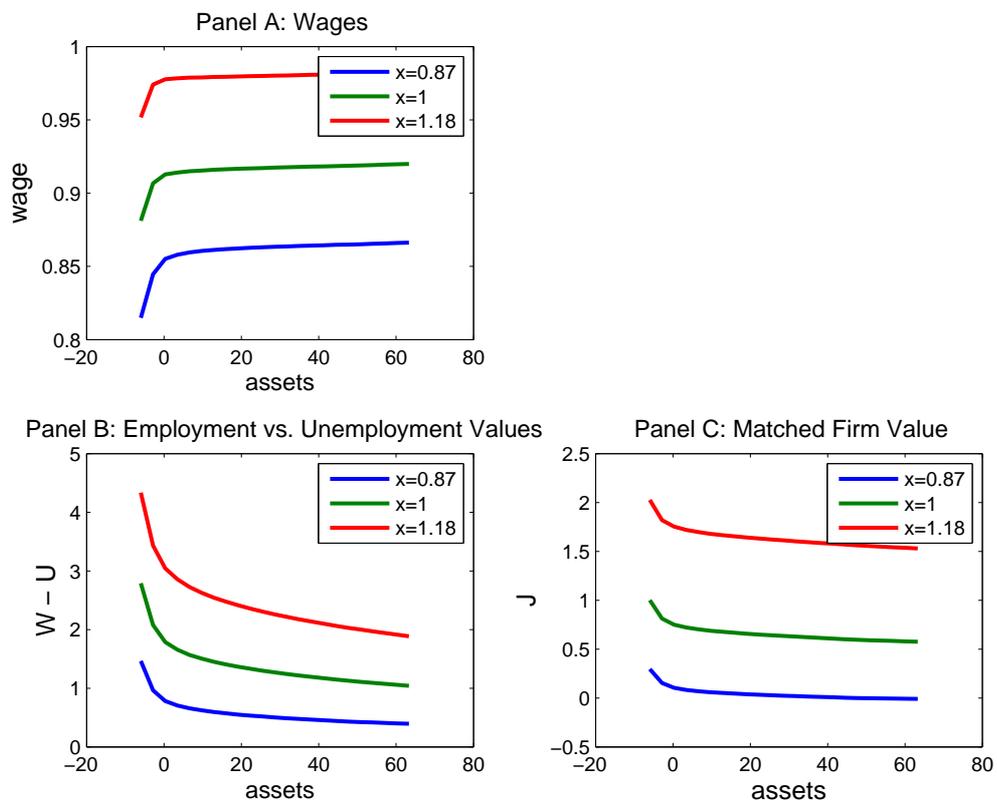


Figure 2: Benchmark Economy: Asset Distributions and Reservation Match Productivity

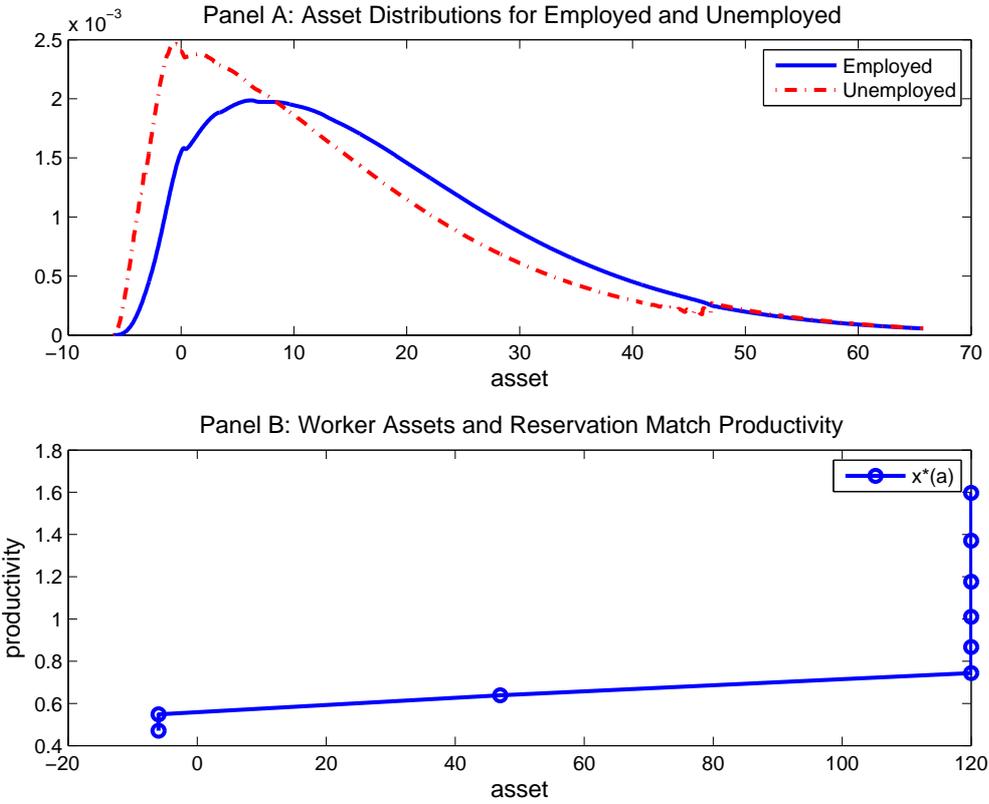


Figure 3: Benchmark Economy: Distribution of Surplus Match Quality ($\ln w - \ln w^*$)

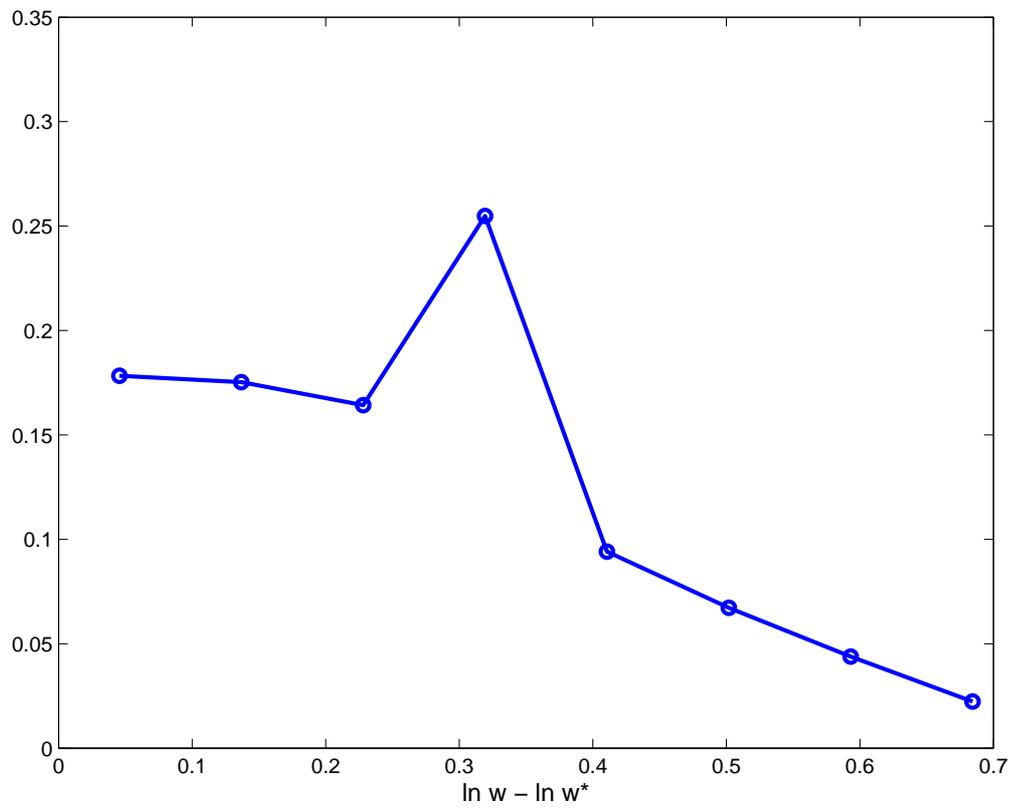


Figure 4: High-volatility Economy

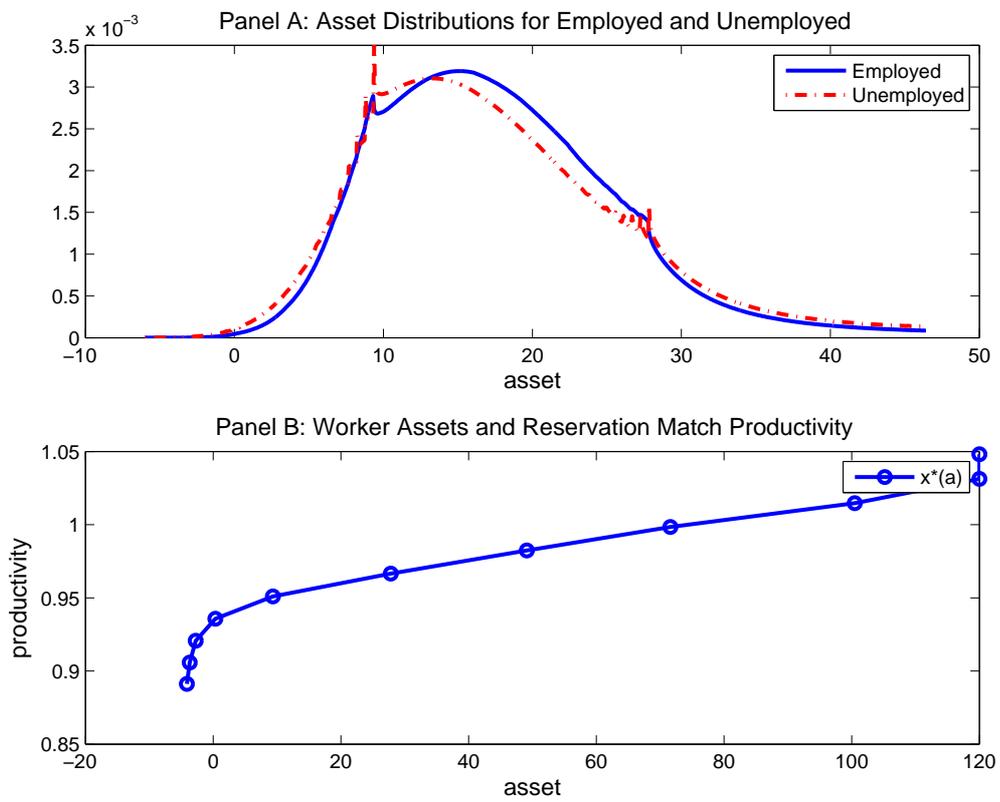


Figure 5: Distribution of Surplus Match Quality ($\ln w - \ln w^*$): High Volatility Economy

