Churning, firm inter-connectivity, and labor market fluctuations

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Abstract

In the US, during downturns of economic activity, firms change their profit rankings more often. Motivated by this fact, this paper studies the effect of firms’ transitions in profit distributions, or churning, on the business cycle. Specifically, I develop and estimate a modified Diamond-Mortenson-Pissarides search and matching model in which an increase in churning leads to a contraction of the labor market and a decline in output. The key feature of the model is firm inter-connectivity. Churning affects the aggregate economy by increasing firms’ chances of cooperating with partners that they are reluctant to work with, which induces firms and their potential partners to reduce inter-firm cooperation. A reduction of inter-firm cooperation depresses other economic activities, such as recruiting. The main prediction of the model is that an increase in churning of an industry causes a recession within its own industry and in its linked industries, which is consistent with the evidence I document in the paper. The model’s key mechanism, furthermore, is supported by microeconomic evidences.

∗Email: yang.yu@duke.edu. I thank my advisers Nir Jaimovich and Craig Burnside as well as my committee members Cosmin Ilut and Yi (Daniel) Xu for their great guidance, encouragement and support. I am also grateful for insightful comments from Anmol Bhandari, Ryan Chahrour, Paul Gagli, Kyle Jurado, Andrea Lanteri, Song Ma, Juan F. Rubio-Ramirez, Edouard Schaal, Sam Schulhofer-Wohl, Juan Carlos Suárez Serrato, Joe Vavra, Gianluca Violante, Yichong Zhang, and seminar participants in the macro lunch at Duke University. All remaining errors are mine. For most up-to-date version go here: http://sites.duke.edu/yangyu/