Imperfect Labor Mobility, Non-Separable Preferences, and Expectation Driven Business Cycles*

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Abstract

A key feature of the business cycle data is that output, employment and investment move up and down together in different sectors of the economy. However, standard business cycle models fail to generate this business cycle sectoral co-movement. In this paper we propose a two-sector business cycle model that generates the sectoral co-movement in response to both contemporaneous shocks and news shocks about fundamentals. The key elements to the model's success are frictions in intersectoral labor mobility and non-separable preferences in consumption and leisure, along with adjustment costs to investment and variable capital utilization. We estimate and compare two alternative mechanisms of generating the sectoral co-movement by using a Bayesian approach. It appears that the data decisively support our proposed mechanism of generating the sectoral co-movement.

Keywords: Sectoral Co-movement; News Shocks; Expectation Driven Business Cycles; Bayesian Estimation.
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