Micro Frictions and Macro Wedges

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Abstract

Business Cycle Accounting (BCA) is a helpful litmus test for quantitative macroeconomic models. Indeed, deviations from the data and a neoclassical growth model can be summarized as distortion of the efficiency of production or to optimality conditions such as leisure-consumption choices and investment Euler equations. These empirical "wedges" are then a simple diagnostic test for the empirical plausibility of aggregate economic models of short-run fluctuations. However, the methodology is not able to distinguish between disaggregated models that imply the same aggregate wedges, each with very different implications for policy prescriptions and ability to be consistent with disaggregated data. In order to illustrate the restrictions of the BCA approach we first show under what conditions disaggregate environments map into single aggregate wedges. We then provide a specific example in which financial frictions drive variations in the extensive margin of labor, creating an aggregate labor wedge by altering the aggregation of both the household and production sides of the economy.

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