

Countercyclical Elasticity of Substitution

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Abstract

We empirically show that the short-run elasticity of substitution between capital and labor (σ_t) is countercyclical. In recessions, capital and labor are more substitutable than in expansions. We explore the effects of the countercyclicity of σ_t on aggregate fluctuations in the context of an otherwise standard competitive-markets business cycle model. The countercyclical σ_t contributes to resolve four main labor-market puzzles: Dunlop-Tarshis phenomenon, labor-productivity puzzle, hours-productivity puzzle, and labor share puzzle.

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