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News Shock, Firm Dynamics and Business Cycles: Evidence and Theory*

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Abstract

The literature of expectation-driven business cycles has overlooked the role played by endogenous entry. This paper documents empirically news shock as a major source of fluctuations in firm dynamics and comovement between firm entry and GDP using structural vector auto-regressions. We then develop a tractable dynamic stochastic general equilibrium model to study the propagation mechanism assuming fixed operating costs for incumbents and decreasing survival rates for entrants. Our quantitative prediction closely matches the positive comovement between firm entries and core macroeconomic indicators upon news shock. These results remain robust at the sectoral level when the baseline model is extended to a two-sector setup.

Keywords: Firm Dynamics, Endogenous Survival Rate, Expectation Driven Business Cycles, Sectoral Comovements

JEL Classification: E22; E32.

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