

# Revisiting TFP Fluctuations: The Role of Goods Market Search and Time Allocation

Job Market Paper  
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## Abstract

Measured productivity fluctuates far more over the business cycle than technology. This paper shows that these swings largely reflect coordination failures in the goods market rather than shifts in productive technology. I develop a New Keynesian DSGE model inspired by Barro (2025) in which households allocate time between work and shopping, firms supply unmatched production capacity, and trades form through a goods market search-and-matching mechanism that determines matching efficiency, capacity utilization, and thus measured total factor productivity (TFP). Bayesian estimation on U.S. and Euro Area data – using survey-based capacity-utilization measures – demonstrates that incorporating goods market frictions substantially improves model fit and shifts business cycle variation from supply to demand shocks as the price elasticity of demand becomes endogenous. Excess demand amplifies TFP by raising search effort and matching rates, while excess supply dampens it by leaving capacity idle. These coordination-based mechanisms explain the missing-deflation episode after 2008 as a low-efficiency regime and the post-COVID inflation surge as a high-tightness regime. The results imply that short-run TFP fluctuations are coordination-driven and that monetary policy operates in a state-dependent environment where stabilizing market efficiency is as central as managing aggregate demand.

*Keywords:* Total factor productivity, capacity utilization, search-and-matching, supply-determined equilibrium, household time-allocation, Bayesian estimation

*JEL:* E22, E23, E3, J20

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## 1. Introduction

Periods of expansion and recession reveal a recurring puzzle: factories, offices, and workers often stand idle in downturns, even though the underlying production technology remains intact. In booms, by contrast, buyers queue up for scarce goods, delivery times lengthen, and firms struggle to meet demand. These fluctuations in resource use appear in measured total factor productivity (TFP), yet technology itself changes far less.

Standard measures of productivity treat the process of matching buyers and sellers as instantaneous and costless. But in reality, this process consumes time, information, and organizational resources. Consumers search for products and queue; firms advertise, hold inventories, and staff marketing. When matching becomes less efficient, productive capacity goes idle; when it improves, the same inputs yield more output<sup>3</sup>. Therefore, fluctuations in measured productivity may reflect shifts in *market coordination*, not technology.

This idea suggests that part of "production" takes place not inside factories but in the *interaction between buyers and sellers*. The act of matching supply with demand is itself productive: it transforms available production capacity into actual sales. When either side cuts back its search effort – firms reducing their supply or households reducing shopping – output falls even if machines, labor, and ideas remain unchanged<sup>4</sup> – what macroeconomists label a productivity shock may thus be a coordination shock.

This view helps reconcile an inconsistency at the heart of the New-Keynesian paradigm

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<sup>3</sup>Shopping time increases by 1.1 – 1.5% in GDP (Petrosky-Nadeau et al., 2016); advertisement is salient and procyclical (slope in real GDP above one) for US data (Hall, 2012); inventory investment explains up to one-fourth of real GDP growth (Den Haan and Sun, 2024) and the inventory-sales ratio is countercyclical (Bils and Kahn, 2000). Capacity utilization is procyclical, has a long-term average 82 – 89%, and shows a standard deviation of 1.87 – 2.93 in a data sample of the US (1984q1-2019q4), Spain, Germany, and France (1998q1-2019q4). Survey data from the European Commission shows that this is the result of "lack of demand" for firms rather than of "lack of input factors". See Appendix C for their description and sources.

<sup>4</sup>Additional to the procyclical shopping (Petrosky-Nadeau et al., 2016) effort which is positively correlated with TFP and capacity utilization (Bai et al., 2025), there is also evidence that firms employ excess capacity to attract additional customers (Sun, 2024).

(Barro, 2025). By construction, those models assume that firms must supply any quantity demanded at posted prices. But the economy frequently exhibits both excess supply and excess demand – e.g. the 1970s oil shocks or 2008 Great Recession. A framework that allows output to be *either demand-determined or supply-determined*, depending on how efficiently markets match buyers and sellers, can better capture these episodes (Barro and Grossman, 1971) – and provide a richer account of why TFP fluctuates over the business cycle.

Varying matching efficiency has a behavioral dimension: At the household level, the search for goods competes with work, leisure, and home production. When households devote less time to finding goods and firms scale back sales effort, transactions slow and capacity goes unused. From a policy perspective, such shifts in time use and coordination can appear as technological shocks: measured productivity falls even though the underlying technology has not changed. Treating such *coordination failures* as “TFP shocks” risks overstating the role of technology and understating the role of market functioning<sup>5</sup>.

Traditional mechanisms – capital utilization, labor effort, or fixed production costs (Christiano et al., 2005) – operate within the production process, altering how intensively inputs are used, while goods market search-and-matching governs how goods are exchanged. TFP co-moves with sales, inventories, shopping time, and capacity utilization (Bai et al., 2025; Den Haan and Sun, 2024) – indicators of market efficiency. By linking household time allocation and firms’ sales effort to aggregate output, the model provides a behavioral foundation for cyclical productivity that existing channels cannot capture.

To study this mechanism, we develop a New-Keynesian DSGE model (Cacciatore et al., 2020; Christiano et al., 2010; Smets and Wouters, 2007) in which households allocate time not only to work but also to *searching for goods*, and firms face frictions in selling their output (Bai et al., 2025; Michaillat and Saez, 2015; Qiu and Rios-Rull, 2022). Matching efficiency, and thus effective productivity, vary endogenously with the state of the economy. Price setting combines sticky posted prices with flexible search prices, generating a state-dependent price

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<sup>5</sup>Diamond (1982); Diamond and Fudenberg (1989) have shown that search models and their trade-off between search and work allow for multiple equilibria where the equilibrium path depends on sentiment, thus demand management.

elasticity of demand. Capacity utilization becomes an endogenous function of search effort and market tightness. The model is estimated on U.S. and Euro Area data using Bayesian methods and survey-based measures of capacity utilization to elicit the explanatory power of goods market search-and-matching (SaM) and compare it with the literature. The central question of this paper is therefore:

*Can fluctuations in the efficiency with which buyers and sellers find each other explain the cyclical behavior of measured total factor productivity – and with it, key features of the business cycle?*

The paper delivers four main results. First, introducing goods market search-and-matching markedly improves empirical fit – especially for capacity utilization and inflation – and substantially reduces the role of ad-hoc cost-push shocks. Second, short-run movements in measured TFP are driven primarily by matching efficiency and household time allocation rather than by fluctuations in technology or traditional utilization margins. Excess demand raises TFP by increasing search effort and match rates, whereas excess supply depresses TFP by leaving capacity idle. Third, the interaction of sticky posted prices with endogenous search intensity generates a state-dependent price elasticity of demand, smoothing markups and weakening the conventional link between inflation and the output gap. Fourth, these coordination forces explain central macroeconomic puzzles: the missing deflation after 2008 corresponds to a low-efficiency regime with weak matching, while the post-COVID inflation surge reflects an exceptionally tight regime with high matching efficiency and reduced effective demand elasticity.

These findings show that coordination failures and time-allocation inefficiencies explain major deviations of inflation and output from traditional New-Keynesian predictions, weakening the inflation–output-gap link and emphasizing the role of market functioning for stabilization policy.

*Literature Review.* This paper contributes to three strands of literature. First, a large empirical literature estimates TFP and its determinants ([Basu and Fernald, 2002](#); [Basu et al., 2006](#); [Comin et al., 2025](#); [Fernald, 2014](#); [Huo et al., 2023](#)), showing that technology

drives long-run growth while capacity utilization dominates short-run variation. Capacity utilization is typically inferred from price equations derived from cost minimization and related to observable hours per worker. More recent studies use industry survey data on capacity utilization ([Comin et al., 2025](#)), implicitly accounting for labor shocks – an especially relevant adjustment for European data.

Second, theoretical papers analyzing endogenous TFP fluctuations build on capital utilization of a quasi-fixed stock ([Greenwood et al., 1988](#); [Burnside et al., 1995](#)), often combined with production fixed costs ([Christiano et al., 2005](#); [Smets and Wouters, 2007](#)), and labor effort ([Bils and Cho, 1994](#); [Basu and Kimball, 1997](#)) which tends to be favored by the data ([Lewis et al., 2019](#)). Other work emphasizes composition and dispersion effects, where shifts across heterogeneous industries create aggregation-driven TFP fluctuations ([Baqaee and Farhi, 2020](#); [Lagos, 2006](#)). Similarly, labor-market SaM models generate TFP movements as vacancy costs reduce effective productive capacity when workers are reallocated from production to hiring ([Blanchard and Gali, 2010](#)).

Third, this paper builds on the goods market SaM literature, which models coordination frictions through explicit search and matching costs. Goods market SaM models formalize coordination frictions<sup>6</sup>, their amplification of unemployment ([Michaillat and Saez, 2015](#); [Lehmann and Van der Linden, 2010](#); [Petrosky-Nadeau and Wasmer, 2015](#)), productivity ([Qiu and Rios-Rull, 2022](#)), and inventory dynamics ([Den Haan and Sun, 2024](#)), and demand management for equilibrium selection ([Diamond, 1982](#); [Diamond and Fudenberg, 1989](#)). Time-allocation and search effort are central, as search is procyclical and drives business-cycle variation ([Petrosky-Nadeau et al., 2016](#); [Bai et al., 2025](#)). Price-setting becomes a three-dimensional decision, shaped by marginal costs and the state of excess demand or supply ([Michaillat and Saez, 2024](#); [Gantert, 2025](#)). A related price-search literature ([Benabou, 1988, 1992](#); [Burdett and Judd, 1983](#); [Diamond, 1971](#); [Kaplan and Menzio, 2016](#); [Pytko, 2024](#)) models search for price dispersion rather than as a productive input, and is thus complementary but

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<sup>6</sup>Two approaches exist: quantity search, where supply enters the matching function, and variety search, where it does not. This paper adopts the quantity-search approach ([Michaillat and Saez, 2015](#); [Sun, 2024](#)) and views the alternative frameworks ([Qiu and Rios-Rull, 2022](#); [Bai et al., 2025](#)) as complementary.

conceptually distinct from the mechanism studied here.

Embedding a goods market SaM structure into a New-Keynesian framework, the paper contributes to the literature by reconceptualizing short-run TFP as reflecting not only input utilization but also market coordination efficiency – the effectiveness with which buyers and sellers match in the goods market. It derives market tightnesses as alternative indicators for cyclical gaps and quantifies TFP dynamics across four major economies. Using survey-based measures of capacity utilization, the analysis shows how coordination frictions reshape the propagation and interpretation of business cycle shocks. By introducing a state-dependent price elasticity of demand and endogenizing capacity utilization, the framework embeds Barro’s (2025) rationing logic into a modern DSGE structure, reduces reliance on cost-push shocks, and redefines the monetary policy trade-off in the presence of variable matching efficiency. The rest of the paper is organized as follows. [Section 2](#) introduces the model, its dynamics, and the TFP decomposition. [Section 3](#) discusses the calibration, prior setting, estimation strategy, and identification strategy. [Section 4](#) discusses the estimation results. [Section 5](#) analyzes the drivers of the efficiency wedge across shocks before discussing the broader implications for the business cycle properties of the model. [Section 6](#) concludes.

## 2. Model Setup

The model builds on a state-of-the-art New-Keynesian business cycle framework ([Christiano et al., 2005](#); [Smets and Wouters, 2007](#)) with capital utilization and a labor market that distinguishes employment, hours, and labor effort ([Bils and Cho, 1994](#); [Cacciatore et al., 2020](#)). It features three agents – households, monopolistically competitive firms, and a government – trading on four markets: goods, labor, capital, and nominal bonds. Goods and labor markets are non-Walrasian and subject to search-and-matching (SaM) frictions, while capital and bond markets remain Walrasian. The key innovation is the introduction of goods market SaM ([Michaillat and Saez, 2015, 2024](#)) combined with price adjustment costs ([Rotemberg, 1982](#)) and directed search ([Moen, 1997](#)). Households supply costly yet productive search effort, and firms contribute unmatched production capacity to a matching function that generates trades. The interaction of household search and firm pricing creates an endogenous

price elasticity of demand, while firms' trade-off between markups and capacity utilization under adjustment costs drives fluctuations in the utilization rate. An analytical version of the model is presented in the companion paper (Gantert, 2025).

### 2.1. Labor and Goods Markets

Employment is a long-lasting relationship between workers and firms. Unemployed workers supply their labor inelastically. The employment rate<sup>7</sup> is determined by

$$N_t = (1 - \delta_N) N_{t-1} + m_{N,t}, \quad (1)$$

where  $0 < \delta_N \leq 1$  is an exogenous separation rate. New matches are formed by beginning-of-period unemployed workers and firm  $i$  vacancies,  $v_t(i)$  by a matching function

$$m_{N,t} = \psi_{N,t} \left( 1 - (1 - \delta_N) N_{t-1} \right)^{\gamma_N} \left( \int_0^1 v_t(i) di \right)^{1-\gamma_N}, \quad (2)$$

where  $0 < \gamma_N \leq 1$  and  $\psi_{N,t}$  varies with a labor mismatch shock. Job-finding and vacancy-filling probabilities are given by  $f_{N,t} = \frac{m_{N,t}}{u_t}$  and  $q_{N,t}(i) = \frac{m_{N,t}}{v_t(i)}$ . Labor market tightness is defined by  $x_{N,t} = \frac{v_t}{u_t}$ .

The *goods market* is segmented by varieties of the differentiated good. Households allocate search effort,  $D_t(i)$ , to each variety  $i$ , while firm  $i$  supplies unmatched production capacity of its unique variety,  $S_t(i)$ . Household search is directed towards each variety individually<sup>8</sup> (Moen, 1997). Customer relationships form according to

$$T_t(i) = (1 - \delta_T) T_{t-1}(i) + m_{T,t}(i), \quad (3)$$

where  $0 < \delta_T \leq 1$  is an exogenous separation rate and each relationship trades one unit of its variety. New matches are formed by

$$m_{T,t}(i) = \psi_{T,t} \left[ \gamma_T D_t(i)^\Gamma + (1 - \gamma_T) S_t(i)^\Gamma \right]^{\frac{1}{\Gamma}}, \quad (4)$$

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<sup>7</sup>We normalize the inelastic worker supply to one. Hence, the employment level and the employment rate are equivalent as the Cobb-Douglas matching function has constant-returns-to-scale.

<sup>8</sup>From this assumption, it follows that there are as many individual goods markets as varieties. Each market contains one firm offering variety  $i$  and infinitely many households search for this variety.

where  $-\infty < \Gamma \leq 0$ ,  $\gamma_T \in [0, 1)$ , and  $\psi_{T,t}$  varies with a goods mismatch shock<sup>9</sup>. Good  $i$  matching and selling probabilities are given by  $f_{T,t}(i) = \frac{m_{T,t}(i)}{D_t(i)}$  and  $q_{T,t}(i) = \frac{m_{T,t}(i)}{S_t(i)}$ . Goods market  $i$  tightness is defined by  $x_{T,t}(i) = \frac{D_t(i)}{S_t(i)}$  – the ratio of demand to unmatched supply.

## 2.2. Households

There are infinitely many households on the unit interval. Each household has infinitely many workers. The representative household maximizes its intertemporal utility

$$\mathbb{W}_0 = \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t Z_t \frac{(\mathbb{U}_{C,t} - \mathbb{U}_{N,t})^{1-\sigma} - 1}{1-\sigma},$$

where  $\sigma \geq 0$ ,  $0 \leq \beta < 1$ , and  $Z_t \geq 0$  is a discount factor shock. Households derive utility from consumption,  $C_t$ , as defined in

$$\mathbb{U}_{C,t} = C_t - \theta_C C_{t-1} - \frac{\mu_D}{1 + \nu_D} \left[ \left( \int_0^1 D_t(i) di \right)^{1+\nu_D} - \theta_D \left( \int_0^1 D_{t-1}(i) di \right)^{1+\nu_D} \right], \quad (5)$$

where  $\nu_D > 0$  determines search effort elasticity<sup>10</sup> and  $\mu_D > 0$ . Consumption and search habits are set by  $0 \leq \theta_C, \theta_D < 1$  (Christiano et al., 2005; Qiu and Rios-Rull, 2022). Labor supply has three margins – employment, hours per worker, and labor effort. Labor disutility (Bils and Cho, 1994) is given by

$$\mathbb{U}_{N,t} = X_t \int_0^1 N_t(i) \left( \frac{\mu_{H,t}}{1 + \nu_H} H_t(i)^{1+\nu_H} + \frac{\mu_e}{1 + \nu_e} H_t(i) e_{H,t}(i)^{1+\nu_e} \right) di, \quad (6)$$

where  $X_t = \mathbb{U}_{C,t}^\omega X_{t-1}^{1-\omega}$  with  $0 \leq \omega \leq 1$  is a flexible parameterization of short-run wealth effects on labor supply (Jaimovich and Rebelo, 2009)<sup>11</sup>.  $H_t(i)$  is hours per worker at firm  $i$

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<sup>9</sup>Goods market matching efficiency varies with a goods mismatch shock, capturing exogenous shifts in matching technology as well as composition and dispersion effects from unmodelled heterogeneity (e.g., geography, product type, quality, or timing of supply).

<sup>10</sup>Search-effort disutility captures overall search costs – information gathering, shopping, travel, and other procurement expenses (Michaillat and Saez, 2015). Yet, information time accounts for only a small share of total shopping time (Petrosky-Nadeau et al., 2016).

<sup>11</sup>As Cacciatore et al. (2020) show, this approach reconciles the behavior of unemployment and hours per worker together with macroeconomic aggregates. For  $\omega = 0$ , wealth effects cancel out along the lines of Greenwood et al. (1988)-preferences. For  $\omega = 1$ , utility is a product of consumption and labor supply.



where  $\mu_{H,t} > 0$  varies with an hours supply shock, and  $e_{H,t}(i)$  is labor effort at firm  $i$  with  $\mu_e > 0$ . Their supply elasticities are set by  $\nu_H, \nu_e > 0$ . Workers can adjust hours and effort instantaneously while employment is quasi-fixed.

Aggregate *search effort* is given by  $D_t = \left( \int_0^1 D_t(i) di \right)^{1+\nu_D}$ <sup>12</sup> and the aggregate goods bundle (Dixit and Stiglitz, 1977) by  $T_t = \left( \int_0^1 T_t(i)^{\frac{\epsilon_t-1}{\epsilon_t}} di \right)^{\frac{\epsilon_t}{\epsilon_t-1}}$ , where  $1 \leq \epsilon_t \leq \infty$  is the elasticity of substitution of varieties which fluctuates with a price cost-push shock (Ireland, 2004). A household allocates his goods to consumption,  $C_t$ , and fixed-capital investment,  $I_{K,t}$ , where  $T_t = C_t + P_{I,t}(1 + c_{I,t}) I_{K,t}$ , with convex fixed-capital investment adjustment costs,  $c_{I,t} = \frac{\kappa_I}{2} \left( \frac{I_{A,t}}{I_{A,t-1}} - 1 \right)^2$ , and an investment (price) shock,  $P_{I,t} > 0$ . Investment adjustment costs do not apply to investment resulting from capital utilization, i.e.  $I_{A,t} = I_{K,t} - \delta_K(e_{K,t}) K_{t-1}$ , as they represent maintenance investment (Qiu and Rios-Rull, 2022). The capital stock is given by  $K_t = (1 - \delta_{K,1} - \delta_K(e_{K,t})) K_{t-1} + I_{K,t}$ , where  $\delta_K(e_{K,t}) = \frac{\phi_{K,1}\phi_{K,2}}{2} (e_{K,t} - 1)^2 + \phi_{K,1} (e_{K,t} - 1)$  with  $\delta_{K,1} > 0$  setting independent capital depreciation, and  $\phi_{K,1}, \phi_{K,2} \geq 0$  setting capital depreciation (convexity) due to capital utilization. Each household follows its intertemporal budget constraint given by

$$\begin{aligned} B_t = & (1 + r_{B,t-1}) B_{t-1} + \int_0^1 W_t(i) L_t(i) di + P_t ub \left( 1 - \int_0^1 N_t(i) di \right) \\ & + P_t r_{K,t} K_{e,t} - \int_0^1 P_t(i) T_t(i) di - Tax_t + \Pi_t \end{aligned} \quad (7)$$

where  $B_t$  are one-period nominal bonds,  $L_t(i) = N_t(i) H_t(i) e_{H,t}(i)$  is effective labor supply, and  $K_{e,t} = e_{K,t} K_{t-1}$  is effective capital supply. Income is set by nominal wages<sup>13</sup>,  $W_t(i)$ , unemployment benefits,  $ub$ , capital interest,  $P_t r_{K,t}$ , bond interest,  $r_{B,t-1}$ , and firm dividends,  $\Pi_t$ <sup>14</sup>. Expenses are set by consumption and investment expenditures,  $\int_0^1 P_t(i) T_t(i) di$ , and lump-sum taxes,  $Tax_t$ , charged to pay for unemployment benefits and public spending.

<sup>12</sup>We assume that household search costs are convex in their aggregate level, not in their idiosyncratic level per search for variety  $i$ . This has first and foremost quantitative reasons as in the alternative assumption markups explode and the model becomes indeterminate for many calibrations.

<sup>13</sup>Aggregate labor equals total employment across firms,  $N_t = \int_0^1 N_t(i) di$ . With infinitely many workers and random matching, all households share identical employment histories and perfect unemployment insurance.

<sup>14</sup>Each household owns an identical share of a mutual fund holding all firms, so dividend income  $\Pi_t$  is identical across households.

### 2.3. Firms

There are infinitely many firms on the unit interval. Each firm produces a unique variety  $i$  by employing labor and capital in a production function<sup>15</sup>,  $F_t(i) = L_t(i)^{1-\alpha} K_{e,t}(i)^\alpha$ , where  $0 \leq \alpha \leq 1$ . It maximizes its intertemporal profits by

$$\Pi_0 = \mathbb{E}_0 \sum_{t=0}^{\infty} \beta_{0,t} P_t(i) \left[ T_t(i) + G_t(i) - \frac{W_t(i)}{P_t(i)} L_t(i) - r_{K,t} K_{e,t}(i) \right],$$

where  $0 \leq \beta_{0,t} < 1$  is the stochastic discount factor<sup>16</sup>. Revenue is created by sales on private markets,  $T_t(i)$ , and by exogenous public spending,  $G_t(i)$ . Each firm  $i$  pays wages,  $W_t(i)$ , for effective labor,  $L_t(i)$ , and capital interest,  $r_{K,t}$ , for the effective capital stock,  $K_{e,t}(i)$ . The production capacity of a firm is given by

$$\mathcal{Y}_t(i) = (1 - \mathcal{C}_t(i)) A_{H,t} F_t(i) - \vartheta, \quad (8)$$

where  $\mathcal{C}_t(i) = c_{P,t}(i) + c_{W,t}(i) + c_{N,t}(i) + c_{H,t}(i)$  summarizes firm adjustment costs.  $c_{P,t}(i) = \frac{\kappa_P}{2} \left( \frac{P_t(i)}{P_{t-1}(i)} (1 + \pi)^{\iota_P - 1} (1 + \pi_{t-1})^{-\iota_P} - 1 \right)^2$  are price adjustment costs with  $\kappa_P \geq 0$ , and  $c_{W,t}(i) = \frac{\kappa_W}{2} \left( \frac{W_t(i)}{W_{t-1}(i)} (1 + \pi)^{\iota_W - 1} (1 + \pi_{t-1})^{-\iota_W} - 1 \right)^2$  are nominal wage adjustment costs with  $\kappa_W \geq 0$ . Inflation indexation is given by  $\iota_P, \iota_W \geq 0$ .  $c_{N,t}(i) = \frac{\kappa_N}{2} \left( \frac{v_t(i)}{L_t(i)} \right)^2$  are labor matching costs – spent on vacancies,  $v_t(i)$ , to search and match additional workers – with  $\kappa_N \geq 0$  (Merz and Yashiv, 2007).  $c_{H,t}(i) = \frac{\kappa_H}{2} \left( \frac{H_t(i) - \bar{H}(i)}{\bar{H}(i)} \right)^2$  are hours adjustment costs with  $\kappa_H \geq 0$  (Cacciatore et al., 2020). The technology level,  $A_{H,t} > 0$ , varies with a shock, and firms have identical production fixed costs,  $\vartheta \geq 0$ . Matching on a goods market depends on the beginning-of-period unmatched production capacity,  $S_t(i)$ , given by

$$S_t(i) = \mathcal{Y}_t(i) - G_t(i) - (1 - \delta_T) T_{t-1}(i) + (1 - \delta_I) I_{S,t-1}(i), \quad (9)$$

where  $I_{S,t-1}(i) = (1 - q_{T,t-1}(i)) S_{t-1}(i)$  is the depreciated end-of-period inventory stock with  $0 < \delta_I \leq 1$ . Unmatched production capacity,  $S_t(i)$ , serves as a productive input to the goods

<sup>15</sup>Burnside et al. (1995); Basu et al. (2006) show that any evidence on non-constant-returns-to-scale vanishes as we include capacity utilization in the model.

<sup>16</sup>The firm stochastic discount factor is equal to the household stochastic discount factor as all firms are owned by a mutual fund owned by the representative household.

market matching function stimulating demand (Sun, 2024).

Each firm supplies  $S_t(i)$  to form customer relationships according to (3). It maximizes its profits by setting its price in a trade-off between markups and capacity utilization following from a combination of directed search (Moen, 1997) and sticky prices (Rotemberg, 1982). Each firm is a monopolist for its variety (Dixit and Stiglitz, 1977). Therefore, it takes the demand function for its variety (19) into account while setting prices and deciding on unmatched capacity to maximize profits (8).

#### 2.4. General Equilibrium

To close the model, we define the real gross domestic product of the economy by

$$Y_t = C_t + G_t + Inv_t, \quad (10)$$

where  $C_t$  is the numéraire good, and  $Inv_t = P_{I,t}I_{K,t} + I_{S,t} - I_{S,t-1} - \delta_K(e_{K,t})K_{t-1}$  is private investment. Capital depreciation costs due to capital utilization are excluded from real GDP as this is maintenance investment and thus an intermediate input (Qiu and Rios-Rull, 2022). The government budget is always in equilibrium,  $Tax_t = G_t + P_{tub}\left(1 - \int_0^1 N_t(i)di\right)$ . Aggregate survey data capacity utilization is defined as

$$\bar{c}u_t = \frac{Y_t}{\bar{\mathcal{Y}}_t}. \quad (11)$$

where  $\bar{\mathcal{Y}}_t$  is the long-run sustainable production capacity<sup>17</sup> given by

$$\bar{\mathcal{Y}}_t = (1 - \bar{\mathcal{C}}) A_{H,t} (\bar{e}_H \bar{H} N_t)^{1-\alpha} (\bar{e}_K K_{t-1})^\alpha - \vartheta. \quad (12)$$

The central bank follows a Taylor (1993)-type rule to determine the nominal interest rate by

$$\frac{1 + r_{B,t}}{1 + r_B} = \left[ \frac{1 + r_{B,t-1}}{1 + r_B} \right]^{i_r} \left[ \left( \frac{1 + \pi_t}{1 + \pi} \right)^{i_\pi} \left( \tilde{Y}_t \right)^{i_{gap}} \left( \frac{\tilde{Y}_t}{\tilde{Y}_{t-1}} \right)^{i_{\Delta gap}} \right]^{1-i_r} \cdot M_t, \quad (13)$$

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<sup>17</sup>Long-run sustainable production capacity follows three assumptions (Comin et al., 2025): (1) the capital stock is measured at its predetermined level including non-utilized capital; (2) the level of employment is measured at its current level as it is a quasi-fixed long-term relationship; (3) labor matching costs, hours per worker, and labor effort are measured at their steady-state as deviations are not sustainable in the long-run. A discussion of the assumptions on the capacity utilization definition is given in Appendix C.2.

where  $\pi$  is the steady-state inflation target,  $\tilde{Y}_t$  is the output gap<sup>18</sup>,  $i_r, i_{gap}, i_{\Delta gap} \geq 0$  and  $i_\pi > 1$  are policy coefficients, and  $M_t$  is a monetary policy shock. The price and wage cost-push shocks follow an ARMA(1, 1) process and all other shocks follow an AR(1) process. The public spending shock is correlated with the technology shock while all other shocks are orthogonal (Smets and Wouters, 2007).

## 2.5. Dynamic System of the Model Economy

The behavior of households and firms is governed by their first-order conditions. We assume that all firms use the same technology and are summarized by a representative firm.

*Consumption Euler Equation.* The representative household allocates consumption by

$$\mathbb{U}_{\chi,t} = (\mathbb{U}_{C,t} - \mathbb{U}_{N,t})^{-\sigma} + \omega \frac{\chi_t}{\mathbb{U}_{C,t}}, \quad (14)$$

$$\chi_t = (1 - \omega) \beta \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \chi_{t+1} - \frac{\mathbb{U}_{N,t}}{(\mathbb{U}_{C,t} - \mathbb{U}_{N,t})^\sigma}, \quad (15)$$

$$\mathbb{W}_{C,t} = \mathbb{U}_{\chi,t} - \beta \theta_C \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \mathbb{U}_{\chi,t+1}, \quad (16)$$

$$\mathbb{W}_{D,t} = \mathbb{U}_{\chi,t} - \beta \theta_D \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \mathbb{U}_{\chi,t+1}, \quad (17)$$

$$muc_t = \beta \mathbb{E}_t \frac{1 + r_{B,t}}{1 + \pi_{t+1}} \frac{Z_{t+1}}{Z_t} muc_{t+1}, \quad (18)$$

where  $\mathbb{U}_{\chi,t}$  is the marginal utility of the consumption stock corrected for wealth effects by  $\chi_t$ , and  $\mathbb{W}_{C,t}, \mathbb{W}_{D,t}$ <sup>19</sup> is intertemporal marginal (dis-)utility of consumption (search effort). Marginal (net) utility of consumption,  $muc_t$ , is given by  $\mathbb{W}_{C,t}$  net of  $\mathbb{W}_{D,t}$ , which is forward-looking due to the potential long-term nature of customer relationships. Its value – expressed in the numeraire good – is determined by

$$P_{T,t} = 1 + P_{D,t} - (1 - \delta_T) \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} P_{D,t+1}, \quad (19)$$

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<sup>18</sup>The output gap is defined as the ratio of GDP over its flexible prices and wages counterpart absent price and wage cost-push shocks (Smets and Wouters, 2007)

<sup>19</sup>Distinct habit parameters for consumption and search effort enable separate estimation, since their persistence may differ a priori.

where we define the total price,  $P_{T,t} = \frac{\mathbb{W}_{C,t}}{muc_t}$ , and the search price,  $P_{D,t} = \frac{\mathbb{W}_{D,t}}{muc_t} \frac{\mu_D D_t^{\nu_D}}{f_{T,t}}$ . The price elasticity of demand is given by

$$\Xi_t = (-\epsilon_t) \left[ 1 + P_{D,t} - (1 - \delta_T) \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} P_{D,t+1} \right]^{-1}, \quad (20)$$

which fluctuates with search prices and price cost-push shocks, and is inversely related to the total price,  $\Xi_t = \frac{-\epsilon_t}{P_{T,t}}$ . Substituting (19) in (18) leads to

$$\mathbb{W}_{C,t} = \beta \mathbb{E}_t \frac{1 + r_{B,t}}{1 + \pi_{t+1}} \frac{Z_{t+1}}{Z_t} \frac{P_{T,t}}{P_{T,t+1}} \mathbb{W}_{C,t+1}, \quad (21)$$

which highlights the inflation-like impact of search prices growth on household intertemporal consumption allocation (Ganert, 2025). We interpret  $\frac{P_{T,t}}{P_{T,t+1}}$  as a correction for the mismeasurement of overall consumption costs.

*Price Setting.* The *representative firm* supplies its unmatched capacity to the goods market to form matches with buyers. The *asset value of production capacity* is given by

$$Q_{Y,t} = q_{T,t} Q_{T,t} + \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} (1 - \delta_I) (1 - q_{T,t}) Q_{Y,t+1}, \quad (22)$$

which is forward-looking due to the option to hold unmatched goods in inventory. It increases in the asset value of matched goods,  $Q_{T,t}$ , weighted by  $q_{T,t}$ . Marginal costs are defined by  $mc_t = \frac{Q_{Y,t}}{e_{M,t}}$  where we correct<sup>20</sup> for the matched capacity rate,  $e_{M,t} = \frac{T_t + G_t}{\mathcal{Y}_t}$ . The *asset value of matched goods* is given by

$$(1 + \varphi_t) Q_{T,t} = 1 + \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} \left[ \left[ (1 - \delta_I) \varphi_t - (1 - \delta_T) \right] Q_{Y,t+1} + (1 - \delta_T) Q_{T,t+1} \right], \quad (23)$$

which increases in long-term contracts as they reduce search costs per good sold. However, long-term contracts also decrease unmatched production capacity tomorrow and thus increase goods markets tightness tomorrow, especially if  $Q_{Y,t+1}$  is expected to be high. Inventories have the opposite effect on expected goods market tightness. Generally,  $Q_{T,t} < 1$ , which

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<sup>20</sup>Marginal costs follow the standard NK definition and empirical implementation of De Loecker et al. (2020), ensuring comparability with markup studies. They are adjusted for the implicit cost of unsold capacity, preventing markups from reflecting unmatched production.

indicates a markup over the actual matching costs following from monopolistic competition and goods market SaM. It is set by  $\varphi_t = \frac{1}{\epsilon_t} \frac{\gamma_T x_{T,t}^\Gamma}{1-\gamma_T} \frac{m_{T,t}}{T_t} \frac{P_{T,t}}{P_{D,t}}$  and affected<sup>21</sup> by goods market SaM in three ways: markups (1) increase in  $\gamma_T$  as search effort is more productive; (2) increase in the share of newly to overall matched goods,  $\frac{m_{T,t}}{T_t}$ ; and (3) decrease in  $P_{D,t}$  as firms lower prices to attract additional customers in tight goods markets<sup>22</sup>.

A firm posts prices on the goods market with a markup over marginal costs taking goods market tightness and the household price elasticity into account. The *New-Keynesian Phillips curve* is given by

$$\begin{aligned} \frac{c'_{P,t}}{1 - \mathcal{C}_t - \vartheta_{S,t}} &= \frac{\theta_{T,t}}{mc_t} - \frac{\gamma_T x_{T,t}^\Gamma}{1 - \gamma_T} \frac{\theta_{S,t}}{P_{D,t}} \left( 1 - \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} (1 - \delta_I) \frac{e_{M,t+1} mc_{t+1}}{e_{M,t} mc_t} \right) \\ &\quad + \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} \frac{mc_{t+1}}{mc_t} \frac{Y_{t+1}}{Y_t} \frac{c'_{P,t+1}}{1 - \mathcal{C}_{t+1} - \vartheta_{S,t+1}}, \end{aligned} \quad (24)$$

where  $c'_{P,t} = \frac{\partial c_{P,t}}{\partial P_t}$  and  $c'_{P,t+1} = (-1) \frac{\partial c_{P,t+1}}{\partial P_t}$  are marginal price adjustment costs,  $\vartheta_{S,t}$  is the fixed costs share of overall costs,  $\theta_{T,t}$  is the ratio of goods sold (excluding inventories) to GDP, and  $\theta_{S,t}$  is the beginning-of-period share of unmatched production capacity<sup>23</sup>.

High markups ( $mp_t = \frac{1}{mc_t}$ ) permit greater marginal price adjustment costs ( $c'_{P,t}$ ) and thus higher inflation. This effect weakens when inventories rise ( $\theta_{T,t}$ ), while goods market SaM frictions lower equilibrium adjustment costs – and hence inflation – for a given markup. As  $\gamma_T$  rises, search effort becomes more effective in matching goods, so smaller price changes suffice to meet demand. Higher search prices  $P_{D,t}$  instead reduce demand elasticity (20) and raise inflation. Inventories act similarly: the ability to buy low and sell high increases firms' market power. When much capacity is locked in long-term contracts ( $\theta_{S,t}$ ), goods market SaM effects weaken because less output requires matching each period. With price adjustment costs, posted prices – and thus search prices and effort – adjust gradually and

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<sup>21</sup> $\varphi_t \rightarrow 0$  as  $\epsilon_t \rightarrow \infty$  (no monopol. competition);  $\varphi_t = \frac{1}{\epsilon_t}$  as  $\gamma_T \rightarrow 0 \Rightarrow P_{D,t} = 0$  (no goods market SaM).

<sup>22</sup>Although demand elasticity (20) declines with  $P_{D,t}$ , firms cannot raise markups because households react to goods market tightness and search prices by lowering search effort.

<sup>23</sup>The composite terms of the Phillips curve are defined as follows: (1)  $\vartheta_{S,t} = \frac{\vartheta}{A_{H,t} F_t}$ ; (2)  $\theta_{T,t} = \left(1 + \frac{\Delta I_{S,t}}{T_t + G_t}\right)^{-1}$ ; and (3)  $\theta_{S,t} = 1 - \frac{G_t + (1-\delta_T)T_{t-1} - (1-\delta_I)I_{S,t-1}}{Y_t}$ .

sub-optimally, generating fluctuations in matching efficiency. The interaction of sticky posted and flexible search prices drives cyclical variation in search prices and matching probabilities.

*Capital Allocation.* The *representative household* invests into fixed-capital according to

$$Q_{K,t} = \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} \left[ r_{K,t+1} e_{K,t+1} + (1 - \delta_{K,1}) Q_{K,t+1} - (1 + c_{I,t+1}) P_{T,t+1} P_{I,t+1} \delta_K (e_{K,t+1}) \right], \quad (25)$$

$$Q_{K,t} = P_{T,t} P_{I,t} \left[ (1 + c_{I,t}) + \frac{I_{K,t} \left\{ c'_{I,t} - \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} \frac{P_{T,t+1} P_{I,t+1}}{P_{T,t} P_{I,t}} \frac{I_{K,t+1}}{I_{K,t}} c'_{I,t+1} \right\}}{I_{K,t} - \delta_K (e_{K,t}) K_{t-1}} \right], \quad (26)$$

$$r_{K,t} = (1 + c_{I,t}) P_{T,t} P_{I,t} (\phi_{K,1} \phi_{K,2} (e_{K,t} - 1) + \phi_{K,1}), \quad (27)$$

where  $Q_{K,t}$  is the *asset value of installed capital* (Tobin, 1969). It rises with investment adjustment costs and with search prices through  $P_{T,t}$ , since acquiring capital goods requires household search effort. The *representative firm* employs capital according to

$$r_{K,t} = \alpha (1 - \mathcal{C}_t) \frac{A_{H,t} F_t}{e_{K,t} K_{t-1}} e_{M,t} m c_t, \quad (28)$$

where the capital interest rate increases in marginal productivity, marginal costs, and the matched capacity rate. Goods market frictions, via  $e_{M,t}$  and  $P_{T,t}$ , reduce both capital demand and utilization as firms and households anticipate imperfect matching of productive capacity.

*Labor Allocation.* The *representative firm* employs labor according to

$$Q_{F,t} = \mathcal{C}'_{N,t} \frac{A_{H,t} F_t}{N_t} e_{M,t} m c_t - w_t e_{H,t} H_t + (1 - \delta_N) \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} Q_{F,t+1}, \quad (29)$$

$$Q_{F,t} = 2c_{N,t} \frac{A_{H,t} F_t}{q_{N,t} v_t} e_{M,t} m c_t, \quad (30)$$

where  $\mathcal{C}'_{N,t} = (1 - \alpha) (1 - \mathcal{C}_t) + 2c_{N,t}$ . The *firm asset value of marginal employment*,  $Q_{F,t}$ , increases in the marginal labor productivity and matched capacity rate and decreases in labor matching costs and real wages. Firms post vacancies as long as the marginal labor matching costs (free-entry condition). Each worker-firm match *bargains over the conditions of work* (Nash, 1950) maximizing the joint surplus by bargaining over the real wage, hours

per worker, and labor effort jointly as described by

$$w_t H_t e_{H,t} = ub + \frac{P_{T,t} \frac{\partial \mathbb{U}_{N,t}}{\partial N_t}}{\mathbb{W}_{C,t} (\mathbb{U}_{C,t} - \mathbb{U}_{N,t})^\sigma} + \eta_{H,t} Q_{F,t} - \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} (1 - \delta_N) (1 - f_{N,t+1}) \eta_{H,t+1} Q_{F,t+1}, \quad (31)$$

$$w_t e_{H,t} = (c'_{H,t} - (1 - \alpha) c'_{H,t}) \frac{A_{H,t} F_t}{H_t N_t} \frac{Q_{Y,t}}{1 - \tau_{W,t}} - \frac{P_{T,t} \frac{\partial^2 \mathbb{U}_{N,t}}{\partial N_t \partial H_t}}{\mathbb{W}_{C,t} (\mathbb{U}_{C,t} - \mathbb{U}_{N,t})^\sigma} \frac{\tau_{W,t}}{1 - \tau_{W,t}}, \quad (32)$$

$$w_t H_t = c'_{H,t} \frac{A_{H,t} F_t}{e_{H,t} N_t} \frac{Q_{Y,t}}{1 - \tau_{W,t}} - \frac{P_{T,t} \frac{\partial^2 \mathbb{U}_{N,t}}{\partial N_t \partial e_{H,t}}}{\mathbb{W}_{C,t} (\mathbb{U}_{C,t} - \mathbb{U}_{N,t})^\sigma} \frac{\tau_{W,t}}{1 - \tau_{W,t}}, \quad (33)$$

where  $c'_{H,t} = (1 - \alpha)^2 (1 - \mathcal{C}_t) - 4\alpha c_{N,t}$  and  $\eta_{H,t} = \frac{\eta_t}{1 - \eta_t} \frac{1}{\tau_{W,t}}$ . The household bargaining power,  $0 \leq \eta_t \leq 1$ , varies with an exogenous wage cost-push shock, and  $\tau_{W,t}$  is a sticky wage wedge<sup>24</sup> with  $\tau_W = 1$  and increasing monotonically with wage inflation. Real wages are set by a weighted average of opportunity costs and marginal productivity determined by the effective household bargaining weight,  $\eta_{H,t}$ . Hours per worker and labor effort<sup>25</sup> are determined to maximize their marginal productivities over disutilities, taking wage and hours setting frictions into account. Goods market SaM influences labor demand via the matched capacity rate,  $e_{M,t}$  (implicit in  $Q_{F,t}$ ), and labor supply through search price effects on  $P_{T,t}$ . Higher  $e_{M,t}$  raises the marginal value of labor, but if search prices rise with utilization, the resulting increase in  $P_{T,t}$  and wages dampens labor expansion.

The equilibrium conditions imply that output depends not only on technology and inputs but also on their utilization across markets. Labor effort, capital utilization, fixed costs degression, and the matching probability jointly determine effective productive capacity. Consequently, the measured Solow residual mixes true technological change with utilization-driven efficiency fluctuations. The next subsection formalizes this link by expressing TFP as a function of technology and the four utilization margins, introducing the *efficiency wedge* later identified in the estimation.

<sup>24</sup>See [Appendix A](#) for details on wage bargaining and  $\tau_{W,t}$ .

<sup>25</sup>We use (33) and the production function to derive a steady-state increasing returns to scale parameter in hours per worker following from latent labor effort by  $\phi = 1 + \frac{\nu_H}{1 + \nu_e}$  ([Lewis et al., 2019](#)).  $\phi$  is set as a prior in the estimation to elicit the impact of labor effort on capacity utilization. Over the business cycle, it is also affected by variation in marginal hours adjustment costs,  $c'_{H,t}$ .



## 2.6. Measuring Total Factor Productivity

Building on the equilibrium relationships of the model, we define measured TFP and decompose it into (utilization-adjusted) technology and utilization components. We linearize the relationships around their deterministic steady-states for ease of exposition, e.g.  $\hat{gdp}_t = \frac{GDP_t - GDP}{GDP}$ . Measured TFP in the model follows from the aggregate production identity and reflects both technological efficiency and utilization of inputs across capital, labor, and the goods market. Linearizing the production function and substituting for variable utilization rates yields

$$G\hat{D}P_t = \hat{A}_t + \alpha \hat{K}_{t-1} + (1 - \alpha) (\hat{N}_t + \hat{H}_t) + \hat{u}_t^K + \hat{u}_t^L + \hat{u}_t^\vartheta + \hat{u}_t^{GM}, \quad (34)$$

where  $\hat{A}_t = A(A_{H,t}, \psi_{T,t})$  denotes utilization-adjusted TFP<sup>26</sup>,  $\hat{u}_t^K$  capital utilization,  $\hat{u}_t^L$  labor utilization,  $\hat{u}_t^\vartheta$  fixed costs degression, and  $\hat{u}_t^{GM}$  goods market utilization derived from the goods market SaM block. Measured TFP (Solow (1957)-residual) is therefore

$$T\hat{F}P_t = \hat{A}_t + \hat{u}_t^K + \hat{u}_t^L + \hat{u}_t^\vartheta + \hat{u}_t^{GM} = \hat{A}_t + \hat{\Phi}_t, \quad (35)$$

which consists of both utilization-adjusted TFP,  $\hat{A}_t$ , and utilization variation represented by the *efficiency wedge*,  $\hat{\Phi}_t$  – variation in TFP explained by endogenous propagation of shocks in the model. Goods market utilization,  $\hat{u}_t^{GM}$ , captures efficiency losses due to incomplete matching between goods supplied and demanded, including long-term contracts and inventory changes. It depends on the matching probability,  $q_{T,t}$ , and the search price,  $P_{D,t}$ . Utilization in the labor margin enters through  $\nu_e$ , but also through working time provided to labor matching,  $\hat{c}_{N,t}$ ; utilization in the capital margin enters through  $\phi_{K,2}$ ; and in the production fixed costs margin through  $\vartheta$ . The *efficiency wedge* increases in all four channels.

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<sup>26</sup>Whether the goods mismatch shock,  $\hat{\psi}_{T,t}$ , represents a true technology shock is ambiguous, as it may also reflect dispersion or composition effects. To account for this, [section 3](#) defines upper and lower bounds of TFP decomposition,  $\hat{A}_{Up,t}$  and  $\hat{A}_{Low,t}$ . The analysis uses the upper-bound case, while the lower bound – derived symmetrically – is presented in [Appendix B](#). In general, we use the term “utilization-adjusted TFP” rather than “technology”, as it further captures unmodeled dispersion or composition effects of technology,  $A_{H,t}$  whose effect on TFP is similar to that of capacity utilization ([Basu et al., 2006](#)).

In the empirical analysis, we identify measured TFP and the *efficiency wedge* through observables and equilibrium relationships, use the decomposition (35) to identify the determinants of the *efficiency wedge*, and use the smoothed states from the Kalman filter to compute the utilization-adjusted TFP component. Detailed derivations of the TFP decomposition are given in [Appendix B](#). The decomposition provides the basis for the results in [section 4](#), where we compare how each utilization channel contributes to TFP dynamics in the data. [Section 3](#) details how this structure is estimated and how the *efficiency wedge* and utilization margins are identified in the data.

### 3. Estimation and Identification

This section connects the theoretical model and the TFP decomposition to the data. It describes the datasets and prior choices, outlines the Bayesian estimation strategy, and explains how the key goods market SaM parameters are identified. The estimation includes survey-based capacity utilization that anchors the *efficiency wedge* in TFP. Identification relies on cross-equation restrictions linking utilization, consumption dynamics, and inflation to the goods market SaM block of the model. The section concludes by conceptually defining alternative model specifications – capital utilization, labor effort, and goods market SaM – of the efficiency wedge.

#### 3.1. Data and Prior Description

We estimate the model on quarterly U.S. (1984q1 - 2019q4) and Euro Area data (1998q1 - 2019q4) using nine observables: real growth rates of GDP, private and consumption, labor compensation, and capacity utilization, hours per worker, employment rate, GDP deflator, and the policy rate. Hours per worker and the employment rate are linearly detrended ([Cacciatore et al., 2020](#)). Growth rates are detrended by mean GDP growth, except capacity utilization growth which is de-measured as the stationary rates ([Smets and Wouters, 2007](#)). The policy rate is adjusted by the shadow rate for the zero-lower-bound period ([Wu and Xia, 2016](#)). Capacity utilization data combine industrial and imputed service sector measures; construction and sources appear in [Appendix C](#). Given sample size differences, the main

analysis uses U.S. data, with Euro Area results provided as robustness checks.

General parameters of the model are calibrated while research question specific parameters are estimated. The calibrated parameters are in line with the literature (Blanchard and Gali, 2010; Christiano et al., 2010). The prior setup is shown in table 3. The calibration and estimation strategy is described in detail in Appendix C.

We estimate several parameters through proxies to improve stability and constrain the permissible range. The steady-state markup determines  $\epsilon$  with a Beta(0.2, 0.1) prior, which in turn determines the production fixed costs through a steady-state zero profit assumption. The labor effort elasticity,  $\nu_e$ , is inferred from steady-state increasing returns in hours per worker,  $\phi = 1 + \frac{\nu_H}{1+\nu_e}$ , with a Gamma prior with mean 1.75 and standard deviation 0.25 (Lewis et al., 2019). The capital utilization elasticity,  $\phi_{K,2}$ , is estimated with a Gamma prior with mean 2 and standard deviation 1 (Christiano et al., 2010; Qiu and Rios-Rull, 2022). All three priors are deliberately wide to allow for potential trade-offs with the goods market SaM block. For the goods market SaM parameters,  $\gamma_T$ , is normalized by an upper bound,  $\gamma_{T,ub} = 0.5$ , reflecting the literature (Michaillat and Saez, 2015; Bai et al., 2025; Huo and Rios-Rull, 2020; Qiu and Rios-Rull, 2022) and estimated via  $\gamma_T^{prox} = \gamma_T / \gamma_{T,ub}$  with a Beta(0.5, 0.2) prior. The same approach applies to  $\Gamma$  with a lower bound  $\Gamma_{lb} = -5$  and estimated via  $\Gamma^{prox} = \frac{\Gamma}{\Gamma_{lb}}$  with a Beta(0.1, 0.05) prior<sup>27</sup>. The search effort disutility parameter,  $\nu_D$ , is modeled as a multiple of  $\nu_H$  and estimated with a Gamma prior with mean 1 and standard deviation 0.5, which reflects the idea of equal disutility across time-uses (Huo and Rios-Rull, 2020). The inventory depreciation rate,  $\delta_I$ , uses a Beta (0.15, 0.05) prior for the industry share of the economy, accounting for  $\delta_{S,I} = 1$  in services (Khan and Thomas, 2007). Finally, the contract separation rate,  $\delta_T$ , uses a Beta (0.25, 0.15) prior (Mathä and Pierrard, 2011) where the wide prior adjusts for household–firm rather than inter-firm contracts.

### 3.2. Estimation Strategy

We estimate the model using full-information Bayesian methods. The model is linearized around its deterministic steady state and solved using Dynare (Adjemian et al., 2024).

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<sup>27</sup>This interval allows mild complements around Cobb–Douglas elasticity while excluding extreme cases.

The posterior distribution combines the likelihood obtained from the Kalman filter with the prior densities described above. We compute the posterior mode using the NewRat optimizer and draw four Markov chains of 1,000,000 iterations each from a random-walk Metropolis–Hastings algorithm, discarding the first half as burn-in. The proposal scale is tuned automatically to achieve an acceptance rate of approximately 30%. Posterior convergence is assessed using the Brooks and Gelman (1998) and Geweke (1999) diagnostics, which are available upon request. The observables-to-model mapping follows Pfeifer (2018), linking nine observables to the model’s measurement equations as shown in Appendix C.3. Model comparison relies on the log data density, computed with the modified harmonic mean estimator (Geweke, 1999). Differences in log data densities are evaluated using the Bayes factor (Kass and Raftery, 1995), where values above 10 indicate a decisive improvement in model fit.

### 3.3. Identification of the Goods Market SaM Mechanism

Identification relies on two complementary sources of information: (i) survey-based capacity utilization, which determines the *efficiency wedge* and the goods market matching probability,  $q_{T,t}$ ; and (ii) cross-equation restrictions linking the consumption and investment Euler equations and the New Keynesian Phillips curve to the latent search price,  $P_{D,t}$ . Together, these moments identify the capacity utilization and price elasticity channels of the goods market SaM mechanism. Using (11) and (35), the *efficiency wedge* is given by

$$\hat{\Phi}_t = \frac{\hat{c}u_t}{1 + \vartheta_{gdp}cu} + \frac{\vartheta_{gdp}cu \hat{g}dp_t}{1 + \vartheta_{gdp}cu} - (1 - \alpha) \hat{H}_t - \varphi_\psi \hat{\psi}_{T,t}, \quad (36)$$

where  $\varphi_\psi = \frac{1-cu(1-(1-g_S)\delta_T\delta_I)}{(1+\vartheta_{gdp}cu)\delta_I}$ . It depends on observables – capacity utilization, fixed-cost depression (proxied by real GDP), and hours per worker<sup>28</sup> – and on a latent goods mismatch shock<sup>29</sup>. This formulation extends the standard approach (Fernald, 2014; Comin et al., 2025)

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<sup>28</sup>Holding utilization fixed: (1) hours per worker affect both short-run capacity and output but are not part of long-run sustainable capacity; (2) fixed cost depression raises the marginal productivity of additional inputs.

<sup>29</sup>Goods mismatch shocks are treated as technology shocks (upper-bound) that exogenously move utilization. Under the lower-bound interpretation, they represent non-technological composition and dispersion effects.

by including a market technology term that drives utilization exogenously. While this alters the behavior of the efficiency wedge in model and data, it does not affect the identification of goods market SaM, only its accounting within the wedge.

Capacity utilization data further disciplines the goods market SaM block through (11), which links capacity utilization to matching efficiency  $\psi_T$ , goods matching probability,  $q_{T,t}$ , and long-term contract and inventory dynamics. We rewrite (11) as

$$\hat{c}\hat{u}_t = (1 - g_S) \left[ \delta_T \left( \hat{q}_{T,t} + \hat{S}_t \right) + (1 - \delta_T) \hat{T}_{t-1} \right] + g_S \hat{G}_t + i_S \Delta \hat{I}_{S,t} - \hat{\mathcal{Y}}_t \quad (37)$$

where  $g_S$  is the government spending ratio,  $i_S$  is inventory-to-GDP ratio, and  $\bar{\mathcal{Y}}_t$  is determined by input factors and utilization-adjusted TFP only – see (12). Conventional capacity utilization channels affect available production capacity,  $S(\hat{e}_{H,t}, \hat{e}_{K,t}; \vartheta, \delta_T, \delta_I)$  – see (9). Hence, the goods matching probability,  $q_{T,t}$ , is a main determinant of capacity utilization as input factors are fixed through observables and long-term contracts and inventory investment are jointly determined in the goods market SaM block. However, both capacity utilization and the *efficiency wedge* can also be described by the conventional utilization channels affecting available production capacity. Hence, we rely on cross-equation restrictions laid out next to elicit the log data density of each channel in the model.

Search prices as defined in (19) are a latent variable as shopping time data is not available on a quarterly basis. Cross-equation restrictions given by the consumption (21) and investment (26) Euler equations and the Phillips curve (24) discipline the search price component working through  $P_{T,t}$ , in conjunction with consumption, investment, and inflation data. Search prices are further disciplined by survey data on capacity utilization through their interaction with goods market tightness (4) which separately helps to identify the search effort disutility and goods market tightness components of search prices.

The labor effort margin is identified by hours per worker as shown in (33), which is disciplined through employment decisions on the demand (29) and supply side (31). The capital utilization margin is identified by the capital interest rate as shown in (27), which is disciplined through capital investment decision on the demand (28) and supply side (26). Labor and capital supply are jointly determined with search prices working through  $P_{T,t}$  and

**Table 1:** Model Variants by Active Utilization Channel

Model	Active Utilization Channels	Purpose in Comparison
K-UTIL	Capital-utilization costs $\phi_{K,2}$	Replicates standard DSGE ( <a href="#">Christiano et al., 2010</a> ; <a href="#">Smets and Wouters, 2007</a> )
	Production fixed costs $\vartheta$	
L-UTIL	Labor-effort elasticity $\nu_e$	Current state of the literature ( <a href="#">Fernald, 2014</a> ; <a href="#">Lewis et al., 2019</a> )
	Production fixed costs $\vartheta$	
GM-UTIL	Goods market SaM ( $\psi_T, \gamma_T, \Gamma$ )	Tests goods market SaM mechanism ( <a href="#">Michaillat and Saez, 2015</a> )
	Production fixed costs $\vartheta$	
FULL-UTIL	All margins as in <a href="#">section 2</a>	Full specification analysis

*NOTE:* Each model name in small caps indicates the active utilization margin. The FULL-UTIL specification represents the complete version of the framework. Inventories imply durable consumption, which are otherwise excluded. Any combination of the presented models is possible. All variants share identical priors and data; differences in log data density therefore capture the marginal explanatory contribution of each utilization channel.

labor and capital demand are jointly determined with matched capacity,  $e_{M,t}$ .

The joint estimation across these equations allows the data to distinguish whether fluctuations in TFP originate from underlying technology shocks, from input utilization, from coordination frictions, or a combination of them. The key insight is that capacity utilization and inflation jointly anchor the goods market SaM mechanism, while real activity variables discipline the propagation of utilization and search effort to output and prices.

### 3.4. Model Comparison Design

To evaluate the contribution of each utilization mechanism, we estimate and compare several nested versions of the model. Each variant activates a different channel linking input factors to measured TFP while keeping all other structures and priors identical. This approach isolates how the new goods market SaM block improves model fit relative to existing utilization margins in the literature.

The benchmark combines [Christiano et al. \(2010\)](#); [Lewis et al. \(2019\)](#) and includes labor effort, capital utilization, and production fixed costs but excludes goods market SaM. Alter-

native specifications sequentially introduce both mechanisms. The preferred specification<sup>30</sup> combines the benchmark and goods market SaM channels. A further robustness model adds intertemporal SaM components (inventories and long-term contracts). All models are estimated with identical data, priors, and sampling settings, ensuring that Bayes-factor differences reflect economic – not numerical – variation. [Table 1](#) summarizes the model hierarchy. Different combinations of the presented margins are evaluated in [section 4](#) as e.g. the *preferred model* combining the KL&GM-UTIL margins. Posterior estimates, log data densities, and variance decompositions reported in [section 4](#) quantify the relative explanatory power of each specification.

Having established the estimation framework and identified the efficiency wedge and its decomposition, we now turn to the empirical results. [Section 4](#) presents the posterior estimates and model fit, compares the alternative utilization specifications introduced in [section 3.4](#), and evaluates the contribution of each margin to fluctuations in TFP. We first discuss log data densities and posterior parameters. We then examine the implied dynamics of the efficiency wedge and recent U.S. business cycles. A variance decomposition of the business cycle shocks provides the empirical foundation for the interpretation of business cycle utilization behavior in [section 5](#).

## 4. Estimation Results

Goods market SaM improves the model’s log data density in all countries. The relative roles of price elasticity and capacity utilization vary by country, but priors and posteriors show well-identified parameters – especially for goods market SaM. The model matches second moments of search effort and yields consistent TFP and efficiency wedge estimates. Applied to the U.S., it helps to explain both the “missing-deflation” and post-COVID inflation episodes using the [Barro and Grossman \(1971\)](#) framework. Variance decompositions show a shift away from price cost-push shocks due to endogenous price elasticity, and results remain robust across checks.

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<sup>30</sup>For expositional clarity, we label the models as the *benchmark* and *preferred* specifications to organize the terminology early on. The labels are a result from the estimation and are not presupposed in any way.

#### 4.1. Log Data Density – Does Goods Market SaM Explain the Data Better?

The goods market SaM mechanism decisively improves the model’s ability to explain macroeconomic fluctuations. [Table 2](#) summarizes log data densities for all model variants and countries. Relative to the benchmark with labor effort and capital utilization, adding goods market SaM shows a Bayes factor between 89 and 150 points, indicating a decisive improvement in fit. The data therefore favors a contemporaneous SaM channel that complements the labor effort margin, while capital utilization and intertemporal SaM extensions add little explanatory power.

*Benchmark vs Preferred Model.* Across economies, the hierarchy of models is consistent. Labor effort utilization outperforms capital utilization decisively, reproducing results in [Lewis et al. \(2019\)](#). However, the combination of the two improves the data fit further, thus informing our *benchmark model* choice. A simple GM-UTIL model outperforms the benchmark with a Bayes factor between 13 and 114 – indicating a decisive improvement in data fit and highlighting the importance of goods market SaM.

Combining the traditional utilization margins with goods market SaM (KL&GM-UTIL) shows the highest performing model across countries – thus informing our *preferred model* choice. However, neglecting the capital utilization channel (K&GM-UTIL) does not lead to a decisive deterioration in data fit, confirming that the labor effort and goods market margins jointly capture most of the relevant dynamics<sup>31</sup>. Including long-term contracts or inventories (FULL-UTIL) leads to a negative Bayes factor of roughly  $-33$  to  $-60$  points, suggesting that the data prefers short-lived, contemporaneous matching frictions to persistent contractual mechanisms.

This pattern implies that aggregate capacity utilization fluctuations arise mainly from coordination frictions on the goods market. The high posterior likelihood of the models with goods market SaM indicates that search effort and market tightness provide critical information about measured TFP variation.

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<sup>31</sup>For the U.S., the GM-UTIL vs. K-UTIL comparison replicates [Qiu and Rios-Rull \(2022\)](#) with a Bayes factor of 100, but combining both margins slightly worsens the fit.



**Table 2:** Log Data Densities and Bayes Factors Across Different Model Variants

Model Setup	U.S.	Spain	Germany	France
<i>Models from the Literature</i>				
K-UTIL	5174.6	2634.3	2905.1	3043.2
L-UTIL	5213.3	2675.4	2927.3	3092.5
<b>K&amp;L-Util</b> <b>Benchmark</b>	<b>5218.2</b>	<b>2680.1</b>	<b>2925.9</b>	<b>3085.9</b>
<i>Goods Market Search-and-Matching Models</i>				
GM-UTIL	5224.6	2687.4	2975.2	3149.3
K&GM-UTIL	5222.7	2688.4	2978.1	3150.1
L&GM-UTIL	5261.4	2710.0	3002.5	3160.8
<b>KL&amp;GM-Util</b> <b>Preferred</b>	<b>5262.7</b>	<b>2709.1</b>	<b>3004.7</b>	<b>3160.8</b>
FULL-UTIL	5229.7	2683.8	2986.8	3134.9
<b>Bayes Factor:</b> Preferred - Benchmark	<b>89.0</b>	<b>69.2</b>	<b>150.4</b>	<b>136.6</b>
<i>Goods Market SaM Channel Decomposition</i>				
L&GM-UTIL (Complements)	5243.4	2658.8	2940.6	3090.4
<b>Bayes Factor:</b> Complements - Preferred	<b>-38.6</b>	<b>-102.4</b>	<b>-123.8</b>	<b>-140.8</b>
<i>No Capacity Utilization Data as an Observable</i>				
L-UTIL (no CU)	4675.9	2462.4	2622.4	2823.7
L&GM-UTIL (complements & no CU)	4688.8	2471.6	2679.6	2898.0
L&GM-UTIL (no CU)	4713.1	2466.1	2693.1	2895.3
<b>Bayes Factor:</b> Preferred - Benchmark	<b>74.4</b>	<b>7.4</b>	<b>141.4</b>	<b>143.2</b>

*NOTE:* The table shows log data densities and Bayes factors for different model variants estimated on U.S. data (1984q1-2019q4) and Euro Area data (1998q1-2019q4). Log data densities are calculated by the modified harmonic mean following Geweke (1999). Different variants are compared using the Bayes factor (Kass and Raftery, 1995): a value of 5 or higher indicates an improvement in data fit, a value of 10 or higher a decisive improvement in data fit.

*Goods Market SaM Channel Decomposition.* We find that both the *price elasticity* and *capacity utilization* channels contribute to the decisive improvement in data fit of the L&GM-UTIL model. To assess their contributions, we separately identify their effects following section 3.3. This decomposition clarifies whether the inclusion of goods market SaM enhances the model primarily by improving the measurement of capacity utilization and TFP, or

instead by refining the dynamics of other equations through the price elasticity channel.

Two caveats apply when identifying the separate contributions of the goods market SaM channels. First, we observe data on capacity utilization but not on search effort. Second, variation in price elasticity is partly driven by changes in capacity utilization, creating an interaction between the two channels.

We isolate the joint effect of capacity utilization and interaction channels by setting matching inputs as perfect complements ( $\Gamma \approx -\infty$ ) and re-estimating the model. Bayes factors from  $-39$  to  $-141$  show a decisive loss of fit when search effort ceases to be productive, confirming their positive joint contribution to goods market SaM performance. The residual Bayes factor reflects the price elasticity channel alone: in the U.S. and Germany, the L&GM-UTIL (COMPLEMENTS) model still outperforms the benchmark, while fit deteriorates for Spain and France. Overall, capacity utilization and its interaction with price elasticity strengthen model fit, whereas price elasticity alone yields mixed results.

Next, we drop capacity utilization data to isolate its joint effect with the interaction channel. Even without targeting utilization, adding goods market SaM improves log data density, with Bayes factors from  $7$  to  $143$  – reflecting the combined impact of price elasticity and interaction channels. Imposing perfect matching complements to shut off interactions improves fit for Spain and France, and worsens it for the U.S. and Germany, where fit relies on interaction amplification. Thus, without utilization data, the price elasticity channel dominates in Spain, and France, while the U.S. and Germany depend on the interaction effect.

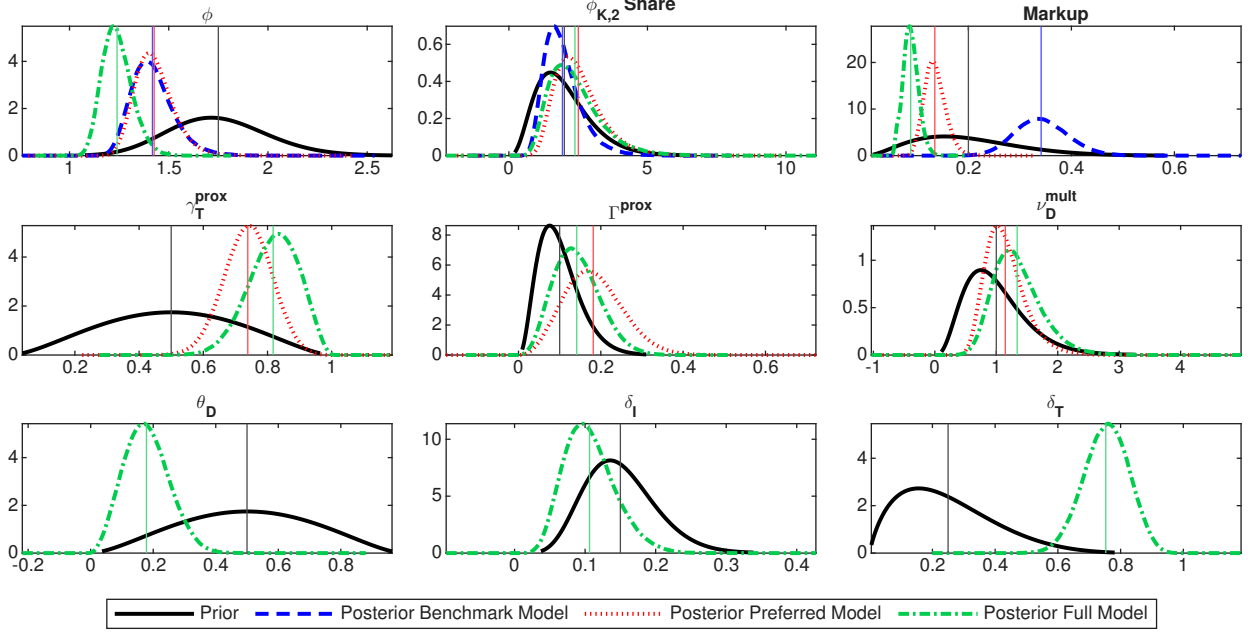
Overall, both goods market SaM channels and the interaction channel contribute equally to model fit in the U.S. and Germany, while in Spain and France, capacity utilization and interaction channels dominate<sup>32</sup>.

*Robustness Analysis.* The results are robust to alternative specifications varying the treatment of investment and output, sectoral weights in the construction of capacity utilization data, and the sample period, as reported in [table D.6](#). The preferred model also performs similarly

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<sup>32</sup>Without targeting utilization data, the price elasticity channel still modestly improves fit for Spain and France, supporting both channels.

**Figure 1:** Prior-Posteriors Densities of the Utilization Margins (U.S. Data)



NOTE: The figure shows the prior and posterior distribution for the benchmark (K&L-UTIL), preferred (KL&GM-UTIL), and full (FULL-UTIL) models. The estimation follows the description in [Appendix C](#).

when estimating without capacity utilization data – potentially subject to measurement bias ([section Appendix C](#)). Bayes factors thus confirm that incorporating the goods market SaM mechanism decisively improves model fit, motivating the following analysis of the posterior parameter estimates that underpin these findings.

#### 4.2. Prior-Posterior Analysis

Posterior densities are sharply peaked and consistent across countries, indicating precise identification of the utilization mechanisms. The results confirm that the goods market SaM block is well supported by the data and that its parameters explain the improvement in model fit. [Figure 1](#) highlights the posterior densities of the goods market SaM parameters; a full overview is given in [table 3](#). All posteriors are well within their prior intervals, and posteriors of general parameters are mostly consistent across models.

*Goods market SaM.* The estimated goods market SaM parameters indicate a strong and productive search elasticity. The high posterior mean of  $\gamma_T$  suggests that household search

effort is a key component of the matching process. The curvature parameter  $\Gamma$  centers around 0.16, close to a Cobb–Douglas form, highlighting the substitutability of matching inputs, though it remains largely prior-driven due to limited data informativeness. The disutility of search effort,  $\nu_D$ , is somewhat higher than that of labor effort ( $\frac{\nu_D}{\nu_H} \approx 1.15 - 1.34$ ), implying that time spent searching carries a similar but slightly higher opportunity cost to working<sup>33</sup>. Intertemporal goods market SaM parameters are small. The posterior mean of the contract separation rate,  $\delta_T$ , points to short-lived matches, while the posterior mean of  $\theta_D$  indicates low habit persistence in search. The inventory depreciation rate is low and precisely estimated. However, as only about one-fourth of U.S. firms can hold inventories, the data clearly favor contemporaneous over intertemporal goods market frictions – hence their exclusion from the preferred model. Overall, the results highlight search effort as a quantitatively important adjustment margin and a key driver of utilization and price elasticity dynamics, consistent with [Bai et al. \(2025\)](#); [Michaillat and Saez \(2015\)](#); [Qiu and Rios-Rull \(2022\)](#). The strong model fit stems primarily from current-period search activity rather than from accumulated contracts or unsold inventories.

*Steady-state markups.* Estimated steady-state markups decline once goods market SaM is introduced, reflecting stronger effective competition as firms respond more flexibly to search conditions. A high search elasticity ( $\gamma_T$ ) and low curvature ( $\Gamma$ ) make search effort highly responsive to demand, which dampens steady-state markups, implying smaller effective fixed costs and higher capacity utilization, as firms operate closer to their efficient scale. The preferred model shows steady-state markups roughly 21%-points smaller than in the benchmark model. Hence, goods market SaM captures an endogenous reduction in overhead.

*Capital utilization and labor effort.* Turning to traditional utilization margins, the labor effort elasticity  $\nu_e$  remains significant<sup>34</sup> and continues to dominate over capital utilization

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<sup>33</sup>The estimated  $\nu_D$  exceeds values in [Michaillat and Saez \(2015\)](#), is below those in [Bai et al. \(2025\)](#), and broadly aligns with [Huo and Rios-Rull \(2020\)](#).

<sup>34</sup>The posterior mean of the steady-state labor effort elasticity,  $\frac{1}{\nu_e} = \left( \frac{\nu_H}{\phi-1} - 1 \right)^{-1}$ , ranges between 0.12 and 0.24 given the estimated  $\nu_H$ . This is below the literature value of approximately 0.6 ([Bils and Cho,](#)

costs although they remain well identified across specifications. The implied elasticity of capital utilization is much lower than values reported in the literature<sup>35</sup>. Overall, the results align with existing evidence, confirming the salient role of labor effort in short-run utilization dynamics (Lewis et al., 2019).

*Further posteriors across models.* Table 3 summarizes priors and posteriors, showing largely consistent parameters across models. The Frisch elasticity,  $\nu_H$ , and hours adjustment costs,  $\kappa_H$ , increase as we introduce goods market SaM reflecting the time allocation trade-off from goods market SaM. Price adjustment costs,  $\kappa_P$ , decrease and investment adjustment costs,  $\kappa_I$ , increase with goods market SaM, suggesting weaker inflation variation and stronger investment variation driven by price elasticity changes.

*Robustness.* The cross-country evidence is largely uniform<sup>36</sup>: the U.S., Germany, France, and Spain exhibit tight posteriors with the same qualitative ordering – high  $\gamma_T$ , low  $\delta_T$ , and moderate  $\Gamma$ . Hence, the data consistently support a contemporaneous goods market SaM mechanism that complements the labor effort and fixed cost margins, with the initially dominant margin differing across countries<sup>37</sup>. Prior-posterior comparisons between the U.S., Spain, Germany, and France can be found in Appendix D.2. These parameter estimates provide the structural basis for the subsequent analysis, which translates the posterior results into observable U.S. business-cycle dynamics through the model-implied latent gaps.

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1994), indicating that labor effort becomes less elastic once goods market SaM is introduced. In the short run, however, hours adjustment costs  $\kappa_H$  raise the elasticity as hours per worker are slow to adjust.

<sup>35</sup>The GM&KL-UTIL model yields a  $\phi_{K,2}$  posterior mean of 3.06. The implied elasticity of utilization with respect to marginal utilization costs,  $\sigma_{e_K} = \frac{\delta'_K}{\delta''_K e_{K,t}}$ , lies between 0.4 and 0.52, far below the estimate of 3.33 (Christiano et al., 2010).

<sup>36</sup>Expected Euro Area deviations include more rigid labor markets, country-specific investment patterns with consistent SaM effects, lower markups, and a stronger monetary focus on inflation.

<sup>37</sup>Goods market SaM reduces steady-state markups in Germany and lessens labor effort contributions in Spain and France, improving the explanation of capacity utilization through country-specific channels.

**Table 3:** Prior-Posterior Estimates of the Model Parameters (U.S. Data)

Parameter	Distribution	Prior		Posterior		
		Mean	Std.Dev.	Benchmark (90% HDP)	Preferred (90% HDP)	Full (90% HDP)
<i>General Parameters</i>						
$\omega$	Beta	0.5	0.2	0.70 (0.33-0.96)	0.67 (0.41-0.94)	0.78 (0.60-0.97)
$\theta_H$	Beta	0.7	0.1	0.75 (0.68-0.83)	0.70 (0.63-0.77)	0.73 (0.65-0.79)
$\nu_H$	Gamma	2	0.5	1.67 (1.22-2.11)	2.21 (1.64-2.76)	2.17 (1.58-2.78)
$\frac{1}{mc} - 1$	Beta	0.2	0.1	0.34 (0.26-0.42)	0.13 (0.10-0.17)	0.09 (0.06-0.11)
$\kappa_H$	Gamma	4	1.5	3.02 (2.28-3.77)	4.05 (3.14-4.91)	4.483 (3.51-5.45)
$\kappa_I$	Gamma	4	1.5	4.53 (3.11-5.90)	9.69 (7.11-12.21)	9.63 (6.80-12.42)
$\kappa_W$	Gamma	30	5	28.4 (20.9-35.9)	27.0 (19.5-34.4)	17.1 (10.4-23.5)
$\kappa_P$	Gamma	180	20	203.3 (169.1-234.5)	159.1 (131.9-185.9)	173.5 (144.5-202.5)
$\iota_W$	Beta	0.5	0.15	0.38 (0.15-0.60)	0.44 (0.20-0.68)	0.44 (0.20-0.68)
$\iota_P$	Beta	0.5	0.15	0.13 (0.04-0.20)	0.08 (0.03-0.13)	0.09 (0.03-0.14)
$i_\pi$	Gamma	1.8	0.1	1.76 (1.61-1.91)	1.81 (1.66-1.95)	1.87 (1.73-2.02)
$i_{gap}$	Gamma	0.12	0.05	0.15 (0.08-0.21)	0.10 (0.04-0.15)	0.09 (0.03-0.14)
$i_{\Delta gap}$	Gamma	0.12	0.05	0.12 (0.4-0.19)	0.14 (0.05-0.22)	0.10 (0.04-0.15)
<i>Benchmark Utilization Parameters</i>						
$\phi$	Gamma	1.75	0.25	1.42 (1.25-1.58)	1.43 (1.27-1.58)	1.24 (1.12-1.36)
$\phi_{K,2}$	Gamma	2	1	1.93 (0.92-2.92)	2.51 (1.21-3.76)	2.38 (0.97-3.76)
<i>Goods Market SaM Utilization Parameters</i>						
$\gamma_T^{prox}$	Beta	0.5	0.2	—	0.74 (0.62-0.86)	0.82 (0.70-0.95)
$\Gamma^{prox}$	Beta	0.1	0.05	—	0.18 (0.07-0.29)	0.14 (0.04-0.23)
$\nu_D^{mult}$	Gamma	1	0.5	—	1.15 (0.64-1.64)	1.34 (0.73-1.96)
$\theta_D$	Beta	0.5	0.2	—	—	0.18 (0.06-0.29)
$\delta_I$	Beta	0.15	0.05	—	—	0.11 (0.05-0.16)
$\delta_T$	Beta	0.25	0.15	—	—	0.75 (0.64-0.87)

NOTE: The table shows the prior (identical across models) and posterior densities of the estimated parameters for the (1) benchmark model (K&L-UTIL), (2) preferred model (KL&GM-UTIL), and (3) full model (FULL-UTIL). The 90% HDP intervals are given in paranthesis.

#### 4.3. Validating Search-and-Matching through Moments of Latent Variables

Unmatched moments show that goods market search effort is procyclical and closely tied to capacity utilization, empirically supporting the behavioral regularities of the goods market SaM mechanism. To assess behavioral realism beyond the estimation targets, we analyze non-targeted second moments from the preferred specification ([Appendix D.3](#)). Hours per worker correlate with capacity utilization ( $corr. = 0.67$ ) and search effort ( $corr. = 0.57$ )

in U.S. data, though the imperfect link suggests utilization surveys capture broader time-allocation behavior (Comin et al., 2025). The model predicts strongly procyclical search effort with a GDP elasticity of 0.53<sup>38</sup> and a relative standard deviation to GDP of 1.02, consistent with Petrosky-Nadeau et al. (2016). Goods mismatch shocks explain 30.0% of search effort variation, showing strong internal propagation through other business cycle shocks<sup>39</sup>. Search effort remains only weakly correlated with TFP ( $corr. = -0.4$ ), capacity utilization ( $corr. = 0.34$ ), and goods market tightness ( $corr. = 0.31$ ), reflecting time-allocation and matching-efficiency shifts beyond pure demand effects.

Model-implied U.S. TFP growth<sup>40</sup> is tightly identified, with a correlation near one and standard deviations of 0.479% and 0.483% for the benchmark and preferred models. The correlation with the data is 0.66, and the empirical standard deviation is 0.732% (Fernald, 2014). Deviations arise mainly from using (1) capital investment rather than estimated capital stock data and (2) aggregate data that ignore input composition and cross-industry productivity heterogeneity. Hence, model-generated TFP aligns closely with empirical estimates, and differences across models and decompositions reflect shifts in underlying drivers rather than divergent TFP behavior.

The growth rate of the efficiency wedge, as defined in (36), shows a consistently positive correlation between models and the data. Under the lower-bound definition – excluding goods mismatch shocks as technology shocks, consistent with Comin et al. (2025) – the benchmark and preferred models correlate at 0.96. The benchmark model fits the data more closely ( $corr. = 0.54$ ) than the preferred ( $corr. = 0.45$ ), and its standard deviation (0.32%) is close to the preferred model (0.31%) but distant to its empirical value (0.73%).

Including goods mismatch shocks as technology shocks (upper-bound definition) reduces the correlation between the two models to 0.36, revealing their differential response to goods

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<sup>38</sup>OLS of smoothed log search effort on log GDP; constant = 0.39. Without constant: elasticity = 1.04.

<sup>39</sup>Main drivers: investment (36.1%), monetary policy (7.9%), hours supply (7.1%), technology (5.7%), discount factor (5.4%), and price cost-push (5.0%).

<sup>40</sup>Growth rates are used instead of steady-state deviations, as external data are available only in this format.

market frictions. The benchmark model then tracks the data poorly ( $corr. = -0.16$ ), while the preferred model retains moderate fit ( $corr. = 0.37$ ). Standard deviations improve: the preferred model rises to 0.67% and the benchmark to 0.43%.

Examining the correlation between TFP and efficiency wedge growth, the benchmark model aligns better with the data ( $corr_{low} = 0.53$ ,  $corr_{up} = 0.0$ ; data  $corr. = 0.55$ ) than the preferred model ( $corr_{low} = 0.37$ ,  $corr_{up} = 0.04$ ). Both specifications thus capture the efficiency wedge reasonably well under empirical definitions (lower-bound) (Fernald, 2014; Comin et al., 2025), though their strengths differ. Yet, once goods mismatch shocks are treated as technology shocks, the implied business cycle dynamics of the efficiency wedge diverge markedly – highlighting the sensitivity of its empirical identification to assumptions about coordination frictions.

#### 4.4. *The U.S. Business Cycle through the Lens of Goods Market SaM*

The model’s output, unemployment, and market-tightness gaps reinterpret U.S. cycles through the lens of Barro and Grossman (1971)-regimes: the post-2008 “missing deflation” reflects coordination failures on the goods market, while post-COVID inflation spikes arise from surging goods market tightness.

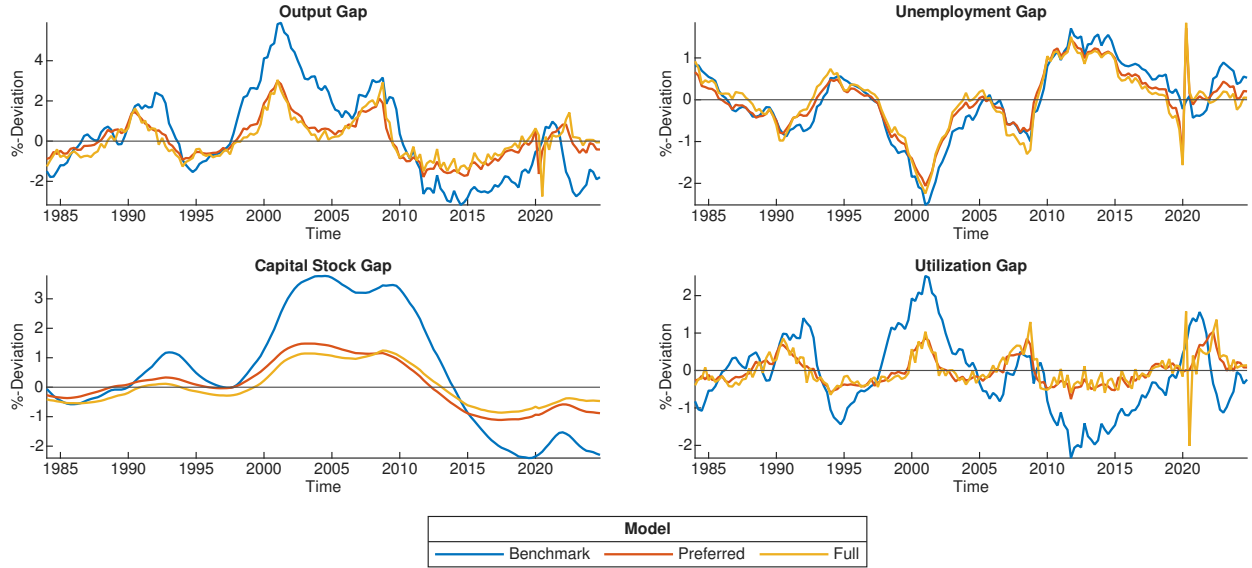
The consistent estimation of TFP and the efficiency wedge implies that the model captures well the utilization margins underlying business cycle fluctuations. To trace how these mechanisms manifest in macroeconomic dynamics, we use the smoothed latent states from the Kalman filter to construct cyclical gaps in output, unemployment, labor market tightness, and goods market tightness – defined as deviations from their flexible-price counterparts<sup>41</sup>. These gaps summarize the general state of the business cycle as well as excess demand and supply on specific markets. The output and unemployment gaps capture standard real and nominal activity fluctuations, while the labor and goods market tightness gaps measure

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<sup>41</sup>The flexible price economy of the model presented in section 2 is constrained efficient as labor is supplied inelastically and goods markets follow directed search (Moen, 1997). The flexible price economy thus also represents the social planner assuming that market frictions are a basic part of the economy which can be optimized but not entirely cleared.



**Figure 2:** U.S. Business Cycles through the Lens of Gap Variables



*NOTE:* The figure shows U.S. time series on the output, unemployment, capital, and capacity utilization gaps derived from two model variants – benchmark and preferred models – and U.S. data where available. The sample covers 1984q1 – 2024q4 where the model is estimated on 1984q1 – 2019q4 and the period after is derived from a calibrated smoother applied to the model.

shifts in coordination efficiency on either market. Together they link the efficiency wedge to observable macroeconomic behavior, allowing us to reinterpret U.S. business cycles as fluctuations in utilization and market coordination.

Figure 2 shows the smoothed latent gap variables implied by the benchmark and preferred models. The qualitative cyclical pattern is almost identical across models as the correlations for the gaps on output, capacity utilization, capital, and unemployment are 0.98, 0.93, 0.98, and 0.99. The quantitative pattern, however, shows lower standard deviations for the output gap (2.30% vs 3.77%), the capacity utilization gap (2.02% vs 1.03%), and capital stock gap (3.90% vs 2.60%), while the unemployment gap standard deviation (2.06% vs 1.95%) is close across models. Consequently, differences in utilization gap dynamics coupled with differences in the capital stock gap account for most of the output gap discrepancy across models.

Recessions are represented by an interplay of the gap variables. Figure 3 (b) shows the negative relationship between the output and unemployment gaps over the business cycle. Hence, a positive output gap appears most likely with unemployment below its natural rate.

Combinations of a positive output gap and a unemployment above its natural rate are less likely, less pronounced, and often transitory. This pattern applies to [figure 2](#) where it shows e.g. the (1) 1990s oil crunch, (2) the Great Recession and followed by a persistent slump, and (3) the COVID recession<sup>42</sup> followed by inflation spikes during reopening of the economy. Therefore, the output and unemployment gaps derived from the model are largely in line with the general perception of these episodes.

Using the search-and-matching framework on both goods and labor markets, we can derive an excess demand and supply framework<sup>43</sup> similar to [Barro and Grossman \(1971\)](#). This allows us to determine whether either market is demand- or supply-determined at any point in time. Demand-determined indicates that demand relative to supply is above its steady-state value (or above its flexible price counterpart for the gap variable). The same definition applies to labor markets. This alternative view on the business cycle based on market tightness gaps offers additional information to identify the type of a recession or boom.

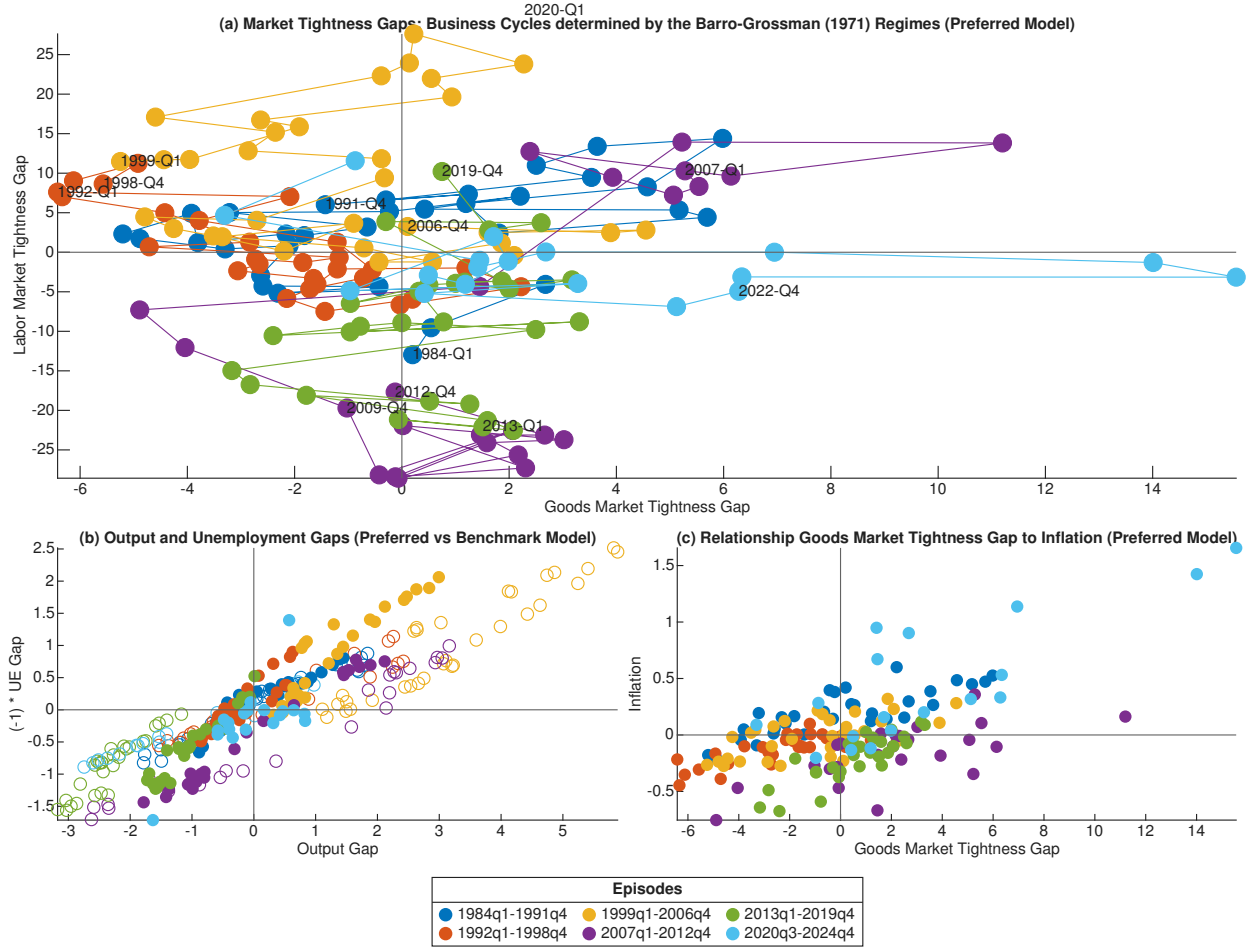
[Figure 3](#) presents (a) the labor and goods market tightness gaps and (c) the labor and goods market tightness deviations from steady-state for the U.S. dataset. We follow [Barro and Grossman \(1971\)](#) and identify four regimes of the economy: (i) Walrasian equilibrium ( $x_T < 0, x_N > 0$ ); (ii) Keynesian unemployment ( $x_T < 0, x_N < 0$ ); (iii) classical unemployment ( $x_T > 0, x_N < 0$ ); and (iv) repressed inflation ( $x_T > 0, x_N > 0$ ). The respective regime informs us on optimal policy depending on the states of excess demand and supply. The period following the Volcker disinflation is commonly referred to as the “Great Moderation,” characterized by subdued business cycle fluctuations. During this time, the economy remained largely in a Walrasian equilibrium, with only mild episodes of Keynesian unemployment and periods of depressed inflation. Goods market tightness rose slightly toward the onset of the Great Recession. Examining deviations of labor and goods market tightness from

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<sup>42</sup>The model is only estimated until 2019q4. Data between 2020q1 and 2024q4 is inferred from the estimated model by using a calibrated smoother with available observables until 2024q4.

<sup>43</sup>As [Michaillat and Saez \(2015\)](#) show and [Barro \(2025\)](#) argues, this might be a suitable DSGE-representation of the original four-regime model of [Barro and Grossman \(1971\)](#) which allows for an alternative interpretation of business cycles compared to the output gap paradigm proposed by the New-Keynesian literature.

**Figure 3: U.S. Business Cycles through the Lens of Market Tightness Gaps**



*NOTE:* The figure shows scatter plots of market tightness gaps, output and unemployment gaps, and inflation representing U.S. business cycles 1984q1 – 2024q4 through the lens of the preferred model. (a) shows the relationship between goods and labor market tightness gaps; (b) shows the relationship between output and unemployment gaps for the benchmark (hollow dots) and preferred model (filled dots); and (c) shows the relationship between goods market tightness gaps and inflation. Business cycle episodes are identified by color as given in the legend.

their steady states (figure 4) provides an even clearer picture. The framework thus points to potential demand management during the 1990 recession – if at all – but otherwise implies little need for policy intervention throughout most of this period, as goods markets exhibited mild excess supply while labor markets showed excess demand. This combination sustained a prolonged boom with limited inflationary pressure, though the output gap indicates emerging inflationary pressures around 1999.

*Macroeconomic Puzzles through the Barro and Grossman (1971)-Lens.* We apply our model and the Barro and Grossman (1971)-regimes to revisit two recent macroeconomic puzzles: The "missing deflation puzzle" (Ball and Mazumder, 2011; Coibion and Gorodnichenko, 2015) in the aftermath of the Great Recession; and the inflation spike following the reopening of the economy after COVID. The framework highlights coordination failures reducing the potential of the economy and repressed inflation due to spikes in goods market tightness as explanations for this episodes.

As shown in figure 3, the Great Recession and its aftermath were marked by persistent labor market slack, while goods markets alternated between excess demand and supply. The output gap stayed negative until 2019, yet the preferred model shows a much smaller gap than the benchmark, reflecting an almost closed capacity utilization gap (figure 2). This indicates that the downturn stemmed not only from weak demand but from a fall in production capacity. Search effort and goods market tightness both declined sharply; the former remained depressed through 2019, while the latter stayed slightly positive, signaling an even deeper contraction in production capacity (figure D.13a).

The economy entered the crisis from a repressed-inflation regime with excess demand in both markets, then shifted into Keynesian unemployment around 2009, producing deflationary pressure (figure 3). Fiscal and monetary measures – e.g. the American Recovery and Reinvestment Act (2009), Payroll Tax Cuts and Unemployment Insurance Extensions (2010), and expansionary monetary policy – lifted demand, creating positive goods market tightness gap but leaving labor slack. This mix of tight goods markets and weak labor demand *explains the absence of strong deflation*. As stimulus waned after the Budget Control Act (2011–2016), the economy briefly re-entered Keynesian unemployment (2014–2015) – showing some renewed decrease in inflation – before converging towards equilibrium by 2016. By 2019, output and unemployment gaps had closed, with mild goods market excess demand and low inflation.

Overall, the Great Recession represents a prolonged regime of labor market slack. The "missing deflation puzzle" stems from moderately tight goods markets that offset deflationary

pressures<sup>44</sup>. In essence, excessive search effort combined with weak labor demand reflects a *mismatch in household time allocation* – one of the episode’s key underlying drivers. While demand management was appropriate in the initial downturn, persistent slack in a classical unemployment regime required supply-side measures. The model therefore attributes post-crisis stagnation to coordination failures in the labor market rooted in goods market matching and time allocation, consistent with research on financial frictions, technology, and capital deepening (Christiano et al., 2015; Fernald, 2015).

The COVID-19 pandemic produced a short but severe recession during the initial lockdown, corresponding to a Keynesian unemployment regime characterized by low goods and labor market tightness gaps with a positive capacity utilization gap following from substantial shifts in consumption and available capacity (see figure 2). Subsequently, the economy entered a classical unemployment regime as potential output declined sharply – evident from the pronounced rightward shift of the labor market Beveridge curve, signaling substantial matching inefficiency (Shimer, 2007; Şahin et al., 2014). Massive fiscal support and the rapid reopening of the economy then generated a surge in goods market tightness: demand recovered faster than production capacity while labor markets remained near equilibrium tightness. Search effort spiked, shifting the goods market Beveridge curve upward (figure D.14) and moving the economy toward a repressed inflation regime. The resulting inflation surge reflected intense demand pressure.

Goods market tightness gaps display a clear positive relationship with the inflation spike, whereas the output gap would require strong nonlinearities to reproduce the same pattern (Harding et al., 2022). Similarly, capacity utilization gaps show no clear correspondence with the sharp rise in inflation. The contrasting movements of the Beveridge curves – an upward shift in the goods market and a rightward shift in the labor market – indicate that surging demand collided with constrained labor supply. Elevated unemployment alongside strong

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<sup>44</sup>The pattern of persistent labor market slack alongside varying goods market performance is mirrored in the Beveridge curves. The labor market Beveridge curve shifted downward, indicating reduced matching efficiency, whereas the goods market curve remained largely stable – experiencing a brief decline in efficiency at the start of the Great Recession followed by a swift recovery. These dynamics are illustrated in figure D.14.

labor demand points to coordination frictions and limited productive expansion despite high search effort. Labor market tightness remained close to equilibrium, which may explain the absence of a wage–price spiral. Overall, the model attributes a significant share of post-pandemic inflation surge to heightened search effort and demand pressure indicated by an elevated goods market tightness – a feature the textbook New-Keynesian model is struggling with.

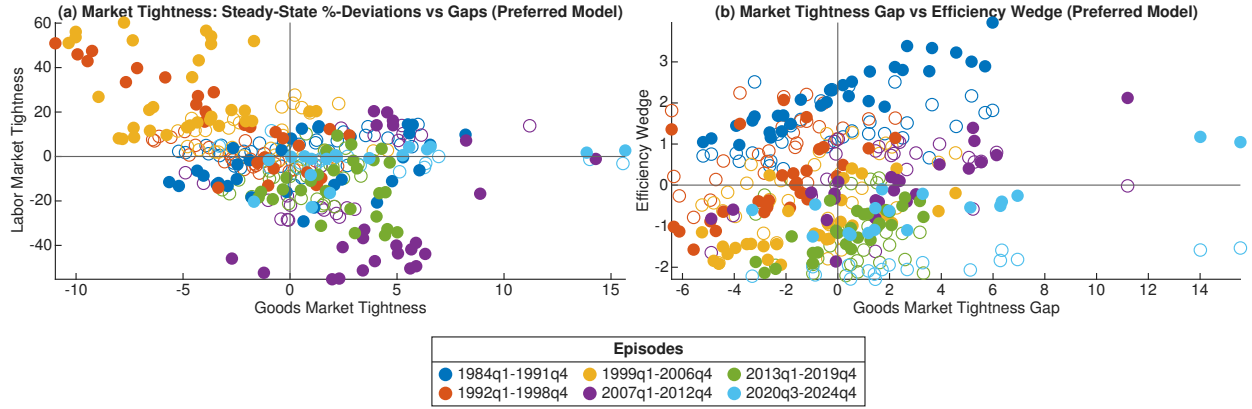
These results show that coordination efficiency in labor and goods markets – rather than technology – drives regime shifts in the U.S. business cycle, explaining both the post-2008 “missing deflation” and the 2022 inflation surge. The market-tightness-gap framework improves understanding of business cycle origins and policy design: demand management was appropriate after the Great Recession, but the subsequent classical unemployment regime required supply-side measures. While output and unemployment gaps identify recessions, market-tightness gaps guide policy and signal inflation risks. Together, they provide complementary views of business-cycle dynamics.

#### *4.5. Linking Back to the Efficiency Wedges*

The business cycle analysis based on a [Barro and Grossman \(1971\)](#) framework crucially depends on data availability on both labor and goods market tightness gaps. As [figure 4](#) shows, both gaps can sufficiently be estimated by their steady-state deviations with a correlation for goods market tightness of 0.87. While there is data available on labor market tightness and it is otherwise also well proxied by real GDP (model:  $\text{corr}(x_N, \text{gdp}) = 0.77$ ,  $\text{corr}(x_{N,\text{gap}}, \text{gdp}) = 0.68$ ), the task for goods market tightness gap is harder. Its correlation with real GDP ( $\text{corr.} = -0.07$ ) and the output gap (0.22) are low. Otherwise, we would not need this additional framework. Natural candidates to measure goods market slack are TFP and capacity utilization. However, neither TFP ( $\text{corr.} = -0.27$ ), nor capacity utilization sufficiently ( $\text{corr.} = 0.15$ ) proxy it. This pattern highlights technology and supply-determined booms and busts which drive TFP and capacity utilization in the opposite direction to goods market tightness.

As [figure 4](#) shows, the efficiency wedge is a better proxy of the goods market tightness gap

**Figure 4:** Proxies for Market Tightness Gaps (U.S. Data)



*NOTE:* The figure shows scatter plots of proxies for the labor and goods market tightness gaps representing U.S. business cycles 1984q1 – 2024q4 through the lens of the preferred model. (a) shows the relationship between labor and goods market tightness deviations from steady-state (filled dots) and their gaps (hollow dots). (b) shows the relationship between goods market tightness gaps and capacity utilization gaps. Business cycle episodes are identified by color as given in the legend.

than standard slack measures, but its unconditional correlation remains low – 0.32 for the upper-bound definition and essentially zero for the lower-bound. Steady-state deviations of goods market tightness perform only slightly better, with correlations of 0.05 (lower-bound) and 0.40 (upper-bound). These patterns illustrate both the difficulty of proxying tightness gaps and the importance of properly accounting for goods mismatch shocks and their technology component in the efficiency wedge.

However, [figure 4](#) also reveals a strong linear relationship between the efficiency wedge and the goods market tightness gap within individual business cycle episodes. Once shifts in the natural efficiency rate (flexible price benchmark) are taken into account, the efficiency wedge becomes a good proxy. For example, over 1999q1–2024q4 the correlation of the upper-bound efficiency wedge with the tightness gap is 0.68, whereas the lower-bound measure yields only 0.11, again underscoring the relevance of including goods mismatch shocks when constructing the wedge. After adjusting for such shifts (analogous to the Beveridge curve, ([Diamond and Şahin, 2015](#))) the regime analysis aligns closely with movements in the efficiency wedge, which summarizes fluctuations in goods market coordination and efficiency. Shopping time offers a similarly informative proxy, correlating with the tightness gap at roughly 0.7 and supporting [Petrosky-Nadeau et al. \(2016\)](#).

#### 4.6. Variance Decomposition: The Determinants of the Efficiency Wedge

While the previous analysis identified business cycle regimes through the lens of excess demand and supply, it did not examine the underlying drivers or how they change when introducing goods market SaM. [Figure 5](#) addresses this by presenting the variance decomposition of real GDP, inflation, capacity utilization, TFP, and the efficiency wedge (upper bound) for both the benchmark and preferred models. The figure reports unconditional decompositions as well as conditional decompositions at forecast horizons of 1, 2, 5, 10, 40, and 100 quarters ahead.

*Real GDP.* The main business cycle drivers remain similar across the benchmark and preferred models: technology, investment, hours supply, and goods mismatch shocks dominate real GDP variation. Yet a modest shift occurs from labor and supply shocks toward demand and market-efficiency shocks<sup>45</sup> as coordination frictions make demand a productive input. At business cycle frequencies, demand shocks – especially investment – dominate; in the medium-run, goods mismatch gains importance, and in the long-run, production shocks prevail. Monetary policy plays a smaller cyclical role as interest rate changes have weaker effects on consumption growth through search price dynamics ([Gantert, 2025](#)), consistent with (21). Apart from quantitative differences in the unconditional decomposition, patterns are similar across models, and the shift in GDP variance highlights the role of coordination frictions.

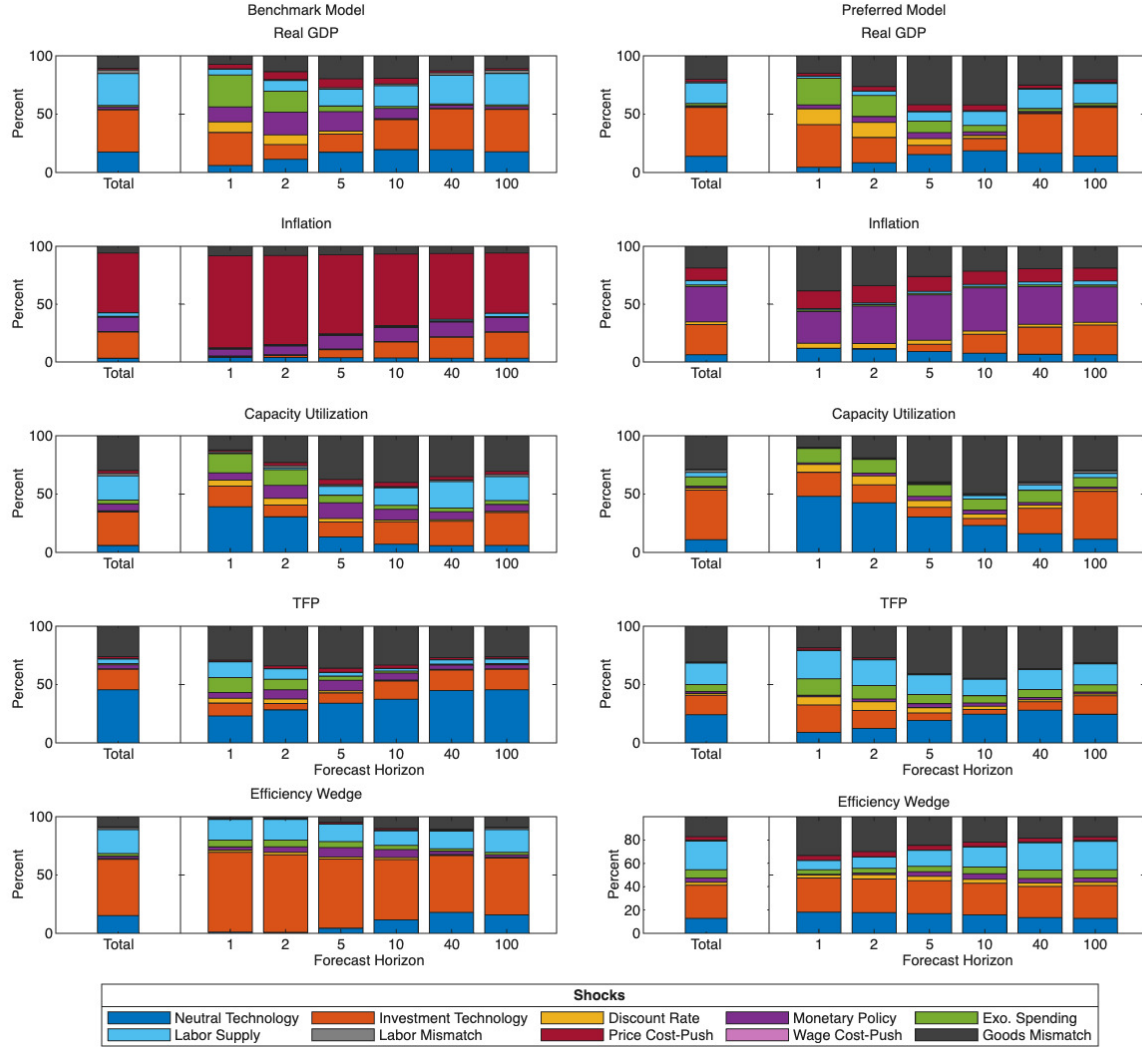
*Inflation.* Inflation is primarily driven by demand and price cost-push shocks in both models. In the benchmark model – consistent with [Smets and Wouters \(2007\)](#); [Justiniano et al. \(2010\)](#) – price cost-push shocks dominate, explaining over 80% of inflation at business cycle frequencies, while investment and monetary policy shocks account for up to one third of medium- and long-run variation. Introducing goods market SaM alters this pattern substantially: price cost-push shocks explain no more than 16% (and only 10% on average) of inflation, while

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<sup>45</sup>*Supply:* technology  $A_{H,t}$ , price cost-push  $\epsilon_t$ , goods mismatch  $\psi_{T,t}$ ; *Demand:* investment  $P_{I,t}$ , discount factor  $Z_t$ , spending  $G_t$ , monetary policy  $M_t$ ; *Labor:* hours supply  $\mu_{H,t}$ , wage cost-push  $\eta_t$ , labor mismatch:  $\psi_{N,t}$ .



**Figure 5:** Conditional Variance Decomposition (U.S. Data)



*NOTE:* The figure shows the unconditional and conditional variance decomposition of 1, 2, 5, 10, 40, and 100 quarters ahead for the benchmark and preferred models. The share of the variance of a variable explained by a certain shock is indicated by color and ordered from the bottom of the top of each bar following the legend.

investment, monetary policy, and goods mismatch shocks together drive more than half of the variation, particularly at business cycle frequencies.

*Capacity Utilization.* The three shocks directly affecting the resource constraint – technology, investment, and goods mismatch – account for most capacity utilization variation, as they exogenously shift available resources. In the benchmark model, hours supply shocks also

matter (up to 20%), since they alter hours per worker and labor effort not captured in long-run sustainable capacity but relevant for GDP. These effects partly offset each other: labor effort responds quickly, while hours per worker adjust slowly. Investment and other demand shocks raise utilization by boosting demand.

Introducing goods market SaM changes the composition: technology shocks gain short-run importance at business cycle frequencies, reflecting excess supply effects, while demand shocks play a larger role and hours supply shocks virtually disappear. This pattern highlights the model's time-allocation and coordination frictions – demand shocks increase search effort and thus utilization, whereas hours supply shocks trigger reallocation between work and search, neutralizing their aggregate impact. Consequently, capacity utilization becomes closely tied to time-allocation trade-offs central to the business cycle.

*TFP and the Efficiency Wedge.* Two shocks drive TFP exogenously – technology and goods mismatch – explaining most of its variation in both models, particularly in the long-run as utilization adjustments fade. The remaining TFP variation stems from the efficiency wedge, which operates mainly in the short-run. In the benchmark model, it is driven by investment shocks that expand capital under low utilization and by hours supply shocks shifting hours per worker into labor effort, while other demand shocks play a minor role. Introducing goods market SaM reduces the direct impact of technology shocks on TFP, as their propagation through the efficiency wedge offsets the exogenous effect. Overall, the efficiency wedge gains importance in the preferred model, amplifying coordination frictions through internal propagation rather than solely through exogenous components. A complementary perspective – TFP multipliers: TFP variation relative to GDP variation – is presented in [figure D.17](#).

Across both models, the determinants of the efficiency wedge align closely with those of real GDP. The endogenous price elasticity of demand renders large price cost-push shocks unnecessary, showing how goods market SaM better explains inflation episodes such as the post-COVID spike ([section 4.4](#)). Efficiency is shaped by time-allocation trade-offs and coordination frictions, examined further in the next section. The rising importance of hours supply shocks for TFP variation highlights how household time misallocation can depress

productivity, while the growing role of public spending shocks shows that shifting demand from frictional private to frictionless public markets<sup>46</sup> raises effective utilization. Overall, capacity utilization and goods market tightness reflect the interaction of demand and supply mediated by household time allocation, highlighting that goods market SaM shifts cyclical variation from exogenous supply shocks to endogenous coordination frictions.

## 5. Inspecting the Mechanism: Coordination Frictions over the Business Cycle

Adding goods market SaM improves the model’s fit decisively by endogenizing both the price elasticity of demand and capacity utilization. The estimated model reveals distinct coordination regimes in U.S. data. Periods of low goods and labor market tightness correspond to Keynesian unemployment, such as at the onset of the Great Recession, whereas periods of low labor tightness but high goods market tightness correspond to classical unemployment, as in its aftermath. This distinction helps explain the missing-deflation puzzle and shows that tight goods markets are necessary to generate inflation spikes, such as those observed after COVID. These regimes arise endogenously from the estimated SaM mechanism and the time-allocation trade-off between work and search effort. An efficiency wedge identified through capacity utilization data proxies goods market tightness and makes the framework applicable to real-world episodes.

The posterior variance decomposition shows that demand shocks dominate short-run movements in output and inflation, while price cost-push shocks lose relevance because the price elasticity becomes endogenous – adjusting with market tightness and search effort. These findings indicate that short-run productivity variation largely reflects coordination efficiency. To understand how these coordination regimes operate and why the data display such state dependence, we turn to dynamic simulations of the estimated model and trace how goods market SaM shapes impulse responses through its effects on price elasticity and capacity

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<sup>46</sup>This distinction follows by definition as public expenditure is directly pursued at the firm while private spending meets on goods markets. This is another way of saying that search costs for public spending are included in the price and thus counted as value added. This assumption does not imply that private markets are less efficient than public markets.

utilization. We first examine the propagation of demand and supply shocks, then show how goods market SaM alters the efficiency wedge transmission, illustrate how the model replicates key business-cycle episodes, and conclude with brief policy implications.

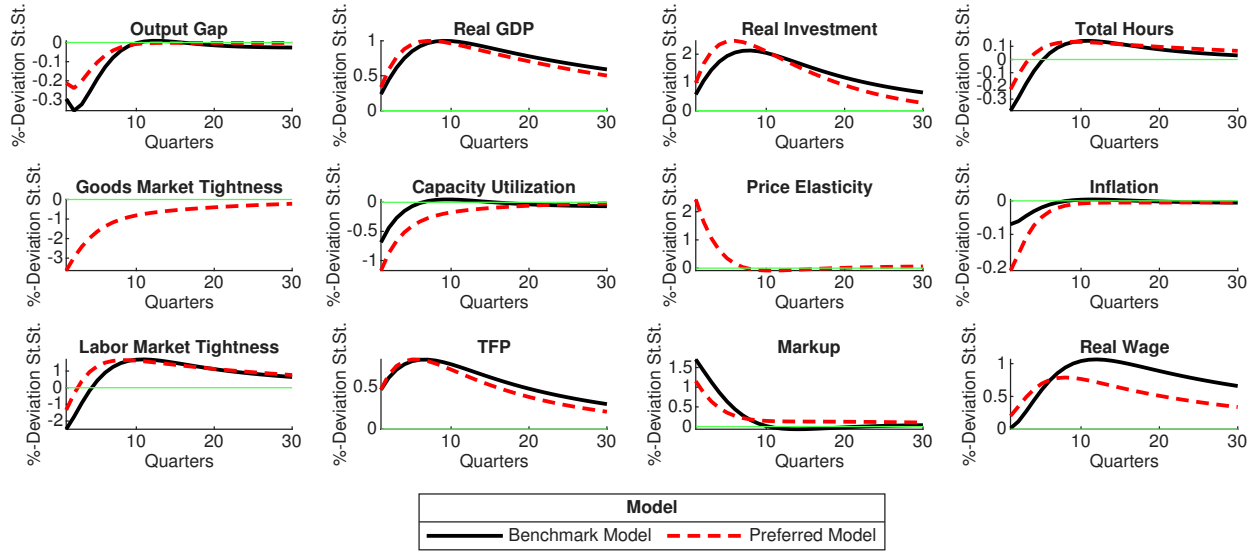
### *5.1. Propagation of Demand and Supply Shocks*

Goods market tightness permits both demand- and supply-determined equilibria and drives the two key goods market SaM channels identified in [section 2](#): endogenous price elasticity and productive search effort that determines capacity utilization. These channels influence firms’ price-setting through the household demand equation and affect marginal costs via utilization, as shown in [section 5.2](#). Building on [Gantert \(2025\)](#), we demonstrate how goods market SaM shapes model transmission and overall business cycle properties. IRFs are normalized across models by scaling with the absolute maximum deviation of real GDP in each model.

*Supply Shocks.* [Figure 6](#) shows the IRFs to an expansionary technology shock. The responses are qualitatively similar across models but differ in magnitude. In the benchmark model, real GDP and investment exhibit the usual hump-shaped increase, while total hours decline amid falling but sticky prices and low capacity utilization. Real wages and markups rise with the exogenous TFP improvement. The economy enters a negative output-gap state (a positive unemployment gap), and labor-market tightness tracks total hours—initially slack due to higher capacity but recovering as demand strengthens.

Introducing goods market SaM changes the IRFs quantitatively but not qualitatively. Higher technology expands available capacity exogenously, yet households must match it, generating excess supply as low goods-market tightness reduces utilization. Weak tightness lowers search prices, raises price elasticity, and compresses markups. Firms respond by cutting prices or expanding supply to further reduce search prices, both of which stimulate additional search effort. In equilibrium, firms mostly cut prices, since heightened elasticity makes demand highly responsive; they do so just enough to induce optimal search effort and balance markups with utilization. Total hours gradually rise, though real wages increase less because higher elasticity boosts labor supply, reducing wage and markup volatility in line with the data.

**Figure 6:** IRFs to an Expansionary Technology Shock

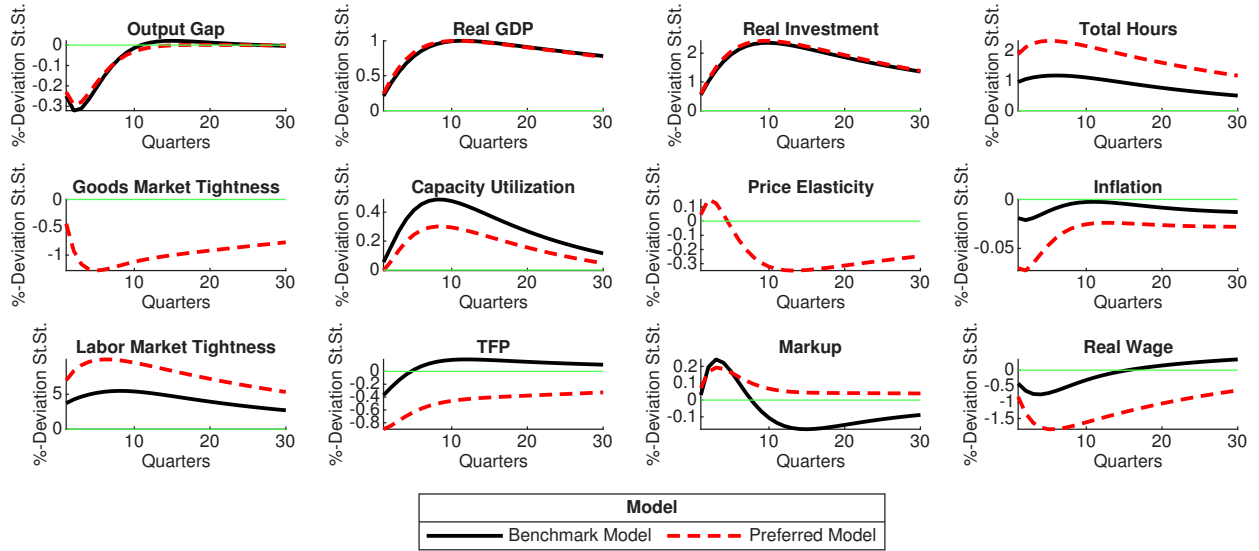


NOTE: The figure shows IRFs of different variables to different business cycle shocks for both the benchmark and preferred models. The deviations are measured in percentage deviations from the deterministic steady-state. IRFs are normalized across models by scaling with the absolute maximum deviation of real GDP in each model.

Output gap variation falls as utilization declines – even under flexible prices – reflecting the convexity of search prices. An expansionary goods mismatch shock generates nearly identical dynamics, except that utilization rises exogenously (figure E.20). Both technology and goods mismatch shocks therefore produce combinations of tight labor markets and slack goods markets, and vice versa, giving rise to Walrasian or classical-unemployment equilibria.

*Time-Allocation Shocks.* Figure 6 reports the IRFs to an expansionary hours supply shock. The responses are qualitatively similar across models but differ in magnitude. In the benchmark model, real GDP and investment rise in a hump-shaped pattern following the exogenous increase in hours per worker. Capacity utilization increases because higher hours raise output, though not long-run sustainable capacity, and input utilization rises with stronger factor demand. A higher hours supply elasticity lowers real wages, reduces inflation, and tightens labor markets. TFP initially falls as capital adjusts more slowly than labor while markups rise. The economy enters a negative output gap state due to sluggish price adjustment and a negative unemployment gap driven by wage rigidity.

**Figure 7: IRFs to an Expansionary Hours Supply Shock**

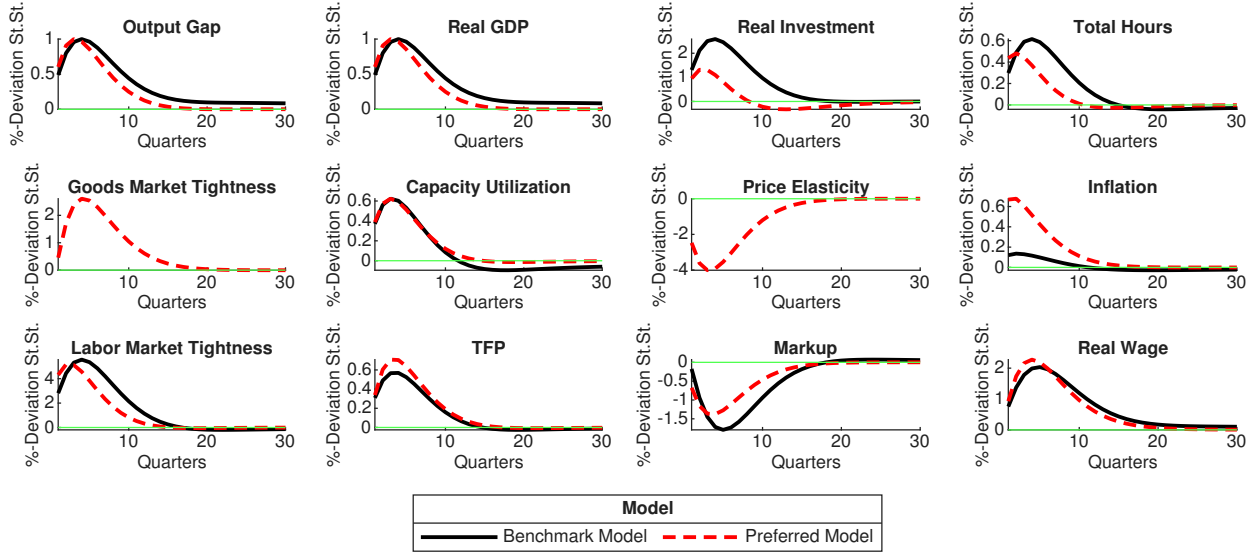


*NOTE: The figure shows IRFs of different variables to different business cycle shocks for both the benchmark and preferred models. The deviations are measured in percentage deviations from the deterministic steady-state. IRFs are normalized across models by scaling with the absolute maximum deviation of real GDP in each model.*

Introducing goods market SaM alters households' time-allocation trade-offs. An hours supply shock raises labor input, but the additional capacity must be matched, requiring more search effort. Firms react by cutting prices or expanding capacity (lowering search prices); both occur, though price cuts dominate, producing stronger disinflation and lower price elasticity. The reduced elasticity raises markups and depresses real wages relative to the benchmark. Total hours increase further due to the stronger hours supply response, generating a similar GDP rise but lower capacity utilization. As hours per worker adjust slowly, firms hire more workers, reflected in higher labor market tightness. Greater input use combined with weaker utilization makes the economy less efficient than in steady state. Hence, with time-allocation trade-offs, higher labor supply alone cannot raise output or productivity. The resulting negative output gap and goods market slack mirror the dynamics seen under labor mismatch, wage, and price cost-push shocks ([figure E.21](#), [figure E.22](#), [figure E.23](#)).

*Demand Shocks.* [Figure 8](#) reports the IRFs to an expansionary monetary policy shock. The responses are qualitatively similar across models but differ in magnitude. In the benchmark

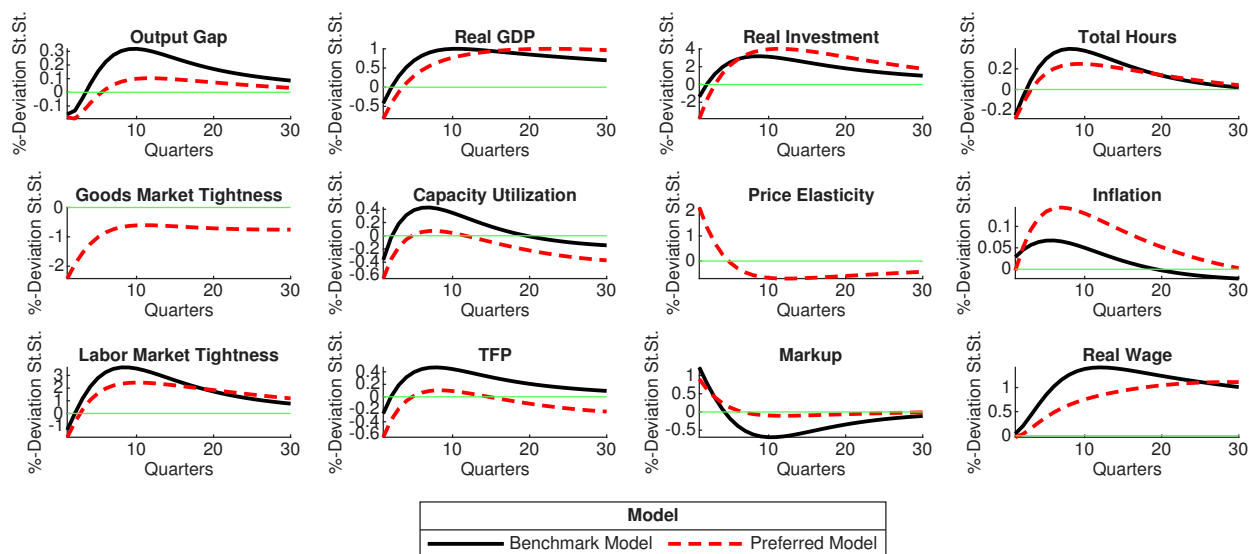
**Figure 8:** IRFs to an Expansionary Monetary Policy Shock across Models



*NOTE:* The figure shows IRFs of different variables to different business cycle shocks for both the benchmark and preferred models. The deviations are measured in percentage deviations from the deterministic steady-state. IRFs are normalized across models by scaling with the absolute maximum deviation of real GDP in each model.

model, a cut in the nominal interest rate raises aggregate demand as sticky prices slow adjustment. Real wages and search effort rise, markups fall, and input allocation and utilization increase. The economy displays a positive output gap, a negative unemployment gap (high labor-market tightness), and positive TFP deviations, while the underlying flexible-price economy remains unchanged – characteristic of a standard demand-driven expansion. With goods-market SaM, a rate cut raises demand, increasing search effort and capacity utilization, which boosts goods-market tightness and lowers price elasticity. Firms exploit the reduced elasticity to raise prices, so markups fall less than in the benchmark. Households shift time from work to search, as short-run demand is better met through higher utilization than through quasi-fixed inputs. Greater utilization makes the economy more efficient than in steady state. In a time-allocation framework, expansions therefore arise through utilization rather than input growth, while tighter goods and labor markets reduce price elasticity and dampen markup variation. Goods- and labor-market tightness rise jointly with output and employment, confirming that demand shocks propagate through the standard

**Figure 9: IRFs to an Expansionary Investment Shock across Models**



NOTE: The figure shows IRFs of different variables to different business cycle shocks for both the benchmark and preferred models. The deviations are measured in percentage deviations from the deterministic steady-state. IRFs are normalized across models by scaling with the absolute maximum deviation of real GDP in each model.

output–unemployment channel, with tightness offering a complementary measure of cyclical pressure. Exogenous spending (figure E.24) and discount-factor (figure E.25) shocks exhibit symmetric patterns.

Figure 9 shows the IRFs to an expansionary investment shock. In the benchmark model, the dynamics mirror those of monetary policy and other demand shocks: real GDP increases with greater input use, higher inflation and real wages, lower markups, and rising capacity utilization and TFP. Consistent with Justiniano et al. (2010); Smets and Wouters (2007), the investment shock is therefore typically classified as a demand shock. Business-cycle slack appears as a positive output gap and tight labor markets, as the demand component outweighs its supply effect.

Introducing goods market SaM yields a more nuanced business-cycle pattern in which goods markets remain slack even when the output gap is positive. Although real GDP, inputs, prices, and wages rise as in the benchmark, capacity utilization and TFP fall, displaying a hump-shaped negative response that reflects the interaction of short-run demand effects and



long-run supply expansion<sup>47</sup>. As capital accumulation increases available capacity, goods market tightness declines and stays persistently below steady state. Search prices fall initially – raising price elasticity – but remain low for an extended period due to strong output growth and the convexity of search prices. Households face higher total search costs as they must match more goods despite stable medium- to long-run tightness. The output gap stays positive but is smaller, even alongside slack goods markets, yielding a distinct view of the business cycle. Coordination frictions therefore show that investment shocks differ from pure demand shocks by embedding a technology-driven expansion component: even when output exceeds potential, matching additional consumption remains relatively easy. This makes investment shocks a key source of both prolonged booms, such as during the Great Moderation, and persistent slumps, as after the Great Recession. The [Barro and Grossman \(1971\)](#) regimes help identify the resulting goods market excess supply and motivate policy responses distinct from those of standard demand shocks.

Overall, goods market SaM amplifies business cycle dynamics through endogenous variation in price elasticity, with particularly strong effects on capacity utilization. This amplification stems from the costly yet productive household search effort required to match available capacity. Goods market tightness summarizes the state of this process, identifies the short side of the market, and places time-allocation trade-offs at the center of the analysis. However, it remains an imperfect proxy for the optimal tightness implied by the flexible price model ([section 4.5](#)). We therefore examine the dynamics of the efficiency wedge and its relation to the goods market tightness gap to assess when this proxy is informative and how it helps determine the economy’s goods market state.

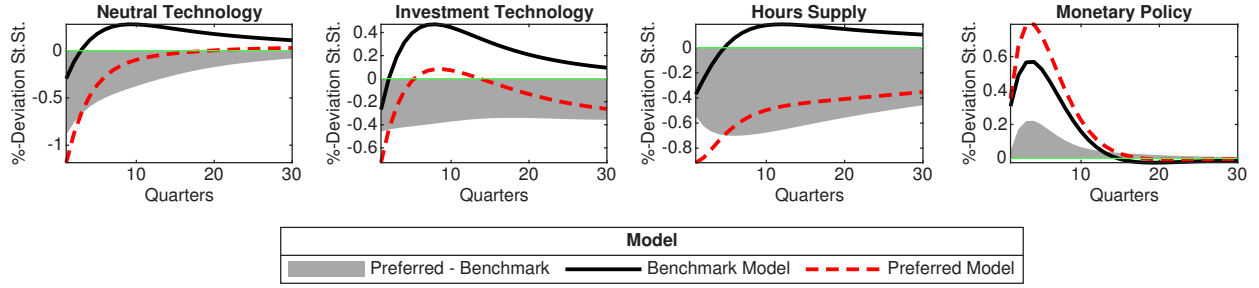
## 5.2. *The Efficiency Wedge and the [Barro and Grossman \(1971\)](#)-Regimes*

How large is the efficiency wedge between TFP and utilization-adjusted TFP for the different business cycle shocks and how does goods market SaM affect them? [Figure 10](#) shows the efficiency wedge dynamics for the benchmark and preferred models IRFs. We analyze in

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<sup>47</sup>Real GDP and inputs initially decline because investment adjustment costs delay capital accumulation and lower the valuation of current investment by construction.

**Figure 10:** The Cyclical Efficiency Wedges across Models

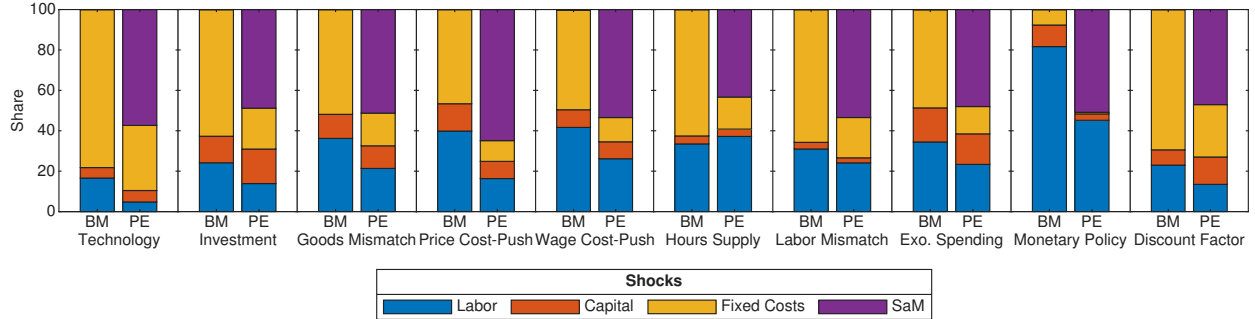


NOTE: The figure shows IRFs of the efficiency wedge to different business cycle shocks according to (35). The deviations are measured in percentage deviations from the deterministic steady-state. The different curves represent the benchmark (black curves) and preferred (red dashed curves) model.

particular the differences in IRFs between the two models as indicated by the gray areas. The fluctuations in the efficiency wedge of each model can be driven by the labor, capital, fixed costs, and goods market channel as shown in (35). The dynamic channel decomposition is shown in figure E.18 and an overview of the share of variation explanation of each model and channel is given in figure 11.

*Efficiency Wedge IRFs.* In the benchmark model, the efficiency wedge IRF to an expansionary technology shock shows a brief initial decline followed by a persistently positive deviation, driven mainly by fixed cost depression, with labor and capital utilization each explaining up to 20% of the variation. Introducing goods market SaM alters this pattern sharply: the efficiency wedge becomes persistently and substantially negative, as lower fixed costs reduce the depression channel and the additional capacity must first be matched, creating slack goods markets. This is reflected in goods market SaM accounting for nearly 60% of the variance share. As a result, short-run TFP responses in figure 6 are far smaller than implied by the exogenous shock and only converge to their underlying technology component after roughly 10 quarters. The model therefore underestimates the technology shock (figure E.19) due to *substantial excess supply*. Expansionary goods mismatch shocks and investment shocks exhibit the same mechanism. Although investment shocks are often classified as demand shocks, they generate substantial and persistent excess supply as the capital stock expands. Unlike technology shocks, hours supply shocks do not exogenously expand capacity; thus,

**Figure 11:** Decomposition of the Efficiency Wedge Fluctuations



*NOTE:* The efficiency wedge variance shares are shown for the benchmark (BM) and preferred (PE) models. They are calculated as the share of absolute fluctuations in labor, capital, goods market, and fixed cost efficiency wedge.

variation in the efficiency wedge mirrors the TFP dynamics shown in [figure 7](#). In the benchmark model, efficiency-wedge movements are modest, whereas in the preferred model efficiency falls markedly—by up to 0.7% for a peak 1% increase in real GDP. As [figure 11](#) indicates, the benchmark model’s variation is driven mainly by fixed costs, with labor effort explaining up to 35%. In the preferred model, the determinants shift sharply toward goods market SaM (about 50%), reducing the role of fixed costs while preserving a substantial contribution from labor effort. Hours supply shocks therefore generate expansions via input accumulation, producing lower efficiency through *substantial excess supply*. The same logic applies to labor mismatch and price- and wage–cost-push shocks, which display symmetric patterns.

Demand shocks (monetary policy, discount factor, and exogenous spending) generate expansions through lower markups, input expansion, and sticky prices. Because these shocks are short-run, firms rely on utilization rather than quasi-fixed inputs, raising the efficiency wedge in the benchmark model. Introducing goods market SaM preserves this pattern but amplifies it, as additional demand is met through extra search effort and the matching of otherwise idle capacity. In the benchmark model, the efficiency wedge for demand shocks is driven mainly by fixed costs and, in the case of monetary policy, labor effort. In the preferred model, these determinants shift toward a more uniform distribution, with roughly 50% explained by goods market SaM. All three demand shocks exogenously increase goods market tightness,

producing a more procyclical efficiency wedge response due to *substantial excess demand*. *Excess demand and supply states* systematically amplify the efficiency wedge responses. Technology shocks show muted TFP gains due to a negative efficiency wedge; demand shocks are amplified through productive search; and time-allocation shocks generate expansions through excess supply rather than high utilization. In the benchmark model, the wedge is driven mainly by production fixed costs (up to 80%), with labor effort also important and capital utilization largely irrelevant. In the preferred model, goods market SaM explains over 50% of the wedge for most shocks, accompanied by a sharp decline in the role of fixed costs – consistent with the lower steady-state markup. In line with the log data density results in [section 4](#), goods market SaM becomes the dominant driver of the efficiency wedge across shocks. Allowing for supply-determined equilibria in a NK-DSGE model therefore fundamentally reshapes efficiency-wedge transmission.

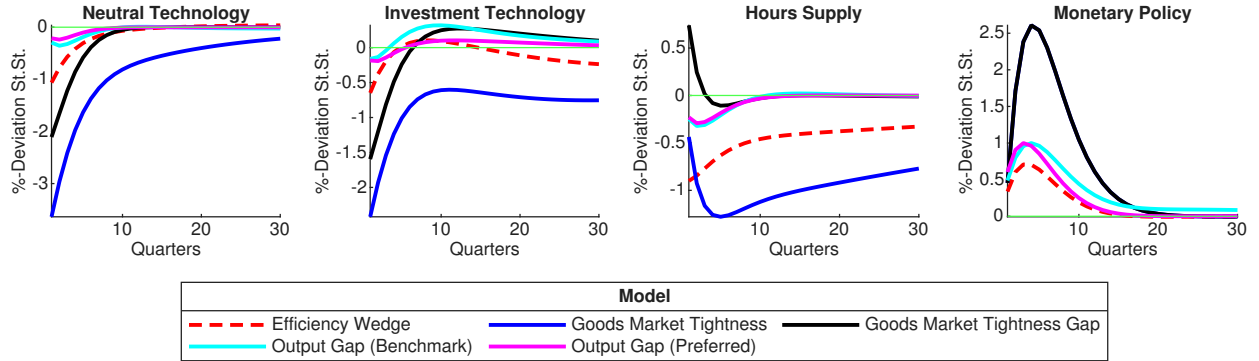
*Connecting Shocks to Regimes and Policy Implications.* We have shown that the efficiency wedge is a good proxy for the goods market tightness gap post 1999q1. This conditionality and the potential shift of the "natural" efficiency wedge depend on the type of shock underlying the business cycle fluctuations. In order to make this framework applicable and its results useful for policy, we must understand when the proxies for the [Barro and Grossman \(1971\)](#)-regimes work and when not.

[Figure 12](#) reports the impulse responses of the goods market tightness gap and its proxies – goods market tightness, the output gap from the benchmark and preferred models, and the efficiency wedge. We structure the analysis around the four main shocks.

For an expansionary technology shock, the negative efficiency wedge closely proxies the goods market tightness gap, exhibiting similar persistence and variation. Goods market tightness matches the gap in the very short run but becomes too persistent, as flexible price tightness falls steadily with higher technology. The output gaps of both models generally align but display little variation, making them vulnerable to measurement error in practical applications.

For an expansionary demand shock (monetary policy shock), the goods market tightness

**Figure 12:** Cyclical Goods Market Tightness Gaps



NOTE: The figure shows IRFs of the efficiency wedge to different business cycle shocks according to (35). The deviations are measured in percentage deviations from the deterministic steady-state. The different curves represent the benchmark (black curves) and preferred (red dashed curves) model.

gap displays a hump-shaped and persistent positive deviation. Because this is a nominal shock that leaves the flexible price economy unchanged, all four measures closely track the state of the goods market, with high correlation and similar though modest variation. Thus, for standard supply and demand shocks, the framework offers no direct identification advantage beyond providing proxies with greater variation and therefore less susceptibility to measurement error.

This changes for the investment shock, which – as in Justiniano et al. (2010) – is the main driver of business cycle variation. The initial goods market tightness (gap) is strongly negative, indicating *excess supply*, whereas the output gap does not capture this<sup>48</sup>. The efficiency wedge, by contrast, shows a clear initial negative deviation and closely proxies the goods market tightness gap. In the medium to long run, however, the efficiency wedge falls below steady state because capital accumulation increases productive capacity. Since this occurs in the flexible price economy as well, it signals a *positive* goods-market tightness gap. In this region, the output gap from either model aligns better with the true tightness gap than the efficiency wedge or goods market tightness.

For an expansionary hours supply shock, the picture is considerably more complex. A

<sup>48</sup>The small initial negative output gap deviation is a calibration artifact that disappears under lower investment adjustment costs, while the negative goods-market tightness gap persists.

reduction in the disutility of labor lowers goods market tightness but raises its gap in the short-run. Households supply additional hours and accept a lower real wage, yet they do so even more in the flexible price economy, where prices and wages adjust freely. Goods markets therefore become slack, but could be even slacker – capturing the essence of the time-allocation trade-off discussed in [figure 7](#). The tightness gap is short-lived, with a small negative dip before returning to steady state. For business cycle analysis, however, the early quarters are most relevant, and in this region all proxies fail to identify the state of the goods market. Doing so would require knowledge of the natural goods market tightness, which is determined by household preferences. Overall, the goods market tightness gap is a valuable benchmark for identifying the state of goods markets, but it is difficult to proxy. For demand shocks, it delivers the same conclusions as the textbook output gap framework. For time-allocation shocks, it signals shifts in optimal time use that our proxies fail to capture. It is more informative for technology shocks, where the proxies exhibit greater variation, and especially for investment shocks, where it correctly identifies slack goods markets while the output gap instead signals production above long-run capacity.

## 6. Concluding Remarks

This paper reinterprets short-run TFP fluctuations through the lens of goods market search-and-matching. Building on [Barro \(2025\)](#) critique of frictionless product markets, the model shows that measured productivity depends not only on technology and input utilization but also on the efficiency with which buyers and sellers match. When households devote less time to shopping or firms hold idle capacity, matching efficiency falls and measured TFP declines even if the production technology is unchanged. Embedding this mechanism into a New-Keynesian DSGE framework generates an endogenous coordination margin that reshapes the propagation of shocks.

Bayesian estimation on U.S. and Euro Area data provides strong empirical support for this view. Goods market frictions substantially improve model fit – especially for capacity utilization and inflation – and sharply reduce the role of cost-push shocks. The estimation reveals systematic asymmetries in productivity dynamics: excess demand raises TFP by

increasing search effort and matching rates, while excess supply depresses it by leaving capacity idle. These coordination forces help explain the missing-deflation episode after 2008 and the amplification of inflation in the post-COVID period.

The broader implication is that goods market coordination introduces meaningful state dependence into both real and nominal dynamics. By shaping the price elasticity of demand and the utilization of productive capacity, matching efficiency weakens the standard link between inflation and the output gap and alters the transmission of monetary policy. Understanding business cycles therefore requires understanding how effectively markets match buyers and sellers. Future work could explore heterogeneity, inventories, or optimal policy in environments where coordination failures interact with nominal rigidities.

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## Appendix A. Model Setup and Derivations

### Appendix A.1. Household Optimization Problem

The household maximizes its utility by choosing  $C_{S,t}$ ,  $C_t$ ,  $D_t(i)$ ,  $X_t$ ,  $B_t$ ,  $T_t(i)$ ,  $e_{K,t}$ ,  $K_t$ ,  $I_{A,t}$ ,  $I_{K,t}$ , and  $N_t(i)$ . Its constrained utility maximization problem is given by

$$\begin{aligned} \mathcal{L} = \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t Z_t & \left\{ \frac{\left[ \mathbb{U}_C(C_{S,t}; C_{S,t-1}; D_t(i); D_{t-1}(i)) - \mathbb{U}_N(X_t; N_t(i); H_t(i); e_{H,t}(i)) \right]^{1-\sigma} - 1}{1-\sigma} \right. \\ & - \lambda_{1,t} \left[ B_t - (1 + r_{B,t-1}) B_{t-1} - \int_0^1 W_t(i) e_{H,t}(i) H_t(i) N_t(i) di - P_t ub \left( 1 - \int_0^1 N_t(i) di \right) \right. \\ & \quad \left. + \int_0^1 P_t(i) T_t(i) di - P_t r_{K,t} e_{K,t} K_{t-1} + Tax_t - \Pi_t \right] \\ & - \lambda_{2,t} \left[ X_t - \left[ \mathbb{U}_C(C_{S,t}; C_{S,t-1}; D_t(i); D_{t-1}(i)) \right]^\omega X_{t-1}^{1-\omega} \right] \\ & - \lambda_{3,t} \left[ C_t + P_{I,t} I_{K,t} (1 + c_I(I_{A,t}; I_{A,t-1})) - \left( \int_0^1 T_t(i)^{\frac{\epsilon_t-1}{\epsilon_t}} di \right)^{\frac{\epsilon_t}{\epsilon_t-1}} \right] \\ & - \int_0^1 \lambda_{4,t}(i) \left[ T_t(i) - (1 - \delta_T) T_{t-1}(i) - f_{T,t}(i) D_t(i) \right] di \\ & - \lambda_{5,t} \left[ \int_0^1 N_t(i) di - (1 - \delta_N) \int_0^1 N_{t-1}(i) di - f_{N,t} \left( 1 - (1 - \delta_N) \int_0^1 N_{t-1}(i) di \right) \right] \\ & - \lambda_{6,t} [K_t - (1 - \delta_{K,1} - \delta_K(e_{K,t})) K_{t-1} - I_{K,t}] \\ & - \lambda_{7,t} [C_{S,t} - (1 - \delta_S) C_{S,t-1} - C_t] \\ & \left. - \lambda_{8,t} [I_{A,t} - I_{K,t} + \delta_K(e_{K,t}) K_{t-1}] \right\}, \end{aligned}$$

where the no-Ponzi scheme condition  $\lim_{T \rightarrow \infty} B_T \geq 0$  holds.

First-order conditions.

$$\begin{aligned} \mathcal{L}_{C_{S,t}} : \lambda_{3,t} = & \left( \frac{1}{(\mathbb{U}_{C,t} - \mathbb{U}_{N,t})^\sigma} + \frac{\omega X_t \lambda_{2,t}}{\mathbb{U}_{C,t}} \right) \frac{\partial \mathbb{U}_{C,t}}{\partial C_{S,t}} + \beta (1 - \delta_S) \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \lambda_{3,t+1} \\ & + \beta \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \left( \frac{1}{(\mathbb{U}_{C,t+1} - \mathbb{U}_{N,t+1})^\sigma} + \frac{\omega X_{t+1} \lambda_{2,t+1}}{\mathbb{U}_{C,t+1}} \right) \frac{\partial \mathbb{U}_{C,t+1}}{\partial C_{S,t}} \end{aligned} \quad (\text{A.1})$$

$$\begin{aligned} \mathcal{L}_{D_t(i)} : \lambda_{4,t} = & (-1) \left[ \frac{1}{(\mathbb{U}_{C,t} - \mathbb{U}_{N,t})^\sigma} + \frac{\omega X_t \lambda_{2,t}}{\mathbb{U}_{C,t}} \right] \frac{\frac{\partial \mathbb{U}_{C,t}}{\partial D_t(i)}}{f_{T,t}(i)} \\ & - \beta \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \left[ \frac{1}{(\mathbb{U}_{C,t+1} - \mathbb{U}_{N,t+1})^\sigma} + \frac{\omega X_{t+1} \lambda_{2,t+1}}{\mathbb{U}_{C,t+1}} \right] \frac{\frac{\partial \mathbb{U}_{C,t+1}}{\partial D_t(i)}}{f_{T,t}(i)} \end{aligned} \quad (\text{A.2})$$

$$\mathcal{L}_{X_t} : \lambda_{2,t} X_t = \frac{(-1) \mathbb{U}_{N,t}}{(\mathbb{U}_{C,t} - \mathbb{U}_{N,t})^\sigma} + \beta (1 - \omega) \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \lambda_{2,t+1} X_{t+1} \quad (\text{A.3})$$

$$\mathcal{L}_{B_t} : \lambda_{1,t} = \beta (1 + r_{B,t}) \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \lambda_{1,t+1} \quad (\text{A.4})$$

$$\mathcal{L}_{T_t(i)} : \lambda_{1,t} P_t(i) = \lambda_{3,t} \left( \frac{T_t}{T_t(i)} \right)^{\frac{1}{\epsilon_t}} - \lambda_{4,t} + \beta (1 - \delta_T) \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \lambda_{4,t+1} \quad (\text{A.5})$$

$$\begin{aligned} \mathcal{L}_{N_t(i)} : \lambda_{5,t} = & \lambda_{1,t} (W_t(i) e_{H,t}(i) H_t(i) - P_t u b) - \frac{\frac{\partial \mathbb{U}_{N,t}(i)}{\partial N_t(i)}}{(\mathbb{U}_{C,t} - \mathbb{U}_{N,t})^\sigma}, \\ & + \beta (1 - \delta_N) \mathbb{E}_t \frac{Z_{t+1}}{Z_t} (1 - f_{N,t+1}) \lambda_{5,t+1} \end{aligned} \quad (\text{A.6})$$

$$\begin{aligned} \mathcal{L}_{e_{K,t}} : \lambda_{6,t} \frac{\partial \delta_K(e_{K,t})}{\partial e_{K,t}} K_{t-1} = & \lambda_{1,t} P_t r_{K,t} - \lambda_{3,t} P_{I,t} I_{K,t} \frac{\partial c_{I,t}}{\partial e_{K,t}} \\ & - \beta \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \lambda_{3,t+1} P_{I,t+1} I_{K,t+1} \frac{\partial c_{I,t+1}}{\partial e_{K,t}} \end{aligned} \quad (\text{A.7})$$

$$\begin{aligned} \mathcal{L}_{K_t} : \lambda_{6,t} = & \beta \mathbb{E}_t \frac{Z_{t+1}}{Z_t} (\lambda_{1,t+1} P_{t+1} e_{K,t+1} r_{K,t+1} + (1 - \delta_K(e_{K,t})) \lambda_{6,t+1}) \\ & - \beta \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \left[ P_{I,t+1} I_{K,t+1} \frac{\partial c_{I,t+1}}{\partial K_t} \lambda_{3,t+1} + \beta \frac{Z_{t+2}}{Z_{t+1}} P_{I,t+2} I_{K,t+2} \frac{\partial c_{I,t+2}}{\partial K_t} \lambda_{3,t+2} \right] \end{aligned} \quad (\text{A.8})$$

$$\mathcal{L}_{I_{K,t}} : \lambda_{6,t} = \lambda_{3,t} P_{I,t} \left( 1 + c_{I,t} + \frac{\partial c_{I,t}}{\partial I_{K,t}} \right) + \beta \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \lambda_{3,t+1} P_{I,t+1} I_{K,t+1} \frac{\partial c_{I,t+1}}{\partial I_{K,t}} \quad (\text{A.9})$$

*Applying functional forms.* We use the following functional forms for the utility function, investment adjustment costs, and capital utilization costs given by

$$\begin{aligned}
\mathbb{U}_{C,t} &= C_{S,t} - \theta_C C_{S,t-1} - \frac{\mu_{D,t}}{1 + \nu_D} \left( \left( \int_0^1 D_t(i) di \right)^{1+\nu_D} - \theta_D \left( \int_0^1 D_{t-1}(i) di \right)^{1+\nu_D} \right), \\
\mathbb{U}_{N,t} &= X_t \int_0^1 N_t(i) \left( \frac{\mu_{H,t}}{1 + \nu_H} H_t(i)^{1+\nu_H} + H_t(i) \frac{\mu_e}{1 + \nu_e} e_{H,t}(i)^{1+\nu_e} \right) di, \\
I_{A,t} &= I_{K,t} - \delta_K (e_{K,t}) K_{t-1}, \\
c_{I,t} &= \frac{\kappa_I}{2} \left( \frac{I_{A,t}}{I_{A,t-1}} - 1 \right)^2, \\
\delta_K (e_{K,t}) &= \frac{\phi_{K,1} \phi_{K,2}}{2} (e_{K,t} - 1)^2 + \phi_{K,1} (e_{K,t} - 1).
\end{aligned}$$

Further, we define  $muc_t = \lambda_{1,t} P_t$ ,  $\mathbb{W}_{C,t} = \lambda_{3,t}$ ,  $\mathbb{W}_{D,t} = \lambda_{4,t}$ ,  $\mathbb{U}_{\chi,t} = \frac{1}{(\mathbb{U}_{C,t} - \mathbb{U}_{N,t})^\sigma} + \frac{\omega X_t \lambda_{2,t}}{\mathbb{U}_{C,t}}$ , and  $\chi_t = \lambda_{2,t} X_t$  to rewrite (A.1), (A.2), (A.3), and (A.4) as follows

$$\mathbb{W}_{C,t} = \mathbb{U}_{\chi,t} - \beta \theta_C \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \mathbb{U}_{\chi,t+1} + \beta (1 - \delta_S) \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \mathbb{W}_{C,t+1}, \quad (\text{A.10})$$

$$\mathbb{W}_{D,t} = \mathbb{U}_{\chi,t} - \beta \theta_D \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \mathbb{U}_{\chi,t+1}, \quad (\text{A.11})$$

$$\chi_t = \beta (1 - \omega) \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \chi_{t+1} - \frac{\mathbb{U}_{N,t}}{(\mathbb{U}_{C,t} - \mathbb{U}_{N,t})^\sigma}, \quad (\text{A.12})$$

$$muc_t = \beta \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \frac{1 + r_{B,t}}{1 + \pi_{t+1}} muc_{t+1}, \quad (\text{A.13})$$

where  $(1 + \pi_{t+1}) = \frac{P_{t+1}}{P_t}$  and  $\beta \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \frac{muc_{t+1}}{muc_t} = \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}}$  follows from the Euler equation (A.13).

Marginal consumption utility is derived from (A.5) and given by

$$\begin{aligned}
muc_t &= \frac{P_t}{P_t(i)} \left[ \mathbb{W}_{C,t} \left( \frac{T_t}{T_t(i)} \right)^{\frac{1}{\epsilon_t}} - \mathbb{W}_{D,t} c'_{D,t}(i) + \beta (1 - \delta_T) \mathbb{E}_t \frac{Z_{t+1}}{Z_t} \mathbb{W}_{D,t+1} c'_{D,t+1}(i) \right], \\
\Leftrightarrow \frac{P_t(i)}{P_t} &= P_{T,t} \left( \frac{T_t}{T_t(i)} \right)^{\frac{1}{\epsilon_t}} - P_{D,t}(i) + (1 - \delta_T) \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} P_{D,t+1}(i)
\end{aligned} \quad (\text{A.14})$$

where  $P_{T,t} = \frac{\mathbb{W}_{C,t}}{muc_t}$ ,  $P_{D,t}(i) = \frac{c'_{D,t}(i) \mathbb{W}_{D,t}}{muc_t}$ , and  $c'_{D,t}(i) = \mu_{D,t} \frac{D_t(i)^{\nu_D}}{f_{T,t}(i)}$ . Define  $Q_{H,t} = \frac{\lambda_{5,t}}{muc_t}$  and plug it into (A.6) to derive the value function of marginal employment of the household denominated in the numéraire good

$$\begin{aligned}
Q_{H,t}(i) &= \left( \frac{W_t(i)}{P_t} e_{H,t}(i) H_t(i) - ub \right) - \frac{\frac{\partial \mathbb{U}_{N,t}(i)}{\partial N_t(i)}}{muc_t (\mathbb{U}_{C,t} - \mathbb{U}_{N,t})^\sigma} \\
&\quad + \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} (1 - \delta_N) (1 - f_{N,t+1}) Q_{H,t+1}(i),
\end{aligned} \quad (\text{A.15})$$

where  $\frac{\partial \mathbb{U}_{N,t}(i)}{\partial N_t(i)} = X_t \left( \frac{\mu_{H,t}}{1+\nu_H} H_t(i)^{1+\nu_H} + H_t(i) \frac{\mu_e}{1+\nu_e} e_{H,t}(i)^{1+\nu_e} \right)$  is the marginal disutility of working for one specific firm  $i$ . Define  $Q_{K,t} = \frac{\lambda_{6,t}}{muc_t}$  and rewrite the capital market equations (A.7)-(A.9) denominated in the numéraire good

$$r_{K,t} = (1 + c_{I,t}) P_{T,t} P_{I,t} (\phi_{K,1} \phi_{K,2} (e_{K,t} - 1) + \phi_{K,1}), \quad (\text{A.16})$$

$$Q_{K,t} = P_{T,t} P_{I,t} \left[ (1 + c_{I,t}) + \frac{I_{K,t} \left\{ c'_{I,t} - \mathbb{E}_t \frac{1+\pi_{t+1}}{1+r_{B,t}} \frac{P_{T,t+1} P_{I,t+1}}{P_{T,t} P_{I,t}} \frac{I_{K,t+1}}{I_{K,t}} c'_{I,t+1} \right\}}{I_{K,t} - \delta_K (e_{K,t}) K_{t-1}} \right], \quad (\text{A.17})$$

$$Q_{K,t} = \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} \left[ r_{K,t+1} e_{K,t+1} + (1 - \delta_{K,1}) Q_{K,t+1} - (1 + c_{I,t+1}) P_{T,t+1} P_{I,t+1} \delta_K (e_{K,t+1}) \right], \quad (\text{A.18})$$

where  $c'_{I,t} = \kappa_I \left( \frac{I_{A,t}}{I_{A,t-1}} - 1 \right) \frac{I_{A,t}}{I_{A,t-1}}$ . If we instead assume  $I_{A,t} = I_{K,t}$ , which implies that capital utilization costs affect investment adjustment costs through their impact on capital investments, the household capital FOCs are given by

$$Q_{K,t} = \frac{r_{K,t}}{\phi_{K,1} \phi_{K,2} (e_{K,t} - 1) + \phi_{K,1}}, \quad (\text{A.19})$$

$$Q_{K,t} = P_{T,t} P_{I,t} (1 + c_{I,t} + c'_{I,t}) - \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} P_{T,t+1} P_{I,t+1} \frac{I_{K,t+1}}{I_{K,t}} c'_{I,t+1}, \quad (\text{A.20})$$

$$Q_{K,t} = \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_t} \left[ e_{K,t+1} r_{K,t+1} + (1 - \delta_{K,1} - \delta_K (e_{K,t})) Q_{K,t+1} \right]. \quad (\text{A.21})$$

*Price Elasticity of Demand.* For any two varieties  $(i, j)$  of the differentiated consumption good, we can use (A.14) to derive the household consumption demand equation by

$$\begin{aligned} \frac{P_t(i)}{P_t(j)} &= \frac{\left( \frac{T_t}{T_t(i)} \right)^{\frac{1}{\epsilon_t}} \mathbb{W}_{C,t} - c'_{D,t}(i) \mathbb{W}_{D,t} + \beta (1 - \delta_T) \mathbb{E}_t \frac{Z_{t+1}}{Z_t} c'_{D,t+1}(i) \mathbb{W}_{D,t+1}}{\left( \frac{T_t}{T_t(j)} \right)^{\frac{1}{\epsilon_t}} \mathbb{W}_{C,t} - c'_{D,t}(j) \mathbb{W}_{D,t} + \beta (1 - \delta_T) \mathbb{E}_t \frac{Z_{t+1}}{Z_t} c'_{D,t+1}(j) \mathbb{W}_{D,t+1}}, \\ &= \frac{\left( \frac{T_t}{T_t(i)} \right)^{\frac{1}{\epsilon_t}} P_{T,t} - P_{D,t}(i) + \mathbb{E}_t \frac{1+\pi_{t+1}}{1+r_{B,t}} P_{D,t+1}(i)}{\left( \frac{T_t}{T_t(j)} \right)^{\frac{1}{\epsilon_t}} P_{T,t} - P_{D,t}(j) + \mathbb{E}_t \frac{1+\pi_{t+1}}{1+r_{B,t}} P_{D,t+1}(j)}, \end{aligned}$$

where we use the definitions for search prices,  $P_{D,t}(i) = \frac{c'_{D,t}(i) \mathbb{W}_{D,t}}{muc_t}$ , and overall prices,  $P_{T,t} = \frac{\mathbb{W}_{C,t}}{muc_t}$ .

The price elasticity of demand is defined by

$$\Xi_t(i) = \frac{\partial T_t(i)}{\partial P_t(i)} \frac{P_t(i)}{T_t(i)},$$



where we use (A.14) to derive the first-order condition. This results in

$$\begin{aligned}\Xi_t(i) &= (-\epsilon_t) \frac{muc_t}{\mathbb{W}_{C,t}} \left( \frac{T_t(i)}{T_t} \right)^{\frac{1}{\epsilon_t}} \frac{P_t(i)}{P_t} = (-\epsilon_t) P_{T,t}^{-1} \left( \frac{T_t(i)}{T_t} \right)^{\frac{1}{\epsilon_t}} \frac{P_t(i)}{P_t}, \\ &= \frac{(-\epsilon_t) \frac{P_t(i)}{P_t}}{\frac{P_t(i)}{P_t} + P_{D,t}(i) - \mathbb{E}_t \frac{1+\pi_{t+1}}{1+r_{B,t}} P_{D,t+1}(i)}\end{aligned}$$

which decreases in  $P_{T,t}$  and thus in  $P_{D,t}(i)$ .

## Appendix A.2. Firm Optimization Problem

The firm profit maximization (MAX:  $T_t(i)$ ,  $S_t(i)$ ,  $x_{T,t}(i)$ ,  $P_t(i)$ ,  $N_t(i)$ ,  $v_t(i)$ ,  $K_{e,t}(i)$ ) given the necessary constraints is given by

$$\begin{aligned}\mathcal{L} &= \mathbb{E}_0 \sum_{t=0}^{\infty} \beta_{0,t} \left\{ \left[ P_t(i) [T_t(i) + G_t(i)] - W_t(i) e_{H,t}(i) H_t(i) N_t(i) - P_t(i) r_{K,t} K_{e,t}(i) \right] \right. \\ &\quad - \phi_{1,t} \left[ S_t(i) - [1 - c_{N,t}(i) - c_{P,t}(i) - c_{W,t}(i) - c_{H,t}(i)] A_{H,t} F_t(i) + \vartheta \right. \\ &\quad \quad \left. + G_t(i) + (1 - \delta_T) T_{t-1}(i) - (1 - \delta_I) (1 - q_{T,t-1}(i)) S_{t-1}(i) \right] \\ &\quad - \phi_{2,t} \left[ T_t(i) - (1 - \delta_T) T_{t-1}(i) - q_{T,t}(i) S_t(i) \right] \\ &\quad - \phi_{3,t} \left[ N_t(i) - (1 - \delta_N) N_{t-1}(i) - q_{N,t} v_t(i) \right] \\ &\quad \left. - \phi_{4,t} \left[ \frac{P_t(i)}{P_t} - P_{T,t} \left( \frac{T_t}{T_t(i)} \right)^{\frac{1}{\epsilon_t}} + P_{D,t}(i) - \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} P_{D,t+1}(i) \right] \right\}\end{aligned}$$

where

$$\begin{aligned}F_t(i) &= A_{H,t} [e_{H,t}(i) H_t(i) N_t(i)]^{1-\alpha} K_{e,t}(i)^\alpha, \\ K_{e,t}(i) &= e_{K,t} K_{t-1}(i), \\ c_{P,t}(i) &= \frac{\kappa_P}{2} \left( \frac{P_t(i)}{P_{t-1}(i)} (1 + \pi)^{\iota_P - 1} (1 + \pi_{t-1})^{-\iota_P} - 1 \right)^2, \\ c_{W,t}(i) &= \frac{\kappa_W}{2} \left( \frac{W_t(i)}{W_{t-1}(i)} (1 + \pi)^{\iota_W - 1} (1 + \pi_{t-1})^{-\iota_W} - 1 \right)^2, \\ c_{N,t}(i) &= \frac{\kappa_N}{2} \left( \frac{v_t(i)}{e_{H,t}(i) H_t(i) N_t(i)} \right)^2, \\ c_{H,t}(i) &= \frac{\kappa_H}{2} \left( \frac{H_t(i) - \bar{H}(i)}{\bar{H}(i)} \right)^2.\end{aligned}$$

First-order conditions.

$$\mathcal{L}_{T_t(i)} : \phi_{2,t} = P_t(i) - \phi_{4,t} \frac{1}{\epsilon_t} \left( \frac{T_t}{T_t(i)} \right)^{\frac{1}{\epsilon_t}} \frac{P_{T,t}}{T_t(i)} + \mathbb{E}_t \beta_{t,t+1} (1 - \delta_T) (\phi_{2,t+1} - \phi_{1,t+1}) \quad (\text{A.22})$$

$$\begin{aligned} \mathcal{L}_{S_t(i)} : \phi_{1,t} = \phi_{2,t} \frac{\partial m_{T,t}(i)}{\partial S_t(i)} - \phi_{4,t} \frac{\partial P_{D,t}(i)}{\partial S_t(i)} \\ + \mathbb{E}_t \beta_{t,t+1} (1 - \delta_I) \phi_{1,t+1} \left( 1 - q_{T,t}(i) - S_t(i) \frac{\partial q_{T,t}(i)}{\partial S_t(i)} \right) \end{aligned} \quad (\text{A.23})$$

$$\mathcal{L}_{x_{T,t}(i)} : \phi_{4,t} \frac{\partial P_{D,t}(i)}{\partial x_{T,t}(i)} = \phi_{2,t} \frac{\partial m_{T,t}(i)}{\partial x_{T,t}(i)} - \mathbb{E}_t \beta_{t,t+1} (1 - \delta_I) S_t(i) \frac{\partial q_{T,t}(i)}{\partial x_{T,t}(i)} \phi_{1,t+1} \quad (\text{A.24})$$

$$\begin{aligned} \mathcal{L}_{P_t(i)} : \frac{\partial c_{P,t}(i)}{\partial P_t(i)} A_{H,t} F_t(i) \phi_{1,t} = T_t(i) + G_t(i) - \phi_{4,t} \frac{1}{P_t} \\ - \mathbb{E}_t \beta_{t,t+1} \phi_{1,t+1} A_{H,t+1} F_{t+1}(i) \frac{\partial c_{P,t+1}(i)}{\partial P_t(i)} \end{aligned} \quad (\text{A.25})$$

$$\begin{aligned} \mathcal{L}_{N_t(i)} : \phi_{3,t} = \phi_{1,t} \frac{A_{H,t} F_t(i)}{N_t(i)} \left[ (1 - \alpha) (1 - \mathcal{C}_t(i)) - \frac{\partial c_{N,t}(i)}{\partial N_t(i)} N_t(i) \right] \\ - W_t(i) e_{H,t}(i) H_t(i) + \mathbb{E}_t \beta_{t,t+1} (1 - \delta_N) \phi_{3,t+1} \end{aligned} \quad (\text{A.26})$$

$$\mathcal{L}_{v_t(i)} : \phi_{3,t} = \phi_{1,t} \frac{A_{H,t} F_t(i)}{q_{N,t}} \frac{\partial c_{N,t}(i)}{\partial v_t(i)} \quad (\text{A.27})$$

$$\mathcal{L}_{K_{e,t}(i)} : P_t(i) r_{K,t} = \phi_{1,t} (1 - \mathcal{C}_t(i)) \alpha \frac{A_{H,t} F_t(i)}{K_{e,t}(i)} \quad (\text{A.28})$$

Define the asset value of production capacity as  $Q_{Y,t}(i) = \frac{\phi_{1,t}}{P_t(i)}$ , and the asset value of matched goods as  $Q_{T,t}(i) = \frac{\phi_{2,t}}{P_t(i)}$ . Marginal costs are given by  $mc_t(i) = \frac{Q_{Y,t}(i)}{e_{M,t}(i)}$  where  $e_{M,t}(i) = \frac{Y_t(i)}{\mathcal{Y}_t(i)}$  is short-run capacity utilization. Substitute (A.24) in (A.22), and (A.23) for the marginal costs equations

$$\begin{aligned} Q_{T,t}(i) = \frac{\frac{P_t(i)}{P_t} + \mathbb{E}_t \frac{1+\pi_{t+1}}{1+r_{B,t}} (1 - \delta_T) (Q_{T,t+1}(i) - Q_{Y,t+1}(i))}{1 + \frac{1}{\epsilon_t} \varphi_{\mathbb{W},t}(i) \varphi_{\Gamma,t}(i)} \\ + \frac{\mathbb{E}_t \frac{1+\pi_{t+1}}{1+r_{B,t}} (1 - \delta_I) \frac{1}{\epsilon_t} \varphi_{\mathbb{W},t}(i) \varphi_{\Gamma,t}(i) Q_{Y,t+1}(i)}{1 + \frac{1}{\epsilon_t} \varphi_{\mathbb{W},t}(i) \varphi_{\Gamma,t}(i)}, \end{aligned} \quad (\text{A.29})$$

$$\begin{aligned} Q_{Y,t}(i) = q_{T,t}(i) Q_{T,t}(i) \frac{1 + \varphi_{\Gamma,t}(i)}{1 + \frac{\gamma_T x_{T,t}(i)^\Gamma}{1 - \gamma_T}} \\ + \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} (1 - \delta_I) \left( 1 - q_{T,t}(i) \frac{1 + \varphi_{\Gamma,t}(i)}{1 + \frac{\gamma_T x_{T,t}(i)^\Gamma}{1 - \gamma_T}} \right) Q_{Y,t+1}(i), \end{aligned} \quad (\text{A.30})$$

where

$$\begin{aligned} \varphi_{\mathbb{W},t}(i) &= \frac{P_{T,t}}{P_{D,t}(i)} \left( \frac{T_t}{T_t(i)} \right)^{\frac{1}{\epsilon_t}} \frac{q_{T,t}(i) S_t(i)}{T_t(i)}, \\ \varphi_{\Gamma,t}(i) &= \frac{\gamma_T x_{T,t}(i)^\Gamma}{(1 - \gamma_T)}. \end{aligned}$$

Substitute (A.24) in (A.25) for the New-Keynesian Phillips Curve

$$c'_{P,t}(i) = \frac{T_t(i)}{A_{H,t}F_t(i)Q_{Y,t}(i)} \left[ \left( 1 + \frac{G_t(i)}{T_t(i)} \right) - \frac{q_{T,t}(i)S_t(i)}{T_t(i)P_{D,t}(i)} \varphi_{\Gamma,t}(i) \left( Q_{T,t}(i) - \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} (1 - \delta_I) Q_{Y,t+1}(i) \right) \right] + \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} \frac{Q_{Y,t+1}(i)A_{H,t+1}F_{t+1}(i)}{Q_{Y,t}(i)A_{H,t}F_t(i)} c'_{P,t+1}(i). \quad (\text{A.31})$$

Define the value of marginal employment for the firm as  $Q_{F,t}(i) = \frac{\phi_{3,t}}{P_t(i)}$  and rewrite the input factor demand equations (A.26)-(A.28) by

$$Q_{F,t}(i) = [(1 - \alpha)(1 - \mathcal{C}_t(i)) + 2c_{N,t}(i)] \frac{A_{H,t}F_t(i)}{N_t(i)} Q_{Y,t}(i) - w_t(i)e_{H,t}(i)H_t(i) + \mathbb{E}_t \frac{1 + \pi_{t+1}(i)}{1 + r_{B,t}} (1 - \delta_N) Q_{F,t+1}(i), \quad (\text{A.32})$$

$$Q_{F,t}(i) = 2c_{N,t}(i) \frac{A_{H,t}F_t(i)}{q_{N,t}v_t(i)} Q_{Y,t}(i), \quad (\text{A.33})$$

$$r_{K,t} = (1 - \mathcal{C}_t(i)) \alpha \frac{A_{H,t}F_t(i)}{K_{e,t}(i)} Q_{Y,t}(i). \quad (\text{A.34})$$

### Appendix A.3. Nash Bargaining: Real Wages, Hours per Worker, and Labor Effort

Each worker-firm match maximizes its joint surplus by solving a Nash bargaining problem

$$\max_{W_t(i); H_t(i); e_{H,t}(i)} (Q_{H,t}(i))^{\eta_t} (Q_{F,t}(i))^{1-\eta_t},$$

where  $0 \leq \eta_t \leq 1$ .

The first-order conditions for the real wage, hours per worker, and labor effort are given by

$$\frac{\eta_t}{1 - \eta_t} \frac{Q_{F,t}(i)}{Q_{H,t}(i)} = (-1) \frac{\frac{\partial Q_{F,t}(i)}{\partial W_t(i)}}{\frac{\partial Q_{H,t}(i)}{\partial W_t(i)}} \quad (\text{A.35})$$

$$\frac{\eta_t}{1 - \eta_t} \frac{Q_{F,t}(i)}{Q_{H,t}(i)} = (-1) \frac{\frac{\partial Q_{F,t}(i)}{\partial H_t(i)}}{\frac{\partial Q_{H,t}(i)}{\partial H_t(i)}} \quad (\text{A.36})$$

$$\frac{\eta_t}{1 - \eta_t} \frac{Q_{F,t}(i)}{Q_{H,t}(i)} = (-1) \frac{\frac{\partial Q_{F,t}(i)}{\partial e_{H,t}(i)}}{\frac{\partial Q_{H,t}(i)}{\partial e_{H,t}(i)}} \quad (\text{A.37})$$

Deriving the first-order conditions of (A.15) and (A.32) with respect to  $W_t(i)$  and plugging them into (A.35) gives the sticky wage horizon equation that determines the impact of sticky wages on

the wage setting process

$$\tau_{W,t}(i) = \frac{\eta_t}{1 - \eta_t} \frac{Q_{F,t}(i)}{Q_{H,t}(i)} = (-1) \frac{\frac{\partial Q_{F,t}(i)}{\partial W_t(i)}}{\frac{\partial Q_{H,t}(i)}{\partial W_t(i)}} \quad (\text{A.38})$$

$$\begin{aligned} &= 1 + (1 - \alpha) \frac{A_{H,t} F_t(i)}{e_{H,t}(i) H_t(i) N_t(i)} Q_{Y,t}(i) P_t \frac{\partial c_{W,t}(i)}{\partial W_t(i)} \\ &\quad + \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_{B,t}} (1 - \delta_N) (1 - \alpha) \frac{A_{H,t+1} F_{t+1}(i)}{N_{t+1}(i)} \frac{Q_{Y,t+1}(i)}{e_{H,t}(i) H_t(i)} P_t \frac{\partial c_{W,t+1}(i)}{\partial W_t(i)}. \end{aligned} \quad (\text{A.39})$$

where  $\frac{\partial c_{W,t}(i)}{\partial W_t(i)} = c'_{W,t}(i) \frac{1}{W_t(i)}$  and  $\frac{\partial c_{W,t+1}(i)}{\partial W_t(i)} = (-1) c'_{W,t+1}(i) \frac{1}{W_t(i)}$  with

$$c'_{W,t}(i) = \kappa_W \left[ \frac{W_t(i)}{W_{t-1}(i)} (1 + \pi)^{\iota_W - 1} (1 + \pi_{t-1})^{\iota_W} - 1 \right] \frac{W_t(i)}{W_{t-1}(i)} (1 + \pi)^{\iota_W - 1} (1 + \pi_{t-1})^{\iota_W}.$$

Plugging (A.35) into (A.15) gives the real wage bargaining equation from the point of view of the household for each match

$$\begin{aligned} &w_t(i) e_{H,t}(i) H_t(i) - ub - \frac{1}{muc_t} \frac{\frac{\partial \mathbb{U}_{N,t}(i)}{\partial N_t(i)}}{(\mathbb{U}_{C,t} - \mathbb{U}_{N,t})^\sigma} \\ &= \frac{\eta_t}{1 - \eta_t} \frac{Q_{F,t}(i)}{\tau_{W,t}(i)} - \mathbb{E}_t \frac{1 + \pi_{t+1}}{1 + r_t} (1 - \delta_N) (1 - f_{N,t+1}) \frac{\eta_{t+1}}{1 - \eta_{t+1}} \frac{Q_{F,t+1}(i)}{\tau_{W,t+1}(i)}. \end{aligned} \quad (\text{A.40})$$

Deriving the first-order conditions of (A.15) and (A.32) with respect to  $H_t(i)$  and plugging them into (A.36) gives the optimality condition of hours per worker for each match

$$\begin{aligned} &w_t(i) e_{H,t}(i) \Gamma_{W,t}(i) \\ &= \frac{\tau_{W,t}(i)}{muc_t} \frac{\frac{\partial^2 \mathbb{U}_{N,t}(i)}{\partial N_t(i) \partial H_t(i)}}{(\mathbb{U}_{C,t} - \mathbb{U}_{N,t})^\sigma} \\ &\quad - \left[ (1 - \alpha)^2 (1 - \mathcal{C}_t(i)) - 4\alpha c_{N,t}(i) - (1 - \alpha) c'_{H,t}(i) \right] \frac{A_{H,t} F_t(i)}{H_t(i) N_t(i)} Q_{Y,t}(i), \end{aligned} \quad (\text{A.41})$$

where  $\Gamma_{W,t}(i) = \tau_{W,t}(i) - 1$  and  $c'_{H,t}(i) = \kappa_H \left( \frac{H_t(i) - \bar{H}(i)}{\bar{H}(i)} \right) \frac{1}{\bar{H}(i)}$ . Deriving the first-order conditions of (A.15) and (A.32) with respect to  $e_{H,t}(i)$  and plugging them into (A.37) gives the optimality condition of labor effort for each match

$$\begin{aligned} &w_t(i) H_t(i) \Gamma_{W,t}(i) \\ &= \frac{\tau_{W,t}(i)}{muc_t} \frac{\frac{\partial^2 \mathbb{U}_{N,t}(i)}{\partial N_t(i) \partial e_{H,t}(i)}}{(\mathbb{U}_{C,t} - \mathbb{U}_{N,t})^\sigma} - \left[ (1 - \alpha)^2 (1 - \mathcal{C}_t(i)) - 4\alpha c_{N,t}(i) \right] \frac{A_{H,t} F_t(i)}{e_{H,t}(i) N_t(i)} Q_{Y,t}(i). \end{aligned} \quad (\text{A.42})$$

## Appendix B. Utilization-adjusted TFP and TFP wedge

*Calculating the utilization-adjusted TFP.* Total factor productivity is defined as real GDP divided by the input factors in an appropriate production function (Solow, 1957). It is given by

$$TFP_t = \frac{GDP_t}{(N_t H_t)^{1-\alpha} (K_{t-1})^\alpha} = \frac{T_t + I_{S,t} - I_{S,t-1} + G_t - \delta_K (e_{K,t}) K_{t-1}}{(N_t H_t)^{1-\alpha} (K_{t-1})^\alpha}. \quad (\text{B.1})$$

Next, using  $T_t = (1 - \delta_T) T_{t-1} + q_{T,t} S_t$  to substitute for  $T_t$ , we get

$$TFP_t = \frac{(1 - \delta_T) T_{t-1} + q_{T,t} S_t + I_{S,t} - I_{S,t-1} + G_t - \delta_K (e_{K,t}) K_{t-1}}{(N_t H_t)^{1-\alpha} (K_{t-1})^\alpha},$$

and substitute for  $S_t$  with the firm resource constraint (9), we get

$$\begin{aligned} TFP_t = & \frac{q_{T,t} \{ (1 - C_t) A_{H,t} F_t - \vartheta - G_t - (1 - \delta_T) T_{t-1} + I_{S,t} \}}{(N_t H_t)^{1-\alpha} (K_{t-1})^\alpha}, \\ & + \frac{(1 - \delta_T) T_{t-1} + I_{S,t} - I_{S,t-1} + G_t - \delta_K (e_{K,t}) K_{t-1}}{(N_t H_t)^{1-\alpha} (K_{t-1})^\alpha}. \end{aligned}$$

Substituting for  $F_t$  with the production function and expanding the right side with  $\frac{GDP_t}{GDP_t}$  we get

$$\begin{aligned} & q_{T,t} (1 - C_t) \frac{A_{H,t}}{TFP_t} e_{H,t}^{1-\alpha} e_{K,t}^\alpha \\ = & 1 - (1 - q_{T,t}) (g_{S,t} + i_{S,t}) + i_{S,t-1} + q_{T,t} \vartheta_{GDP,t} \\ & + \delta_K (e_{K,t}) k_{t-1} - (1 - q_{T,t}) (1 - \delta_T) t_{t-1} \end{aligned} \quad (\text{B.2})$$

where  $g_{S,t} = \frac{G_t}{GDP_t}$ ,  $i_{S,t} = \frac{I_{S,t}}{GDP_t}$ ,  $i_{S,t-1} = \frac{I_{S,t-1}}{GDP_t}$ ,  $\vartheta_{GDP,t} = \frac{\vartheta}{GDP_t}$ ,  $k_{t-1} = \frac{K_{t-1}}{GDP_t}$ , and  $t_{t-1} = \frac{T_{t-1}}{GDP_t}$ . Note,  $q_{T,t} = \psi_{T,t} \left[ \gamma_T x_{T,t}^\Gamma + (1 - \gamma_T) \right]^{\frac{1}{\Gamma}}$  contains endogenous reactions to goods market tightness and to goods mismatch shocks.

*Linearization.* We linearize (B.2) around its deterministic steady-state and group all variables to their respective channel. However, there is an ambiguity in the goods mismatch shock,  $\psi_{T,t}$ , as it can be both a market technology shock or a composition and dispersion shock. We therefore derive a lower and upper bound of the TFP decomposition. Linearizing (B.2) leads to

$$T\hat{F}P_t = \hat{A}_t + \hat{u}_t^K + \hat{u}_t^L + \hat{u}_t^\vartheta + \hat{u}_t^{GM}, \quad (\text{B.3})$$

where  $\hat{u}_t^K$  summarizes the capital market impact on TFP,  $\hat{u}_t^L$  summarizes the labor market impact on TFP,  $\hat{u}_t^\vartheta$  summarizes the impact of production fixed costs on creating short-run increasing returns-to-scale,  $\hat{u}_t^{GM}$  summarizes the goods market search-and-matching impact on TFP, and  $\hat{A}_t$

summarizes technology shocks. The channels unaffected by the definition of goods market mismatch shocks and technology are given by

$$\hat{u}_t^K = \left[ \alpha - \frac{1 - cu(1 - (1 - g_S)\delta_T\delta_I)}{(1 + \vartheta_{GDPCu})(1 - g_S)\delta_T\delta_I} k\phi_{K,1} \right] \hat{e}_{K,t}, \quad (B.4)$$

$$\hat{u}_t^L = (1 - \alpha) \hat{e}_{H,t} - \frac{c_N}{1 - c_N} \hat{e}_{N,t}, \quad (B.5)$$

$$\hat{u}_t^\vartheta = \frac{\vartheta_{GDPCu}}{1 + \vartheta_{GDPCu}} \hat{g} \hat{d} p_t. \quad (B.6)$$

The lower bound for  $\hat{u}_t^{GM}$  and  $\hat{A}_t$  is identified by no technology component for the goods mismatch shock and given by

$$\begin{aligned} \hat{u}_t^{GM,Low} &= \frac{(1 - cu)g_S}{(1 + \vartheta_{GDPCu})(1 - g_S)\delta_T\delta_I} \hat{g}_{S,t} - \frac{1 - cu(1 - (1 - g_S)\delta_T\delta_I)}{(1 + \vartheta_{GDPCu})(1 - g_S)\delta_T\delta_I} i_S \hat{i}_{S,t-1} \\ &\quad + \left( \frac{cu}{1 + \vartheta_{GDPCu}} + \frac{1 - cu(1 - (1 - g_S)\delta_T\delta_I)}{(1 + \vartheta_{GDPCu})(1 - cu)\delta_T\delta_I} \right) i_S \hat{i}_{S,t} \\ &\quad + \frac{(1 - cu)(1 - \delta_T)}{(1 + \vartheta_{GDPCu})\delta_T\delta_I} \hat{t}_{t-1} + \frac{1 - cu(1 - (1 - g_S)\delta_T\delta_I)}{(1 + \vartheta_{GDPCu})\delta_I} \hat{q}_t, \end{aligned} \quad (B.7)$$

$$\hat{A}_t^{Low} = \hat{A}_{H,t}. \quad (B.8)$$

The upper bound for  $\hat{u}_t^{GM}$  and  $\hat{A}_t$  is identified by all technology component for the goods mismatch shock and given by

$$\begin{aligned} \hat{u}_t^{GM,Up} &= \frac{(1 - cu)g_S}{(1 + \vartheta_{GDPCu})(1 - g_S)\delta_T\delta_I} \hat{g}_{S,t} - \frac{1 - cu(1 - (1 - g_S)\delta_T\delta_I)}{(1 + \vartheta_{GDPCu})(1 - g_S)\delta_T\delta_I} i_S \hat{i}_{S,t-1} \\ &\quad + \left( \frac{cu}{1 + \vartheta_{GDPCu}} + \frac{1 - cu(1 - (1 - g_S)\delta_T\delta_I)}{(1 + \vartheta_{GDPCu})(1 - cu)\delta_T\delta_I} \right) i_S \hat{i}_{S,t} \\ &\quad + \frac{(1 - cu)(1 - \delta_T)}{(1 + \vartheta_{GDPCu})\delta_T\delta_I} \hat{t}_{t-1} + \frac{1 - cu(1 - (1 - g_S)\delta_T\delta_I)}{(1 + \vartheta_{GDPCu})\delta_I} \gamma_S \hat{x}_{T,t}, \end{aligned} \quad (B.9)$$

$$\hat{A}_t^{Up} = \hat{A}_{H,t} + \frac{1 - cu(1 - (1 - g_S)\delta_T\delta_I)}{(1 + cu\vartheta_{GDPCu})\delta_I} \hat{\psi}_{T,t}. \quad (B.10)$$

*TFP and Capacity Utilization.* Instead of solving for the private goods market and its determinants, we can use the definition of capacity utilization

$$cu_t = \frac{GDP_t}{(1 - \bar{c}) A_{H,t} (\bar{e}_H \bar{H} N_t)^{1-\alpha} (\bar{e}_K K_{t-1})^\alpha - \vartheta}. \quad (B.11)$$

Substituting (B.11) in (B.1) and linearizing around its deterministic steady-state results in

$$T\hat{F}P_t = \hat{A}_{H,t} + \frac{[\hat{c}u_t - \vartheta_{GDPCu}\hat{\vartheta}_{GDP,t}]}{1 + \vartheta_{GDPCu}} - (1 - \alpha) \hat{H}_t. \quad (B.12)$$

We use (B.3) and (B.11) to substitute for  $(T\hat{F}P_t - \hat{A}_{H,t})$  and solve for the efficiency wedge

$$\hat{\Phi}_t^{Low} = \frac{[\hat{c}\hat{u}_t - \vartheta_{GDPcu}\hat{\vartheta}_{GDP,t}]}{1 + \vartheta_{GDPcu}} - (1 - \alpha)\hat{H}_t, \quad (\text{B.13})$$

$$\hat{\Phi}_t^{Up} = \Phi_{SaM,t}^{Low} - \frac{1 - cu(1 - (1 - g_S)\delta_T\delta_I)}{(1 + \vartheta_{GDPcu})\delta_I}\hat{\psi}_{T,t}, \quad (\text{B.14})$$

where the efficiency wedge is determined by observables – capacity utilization, production fixed costs (proxied by real GDP), and hours per worker – and a latent goods mismatch shock.

## Appendix C. Connecting the Model with the Data

### Appendix C.1. Calibration of the Model Parameters

Table C.4 gives an overview of all calibrated parameters in the model. Those parameters are either not well identified by the data and a good micro estimate exists or they can be determined by a clear steady-state relationship of an endogenous variable. There are some steady-state targets worth discussing as their derivation might not be straight forward. First, the vacancy posting costs as a share of GDP is commonly set to 1% in the literature. As vacancy posting costs are a share of production capacity, we have to derive the relation to realized GDP. It follows that

$$\begin{aligned} c_{N,GDP} &= \frac{c_N AF}{GDP} \\ \Leftrightarrow cuY &= \frac{c_N AF}{c_{N,GDP}} \\ \Leftrightarrow c_N &= c_{N,GDPcu} \left[ (1 - c_N) - \frac{\vartheta}{AF} \right] \\ \Leftrightarrow c_N &= \frac{c_{N,GDPcu} \left[ 1 - \frac{\vartheta}{AF} \right]}{1 + c_{N,GDPcu}}, \end{aligned}$$

where the vacancy posting costs share of production capacity can be derived from the vacancy posting costs share of GDP by correcting for capacity utilization and production fixed costs.

Next, we set the capital elasticity with respect to production capacity,  $\alpha$ , by matching the labor share of income in the data to prevent any bias in input factors in the estimation of TFP and technology. If  $\alpha$  is set incorrectly, it biases the impact of labor and capital have on production and TFP. Comin et al. (2025) show that neglecting e.g. markups in U.S. data can lead to a biased  $\alpha$ , where the impact of capital on production and TFP is overestimated. We follow the approach of

**Table C.4:** Calibrated Parameters of the Model

Parameter	Value	Description	Reference
$ub$	$\bar{N}_{Data}$	Unemployment benefits	Data
$\mu_H$	$(H = 1)$	Hours supply disutility	Normalization
$\mu_e$	$(e_H = 1)$	Labor effort supply disutility	Normalization
$\psi_N$	$(q_N = 0.7)$	Labor matching efficiency	Blanchard and Gali (2010)
$\gamma_N$	0.6	Labor matching elasticity	Petrongolo and Pissarides (2001)
$\delta_N$	0.12	Employment separation rate	Blanchard and Gali (2010)
$\kappa_N$	$(\frac{c_N Y}{GDP} = 0.01)$	Vacancy posting cost	Blanchard and Gali (2010)
$\eta$	0.5	Wage bargaining weight	Blanchard and Gali (2010)
$\psi_T$	$\bar{c}u_{Data}$	Goods matching efficiency	Data
$\Omega$	$\bar{C}_{I,Data}$	Industry share of GDP	Data
$\mu_D$	$(x_T = 1)$	Search effort disutility	Normalization
$\vartheta$	$(\Pi = 0)$	Production fixed costs	Christiano et al. (2010)
$G$	$\bar{g}_{S,Data}$	Government spending share of GDP	Data
$\beta$	0.99	Discount factor	Christiano et al. (2010)
$\alpha$	$\bar{l}s_{Data}$	Capital elasticity of production	Data
$\sigma$	1.5	Elasticity of intertemporal substitution	Smets and Wouters (2007)
$\delta_{K,1}$	0.025	Capital depreciation rate	Christiano et al. (2010)
$\phi_{K,1}$	$(e_K = 1)$	Capital utilization cost exponent	Normalization

NOTE: The economy-wide capacity utilization is calculated by industry capacity utilization and estimated service capacity utilization weighted by their consumption shares.

Solow (1957); Fernald (2014); Comin et al. (2025) and solve for the steady-state of the employment demand equation<sup>49</sup> and its free-entry condition to retrieve a steady-state equation for  $\alpha$  as follows

$$\begin{aligned}
ls &= \frac{we_H HN}{GDP} \\
\Leftrightarrow \quad ls \frac{GDP}{AF} \frac{1}{Q_Y} &= (1 - c_N) - \alpha(1 - c_N) + 2c_N - 2\frac{c_N}{\delta_N}(1 - \beta(1 - \delta_N)) \\
\Leftrightarrow \quad ls \cdot \frac{cu}{Q_Y} \left[ (1 - c_N) - \frac{\vartheta}{AF} \right] &= (1 - c_N) - \alpha(1 - c_N) + 2c_N - 2\frac{c_N}{\delta_N}(1 - \beta(1 - \delta_N)) \\
\Leftrightarrow \quad \alpha &= 1 - \frac{2c_N}{1 - c_N} \frac{(1 - \beta)(1 - \delta_N)}{\delta_N} - ls \frac{cu}{Q_Y} \left( 1 - \frac{\frac{\vartheta}{AF}}{1 - c_N} \right),
\end{aligned}$$

<sup>49</sup>In contrast to the literature,  $\alpha$  represents the elasticity of the production capacity function, not the production function. But production is always a share of production capacity. Hence, there is a linear relationship between production and production capacity, independent of capital and labor shares. It follows, that the production capacity elasticities are applicable to the production elasticities.



where the labor demand FOCs determines real wages and thus in turn the labor share. The output elasticity  $\alpha$  depends on vacancy posting costs, the employment separation rate, and the targeted labor share corrected for capacity utilization and production fixed costs. If we set production fixed costs such that firm profits are zero in steady-state,  $1 - \alpha$  is equal to the labor share.

Next, we set the elasticity of substitution of differentiated goods,  $\epsilon$ , such that the markup target is matched. The target condition is

$$\bar{\mu} = \frac{e_M}{Q_Y} = \frac{1}{mc},$$

where the gross markup is the inverse of the marginal costs,  $mc$ , or asset value of production capacity,  $Q_Y$ , corrected for short-run capacity utilization,  $e_M = \frac{T+G}{Y} = cu$ , which is equal to long-run capacity utilization in steady-state. We use the firm FOCs to substitute for  $Q_Y$  and the goods market matching conditions to substitute for  $cu$ . It follows

$$\begin{aligned} & \frac{\gamma_T}{1 - \gamma_T} \frac{1 + P_D (1 - \beta (1 - \delta_T))}{\epsilon P_D} + (1 - \beta (1 - \delta_T)) \\ &= \frac{\delta_T \delta_I (1 - g_S) cu}{1 - cu [g_S + (1 - g_S) (1 - \delta_T \delta_I)]} \left[ \frac{\frac{\bar{\mu}}{cu}}{1 - \beta (1 - \delta_I)} - \beta (1 - \delta_T) - \frac{\beta (1 - \delta_I)}{1 - \beta (1 - \delta_I)} \right], \end{aligned}$$

which does not have a closed-form solution in  $\epsilon$  as  $P_D$  depends inversely and non-linear on  $\epsilon$ . Hence, we solve for  $\epsilon$  numerically targeting  $\bar{\mu}$  while simultaneously solving for the goods market block. To get some intuition how  $\epsilon$  depends on goods market frictions and the markup target, we derive a simplified version setting  $\delta_T = \delta_I = 1$  which offers a closed-form solution. It is given by

$$\epsilon = \frac{1}{1 - g_S} \left[ 1 + \frac{(1 - g_S cu) \left( 1 + (1 - g_S) \frac{\gamma_T}{1 - \gamma_T} \right)}{(\bar{\mu} - 1) - g_S (\bar{\mu} - cu)} \right] \stackrel{g_S=0}{=} \frac{\bar{\mu} + \frac{\gamma_T}{1 - \gamma_T}}{\bar{\mu} - 1},$$

which shows that  $\epsilon$  is increasing in  $\gamma_T$  and  $g_S$  while keeping  $\bar{\mu}$  fixed. Hence, markups increase in goods market frictions and the government spending share. When targeting the steady-state markup, goods markets become more competitive in goods market frictions and the government spending share.

Lastly, we derive the steady-state relationship for production fixed costs from the firm profit

condition given by

$$\begin{aligned}
\Pi &= GDP - w e_H H N - r_K e_K K \\
\Leftrightarrow \quad \frac{\Pi}{GDP} &= 1 - \left[ (1 - \alpha)(1 - c_N) + 2c_N - 2\frac{c_N}{\delta_N}(1 - \beta(1 - \delta_N)) \right] \frac{AF}{GDP} Q_Y \\
&\quad - \alpha(1 - c_N) \frac{AF}{GDP} Q_Y \\
\Leftrightarrow \quad \bar{\Pi}_{GDP} &= 1 - \left[ (1 - c_N) - 2c_N \frac{(1 - \beta)(1 - \delta_N)}{\delta_N} \right] \frac{AF}{GDP} Q_Y \\
\Leftrightarrow \quad (1 - \bar{\Pi}_{GDP}) &= \left[ (1 - c_N) - 2c_N \frac{(1 - \beta)(1 - \delta_N)}{\delta_N} \right] \left[ 1 - c_N - \frac{\vartheta}{AF} \right]^{-1} \frac{Q_Y}{cu} \\
\Leftrightarrow \quad \frac{\vartheta}{AF} &= (1 - c_N) \left[ 1 - \left( 1 - \frac{2c_N}{1 - c_N} \frac{(1 - \beta)(1 - \delta_N)}{\delta_N} \right) \frac{Q_Y}{cu} \frac{1}{1 - \bar{\Pi}_{GDP}} \right],
\end{aligned}$$

where we target the profit share of GDP,  $\bar{\Pi}_{GDP}$ . The production fixed costs increases in vacancy posting costs and markups, and decrease in the steady-state profit share. A common assumption in the literature also taken here is a zero profit condition,  $\bar{\Pi}_{GDP} = 0$ , which indicates that markups pay for production fixed costs but no additional profit is made by the firm (Christiano et al., 2010). The previous four steady-state conditions all depend on each other. Hence, we solve them numerically in one block when solving for the steady-state of the model and thereby setting the parameter values determined by the steady-state targets.

## Appendix C.2. Data Sources and Data Construction

*Real GDP.* Output growth is given by

$$\Delta GDP_{data,t} = \ln \left( \frac{GDP_t}{Defl_t \cdot Pop_t} \right) - \ln \left( \frac{GDP_{t-1}}{Defl_{t-1} \cdot Pop_{t-1}} \right),$$

where  $GDP_t$  is nominal GDP (BEA code: A191RC; Eurostat code: namq-10.gdp),  $Defl_t$  is the GDP deflator calculated below, and  $Pop_t$  is non-institutional population over 16 years for the U.S. (BLS code: CNP16OV) and total population for the Euro Area countries (Eurostat code: namq-10.pe).

*Real Consumption.* Nominal consumption is calculated as nominal private consumption (BEA code: DPCERC; Eurostat code: namq-10.gdp). We subtract nominal durable private consumption (BEA code: DDURRC; Euro Area data – Eurostat code: namq-10.fcs) following Justiniano et al. (2010) for all model versions without inventories and durable consumption. Real Consumption growth is

$$\Delta C_{data,t} = \ln \left( \frac{Const - Cons_{dur,t}}{Defl_t \cdot Pop_t} \right) - \ln \left( \frac{Const_{t-1} - Cons_{dur,t-1}}{Defl_{t-1} \cdot Pop_{t-1}} \right).$$

*Real Investment.* Nominal investment is calculated as nominal (private<sup>50</sup>) investment (BEA code: A006RC, Eurostat code: namq\_10\_gdp). We add nominal durable private consumption following Justiniano et al. (2010) for all model versions without inventories and durable consumption. Real investment is

$$\Delta I_{data,t} = \ln \left( \frac{Inv_t + Cons_{dur,t}}{Defl_t \cdot Pop_t} \right) - \ln \left( \frac{Inv_{t-1} + Cons_{dur,t-1}}{Defl_{t-1} \cdot Pop_{t-1}} \right).$$

*Real Government Spending.* The steady-state target of exogenous government spending is calibrated according to the data mean of real government spending across the observation period for each country as given by

$$gs = \frac{1}{T} \sum_{t=1}^T \frac{Gov_t}{GDP_t},$$

where the GDP deflator and adjustment for population growth cancel out as both nominal government spending (BEA code: A822RC; Eurostat code: namq\_10\_gdp) and nominal GDP are adjusted.

*Total Hours Worked.* For the U.S., total hours worked is the total of hours worked of all persons employed in the non-farm business sector (BLS code: HOANBS). Data is retrieved from U.S. Bureau of Labor Statistics. Total Hours Worked is calculated by

$$TH_{US,data,t} = \ln \left( \frac{TotHours_t}{Pop_t} \right).$$

For the Euro Area countries, total hours worked are calculated from real labor productivity per hour worked (Eurostat code: namq\_10\_lp\_ulc) given by

$$TH_{EA,data,t} = \ln \left( \frac{GDP_t}{Defl_t \cdot Pop_t} \cdot lpr_t^{-1} \right).$$

We follow Cacciatore et al. (2020) and linearly detrend both U.S. and Euro Area total hours time series to retrieve business cycle fluctuations in the total hours worked.

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<sup>50</sup>For the Euro Area countries private investment data is not available. We use gross capital formation instead. This alternative should not be critical, as government investment is mostly acyclical.

*Employment Rate.* The employment rate is based on the number of total non-farm employees for the U.S. (FRED code: PAYEMS) and total employees for the Euro Area countries (Eurostat code: namq\_10\_pe). It is calculated by

$$N_{data,t} = \frac{TotEmp_t}{Pop_t},$$

where we follow [Cacciatore et al. \(2020\)](#) and linearly detrend this series to retrieve business cycle fluctuations in the employment rate.

*Unemployment.* The steady-state target for employment for each country is calculated by the data mean unemployment rate across the observation period as given by

$$\bar{N} = \frac{1}{T} \sum_{t=1}^T (1 - ue_t),$$

where  $ue_t$  is the current unemployment rate (FRED code: UNRATE; Eurostat code: ei\_lmhr\_m).

*Labor Income Share.* The steady-state target of the labor income share for each country is calculated by the data mean of annual labor income share across the observation period as given by

$$\bar{ls} = \frac{1}{T} \sum_{t=1}^T ls_t,$$

where we retrieve the labor income share data for all countries from Penn World Table (<https://doi.org/10.34894/QT5BCC>).

*Capacity Utilization.* We connect the data with the model by applying the production capacity definition of the Federal Reserve Board. Capacity utilization is constructed by the output index divided by the capacity index<sup>51</sup> where the long-run sustainable production index is defined as: *"The Federal Reserve Board's capacity indexes attempt to capture the concept of sustainable maximum output—the greatest level of output a plant can maintain within the framework of a realistic work schedule, after factoring in normal downtime and assuming sufficient availability of inputs to operate the capital in place."*

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<sup>51</sup>Both time series are regularly calculated by the Federal Reserve Board and published as the "Industrial Production and Capacity Utilization - G.17", which can be found online: <https://www.federalreserve.gov/releases/g17/>.

We follow the interpretation of [Comin et al. \(2025\)](#) and set three assumptions: (1) the capital stock is measured at the current available (predetermined) capital stock of a firm including non-utilized capital  $e_{K,t}$ ; (2) the level of employment is measured at their current long-term rate; (3) labor matching costs, hours per worker, and labor effort are measured at the steady-state as any deviations are not sustainable in the long-run production capacity index. This interpretation is different to [Morin and Stevens \(2004\)](#); [Michaillat and Saez \(2015\)](#) as it assumes employment at the current quasi-fixed level instead of the long-run equilibrium (steady-state). As our framework allows us to separate extensive and intensive labor margins, we set only the flexible margins at steady-state levels as long-term employment changes much like the pre-determined capital stock the long-run production capacity of a firm. If we interpret an expansion of the capital stock as a new plant of a firm, additional employment is necessary to run this additional plant at normal operation. Setting employment to its steady-state rate would thus underestimate the employment rate at normal operation given the quasi-fixed predetermined capital stock.

The European Commission does not provide a clear-cut definition of full capacity. The EC survey asks for more subjective rates of capacity utilization from survey participants instead of calculating a measure of production capacity. Hence, we use the U.S. definition of full capacity and apply it to the model when estimating Euro Area country data as well.

Capacity utilization data is for the entire observation period only available for the industry sector. For the service sector, which roughly is two-thirds of GDP<sup>52</sup>, we lack data before 2011 for the Euro Area and for the U.S. completely. Therefore, we backcast service sector capacity utilization rates. We follow [Comin et al. \(2025\)](#) and use a simple regression model to estimate the relationship between service and industry capacity utilization for the observation period where both time series are available. The estimated model is then used to backcast service sector capacity utilization based on the available industry sector capacity utilization data. The regression model is given by

$$cu_{S,t} = K + \beta_{cu} cu_{I,t} + \varepsilon_t \quad (\text{C.1})$$

where  $cu_{S,t}$  is service sector capacity utilization,  $cu_{I,t}$  is industry sector capacity utilization,  $K$  is a constant,  $\beta_{cu}$  a coefficient to be estimated, and  $\varepsilon \sim \mathcal{N}(0, \sigma_\varepsilon)$  is an error term. We estimate this

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<sup>52</sup>There is no data on the capacity utilization of agriculture, forestry, fishing, and hunting sector. Also, not for other economies similar to the U.S. As this sector comprises about 1% of the U.S. economy we neglect it in the analysis of economy-wide capacity utilization.

**Table C.5:** Correlation of industry and service sector capacity utilization in the European Union

	U.S. (European Union)	Spain	Germany	France	Italy
$\sigma_{cu_I}$	2.66%	3.64%	3.40%	2.86%	3.08%
$K$	0.47	0.33	0.69	0.54	0.54
$\beta_{cu}$	0.52	0.67	0.24	0.44	0.46
$R^2$	0.77	0.70	0.39	0.46	0.52

relationship for each Euro Area country considered separately with data from 2011q1 to 2019q4 and use the estimated model to calculate service sector capacity utilization between 1998q1 and 2010q4. For the U.S., as there is not service sector capacity utilization data available, we use European Union data from 2011q1 to 2019q4 to estimate (C.1) and calculate service sector capacity utilization data between 1984q1 to 2019q4 plugging in U.S. industry capacity utilization data. Table C.5 shows the R-squared of those exercises. Besides the regressions for the European Union and Spain, the R-squared are rather low. However, the sample 2011q1-2019q4 is rather short and not containing any major business cycle<sup>53</sup>. We rely on findings by Wohlrabe and Wollmershäuser (2017) who use additionally business sentiment data for the different sectors to show that for Germany both service and industry capacity utilization rates are highly correlated. Hence, we are confident that the regression model backcasts service sector capacity utilization better than the R-squared would let us to belief.

We construt an economy-wide capcacity utilization rate taking into account both industry and services capacity utilization time series by

$$cu_t = (1 - \Sigma_{S,t}) cu_{I,t} + \Sigma_{S,t} cu_{S,t}$$

where  $\Sigma_{S,t} = \frac{C_{Service,t}}{C_t}$  is a consumption-based services weight<sup>54</sup>, thus taking into account the changing shares of industry and service sectors across time. Finally, we calculate the growth rate of

<sup>53</sup>We exclude 2020q1-2024q4 as the COVID business cycle has not concluded and represents an extraordinary business cycle not necessarily representing the average business cycle.

<sup>54</sup>Alternatively, we could have used services value-added weights. As the model focuesss on household impact of goods market trade, we decided to take consumption based weights.

the economy-wide capacity utilization rate and demean each time series by

$$\Delta cu_{data,t} = \Delta cu_t - \frac{1}{T} \sum_{t=1}^T \Delta cu_t = \Delta \hat{CU}_t$$

where the de-meaned growth rate is a direct observable of model capacity utilization growth rates,  $\Delta \hat{CU}_t$ .

*Inventory-Sales Ratio.* The inventory-sales ratio gives a measure of production over sales and thus a proxy for goods market tightness. There is only data available for the U.S. We use real private inventories (BEA code: A371RX) and calculate the ratio given by

$$isr_{data,t} = \frac{Inv_{S,t}}{\frac{GDP_t}{Defl_t \cdot Pop_t}} \cdot C_{S,Weight,t},$$

where we weight with  $C_{S,Weight,t} = 1 + \frac{C_{Service,t}}{C_t} - \frac{1}{T} \sum_{t=1}^T \frac{C_{Service,t}}{C_t}$  to account for the long-run trend in industry/service shares in the data but fixed shares in the model.

*GDP Deflator.* The GDP deflator is the log difference of nominal GDP and real GDP (BEA codes: A191RC and A191RX; Eurostat code: namq.10\_gdp). Price Inflation is given by

$$\pi_{data,t} = \ln \left( \frac{GDP_{nom,t}}{GDP_{real,t}} \right) - \ln \left( \frac{GDP_{nom,t-1}}{GDP_{real,t-1}} \right).$$

*Real Labor Compensation.* Nominal labor compensation for the U.S. is given by the non-farm business sector labor compensation per hour (BLS code: COMPNFB). Real wage inflation is given by

$$\pi_{US,W,data,t} = \ln \left( \frac{W_t}{Defl_t} \right) - \ln \left( \frac{W_{t-1}}{Defl_{t-1}} \right).$$

For the Euro Area countries, we construct nominal labor compensation by nominal unit labor costs per hour worked and real labor productivity per hour worked as given by

$$\pi_{EA,W,data,t} = \ln \left( \frac{ulc_t}{lpr_t} \right) - \ln \left( \frac{ulc_{t-1}}{lpr_{t-1}} \right).$$

The seasonally adjusted nominal labor compensation time series are retrieved from the ECB: DE Code: MNA.Q.S.DE.W2.S1.S1..Z.ULC\_HW..Z..T..Z.IX.D.N; ES code: MNA.Q.Y.ES.W2.S1.S1..Z.ULC\_HW..Z..T..Z.IX.D.N; FR code: MNA.Q.S.FR.W2.S1.S1..Z.ULC\_HW..Z..T..Z.IX.D.N; IT code: MNA.Q.Y.IT.W2.S1.S1..Z.ULC\_HW..Z..T..Z.IX.D.N.

*Policy Rate.* The policy rate for the U.S. is given by the Federal Reserve Bank of New York, Effective Federal Funds Rate (FRED Code: EFFR) and for the Euro Area countries by the 3-month EURIBOR rate (ECB code: FM.M.U2.EUR.RT.MM.EURIBOR3MD..HSTA). For the period of binding zero lower bound, we use the shadow rate of [Wu and Xia \(2016\)](#) for both the U.S. and Euro Area countries as the model does not incorporate a lower bound on its nominal interest rate. We follow [Wu and Zhang \(2019\)](#), who show that the shadow rate is a good representation of the interest rate in a New-Keynesian model. The constructed time series shows quarterly annualized interest rates. We calculate the quarterly interest rate by

$$r_{data,t} = (1 + int_{year,t})^{\frac{1}{4}} - 1.$$

### Appendix C.3. Connecting the Data to the Model

The growth rates of real GDP, real investment, real consumption, and real labor compensation are de-measured by the mean growth rate (indicated by a bar) of real GDP ([Smets and Wouters, 2007](#)). The GDP deflator, the policy rate, and the capacity utilization growth rate are demeaned by their own mean. The log of total hours worked and the employment rate are linearly de-trended [Cacciatore et al. \(2020\)](#). The data and structural model are connected as follows:

$$\begin{bmatrix} \Delta GDP_{data,t} \\ \Delta C_{data,t} \\ \Delta I_{data,t} \\ TH_{data,t} \\ N_{data,t} \\ cu_{data,t} \\ \pi_{data,t} \\ \pi_{W,data,t} \\ r_{data,t} \end{bmatrix} - \begin{bmatrix} \overline{\Delta GDP_{data,t}} \\ \overline{\Delta GDP_{data,t}} \\ \overline{\Delta GDP_{data,t}} \\ TH_{trend,t} \\ N_{trend,t} \\ \overline{cu_{data,t}} \\ \overline{\pi_{data,t}} \\ \overline{\Delta GDP_{data,t}} \\ \overline{r_{data,t}} \end{bmatrix} = \begin{bmatrix} \Delta \log(gdp_t) \\ \Delta \log(C_t) \\ \Delta \log(Inv_t) \\ \log(th_t) - \log(\bar{th}) \\ N_t - \bar{N} \\ \Delta cu_t \\ \pi_t - \bar{\pi} \\ \frac{1+\pi_{W,t}}{1+\pi_t} \cdot \frac{e_{H,t}}{e_{H,t-1}} - 1 \\ r_{B,t} - \bar{r}_B \end{bmatrix}$$



## Appendix D. Bayesian Estimation and Posterior Results

### Appendix D.1. Additional Results on Log Data Densities

**Table D.6:** Log data density of different model setups in explaining U.S. data (1984q1-2019q4) and core Euro area data (1998q1-2019q4)

Model Setup	U.S.	Spain	Germany	France
<i>Alternative Capital Utilization Assumption</i>				
Capital Utilization (CW)	5096.2	2634.3	2905.1	3043.2
CW (ALT)	5099.2	2649.1	2926.2	3064.0
<b>Bayes Factor:</b> Baseline - Alternative	<b>6.0</b>	<b>29.6</b>	<b>42.2</b>	<b>41.6</b>
CW + WE + SaM	5187.7	2709.1	3004.7	3160.8
CW + WE + SaM (ALT)	5186.4	2712.2	3004.2	3156.6
<b>Bayes Factor:</b> Baseline - Alternative	<b>-2.6</b>	<b>6.2</b>	<b>-1.0</b>	<b>-8.4</b>
<i>Alternative Weights in Aggregate Capacity Utilization Construction</i>				
Benchmark	5159.9	2652.7	2884.2	3047.6
Preferred	5198.7	2685.8	2953.2	3124.1
<b>Bayes Factor:</b> Preferred - Benchmark	<b>77.6</b>	<b>66.2</b>	<b>138.0</b>	<b>153.0</b>
<i>Alternative Time Period: 1967q1 - 2019q4</i>				
Benchmark	7287.2	—	—	—
Preferred	7336.8	—	—	—
<b>Bayes Factor:</b> Complements - Preferred	<b>99.2</b>	<b>-</b>	<b>-</b>	<b>-</b>
<i>Adding Hours Adjustment Costs</i>				
Benchmark	5194.9	2678.4	2933.6	3096.4
Preferred	5235.9	2707.0	3007.0	3171.9
<b>Bayes Factor:</b> Complements - Preferred	<b>82.0</b>	<b>57.2</b>	<b>146.8</b>	<b>151.0</b>

NOTE: Log data densities are calculated by the modified harmonic mean following Geweke (1999). To compare different versions of the model, I use the  $2\ln$  Bayes factor as described by Kass and Raftery (1995). Log data densities with an asteriks are obtained from a Laplace approximation given limited computing power.

Appendix D.2. Additional Results on the Prior-Posterior Analysis

**Table D.7:** Posteriors: International Comparison – Benchmark Model

Parameter	U.S. (90% HDP)	Spain (90% HDP)	Germany (90% HDP)	France (90% HDP)
<i>General Parameters</i>				
$\omega$	0.25 (0.06-0.49)	0.85 (0.72-0.98)	0.32 (0.01-0.85)	0.04 (0.02-0.05)
$\theta_H$	0.79 (0.71-0.86)	0.69 (0.58-0.81)	0.90 (0.83-0.96)	0.71 (0.65-0.76)
$\nu_H$	2.87 (2.20-3.51)	3.25 (2.48-3.99)	2.76 (1.97-3.53)	1.55 (1.19-1.88)
$\frac{1}{mc} - 1$	0.33 (0.20-0.46)	0.03 (0.02-0.05)	0.29 (0.02-0.66)	0.09 (0.05-0.13)
$\kappa_I$	1.72 (1.22-2.21)	1.6 (1.03-2.16)	1.11 (0.50-1.73)	1.62 (1.10-2.13)
$\kappa_W$	30.3 (22.0-38.3)	29.9 (21.8-37.8)	27.0 (17.4-36.7)	28.0 (19.5-36.2)
$\kappa_P$	170.5 (138.9-201.0)	167.8 (136.0-199.5)	172.5 (136.5-208.9)	165.0 (134.4-196.6)
$\iota_W$	0.44 (0.20-0.67)	0.59 (0.39-0.80)	0.61 (0.36-0.86)	0.55 (0.34-0.78)
$\iota_P$	0.07 (0.02-0.11)	0.08 (0.02-0.13)	0.15 (0.04-0.25)	0.09 (0.03-0.14)
$i_\pi$	1.77 (1.62-1.91)	1.77 (1.62-1.93)	1.87 (1.69-2.05)	1.73 (1.57-1.89)
$i_{gap}$	0.03 (0.01-0.04)	0.06 (0.04-0.09)	0.06 (0.01-0.12)	0.01 (0.00-0.01)
$i_{\Delta gap}$	0.34 (0.20-0.47)	0.11 (0.04-0.18)	0.12 (0.03-0.21)	0.15 (0.06-0.24)
$i_r$	0.76 (0.72-0.80)	0.89 (0.87-0.92)	0.86 (0.83-0.90)	0.78 (0.73-0.83)
<i>Benchmark Utilization Parameters</i>				
$\phi$	2.32 (1.99-2.65)	1.96 (1.67-2.24)	1.98 (1.49-2.45)	2.77 (2.40-3.16)
$\phi_{K,2}$	—	—	—	—
<i>Goods Market SaM Utilization Parameters</i>				
$\gamma_T^{prox}$	—	—	—	—
$\Gamma^{prox}$	—	—	—	—
$\nu_D^{mult}$	—	—	—	—
$\theta_D$	—	—	—	—
$\delta_I$	—	—	—	—
$\delta_T$	—	—	—	—

**Table D.8:** Posteriors: International Comparison – Preferred Model

Parameter	U.S. (90% HDP)	Spain (90% HDP)	Germany (90% HDP)	France (90% HDP)
<i>General Parameters</i>				
$\omega$	0.03 (0.00-0.07)	0.02 (0.00-0.04)	0.02 (0.01-0.04)	0.08 (0.02-0.13)
$\theta_H$	0.85 (0.80-0.90)	0.90 (0.85-0.98)	0.96 (0.93-0.98)	0.88 (0.82-0.94)
$\nu_H$	2.91 (2.27-3.54)	2.76 (2.15-3.34)	3.13 (2.50-3.76)	2.86 (2.20-3.52)
$\frac{1}{mc} - 1$	0.24 (0.16-0.32)	0.07 (0.05-0.09)	0.11 (0.09-0.14)	0.09 (0.06-0.12)
$\kappa_I$	3.12 (2.36-3.86)	5.89 (4.41-7.32)	1.88 (1.36-2.38)	1.73 (1.24-2.22)
$\kappa_W$	26.6 (18.9-34.2)	22.7 (16.2-29.1)	23.7 (17.5-29.8)	26.4 (19.6-32.9)
$\kappa_P$	161.7 (132.8-190.2)	176.6 (144.4-209.3)	158.4 (129.2-187.3)	168.8 (139.4-197.6)
$\iota_W$	0.48 (0.23-0.72)	0.51 (0.28-0.74)	0.49 (0.26-0.72)	0.51 (0.29-0.73)
$\iota_P$	0.05 (0.02-0.08)	0.05 (0.02-0.08)	0.07 (0.03-0.12)	0.07 (0.03-0.11)
$i_\pi$	1.72 (1.58-1.86)	1.71 (1.55-1.88)	1.84 (1.69-1.99)	1.76 (1.60-1.91)
$i_{gap}$	0.02 (0.01-0.04)	0.04 (0.01-0.06)	0.07 (0.03-0.11)	0.06 (0.02-0.10)
$i_{\Delta gap}$	0.39 (0.20-0.57)	0.15 (0.05-0.25)	0.16 (0.06-0.26)	0.18 (0.07-0.30)
$i_r$	0.61 (0.54-0.68)	0.66 (0.60-0.72)	0.65 (0.58-0.71)	0.56 (0.50-0.63)
<i>Benchmark Utilization Parameters</i>				
$\phi$	2.2 (1.88-2.52)	1.61 (1.37-1.85)	1.88 (1.61-2.15)	1.72 (1.44-2.01)
$\phi_{K,2}$	—	—	—	—
<i>Goods Market SaM Utilization Parameters</i>				
$\gamma_T^{prox}$	0.78 (0.65-0.91)	0.94 (0.89-0.99)	0.87 (0.77-0.98)	0.94 (0.89-0.99)
$\Gamma^{prox}$	0.06 (0.00-0.12)	0.04 (0.00-0.08)	0.10 (0.00-0.20)	0.03 (0.00-0.06)
$\nu_D^{mult}$	1.01 (0.50-1.49)	1.12 (0.63-1.60)	1.50 (0.78-2.20)	1.57 (0.84-2.28)
$\theta_D$	0.17 (0.03-0.30)	0.23 (0.04-0.41)	0.23 (0.04-0.41)	0.17 (0.03-0.31)
$\delta_I$	—	—	—	—
$\delta_T$	—	—	—	—

**Table D.9:** Posteriors: International Comparison – Full Model

Parameter	U.S. (90% HDP)	Spain (90% HDP)	Germany (90% HDP)	France (90% HDP)
<i>General Parameters</i>				
$\omega$	0.09 (0.00-0.15)	0.85 (0.72-0.98)	0.46 (0.01-0.86)	0.17 (0.02-0.45)
$\theta_H$	0.85 (0.79-0.94)	0.70 (0.63-0.78)	0.72 (0.61-0.96)	0.79 (0.68-0.92)
$\nu_H$	3.08 (2.36-3.81)	3.75 (2.85-4.64)	3.46 (2.67-4.22)	3.08 (2.35-3.80)
$\frac{1}{mc} - 1$	0.18 (0.13-0.23)	0.12 (0.10-0.15)	0.12 (0.10-0.15)	0.13 (0.10-0.15)
$\kappa_I$	2.82 (1.99-3.64)	6.75 (4.67-8.78)	2.57 (1.70-3.42)	2.39 (1.53-3.22)
$\kappa_W$	25.3 (17.4-33.3)	28.4 (20.0-36.6)	21.7 (15.3-28.0)	25.4 (18.3-32.3)
$\kappa_P$	171.1 (141.7-201.1)	176.2 (144.6-207.2)	162.4 (133.9-190.2)	163.8 (135.4-191.3)
$\iota_W$	0.39 (0.17-0.62)	0.37 (0.16-0.57)	0.49 (0.26-0.72)	0.46 (0.24-0.69)
$\iota_P$	0.05 (0.02-0.08)	0.10 (0.03-0.17)	0.07 (0.02-0.11)	0.08 (0.03-0.12)
$i_\pi$	1.76 (1.61-1.90)	1.73 (1.57-1.88)	1.75 (1.58-1.92)	1.78 (1.62-1.94)
$i_{gap}$	0.03 (0.01-0.04)	0.06 (0.04-0.09)	0.10 (0.03-0.16)	0.05 (0.02-0.09)
$i_{\Delta gap}$	0.24 (0.14-0.34)	0.14 (0.05-0.22)	0.16 (0.06-0.26)	0.13 (0.06-0.20)
$i_r$	0.64 (0.57-0.71)	0.89 (0.86-0.91)	0.72 (0.64-0.80)	0.70 (0.62-0.79)
<i>Benchmark Utilization Parameters</i>				
$\phi$	2.25 (1.92-2.57)	1.91 (1.64-2.17)	1.90 (1.61-2.19)	1.82 (1.50-2.13)
$\phi_{K,2}$	4.85 (2.83-6.84)	2.16 (1.22-3.07)	3.16 (1.31-4.96)	1.97 (0.79-3.12)
<i>Goods Market SaM Utilization Parameters</i>				
$\gamma_T^{prox}$	0.84 (0.71-0.97)	0.65 (0.50-0.81)	0.87 (0.76-0.98)	0.92 (0.85-0.99)
$\Gamma^{prox}$	0.06 (0.00-0.12)	0.04 (0.00-0.09)	0.07 (0.00-0.14)	0.04 (0.00-0.08)
$\nu_D^{mult}$	1.27 (0.53-2.01)	1.65 (0.88-2.39)	2.84 (1.31-4.17)	2.25 (1.31-3.17)
$\theta_D$	0.22 (0.04-0.40)	0.20 (0.05-0.33)	0.18 (0.03-0.33)	0.18 (0.03-0.32)
$\delta_I$	0.22 (0.12-0.32)	0.21 (0.11-0.30)	0.16 (0.07-0.24)	0.15 (0.07-0.22)
$\delta_T$	0.64 (0.48-0.80)	0.60 (0.46-0.73)	0.79 (0.68-0.91)	0.80 (0.70-0.91)

**Table D.10:** Posteriors: Goods Market SaM Decomposition (U.S. Data)

Parameter	No Capacity Utilization Data			Preferred Model	
	Benchmark	Preferred	Perf. Compl.	Preferred	Perf. Compl.
	(90% HDP)	(90% HDP)	(90% HDP)	(90% HDP)	(90% HDP)
<i>General Parameters</i>					
$\omega$	0.16 (0.09-0.23)	0.03 (0.01-0.05)	0.07 (0.01-0.12)	0.03 (0.00-0.07)	0.02 (0.01-0.02)
$\theta_H$	0.84 (0.79-0.90)	0.92 (0.88-0.96)	0.89 (0.85-0.93)	0.85 (0.80-0.90)	0.90 (0.87-0.93)
$\nu_H$	2.43 (1.90-2.94)	2.70 (2.13-3.26)	2.60 (2.04-3.15)	2.91 (2.27-3.54)	2.28 (1.79-2.77)
$\frac{1}{mc} - 1$	0.37 (0.21-0.52)	0.16 (0.08-0.22)	0.19 (0.12-0.25)	0.24 (0.16-0.32)	0.26 (0.18-0.34)
$\kappa_I$	2.21 (1.65-2.76)	3.07 (2.16-3.98)	2.49 (1.82-3.15)	3.12 (2.36-3.86)	2.91 (2.09-3.72)
$\kappa_W$	30.0 (22.1-37.7)	26.1 (18.5-33.5)	28.2 (20.5-35.8)	26.6 (18.9-34.2)	23.6 (16.7-30.3)
$\kappa_P$	169.9 (138.1-201.6)	152.0 (123.6-180.3)	174.9 (143.0-206.4)	161.7 (132.8-190.2)	179.5 (145.9-211.7)
$\iota_W$	0.50 (0.26-0.74)	0.51 (0.26-0.75)	0.57 (0.34-0.80)	0.48 (0.23-0.72)	0.52 (0.28-0.76)
$\iota_P$	0.08 (0.03-0.13)	0.07 (0.02-0.11)	0.08 (0.03-0.13)	0.05 (0.02-0.08)	0.07 (0.02-0.11)
$i_\pi$	1.75 (1.60-1.89)	1.77 (1.63-1.92)	1.83 (1.68-1.98)	1.72 (1.58-1.86)	1.81 (1.66-1.95)
$i_{gap}$	0.03 (0.01-0.05)	0.03 (0.01-0.05)	0.03 (0.01-0.05)	0.02 (0.01-0.04)	0.02 (0.01-0.02)
$i_{\Delta gap}$	0.48 (0.33-0.64)	0.35 (0.13-0.55)	0.28 (0.11-0.45)	0.39 (0.20-0.57)	0.32 (0.15-0.47)
$i_r$	0.73 (0.68-0.78)	0.66 (0.58-0.74)	0.74 (0.69-0.79)	0.61 (0.54-0.68)	0.74 (0.68-0.79)
<i>Benchmark Utilization Parameters</i>					
$\phi$	2.63 (2.29-2.97)	2.51 (2.18-2.82)	2.48 (2.17-2.8)	2.20 (1.88-2.52)	2.40 (2.08-2.71)
$\phi_{K,2}$	—	—	—	—	—
<i>Goods Market SaM Utilization Parameters</i>					
$\gamma_T^{prox}$	—	0.62 (0.46-0.78)	0.78 (0.65-0.92)	0.78 (0.65-0.91)	0.80 (0.67-0.93)
$\Gamma^{prox}$	—	0.13 (0.00-0.28)	—	0.06 (0.00-0.12)	—
$\nu_D^{mult}$	—	1.14 (0.28-1.93)	0.31 (0.10-0.51)	1.01 (0.50-1.49)	0.26 (0.07-0.44)
$\theta_D$	—	0.24 (0.05-0.43)	0.33 (0.09-0.56)	0.17 (0.03-0.30)	0.39 (0.13-0.65)
$\delta_I$	—	—	—	—	—
$\delta_T$	—	—	—	—	—

NOTE:

Appendix D.3. Additional Results on Latent Variables and Second Moments

**Table D.11:** Steady-State Ratios of the Estimated Models

Model	$\frac{K}{Y}$	$\frac{I_K}{Y}$	$\frac{I_S}{Y}$	$\frac{K}{N}$	$mp$	$\Xi$	$P_D$	$\frac{P_D}{P_T}$
<i>United States</i>								
Benchmark	11.2	0.28	0.00	32.5	1.33	−5.0	0.00	0.00
Preferred	7.8	0.20	0.00	15.8	1.24	−7.4	0.43	0.30
Full	9.3	0.23	0.06	22.9	1.17	−11.2	0.31	0.26
<i>Spain</i>								
Benchmark	11.4	0.29	0.00	54.5	1.03	−37.7	0.00	0.00
Preferred	6.7	0.17	0.00	15.3	1.07	−38.5	0.71	0.41
Full	10.1	0.25	0.08	28.1	1.11	−22.4	0.22	0.19
<i>Germany</i>								
Benchmark	10.6	0.27	0.00	28.5	1.29	−5.6	0.00	0.00
Preferred	6.7	0.17	0.00	14.0	1.11	−16.9	0.58	0.37
Full	8.1	0.20	0.05	18.6	1.11	−17.2	0.39	0.30
<i>France</i>								
Benchmark	10.9	0.27	0.00	40.4	1.09	−16.0	0.00	0.00
Preferred	6.6	0.17	0.00	14.7	1.09	−27.1	0.65	0.39
Full	8.2	0.20	0.05	19.6	1.12	−18.9	0.41	0.31

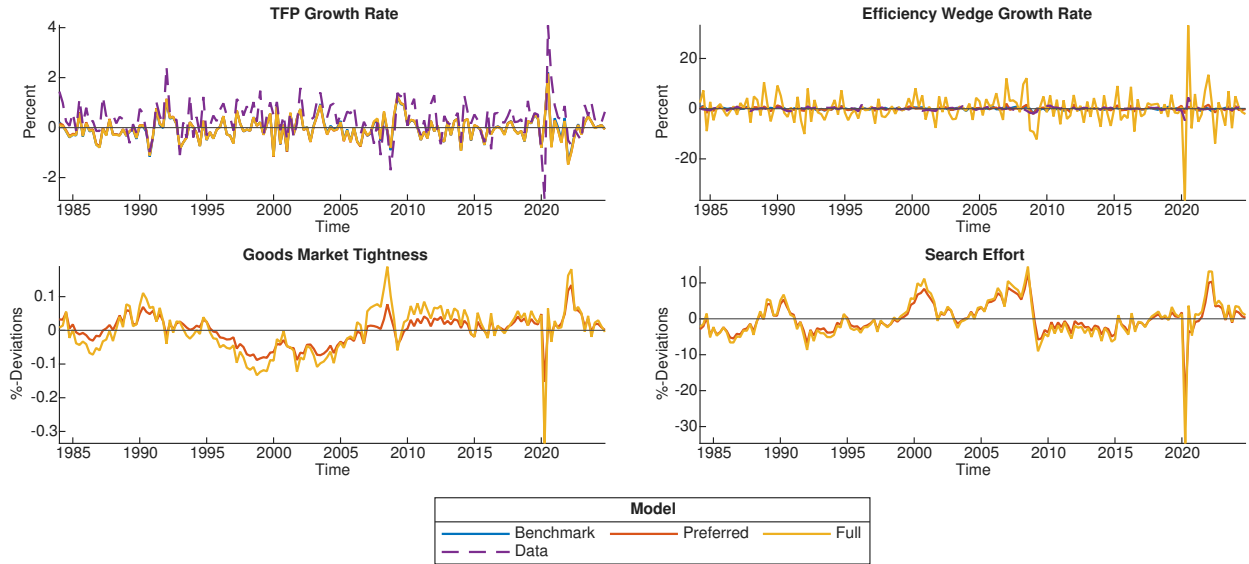
**Table D.12:** Correlations of Latent Variables Derived form the Preferred Model

	$GDP$	$\widetilde{GDP}$	$TFP$	$CU$	$\Xi$	$x_T$	$\tilde{x}_T$	$H$	$D$
$GDP$	1.00	0.82	0.52	0.48	0.75	-0.83	-0.57	0.45	0.61
$\widetilde{GDP}$	0.82	1.00	0.53	0.38	0.88	-0.76	-0.62	0.43	0.61
$TFP$	0.52	0.53	1.00	0.31	0.51	-0.52	-0.61	-0.22	-0.07
$CU$	0.48	0.38	0.31	1.00	0.52	-0.24	-0.16	0.67	0.25
$\Xi$	0.75	0.88	0.51	0.52	1.00	-0.82	-0.77	0.55	0.36
$x_T$	-0.84	-0.76	-0.52	-0.24	-0.82	1.00	0.87	-0.34	-0.28
$\tilde{x}_t$	-0.57	-0.62	-0.61	-0.16	-0.77	0.87	1.00	-0.08	0.13
$H$	0.45	0.43	-0.22	0.67	0.55	-0.34	-0.08	1.00	0.54
$D$	0.61	0.61	-0.07	0.25	0.36	-0.28	0.13	0.55	1.00

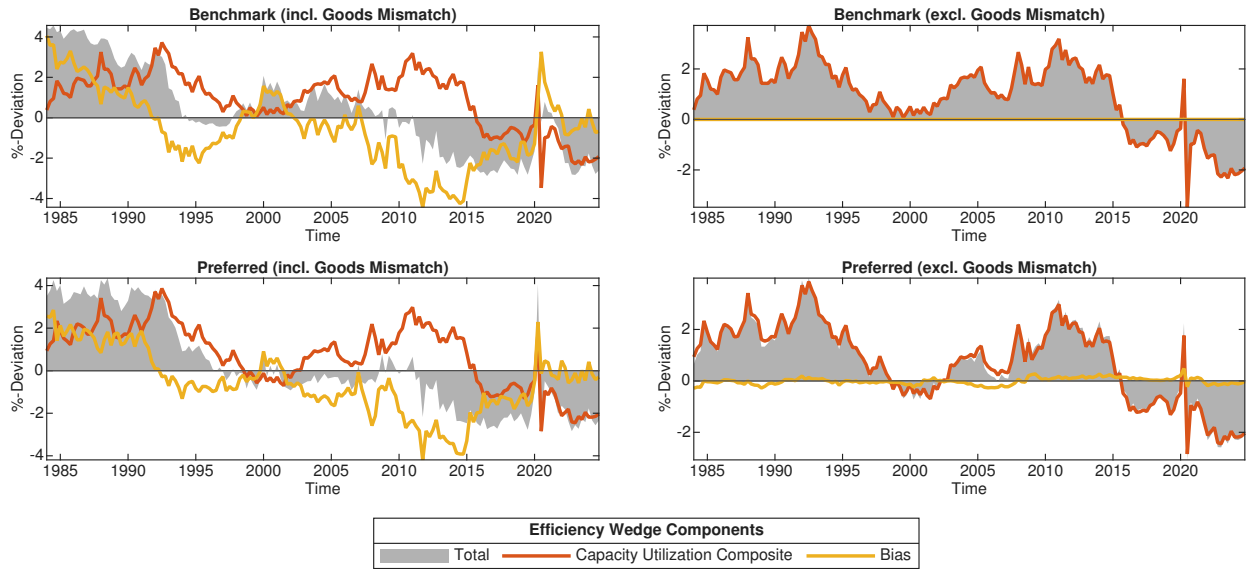
NOTE: The table features correlations of the preferred model derived from the estimated latent time series of U.S. data (1984q1-2024q4).

Figure D.13

(a)



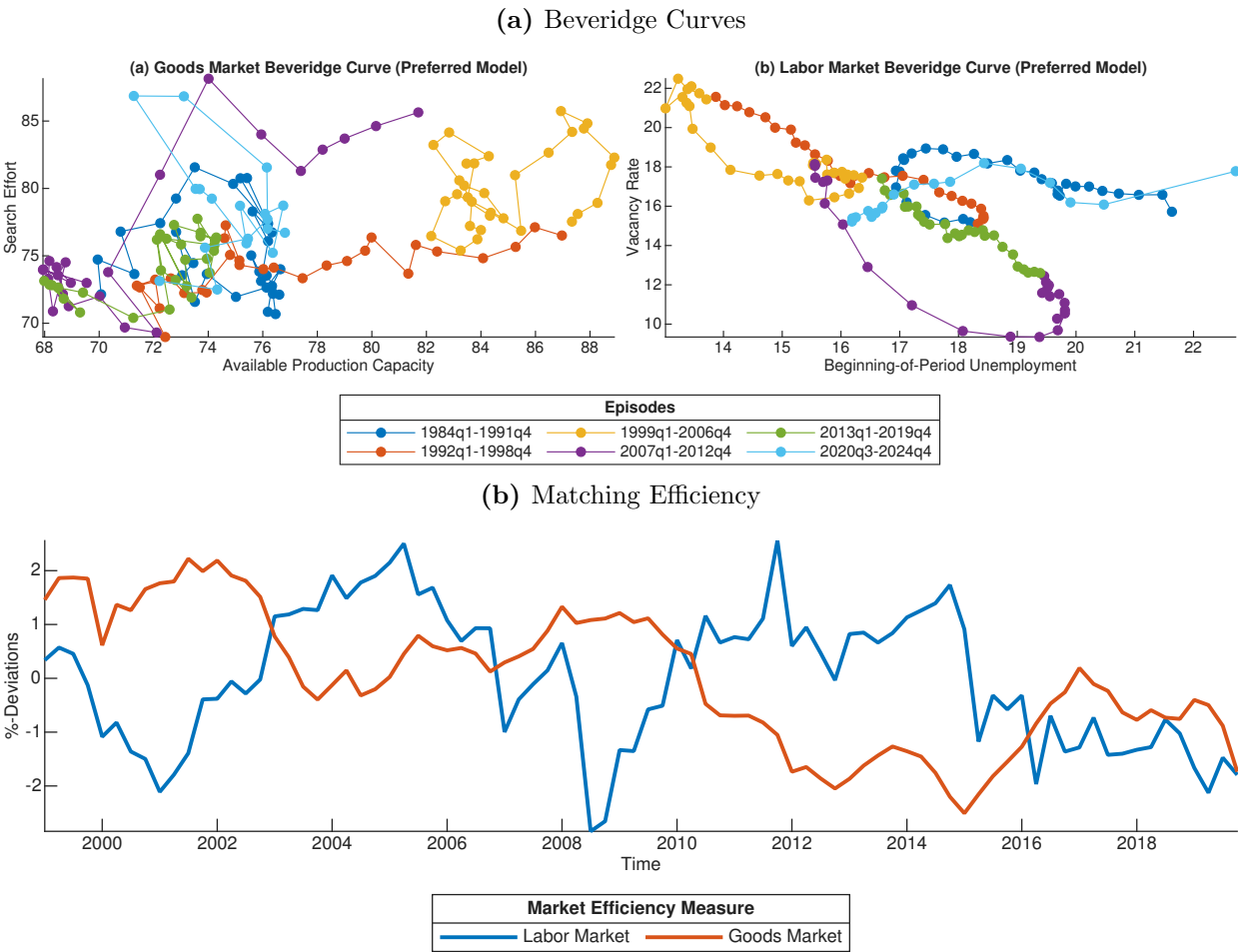
(b) Estimated Efficiency Wedges (both definitions)



NOTE: The figure shows estimated efficiency wedges for US data 1984q1-2024q4 decomposing them into the term explained by capacity utilization and other observables and the TFP bias. The upper graphs show the efficiency wedge and TFP bias including goods mismatch shocks as technology shocks. The lower graphs exclude the shock. Both the benchmark and the preferred model results are shown.

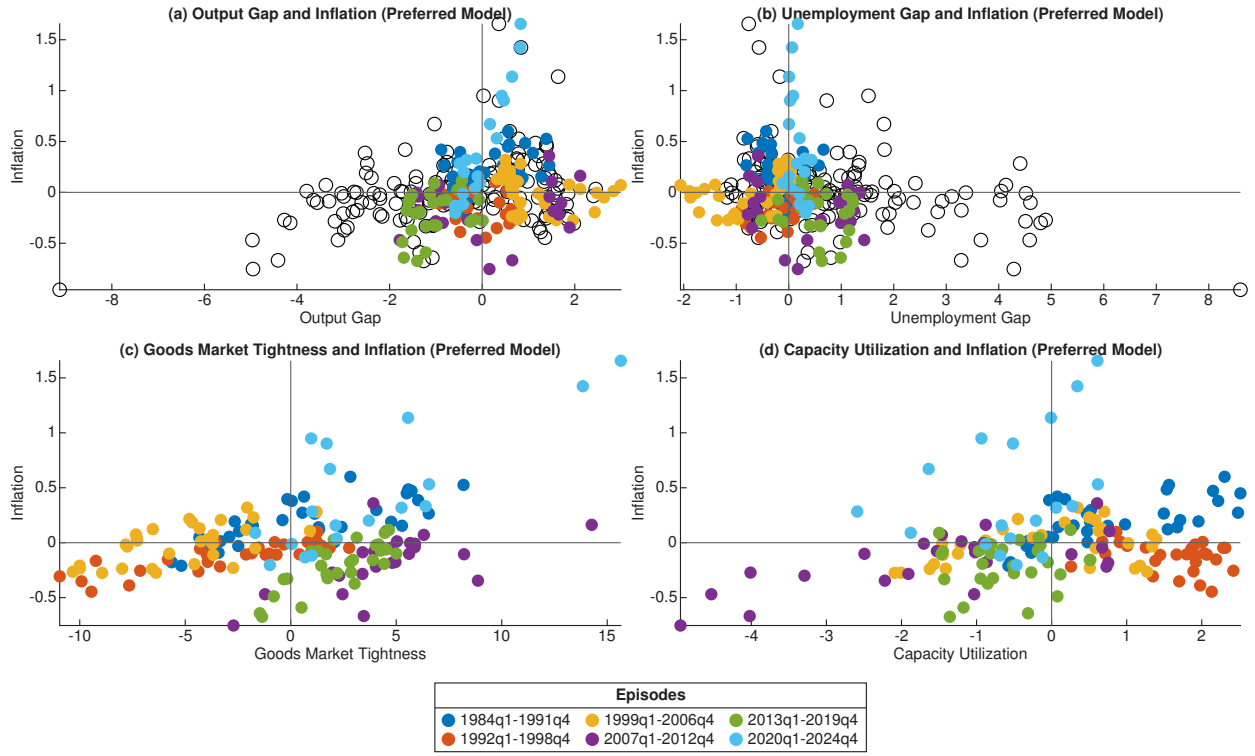


Figure D.14: Beveridge Cycles (U.S. Data) - Goods and Labor Markets

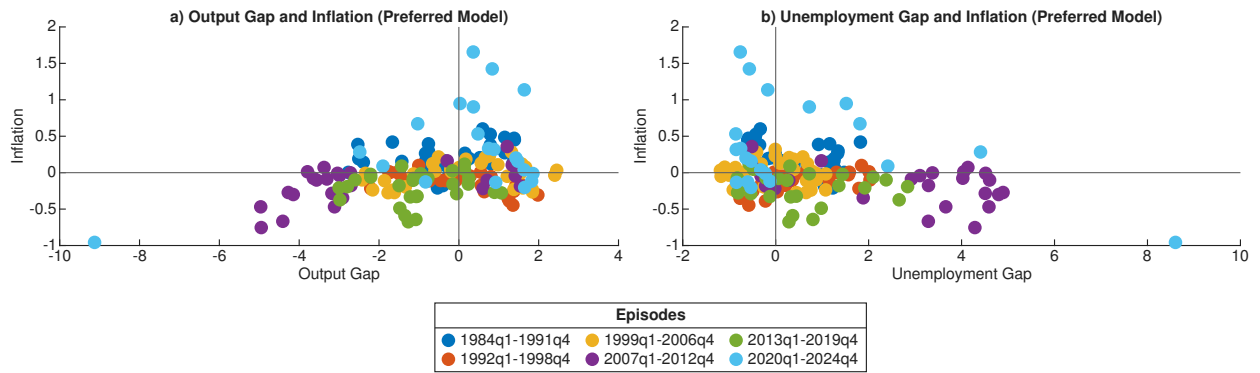


**Figure D.15: Preferred Model – Baseline Observables**

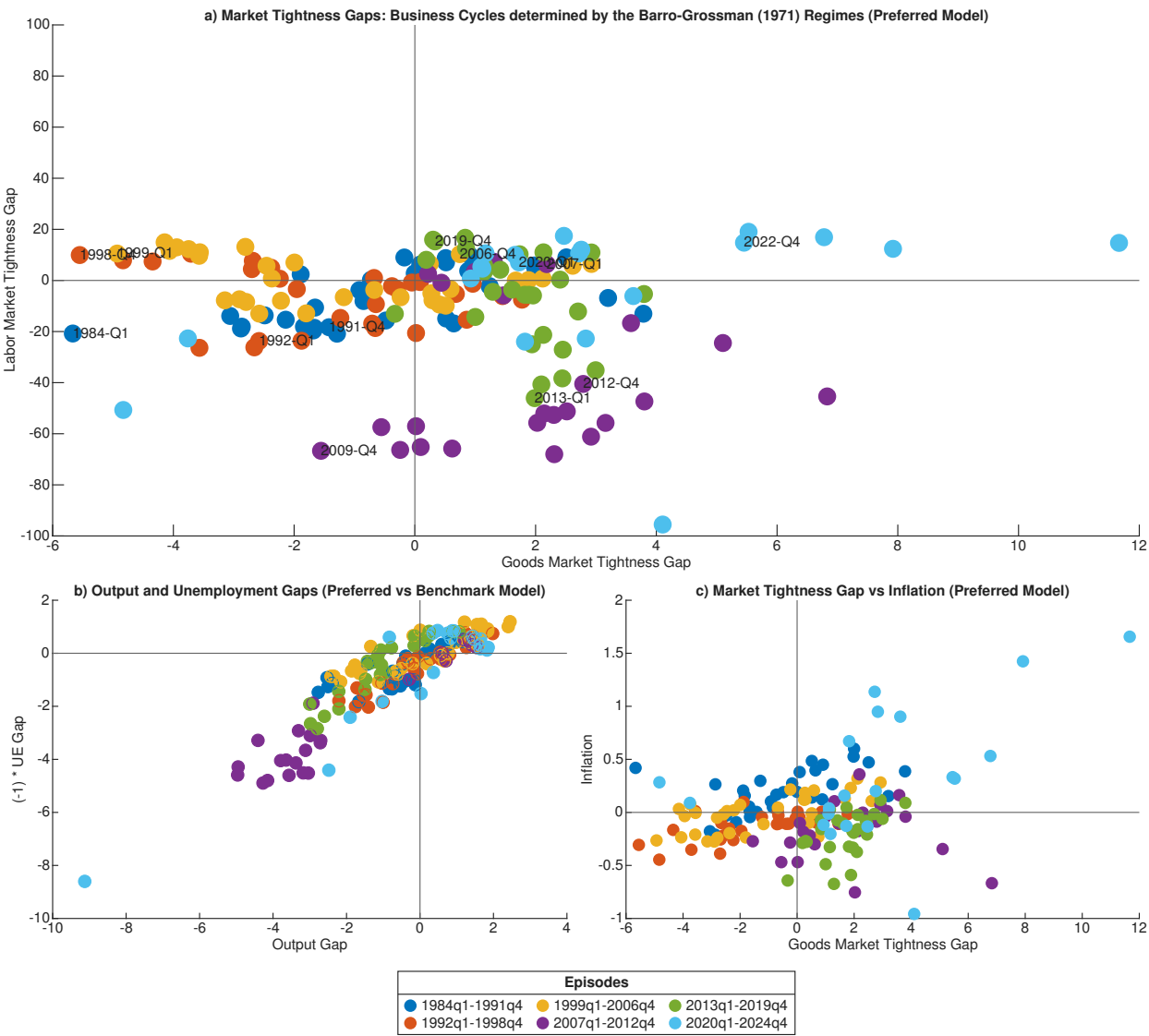
**(a) Output and Unemployment Gaps as Determinants of Inflation**



**(b) Preferred Model – Targeting Output and Unemployment Gaps**

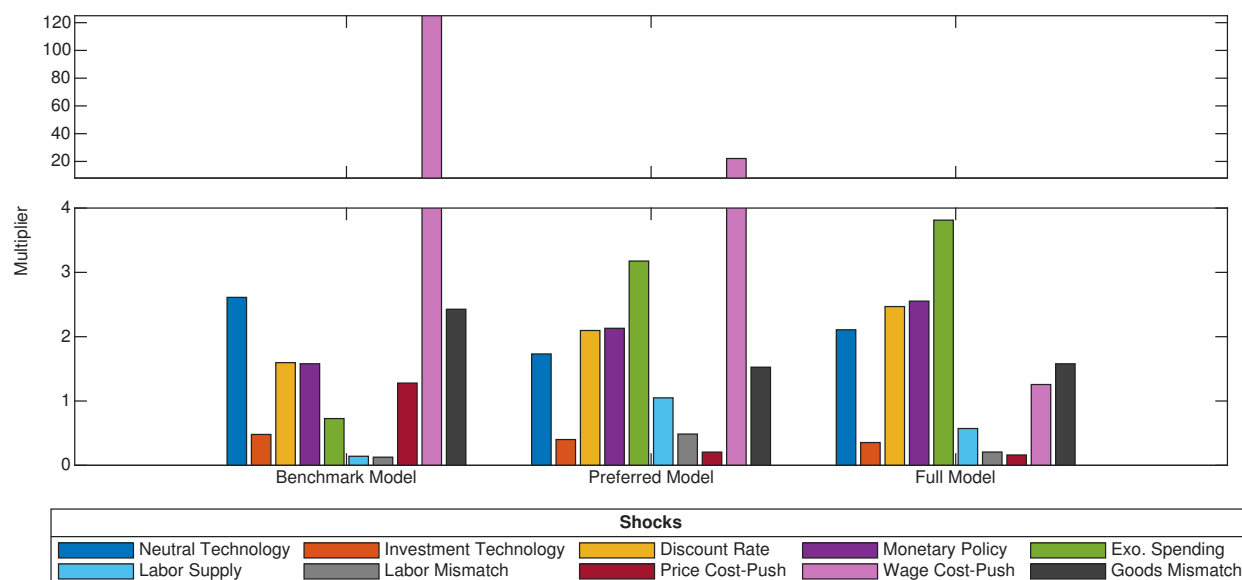


**Figure D.16:** Business Cycles (U.S.) through Market Tightness (Targeting Output and Unemployment Gaps)



Appendix D.5. Additional Results on the Variance Decomposition

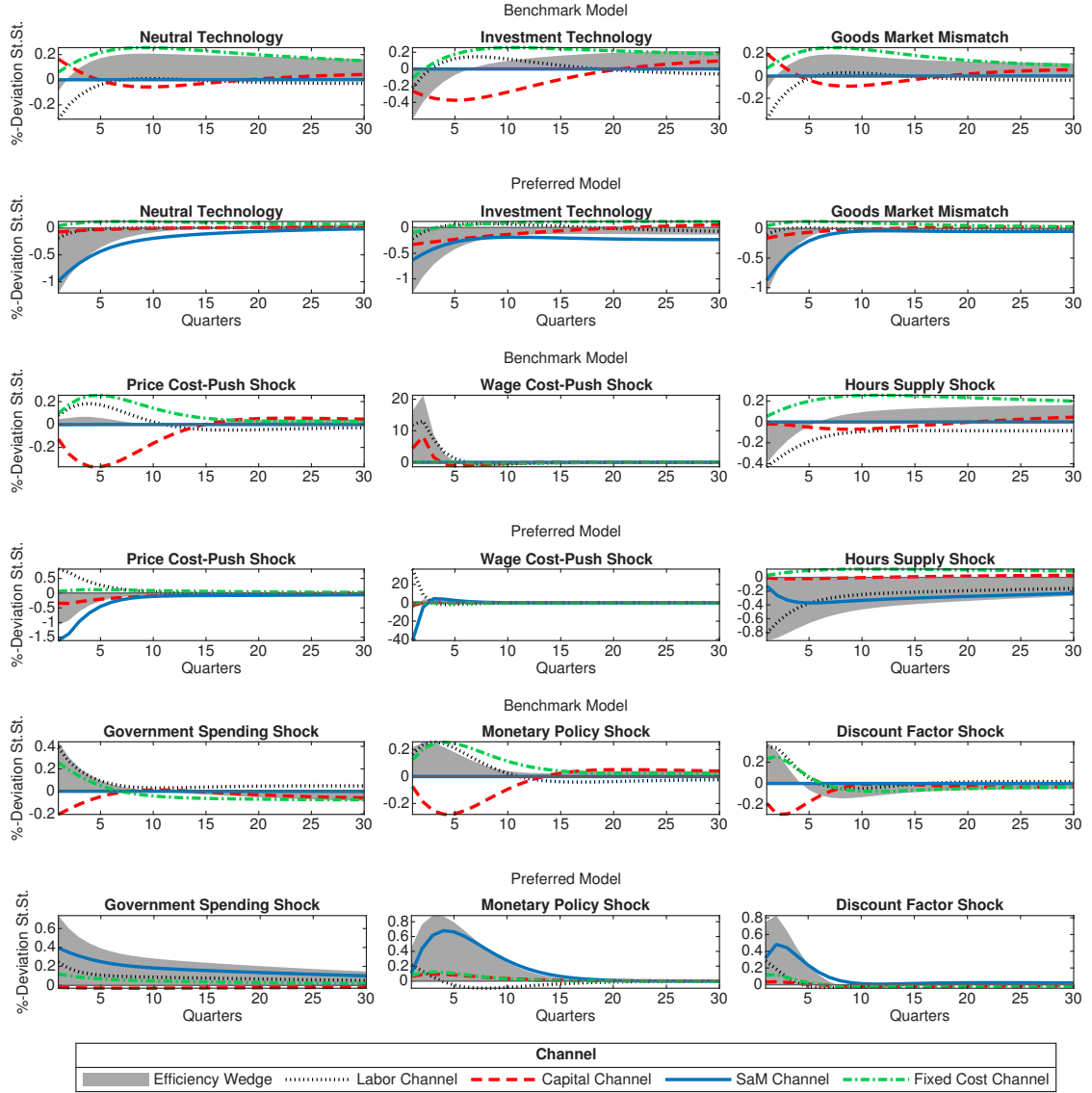
**Figure D.17:** TFP Variance Multipliers (relative to GDP Variance Shares)



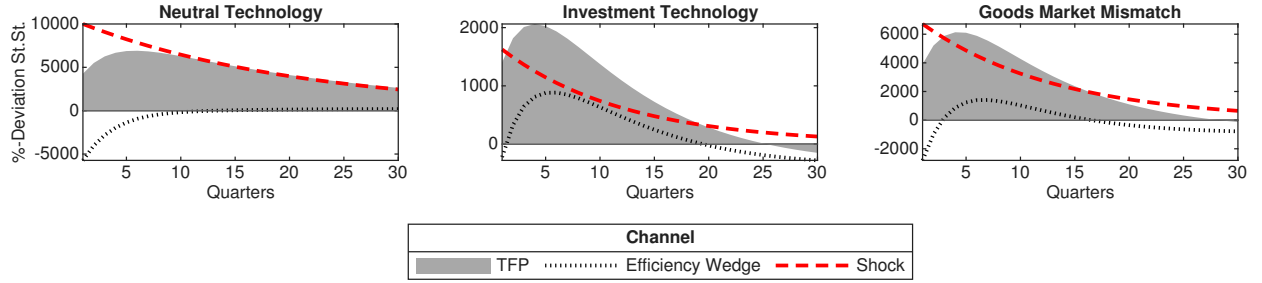
## Appendix E. TFP Bias and Multipliers Sensitivity Analysis

### Appendix E.1. Determinants of the Efficiency Wedge

**Figure E.18:** Dynamics of the Determinants of the Efficiency Wedge



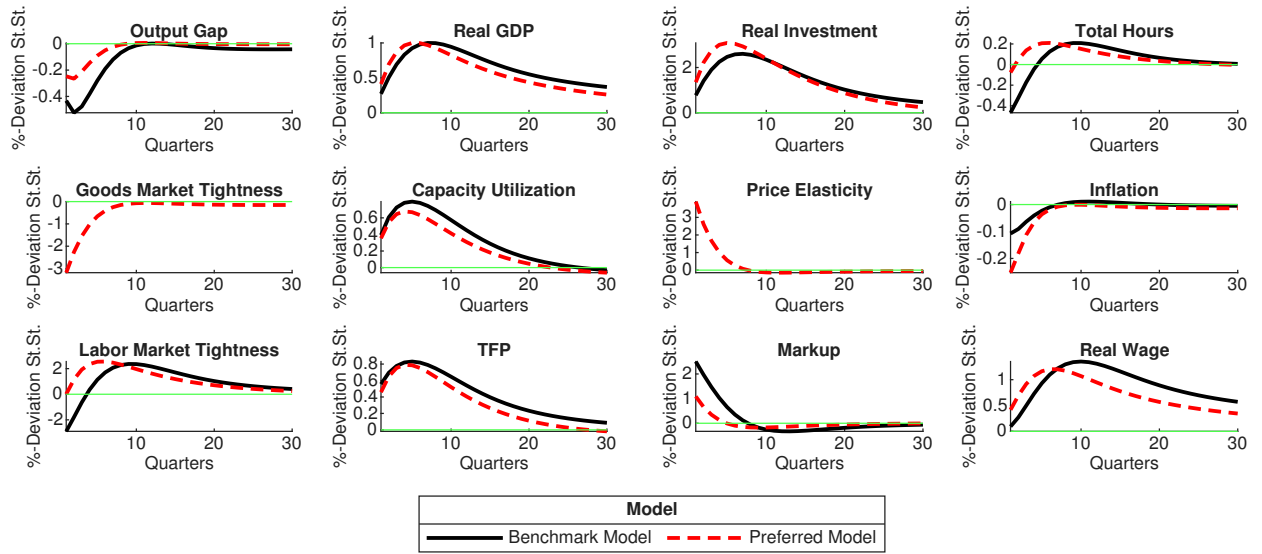
**Figure E.19:** Decomposing TFP into Wedge and Shock for the Technology Shocks



NOTE: The figure shows the decomposition of the impulse response functions of the efficiency wedge to technology shocks for the full model. The deviations are measured in percentage deviations from the deterministic steady-state. TFP IRFs (grey areas) are decomposed into the efficiency wedge (black dotted curves) and the exogenous shock (red dashed curves).

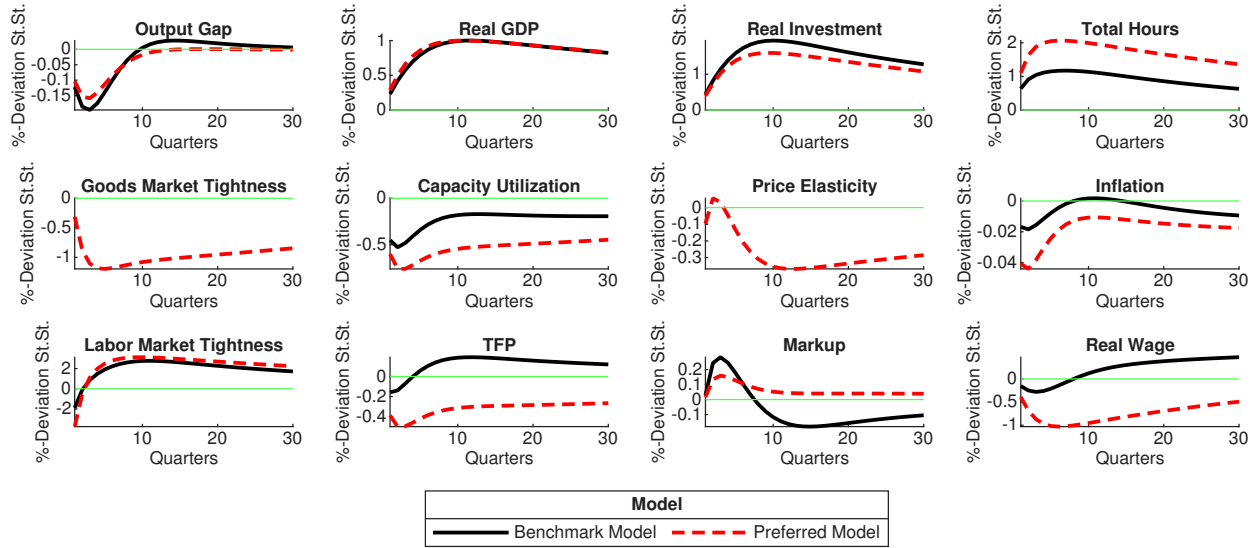
## Appendix E.2. IRFs to Additional Business Cycle Shocks

**Figure E.20:** IRFs to an Expansionary Goods Mismatch Shock



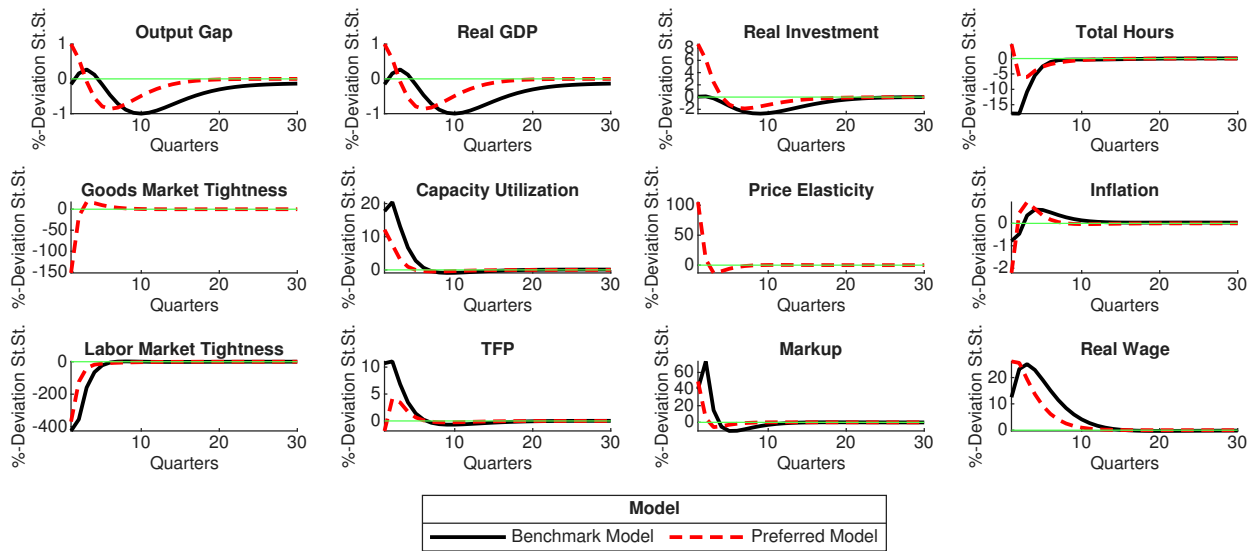
NOTE: The figure shows IRFs of different variables to different business cycle shocks for both the benchmark and preferred models. The deviations are measured in percentage deviations from the deterministic steady-state. IRFs are normalized across models by scaling with the absolute maximum deviation of real GDP in each model.

**Figure E.21:** IRFs to an Expansionary Labor Mismatch Shock



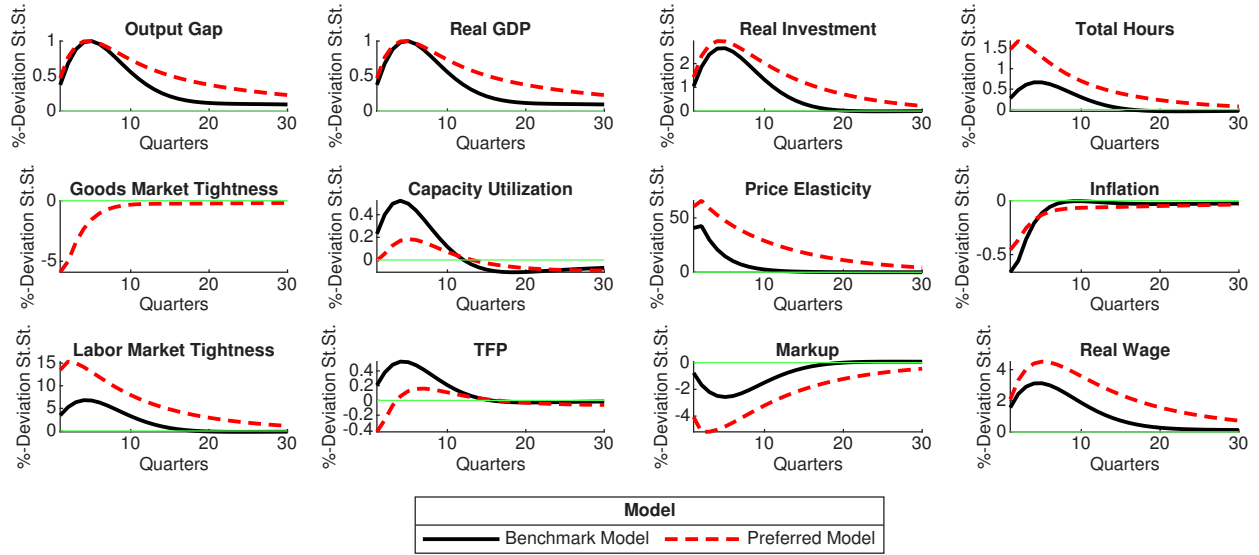
NOTE: The figure shows IRFs of different variables to different business cycle shocks for both the benchmark and preferred models. The deviations are measured in percentage deviations from the deterministic steady-state. IRFs are normalized across models by scaling with the absolute maximum deviation of real GDP in each model.

**Figure E.22:** IRFs to an Expansionary Wage Cost-Push Shock



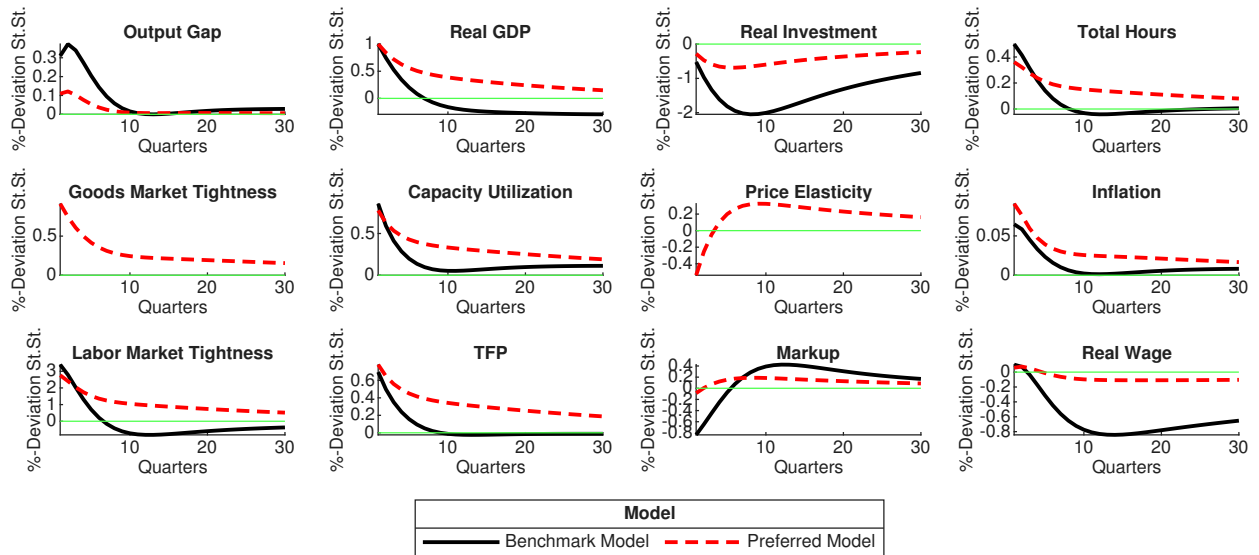
NOTE: The figure shows IRFs of different variables to different business cycle shocks for both the benchmark and preferred models. The deviations are measured in percentage deviations from the deterministic steady-state. IRFs are normalized across models by scaling with the absolute maximum deviation of real GDP in each model.

**Figure E.23: IRFs to an Expansionary Price Cost-Push Shock**



NOTE: The figure shows IRFs of different variables to different business cycle shocks for both the benchmark and preferred models. The deviations are measured in percentage deviations from the deterministic steady-state. IRFs are normalized across models by scaling with the absolute maximum deviation of real GDP in each model.

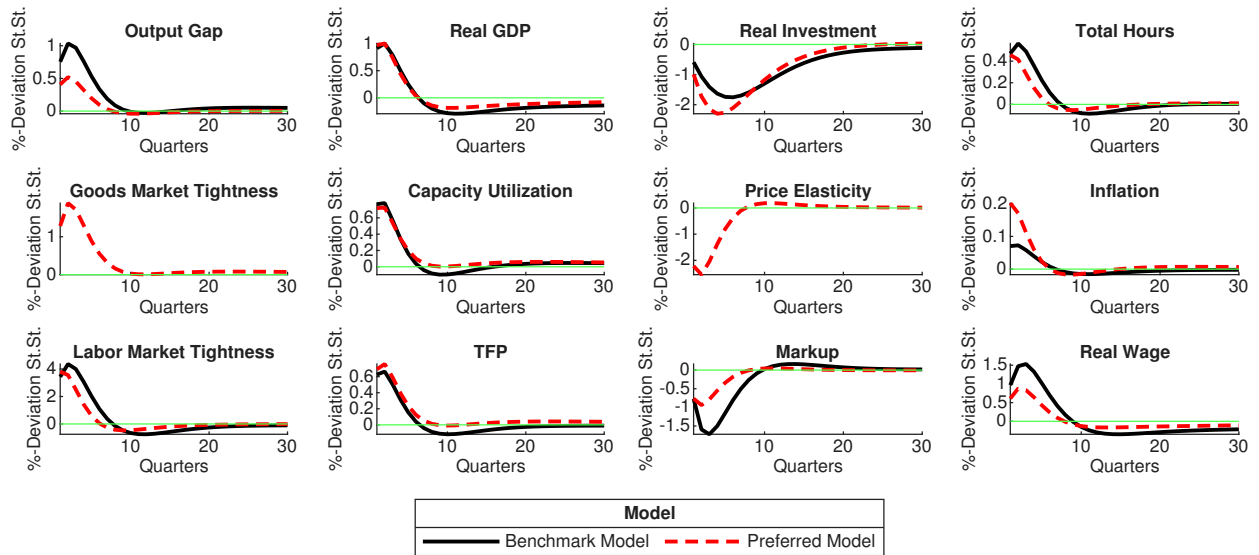
**Figure E.24: IRFs to an Expansionary Exogenous Spending Shock**



NOTE: The figure shows IRFs of different variables to different business cycle shocks for both the benchmark and preferred models. The deviations are measured in percentage deviations from the deterministic steady-state. IRFs are normalized across models by scaling with the absolute maximum deviation of real GDP in each model.



**Figure E.25:** IRFs to an Expansionary Discount Factor Shock



*NOTE: The figure shows IRFs of different variables to different business cycle shocks for both the benchmark and preferred models. The deviations are measured in percentage deviations from the deterministic steady-state. IRFs are normalized across models by scaling with the absolute maximum deviation of real GDP in each model.*