The Fed - Search Frictions, Labor Supply, and the Asymmetric Business Cycle

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We develop a business cycle model with search frictions in the labor market and a labor supply decision along the extensive margin that yields cyclical asymmetry between peaks and troughs of the unemployment rate and symmetric fluctuations of the labor force participation rate as in the U.S. data. We calibrate the model and find that cyclical changes in the extent of search frictions are solely responsible for the peak-trough asymmetry. Participation decisions do not generate asymmetry but contribute to the fluctuations in search frictions by changing the size and composition of the pool of job seekers, which in turn affects the tightness ratio and thereby slack in the labor market. The participation rate would be counterfactually asymmetric absent labor supply responses to shocks.