

Chapter 1

A Meso-economic Aggregation Rule for Microeconomic Shocks*

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Abstract

Latest theoretical advances have called the invariance of sales shares with respect to productivity differences into question, arguing that sizable higher-order macroeconomic effects may emerge when sales shares react to productivity shocks. Here we propose a parsimonious model for the adjustment of sales shares in response to productivity shocks, and operationalize it to readily quantify the impact of idiosyncratic shocks on aggregate fluctuations. Using input-output data for the European (EU28) economy, we find that our model significantly outperforms recently suggested specifications that rely either on the granularity of sales shares or the heavily skewed distribution of connections in production networks. While our results confirm earlier findings in the sense that microeconomic shocks are an important driver of macroeconomic fluctuations, we demonstrate that previous approaches substantially underestimate their relative impact because they fail to account for what we term the meso-economic interaction of granularity and network effects. Our main empirical finding is that idiosyncratic shocks to less than two percent of industries already explain almost eighty percent of the business cycle once we account for this interaction.

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