

JEDC to florian

Ms. Ref. No.: JEDC-D-14-00233

Title: Endogenous profitability risk

Journal of Economic Dynamics and Control

Dear Mr. Florian Kuhn,

Thank you for submitting your paper to the Journal of Economic Dynamics and Control. Fyi, JEDC has a new editorial board and is in transition, trying to improve quality and turnaround times. Over the next several years JEDC would like to get much closer to being a top field journal. During the transition the threshold for acceptance has increased.

I have reports from two reviewers and a letter from an associate editor. All of them are experts on the subject matter of your paper. The two reviewers are generally positive about your paper and recommend major revisions; the associate editor is positive as well, but recommends rejection since the revision involves a substantial amount of work (more on this below). After reading the reports and the associate editor's letter, I came to the conclusion that the contribution of your paper in its current form is not significant enough for a top field journal like the JEDC. I decided to reject the paper although you will see below that it is not a straightforward reject.

Both reviewers and the associate editor like your idea of generating countercyclical dispersion of revenue productivity. All of them think there is something novel here. The main area that needs improvement is the execution of your novel idea in a convincing manner. For instance, the mechanism that you propose has sharp predictions for pricing and investment policies of high and low productivity firms. Business cycle evidence pointing to the mechanism in your paper would be persuasive to the reader.

Below you will see numerous suggestions for revising your paper, ranging from model improvements to better calibration. The suggestions call for a major overhaul of the paper, to an extent that the new paper could not be called a "revision." (I am trying to mimic at least the spirit of Spiegel, 2012, RFS, "Reviewing less progressing more" <http://rfs.oxfordjournals.org/content/25/5/1331>.) So, should you submit the "revision" to JEDC, it would be a new submission. You are welcome to cite the history of this paper and request me as an editor if you wish. Should you choose to pursue this path and submit it again to JEDC I would be happy to consider it. And, I will send it to the same reviewers and associate editor, so your efforts to revise the paper are not wasted. (In short, your paper falls into the "reject/revise" category, which is formally non-existent in JEDC; hence, the new submission noted above.)

For your guidance, the reviewers' comments are included below.

Thank you for giving us the opportunity to consider your work and we hope you will consider Journal of Economic Dynamics and Control for your future papers.

Yours sincerely,

B Ravikumar

Co-Editor

Journal of Economic Dynamics and Control

Reviewers' comments:

Please note that editors and/or reviewers may have uploaded files related to this submission. To access these file(s) while you are not logged into the system, please click on the link below. (Note: this link will expire after 5 clicks or 30 days.) Alternatively, you may log in to the system and click the 'View Review Attachments' link in the Action column.

Please note that editors and/or reviewers have uploaded files related to this submission. To access these file(s) while you are not logged into the system, please click on the link below. (Note: this link will expire after 5 clicks or 30 days.) Alternatively, you may log in to the system and click the 'View Review Attachments' link in the Action column.

Reviewer #1: See the pdf attachment.

Reviewer #2: The paper considers monopolistic competitive firms with firm-specific (physical) productivity and fixed costs of capital adjustment. If high productivity firms are more likely to adjust their capital, then in a recession, high productivity firms can support their price better by scaling down production: hence the gap in revenue productivity between high and low productivity firms widens although the gap in physical productivity stays the same. This is the main result: the countercyclical dispersion in revenue productivity arises endogenously.

1. The paper targets the uncertainty literature and claims that its result shows uncertainty shocks needed to explain the empirical findings on the countercyclical firm risk may be smaller. This claim is misleading. The uncertainty literature uses the dispersion in productivity (or other firm performance measures) "growth rates" as a measure of firm risk and documents its countercyclical. This paper endogenizes the dispersion in productivity "levels" only, which the uncertainty literature rightly doesn't rely on. I think it is more appropriate for this paper to target the literature (the paper mentions a few in Introduction) which does focus on the dispersion in productivity "levels": this literature typically explains the cyclical of productivity dispersion by time-varying reallocation, and this paper offers an alternative explanation.

2. It would be very interesting if the paper can provide more direct empirical evidence on its key mechanism: Is the relative price of high to low productivity firms countercyclical in the data? Is the relative size of high to low productivity firms procyclical? Do high productivity firms adjust capital more readily over the business cycle?

3. It is empirically well documented that firm-level volatility is far larger than aggregate volatility. The paper, however, assumes the standard deviation of aggregate shocks is similar to that of idiosyncratic shocks for the baseline results. Moreover, the paper shows the time variation in productivity dispersion is quite sensitive to the size of idiosyncratic shocks. This raises doubt about calibration.

4. The author takes it for granted that the benefit of capital adjustment is larger for high productivity firm (page 12), but it is not obvious: high productivity firms tend to accumulate more capital, hence the marginal value of capital is not necessarily higher than low productivity firms. It would be helpful to see the computed policy function indeed displays this pattern in a range of parameters. As another robustness check, I would explore the case in which the fixed capital adjustment cost is denominated in units of labor: it will help determine whether the paper's result is instead driven by procyclical capital adjustment by all-both high and low productivity-firms.

5. The paper claims that another contribution is to endogenously generate countercyclical credit spreads and credit spread dispersion, but the paper does not explain how the model generates this result at all. It is well known that costly external finance model typically implies procyclical credit spreads as high investment in a boom leads to a rise in leverage and default risk. It would be interesting to see what drives the opposite result in this paper.

6. The aggregate state of the model includes the distribution of heterogeneous firms over productivity, capital and debt. The paper approximates this distribution by the mean of capital only. It is not clear why the mean of debt is not used as well. It is hard to judge approximation accuracy in heterogeneous firm models, but it would be still helpful to see the resulting forecasting rules and some sensitivity analysis.

7. The representative household receives all profits from the banking and intermediate good sectors, but their stochastic discount factors are all different: the banking sector is risk neutral, and the intermediate good sectors are less patient. This inconsistency should be fixed.

For further assistance, please visit our customer support site at <http://help.elsevier.com/app/answers/list/p/7923>. Here you can search for solutions on a range of topics, find answers to frequently asked questions and learn more about EES via interactive tutorials. You will also find our 24/7 support contact details should you need any further assistance from one of our customer support representatives.