Risky Business Cycles*

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Abstract

We identify a shock that explains the bulk of fluctuations in equity risk premia, and show that the shock also explains a large fraction of the business-cycle comovements of output, consumption, employment, and investment. Recessions induced by the shock are associated with reallocation away from full-time permanent labor positions, towards part-time and flexible contract workers. A flexible-price model with labor market frictions and fluctuations in risk appetite can explain all of these facts, both qualitatively and quantitatively. The size of risk-driven fluctuations depends on the relationship between the riskiness and the marginal product of different stores of value: if safe savings vehicles have relatively low marginal products, then a flight to safety will drive a larger aggregate contraction.

Keywords: Business Cycles; Risk Premia; Uncertainty.
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