Recent studies find that shocks to the marginal efficiency of investment are main drivers of business cycles. However, they struggle to explain why consumption co-moves with key real variables such as investment and output. In this paper, we show that, within a conventional business cycle model, rule-of-thumb consumption provides a straightforward explanation of macroeconomic co-movement after a shock to the marginal efficiency of investment.
financial markets to smooth consumption, instead spending their entire disposable income each period. We build our analysis on the model used by Gali, López-Salido, and Valles (GLV, hereafter) (2007) to explain how government spending can stimulate private consumption, extended with sticky wages, as in Furlanetto (2011) and Furlanetto and Seneca (2012). As in standard models, when the economy is hit by an MEI shock, agents who trade in financial markets cut consumption to finance investment. Rule-of-thumb agents, in contrast, increase their consumption because the MEI shock stimulates labour income. Hence, if the share of rule-of-thumb agents is large enough, aggregate consumption may increase.

A central feature of our model is nominal rigidity. Nominal rigidities effectively work to shift the labour demand schedule up following a positive MEI shock, as they prevent firms from increasing prices and workers from increasing wages. This feature allows consumption to increase along with investment, output, and hours worked following the shock. Although price rigidity alone may allow rule-of-thumb consumption behaviour to generate co-movement following an MEI shock, co-movement can be achieved for a much larger subset of the parameter space if both prices and wages are rigid.

We include nominal wage rigidity for other reasons as well. In addition to its empirical justification, wage stickiness has proven to be particularly important in models with rule-of-thumb consumers as equilibrium dynamics are highly sensitive to other model-specific assumptions when wages are flexible, as emphasised by Colciago (2011) and Natvik (forthcoming). In addition, we show that the inclusion of wage stickiness leads to an aggregate consumption Euler equation in a model with rule-of-thumb behaviour that is observationally different from the Euler equation arising from a model in which preferences are non-separable in consumption and leisure. This finding is interesting because non-separability has previously been proposed as an explanation of macroeconomic co-movement.4

Beyond providing a simple explanation of positive co-movement of consumption with other key variables after MEI shocks, our results contribute to the literature on rule-of-thumb consumers in macroeconomic models. Previous studies have primarily focused on explaining the effects of fiscal shocks (GLV, 2007; Mankiw, 2000) and neutral technology shocks (Furlanetto and Seneca, 2012), as well as the monetary policy stance required to prevent equilibrium indeterminacy (GLV, 2004; Bilbiie, 2008; Natvik, 2009; Motta and Tirelli, 2012). As recent evidence from estimated models points toward MEI shocks as the main driver of business cycles, our finding is potentially the most important reason to account for rule-of-thumb behaviour in macroeconomic models.

The paper is organised as follows. Section 2 briefly presents the model, and Section 3 describes its parameterisation. The results are presented in Section 4. Section 5 discusses the role of wage rigidity. Section 6 concludes.

2. The model

We consider a dynamic stochastic general equilibrium (DSGE) model with sticky wages, sticky prices, endogenous capital accumulation, capital adjustment costs, and rule-of-thumb consumers. Essentially, our model is the one proposed by GLV (2007) augmented with wage stickiness. We therefore go straight to presenting the log-linear version of the model. The derivation of the New Keynesian Phillips curve for wages that distinguishes our model from the one in GLV is given in the appendix. We use lower-case letters to denote variables in log-deviations from steady state and upper-case letters without time subscripts to express steady state values.

Our main interest is the MEI-shock, $m_t$, which affects the transformation of current investment, $i_t$, into future capital, $k_{t+1}$, as seen in the capital accumulation equation

$$k_{t+1} = (1 - \delta)k_t + \delta(k_t + m_t),$$

where $\delta$ is the depreciation rate. The shock follows the exogenous process

$$m_t = \rho_m m_{t-1} + \epsilon_{mt},$$

where $\rho_m$ measures the persistence of the shock process and $\epsilon_{mt}$ is an i.i.d. innovation.

The economy consists of a continuum of firms, a continuum of households, a continuum of labour unions, a central bank responsible for monetary policy, and a government that collects a constant stream of lump-sum taxes to finance a fixed amount of government spending. There is monopolistic competition in goods and labour markets with a continuum of differentiated intermediate goods and a continuum of differentiated labour services. These features lead to downward-sloping demand curves for each intermediate good and each labour type.

A fraction $\lambda$ of households are rule-of-thumb consumers. These agents simply consume their respective disposable incomes each period:

$$c_t' = \frac{WN}{\bar{PC}} (w_t - p_t + n_t).$$

(1)

Here, $w_t$ is the nominal wage, $p_t$ is the price level, and $n_t$ is the number of hours worked by each rule-of-thumb agent.

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4 In the literature, alternative explanations of co-movement in response to MEI shocks have been given. Greenwood et al. (1988) and Jaimovich and Rebelo (2009) propose preferences with low or no wealth effect on labour supply together with variable capacity utilisation. Guerrieri et al., 2010) obtain co-movement in a two-sector model. Furlanetto and Seneca (2010) show that a combination of non-separable preferences and nominal rigidities deliver co-movement under very general parameterisations. Eusepi and Preston (2009) emphasise heterogeneity in consumption between employed and unemployed workers. Kahn and Tsoukalas (2011) combine some of these elements and show that it is possible to obtain co-movement in an estimated model.
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