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Güneş Kamber, Konstantinos Theodoridis, Christoph Thoenissen

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News-driven business cycles in small open economies *

Güneş Kamber[†] Konstantinos Theodoridis[‡] Christoph Thoenissen[§]

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Abstract

The focus of this paper is on news-driven business cycles in small open economies. We make two significant contributions. First, we develop a small open economy model where the presence of financial frictions permits the replication of business cycle co-movements in response to news shocks. Second, we use VAR analysis to identify news shocks using data on four advanced small open economies. We find that expected shocks about the future Total Factor Productivity generate business cycle co-movements in output, hours, consumption and investment. We also find that news shocks are associated with countercyclical current account dynamics. Our findings are robust across a number of alternative identification schemes.

Key words: News shocks, business cycles, open economy macroeconomics, financial frictions, VAR.

J.E.L. codes: E32, F4

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[†]Bank of International Settlements and CAMA. E-mail: Gunes.Kamber@bis.org

[‡]Bank of England. E-mail: Konstantinos.Theodoridis@bankofengland.co.uk

[§]Corresponding Author: University of Sheffield and CAMA. Department of Economics, University of Sheffield, Sheffield, S1 4DT, UK . E-mail: c.thoenissen@sheffield.ac.uk

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