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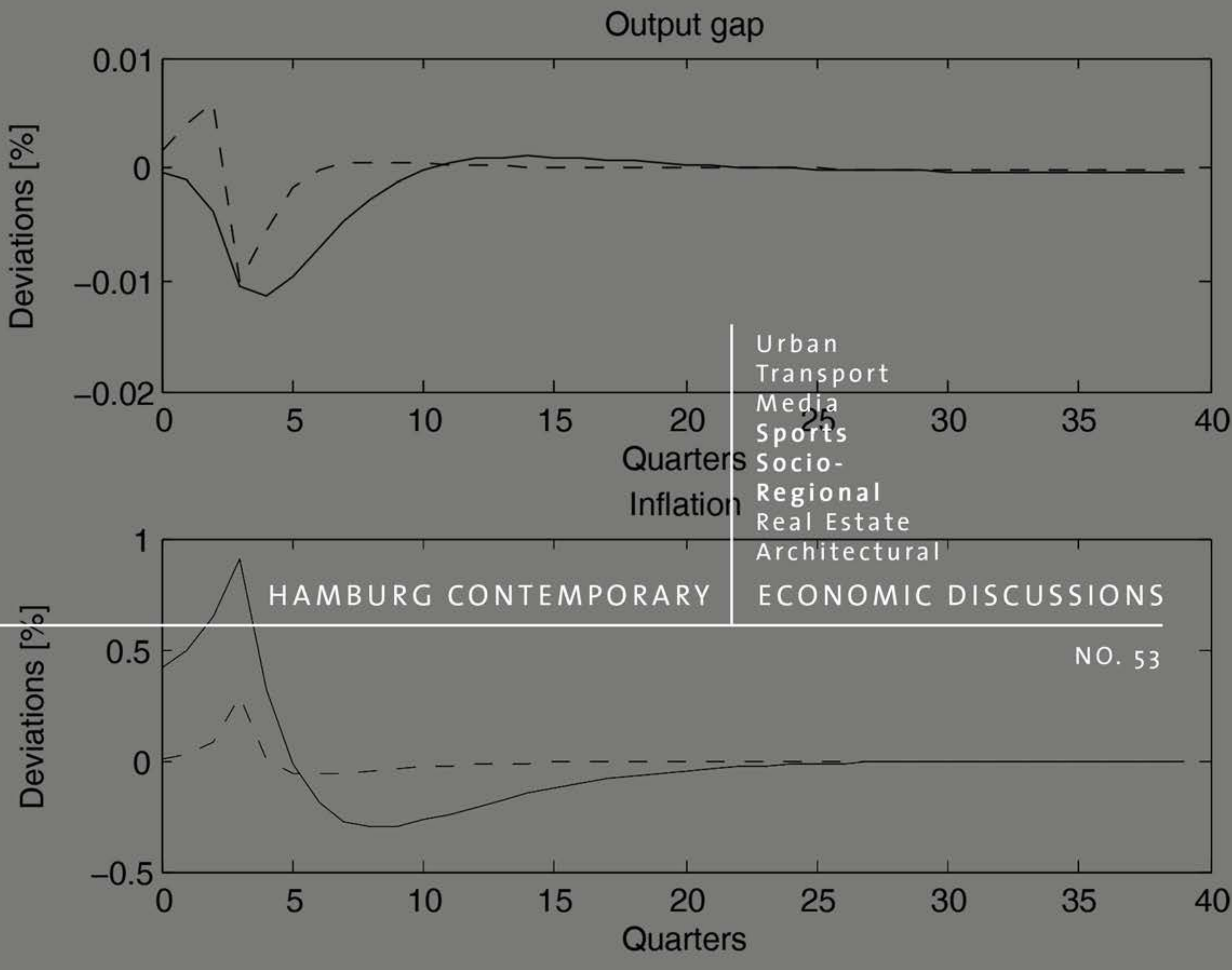
GOOD NEWS ABOUT NEWS SHOCKS



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Viktoria C. E. Langer

Good news about news shocks

Abstract: Extending and modifying the canonical New Keynesian (NK) model, this study provides a novel approach to examine the impact of anticipated shocks called "news shocks" on business cycles. The analysis shows that news shocks are less stressful for an economy than commonly assumed. The main results are as follows: (1) triggering lower economic fluctuations than unanticipated shocks of equal size news shocks behave in a welfare-enhancing manner, and (2) purely history-dependent monetary policy rules do not constitute an effective monetary instrument to keep welfare losses to a minimum.

Keywords: Anticipated shock; welfare; business cycle; monetary policy

JEL classification: E32, E52

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Highlights:

- An economy is better off with news shocks than with unanticipated shocks of equal size.
- Anticipation of forthcoming disturbances might stabilize business cycle fluctuations.
- Stabilizing economic fluctuation news shocks behave in a welfare-enhancing manner.
- The search for an optimal monetary policy rule reveals ambiguous results.

1 Introduction

Business cycles cannot be explained only on the basis of unpredictable random shocks that immediately cause reactions in current macroeconomic fundamentals, such as productivity. Also household's expectations about the future economic development represent a key determinant. Recent literature emphasizes the destabilizing effects of anticipated shocks as an important source of economic fluctuations (see, among others, Fève et al. (2009), Schmitt-Grohé and Uribe (2012), Beaudry and Portier (2006), Winkler and Wohltmann (2012), or Davis (2007)). Anticipated shocks contain useful information for predicting future fundamentals but do not cause changes in current fundamentals. Thus, news shocks affect only agent's expectations. However, Jaimovich and Rebelo (2009) can show that an increase in the availability of information leads to a reduction in economic fluctuation. For this purpose, they propose a Real Business Cycle framework that is able to generate pro-cyclical economic development in response to good news –

in form of anticipated productivity shocks – about the future. Applying the methods suggested by Jaimovich and Rebelo (2009) by embedding their preference structure in the basic NKM, this paper provides a novel model framework that corroborates their results: news shocks compared to unanticipated shocks may dampen the volatility of endogenous variables (such as output, consumption, and hours worked) and thus behave in a welfare-enhancing manner. Given this, the study addresses the question of how monetary policy should be conducted in a dynamic stochastic general equilibrium (DSGE) model.

The paper is organized as follows: Section 2 details the DSGE model framework. Section 3 investigates macroeconomic volatility effects and monetary policy implications of when an economy is faced with (un)anticipated disturbances. Section 4 concludes.

2 Theoretical framework

Assume a rational expectations NK model[1] for a cashless economy without capital as proposed by Galí (2008). However, the conventional additively separable utility function of the canonical NK model is replaced by a preference structure first proposed by Greenwood et al. (1988) and generalized by Jaimovich and Rebelo (2009). Thus, the utility of an infinitely-lived representative household takes the form

$$E_t \sum_{k=0}^{\infty} \beta^k \, U_{t+k}(C_{t+k}, N_{t+k}, S_{t+k}) = E_t \sum_{k=0}^{\infty} \beta^k \left[\frac{\left(C_{t+k} - \psi N_{t+k}^{\theta} S_{t+k}\right)^{1-\sigma} - 1}{1-\sigma} \right] \quad (1)$$

with $S_{t+k} = C_{t+k}^{\gamma} S_{t+k-1}^{1-\gamma}$, (2)

where $U_{t+k}(k = 0,1,2, \dots), 0 < \beta < 1, \psi > 0, \gamma \in (0,1], \theta > 0,$ and $\sigma > 0$. E_t is the expectation operator, conditional on information available up to period t. β is the discount factor. S_t, the geometric average of the current and the past consumption level, represents a backward-looking element. Eqs. (1) and (2) denote the nonseparability in preferences over consumption C_t and labor service N_t. $\frac{1}{\sigma}$ and θ represent the intertemporal elasticity of consumption and labor supply, respectively. A crucial element in this utility function is parameter $\gamma \in (0,1]$, as this parameter stands for the household's substitution behavior between consumption and hours worked (or leisure)

[1] For a detailed derivation of the basic NK model see, among others, Galí (2008).

as a consequence of an economic shock. If, for example, a favorable productivity shock hits an economy, households increase both consumption and leisure. The latter requires a reduction in labor supply which causes a decline in output. Controlling the household's adjustment process or, in other words the strength of the wealth effect on labor supply suggests the possibility to generate procyclical comovements of endogenous variables in the presence of unanticipated shocks as well as news shocks of equal magnitude.
In addition, households maximize their utility given by Eq. (1) subject to Eq. (2) and the period budget constraint

$$C_{t+k} = \frac{-B_{t+k}}{P_{t+k}} + \frac{W_{t+k}}{P_{t+k}} N_{t+k} + (1 + i_{t+k-1}) \frac{B_{t+k-1}}{P_{t+k}} + \Pi^r_{t+k} - \frac{T_{t+k}}{P_{t+k}}. \tag{3}$$

The Lagrangian is then given by

$$L_t = E_t \sum_{k=0}^{\infty} \beta^k \left\{ \frac{\left(C_{t+k} - \psi N^{\theta}_{t+k} S_{t+k}\right)^{1-\sigma} - 1}{1-\sigma} + \lambda_{1,t} \left(C_{t+k} + \frac{B_{t+k}}{P_{t+k}} - \frac{W_{t+k}}{P_{t+k}} N_{t+k} - (1 + i_{t+k-1}) \frac{B_{t+k-1}}{P_{t+k}} - \Pi^r_{t+k} + \frac{T_{t+k}}{P_{t+k}} \right) + \lambda_{2,t} \left(S_{t+k} - C^{\gamma}_{t+k} S^{1-\gamma}_{t+k-1} \right) \right\}, \tag{4}$$

where $\lambda_{1,t}$ and $\lambda_{2,t}$ are the Lagrangian multipliers on the corresponding constraints. Moreover, the notation is as follows: B_t denotes riskless nominal government bonds, i_t is the nominal interest rate, P_t is the price level, T_t represents nominal taxes or dividends, W_t is nominal wage, and Π_t denotes real profits. The first-order conditions for an economy's planning problem are:

$$\frac{\partial L}{\partial C_t} = X_t^{-\sigma} + \lambda_{1,t} - \lambda_{2,t} \gamma C_t^{\gamma-1} S_{t-1}^{1-\gamma} = 0 \tag{5}$$

$$\frac{\partial L}{\partial N_t} = -\lambda_{1,t} \frac{W_t}{P_t} - X_t^{-\sigma} N_t^{\theta-1} \psi S_t \theta = 0 \tag{6}$$

$$\frac{\partial L}{\partial S_t} = \lambda_{2,t} - \psi N_t^{\theta} X_t^{-\sigma} + \beta(\gamma - 1) C_{t+1}^{\gamma} \lambda_{2,t+1} S_t^{-\gamma} = 0 \tag{7}$$

$$\frac{\partial L}{\partial B_t} = \lambda_{1,t} \frac{1}{P_t} - \beta \lambda_{1,t+1} (1 + i_t) \frac{1}{P_{t+1}} = 0 \tag{8}$$

with $X_t = C_t - \psi N_t^{\theta} S_t$.

The combination of Eqs. (5), (6) and (8) yields the non-linear forward-looking IS curve

$$\frac{\lambda_{2,t}}{\lambda_{2,t+1}}\frac{\gamma C_t^{\gamma-1}S_{t-1}^{1-\gamma}+\lambda_{1,t}\frac{W_t N_t^{1-\theta}}{P_t\,\psi S_t\theta}}{\gamma C_{t+1}^{\gamma-1}S_t^{1-\gamma}+\lambda_{1,t+1}\frac{W_{t+1}\,N_{t+1}^{1-\theta}}{P_{t+1}\,\psi S_{t+1}\theta}}=\beta\frac{1(1+i_t)}{\pi_{t+1}}. \tag{9}$$

Finally, the model comprises the log-linearized form of the standard pure forward-looking dynamic NK Phillips curve which is given by

$$\hat{\pi}_t=\beta E_t\hat{\pi}_{t+1}+\kappa\hat{z}_t+\hat{e}_t, \tag{10}$$

where $(0<\beta<1)$.[2]

$\hat{\pi}_t$ is inflation and $\hat{z}_t$ denotes the output gap and $\hat{e}_t$ is a temporary cost-push shock. Parameter $\kappa=(\sigma+\theta)\frac{(1-\omega)(1-\omega\beta)}{\omega}$ refers to the negative correlation between the degree of price rigidity ω and the inflation rate: $\frac{d\kappa}{d\omega}=\frac{\beta\omega^2-1}{\omega^2}<0$.

3 Welfare analysis and monetary policy

In the following analyses, business cycle fluctuations in the model are driven by temporary (un)anticipated cost-push shocks $\hat{e}_t$ (price mark-up shocks, wage mark-up shocks). Therefore, $\hat{e}_t$follows an exogenous process and takes the log-linearized form $\hat{e}_t=\rho\hat{e}_{t-1}+\varepsilon_{t-q}$, where $\rho\epsilon[0,1)$ denotes persistence. ε_t denotes an i.i.d. random economic disturbance with zero mean, which is announced q quarters before it materializes. Note, for $q=3$ the innovation is signalized three quarters ahead, whereas for $q=0$ the disturbance is unpredictable by agents. The monetary authority adopts an inflation targeting regime, i.e. price stability is the main goal of monetary policy, and minimizes the intertemporal quadratic loss function. The loss function

$$J_t=E_t\sum_{k=0}^{\infty}\beta^k(\alpha_1\pi_{t+k}^2+\alpha_2 z_{t+k}^2) \tag{11}$$

is ad-hoc given, and does not follow from a second-order approximation of Eq. (1). In numerical simulations[3] of this study, the parameterization follows closely Jaimovich and

[2] Notice that variables with hats represent percentage deviation from steady state.

[3] Numerical simulations were solved with Dynare developed by Adjemian et al. (2011).

Rebelo (2009): $\alpha_1 = 1$, $\alpha_2 = 0.5$, $\beta = 0.99$, $\rho = 0.8$, $\sigma = 1$, $\delta_z = 0.5$, $\delta_\pi = 1.5$, $\omega = 0.75$. The parameters $\gamma = 0.007$ and $\theta = 1.16$ follow Schmitt-Grohé and Uribe (2012).

3.1 Monetary policy under commitment

Among others, Walsh (2010) supplies evidence that unrestricted policy under commitment constitutes the optimal monetary response when cost-push shocks enter an economy. This study indicates the same. Based on this, Tab. 1 depicts further results: by extending the anticipation horizon q, announced shocks mitigate the volatility of $\hat{z}_t$ (measured by the output gap variance ϕ_z) compared to analogous unanticipated shocks. As in the news-driven model suggested by Jaimovich and Rebelo (2009) the anticipation of forthcoming changes leads to a decline in macroeconomic volatility and therefore stabilizes economic fluctuation. These results seem to be intuitively. However, there is no general agreement concerning the contribution of news shocks in business cycles. By emphasizing the destabilizing effects of news shocks, another strand of literature argues exactly the converse. For instance, Schmitt-Grohé and Uribe (2012) estimate a DSGE model and claim that news shocks are an important source of economic fluctuations and account for the major part of the variance of macroeconomic fundamentals.

In line with Galí (2008), the results in Tab. 1 also indicate: the more fluctuation in output, the higher the welfare loss J_t. Furthermore, J_t is a decreasing function of the anticipation horizon. The sooner agents learn about a forthcoming cost-push shock, the lower the sustained social welfare loss. Moreover, due to an increasing wealth effect in labor supply and a decreasing output, high values of the key parameter γ involve drops in losses. The lowest loss $J_{q=8}^{\gamma=1} = 1.8385$ arises given a disturbance announced eight quarters ahead.

Tab. 1 Output gap variance and welfare loss in case of unrestricted monetary policy under commitment

		q = 0	q = 3	q = 8
$\gamma = 0.001$	ϕ_z	0.0020	0.0014	0.0011
	J_t	2.8211	2.2426	1.9455
$\gamma = 0.007$	ϕ_z	0.0022	0.0013	0.0007
	J_t	2.8212	2.2427	1.9457
$\gamma = 1$	ϕ_z	0.3370	0.2340	0.2005
	J_t	2.6431	2.1199	1.8385

Note: Tab. 1 reports the relative output gap variance ϕ_z and the welfare loss J_t in response to a temporary (un)anticipated cost-push shock ($\rho = 0.8$).

3.2 Optimal simple rules

This section discusses the structure and welfare implications of (optimal) simple policy rules in the presence of cost-push shocks. The monetary rules employed are variants of the canonical Taylor rule (see, Taylor (1993)) and condition on both inflation and output targeting. The values of the coefficients $\delta_z, \delta_\pi, \delta_{z-1}, \delta_{\pi-1}, \delta_{z+1}$ and $\delta_{\pi+1}$ result from the minimization of the loss function J_t and depend on the underlying rule. The analyzed rules support the validity of the acquired results: welfare losses that arise due to anticipated cost-push shocks are lower than the corresponding losses of unpredictable shocks of equal size.

Tab. 2 Welfare loss due to (un)anticipated shocks in case of various monetary policy rules

	Monetary policy rule	Loss J_t		
		q = 0	q = 3	q = 8
I.	$i_t = f(z_t, \pi_t)$	2.8212	2.2430	1.9460
II.	$i_t = f(z_t, \pi_t, z_{t+1})$	2.8212	2.2431	1.9460
III.	$i_t = f(z_t, \pi_t, z_{t+1}, \pi_{t+1})$	2.8212	2.2430	1.9459
IV.	$i_t = f(z_t, \pi_{t+1})$	2.8220	2.2432	1.9460
V.	$i_t = f(z_{t+1}, \pi_t)$	2.8460	2.6505	2.3665
VI.	$i_t = f(z_t, \pi_t, z_{t-1})$	2.8259	2.2432	1.9462
VII.	$i_t = f(z_t, \pi_t, z_{t-1}, \pi_{t-1})$	2.8290	2.2430	1.9460
VIII.	$i_t = f(z_t, \pi_{t-1})$	2.8217	2.2430	1.9458
IX.	$i_t = f(z_{t-1}, \pi_t)$	2.8432	2.4199	2.1134
X.	$i_t = f(z_{t-1}, \pi_{t-1})$	3.1667	2.7164	2.1310

Note: Tab. 2 shows the welfare loss J_t due to a temporary (un)anticipated cost-push shock ($\rho = 0.8$) depending on the underlying rule (with $\gamma = 0.007$).

Assuming unpredictable $(q = 0)$ cost-push shocks, the lowest loss ($J^{I}_{q=0} = 2.8212$) comes along with a central bank's monetary policy in which interest rate rules respond to contemporaneous values of inflation and output. The analysis also indicates the same loss for policy rules that incorporate an additional forward-looking element and thus respond not only to current but also to expected future economic conditions (see rules II and III). These results are consistent with findings of Winkler and Wohltmann (2011) who assume a normal NK IS curve. Establishing unanticipated disturbances in the basic NKM, Winkler and Wohltmann (2011) demonstrate that the additional inclusion of forward-looking components has no influence on the performance of interest rate rules. Letting disturbances be announced $(q > 0)$ three or eight quarters before they hit an economy, the analysis reveals ambiguous results. The best results ($J^{VIII}_{q=3} = 2.2430$, $J^{VIII}_{q=8} = 1.9458$) yield monetary policy rule VIII. which comprises a current-looking value of output as well as an additional backward-looking element concerning inflation. However, rule III which includes current-looking as well as forward-looking values of both inflation and output, and monetary policy rule I which is purely current-looking also present a reasonable choice for a policy maker. In comparison with rule VIII, the deterioration obtained by applying rule III, or rule I. is rather small and does not show large differences in terms of associated welfare losses. Consequently, it is not possible to conclusively recommend an optimal strategy.

Furthermore, Tab. 2 shows another important finding: interest rate rules which are purely history-depending and which do not respond to contemporaneous values of output respectively, tend to have a negative effect on the performance of monetary policy rules and thus achieve the worst results ($J^{X}_{q=0} = 3.1667$,$J^{X}_{q=3} = 2.7164$, $J^{V}_{q=8} = 2.3665$), whether the cost-push shocks are anticipated or not.

4 Conclusion

This paper suggests a novel approach to investigate news shocks and their implications for monetary policy. At present, there is no consensus among economists regarding the (de)stabilizing effects of news shocks. However, by mitigating the volatility of macroeconomic variables, summarized by output volatility, this study offers evidence that the anticipation of forthcoming disturbances has a welfare-enhancing effect. Unrestricted monetary policy under commitment forms the optimal policy maker's choice. Based on the underlying welfare analysis, the question about an (optimal) simple monetary rule cannot be answered conclusively. But, depending on the chosen non-separable utility function, this study concludes that more information improves social welfare. Based on these findings, it can be rational for a central bank to announce monetary policy responses to economic shocks in advance.

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