Uncertainty shocks in a flexible price environment

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Abstract

Uncertainty shocks generate counter factual results in frictionless neoclassical models. Current theoretical frameworks are able to produce the right business cycle co-movements only under assumptions of nominal rigidities or search frictions. I document the relationship between uncertainty and a firm's financial soundness and propose a heterogeneous-firms business cycle model with flexible prices which delivers empirically consistent co-movements between macroeconomic aggregates and uncertainty shocks. Following a volatility shock, households seek to increase savings and expand labor supply due to precautionary motives. Under a state of heightened uncertainty, however, producers choose to make conservative bets about their production, reducing the amount of factor inputs they optimally hire. In line with the data, the model predicts drops in consumption, investment, hours worked and aggregate output

Keywords: Volatility shocks, Uncertainty, Firm Dynamics.

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