

Confidence and the Propagation of Demand Shocks*

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Abstract

We revisit the question of why shifts in aggregate demand drive business cycles. Our theory combines intertemporal substitution in production with rational confusion, or bounded rationality, in consumption and investment. The first element allows aggregate supply to respond to shifts in aggregate demand without nominal rigidity. The second introduces a “confidence multiplier,” that is, a positive feedback loop between real economic activity, consumer expectations of permanent income, and investor expectations of returns. This mechanism amplifies the business-cycle fluctuations triggered by demand shocks (but not necessarily those triggered by supply shocks); it helps investment to comove with consumption; and it allows front-loaded fiscal stimuli to crowd in private spending.

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1 Introduction

Fluctuations in consumer spending, such as those triggered by financial shocks, appear to cause business cycles in the data (Mian and Sufi, 2014). Yet, the mechanism through which such a drop in aggregate demand can precipitate a recession is debatable.

To fix ideas, take the textbook New Keynesian model and consider a negative discount rate shock (a standard proxy for shocks in consumer spending). Insofar as monetary policy stabilizes inflation (equivalently, replicates flexible-price outcomes), the drop in Aggregate Demand (AD) does *not* generate a recession. It only triggers an offsetting movement in the natural rate of interest.¹ How does the model then make room for demand-driven business cycles? By equating AD shocks to monetary contractions (relative to flexible-price outcomes), and to movements along a Phillips curve.

This seems unsatisfactory, not only for intellectual reasons but also on empirical grounds. Phillips curves are elusive in the data (Mavroeidis, Plagborg-Møller, and Stock, 2014). And the principal component of the business cycle fits better the template of a non-inflationary, non-monetary demand shock (Angeletos, Collard, and Dellas, 2020). In our view, this calls for theories that let AD shocks be the main business-cycle driver without a strict reliance on nominal rigidity.

The theory articulated in this paper combines two key elements. The first element, intertemporal substitution in production via variable utilization, opens the door to demand-driven fluctuations in the natural rate of output. The second element, rational confusion or bounded rationality in the demand side of the economy, introduces a “confidence multiplier.” This is a feedback loop between outcomes and expectations that amplifies demand shocks (but not necessarily supply shocks), helps investment comove with consumption, and lets government spending crowd in private spending.

A non-vertical AS curve (with flexible prices). In the textbook New Keynesian model, there is no room for demand-driven business cycles when monetary policy replicates flexible price allocations. This is because Aggregate Supply (AS) is vertical in the sense that the aggregate production of today’s goods is irresponsive to their relative price, i.e., the real interest rate.² Our contribution starts with the elementary observation that the AS curve becomes non-vertical once we accommodate intertemporal substitution in production via the combination of two “neoclassical” features: variable capacity utilization; and adjustment costs to capital or investment.

More specifically, our baseline model allows for variable utilization but sets the aforementioned adjustment cost to be infinite. This accommodates the needed supply-side margin while abstracting—but only tentatively—from the question of whether investment comoves with consumption.

Our supply-side margin, which does not require either nominal rigidity or any departure from full information, seems empirically relevant on its own right: utilization is strongly pro-cyclical in the data.

¹This relates to the problem first highlighted in Barro and King (1984).

²Note that here we have in mind an AS curve in the space of real output today vs its *relative* price. This differs from the Keynesian tradition that casts the AS curve as a Phillips curve, namely as a positive relation between real output and the *nominal* price level, or the nominal inflation rate.

But a literal interpretation of this element of our theory is not strictly needed: as long as there is *some* neoclassical margin of intertemporal substitution in production, the second part of our contribution, which regards the Aggregate Demand (AD) side of the economy, is likely to go through.

AD and the confidence multiplier. With fully informed and fully rational consumers, the AD side of our model is standard: it boils down to the Euler condition of a representative consumer. We depart from this benchmark by letting consumers confuse aggregate and idiosyncratic income fluctuations when deciding how much to spend. In our main analysis, such confusion is rational, resulting from lack of information about, or inattention to, aggregate economic conditions.³ But it could also be the product of bounded rationality. Our key insight is that this friction introduces a Keynesian feedback loop in our neoclassical economy.

Following a negative AD shock, firms cut down on utilization and, along with it, labor demand and production. Consumers experience a drop in their current employment and income but can't tell whether this was because of a negative AD shock or an adverse idiosyncratic shock. For the reason explained next, this causes them to perceive a reduction in their permanent income even though no such reduction actually takes place.

In our environment, AD shocks have *no* effect on actual permanent income; they only shift the intertemporal decomposition of aggregate permanent income, not its total value. This property may seem counterintuitive under the prism of the New Keynesian model. But in a neoclassical economy such as ours, it follows naturally from a dynamic translation of [Hulten's \(1978\)](#) theorem: just as in his context sector-specific taste shocks have no first-order effect on GDP, in our context intertemporal taste shocks have no first-order effect on aggregate permanent income. This basic property has the following key implication for our purposes: as long as consumers confuse aggregate income fluctuations for idiosyncratic ones, a negative AD shock *necessarily* causes them to turn pessimistic about their permanent income, even though permanent income is actually fixed.

Consumers thus lose confidence, in the sense that they become excessively pessimistic relative to the full-information benchmark. As they do so, they also spend less, amplifying the original drop in aggregate demand. This feeds into a further cut in employment and output, a further drop in confidence, and so on. We refer to this mechanism as the “confidence multiplier.”

Discounting the GE adjustment in the real interest rate. Our confidence multiplier is active even if the AD shock lasts only one period. When it is persistent, an additional mechanism emerges: consumers discount the future GE adjustment in real interest rates, because they perceive the concurrent adjustment as “noise” and/or they under-estimate how much *others* are reducing their spending.

This mechanism is akin to the form of GE attenuation articulated in [Angeletos and Lian \(2017, 2018\)](#) with the help of incomplete information, and the close relatives obtained in [Farhi and Werning \(2019\)](#) and [Gabaix \(2020\)](#) with the help of bounded rationality. But whereas in the New Keynesian context, the

³This follows the traditions of [Lucas \(1973\)](#) and [Sims \(2003\)](#). See also [Mackowiak and Wiederholt \(2009\)](#) for why agents may optimally choose to be relatively uninformed about aggregate shocks.

focus of the latter three papers, GE attenuation translates to *under*-reaction of the output gap to news about future monetary policy, in our neoclassical context it maps to *over*-reaction of the natural rate of output to AD shocks.⁴ This mechanism thus complements our confidence multiplier in amplifying the business cycles triggered by such shocks.

Behavioral reinterpretation. The last paragraph hinted at how bounded rationality could substitute for incomplete information vis-a-vis the form of discounting discussed above. A similar point applies to our confidence multiplier: the same feedback loop may obtain in variants in which agents are fully informed but form simple extrapolative beliefs as in [Greenwood and Shleifer \(2014\)](#) and [Gennaioli, Ma, and Shleifer \(2016\)](#), or hold a sparse representation of the world as in [Molavi \(2019\)](#). This clarifies that the essential friction is the failure of consumers to differentiate their *responses* to idiosyncratic and aggregate shocks as finely as assumed in standard macro models. And it allows for a behavioral re-interpretation of our confidence multiplier, which we welcome.

Supply shocks. Consider AS shocks, namely aggregate TFP shocks. Such shocks *do* affect permanent income, so their confusion with idiosyncratic shocks has an ambiguous effect on consumer confidence: consumers under-estimate the aggregate fluctuations in permanent income at the same time that they over-estimate the idiosyncratic ones. In an empirically plausible benchmark, these effects wash out and our confidence multiplier is switched off. Furthermore, because the GE adjustment in the real interest rate triggered by supply shocks is the reverse of that triggered by demand shocks, the effect of the second mechanism is also the reverse: when consumers under-estimate the adjustment in future real interest rates, they respond *more* to demand shocks but *less* to supply shocks. All in all, supply shocks are thus dampened at the same time that demand shocks are amplified, helping match the observed disconnect between business cycles and TFP.⁵

Investment-consumption comovement. As previously mentioned, our baseline model assumes, in effect, an infinite adjustment cost for investment. If we let this cost be finite but non-zero, the intertemporal substitution margin remains active and, as a result, the equilibrium levels of utilization, employment, and output continue to increase with an AD shock. In this sense, the supply side of our theory is not affected. But a familiar puzzle emerges on the demand side: whenever consumers spend less, the real interest rate goes down, causing investment to move in the opposite direction.⁶

A version of our confidence multiplier applied to investment decisions helps resolve this puzzle. Insofar as investors are subject to a similar confusion as consumers, a temporary drop in *either* the household or the business component of aggregate demand can trigger a drop in *both* consumer

⁴This reflects an important difference in the underlying form of strategic interaction, or the way higher-order beliefs matter. See Section 5.4 for more details.

⁵Consistent with our theory, here we have in mind *utilization-adjusted* TFP in the data, as in [Basu, Fernald, and Kimball \(2006\)](#). See also [Blanchard and Quah \(1989\)](#), [Gali \(1999\)](#), [Barsky and Sims \(2011\)](#), and [Angeletos, Collard, and Dellas \(2020\)](#) for additional facets of the disconnect between technology and business cycles.

⁶This puzzle extends from the basic RBC model ([Barro and King, 1984](#)) to state-of-the-art DSGE models, such as [Justiniano, Primiceri, and Tambalotti \(2010\)](#) and [Christiano, Motto, and Rostagno \(2014\)](#). [Jaimovich and Rebelo \(2009\)](#) is a notable exemption, which we discuss in Section 2 below.

confidence (expectations of income) and investor sentiment (expectations of returns). This allows investment and consumption to comove.

Borrowers and savers. For essentially the same reason as that articulated above, our theory helps generate comovement across different consumers. In particular, when only a subset of the population is hit by an exogenous discount-rate shock (think of them as “borrowers” responding to a “credit crunch”), both the misperception of permanent income and the discounting of the future GE adjustment in the real interest rate contribute towards making the remaining agents (the “savers”) cut down their spending, too. This illustrates how our theory is distinct from, but also complementary to, theories emphasizing credit constraints.

Fiscal policy. Commentators often claim that fiscal policy can “boost confidence” without clarifying what this means.⁷ Our theory provides a way to think about this idea. On the one hand, it allows fiscal stimuli to boost consumer confidence in the sense defined here. On the other hand, it qualifies that this is possible only when the stimulus is front-loaded. Such a stimulus raises the aggregate demand for today’s goods, putting our confidence multiplier in motion. When this multiplier is large enough, the stimulus can *crowd in* private spending, despite the higher tax burden. By contrast, news of a backloaded stimulus fails to raise consumer confidence and necessarily crowds out private spending.

2 Related literature

Our theory fits the “main business cycle shock” identified by [Angeletos, Collard, and Dellas \(2020\)](#): the principal component of the business-cycle fluctuations in unemployment, GDP, hours worked, consumption, and investment in the data is largely disconnected from *both* technology and inflation. This provides support for a class of theories that aim at accommodating non-inflationary, non-monetary, demand-driven fluctuations. Examples of such theories include the older literature on coordination failures and multiple equilibria ([Benhabib and Farmer, 1994](#); [Cooper and John, 1988](#); [Diamond, 1982](#)), as well as a more recent literature that emphasizes other frictions ([Angeletos, Collard, and Dellas, 2018](#); [Angeletos and La’O, 2013](#); [Bai, Rios-Rull, and Storesletten, 2019](#); [Basu et al., 2021](#); [Beaudry and Portier, 2013, 2018](#); [Di Tella and Hall, 2021](#); [Huo and Rios-Rull, 2020](#)). Our marginal contribution vis-a-vis these literatures comes from two novel elements: the margin for intertemporal substitution on the supply side; and the confidence multiplier on the demand side. And although some of these works make room for fluctuations in “confidence,” they do so by equating such fluctuations to exogenous shifts across

⁷For instance, Robert Shiller made such a claim during the Great Recession (a similar claim is echoed in [Akerlof and Shiller, 2010](#)), prompting the following response by N. Gregory Mankiw (<http://gregmankiw.blogspot.com/2009/01/>):

“Yale’s Bob Shiller argues that confidence is the key to getting the economy back on track. I think a lot of economists would agree with that. The question is what it would take to make people more confident. ... Until we figure it out, it is best to be suspicious of any policy whose benefits are supposed to work through the amorphous channel of ‘confidence.’”

multiple equilibria or other *extrinsic* shocks to higher-order beliefs. We instead allow confidence to vary endogenously, and in response to *intrinsic* shocks.

Closely related in this respect are [Chahrouh and Gaballo \(2021\)](#) and [Ilut and Saijo \(2020\)](#). Like our paper, these papers let intrinsic shocks drive certain “wedges” in beliefs. In addition, [Chahrouh and Gaballo \(2021\)](#) features a form of rational confusion that reminds ours even though it works over different shocks;⁸ and [Ilut and Saijo \(2020\)](#) shares the idea of letting the aforementioned belief wedges be the source of comovement. Ultimately, though, the main difference is that both of these works focus on different phenomena and mechanisms than we do. The first focuses on how increases in housing prices driven by adverse supply shocks can be confused for good news about wealth, the second on how ambiguity and learning modify the propagation of shocks in the New Keynesian model.

Another distinctive feature of our paper is that it accommodates an informational friction in AD but rules it out in AS. This serves two functions. First, it allows us to preserve production efficiency, which in turn yields our translation of [Hulten’s \(1978\)](#) theorem in terms of the invariance of aggregate permanent income to AD shocks. And second, it separates our paper from previous works that have shown how informational frictions on the production side can also accommodate Keynesian elements without nominal rigidity, in effect by providing an information-based theory of the movements in the labor wedge (e.g., [Angeletos and La’O, 2010](#); [Angeletos, Collard, and Dellas, 2018](#); [Ilut and Saijo, 2020](#)). Needless to say, we view that mechanism and ours as strong complements.

Our confidence multiplier originates from an informational friction à la [Lucas \(1972\)](#), [Sims \(2003\)](#), and [Mackowiak and Wiederholt \(2009\)](#). Empirical evidence in support of such a friction abounds.⁹ Most recently, [Andrade et al. \(2020\)](#) document that firms confuse aggregate and idiosyncratic (industry-specific) shocks. We suspect the same is true for consumers. And while we commit to rational confusion for our main analysis, we welcome behavioral reinterpretations; see the discussion in Section 6.5. From this perspective, our theory has a similar flavor as the narrative in [Akerlof and Shiller \(2010\)](#).

Our combination of informational frictions and demand shocks is reminiscent of [Lorenzoni \(2009\)](#). That paper proposes a new micro-foundation of demand shocks, in terms of noise in expectations of future productivity and income. But it maintains the propagation mechanism of the New Keynesian model, translating such shocks to procyclical gaps from flexible-price outcomes. Our paper instead revisits the propagation mechanism itself, dropping nominal rigidity altogether and allowing for demand-driven fluctuations in the natural rate of output itself.

Last but not least, our paper connects to the RBC literature on utilization ([Burnside, Eichenbaum, and Rebelo, 1995](#); [Greenwood, Hercowitz, and Huffman, 1988](#); [King and Rebelo, 1999](#)). This literature has emphasized how variable utilization helps flatten the aggregate labor demand curve and amplify the response of aggregate employment and output to productivity and government spending shocks.

⁸While in our paper households confuse a *positive* aggregate demand shock for good news about idiosyncratic permanent income, in that paper households confuse a *negative* aggregate supply shock that raises house prices for such good news.

⁹See, inter alia, [Mankiw, Reis, and Wolfers \(2004\)](#), [Coibion and Gorodnichenko \(2012, 2015\)](#), [Coibion, Gorodnichenko, and Ropele \(2019\)](#), [Cavallo, Cruces, and Perez-Truglia \(2017\)](#), [Kohlhas and Walther \(2019\)](#), and [Angeletos, Huo, and Sastry \(2021\)](#). See also [Gabaix \(2019\)](#) for a review of the broader empirical and theoretical literatures on inattention.

But, with a notable exception that we discuss next, this literature has worked with models that render the choice of utilization to a static decision and has thus not accommodated our supply-side margin. The same is true for a DSGE literature that follows the lead of (Christiano, Eichenbaum, and Evans, 2005): that work, too, models utilization as a static decision.

The exemption alluded to above is Jaimovich and Rebelo (2009). That paper shares our two “neoclassical” ingredients, variable utilization and adjustment costs; and it shows that the combination of these ingredients with a third one, a certain form of internal habit in preferences, can generate positive co-movement out of news about future TFP. From this perspective, it may appear that we merely replace their assumption about preferences with an assumption about beliefs. But the differences are much subtler. First, the adjustment cost in Jaimovich and Rebelo (2009) takes the form postulated in Christiano, Eichenbaum, and Evans (2005) as opposed to the classic one in Q theory. This amounts to introducing a desire to smooth investment, which in turn is strictly needed for investment to respond positively to news shocks; with the classic formulation, investment would have moved in the opposite direction. And second, as highlighted in Lorenzoni (2011, p.541-2), the form of habit in Jaimovich and Rebelo (2009) amounts to assuming that labor supply *increases* in the short run with positive wealth shocks (e.g., capital gains). This is key to the model’s ability to generate a positive response in employment to news shocks, but seems counterfactual. By contrast, our model obtains the requisite co-movement in all the key macroeconomic variables, and in the price of capital as well, by letting (i) intertemporal substitution in production and (ii) correlated consumer and investor misperceptions.

The same bottom line separates our paper from Basu and Kimball (1997) and Miao, Wang, and Xu (2015). These works emphasize the forward-looking nature of utilization, but do not share either our focus on consumption-driven business cycles or our confidence mechanism.

3 The Model

We consider a neoclassical economy, with flexible prices. There is a single aggregate shock, which proxies for fluctuations in aggregate demand, and various idiosyncratic shocks, which play the dual role of introducing idiosyncratic income fluctuations and of allowing for an informational friction. This friction is the core element of the demand block of our model. The core element of the supply block is a margin for intertemporal substitution in production.

Islands. We represent the economy as a continuum of islands, indexed by $i \in [0, 1]$. On each island, there is a continuum of firms, each being a monopolistically competitive producer of a differentiated good. We use (i, j) to identify both the j -th variety produced on island i and the firm producing it, with $j \in [0, 1]$. On each island, there is also a representative household (or consumer), indexed by $h = i$. Time is discrete and horizons are infinite. In each period $t \in \{0, 1, \dots\}$, the household is employed on the particular island it resides in but consumes the goods of all islands.

Household preferences. The preferences of any household h are represented by

$$\mathcal{U}(c_0^h, n_0^h) + \beta_0^h \mathcal{U}(c_1^h, n_1^h) + \beta_0^h \beta_1^h \mathcal{U}(c_2^h, n_2^h) + \dots, \quad (1)$$

where c_t^h and n_t^h are its consumption and labor supply at t , β_t^h is its discount factor between t and $t+1$, and \mathcal{U} is the per-period utility function. The latter is given by

$$\mathcal{U}(c, n) = \frac{c^{1-\frac{1}{\sigma}}}{1-\frac{1}{\sigma}} - \frac{n^{1+\frac{1}{\nu}}}{1+\frac{1}{\nu}}, \quad (2)$$

where $\sigma > 0$ and $\nu > 0$ are, respectively, the elasticity of intertemporal substitution in consumption and the Frisch elasticity of labor supply.

Consumption is given by $c_t^h = F(\{c_{i,t}^h, \xi_{i,t}\}_{i \in [0,1]})$ with $c_{i,t}^h = H(\{c_{i,j,t}^h\}_{j \in [0,1]})$, where F and H are CES aggregators, $c_{i,j,t}^h$ is the consumption of variety j from island i in period t , $c_{i,t}^h$ is a consumption index for all the varieties consumed from island i in period t , and $\xi_{i,t}$ is an island-specific taste shock. The latter follows an AR(1) process with persistence $\rho_\xi \in [0, 1)$:

$$\log \xi_{i,t} = \rho_\xi \log \xi_{i,t-1} + \log \epsilon_{i,t}^\xi, \quad (3)$$

where $\xi_{i,-1} = 1$ and $\log \epsilon_{i,t}^\xi \sim \mathcal{N}(0, \sigma_\xi^2)$ is i.i.d. across (i, t) and independent from other shocks.

One can think of the islands as different categories of expenditure. To simplify the exposition, we fix the elasticity of substitution across them to 1. On the other hand, we let the elasticity of substitution across the different varieties of the same island be $1 + \frac{1}{\mu}$, for some $\mu > 0$ that ultimately pins down the monopoly markup.¹⁰ Perfect competition is nested as $\mu \rightarrow 0$.¹¹

AD shocks. The household's discount factor follows an AR(1) process with persistence $\rho_\beta \in [0, 1)$:

$$\log \beta_t^h = (1 - \rho_\beta) \log \beta + \rho_\beta \log \beta_{t-1}^h - \log \eta_t + \log \epsilon_t^{\beta,h}, \quad (4)$$

where $\beta \in (0, 1)$ is the steady-state discount factor, $\beta_{-1}^h = \beta$, $\log \eta_t \sim \mathcal{N}(0, \sigma_{\text{AD}}^2)$ is the aggregate innovation, i.i.d. across t , and independent of all other shocks, and $\log \epsilon_t^{\beta,h} \sim \mathcal{N}(0, \sigma_\beta^2)$ is the idiosyncratic innovation, i.i.d. across (h, t) , and independent of other shocks. The aggregate innovation introduces fluctuations in aggregate demand. Note in particular that η_t enters (4) with a minus, so that a positive realization for η_t corresponds to an urge to consume more, or a positive AD shock. Finally, the sole modeling role of the idiosyncratic shock, $\epsilon_t^{\beta,h}$, is to make sure that the household does not know the aggregate shock even though it knows its own discount factor.

Inter-temporal trading. Let R_t denote the aggregate, real, gross, interest rate between t and $t+1$. The corresponding rate faced by the household on island i is given $R_{i,t} = R_t \epsilon_{i,t}^R$, where $\log \epsilon_{i,t}^R \sim \mathcal{N}(0, \sigma_R^2)$ is an idiosyncratic shock, i.i.d. across (i, t) , and independent from other shocks. This idiosyncratic shock can be interpreted as the product of a random intermediation cost and its sole modeling role is

¹⁰That is, $F(\{c_{i,t}^h, \xi_{i,t}\}_{i \in [0,1]}) = \exp\left(\frac{\int_{i \in [0,1]} \xi_{i,t} \ln(c_{i,t}^h) di}{\int_{i \in [0,1]} \xi_{i,t} di}\right)$ and $H(\{c_{i,j,t}^h\}_{j \in [0,1]}) = \left(\int_{j \in [0,1]} (c_{i,j,t}^h)^{\frac{1}{1+\mu}} dj\right)^{\mu+1}$.

¹¹Monopoly power is allowed but not strictly needed. It only facilitates the narrative that firms respond to consumer demand instead of Walrasian prices, and a bridge to the New Keynesian model (Appendix B).

to limit the information extracted from interest rates.¹² Rational inattention (Sims, 2003; Mackowiak and Wiederholt, 2009) can play a similar modeling role: the results are essentially unchanged if we reinterpret $\epsilon_{i,t}^R$ as idiosyncratic noise in the observation of R_t .

Household budget. The household's total income in period t is $w_{h,t}n_t^h + e_{h,t}$, where $w_{h,t}$ is the wage on the island $i = h$ the household lives in, and $e_{h,t}$ is the sum of the local profits, which the household receives as dividends. Its budget constraint can therefore be written as follows:

$$\int_{i \in [0,1]} \int_{j \in [0,1]} p_{i,j,t} c_{i,j,t}^h dj di + R_{h,t}^{-1} b_{t+1}^h = w_{h,t} n_t^h + e_{h,t} + b_t^h, \quad (5)$$

where $p_{i,j,t}$ is the price of good (i, j) in period t and b_t^h is the net amount of bonds held at the start of period t , with $b_0^h = 0$. All prices and wages are real, quoted in the same-period basket of goods.

Firms and production. Consider firm j on island i . Production is given by a Cobb-Douglas form between labor and land services, so the firm's physical output in period t is given by

$$q_{i,j,t} = (l_{i,j,t})^\alpha (u_{i,j,t} k_{i,j,t})^{1-\alpha}, \quad (6)$$

where $l_{i,j,t}$ is the labor input and $u_{i,j,t} k_{i,j,t}$ are land services. The latter are given by the product of effective land quantity, $k_{i,j,t}$, and utilization rate, $u_{i,j,t}$.

Each firm is a monopolist in the market for the particular commodity it produces and a price taker in the labor market of the island it operates in (and so is the island's representative household). The firm's operating profit in period t is given by $\pi_{i,j,t} = p_{i,j,t} q_{i,j,t} - w_{i,t} l_{i,j,t}$, where $p_{i,j,t}$ is the price of good (i, j) and $w_{i,t}$ is the wage of the local labor market in island i . The firm owns its own land, and is itself owned by the local household. It follows that the firm's objective is its expectation of $\sum_{s=0}^{\infty} m_{i,t,t+s} \pi_{i,j,t+s}$, where $m_{i,t,t+s} \equiv E_t^i[(\prod_{l=1}^s \beta_{l-1}^h) \mathcal{U}_c(c_{t+s}^i, n_{t+s}^i)]$ is the local pricing kernel, or the marginal utility of consumption for household $h = i$. Finally, since each firm in island i distributes its profits as dividends to the local household, the latter's dividend income is given by $e_{h,t} = \int \pi_{h,j,t} dj$.

Land and utilization. The "effective" quantity of land obeys the following law of motion:

$$k_{i,j,t+1} = (1 - \delta(u_{i,j,t})) k_{i,j,t}, \quad (7)$$

where $k_{i,j,0} = \bar{k}_0 > 0$ and $\delta(\cdot)$ is an increasing and convex function. This function captures the negative effect of higher utilization today on land productivity tomorrow. This resembles models where the depreciation of capital increases with its utilization, except that here there is no investment margin.

Accordingly, and to guarantee the existence of a steady state, we herein require that δ is such that $\delta(u^*) = 0$, where u^* is the steady-state value of utilization. Once we add investment in Section 6.4, the steady-state value of depreciation is allowed to be any number in $[0, 1)$. Whatever that number is, it

¹²Although we do not explicitly model this interpretation, here is a sketch of it. Let borrowing and lending take place via a two-tier market. On the bottom, there is a local market for each island, where households trade with financial intermediaries. On the top, there is a centralized market where only intermediaries trade. Idiosyncratic variation in either the resource ("iceberg") cost of such intermediation or the rents extracted by intermediaries could then offer a micro-foundation of $\epsilon_{i,t}^R$. An earlier version of our paper (Angeletos and Lian, 2019) contained a complementary micro-foundation, using decentralized trading and random matching to generate idiosyncratic variation in the intertemporal prices faced by households.

is offset in steady-state by gross investment. The present economy can then be recast as a limit with infinite adjustment costs, or with investment pegged at its steady-state value.

Information. We assume away any informational friction among the firms so as to isolate the role of the informational friction in aggregate consumption, or the demand side of the economy. We then specify the information set of household h in each period t as follows:

$$\mathcal{I}_t^h = \mathcal{I}_{t-1}^h \cup \{\beta_t^h\} \cup \{w_{h,t}, e_{h,t}, R_{h,t}, (p_{i,j,t})_{i \in [0,1], j \in [0,1]}\} \cup \{\eta_{t-1}\}. \quad (8)$$

That is, the household learns its current discount factor, all the objects that enter its current budget (its income, its interest rate, and all commodity prices), and the past aggregate shock.

These properties, the entire structure of the economy, and the fact that agents have rational expectations are common knowledge. It follows that, in equilibrium, households have common knowledge of the *past* aggregate outcomes. Had we let learning be slow, we would presumably have been able to deliver not only amplification and comovement but also additional persistence.¹³ But we would have also sacrificed the ability to deliver sharp analytical results, because of the familiar difficulty in tracking the dynamics of higher-order beliefs in GE settings with persistent shocks and slow learning.

Equilibrium. The solution concept is (Noisy) Rational Expectations Equilibrium. Because of the CES specification and the symmetry of the firms within each island i , the demand faced by each firm (i, j) in period t can always be written as

$$\int_{h \in [0,1]} c_{i,j,t}^h dh = (y_{i,t}/p_{i,t}) (p_{i,j,t}/p_{i,t})^{-1-1/\mu} \quad \forall i, j, t, \quad (9)$$

where $p_{i,t}$ is the ideal price index of the goods produced in island i and $y_{i,t}$ is the total spending on these goods. We denote the corresponding economy-wide aggregates as p_t and y_t , and that for consumption by c_t .¹⁴ We can then define an equilibrium as follows:

1. Each household h chooses contingent plans for consumption and labor supply so as to maximize its expected utility subject to the budget constraint given in (5) and the informational constraints embedded in (8).
2. Each firm (i, j) chooses contingent plans for inputs, production, and prices so as to maximize its expectation of its local valuation subject to (7) and (9).
3. The goods and labor markets clear:

$$\int_{h \in [0,1]} c_{i,j,t}^h dh = q_{i,j,t} \quad \forall i, j, t \quad \text{and} \quad n_t^i = \int_{j \in [0,1]} l_{i,j,t} dj \quad \forall i, t. \quad (10)$$

We do not explicitly require that the bond market clears, because this follows from Walras' law once goods and labor markets clear. Finally, by our choice of numeraire, $p_t = 1$ and $y_t = c_t$. In the monetary

¹³The role of informational frictions in generating persistence is the subject of a large literature, albeit in different contexts (e.g., Mankiw and Reis, 2002; Sims, 2003; Woodford, 2003; Nimark, 2008; Angeletos and Huo, 2021).

¹⁴To be precise, we let $p_{i,t} \equiv (\int_{j \in [0,1]} p_{i,j,t}^{-1/\mu} dj)^{-\mu}$, $y_{i,t} \equiv \int_{h \in [0,1]} \int_{j \in [0,1]} p_{i,j,t} c_{i,j,t}^h dj dh$, $p_t \equiv \int_{i \in [0,1]} \frac{q_{i,t}}{y_t} p_{i,t} di$, $y_t \equiv \int_{i \in [0,1]} y_{i,t} di = \int_{i \in [0,1]} p_{i,t} q_{i,t} di$, and $c_t \equiv \int_{h \in [0,1]} c_t^h dh$.

extension spelled out in Appendix B, this maps to a monetary policy that stabilizes the nominal price level and replicates flexible-price outcomes.

Steady state, log-linearization, and notation. To keep the analysis tractable, we henceforth work with the log-linearization of the model around its steady state.¹⁵ With abuse of notation, we henceforth reinterpret all the variables as the log-deviations from their steady-state counterparts.¹⁶ Finally, because firms are symmetric within islands, we can drop the firm index from all the relevant variables: $l_{i,j,t} = l_{i,t}$, $u_{i,j,t} = u_{i,t}$, $q_{i,j,t} = q_{i,t}$ and $p_{i,j,t} = p_{i,t}$ for all firms j within any given island i .

4 Aggregate Supply, Aggregate Demand, and Beliefs

In this section, we derive the equilibrium conditions of the economy. We organize them in two blocks, one representing aggregate supply (AS) and another representing aggregate demand (AD). We further show how consumer beliefs are determined and how they enter the demand block.¹⁷ We thus set the stage for the next section, which completes the equilibrium characterization by studying the fixed point between aggregate supply, aggregate demand, and beliefs.

4.1 Aggregate Supply

We characterize the supply side in two steps. First, we momentarily take the utilization decisions as given and obtain aggregate employment and aggregate output as functions of the aggregate utilization and the aggregate stock of land. Second, we work out the optimal utilization decisions.

By the Cobb-Douglas specification of the production function, the local output is

$$q_{i,t} = (1 - \alpha)(u_{i,t} + k_{i,t}) + \alpha l_{i,t}. \quad (11)$$

By the first-order condition (FOC) of the firm's problem with respect to its labor input, the local demand for labor is

$$l_{i,t} = p_{i,t} + q_{i,t} - w_{i,t}. \quad (12)$$

By the corresponding FOC for household $h = i$, the local supply of labor satisfies

$$w_{i,t} = \frac{1}{\nu} n_t^i + \frac{1}{\sigma} c_t^i. \quad (13)$$

By market clearing in the local labor market, $l_{i,t} = n_t^i$. Finally, by the Cobb-Douglas specification of the preferences across islands, local demand, or local firm revenue, can be expressed as follows:

$$p_{i,t} + q_{i,t} = y_{i,t} = y_t + \xi_{i,t}. \quad (14)$$

¹⁵For the existence and characterization of the steady state, see Appendix A.

¹⁶The only exception to this rule is that we let the new b_t^h be given by b_t^h/c^* , where c^* is steady-state spending. This is standard in the literature and takes care of the issue that $b^* = 0$ in steady state.

¹⁷Keep in mind that, although the supply side of our model is forward-looking, the informational friction enters the equilibrium only via the demand side, because it is consumers, not firms, who are imperfectly informed.

Aggregating all these conditions, and combining them, we can solve for aggregate output as functions of u_t and k_t , the aggregate utilization rate, and the aggregate land stock. In particular,

$$y_t = (1 - \tilde{\alpha})(u_t + k_t), \quad (15)$$

where $\tilde{\alpha} \equiv 1 - \frac{(1-\alpha)(1+\frac{1}{\nu})}{1+\frac{1}{\nu}-\alpha+\frac{\alpha}{\sigma}} \in (0, 1)$. This reduced-form aggregate production function embeds labor-market equilibrium. This in turn explains why $\tilde{\alpha}$ depends on ν , the Frisch elasticity of labor supply. Indeed, insofar as labor supply is procyclical, a higher ν maps to a lower $\tilde{\alpha}$, or less diminishing returns in the reduced-form production function seen above.¹⁸

Consider now a firm's optimal choice of utilization. Because more utilization increases output today at the expense of degrading the effective stock of land, the optimal utilization choice is naturally forward-looking. Let $\vartheta_{i,t}$ denote the shadow value of land at the end of period t ; this is the present analogue of the "Q" in the Q-theory of investment. The typical firm's FOC for utilization can then be expressed as follows:

$$p_{i,t} + q_{i,t} - u_{i,t} - k_{i,t} = \vartheta_{i,t} + \phi u_{i,t}, \quad (16)$$

where $\phi > 0$ is a scalar that parameterizes the elasticity of utilization.¹⁹ The left-hand side measures the benefit of more utilization in terms of higher current production. The right-hand side measures the cost in terms of higher land depreciation and, thereby, lower production in the future. The evolution of the shadow value of land is finally given by the following asset-pricing-like condition:

$$\vartheta_{i,t} = -R_{i,t} + (1 - \beta) \mathbb{E}_t [p_{i,t+1} + q_{i,t+1} - k_{i,t+1} - u_{i,t+1}] + \beta \mathbb{E}_t [\vartheta_{i,t+1}], \quad (17)$$

where $\mathbb{E}_t [\cdot]$ is the full-information rational expectation in period t .

Combining and aggregating (16)-(17), replacing aggregate output from (15), using the law of motion for land, and solving for u_t , we reach the following Euler condition for aggregate utilization:

$$u_t = \frac{\beta}{\tilde{\alpha} + \beta\phi} R_t + \beta \mathbb{E}_t [u_{t+1}]. \quad (18)$$

This epitomizes the supply-side part of our theory. Other things equal, an increase in the relative price of today's goods stimulates utilization, thus also increasing the aggregate supply of today's goods. Naturally, the elasticity of this margin is negatively related to ϕ , the degree of convexity of the cost of utilization. And it is positively related to ν , the Frisch elasticity of labor supply, because a more elastic labor supply maps, via $\tilde{\alpha}$, to less diminishing returns in production with respect to utilization.²⁰

¹⁸In the model as it is, labor supply is procyclical if and only if $\sigma > 1$. But this σ , which derives from condition (12) and parameterizes the wealth effect on labor supply, is conceptually distinct from the σ that shows up in Proposition 2 and that governs the elasticity of aggregate demand with respect to the real interest rate. The two concepts can be disentangled by replacing the optimal labor supply (12) with an exogenous "wage schedule" of the form $w_{i,t} = \chi_n n_t^i + \chi_c c_t^i$, for some $\chi_c \neq \frac{1}{\sigma}$. A zero wealth effect on labor supply can then be nested with $\chi_c = 0$ and maps to $\tilde{\alpha} = \frac{\alpha\chi_n}{\chi_n + (1-\alpha)}$. This also makes clear the following two points: first, that higher real wage rigidity, proxied here by a lower χ_n , maps to a lower $\tilde{\alpha}$ and, thereby, a more elastic AS curve; and second, that our model could readily accommodate a countercyclical labor wedge as long as $\chi_n < 1/\nu$.

¹⁹This scalar is defined by $\phi \equiv \frac{\delta''(u^*)u^*}{\delta'(u^*)}$, where u^* denotes the steady-state level of utilization. A higher ϕ therefore means a more convex cost for utilization, which translates in equilibrium to a more inelastic utilization margin.

²⁰If we re-interpret the model along the lines of footnote 18, this translates as follows: AS is more elastic when the real wage rigidity is larger.

The supply block is completed with the law of motion for k_t , which in log-linearized form writes as $k_{t+1} = k_t - \kappa u_t$, for some scalar κ .²¹ Putting everything together, we reach the following result.

Proposition 1 (Aggregate Supply). *The optimal behavior of the firms, the optimal labor supply of the households, and market clearing impose the following equilibrium restrictions for all t :*

$$y_t = (1 - \tilde{\alpha})(u_t + k_t), \quad (19)$$

$$u_t = \frac{\beta}{\tilde{\alpha} + \beta\phi} R_t + \beta \mathbb{E}_t[u_{t+1}], \quad (20)$$

$$k_{t+1} = k_t - \kappa u_t, \quad (21)$$

along with $k_0 = \bar{k}_0$ exogenously fixed.

Because the above result does *not* use the optimality of consumer spending, it can be interpreted as a description of the “AS curve” of our model. In the limit as $\phi \rightarrow \infty$, this curve becomes vertical: utilization and output are pegged at their steady-state values. This captures the textbook scenario mentioned at the start of our Introduction. Away from this degenerate case, our AS curve is “upward sloping” in the sense that an increase in the real interest rate triggers an increase in aggregate utilization and, thereby, an increase in aggregate employment and output.

As evident in Proposition 1, our form of upward-sloping AS curve rests on utilization being a forward-looking decision. This depends on the investment margin being absent (as in the present model) or subject to adjustment costs (as in the extension of Section 6.4). Such adjustment costs are empirically relevant (Caballero and Engel, 1999; Bachmann, Caballero, and Engel, 2013). But they are absent in the early RBC literature on variable utilization, such as Burnside, Eichenbaum, and Rebelo (1995), Greenwood, Hercowitz, and Huffman (1988), and King and Rebelo (1999). These works reduced utilization to a static decision, which explains why they did not share our supply-side mechanism.²²

It is also worth emphasizing that we have expressed aggregate supply as an increasing function of the *relative* price of goods today vis-a-vis goods tomorrow. This is like “Econ-101” but unlike the Keynesian tradition, which instead expresses aggregate supply as an increasing function of either the *nominal* price level or the rate of inflation. But this is not just about graphs. In the textbook New Keynesian model, it is possible—although unusual—to express aggregate supply as a positive function of the real interest rate by appropriately combining the Phillips curve with the Taylor rule for monetary policy and the Fisher equation.²³ Still, this possibility hinges exclusively on the presence of nominal

²¹This scalar is given by $\kappa \equiv \frac{\delta'(u^*)u^*}{1-\delta(u^*)}$, where u^* denotes the steady-state level of utilization. As explained in Appendix A, κ ends up coinciding with $\frac{1-\beta}{\beta}$ in the steady state.

²²The same is true for the DSGE literature that builds on Christiano, Eichenbaum, and Evans (2005) and Smets and Wouters (2007), albeit for a different reason: although these works include adjustment costs to investment, they recast the cost of utilization in terms of today’s goods as opposed to future capital, thus shutting down the forward-looking nature of utilization and our margin of intertemporal substitution in production. Finally, Basu and Kimball (1997), Jaimovich and Rebelo (2009), and Miao, Wang, and Xu (2015) allow utilization to be forward-looking in a similar way as in our paper, but do not study the general-equilibrium implications for discount-rate shocks, as we do here. Nor do they contain our (upcoming) confidence multiplier. See also the discussion at the end of Section 2.

²³Write the Phillips curve as $\pi_t = \kappa(y_t - y_t^n) + \beta E_t[\pi_{t+1}]$, the Taylor rule as $i_t = \varphi\pi_t$, and Fisher equation as $i_t = R_t + E_t[\pi_{t+1}]$, where, for the purposes of this footnote, π_t is the rate of inflation, $y_t - y_t^n$ is the output gap, i_t is the nominal interest

rigidity and a monetary policy that fails to replicate flexible prices: in the flexible-price core of that model, AS is invariant to the real interest rate. By contrast, the reason that AS responds to the real interest rate in our model has nothing to do with either nominal rigidity or monetary policy: it is a feature of the “natural” level of output and it reflects the accommodation of intertemporal substitution in production via variable utilization.

4.2 Aggregate Demand

We now turn to optimal consumption and aggregate demand. Consider household h . As usual, the Euler equation and the relevant transversality condition are necessary and sufficient for optimality. Combining these conditions with the household’s budget constraint, we arrive at the following characterization of the household’s (log-linearized) consumption function.

Lemma 1. *For every h and t , household h ’s optimal consumption in period t is given by:*

$$c_t^h = (1 - \beta)b_t^h - \beta\sigma \left\{ \sum_{k=0}^{+\infty} \beta^k E_t^h [R_{h,t+k} + \beta_{t+k}^h] \right\} + (1 - \beta) \left\{ \sum_{k=0}^{+\infty} \beta^k E_t^h [y_{h,t+k}] \right\}, \quad (22)$$

where $E_t^h[\cdot] = E_t[\cdot | \mathcal{I}_t^h]$ is the household’s expectation at period t .

The first term captures initial wealth. The second term combines two intertemporal-substitution effects: that for interest rates and that for intertemporal preference shocks. The last term captures permanent income. In this last part, we have used the fact the household’s income at period t coincides with $y_{h,t} = p_{h,t} + q_{h,t} = y_t + \xi_{h,t}$, or the total revenue of the firms operating in the island where the household lives, works, and receives profits from.

To obtain a representation for aggregate demand, we aggregate (22) and use the facts that average bond holdings are zero, that each household knows its current interest rate, and that the future idiosyncratic shocks to interest rates are unpredictable. This yields the following expression:

$$c_t = -\sigma\beta(R_t + \beta_t) - \beta\sigma \left\{ \int \sum_{k=1}^{+\infty} \beta^k E_t^h [R_{t+k}] dh + \int \sum_{k=1}^{+\infty} \beta^k E_t^h [\beta_{t+k}^h] dh \right\} + (1 - \beta) \left\{ \int \sum_{k=0}^{+\infty} \beta^k E_t^h [y_{h,t+k}] dh \right\}. \quad (23)$$

We next manipulate this condition as follows. We rewrite the first integral in (23) as

$$\int \sum_{k=1}^{+\infty} \beta^k E_t^h [R_{t+k}] dh = \sum_{k=1}^{+\infty} \beta^k \mathbb{E}_t [R_{t+k}] - \frac{1}{\sigma} \mathcal{G}_t, \quad (24)$$

where

$$\mathcal{G}_t \equiv -\sigma \sum_{k=1}^{+\infty} \beta^k \int \left\{ E_t^h [R_{t+k}] - \mathbb{E}_t [R_{t+k}] \right\} dh \quad (25)$$

rate, and R_t is the real interest rate. Suppose next that $y_t^n = 0$, meaning the natural rate of output is fixed, and to derive the point as fast as possible, let $E_t[\pi_{t+1}] = \rho\pi_t$ for some $\rho \in [0, 1]$. The Phillips curve can then be rewritten as $\pi_t = \frac{\kappa}{1-\beta\rho} y_t$, while the Taylor rule plus the Fisher equation give $R_t = i_t - E_t[\pi_{t+1}] = (\varphi - \rho)\pi_t$. Combining, we get $y_t = \frac{(1-\beta\rho)}{\kappa(\varphi-\rho)} R_t$, which gives the AS curve in the (R, y) space instead of the (π, y) space.

captures the average misperception of the future adjustment in the real interest rate. Similarly, we rewrite the second integral as

$$\int \sum_{k=1}^{+\infty} \beta^k E_t^h [\beta_{t+k}^h] dh = \frac{\beta \rho_\beta}{1 - \beta \rho_\beta} \int \beta_t^h dh = \frac{\beta \rho_\beta}{1 - \beta \rho_\beta} \beta_t = \sum_{k=1}^{+\infty} \beta^k \mathbb{E}_t [\beta_{t+k}], \quad (26)$$

and the third integral as

$$\int \sum_{k=0}^{+\infty} \beta^k E_t^h [y_{h,t+k}] dh = \sum_{k=0}^{+\infty} \beta^k \mathbb{E}_t [y_{t+k}] + \frac{\beta}{1-\beta} \mathcal{B}_t, \quad (27)$$

where

$$\mathcal{B}_t \equiv \frac{1-\beta}{\beta} \sum_{k=0}^{+\infty} \beta^k \int \left\{ E_t^h [y_{h,t+k}] - \mathbb{E}_t [y_{t+k}] \right\} dh, \quad (28)$$

captures average misperception of permanent income. Combining the above expressions and replacing c_t with y_t , we obtain the following forward-looking condition for aggregate demand:

$$y_t = -\sigma \beta (R_t + \beta_t) - \beta \sigma \sum_{k=1}^{+\infty} \beta^k \mathbb{E}_t [R_{t+k} + \beta_{t+k}] + (1 - \beta) \left(y_t + \sum_{k=1}^{+\infty} \beta^k \mathbb{E}_t [y_{t+k}] \right) + \beta \mathcal{B}_t + \beta \mathcal{G}_t. \quad (29)$$

Finally, rewriting this condition in a recursive form, we reach the following result.

Proposition 2 (Aggregate Demand). *Aggregate spending satisfies the following condition:*

$$y_t = -\sigma (R_t + \beta_t) + \mathbb{E}_t [y_{t+1}] + (\mathcal{B}_t + \mathcal{G}_t), \quad (30)$$

where \mathcal{B}_t and \mathcal{G}_t are defined in conditions (28) and (25).

This is the ‘‘AD curve’’ of our model. It looks like the Euler condition of a textbook, representative-agent economy, except for the inclusion of the terms \mathcal{B}_t and \mathcal{G}_t . When households share the same information, $E_t^h [\cdot] = \mathbb{E}_t [\cdot]$ for all h and these terms vanish. *Both* terms thus originate from the informational friction. But each one captures a *different* mechanism.

4.3 The Two Belief Wedges

Consider first \mathcal{B}_t . This term captures the average error in households’ beliefs of their permanent income. When $\mathcal{B}_t > 0$, households on average over-estimate their permanent income, and this contributes, other things equal, to higher spending today. (The converse is true when $\mathcal{B}_t < 0$.)

To understand how \mathcal{B}_t behaves, we first characterize the true aggregate permanent income.

Proposition 3 (A Hulten’s Theorem for AD shocks). *Aggregate permanent income satisfies*

$$\sum_{k=0}^{+\infty} \beta^k \mathbb{E}_t [y_{t+k}] = \frac{1-\bar{\alpha}}{1-\beta} k_t \quad (31)$$

and is invariant to η_t , the current aggregate demand shock.

As anticipated in the Introduction, this is a corollary of an intertemporal version of [Hulten’s \(1978\)](#) theorem. The present discounted value of aggregate income in our dynamic economy is the equivalent

of aggregate GDP in a static economy. In the latter context, Hulten's theorem, which only requires production efficiency, implies that aggregate GDP is invariant to intra-sectoral taste shocks. The translation of this result to our context, where production efficiency is effectively preserved even though the demand side is ridden with an informational friction,²⁴ gives Proposition 3 above. In other words, just as in the static context taste shocks affect the cross-sectoral decomposition of GDP without altering its total value, in our dynamic context aggregate demand shocks shift aggregate output from one period to another without altering its present discounted value.

Using this property, which is itself known to households, we can reduce \mathcal{B}_t in (28) to

$$\mathcal{B}_t = \frac{1-\beta}{\beta} \sum_{k=0}^{+\infty} \beta^k \int E_t^h [\xi_{h,t+k}] dh.$$

That is, misperceptions of *total* permanent income reduce to misperceptions of *idiosyncratic* permanent income. Furthermore, because $E_t^h [\xi_{h,t+k}] = \rho_\xi^k E_t^h [\xi_{h,t}]$ and $E_t^h [\xi_{h,t}] = y_{h,t} - E_t^h [y_t]$, we have

$$\mathcal{B}_t = \frac{1-\beta}{\beta(1-\beta\rho_\xi)} (y_t - \bar{E}_t [y_t]), \quad (32)$$

where $\bar{E}_t [\cdot] \equiv \int E_t^h [\cdot] dh$. That is, whenever households underestimate the current aggregate income, they also overestimate their permanent income, and this misperception is larger the more persistent the idiosyncratic income fluctuations are.

Consider next \mathcal{G}_t . By construction, this term captures the average error in beliefs of future real interest rates. When $\mathcal{G}_t > 0$, households on average under-estimate the future real interests, and this, too, contributes towards higher spending today. (The converse is true when $\mathcal{G}_t < 0$.)

The characterization of \mathcal{G}_t is a bit more complicated than that of \mathcal{B}_t , because the present discounted value of the real interest rate, unlike that of aggregate income, does vary with the AD shock. However, it can be shown that the innovations in the equilibrium expectations of future interest rates are proportional to the innovations in the current discount factor. It follows that

$$\mathcal{G}_t = -\frac{\sigma^2}{\sigma+\varsigma} \frac{\beta\rho_\beta}{1-\beta\rho_\beta} (\beta_t - \bar{E}_t [\beta_t]) = \frac{\sigma^2}{\sigma+\varsigma} \frac{\beta\rho_\beta}{1-\beta\rho_\beta} (\eta_t - \bar{E}_t [\eta_t]),$$

with $\varsigma \equiv \frac{1-\bar{\alpha}}{\bar{\alpha}+\beta\phi}$. Therefore, whenever agents underestimate the current aggregate shock, they also underestimate the future GE adjustment in the real interest rate, and this underestimation is larger the more persistent the AD shock is.

In the next section, we show how both of these “wedges” contribute towards amplification. For now, we summarize their characterization in the following result.

Lemma 2. *With incomplete information,*

$$\mathcal{B}_t = \frac{1-\beta}{\beta(1-\beta\rho_\xi)} (y_t - \bar{E}_t [y_t]) \quad \text{and} \quad \mathcal{G}_t = \frac{\sigma^2}{\sigma+\varsigma} \frac{\beta\rho_\beta}{1-\beta\rho_\beta} (\eta_t - \bar{E}_t [\eta_t]),$$

where $\bar{E}_t [\cdot] \equiv \int E_t^h [\cdot] dh$ is the average expectation across households.

²⁴To be precise, production efficiency holds in our setting when firms are perfectly competitive, or $\mu = 0$. But even when $\mu > 0$, Proposition 3 still holds because the monopoly distortion is state- and time-invariant.

5 Equilibrium Characterization

We complete the characterization of the equilibrium in five steps. First, we recast AS and AD in a more convenient form. Second, we show how to measure the informational friction by a scalar $\lambda \in (0, 1]$. Third, we isolate the role of the confidence multiplier. Fourth, we study the complementary role of discounting GE adjustment in interest rates. Finally, we show that there is a unique fixed point between the aggregate dynamics and the signal extraction problem of the households, which completes the existence and uniqueness of the equilibrium and pins down the value of λ .

5.1 Normalized AS and AD

For given beliefs, the equilibrium dynamics are characterized by equations (19)-(21), which characterize AS, together with equation (30), which characterizes AD. To solve this system, it is useful to drop the backward-looking variable k_t and re-express the equilibrium conditions as a purely forward-looking system.²⁵ To this goal, we introduce the following transformation:

$$\tilde{y}_t \equiv \frac{1}{\beta} (y_t - (1 - \tilde{\alpha})k_t) = \frac{1 - \tilde{\alpha}}{\beta} u_t. \quad (33)$$

The first part defines \tilde{y}_t as aggregate output appropriately normalized by the stock of land. The second part notes that \tilde{y}_t is proportional to utilization, which is purely forward-looking. We can then combine Propositions 1 and 2 to obtain the following representation of the equilibrium in our economy.

Proposition 4 (AS and AD). *A path for \tilde{y}_t and R_t is part of an equilibrium if it satisfies the terminal condition $\lim_{t \rightarrow \infty} \beta^t \tilde{y}_t = 0$ along with the following two dynamic equations:*

$$\tilde{y}_t = \varsigma R_t + \beta \mathbb{E}_t [\tilde{y}_{t+1}], \quad (34)$$

$$\tilde{y}_t = -\sigma R_t + \beta \mathbb{E}_t [\tilde{y}_{t+1}] + \mathcal{B}_t + \mathcal{G}_t - \sigma \beta_t, \quad (35)$$

with $\mathcal{B}_t = \frac{1 - \beta}{1 - \beta \rho_\epsilon} (\tilde{y}_t - \bar{E}_t [\tilde{y}_t])$, $\mathcal{G}_t = \frac{\sigma^2}{\sigma + \varsigma} \frac{\beta \rho_\beta}{1 - \beta \rho_\beta} (\eta_t - \bar{E}_t [\eta_t])$, and $\varsigma \equiv \frac{1 - \tilde{\alpha}}{\tilde{\alpha} + \beta \phi}$.

Conditions (34) and (35) are the “normalized” versions of, respectively, aggregate supply (AS) and aggregate demand (AD). Both equations are forward-looking. In the case of AS, it is because utilization is forward-looking. In the case of AD, it is because consumption is forward-looking. Their slopes with respect to the real interest rate are, respectively, ς and $-\sigma$. Finally, the terms \mathcal{B}_t and \mathcal{G}_t , which are present in the AD equation and encapsulate the two mechanisms of interest, have now been restated in terms of the transformed variable \tilde{y}_t rather than the original variable y_t .

The system provided above is easier to work with than the original given earlier in Propositions 1 and 2, because the new system is *purely* forward looking whereas the original contains a backward-looking variable.²⁶ But one has to keep in mind that any solution for \tilde{y}_t must be transformed back to

²⁵This simplification is possible here thanks to the abstraction from investment. In Section 6.4, which adds investment, we instead have to work with a more complicated dynamic system, which in turn explains the greater complexity of the formal arguments in the proof of Proposition 14 relative to those in our baseline model.

²⁶The relevant backward-looking state variable, the effective stock of land, has dropped out of the new system thanks to

a solution for y_t . In particular, holding \tilde{y}_τ constant for all $\tau > t$, an increase in \tilde{y}_t maps to an increase in current aggregate income but also a decrease in future aggregate income. This underscores that an increase in \tilde{y}_t represents an intertemporal shift in resources—which, circling back to our version of Hulten’s theorem, is exactly what a “shift in aggregate demand” means in a neoclassical context.

5.2 Beliefs: a Simple Representation

Recall that, in any given period t , the past is common knowledge and the only aggregate innovation is η_t . It follows that the innovations in the average expectations of all current and future aggregate outcomes, as well in the aggregate outcomes themselves, are all proportional to η_t . That is, for any aggregate variable x in the set $\{\beta, y, \tilde{y}, R\}$ and any $s \geq 0$,

$$\mathbb{E}_t[x_{t+s}] = \mathbb{E}_{t-1}[x_{t+s}] + \gamma_s^x \eta_t, \quad (36)$$

for some scalar γ_s^x .²⁷ Note that this condition uses the full-information expectation operator, not the expectation of the typical household in the economy. But because the information in \mathbb{E}_t is a *superset* of the information in E_t^h , the expectation of the typical household, and because the latter itself contains the information in \mathbb{E}_{t-1} , the following is also true:

$$E_t^h[x_{t+s}] = E_t^h[\mathbb{E}_t[x_{t+s}]] = \mathbb{E}_{t-1}[x_{t+s}] + \gamma_s^x E_t^h[\eta_t].$$

Aggregating across h and letting λ denote the coefficient of the projection of $\bar{E}_t[\eta_t]$ on η_t , we get

$$\bar{E}_t[x_{t+s}] = \mathbb{E}_{t-1}[x_{t+s}] + \gamma_s^x \bar{E}_t[\eta_t] = \mathbb{E}_{t-1}[x_{t+s}] + \gamma_s^x \lambda \eta_t. \quad (37)$$

Combining (36) and (37), we finally reach the following result.

Proposition 5. *In any equilibrium, there exists a scalar $\lambda \in (0, 1)$ such that, for any aggregate variable x in the set $\{\beta, y, \tilde{y}, R\}$, the average forecast of it satisfies*

$$\bar{E}_t[x_{t+s}] = (1 - \lambda) \mathbb{E}_{t-1}[x_{t+s}] + \lambda \mathbb{E}_t[x_{t+s}] \quad \forall t, s \geq 0.$$

That is, it is *as if* the economy is populated by two representative agents: one that only knows the past, and another that also knows the present, with respective population weights $1 - \lambda$ and λ . By the same token, λ is an inverse measure of the severity of the informational friction: the smaller λ is, the further away the economy is from the complete-information benchmark.

The exact value of λ is determined from the fixed point between the aggregate outcomes and the typical household’s inference problem. But the endogeneity of λ is not essential for understanding our main results. We thus postpone its characterization for the end of this section.

the adopted transformation of variables. This transformation also explains why $\mathbb{E}_t[\tilde{y}_{t+1}]$ is discounted by β in the normalized AD curve (35), whereas there is no such discounting in the original AD curve (30).

²⁷The vector $\{\gamma_s^x\}_{s \geq 0}$, which identifies the Impulse Response Function of variable x with respect to the AD innovation, is of course endogenously determined in equilibrium. For the present argument, however, this endogeneity is not relevant.

5.3 Isolating the Confidence Multiplier

We first consider the case $\rho_\beta = 0$, meaning an aggregate demand shock lasting only one period. This implies that $\tilde{G}_t = 0$, and therefore that the AS and AD equations take the following, simpler forms:

$$\tilde{y}_t = \varsigma R_t, \quad (38)$$

$$\tilde{y}_t = -\sigma R_t + \underbrace{(1 - \lambda) \left(\frac{1 - \beta}{1 - \beta \rho_\xi} \right)}_{\mathcal{B}_t} \tilde{y}_t + \sigma \eta_t. \quad (39)$$

This system is essentially static, allowing a straightforward characterization of how the economy responds to the aggregate demand shock.

Consider a negative realization for η_t and start with the complete-information benchmark (herein nested as $\lambda = 1$). In this case, $\mathcal{B}_t = 0$ and the AD curve shifts down by an amount equal to $\sigma \eta_t$. This is represented in Figure 1 by the shift of the AD curve from AD^{old} to AD^1 . The intersection of AD^1 with AS thus identifies the equilibrium pair of \tilde{y} and R that obtain under complete information.

Consider now the role of incomplete information. Had \mathcal{B}_t been zero, the shock would have triggered the same shift in AD as under complete information. But because this “first-round” shift in AD causes current aggregate income to fall, and because households confuse aggregate and idiosyncratic movements in current income, they incorrectly perceive a decrease in their permanent income—even though, as already explained, there is no actual change in their permanent income, only an intertemporal shift. As this happens, the AD curve shifts further down, from AD^1 to AD^2 in Figure 1, triggering a further reduction in aggregate income. This in turn feeds to additional misperception (a further reduction in \mathcal{B}), a further downward shift in the AD curve, and so on.

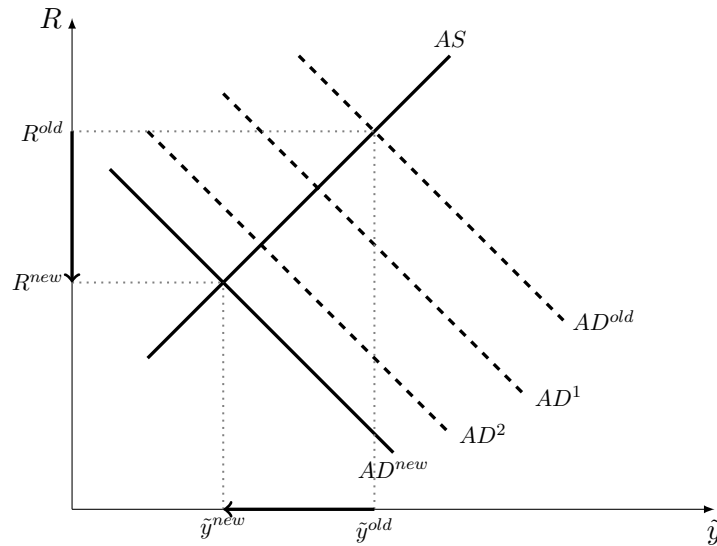


Figure 1. Feedback Mechanism

This series of feedbacks, whose limits correspond to the “final-round” curve AD^{new} in the figure, explains the economics behind our confidence multiplier. The formal result is offered below.

Proposition 6 (The confidence multiplier). *Suppose the aggregate demand shock is entirely transitory ($\rho_\beta = 0$). The equilibrium response of real aggregate output is given by*

$$\frac{\partial y_t}{\partial \eta_t} = \gamma_0 \cdot m^{\text{conf}}(\lambda, \rho_\xi),$$

where $\gamma_0 \equiv \frac{\varsigma \sigma \beta}{\varsigma + \sigma}$ is the complete-information counterpart and

$$m^{\text{conf}}(\lambda, \rho_\xi) \equiv \frac{\varsigma + \sigma}{\varsigma + \sigma - \varsigma \frac{1-\beta}{1-\beta \rho_\xi} (1-\lambda)} > 1 \quad (40)$$

is the “confidence multiplier,” namely a multiplier that captures the mechanism described above.

Note that $m^{\text{conf}}(\lambda, \rho_\xi)$ is decreasing in λ and increasing in ρ_ξ . A lower λ means more confusion of the aggregate fluctuations for idiosyncratic income fluctuations, and a higher ρ_ξ means more extrapolation of the present to the future and therefore a larger change in perceived permanent income for a given aggregate demand shock. Both forces contribute to a larger shift of the AD curve in each step of the series of feedbacks described in Figure 1, and hence also to a larger confidence multiplier.

5.4 The General Case: Confidence Plus Discounting of Future Interest Rates

We now allow the aggregate demand shock to be persistent. This does not affect the logic that the aggregate demand shock has no actual effect on aggregate permanent income: the aggregate demand shock still represents an intertemporal shift between “the long run” and “the short run,” although the short run now last multiple periods (in expectation). It also does not affect the size of our confidence multiplier. What changes, though, are the expectations that households form about *future* real interest rates and their impact on aggregate demand under both complete and incomplete information. This amounts to an additional multiplier, which we formalize below.

Proposition 7 (The General Case). *Allow the aggregate demand shock to be persistent ($\rho_\beta \geq 0$). The equilibrium response of real aggregate output is given by*

$$\frac{\partial y_t}{\partial \eta_t} = \gamma \cdot m^{\text{conf}}(\lambda, \rho_\xi) \cdot m^{\text{GE}}(\lambda, \rho_\beta),$$

where $\gamma \equiv \frac{\beta \sigma \varsigma}{\sigma + \varsigma} \frac{1}{1 - \rho_\beta \beta}$ is the complete-information counterpart, $m^{\text{conf}}(\lambda, \rho_\xi)$ is the same confidence multiplier as that defined in Proposition 6 above, and

$$m^{\text{GE}}(\lambda, \rho_\beta) \equiv 1 + \frac{\rho_\beta \beta \sigma}{\sigma + \varsigma} (1 - \lambda) \geq 1 \quad (41)$$

is another multiplier, which captures the mechanism we refer to as “discounting the future GE adjustment in real interest rates.”

Note that the confidence multiplier is invariant to ρ_β and remains exactly the same as in the case of a transitory AD shock. This is because the size of the misperception in permanent income naturally depends on ρ_ξ , the persistence of the idiosyncratic income fluctuations, but is invariant to ρ_β , the persistence of the AD shock, thanks to our version of Hulten’s theorem. Conversely, ρ_ξ is irrelevant to the

second multiplier, because this has nothing to do with expectations of income. Instead, this multiplier has to do with expectations of future interest rates, whose persistence is governed by ρ_β .

Let us explain this new multiplier. When a negative aggregate demand shock hits the economy, it triggers *in equilibrium* a reduction in the real interest rate, which in turn moderates the original reduction in aggregate demand. This represents a “neoclassical GE adjustment” that partially offsets the direct, PE effect of the shock on aggregate demand. Furthermore, the fall in the real interest rate is as persistent as the demand shock itself.

With complete information, households not only see the current drop in the real interest rate, but also perfectly foresee how much the real interest rate will fall in the future. With incomplete information, households still observe the current drop in real interest rates but under-estimate their future drop. This arrests the forward-looking component of the aforementioned GE adjustment, leaving aggregate demand to move more strongly with the exogenous shock than what it would have done under complete information.²⁸

We refer to this mechanism as “discounting the GE adjustment in real interest rates.” At a high level, this mechanism is the same as that articulated in [Angeletos and Lian \(2018\)](#), [Gabaix \(2020\)](#) and [Farhi and Werning \(2019\)](#) in the context of forward guidance for monetary policy at the zero lower bound. But there are two key differences, on top of the obvious difference in the topics under consideration.

The first difference regards the identity of the object that adjusts in GE. In the context of the aforementioned works, this object is the output gap. In our context, instead, it is the natural rate of output.

The second difference regards the form of strategic interaction, or the way higher-order beliefs matter. The New Keynesian model studied in the aforementioned works corresponds to a game of strategic *complementarity*: when I expect others to spend more in the near future, I want to spend more myself today, because I expect monetary policy to fail to track the natural rate of interest and, instead, accommodate a boom. The kind of RBC model studied here instead corresponds to a game of strategic *substitutability*: when I expect others to spend more in the near future because of a persistent AD shock, I want to spend *less* myself, because I expect the real interest rate to increase. Under-estimating the responses of others leads to under-reaction (dampening) in the first type of games and to over-reaction (amplification) in the latter.²⁹ This explains why the same elementary mechanism maps to diametrically opposite effects in our setting relative to the aforementioned works.

Putting aside these clarifications, the key observation for our purposes is that this mechanism works hand-in-hand with our confidence multiplier: they both help sustain larger movements in AD, and thereby in equilibrium output and employment, than under complete information.

We conclude with a note on comparative statics. As evident from (41), $m^{\text{GE}}(\lambda, \rho_\beta)$ is decreasing in λ and increasing in ρ_β . Intuitively, the larger the informational friction or the longer the GE adjustment in

²⁸Had we allowed households to be inattentive to the *current* real interest rate, because of rational inattention ([Sims, 2003](#)) or sparsity ([Gabaix, 2014](#)), we would have arrested the countervailing effect of the concurrent adjustment in the real interest as well, which of course would only increase the related multiplier.

²⁹For clear articulations of this point in more abstract settings or other applications, see [Angeletos and Lian \(2017\)](#) and [Angeletos and Sastry \(2021\)](#).

interest rates, the larger the multiplier associated with the discounting of this adjustment. Combining this property with the one obtained earlier for the confidence multiplier, we get the following result.

Corollary. *The overall multiplier, $m(\lambda, \rho_\xi, \rho_\beta) \equiv m^{\text{conf}}(\lambda, \rho_\xi)m^{\text{GE}}(\lambda, \rho_\beta)$, is increasing in the severity of the informational friction and the persistence of both kinds of shocks.*

Finally, although our model is too stylized to permit a quantitative evaluation, let us do a simple, back-of-the-envelope calculation. Suppose the slopes of the AS and AD curves are comparable ($\varsigma \approx \sigma$), the discount factor is close to 1, idiosyncratic income follows a random walk ($\rho_\xi \approx 1$), the persistence of the aggregate fluctuations in the model is comparable to that in the data ($\rho_\beta \approx 0.95$), and $\lambda \approx 1/2$ (think of it as half the population being perfectly informed and the rest being completely uninformed). Then, $m \approx 5/3$, which suggests that the documented amplification could be substantial.

5.5 Signal Extraction and the Fixed Point for λ

In the preceding analysis, we have treated the value of λ as given. However, the severity of the informational friction depends on how much households can extract from the available market signals. This implies that the value of λ in our economy is the solution to a fixed point problem that relates the informativeness of these signals to the responsiveness of aggregate output and the real interest rate to the aggregate demand shock: the greater this response, the more precise the information revealed by the aforementioned signals, and the smaller the friction. This fixed point is characterized below.

Proposition 8. *There exists a unique $\lambda \in (0, 1)$ in equilibrium and is given by the solution of the following fixed point problem:*

$$\lambda = \frac{\sigma_\beta^{-2} + \sigma_R^{-2} \{ \varsigma^{-1} \gamma [\beta^{-1} m(\lambda, \rho_\xi, \rho_\beta) - \rho_\beta] \}^2 + \sigma_\xi^{-2} \{ \gamma m(\lambda, \rho_\xi, \rho_\beta) \}^2}{\sigma_{AD}^{-2} + \sigma_\beta^{-2} + \sigma_R^{-2} \{ \varsigma^{-1} \gamma [\beta^{-1} m(\lambda, \rho_\xi, \rho_\beta) - \rho_\beta] \}^2 + \sigma_\xi^{-2} \{ \gamma m(\lambda, \rho_\xi, \rho_\beta) \}^2}, \quad (42)$$

where $m(\lambda, \rho_\xi, \rho_\beta) \equiv m^{\text{conf}}(\lambda, \rho_\xi)m^{\text{GE}}(\lambda, \rho_\beta)$ is the overall multiplier.

The above condition, which follows from the standard formula for combining multiple Gaussian signals, reflects the fact that the household has three such signals about the underlying AD shock: her own discount rate, β_t^h ; her local interest rate $R_{h,t}$; and her own income, or the local demand, $y_{h,t}$. And whereas the informativeness of the first signal is exogenous, that of the other two signals is endogenous. In particular, their informativeness increase with the multiplier: the larger the multiplier, the more these market signals moves with the AD shock, and hence the more precise the information households can extract from them about the underlying shock. This explains why the right-hand side of the above condition decreases with λ , which in turn guarantees the uniqueness of the equilibrium.³⁰

It is also immediate to verify that, for given ρ_ξ and ρ_β , λ is a decreasing function of the ratio σ/σ_{AD} for any $\sigma \in \{\sigma_\beta, \sigma_R, \sigma_\xi\}$. By varying these “noise” parameters, we can indeed induce any value for λ in

³⁰In general, signal extraction problems in GE settings can admit multiple equilibria; see [Galballo \(2017\)](#) and [Chahrouh and Galballo \(2021\)](#). But this is not an issue here because our setting features, in effect, strategic substitutability in signal extraction.

the $(0, 1)$ range. This, together with the uniqueness of λ , justifies our earlier treatment of it as a “free” parameter. Finally, by combining the comparative statics of m with the comparative statics of the fixed point in condition (42) we reach the follow result.

Proposition 9. *Let m^* denote the overall multiplier evaluated at the equilibrium value of λ . This is necessarily increasing in the ratio σ/σ_{AD} for any $\sigma \in \{\sigma_\beta, \sigma_R, \sigma_\xi\}$, as well as in both ρ_ξ and ρ_β .*

That is, our statement “a larger friction implies a larger multiplier,” which was previously formalized with the monotonicity of $m(\lambda, \rho_\xi, \rho_\beta)$ in λ treating the latter as exogenous, is now recast as the monotonicity of m^* in deeper noise parameters. And the lesson that the overall multiplier increases with the persistence of both shocks, which was previously articulated holding λ constant, is robust to taking into account the endogeneity of λ .

We close this section with the following remark on the interpretation of λ . In the present version of our model, the value of λ hinges on the availability of information about the aggregate shock, or the state of the economy. This in turn suggests that a policymaker could regulate the magnitude of the business cycle by providing more or less information to consumers. But this need not be true in two realistic variants, in which the relevant confusion is present even if information about the aggregate state is abundant. In one variant, consumers rationally choose not to pay enough attention to the aggregate state (or to any related communications by policymakers), for the reasons articulated in [Mackowiak and Wiederholt \(2009\)](#). In another, consumers are boundedly rational, in the sense described in Section 6.5. These variants preserve our predictions about amplification, which were the topic of the previous subsections, but not those about the precise value of λ , which were the topic of the present subsection. This explains why we “trust” the former predictions more than the latter.

6 Extensions and Variants

In this section, we consider four extensions/variants of our baseline model. The first two explore our theory’s predictions for the economy’s response to aggregate supply shocks and fiscal stimuli. The remaining two show how our theory can rationalize comovement between “borrowers” and “savers,” and between consumption and investment. In addition, we discuss how the mechanisms at work can be recast as the product of bounded rationality instead of informational friction.

6.1 Aggregate Supply Shocks

The main analysis has focused on AD shocks, in the sense of aggregate discount-factor shocks. We now turn to AS shocks, in the sense of aggregate productivity shocks. The lesson delivered below is that the documented mechanisms may help dampen AS shocks at the same time they amplify AD shocks.

The model is the same, except that we shut down the shocks to the household’s discount factor and,

instead, introduce aggregate productivity shocks. In particular, a firm's output is given by

$$y_{i,j,t} = A_t (l_{i,j,t})^\alpha (u_{i,j,t} k_{i,j,t})^{1-\alpha},$$

where A_t is an aggregate TFP shock. This follows an AR(1) process with persistence $\rho_A \in [0, 1)$:

$$\log A_t = \rho_A \log A_{t-1} + \log \eta_t^A, \quad (43)$$

where $\log \eta_t^A \sim \mathcal{N}(0, \sigma_A^2)$ and A_{-1} is normalized at 1. Finally, the household's information set in period t is given by $\mathcal{I}_t^h = \mathcal{I}_{t-1}^h \cup \{w_{h,t}, e_{h,t}, R_{h,t}, (p_{i,j,t})_{i \in [0,1], j \in [0,1]}\} \cup \{\eta_{t-1}^A\}$. It follows that, although the source of the aggregate shock is different, local income and local interest rates serve again as noisy signals of the underlying aggregate shock.

We once again log-linearize the equilibrium conditions and re-interpret all the variables as log-deviations from their steady-state counterparts. Following similar steps as in Section 4, we reach the following characterization of AS and AD.

Proposition 10. (i) *Aggregate supply is given by*

$$y_t = A_t + (1 - \tilde{\alpha})(u_t + k_t), \quad (44)$$

$$u_t = \frac{\beta}{\tilde{\alpha} + \beta\phi} (A_t - \mathbb{E}_t[A_{t+1}]) + \frac{\beta}{\tilde{\alpha} + \beta\phi} R_t + \beta \mathbb{E}_t[u_{t+1}], \quad (45)$$

$$k_{t+1} = k_t - \kappa u_t. \quad (46)$$

(ii) *Aggregate demand is given by*

$$y_t = -\sigma R_t + \mathbb{E}_t[y_{t+1}] + (\mathcal{B}_t + \mathcal{G}_t), \quad (47)$$

where \mathcal{B}_t and \mathcal{G}_t are defined as (28) and (25).

The characterization of AS is similar to before, except, of course, for the accommodation of the TFP shock.³¹ Turning to AD, this is exactly the same as before, and \mathcal{B}_t and \mathcal{G}_t have the same mathematical definition. However, both terms behave differently from before.

Consider first \mathcal{B}_t , which maps to our confidence multiplier. In the case with AD shocks, the actual aggregate permanent income was fixed, guaranteeing that the confusion of aggregate and idiosyncratic income fluctuations had an unambiguous effect on confidence: following a positive shock, households were necessarily over-estimating their permanent income, so \mathcal{B}_t was necessarily positive. This is not the case with AS shocks. Because such shocks *do* influence actual aggregate permanent income, imperfect knowledge of the shock naturally translates to under-estimation of the corresponding movements in permanent income. In particular, following a positive shock, a consumer over-estimates the idiosyncratic component of her permanent income, which pushes \mathcal{B}_t positive, but also under-estimates the aggregate component, which pushes \mathcal{B}_t negative. This explains why our confidence multiplier is weakened or even turned upside down.

³¹This shows up, not only in (44), the production function, but also in (45), the optimality condition for utilization. Intuitively, the optimal intertemporal pattern of production depends, not only on the relative price of today's goods, but also on their relative cost. The former is captured in condition (45) by R_t , the latter by $A_t - \mathbb{E}_t[A_{t+1}]$.

Consider next \mathcal{G}_t , which corresponds to the discounting of the GE adjustment in real interest rates. In the case of AD shocks, this mechanism contributed towards amplification. Here, it does the exact opposite. When information is complete, a persistent positive TFP shock triggers a persistent *drop* in real interest rates, which in turn stimulates aggregate demand. When information is incomplete, consumers under-estimate the drop in future real interest rates and this *reduces* aggregate demand relative to the complete-information case. This explains why \mathcal{G}_t is necessarily negative following a positive TFP shock, or why the corresponding multiplier is necessarily reversed.

These observations explain the following result:³²

Proposition 11 (Technology Shocks). *The equilibrium response of aggregate output to an aggregate technology shock is given by*

$$\frac{\partial y_t}{\partial \eta_t^A} = \gamma^A \cdot m_A^{\text{conf}}(\lambda, \rho_\xi, \rho_A) \cdot m_A^{\text{GE}}(\lambda, \rho_A),$$

where $\gamma^A > 0$ is the complete-information counterpart, $m_A^{\text{GE}}(\lambda, \rho_A)$ is a multiplier that captures the effect of \mathcal{G}_t , or the discounting of the GE adjustment in interest rates, and $m_A^{\text{conf}}(\lambda, \rho_\xi, \rho_A)$ is a multiplier that captures the effect of \mathcal{B}_t , or the confusion of idiosyncratic and aggregate income fluctuations. Furthermore,

$$m_A^{\text{conf}}(\lambda, \rho_\xi, \rho_A) < 1 \text{ if and only if } \rho_\xi < \bar{\rho}_\xi,$$

for some $\bar{\rho}_\xi = \bar{\rho}_\xi(\rho_A)$ that is itself increasing in ρ_A , and

$$m_A^{\text{GE}}(\lambda, \rho_A) < 1 \text{ necessarily.}$$

To sum up, as long as aggregate TFP shocks and idiosyncratic income shocks have comparable persistence, our first mechanism, the confidence multiplier, is basically switched off or even reversed.³³ And our second mechanism, the discounting of the GE adjustment in the real interest rate, is necessarily reversed.

The following caveat, however, must be raised. In the above analysis, which abstracts from investment, a positive AS shock is necessarily associated with a drop in the real interest rate. But once the investment margin is present, as in the baseline RBC model or the upcoming extension of our model in Section 6.4, the effect of an AS shock on the real interest rate is generally ambiguous. A positive supply shock that is either transitory or does not affect the marginal product of capital tends to lower the real interest rate by increasing today's supply of goods more than consumption; but a positive AS shock that is sufficiently persistent and moves the marginal product of capital enough can cause the real interest rate to rise by increasing the demand for investment. This implies that both of our mechanisms may be ambiguous vis-a-vis AS shocks. But they both seem to work in the "right" direction vis-a-vis AD shocks, which is the core issue for us.

³²Since $m_A^{\text{conf}}(\lambda, \rho_\xi, \rho_A)$ and $m_A^{\text{GE}}(\lambda, \rho_A)$ may increase with λ here, we cannot rule out the possibility of multiple equilibrium values for λ , as we did for AD shocks in Proposition 8. This, however, does not interfere with the result presented here, because this holds regardless of λ .

³³Note that $\bar{\rho}_\xi(1) = 1$. Hence, when both shocks are highly persistent, the confidence multiplier is muted.

6.2 Government Spending

We now study a different kind of AD shocks, namely shocks to government spending. Unsurprisingly, these shocks have similar effects as those featured in our baseline analysis, both with and without common knowledge. But there is an interesting twist, regarding the distinction between front-loaded and back-loaded fiscal stimuli.

The model is the same, except for two modifications. First, we drop the shocks to the household's discount factor and, instead, add shocks to government spending. And second, we abstract from the wealth effect on labor supply. It is well understood both what this effect does in theory and that is probably very weak in reality. By removing it, we isolate what's new.³⁴

In each period, the government purchases a basket of all the goods in the economy. The overall expenditure, denoted by G_t , follows an AR(1) process with persistence $\rho_G \in [0, 1)$:

$$G_t = \rho_G G_{t-1} + \eta_t^G, \quad (48)$$

where $G_{-1} = 0$ and $\eta_t^G \sim \mathcal{N}(0, \sigma_G^2)$ is i.i.d. across t and independent from other shocks. The composition of G_t mirrors that of private spending.³⁵

Turning to taxes, we let government spending be financed by lump-sum taxation and, without further loss of generality, impose budget balance in each period, i.e., $G_t = T_t$. At the same time, we prevent one's own tax from being a perfect signal of the aggregate level of government spending by introducing idiosyncratic tax shocks. Specifically, we let the lump-sum tax levied to household h in period t be given by $T_t^h = T_t + \Delta_t^h$, where T_t is the average tax and $\Delta_t^h \sim \mathcal{N}(0, \sigma_\Delta^2)$ also follows an AR(1) process with persistence ρ_G , and independent from any other shock.³⁶

We close the model by letting the information structure be the same as in the baseline model, modulo, of course, that the knowledge of η_{t-1} and β_t^h is now replaced with the knowledge of η_{t-1}^G and T_t^h . That is, $\mathcal{I}_t^h = \mathcal{I}_{t-1}^h \cup \{T_t^h\} \cup \{w_{h,t}, e_{h,t}, R_{h,t}, (p_{i,j,t})_{i \in [0,1], j \in [0,1]}\} \cup \{\eta_{t-1}^G\}$.

As in the baseline model, we log-linearize the equilibrium conditions and re-interpret all the variables as log-deviations from their steady-state counterparts.³⁷ Following similar steps as in Section 5, we reach the following result.

Proposition 12. *(i) Aggregate supply remains the same as in Proposition 1.*

³⁴Here, we shut this effect down in the manner described earlier in footnote 18. Similar results obtain if we assume GHH preferences, as we did in an earlier draft.

³⁵That is, we impose, for all i, j , and t ,

$$\frac{p_{i,j,t} g_{i,j,t}}{G_t} = \frac{\int_{h \in [0,1]} p_{i,j,t} c_{i,j,t}^h dh}{c_t},$$

where $g_{i,j,t}$ is the government's purchase of variety j from island i in period t .

³⁶By equating the persistence of the idiosyncratic tax shock to that of aggregate government spending, we make sure that households correctly perceive the tax burden of any fiscal stimulus. Relaxing this property may be interesting on its own right—see, for example, [Gabaix \(2020\)](#) for an example that goes in this direction with the help of bounded rationality instead of incomplete information—but it is not the issue we wish to study here.

³⁷The following exception applies: G_t , T_t , $g_{i,j,t}$ and T_t^h henceforth represent, respectively, G_t/y^* , T_t/y^* , $g_{i,j,t}/y^*$, and T_t^h/y^* , where y^* is the steady-state (also, complete-information) value of aggregate output. This is a standard trick in the literature on fiscal multipliers (e.g., [Woodford, 2011](#)) and it simply takes care of the issue that the log-deviation of the government spending is not well defined when its steady-state value is 0.

(ii) Aggregate demand satisfies

$$y_t = -\sigma R_t + (1 - \rho_G) G_t + \mathbb{E}_t [y_{t+1}] + (\mathcal{B}_t + \mathcal{G}_t), \quad (49)$$

where \mathcal{B}_t and \mathcal{G}_t are the same as in (28) and (25), modulo the replacement of ρ_β with ρ_G .

(iii) The equilibrium response of real aggregate output is given by

$$\frac{\partial y_t}{\partial \eta_t^G} = \gamma^G \cdot m^{conf}(\lambda, \rho_\xi) \cdot m^{GE}(\lambda, \rho_G),$$

where $\gamma^G = \frac{(1-\rho_G)\beta\varsigma}{(\sigma+\varsigma)(1-\rho_G\beta)}$ is the complete-information counterpart and $m^{conf}(\cdot, \cdot)$ and $m^{GE}(\cdot, \cdot)$ are the same multipliers as those in Propositions 6–7.

In a nutshell, $(1 - \rho_G) G_t$ replaces $-\sigma\beta_t$ as the AD shock in Proposition 2. The rest is the same. And the following is then immediate.

Corollary. *With complete information, $\frac{\partial y_t}{\partial \eta_t^G} < 1$ necessarily. With incomplete information, instead, $\frac{\partial y_t}{\partial \eta_t^G} > 1$ is possible insofar as $\bar{m}\gamma^G > 1$, where \bar{m} is the maximum of the overall multiplier defined above.³⁸ That is, whereas an increase in government spending crowds out private consumption under complete information, it can crowd in under incomplete information.*

Our theory therefore helps accommodate the Keynesian narrative of how a fiscal stimulus can help boost consumer spending despite the increase in the tax burden. But unlike the Keynesian framework, our theory does not rely on nominal rigidity and does not require the boom to be inflationary.

The fiscal-policy predictions of our theory are even more distinct from those of the Keynesian paradigm if we shift the focus from “front-loaded” to “back-loaded” fiscal stimuli. By front-loaded stimuli, we mean unanticipated shocks to *current* government spending, such as those modeled above. By back-loaded stimuli, we instead have news about *future* government spending.

To see this, let G_t be i.i.d. over time and known one period in advance. That is, $G_t = \eta_{t-1}^G$ where η_{t-1}^G is a “new shock” observed at $t - 1$. Condition (49) then becomes

$$y_t = -\sigma R_t + \eta_{t-1}^G - \eta_t^G + \mathbb{E}_t [y_{t+1}] + (\mathcal{B}_t + \mathcal{G}_t).$$

It is immediate that, other things equal, aggregate demand today decreases with η_t^G , the news about tomorrow’s government spending. This translates, in equilibrium, to a reduction in y_t even when this news shock is perfectly known at t , thanks to the optimal intertemporal reallocation in production: when the economy expects an increase in the demand for goods tomorrow, it responds by economizing on its use of resources today. But when information is imperfect, the reduction in current income can be misperceived by the consumers as a reduction in permanent income. Our confidence multiplier thus kicks in, amplifying the contraction triggered by news of future increases in government spending.³⁹

³⁸The maximum overall multiplier is given by $\bar{m} \equiv m(1, 1, 1) = 1 + \beta + \frac{\varsigma}{\sigma}$.

³⁹There is, however, a countervailing channel. In the frictionless benchmark, the expectation of a higher G_{t+1} triggers an increase in the expected interest rate at $t + 1$, which depresses AD at t . Under incomplete information, the consumers discount this GE adjustment, which moderates the contraction in AD.

Finally, the fact that an increase in current government spending crowds in private consumption when the informational friction is large enough hints at our theory's broader ability to generate positive comovement among different components of aggregate demand. We expand on this point in the next two subsections.

6.3 Borrowers and Savers

Consider a variant of our model that lets only a fraction $\pi \in (0, 1)$ of the households be hit by an exogenous discount-rate shock. Think of them as “borrowers” responding to a credit crunch, and think of the remaining households as “savers.” Although we do not explicitly model this situation, we use this interpretation to allude to how our theory differs from, but also complements, the New Keynesian literature on liquidity constraints (e.g., [Eggertsson and Krugman, 2012](#); [Guerrieri and Lorenzoni, 2017](#)).

The AS side of the economy remains unaltered. What changes is the AD side. The two groups are identical, except for their different exposure to the exogenous shock. (The borrowers are directly exposed, the savers are not.)

When both groups are fully informed, the group-level demands are given by

$$\begin{aligned} c_t^b &= -\sigma R_t + \mathbb{E}_t [c_{t+1}^b] - \sigma \beta_t \\ c_t^s &= -\sigma R_t + \mathbb{E}_t [c_{t+1}^s], \end{aligned}$$

where the superscripts b and s stand for, respectively, borrowers and savers. It follows that, in equilibrium, a negative realization of η_t reduces c_t^b , reduces R_t , and increases c_t^s . As the borrowers cut down their spending, savers pick up some of the slack.⁴⁰

When information is incomplete, the group-level demands are modified as follows:

$$\begin{aligned} c_t^b &= -\sigma R_t + \mathbb{E}_t [c_{t+1}^b] + \mathcal{B}_t + \mathcal{G}_t - \sigma \beta_t \\ c_t^s &= -\sigma R_t + \mathbb{E}_t [c_{t+1}^s] + \mathcal{B}_t + \mathcal{G}_t. \end{aligned}$$

The terms \mathcal{B}_t and \mathcal{G}_t are the same as in our baseline model and the informational friction is again measured by $\lambda \in (0, 1]$.⁴¹

Proposition 13 (Borrowers and Savers). *Suppose that the informational friction is sufficiently large (λ small enough) and/or that the AS curve is sufficiently flat (ς large enough). Then, c_t^s , c_t^b , and y_t comove.*

The logic is straightforward. With complete information, c_t^s moves in the opposite direction of c_t^b because of the GE adjustment in the real interest rate. With incomplete information, this effect is attenuated and, on top of this, the reduction in aggregate income causes savers to misperceive a reduction in their permanent income. To the extent that this effect is strong enough (which is the case

⁴⁰This is immediate to see when the AS curve is vertical ($\varsigma \rightarrow 0$). In this case, aggregate output and consumption are invariant to η_t , implying that $c_t^s = -\frac{\pi}{1-\pi} c_t^b$. More generally, aggregate output and consumption fall with η_t , but it remains true that c_t^s moves in the opposite direction than c_t^b .

⁴¹This imposes, for simplicity, that the two groups have equally precise information about the underlying AD shock.

when the savers are sufficiently confused) and the adjustment in the real interest rate is small enough (which is the case when the AS curve is sufficiently flat), savers cut down their spending in equilibrium, moving in the same direction as the borrowers.

The New Keynesian framework can obtain a similar comovement between savers and borrowers by assuming a sufficiently irresponsive monetary policy, or by translating the credit crunch to a deflationary spiral, as in the ZLB applications by [Eggertsson and Krugman \(2012\)](#) and [Guerrieri and Lorenzoni \(2017\)](#). But this circles back to our motivation of why we find it useful to obtain realistic demand-driven business cycles outside the nexus of sticky prices and Phillips curves: here, we have offered a reason for why comovement between constrained and unconstrained agents may emerge *even if* monetary policy tracks the natural rate of interest, the output gap is zero, and inflation is stable.

6.4 Investment

As noted earlier, our baseline analysis allows for variable utilization of capital (or “land”) but abstracts from investment. If we add investment but let it be decided under complete information, we run into a familiar problem: whenever consumers spend less, the cost of investment (the real interest rate) goes down in equilibrium, causing investment to move in the opposite direction than consumption. We now show how this negative comovement problem is resolved when our confidence multiplier extends from consumption to investment.

To this goal, we re-interpret land as capital and modify its law of motion as follows:

$$k_{i,t+1} = \left(1 - \delta(u_{i,t}) + \Psi(\iota_t^i) + \epsilon_{i,t}^k\right) k_{i,t}, \quad (50)$$

where $u_{i,t}$ is the utilization rate, ι_t^i is the investment rate per unit of capital, $\epsilon_{i,t}^k$ is an idiosyncratic shock, $\delta(\cdot)$ is an increasing and strictly convex function, and $\Psi(\cdot)$ is an increasing and concave function. We let investment choices be made by the households and under the same information as consumption. And we accordingly rewrite the household’s budget constraint as

$$\int_{i \in [0,1]} \int_{j \in [0,1]} p_{i,j,t} c_{i,j,t}^h dj di + R_{h,t}^{-1} b_{t+1}^h = w_{h,t} n_t^h + e_{h,t} - \iota_t^h k_t^h + b_t^h,$$

where $e_{h,t}$, earnings net of labor costs, now represent the returns to capital.

The concavity of Ψ captures adjustment costs to capital, as in standard Q theory. More specifically, we let $\Psi(\iota^*) = \iota^*$, $\Psi'(\iota^*) = 1$, and $\Psi''(\iota^*) = -\psi$, where ι^* denotes the steady-state aggregate investment rate and $\psi > 0$ is a scalar that parameterizes how large the adjustment costs are. As anticipated, such adjustment costs make sure that the supply-side logic of our baseline model extends to the present model. In particular, we can show that the AS curve is positively sloped, or that aggregate employment and output respond positively to η_t , for *any* $\psi > 0$ as long as the real wage is sufficiently acyclical. Had we instead set $\psi = 0$, as in the classics by [Burnside, Eichenbaum, and Rebelo \(1995\)](#), [Greenwood, Hercowitz, and Huffman \(1988\)](#) and [King and Rebelo \(1999\)](#), it would have been impossible to get

aggregate employment and output to increase with η_t .⁴²

To make sure that investment also responds positively, we need the increase in the real interest rate to be offset by an increase in “investor sentiment.” By the latter we mean the analogue of \mathcal{B}_t for investment: in response to an intertemporal shift in aggregate spending, investors confuse an increase in sales and profits today for good news about idiosyncratic firm returns in the future.

The basic logic of how our mechanism gives rise to comovement is therefore similar to that in the previous subsection: just replace borrowers and savers with, respectively, consumption and investment. But the math is considerably more complicated because of the infinite horizon, the transitional dynamics in capital, and the multiple kinds of forward-looking decisions. To contain these complications, we shut down the wealth effect on labor supply, let the aggregate discount-rate shock η_t be transitory (recall that this isolates the confidence multiplier) and the idiosyncratic demand shock $\xi_{i,t}$ to be a random walk. We then prove the sought-after result under the conditions stated below.

Proposition 14 (Consumption-Investment Comovement). *There exist $\bar{\lambda}, \bar{\phi}, \underline{\nu}, \underline{\psi} > 0$ such that $\lambda < \bar{\lambda}$ along with $\phi < \bar{\phi}$, $\nu > \underline{\nu}$, and $\psi > \underline{\psi}$ suffice for both c_t and i_t to increase in response to a positive realization for η_t .*

Because of the aforementioned complications, this result only provides sufficiency in the neighborhood of $\lambda, \phi \approx 0$ and $\nu, \psi \approx \infty$. A sharper necessary and sufficient for comovement over the entire parameter space is offered in Appendix A for a more manageable, two-period version of our model. Both results yield the same lesson: comovement is possible as long as the informational friction is sufficiently large (small λ) and the AS curve is sufficiently flat (small ϕ , large ν and ψ). The first property maps to large procyclical movements in misperceptions of investment returns, the second to small countervailing movements in the real interest rate.

Needless to say, the result presented above is only a proof of concept; its quantitative potential is an open question. Also, the following qualification is important to make. By abstracting from an informational friction in production, we have made sure that utilization is not directly affected by the kind of misperceptions that affect investment and consumption. Had we allowed for the alternative scenario, the same mistake that causes households to raise their demand for investment could also cause firms to reduce their demand for utilization, simply because the negative of utilization is itself a form of investment. From this perspective, our theory appears to require a separation between investment and production, as in models that emphasize frictions in financial intermediation and asset markets, and a higher degree of over-extrapolation in “Wall Street” than in “Main Street.”

That said, once one allows informational frictions to be present in production, such frictions can also affect the demand for labor. Angeletos and La’O (2010, 2013) and Angeletos, Collard, and Dellas (2018) have built on this elementary point to generate business cycles with a Keynesian flavor out of extrinsic shocks in producer sentiment; a similar mechanism is also at work in Ilut and Saijo (2020),

⁴²For the proof of these claims, see the section “Aggregate supply: the role of capital adjustment costs” in Appendix A.

albeit for other shocks. We suspect that a combination of these approaches with ours could provide a more “robust” explanation of how fluctuations in confidence can generate realistic comovement.

6.5 Bounded Rationality

Our confidence multiplier originates from an informational friction in the tradition of [Lucas \(1972\)](#) and [Sims \(2003\)](#). Empirical evidence in support of such a friction abounds.⁴³ More tellingly for our purposes, a recent paper by [Andrade et al. \(2020\)](#) provides evidence in favor of the confusion between industry-specific and aggregate shocks, which is what our model assumes under the interpretation of an “island” as an industry. But neither this interpretation nor rational confusion is strictly needed for our multiplier to apply. A similar feedback loop obtains in a plausible “behavioral” variant in which agents have a less sophisticated understanding of the world than that assumed in Rational Expectations.

Suppose, in particular, that agents use a simple, random-walk model to extrapolate current income to future income:

$$E_t^h [y_{h,t+k}] = y_{h,t}. \quad (51)$$

This resembles the form of simple, “extrapolative” beliefs found in [Barberis et al. \(2015\)](#) and [Gennaioli, Ma, and Shleifer \(2016\)](#). It also proxies an optimally “sparse” representation of the individual income process, in the spirit of [Molavi \(2019\)](#).⁴⁴ Whenever current aggregate income goes up by one unit, agents believe that their permanent income has gone up by $1/(1 - \beta)$. But if the increase in current aggregate income is triggered by an AD shock, their permanent income has not actually changed. It follows that the relevant misperception term (28) is given by

$$\mathcal{B}_t = \frac{1}{\beta} \frac{\partial y_t}{\partial \eta_t} \eta_t.$$

In our original model, this term was given by

$$\mathcal{B}_t = \frac{(1-\beta)(1-\lambda)}{\beta(1-\beta\rho_\xi)} \frac{\partial y_t}{\partial \eta_t} \eta_t.$$

Clearly, the two expressions coincide when $\lambda = 0$ and $\rho_\xi = 1$ (maximal informational friction and random-walk idiosyncratic shocks), illustrating how our confidence multiplier can be recast as the product of bounded rationality. This in turn lets us connect to [Akerlof and Shiller \(2010\)](#), who also talk about feedbacks between economic outcomes and confidence, and have a behavioral interpretation in mind, but do not spell out what exactly this means in terms of a fully articulated model.

A similar re-interpretation is possible for our second mechanism, the discounting of the GE adjust-

⁴³See, inter alia, [Coibion and Gorodnichenko \(2012, 2015\)](#), [Coibion, Gorodnichenko, and Ropele \(2019\)](#), [Cavallo, Cruces, and Perez-Truglia \(2017\)](#), [Angeletos and Sastry \(2021\)](#), and the references there in.

⁴⁴Suppose that individual income is driven by both random-walk idiosyncratic shocks (like $\xi_{h,t}$ in our model) and transitory aggregate shocks (like β_t in our model). Suppose further that agents can only use a lower-dimension, one-factor, statistical model to track current income and form expectations about future income, but can choose that model optimally, as in [Molavi \(2019\)](#). A reasonable conjecture is that the optimal model converges to the static process of the idiosyncratic shock as this shock gets larger and larger relative to the aggregate one.

ment in real interest rates. Consider, in particular, the following scenario. While a fraction of $\ell \in (0, 1)$ of households are both fully informed and fully rational, the remaining are “level-1 thinkers” a la [Farhi and Werning \(2019\)](#): although they experience an urge to consume less, they do not expect *others* to spend less in the future. These agents expect future aggregate demand, and hence also the future real interest rate, to remain unchanged. It follows that the relevant term (25) is given by

$$\mathcal{G}_t = (1 - \ell)\sigma \sum_{k=1}^{+\infty} \beta^k \frac{\partial \mathbb{E}_t[R_{t+k}]}{\partial \eta_t} \eta_t.$$

By comparison, in our baseline model, this term satisfies

$$\mathcal{G}_t = (1 - \lambda)\sigma \sum_{k=1}^{+\infty} \beta^k \frac{\partial \mathbb{E}_t[R_{t+k}]}{\partial \eta_t} \eta_t.$$

Clearly, the two terms coincide when $\lambda = \ell$. In this sense, the lack of information can readily be recast as a lack of sophistication (“some people do not understand GE consequences”).⁴⁵

7 Conclusion

We revisited the question of why shifts in consumer spending, or other aggregate demand shocks, trigger business cycles. Unlike the dominant paradigm, our theory did not rely on nominal rigidity and the failure to implement the natural rate of output. Instead, it combined a neoclassical margin for intertemporal substitution on the supply side with an informational friction, or bounded rationality, on the demand side. The first element allowed the aggregate production of today’s goods to be responsive to intertemporal taste shocks, or other shifts in aggregate demand. The second element gave rise to our confidence multiplier, a positive feedback loop between current economic activity, consumer perceptions of permanent income, and investor expectations of returns.

This mechanism was shown to amplify aggregate demand shocks, without necessarily doing the same for aggregate supply shocks. Furthermore, this mechanism contributed to positive comovement between the different components of aggregate demand, such as private consumption, private investment, and government spending. And last but not least, this mechanism was operating along with flexible-price outcomes, requiring no comovement between inflation and real economic activity.

All in all, our theory is therefore capable of accommodating the Keynesian narrative of the business cycle without a strict reliance on nominal rigidity and on gaps from the natural rate of output. And it helps match—qualitatively—a number of stylized facts about modern business cycles.

Consider, in particular, the empirical template that [Angeletos, Collard, and Dellas \(2020\)](#) provide for the “main business cycle shock” in the data. This is constructed by running a VAR on a few key macroeconomic time series and by identifying the shock (i.e., the linear combination of the VAR residuals) that has the maximal contribution to the fluctuations of unemployment over the business-cycle

⁴⁵This example indicates more broadly the similarity of the bounded-rational approaches taken in [Gabaix \(2020\)](#) and [Farhi and Werning \(2019\)](#) to the incomplete-information approach taken in [Angeletos and Lian \(2018\)](#).

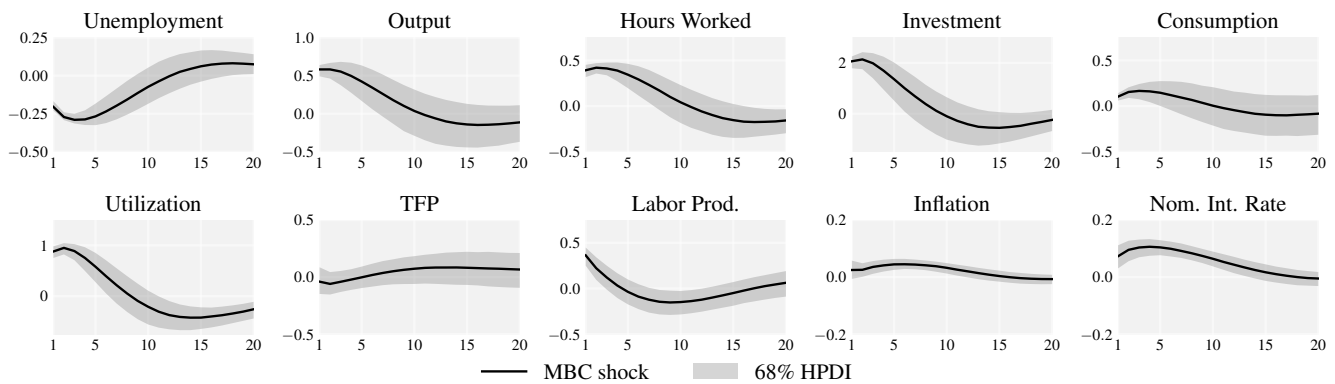


Figure 2. The “Main Business Cycle Shock” in the Data, from [Angeletos, Collard, and Dellas \(2020\)](#)

frequencies. Figure 2 reports the IRFs of all the variables under consideration to this shock.⁴⁶

The key observations for our purposes are the following. First, there is significant comovement between unemployment, output, hours worked, investment, and consumption, without commensurate comovement in TFP and inflation. Second, there is significant pro-cyclical movement in utilization, which in turn appears to account for all the pro-cyclical movement in labor productivity. And third, there is significant pro-cyclical movement in the nominal interest rate and, since inflation is relatively stable, there is nearly equal pro-cyclical movement in the real interest rate.

These properties are consistent with our theory. The first property is essentially the definition of the kind of non-inflationary, demand-driven fluctuation in the data that our theory aspired to deliver. The second provides tentative support for our theory’s emphasis on utilization. The third supports both the idea that the underlying shock is an aggregate demand shock that pushes up the real interest rate and the idea that the monetary authority is tracking the natural rate.

Another notable feature of the data, seen in the bottom left panel of Figure 2, is that the response of utilization reverses sign after a few quarters. This is in line with the supply side element of our theory, and in particular the idea that demand-driven business cycles represent *intertemporal* reallocation of utilization and production. And it hints at the broader value of exploring the robustness of this empirical finding and its theoretical implications.

This is all good news for our theory. But none of the above facts directly speak to our confidence multiplier. Ultimately, the sign and size of the kind of misperceptions—rational or irrational—modeled in this paper is an empirical question. And although we must leave this question for future work, we hope to have provided useful guidance for what exactly future empirical work should explore.

Let us expand on the last point by relating our theory to the empirical findings of [Rozsypal and Schlafmann \(2019\)](#), [Greenwood and Shleifer \(2014\)](#), and [Gennaioli, Ma, and Shleifer \(2016\)](#). These

⁴⁶Figure 2 here is basically a replica of the solid lines from Figure 17 in the Online Appendix of [Angeletos, Collard, and Dellas \(2020\)](#). Relative to the original, we have dropped three variables (stock prices, the relative price of investment, and the labor share) in order to simplify the figure; but as it can be readily verified by comparing the two figures, the inclusion or exclusion of these variables makes no essential difference for the results. We refer the reader to [Angeletos, Collard, and Dellas \(2020\)](#) for a detailed description of the data and the empirical method, a discussion of structural interpretations, and a barrage of robustness exercises; the replication material can be found at <https://www.aeaweb.org/articles?id=10.1257/aer.20181174>.

works are supportive of our confidence mechanism in the sense that they point out in the direction of expectations of income and returns being excessively optimistic in good times and excessively pessimistic at bad times.⁴⁷ They do not, however, distinguish whether such good and bad times are driven by the kind of aggregate demand shocks that are the focus of our paper or by other forces, such as TFP shocks. The litmus test of our theory is therefore *conditional* evidence for how expectations of income and interest rates respond to different kinds of shocks—and it is this specific kind of evidence we invite for future work.

We conclude with the following remark. To isolate our demand-side mechanism, we abstracted from any supply-side friction and any movements in the labor wedge. To the extent that such movements reflect real wage rigidities, they are immediately consistent with the re-interpretation of condition (13) as an arbitrary “real wage schedule,” namely a mapping from aggregate employment to real wages that needs *not* coincide with the household’s optimal labor supply condition.⁴⁸ But another possibility, closer in spirit to our paper, is that the labor wedge is itself the product of informational frictions (at least partially). While we abstracted from this possibility in this paper, this is a central ingredient of papers such as [Angeletos and La’O \(2010\)](#), [Angeletos, Collard, and Dellas \(2018\)](#), and [Ilut and Saijo \(2020\)](#). This suggests that a bridge between these papers and ours could be another fruitful direction for future work.

⁴⁷[Rozsypal and Schlafmann \(2019\)](#) use micro data on household income expectations, and find that consumers over-extrapolate from their current income to expectations of future income, as they overestimate the persistence of their income process. Households with currently high income turn out to be too optimistic about their future income, while households with currently low income turn out to be too pessimistic about their future income. [Gennaioli, Ma, and Shleifer \(2016\)](#) turn the focus to the firm side. They find that firm CFOs over-extrapolate from current earnings to expectations of future earnings. [Greenwood and Shleifer \(2014\)](#) find that investors over-extrapolate from current stock returns to expectations of future stock returns.

⁴⁸See footnote 18 for details. Note that real wage rigidity does not by itself give a non-vertical AS curve. But once our intertemporal-substitution margin is active, it helps make the AS curve flatter (think of real wage rigidity as a larger Frisch elasticity). And, as mentioned in Section 6.2, it also helps mute the wealth effect of government spending.

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