

The Origins and Propagation of Animal Spirits Shocks

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Abstract

This paper presents a business cycle model where animal spirits shocks, originating from idiosyncratic productivity shocks, drive the comovement of investment, consumption, hours worked, and inflation. In the fully characterized comovement mechanism, real wage rigidity and diminishing returns to labor, resulting from the presence of capital, play a crucial role: a positive investment demand shock raises labor demand, decreases the marginal product of labor, and increases the marginal cost of producing final goods. Our model features a firm's lumpy investment, leading to a state-dependent multiplier effect, which depends on the firm's capital profile within an inaction band. Lumpy investments, propagated through the aggregate demand externality, generate an investment avalanche. This offers a micro-foundation for our animal spirits shocks and produces aggregate fluctuations without assuming exogenous aggregate shocks. Additionally, by including a time-to-build process for capital formation, the model can explain the autocorrelation structure.

Keywords: Investment demand shocks, procyclical inflation, endogenous business cycles, lumpy investment, investment avalanche