News-Driven International Business Cycles: Effects of the US News Shock on the Canadian Economy

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Abstract

This paper studies the international transmission effects of the news about the Total Factor Productivity (TFP) of the US to the Canadian economy. First, using the Vector Error Correction Model (VECM), the impulse responses of Canadian macroeconomic variables to the US news shock are estimated. Next, I develop and estimate a two-country RBC model with the preference introduced by Jaimovich and Rebelo (2008) and investment adjustment cost to generate booms in Canadian variables in response to news about future US TFP. I find that international macroeconomic comovements between the US and Canada can be generated by the news about future TFP in the US. Unlike previous studies, I show that the response of Canadian TFP to the US news shock is important in order to generate the boom observed in empirical analysis. Estimated value of the preference parameter indicates that getting rid of the wealth effect on hours worked is important. I also show that low elasticity of substitution between domestically and foreign produced intermediate goods can also help explaining the domestic boom created by the news shock, which highlights the importance of analyzing an open economy.