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The Impact of Idiosyncratic Uncertainty When Investment Opportunities Are Endogenous

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Abstract

This paper develops a general equilibrium model to study the impact of aggregate fluctuations in idiosyncratic volatility that incorporates the endogenous determination of investment opportunities. By making investment options more valuable, an increase in volatility encourages the creation of new investment options. I find the response of the economy to a volatility shock depends on how investment opportunities are obtained. If potential entrants are allowed to invest in new idiosyncratic technologies, thereby acquiring options for further investment, the volatility shock increases overall investment and results in an economic boom. On the other hand, if such an investment in option creation is precluded and investment opportunities are exogenously given, the volatility shock decreases aggregate investment.

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