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STOCK PRICES AND MONETARY POLICY SHOCKS: A GENERAL EQUILIBRIUM APPROACH

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Abstract. Empirical literature documents that unexpected changes in the nominal interest rates have a significant effect on real stock prices: a 100-basis point increase in the nominal interest rate is associated with an immediate decrease in broad real stock indices that may range from 2.2 to 9 percent, followed by a gradual decay as real stock prices revert towards their long-run expected value. We assess the ability of a general equilibrium New Keynesian asset-pricing model to account for these facts. We consider is a production economy with elastic labor supply, staggered price and wage setting, as well as time-varying risk aversion through habit formation. We find that the model predicts a stock market response to policy shocks that matches empirical estimates, both qualitatively and quantitatively. Our findings are robust to a range of variations and parametrizations of the model.

Keywords: Monetary policy; Asset prices; New Keynesian general equilibrium model
JEL Classification: E31, E52, G12

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