# Persistent Noise, Feedback, and Endogenous Optimism: A Rational Theory of Overextrapolation* 

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#### Abstract

I propose a noisy rational expectations model with persistent noise. Firms learn about economic conditions from signals, and the noise in the signals is persistent rather than i.i.d. over time. Firms rationally account for the persistence of noise and update their interpretations of signals based on ex post observations of true economic conditions. I show that this process gives rise to a novel mechanism by which optimism arises endogenously, which in turn amplifies or dampens the effects of underlying shocks. In particular, this model can generate the delayed overreaction in firms' expectations documented in the literature, when firms are better informed about idiosyncratic shocks relative to aggregate shocks. Moreover, strategic complementarity between firms and the resulting higher-order optimism further strengthen my mechanism. Finally, I distinguish empirically my rational theory of optimism from behavioral theories by exploiting the difference in the degree of overextrapolation between consensus and individual forecasts.


Keywords: Expectations, Information, Optimism, Informational Frictions.

[^0]
## 1. Introduction

How do agents form expectations based on the information they have? Can waves of optimism and pessimism play a role in driving the economy? Several strands of macroeconomic literature provide insights into incorporating the role of optimism in business cycle models, focusing on either behavioral changes in beliefs or exogenous shifts in rational expectations, such as sunspots, noise shocks in public signals, and sentiment shocks.

In this paper, we capture optimism in an entirely different yet rational way. Agents learn about economic conditions from signals, but they are uncertain about how to interpret these signals. They are said to be optimistic if they interpret their signals in an optimistic way. Agents try to correct their optimism rationally, and in the presence of strategic interaction between agents, they try to learn the optimism of others as well. In this process, optimism is endogenously determined by the dynamic path of fundamentals and acts as an amplification or dampening mechanism. ${ }^{1}$

The key to our mechanism is the assumption of persistent noise. Agents observe noisy signals about economic conditions, but in contrast to the literature, we assume that noise terms are persistent rather than i.i.d. over time. Agents rationally account for the persistence of noise and update their beliefs about noise based on ex post observations of true economic conditions. I show that this process gives rise to a novel mechanism by which optimism arises endogenously. In particular, when agents observe better than expected economic conditions, they update their expectation of the noise term downward, implying that they interpret their future signals more optimistically.

To illustrate the main idea, consider firms that need to forecast market demand for their products in order to set prices or make production plans. Firms observe noisy signals about market demand at the beginning of each year, for example, from consumer surveys. Firms also receive feedback on their prior forecast by observing the realized market demand ex post through the sale of their products. Suppose that there is a positive shock to market demand, but firms were not well informed about it from their consumer surveys. Then, realized market demand is higher than firms expected, leading them to believe that they were too pessimistic in interpreting the survey results. This, in turn, makes them overly

[^1]optimistic when they make new forecast based on a new survey result. In this way, the effect of the positive shock propagates into the next year.

We begin by calling into question the validity of the i.i.d. noise assumption commonly made in the literature and provide two arguments in favor of persistent noise. We model this persistence by assuming that the noise terms follow an $\operatorname{AR}(1)$ process. Rational agents then take this persistence into account when forming their expectations and try to learn the noise terms in order to best interpret their signals. Their beliefs about the noise terms affect their forecast and hence their actions. We then formally define the notion of optimism. If agents underestimate the noise terms in their signals, they will overestimate the fundamentals for given values of the signals, so we call them optimistic.

We then introduce a macroeconomic noisy rational expectations model in which firms' output choices are made under dispersed information about their productivity. We characterize how firms dynamically learn persistent noise terms in their signals and how this novel channel of learning endogenously generates optimism, which either amplifies or dampens the underlying productivity shock. We assume that firms receive feedback on their previous forecast by observing the actual productivity realization. We assume that the productivity shock consists of two components. Firms receive noisy signals about the first partly-observed component and choose their output levels. However, true productivity is also affected by the second unobserved component. This distinction formalizes the idea that there are many shocks in the real world that differ in the extent to which economic agents are informed about them. ${ }^{2}$ Our main finding is that, with persistent noise, the effect of partly-observed shocks on the next period's output is dampened because they make firms pessimistic, while the effect of unobserved shocks is amplified because they make firms optimistic instead. Following the literature, we further assume that firms are relatively well informed about idiosyncratic shocks, so that partly-observed shocks correspond to idiosyncratic shocks while unobserved shocks correspond to aggregate shocks. In this case, aggregate optimism fluctuates procyclically with the underlying aggregate shocks, and aggregate output exhibits delayed overreaction to aggregate productivity shocks, as in Angeletos, Huo, and Sastry (2020).

Next, we introduce strategic complementarity in our baseline model. This gives firms an incentive to forecast others' optimism, others' beliefs about others' optimism, and so on (i.e., higher-order

[^2]optimism). We characterize how firms update their higher-order optimism and how this higher-order optimism in turn affects firms' output choices through its effect on higher-order beliefs about aggregate productivity. We first show that the main result continues to holds in the extended model with strategic complementarity: the effect of partly-observed shocks is dampened while the effect of unobserved shocks is amplified. Moreover, we show that the presence of strategic complementarity and the resulting higher-order optimism always strengthen our mechanism relative to the baseline model. In other words, when firms observe better than expected economic conditions, they become optimistic not only about their signals (first-order optimism) but also about others' optimism (higher-order optimism). This result is in stark contrast to the literature, which instead documents that the higher the degree of strategic complementarity is, the less responsive agents are to the underlying shocks.

Finally, we turn to the empirical content of our theory: how can we interpret forecast data through the lens of our framework? There is a large body of empirical work that uses survey forecast data to measure agents' expectations directly. This literature often assumes that forecasters do not observe past realizations, even ex post. This is partly because observing past realizations makes the problem essentially static in their setting and makes it difficult to explain what we can observe in the dynamic forecast data. Our theory provides a completely different way of interpreting the forecast data. We view these forecast data as the results of agents' dynamic learning, in which they can observe past realizations but are trying to learn how to interpret their own information, i.e., noise terms. Our model explains prominent empirical findings in the literature, includign Coibion and Gorodnichenko (2015); Kohlhas and Walther (2020); and Angeletos, Huo, and Sastry (2020). However, many other standard models can also explain these findings, in particular behavioral theories of overextrapolation combined with information frictions. To distinguish our model from these theories, we exploit the difference between the degree of overextrapolation in consensus and individual forecasts. In the IBES dataset, analysts' expectations for earnings growth exhibit overextrapolation from past realizations only when we aggregate them into consensus forecasts. This is consistent only with our rational theory of overextrapolation.

The rest of the paper is organized as follows. Section 2 justifies our assumption of persistent noise and formalizes the notion of optimism. Section 3 develops a macroeconomic model without strategic complementarity. We characterize the learning of firms and see how our mechanism amplifies or dampens the underlying productivity shocks. In Section 4, we use an extended model to explore further implications when strategic complementarity is present. Section 5 discusses the new interpretation
of dynamic forecast data and provides empirical evidence that is suggestive of our theory. Section 6 concludes.

## 2. Persistent Noise Terms and Optimism

In this section, we introduce the key element of our theory-persistent noise terms in signals-and illustrate how it naturally leads to a definition of optimism. The literature that investigates the role of expectations and information often postulates that agents receive noisy signals about the true state of nature (hereafter, fundamental) and that they know the stochastic relationships between the signals and fundamental. For example, signals are often modeled as fundamental plus a random noise term with a known distribution:

$$
s_{t}=a_{t}+\xi_{t}
$$

where $s_{t}$ is the signal about the fundamental $a_{t}$ at time $t$, and $\xi_{t}$ is the noise term. This assumption is just a modeling device that captures the idea that we are partly informed about the true state of the world while preserving the tractability of models. Most of the papers in the literature, however, assume that noise is a random variable independent across time. ${ }^{3}$ This time-independence assumption simplifies the analysis a lot, and, combined with normality assumptions, often leads to closed-form solutions.

Whether this i.i.d. assumption is a good or bad description of the real world depends on how we interpret the noisy signal; i.e., what the real-world counterpart of the noise is. There are two prominent interpretations in the literature, and we will argue in this section that whatever interpretation we adopt, persistent noise is more realistic assumption. We then discuss the implications of this persistence in the following sections.

First, we can literally interpret the signal as noise-ridden information about fundamental, and agents directly observe this signal. In the real world, information sources are always biased, and the bias is

[^3]likely to be persistent across time. Agents, however, do not know the exact value of this bias. This gives rise to an additional component of noise, which makes the perceived noise also likely to be persistent. ${ }^{4}$

The second interpretation comes from the literature on rational inattention. Consider a slightly generalized version of the attention problem studied by Sims (2003) and Mackowiak and Wiederholt (2009):

$$
\begin{array}{cl}
\min _{b_{0}, b(\cdot), c_{t}(\cdot)} & \mathbb{E}\left[\left(\mathbb{E}\left[a_{t} \mid s^{t}\right]-a_{t}\right)^{2}\right] \\
\text { s.t. } & \mathcal{I}\left(\left\{s_{t}\right\} ;\left\{a_{t}\right\}\right) \leq \kappa \\
& a_{t}=\rho_{a} a_{t-1}+\varepsilon_{t} \\
& s_{t}=b_{0}+b(L) \varepsilon_{t}+c_{t}(L) \tilde{\xi}_{t}
\end{array}
$$

where $\varepsilon_{t}$ and $\tilde{\xi}_{t}$ follow independent Gaussian white noise processes. ${ }^{5}$ The decision maker chooses a signal process $s_{t}$ to forecast $a_{t}$, subject to a constraint on the information flow between $\left\{s_{t}\right\}$ and $\left\{a_{t}\right\}$, which sets an upper bound for

$$
\mathcal{I}\left(\left\{s_{t}\right\} ;\left\{a_{t}\right\}\right) \equiv \lim _{T \rightarrow \infty} \frac{1}{T} I\left(s_{1}, \cdots, s_{T} ; a_{1}, \cdots, a_{T}\right)
$$

where $I(\cdot ; \cdot)$ denotes the mutual information. Sims (2003) and Mackowiak and Wiederholt (2009) show that it is without loss to assume that the decision maker makes a forecast after observing a signal of the form "true state plus a time-independent noise term:"

$$
s_{t}=a_{t}+\sigma \cdot \tilde{\xi}_{t}
$$

[^4]where $\sigma$ is a constant. In other words, such signals are optimal when agents can choose an information structure under the above constraint.

This result gives an elegant justification for the i.i.d. assumption. It is, however, not robust in the sense that it depends crucially on the precise form of the information constraint. For example, when we consider other forms of information constraints such as

$$
\begin{equation*}
I\left(s_{t} ; a_{t}\right) \leq \kappa, \quad \forall t, \tag{1}
\end{equation*}
$$

then we can easily show that agents can always be better off by inducing correlations in their signals.
Lemma 1. The signals with i.i.d. noise terms, $s_{t}=a_{t}+\sigma \cdot \tilde{\xi}_{t}$, cannot attain the minimum of the following attention problem

$$
\begin{array}{cl}
\min _{b_{0}, b(\cdot), c_{t}(\cdot)} & \mathbb{E}\left[\left(\mathbb{E}\left[a_{t} \mid s^{t}\right]-a_{t}\right)^{2}\right] \\
\text { s.t. } & I\left(s_{t} ; a_{t}\right) \leq \kappa, \forall t \\
& a_{t}=\rho_{a} a_{t-1}+\varepsilon_{t} \\
& s_{t}=b_{0}+b(L) \varepsilon_{t}+c_{t}(L) \tilde{\xi}_{t} .
\end{array}
$$

Instead, signals with persistent noise terms, $s_{t}=a_{t}+\sigma \cdot \tilde{\xi}$ where $\tilde{\xi} \sim \mathcal{N}(0,1)$ attain the minimum.

Proof. All proofs are in Appendix A.
The intuition is simple, agents can make noise terms correlated across time periods for free under this information constraint. ${ }^{6}$ By doing so, however, agents can dynamically learn and correct the persistent component of noise. ${ }^{7}$ There is, of course, no a priori reason that the information constraint in the real world is given by (1). However, the same is true that no reason favors the original information constraint of Sims (2003) and Mackowiak and Wiederholt (2009). Thus, Lemma 1 gives us a takeaway that unless the real-world information constraint is exactly the same as what Sims (2003) and Mackowiak and Wiederholt (2009) postulate, decision makers would optimally choose correlated noise terms in order to exploit their abilities to correct the persistent component of the noise terms over time.

[^5]Illustrative Example. We have argued that regardless of how we interpret the noise term, its counterpart in the real world is likely to be correlated across time periods. To further illustrate this argument, consider a forecaster who makes predictions of, say, the annual US inflation rate. There are various information sources she can use to make her prediction, but suppose that she only gets information from newspapers. There are $N$ available newspapers, each of which is informative about the inflation rate. The forecaster chooses to subscribe to a subset of the newspapers while being subject to attention costs. Thus, these newspapers can be thought of as information sources in Myatt and Wallace (2004) and Pavan (2016). First note that if a specific newspaper gives a positively biased view of the inflation rate this year, then it is likely to give a view biased in the same direction next year. Consider a constraint on the attention cost which requires that the forecaster can read at most, say, three newspapers each year. Under this constraint, which is analogous to the cosntraint (1), the forecaster would optimally choose to read the same set of newspapers every year because she can at least partly correct the bias in the newspapers by herself. ${ }^{8}$ Since the bias in each newspaper is persistent, and the forecaster would choose to read the same newspapers, it is as if she were receiving a noisy signal whose noise term is correlated across time periods. In contrast, under a constraint which is analogous to the original constraint in Sims (2003) and Mackowiak and Wiederholt (2009), if she reads three specific newspapers this year, then it would be strictly more costly (in terms of the cognitive cost) to read the same set of newspapers next year because she is able to get strictly more information from those newspapers. Thus, we reach a counterintuitive conclusion that it can be optimal to read three new newspapers every year.

Remark. To fix ideas, we talked about biased information sources and agents who try to learn the bias. In the real world, however, information sources are not only biased but also absent from a pre-specified way of interpreting them. For example, if you observe that the current unemployment rate is 5\%, then how can you interpret this number as a signal about the current inflation rate? It is indeed informative about the inflation rate to some degree, but it is not like observing a random variable which is distributed around the inflation rate as we assumed. Forecasters need to interpret information sources they have, but they are uncertain about how to interpret them. Thus, the forecaster in the previous example can also be viewed as the one who tries to correct her way of interpreting newspapers. In this sense, "learning noise terms" in this paper also means "learning how to interpret information."

[^6]We have argued so far that it is natural to assume persistent noise terms. From now on, we model this persistence by simply assuming that agents observe a noisy signal about the fundamental $a_{t}$

$$
s_{t}=a_{t}+\xi_{t}
$$

whose noise term $\xi_{t}$ is auto-correlated ${ }^{9}$

$$
\xi_{t}=\rho \xi_{t-1}+\eta_{t} .
$$

This is only a small departure from the literature and enables us to maintain tractability.
The persistence of noise terms naturally leads to a formal definition of optimism. A crucial difference from the model with i.i.d. noise terms is that agents try to learn the noise terms $\xi_{t}$ in their signals. Agents' expectations about the noise terms affect how optimistic they are in interpreting the signals, which in turn affects their forecasts and hence their decisions. We consider two information sets $\tilde{\Omega}_{t}$ and $\Omega_{t}$, which are the information sets of an agent right before and right after, respectively, observing a signal $s_{t}$. From an outside observer's perspective, if an agent underestimates her noise term $\xi_{t}$, then for a given realization of her signal $s_{t}$, she would overestimate the fundamental $a_{t}$. Therefore, an agent is optimistic in interpreting her signal $s_{t}$ if her belief about the noise term $\xi_{t}$ is lower than the true value. This discussion leads to the following definition of (first-order) optimism. ${ }^{10}$

Definition 1. An agent is said to be ex-ante (ex-post, respectively) optimistic if she underestimates the noise term in her signal:

$$
\mathbb{E}\left[\xi_{t} \mid \tilde{\Omega}_{t}\right]<\xi_{t} \quad\left(\mathbb{E}\left[\xi_{t} \mid \Omega_{t}\right]<\xi_{t}, \text { respectively }\right)
$$

The ex-ante (ex-post, respectively) optimism of an agent is defined to be the extent to which she underestimates the noise term:

$$
\tilde{\mathcal{O}}_{t} \equiv \xi_{t}-\mathbb{E}\left[\xi_{t} \mid \tilde{\Omega}_{t}\right] \quad\left(\mathcal{O}_{t} \equiv \xi_{t}-\mathbb{E}\left[\xi_{t} \mid \Omega_{t}\right], \text { respectively }\right)
$$

[^7]Thus, ex-ante optimism captures how optimistic an agent is before observing a signal, and ex-post optimism captures how optimistic she is in interpreting a realized signal. In the next section, we will see how agents' dynamic learning about the persistent noise terms endogenously generates optimism, and how the resulting optimism affects equilibrium outcomes.

## 3. The Baseline Model

We start with a macroeconomic model in which firms' output choices are made under incomplete information about their productivity. The model structure is closely related to the island model in Angeletos and La'O (2009b) and Benhabib, Wang, and Wen (2015), but the timeline is more similar to that in Kohlhas and Walther (2020). In this section, we consider specific parameter values under which we have no strategic complementarity between firms' decisions. This enables us to focus on how firms learn about persistent noise terms in their own signals. Compared to the benchmark case with i.i.d. noise terms-as is often the case in the literature-this novel channel of learning endogenously generates optimism and eitheramplifies or dampens underlying shocks depending on how much firms are informed about the shocks. In the next section, we consider the case with strategic complementarity and show that the presence of strategic complementarity always strengthens our mechanism.

Timeline. There is an infinite number of periods $t=0,1, \ldots$ and a representative household consisting of a continuum of workers. We use the island analogy of Lucas (1972) to capture the incompleteness of information in the real world. There is a continuum of islands $i \in[0,1]$, each of which has its own labor market and own information set. Island $i$ is inhabited by a continuum of firms $j \in[0,1]$, each of which specializes in the production of differentiated commodities. We will index these firms and their commodities by $(i, j) \in[0,1] \times[0,1]$. The timeline is as follows. First, at the beginning of each period, the household sends one worker to each island. Second, after observing noisy signals about island-specific productivity, firms commit to their output levels, and workers post wages at which they commit to supply any amount of labor. Third, the island-specific productivity realizes and firms' labor demand is determined by the committed level of output and the productivity. Finally, workers return to their home and commodity markets open. Prices adjust to clear the markets.

Household. A representative household consists of a continuum of workers who solve a team problem of jointly maximizing the household utility, which is given by

$$
\mathbb{E}_{0}\left[\sum_{t=0}^{\infty} \beta^{t}\left(\log C_{t}-\nu \cdot N_{t}\right)\right]
$$

where $N_{t}=\int_{0}^{1} N_{i t} \mathrm{~d} i$ is the total labor supply of its workers. For simplicity, we assume a unit intertemporal elasticity of substitution and a unit Frisch elasticity of labor supply, but none of our results qualitatively depend on this assumption. The consumption $C_{t}$ has a nested structure. First, it is CES aggregation of the consumption bundle $\left\{C_{i t}\right\}_{i \in[0,1]}$ from different islands,

$$
C_{t}=\left(\int_{0}^{1} C_{i t}^{1-\frac{1}{\sigma}} \mathrm{~d} i\right)^{\frac{\sigma}{\sigma-1}}
$$

where $\sigma \leq 1$ is the elasticity of substitution across consumption from different islands. Second, the consumption $C_{i t}$ from island $i$ is also CES aggregation of the consumption bundle $\left\{C_{i j t}\right\}_{j \in[0,1]}$ from monopolistic firms in island $i$

$$
\begin{equation*}
C_{i t}=\left(\int_{0}^{1} C_{i j t}^{1-\frac{1}{\eta}} \mathrm{~d} j\right)^{\frac{\eta}{\eta-1}} \tag{2}
\end{equation*}
$$

where $\eta>1$ is the elasticity of substitution across firms. We normalize the price index to one,

$$
1=P_{t} \equiv\left(\int_{0}^{1} P_{i t}^{1-\sigma} \mathrm{d} i\right)^{\frac{1}{1-\sigma}} \text { where } P_{i t}=\left(\int_{0}^{1} P_{i j t}^{1-\eta} \mathrm{d} j\right)^{\frac{1}{1-\eta}}
$$

where $P_{i j t}$ is the price of the good from firm $j$ in island $i, P_{i t}$ is the price index for goods in island $i$.
The budget constraint dictates that the total purchase of consumption goods and bonds cannot exceed the total income, which consists of profits, wage, and payment from the bond: ${ }^{11}$

$$
\int_{0}^{1} \int_{0}^{1} P_{i j t} C_{i j t} \mathrm{~d} i \mathrm{~d} j+B_{t+1} \leq \int_{0}^{1} \int_{0}^{1} \Pi_{i j t} \mathrm{~d} i \mathrm{~d} j+\int_{0}^{1} W_{i t} N_{i t} \mathrm{~d} i+\left(1+R_{t}\right) B_{t}
$$

where $B_{t}$ is the bond holding in period $t, R_{t}$ is the gross interest rate between period $t$ and $t+1, \Pi_{i j t}$ is the profit of firm $j$ in island $i, W_{i t}$ is the wage in island $i$, and $N_{i t}$ is the labor supply of its worker sent to island $i$. When workers jointly maximize the utility of the household they belong to, they are subject to informational constraints. The labor supply decisions of workers sent to different islands are

[^8]based on different information sets. After they return to their home, all the information is shared, and the household makes consumption and saving decisions.

Firms. Firm $j$ in island $i$ has a production function

$$
Y_{i j t}=A_{i t} \cdot N_{i j t}^{\theta}
$$

where $A_{i t}$ is the common productivity of firms in island $i, N_{i j t}$ is the firm's employment, and $\theta \in(0,1]$ governs the decreasing return to scale in production. After commodity markets open and prices clear these markets, the firm's realized profit is

$$
\Pi_{i j t}=P_{i j t} Y_{i j t}-W_{i t} N_{i j t} .
$$

Market Clearing. A key feature of the model is that decisions of firms and workers are made under imperfect information. After observing a signal for island-specific productivity, firms commit to the output level, $Y_{i j t}$, and workers post wages $W_{i t}$. As will become evident in Lemma 2 below, this assumption makes firms choose higher output levels when they are more optimistic. Under this assumption, the labor market clearing is trivial: given the island-specific productivity, $A_{i t}$, Firm $j$ in island $i$ demands

$$
\begin{equation*}
N_{i j t}=\left(Y_{i j t} / A_{i t}\right)^{1 / \theta} \tag{3}
\end{equation*}
$$

units of labor at the equilibrium wage $W_{i t}$. After production takes place, goods markets open, and the price $P_{i j t}$ adjusts to clear the market: $C_{i j t}=Y_{i j t}$ for all $(i, j)$.

Shocks and Information. The only uncertainty is on the island-specific productivity, $A_{i t}$, which follows an $\operatorname{AR}(1)$ process in $\log ,{ }^{12}$

$$
a_{i t} \equiv \log A_{i t}=\rho_{a} a_{i t-1}+\varepsilon_{i t} .
$$

We further assume that the innovation $\varepsilon_{i t}$ consists of two components,

$$
\varepsilon_{i t}=\varepsilon_{i t}^{p}+\varepsilon_{i t}^{u}
$$

[^9]where $\varepsilon_{i t}^{p} \sim \mathcal{N}\left(0, \sigma_{p}^{2}\right)$ and $\varepsilon_{i t}^{u} \sim \mathcal{N}\left(0, \sigma_{u}^{2}\right)$ are independent across time periods and independent of each other. ${ }^{13}$ We define corresponding aggregate components of these variables as
$$
a_{t} \equiv \int_{0}^{1} a_{i t} \mathrm{~d} i, \quad \varepsilon_{t}^{p} \equiv \int_{0}^{1} \varepsilon_{i t}^{p} \mathrm{~d} i, \text { and } \varepsilon_{t}^{u} \equiv \int_{0}^{1} \varepsilon_{i t}^{u} \mathrm{~d} i .
$$

The difference between the two components is the extent to which firms are informed about them. The shock $\varepsilon_{i t}^{p}$ is called a partly-observed shock because, before making their decisions, firms and workers in island $i$ receive a noisy signal

$$
\begin{equation*}
s_{i t}=\rho_{a} a_{i t-1}+\varepsilon_{i t}^{p}+\xi_{i t} . \tag{4}
\end{equation*}
$$

Thus, firms are at least partly informed about the component $\varepsilon_{i t}^{p}$ when they make their decisions in period $t$. In contrast, the shock $\varepsilon_{i t}^{u}$ is called unobserved because it is not contained in firms' and workers' information set when they make their decisions at period $t$. Because the distinction between partly-observed shocks and unobserved shocks are important for our mechanism, we summarize it in Definition 2. This distinction formalizes the previous observation that there are many shocks in the real world that differ in the extent to which economic agents are informed about them.

Definition 2. Both partly-observed shocks $\varepsilon_{i t}^{p}$ and unobserved shocks $\varepsilon_{i t}^{u}$ drive the island-specific productivity. But when firms and workers make their decisions, they only receive signals about the partly-observed shocks while being completely uninformed about the unobserved shocks.

Given a period- $t$ information set $\Omega_{i t}$ that we will soon specify, firms and workers in island $i$ maximize their expected profits and expected household utility, respectively. Formally, firm $j$ in island $i$ chooses the level of $Y_{i j t}$ that solves

$$
\begin{array}{ll}
\max _{Y_{i j}} & \mathbb{E}\left[C_{t}^{-1} \cdot \Pi_{i j t} \mid \Omega_{i t}\right] \\
\text { s.t. } & \Pi_{i j t}=P_{i j t} Y_{i j t}-W_{i t} N_{i j t} \\
& Y_{i j t}=\left(\frac{P_{i j t}}{P_{i t}}\right)^{-\eta}\left(\frac{P_{i t}}{P_{t}}\right)^{-\sigma} Y_{t} \\
& Y_{i j t}=A_{i t} \cdot N_{i j t}^{\theta}
\end{array}
$$

[^10]where the second constraint comes from the isoelastic demand relation. Also, the representative worker in island $i$ chooses the level of $W_{i t}$ in a competitive way that solves
\[

$$
\begin{array}{ll}
\max _{W_{i t}} & \mathbb{E}\left[\left.C_{t}^{-1} \frac{W_{i t}}{P_{t}} N_{i t}-\nu N_{i t} \right\rvert\, \Omega_{i t}\right] \\
\text { s.t. } & N_{i t}= \begin{cases}0 & \text { if } W_{i t}>W_{i t}^{\prime} \\
\int_{0}^{1}\left(\frac{Y_{i j t}}{A_{i t}}\right)^{\frac{1}{\theta}} \mathrm{~d} j & \text { if } W_{i t}=W_{i t}^{\prime} \\
\infty & \text { if } W_{i t}<W_{i t}^{\prime}\end{cases}
\end{array}
$$
\]

where $W_{i t}^{\prime}$ is the wage level that other workers in island $i$ choose. We should have $W_{i t}^{\prime}=W_{i t}$ in the equilibrium.

Persistent Noise and Feedback. The modeling assumptions so far are standard in the literature, except possibly for the timing assumption. Now we introduce our two main assumptions. First, we assume that the noise terms in the signals are persistent:

$$
\xi_{i t}=\rho \xi_{i t-1}+\eta_{i t} \quad \text { where } \eta_{i t} \sim \mathcal{N}\left(0,\left(1-\rho^{2}\right) \sigma_{\eta}^{2}\right)
$$

where the innovation $\eta_{i t}$ is i.i.d. across time periods and across islands. ${ }^{14}$ After observing the signal, firms form their beliefs about the island-specific productivity $a_{i t}$.

Second, we assume that firms in island $i$ receive feedback on their previous forecast by observing the true productivity realization $a_{i t}$ after making their decisions. Thus, the information set $\Omega_{i t}$ that the firms' forecast is based on contains not only their signals up to date $t$ but also the history of previous feedback ${ }^{15}$

$$
\Omega_{i t}=\left(\cdots, s_{i t-2}, a_{i t-2}, s_{i t-1}, a_{i t-1}, s_{i t}\right)
$$

This is a natural assumption in our setting. We assume that firms commit to the output levels, $Y_{i j t}$. When labor market opens, hence, they have to know the exact levels of their productivity $A_{i t}$ in order

[^11]to compute the amount of labor needed to fulfill their commitment, which is given by equation (3). Likewise, workers can compute the island-specific productivity based on the labor demand of firms in their island. The main role of this assumption is to allow agents to receive feedback on their previous forecasts by observing the true realization ex post. However, it also plays an important role in making the analysis tractable and is exactly the same assumption that many papers adopt in order to simplify the learning to an essentially static one. In general, firms dynamically learn the values of both $a_{i t}$ and $\xi_{i t}$. The presence of feedback, however, essentially allows us to abstract from the dynamic learning about $a_{i t}$ and to focus on the dynamic learning about $\xi_{i t}$. The logic of this section, however, would still hold insofar as firms observe the true productivity ex post with sufficiently high precision. Lastly, we define an additional information set that agents possess right before observing the signal,
$$
\tilde{\Omega}_{i t}=\Omega_{i t} \backslash\left(s_{i t}\right)=\left(\cdots, s_{i t-2}, a_{i t-2}, s_{i t-1}, a_{i t-1}\right) .
$$

Recall that we define ex ante and ex post optimism as

$$
\begin{array}{ll}
\tilde{\mathcal{O}}_{i t}=\xi_{i t}-\tilde{\mathbb{E}}_{i t}\left[\xi_{i t}\right] & \text { where } \tilde{\mathbb{E}}_{i t}[\cdot] \equiv \mathbb{E}\left[\cdot \mid \tilde{\Omega}_{i t}\right] \\
\mathcal{O}_{i t}=\xi_{i t}-\mathbb{E}_{i t}\left[\xi_{i t}\right] & \text { where } \mathbb{E}_{i t}[\cdot] \equiv \mathbb{E}\left[\cdot \mid \Omega_{i t}\right] .
\end{array}
$$

We summarize the timeline of the model in Table 1. To emphasize the difference in the timing between receiving the signal $s_{i t}$ and receiving the feedback $a_{i t}$, we think of each period as consisting of two stages. Finally, we define an equilibrium as follows where we write $\Omega \equiv\left(\Omega_{i t}\right)_{i}$ and $A \equiv\left(A_{i t}\right)_{i}$.

Definition 3. $A$ rational expectations equilibrium is a sequence of allocations $\left\{C_{i j t}(\Omega, A), Y_{i j t}\left(\Omega_{i t}\right)\right.$, $\left.N_{i j t}\left(\Omega_{i t}, A_{i t}\right)\right\}$ and prices $\left\{W_{i t}\left(\Omega_{i t}\right), P_{i j t}(\Omega, A)\right\}$ such that (i) In stage 1, workers and firms maximize their expected objective functions based on the information they have; (ii) In stage 2, the representative household maximizes its utility, taking the prices as given; and (iii) All markets clear.

Illustrative Example (Continued). To see that the main message of this section is not confined to our macroeconomic example, let us go back to the previous forecaster example. A forecaster $i$ makes a forecast, or nowcast, $y_{i t}=\mathbb{E}_{i t}\left[a_{i t}\right]$ about the inflation rate $a_{i t}$ each year. The forecaster is indeed partly informed about some shocks from the newspapers. However, there are many other shocks that affect the inflation rate while not being covered in the newspapers, or whose effects on the inflation rate are

Table 1: Timeline

|  |  | $\vdots$ |
| :---: | :---: | :---: |
|  |  | $a_{i t-1}=\rho_{a} a_{i t-1}+\varepsilon_{i t-1}^{p}+\varepsilon_{i t-1}^{u}$ |
| period $t$ | stage 1 | $s_{i t}=\rho_{a} a_{i t-1}+\varepsilon_{i t}^{p}+\xi_{i t}$ <br> where $\xi_{i t}=\rho \xi_{i t-1}+\eta_{i t}$ <br> Commit to $Y_{i j t}$ and $W_{i t}$ |
|  | stage 2 | $\boxed{a_{i t}}=\rho_{a} a_{i t-1}+\varepsilon_{i t}^{p}+\varepsilon_{i t}^{u}$ |
|  |  | $\vdots$ |

Note: The variables in boxes are those observed by agents in island $i$. All the shocks (except for $\xi_{i t}$ ) indexed by $t$ are independent across time periods. All different types of shocks are independent of each other.
not even conceived by the forecaster. These are captured in the unobserved shock $\varepsilon_{i t}^{u}$. Afterwards the forecaster can observe the realized value of the inflation rate. ${ }^{16}$

Optimality Conditions. The optimal wage choice of the representative worker in island $i$ is given by

$$
W_{i t}=\nu \cdot\left(\mathbb{E}\left[C_{t}^{-1} \mid \Omega_{i t}\right]\right)^{-1}
$$

which is a intratemporal optimality condition equating the marginal disutility from labor with the marginal utility from consumption. Log-linearizing this condition yields ${ }^{17}$

$$
\begin{equation*}
w_{i t}=\mathbb{E}\left[c_{t} \mid \Omega_{i t}\right] \tag{5}
\end{equation*}
$$

where we use small letters to denote the $\log$ deviations from the steady state values. The higher the aggregate consumption that workers expect, the higher the wage needed to compensate them. Next, consider the firm's optimization problem. Firm $j$ in island $i$ solves

$$
\max _{Y_{i j t}} \mathbb{E}_{i t}\left[Y_{t}^{-1}\left\{Y_{i j t}^{1-\frac{1}{\eta}} Y_{t}^{\frac{1}{\eta}} P_{i t}^{1-\frac{\sigma}{\eta}}-W_{i t}\left(\frac{Y_{i j t}}{A_{i t}}\right)^{\frac{1}{\theta}}\right\}\right]
$$

[^12]where we impose $C_{t}=Y_{t}$. The first order condition gives
$$
\left(1-\frac{1}{\eta}\right) Y_{i j t}^{-\frac{1}{\eta}} \mathbb{E}_{i t}\left[Y_{t}^{-1+\frac{1}{\eta}} P_{i t}^{1-\frac{\sigma}{\eta}}\right]=\frac{1}{\theta} Y_{i j t}^{\frac{1}{\theta}-1} \mathbb{E}_{i t}\left[Y_{t}^{-1} W_{i t} A_{i t}^{-\frac{1}{\theta}}\right] .
$$

Log-linearizing, we have

$$
\left(1-\frac{1}{\eta}-\frac{1}{\theta}\right) y_{i j t}=\mathbb{E}_{i t}\left[-\frac{1}{\eta} y_{t}+w_{i t}-\frac{1}{\theta} a_{i t}-\left(1-\frac{\sigma}{\eta}\right) p_{i t}\right] .
$$

The symmetry across firms in island $i$ implies

$$
P_{i t}=P_{i j t}=\left(\frac{Y_{i t}}{Y_{t}}\right)^{-\frac{1}{\sigma}}
$$

which together with equation (5) shows that the equilibrium of our micro-founded model can be represented by the perfect Bayesian equilibrium of games with strategic complementarity as in Angeletos and La'O (2009a).

Lemma 2. Firms' equilibrium output choices, up to a log-linear approximation, are characterized by the solution to the following fixed-point problem:

$$
y_{i j t}=\mathbb{E}_{i t}\left[(1-\alpha) a_{i t}+\alpha y_{t}\right]
$$

where the degree of strategic complementarity $\alpha$ is given by

$$
\alpha=\frac{1 / \sigma-1}{1 / \theta+1 / \sigma-1} \in[0,1) .
$$

In this section we maintain the following assumption in order to assume away strategic complementarity, $\alpha=0$, so that we can focus on how firm learn about their own noise terms.

Assumption 1 (No Strategic Complementarity). $\sigma=1$.

Remark. Before we proceed, it is worth discussing some of the modeling choices we made. First, it makes no difference if we assume a general CRRA utility from consumption, $\frac{C_{t}^{1-\gamma}}{1-\gamma}$. We can follow the same steps to show that the equilibrium output choice is given by

$$
y_{i j t}=\mathbb{E}_{i t}\left[(1-\alpha) \tilde{a}_{i t}+\alpha y_{t}\right]
$$

where $\tilde{a}_{i t}=\frac{1 / \theta}{1 / \theta+\gamma-1} a_{i t}$ is the normalized productivity. With this normalization, we can get the same result as in the case with $\gamma=1$. Second, if we assume that the disutility from labor has a form $\nu \cdot \frac{N_{t}^{1+\varepsilon}}{1+\varepsilon}$ instead of $\nu \cdot N_{t}$, then we have an additional aggregate productivity term in the representation, $y_{i j t}=\mathbb{E}_{i t}\left[(1-\alpha) a_{i t}+\alpha y_{t}+\beta \cdot a_{t}\right]$ for some constant $\beta>0$. This only complicates the learning of firms without giving further intuition, so we assume constant marginal distutility from labor. Third, if we assume that firms commit to $N_{i j t}$ instead of $Y_{i j t}$, then the optimal labor demand choice $N_{i j t}$ is decreasing instead of increasing in $\mathbb{E}_{i t}\left[A_{i t}\right]$. This is because the CES aggregation (2) features diminishing marginal returns, which implies that if productivity doubles, firms would increase output less than twice as much. Thus, optimism leads to lower output, which is the opposite of what we are trying to capture.

Benchmark: i.i.d. noise terms. We conclude this section with a benchmark case with i.i.d. noise terms, as in the literature. This case is nested in the previous model with $\rho=0$. Since we abstract from dynamic learning of productivity, there is nothing left to learn dynamically, and the problem essentially becomes a repetition of static learning problems. Thus, what happened in one period has no effect on firms' decisions in the next period. In particular, it does not change firms' optimism in the next period. Therefore, shocks can affect tomorrow's output only through their effects on productivity, regardless of whether they are partly-observed or unobserved. This is one of the reasons why Woodford (2003) does not adopt the assumption of Lucas (1972) that fundamentals-monetary disturbances-become public information within a period. Given that monetary statistics are reported promptly, Woodford (2003) follows Sims (2003) in assuming limited attention. In this paper, however, underlying shocks will have persistent effects even if firms observe productivity within a period.

We can guess and verify the coefficients of a linear equilibrium. Proposition 1 summarizes the result.

Proposition 1. If noise terms in signals are i.i.d., $\rho=0$, the optimal output choice of firms is given by

$$
y_{i j t+1}=\rho_{a}^{2} a_{i t-1}+\rho_{a} \varepsilon_{i t}^{p}+\rho_{a} \varepsilon_{i t}^{u}+\tilde{K} \varepsilon_{i t+1}^{p}+\tilde{K} \eta_{i t+1} \quad \text { where } \tilde{K}=\frac{\sigma_{p}^{2}}{\sigma_{\eta}^{2}+\sigma_{p}^{2}} \in(0,1),
$$

which can be aggregated into

$$
y_{t+1}=\rho_{a}^{2} a_{t-1}+\rho_{a} \varepsilon_{t}^{p}+\rho_{a} \varepsilon_{t}^{u}+\tilde{K} \varepsilon_{t+1}^{p} .
$$

Thus, the effects of period-t shocks on period- $(t+1)$ outcomes are identical to their effects on the fundamental:

$$
\frac{\partial y_{t+1}}{\partial \varepsilon_{t}^{u}}=\frac{\partial a_{t+1}}{\partial \varepsilon_{t}^{u}} \quad \text { and } \quad \frac{\partial y_{t+1}}{\partial \varepsilon_{t}^{p}}=\frac{\partial a_{t+1}}{\partial \varepsilon_{t}^{p}} \text {. }
$$

Note that a contemporaneous partly observed shock affects firms' decisions less than one-for-one, reflecting the fact that firms cannot fully identify this shock. On the other hand, a contemporaneous unobserved shock cannot affect their decisions as it is not in their information set.

Persistent noise terms. Let us go back to our main case with persistent noise terms, $\rho \in(0,1)$. We will characterize how firms update their beliefs about their noise terms and how this learning affects firms' forecasts of the productivity and hence their output choices. We write firms' belief about $\xi_{i t-1}$ right before observing $s_{i t}$ as $\xi_{i t-1} \mid \tilde{\Omega}_{i t} \sim \mathcal{N}\left(m_{i t-1}, V_{t-1}\right)$. After observing $s_{i t}$, firms in island $i$ make a forecast about $a_{i t}$ according to Bayes' rule:

Lemma 3. Bayesian updating leads to the following forecast:

$$
\begin{aligned}
\mathbb{E}_{i t}\left[a_{i t}\right] & =\rho_{a} a_{i t-1}+K_{t}\left(s_{i t}-\rho_{a} a_{i t-1}-\rho m_{i t-1}\right) \quad \text { where } K_{t}=\frac{\sigma_{p}^{2}}{\rho^{2} V_{t-1}+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}+\sigma_{p}^{2}} \in(0,1) \\
& =\rho_{a} a_{i t-1}+K_{t}\left(\varepsilon_{i t}^{p}+\tilde{\mathcal{O}}_{i t}\right) \\
& =\rho_{a} a_{i t-1}+\varepsilon_{i t}^{p}+\mathcal{O}_{i t}
\end{aligned}
$$

Since firms in island $i$ know the value of $a_{i t-1}$ at this point, it directly affects their forecasts. The contemporaneous partly-observed shock has less than a one-for-one effect (we will soon show that a positive realization of $\varepsilon_{i t}^{p}$ reduces $\mathcal{O}_{i t}$ ), while the contemporaneous unobserved shock has no effect, as in the benchmark. The difference is that now firms' forecasts also depend on how optimistic they are. Optimistic firms interpret their signals more optimistically, which leads them to make optimistic forecasts.

After making a forecast, firms in island $i$ receive feedback at stage 2 by observing the true productivity, $a_{i t}$, and update their beliefs about the noise term by looking back on their previous forecasts. This learning can be characterized by the Kalman filter and the results are summarized in the next lemma.

Lemma 4. The law of motions for $m_{i t}$ and $V_{t}$ are given by

$$
\begin{aligned}
m_{i t} & =\left(\gamma_{1}\left(V_{t-1}\right)+\gamma_{2}\left(V_{t-1}\right)\right) \cdot s_{i t}+\gamma_{3}\left(V_{t-1}\right) \cdot \rho m_{i t-1}-\gamma_{1}\left(V_{t-1}\right) \cdot \rho_{a} a_{i t-1}-\gamma_{2}\left(V_{t-1}\right) \cdot a_{i t} \\
V_{t} & =\frac{\sigma_{p}^{2} \sigma_{u}^{2}\left(\rho^{2} V_{t-1}+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}\right)}{\left(\sigma_{p}^{2}+\sigma_{u}^{2}\right)\left(\rho^{2} V_{t-1}+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}\right)+\sigma_{p}^{2} \sigma_{u}^{2}}
\end{aligned}
$$

where

$$
\begin{aligned}
& \gamma_{1}\left(V_{t-1}\right)=\frac{\sigma_{u}^{2}\left(\rho^{2} V_{t-1}+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}\right)}{\left(\sigma_{p}^{2}+\sigma_{u}^{2}\right)\left(\rho^{2} V_{t-1}+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}\right)+\sigma_{p}^{2} \sigma_{u}^{2}} \\
& \gamma_{2}\left(V_{t-1}\right)=\frac{\sigma_{p}^{2}\left(\rho^{2} V_{t-1}+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}\right)}{\left(\sigma_{p}^{2}+\sigma_{u}^{2}\right)\left(\rho^{2} V_{t-1}+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}\right)+\sigma_{p}^{2} \sigma_{u}^{2}} \\
& \gamma_{3}\left(V_{t-1}\right)=\frac{\sigma_{p}^{2} \sigma_{u}^{2}}{\left(\sigma_{p}^{2}+\sigma_{u}^{2}\right)\left(\rho^{2} V_{t-1}+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}\right)+\sigma_{p}^{2} \sigma_{u}^{2}} .
\end{aligned}
$$

Note that $\gamma_{1}\left(V_{t-1}\right), \gamma_{2}\left(V_{t-1}\right), \gamma_{3}\left(V_{t-1}\right) \in(0,1)$ and $\gamma_{1}\left(V_{t-1}\right)+\gamma_{2}\left(V_{t-1}\right)+\gamma_{3}\left(V_{t-1}\right)=1$.

We can easily prove that there is a unique fixed point $V$ such that $V_{t-1}=V$ implies $V_{t}=V$. We can also show that the sequence $\left(V_{t}\right)_{t}$ converges to this fixed point for any initial value of $V_{0} \geq 0$. Thus, we will consider a stationary environment in which $V_{t}=V$ for all $t$. We can then write the law of motion for $m_{i t}$ in a time-invariant form:

$$
m_{i t}=\left(\gamma_{1}+\gamma_{2}\right) \cdot s_{i t}+\gamma_{3} \cdot \rho m_{i t-1}-\gamma_{1} \cdot \rho_{a} a_{i t-1}-\gamma_{2} \cdot a_{i t} \quad \text { where } \gamma_{i} \equiv \gamma_{i}(V) .
$$

Also, we define the stationary Kalman gain as $K \equiv \frac{\sigma_{p}^{2}}{\rho^{2} V+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}+\sigma_{p}^{2}} \in(0,1)$. We are now able to characterize the dynamics of optimism. Recall that we defined the optimism as the extent to which firms in island $i$ underestimate $\xi_{i t}$.

Proposition 2. The law of motions for ex ante and ex post optimism, $\tilde{\mathcal{O}}_{i t} \equiv \xi_{i t}-\tilde{\mathbb{E}}_{i t}\left[\xi_{i t}\right]$ and $\mathcal{O}_{i t} \equiv$ $\xi_{i t}-\mathbb{E}_{i t}\left[\xi_{i t}\right]$, are given by

$$
\begin{aligned}
\tilde{\mathcal{O}}_{i t+1} & =\gamma_{3} \rho \tilde{\mathcal{O}}_{i t}-\rho \gamma_{1} \varepsilon_{i t}^{p}+\rho \gamma_{2} \varepsilon_{i t}^{u}+\eta_{i t+1} \\
\mathcal{O}_{i t+1} & =\gamma_{3} \rho \mathcal{O}_{i t}-(1-K) \varepsilon_{i t}^{p}+K \rho \gamma_{2} \varepsilon_{i t}^{u}+K \eta_{i t+1} .
\end{aligned}
$$

Thus, a positive realization of partly-observed shocks (unobserved shocks, respectively) makes firms pessimistic (optimistic, respectively) next period.

First, we can see that there is inertia in optimism, as firms can only correct their optimism through noisy learning. ${ }^{18}$ Thus, a positive shock in the noise term, $\eta_{i t+1}$, increases the firm's optimism, which decays slowly over time. More interesting is the response of optimism to the underlying shocks. The partly observed shock and the unobserved shock have opposite effects on optimism. The intuition is simple. Suppose that realized productivity $a_{i t}=\rho_{a} a_{i t-1}+\varepsilon_{i t}^{p}+\varepsilon_{i t}^{u}$ is greater than its expected value $\rho_{a} a_{i t-1}$, and firms in island $i$ observe this increase at the end of period- $t$. If this increase were solely due to an increase in $\varepsilon_{i t}^{u}$, it would not be reflected in $s_{i t}$ at all, so the realized value of $a_{i t}$ is higher-than-expected from the perspective of firms in island $i$. This makes them think that they were too pessimistic in interpreting $s_{i t}$, which in turn induces them to interpret $s_{i t+1}$ more optimistically in the next period. Therefore, a positive innovation in the unobserved shock increases firms' optimism. In contrast, if the increase in the fundamental is due only to the high $\varepsilon_{i t}^{p}$, agents rationally attribute this increase to both $\varepsilon_{i t}^{p}$ and $\varepsilon_{i t}^{u}$ when they observe $a_{i t}$. However, the high realization of $\varepsilon_{i t}^{p}$ was fully reflected in $s_{i t}$. Thus, the realized value of $a_{i t}$ is lower-then-expected for firms in island $i$. This makes them possess a more pessimistic belief in the next period.

Before turning to the analysis of firms' output choices, we discuss comparative statics results for $\gamma_{1}, \gamma_{2}$, and $\gamma_{3}$ with respect to variance parameters, $\sigma_{p}^{2}, \sigma_{u}^{2}$, and $\sigma_{\eta}^{2}$. Lemma 5 summarizes the results.

Lemma 5. We have the following comparative statics.
(1) $\gamma_{1}$ is increasing in $\sigma_{u}^{2}$ and $\sigma_{\eta}^{2}$, while decreasing in $\sigma_{p}^{2}$
(2) $\gamma_{2}$ is increasing in $\sigma_{p}^{2}$ and $\sigma_{\eta}^{2}$, while decreasing in $\sigma_{u}^{2}$
(3) $\gamma_{3}$ is increasing in $\sigma_{p}^{2}$ and $\sigma_{u}^{2}$, while decreasing in $\sigma_{\eta}^{2}$

To understand this result, first consider Part (2), which states how the effect of the unobserved shock on optimism, $\gamma_{2}$, depends on the variance parameters. The main mechanism that changes optimism is the rational confusion between various shocks. If the partly-observed shock is relatively more volatile, then firms misattribute an increase in the unobserved shock more to the partly-observed shock, so they underestimate their noise terms more. Thus, we get a larger effect of the unobserved shock on optimism. Following the same logic, $\sigma_{u}^{2}$ tends to reduce the effect of the unobserved shock on optimism. Moreover, since optimism arises as firms overestimate or underestimate their $\xi_{i t}$, and firms are more likely to do so

[^13]when $\sigma_{\eta}^{2}$ is high, the effect of the unobserved shock on optimism tends to increase in $\sigma_{\eta}^{2}$. This explains Part (2), and we can apply the same argument to Part (1). For Part (3), note that $\gamma_{3}$ is the coefficient that determines the degree of inertia in optimism. This inertia comes from the rational confusion of firms between $\xi_{i t}$ and $\left(\varepsilon_{i t}^{p}, \varepsilon_{i t}^{u}\right)$, which prevents them from fully correcting their optimism. This explains why $\gamma_{3}$ is decreasing in the relative size of $\sigma_{\eta}^{2}$ compared to $\sigma_{p}^{2}$ and $\sigma_{u}^{2}$.

Combining the results so far, we can characterizes the dynamics of the output choice as in the next theorem, which is our first main result.

Theorem 1. The optimal output choice of firms is given by

$$
y_{i j t+1}=\rho_{a}^{2} a_{i t-1}+\left(\rho_{a}-\rho K \gamma_{1}\right) \varepsilon_{i t}^{p}+\left(\rho_{a}+\rho K \gamma_{2}\right) \varepsilon_{i t}^{u}+K \varepsilon_{i t+1}^{p}+K \eta_{i t+1}+\rho \gamma_{3} K \tilde{\mathcal{O}}_{i t}
$$

hence the aggregate output is

$$
y_{t+1}=\rho_{a}^{2} a_{t-1}+\left(\rho_{a}-\rho K \gamma_{1}\right) \varepsilon_{t}^{p}+\left(\rho_{a}+\rho K \gamma_{2}\right) \varepsilon_{t}^{u}+K \varepsilon_{t+1}^{p}+\rho \gamma_{3} K \int_{0}^{1} \tilde{\mathcal{O}}_{i t} \mathrm{~d} i .
$$

Thus, the effects of partly-observed shocks (unobserved shocks, respectively) on the next period outcomes are dampened (amplified, respectively) compared to their effects on the productivity:

$$
\frac{\partial y_{t+1}}{\partial \varepsilon_{t}^{u}}>\frac{\partial a_{t+1}}{\partial \varepsilon_{t}^{u}} \quad \text { and } \quad \frac{\partial y_{t+1}}{\partial \varepsilon_{t}^{p}}<\frac{\partial a_{t+1}}{\partial \varepsilon_{t}^{p}} \text {. }
$$

Compared to the benchmark case in Proposition 1, this theorem establishes that the effect of the unobserved shock on the next period output is amplified by its effect on the agent's optimism. ${ }^{19}$ At the same time, the effect of the partly-observed shock on the next period output is dampened because firms become pessimistic after a positive innovation in the partly-observed shock. A contemporaneous innovation $\eta_{i t+1}$ has a positive effect on output because firms cannot fully distinguish it from other shocks, and its effect decays slowly over time as firms correct their optimism. A special case of interest is that with $\rho_{a}=0$ (i.i.d. productivity). In this case, we can observe that optimism propagates the effect of unobserved shocks to the next period, while the effect of partly-observed shocks is negative in the next period. Note that shocks in this case cannot affect future output if we assume i.i.d. noise, as in the

[^14]literature. However, with persistent noise, these shocks can affect future output through their effects on firms' optimism.

Illustrative Example (Continued). Consider the inflation rate forecaster example again. Suppose the forecaster predicted an inflation rate of $2 \%$ based on her reading of the newspapers. Now suppose that the actual inflation rate turns out to be $1 \%$. How does her interpretation of the newspaper change? The fact that the inflation rate turned out to be lower-than-expected leads her to believe that she was too optimistic in interpreting the contents of the newspapers. So, the forecaster would rationally take this into account the next time she makes the forecasts, and interpret the contents of the newspapers in a more pessimistic way.

Implication. The results so far may sound like "anything goes." Indeed, they imply that a shock can be either amplified or dampened, depending on how much firms are informed about the shock; i.e., where a given shock falls on the spectrum of the degree of observability, with fully observed shocks at one extreme and unobserved shocks at the other. ${ }^{20}$

There are two ways to overcome this anything goes interpretation. First, we can use forecast data to measure the degree of observability of a shock of interest, and then our theory disciplines its dynamic effects. Another way is to assume that the partly-observed shocks are more likely to be idiosyncratic, while the unobserved shocks are more likely to be common across agents. The assumption that agents are relatively well informed about idiosyncratic shocks and less informed about aggregate shocks is often considered plausible in the literature. ${ }^{21}$ In line with this, we will make an additional assumption.

Assumption 2. Firms make decisions based on noisy information about purely idiosyncratic shocks, but productivity also depends on aggregate shocks. That is,

- Partly-observed shocks are purely island specific: $\varepsilon_{i t}^{p} \stackrel{i i d}{\sim} \mathcal{N}\left(0, \sigma_{p}^{2}\right)$ across islands
- Unobserved shocks are common: $\varepsilon_{i t}^{u} \equiv \varepsilon_{t}^{\text {aggr }} \sim \mathcal{N}\left(0, \sigma_{u}^{2}\right)$

[^15]Under this assumption, partly-observed shocks still lead to rational confusion, but they are averaged out among the continuum of islands, $\varepsilon_{t}^{p} \equiv \int_{0}^{1} \varepsilon_{i t}^{p} \mathrm{~d} i=0$. Thus, we can aggregate Proposition 2 and Theorem 1 as if the aggregate economy were driven only by unobserved shocks.

Corollary 1. Under Assumption 2, the aggregate output and aggregate optimism, $\tilde{\mathcal{O}}_{t}=\int_{0}^{1} \tilde{\mathcal{O}}_{i t} \mathrm{~d} i$, follow

$$
\begin{aligned}
y_{t+1} & =\rho_{a}^{2} a_{t-1}+\beta_{u} \varepsilon_{t}^{a g g r}+\beta_{\mathcal{O}} \tilde{\mathcal{O}}_{t} \\
\tilde{\mathcal{O}}_{t+1} & =\gamma_{3} \rho \tilde{\mathcal{O}}_{t}+\rho \gamma_{2} \varepsilon_{t}^{a g g r}
\end{aligned}
$$

Thus, the aggregate shock has no contemporaneous effect on outcomes, while it has an amplified effect on the next period outcomes:

$$
\frac{\partial y_{t+1}}{\partial \varepsilon_{t}^{\text {aggr }}}>\frac{\partial a_{t+1}}{\partial \varepsilon_{t}^{\text {aggr }}} \quad \text { while } \quad \frac{\partial y_{t+1}}{\partial \varepsilon_{t+1}^{\text {agr }}}=0<\frac{\partial a_{t+1}}{\partial \varepsilon_{t+1}^{\text {aggr }}}
$$

When firms make decisions based on noisy information about their idiosyncratic shocks while the economic condition also depends on an aggregate shock, aggregate optimism fluctuates procyclically with the aggregate shock and thus has an amplified effect on aggregate output after firms receive feedback on their previous forecasts. In contrast, the aggregate shock has no contemporaneous effect on aggregate action and forecast. In other words, the aggregate shock that has little effect on contemporaneous expectations would be amplified later when firms receive feedback. We find suggestive evidence of this result in Angeletos, Huo, and Sastry (2020). They show that, in response to aggregate shocks, agents' expectations underreact initially but overshoot later. They attribute this delayed overreaction to a combination of dispersed information and behavioral over-extrapolation. However, this finding can also be well understood using our result; expectations initially underreact due to the fact that agents are not informed about the aggregate shock - this part is identical to Angeletos, Huo, and Sastry (2020)—and overshoot later on when they receive feedback and adjust their optimism. It is worth noting that the result of Corollary 1 does not depend on the exact form of Assumption 2. In Section 5 we obtain a qualitatively similar delayed overreaction as long as firms are relatively well informed about idiosyncratic shocks.

Remark. We conclude this section by discussing the importance of the interaction between the persistent noise terms and the presence of feedback in obtaining our mechanism. Table 2 summarizes the discussion. First, if the noise terms are i.i.d., then the presence of feedback does not affect the qualitative results.

Table 2: Interaction Between Persistent Noise and Feedback

|  | Without feedback | With feedback |
| :---: | :---: | :---: |
| i.i.d. noise | No optimism | No optimism |
|  | Higher-than-expected outcome | Static learning |
| $\Rightarrow$ pessimism | $\Rightarrow$ optimism |  |

Firms learn nothing ex post, so feedback does not affect firms' learning. Second, the presence of feedback is crucial for our mechanism to work. We essentially assume that firms observe two signals, $s_{i t}$ and $a_{i t}$, and that the second signal provides feedback on the forecast made with the first signal. One might think that the second signal plays a redundant role in the sense that, even if firms only have the first signal, $s_{i t}$, they can receive feedback from the future signal, $s_{i t+1}$, and learn the persistent noise terms. However, to formalize our mechanism, it is crucial to incorporate the second signal in the model. ${ }^{22}$ To see this, suppose that firms in island $i$ observe only the first signal, $s_{i t}=\rho_{a} a_{i t-1}+\varepsilon_{i t}^{p}+\xi_{i t}$, in each period. Firms can indeed get feedback on $s_{i t}$ when they observe the next period signal, $s_{i t+1}$, since it contains some information about $\xi_{i t}$. However, this feedback gives a result that is exactly the opposite of our previous intuition; with this feedback, higher-than-expected outcomes make firms pessimistic. ${ }^{23}$ The reason is that when firms observe a higher-than-expected signal in period $t+1$ due to a positive innovation in $\varepsilon_{i t}^{u}$, they partly attribute this surprise to a higher realization of $\xi_{i t+1}$, which means that they become pessimistic. We conclude that what underlies our mechanism is the interaction between persistent noise terms and the presence of feedback.

## 4. Strategic Complementarity

In this section, we illustrate how the introduction of strategic complementarity provides additional insights. With strategic complementarity, firms have incentives to predict the actions of other firms in different islands. To do so, they try to forecast the optimism of other firms. ${ }^{24}$ Firms in this model are concerned not only with the optimism of others (second-order optimism), but also with higher-order optimism—how other firms think about others' optimism, how other firms think about others' beliefs

[^16]about others' optimism, and so on. We first characterize how firms update their higher-order optimism, and how this higher-order optimism in turn affects firms' output choices through its effects on higherorder beliefs about productivity. In particular, the introduction of strategic complementarity and the resulting higher-order optimism always work in the direction of reinforcing the mechanism we document in the previous section.

The presence of higher-order optimism makes it difficult to solve the model due to the infinite regress problem of Townsend (1983), so we make some simplifying assumptions in order to obtain some sharp analytical results. First, we consider a two-period version of the model where periods are indexed by $t=0,1$. Second, we assume that productivity is i.i.d. across periods (i.e., $\rho_{a}=0$ ), focusing on how agents learn the noise terms. Third, we assume that the noise terms are time-invariant, which we denote by $\xi_{i}$ without $t$ index, so that agents in island $i$ observe a signal of the form

$$
s_{i t}=\varepsilon_{i t}^{p}+\xi_{i}
$$

where $\xi_{i}$ is independent across islands ${ }^{25}$

$$
\xi_{i} \stackrel{i i d}{\sim} \mathcal{N}\left(0, \sigma_{\xi}^{2}\right) .
$$

These assumptions are not essential for our results but simplify our exposition. In a numerical exercise in Section 4.1, we will show that the main message of this section does not rely on these simplifying assumptions. Last but not least, we assume that islands share one common productivity, which we denote by $a_{t}$ without $i$ index,

$$
a_{t}=\varepsilon_{t}^{p}+\varepsilon_{t}^{u}
$$

Remark. The last assumption of common productivity requires further explanation. Our main goal in this section is to study the role of strategic complementarity on firms' learning and optimal output choices under incomplete information. However, if we assume that $\varepsilon_{i t}^{p}$ is a pure idiosyncratic shock, $\int_{0}^{1} \varepsilon_{i t}^{p} \mathrm{~d} i=0$, then the presence of strategic complementarity not only affects the learning of firms but also reduces the importance of productivity in choosing output. To see this clearly, consider the

[^17]following two static examples, which use the notation of our model but are more similar to Woodford (2003) and Angeletos and La'O (2009a) in terms of the information structure.

Example 1. There is a continuum of agents $i \in[0,1]$ who share a common fundamental a $\sim \mathcal{N}\left(0, \sigma_{a}^{2}\right)$. Each agent $i$ chooses an action $y_{i}$ after observing a private signal $s_{i}=a+\xi_{i}$ where $\xi_{i} \sim \mathcal{N}\left(0, \sigma_{\xi}^{2}\right)$ is i.i.d. across agents. Agents' best response is assumed to be $y_{i}=(1-\alpha) \mathbb{E}_{i} a_{i}+\alpha \mathbb{E}_{i} y$ where $y=\int_{0}^{1} y_{j} \mathrm{~d} j$. We can show that the equilibrium action is given by

$$
y_{i}=\frac{(1-\alpha) \sigma_{a}^{2}}{\sigma_{\xi}^{2}+(1-\alpha) \sigma_{a}^{2}} s_{i} \quad \text { and } \quad y=\frac{(1-\alpha) \sigma_{a}^{2}}{\sigma_{\xi}^{2}+(1-\alpha) \sigma_{a}^{2}} a
$$

Example 2. The only difference from Example 1 is that fundamental $a_{i} \sim \mathcal{N}\left(0, \sigma_{a}^{2}\right)$ is i.i.d. across agents, hence $\int_{0}^{1} a_{j} \mathrm{~d} j=0$. In this case, we always have $y=0$ and the equilibrium action is given by

$$
y_{i}=(1-\alpha) \mathbb{E}_{i} a_{i}=\frac{(1-\alpha) \sigma_{a}^{2}}{\sigma_{\xi}^{2}+\sigma_{a}^{2}} s_{i}
$$

Thus, even under complete information $\left(\sigma_{\xi}^{2}=0\right)$, when fundamental is purely idiosyncratic as in Example 2, a higher degree of strategic complementarity makes agents less responsive to the change in fundamental. This comparative static is neither our goal of this section nor the inertia documented by Woodford (2003) and Angeletos and La'O (2009a). Instead, what these papers document is that, in Example 1, a higher degree of strategic complementarity makes agents less responsive to the change in fundamental only when information is incomplete $\left(\sigma_{\xi}^{2}>0\right)$. This is because the higher the degree of strategic complementarity is, the more weight agents put on the common prior. Thus, the role of our last assumption is that it enables us to isolate the effect of strategic complementarity on firms' learning. ${ }^{26}$

As before, all firms observe the realized productivity $a_{t}$ at the end of each period, which depends also on the unobserved shock, $\varepsilon_{t}^{u}$. Thus, firms in island $i$ have three different information sets

$$
\Omega_{i 0}=\left(s_{i 0}\right), \quad \tilde{\Omega}_{i 1}=\left(s_{i 0}, a_{0}\right), \text { and } \Omega_{i 1}=\left(s_{i 0}, a_{0}, s_{i 1}\right)
$$

To introduce strategic complementarity, we depart from Assumption 1 and assume the following.

[^18]Table 3: Timeline

| period 0 | stage 1 | $s_{i 0}$ <br>  |
| :--- | :---: | :---: |
|  | $y_{i 0}=(1-\alpha) \cdot \varepsilon_{0}^{p}+\xi_{i 0} a_{0}+\alpha \cdot \mathbb{E}_{i 0} y_{0}$ |  |
|  |  |  |
| period 1 | stage 2 | $a_{0}=\varepsilon_{0}^{p}+\varepsilon_{0}^{u}$ |
| stage 1 | $y_{i 1}=(1-\alpha) \cdot \mathbb{E}_{i 1} a_{1}+\alpha \cdot \mathbb{E}_{i 1} y_{1}$ |  |
|  |  | Commit to $Y_{i j 1}$ and $W_{i 1}$ |
|  | stage 2 | $a_{i 1}=\varepsilon_{1}^{p}+\xi_{i}$ |
|  |  | $a_{1}=\varepsilon_{1}^{p}+\varepsilon_{1}^{u}$ |

Note: The variables in boxes are those observed by agent $i$. The distribution of each shock is given by $\varepsilon_{t}^{p} \sim \mathcal{N}\left(0, \sigma_{p}^{2}\right), \varepsilon_{t}^{u} \sim \mathcal{N}\left(0, \sigma_{u}^{2}\right)$ and $\xi_{i} \sim \mathcal{N}\left(0, \sigma_{\xi}^{2}\right)$. All the shocks indexed by $i$ are independent across agents. All the shocks indexed by $t$ are independent across time. All different types of shocks are independent of each other.

Assumption 3 (Strategic Complementarity). The trade linkage is strong enough to induce strategic complementarity in output choices across islands: $1 / \sigma>1$.

The inverse of the substitutability between goods from different islands, $1 / \sigma$, governs the strength of a trade linkage. With a strong trade linkage, firms increase their output choices when they expect others to do so. At the same time, however, the log utility features diminishing marginal utility, which makes firms decrease their output choices when they expect other firms to increase their output levels. This is because household is expected to have low marginal utility from consumption, increasing the equilibrium wage. When Assumption 3 holds, the first effect dominates the second, and the optimal output choices feature strategic complementarity across islands:

$$
y_{i j t}=(1-\alpha) \mathbb{E}_{i t}\left[a_{t}\right]+\alpha \mathbb{E}_{i t}\left[y_{t}\right] \quad \text { where } y_{t}=\int_{0}^{1} y_{j t} \mathrm{~d} j
$$

Here, the weight $\alpha=\frac{1 / \sigma-1}{1 / \theta+1 / \sigma-1} \in(0,1)$ is the degree of strategic complementarity and $y_{t}$ is the average action of other firms. We summarize the timeline of the model in Table 3. We assume that this structure of the model is common knowledge among all firms and workers.

Higher-Order Optimism. One might argue that there is no point for firms to learn the average optimism of others because the i.i.d. noise terms of a continuum of firms are averaged out. However, this is not the case. Firms try to correct their optimism by observing their signals, so their endogenous optimism tend to move in the same direction. Higher-order optimism is about how firms think about this comovement, how firms think about others' beliefs about this comovement, and so on. The literature often assumes that optimism arises exogenously, and that this optimism is correlated across economic agents in order for it to affect the economy. However, it is difficult to justify this correlation if we are silent about the origin of optimism. Our paper provides the answer: optimism is correlated across agents because they observe the same economic outcomes.

Now we formally define the higher-order optimism. Recall that we define the optimism of a firm in island $i$ at time $t$ as the extent to which this firm underestimates its noise term, $\xi_{i t}$. Likewise, from a firm's perspective, other firms in different islands are expected to be optimistic in interpreting their signals if they are expected to underestimate their noise terms. As we consider an environment with strategic complementarity, we can call it the firm's optimism about others' optimism or the second-order optimism. We proceed in a similar manner to define (ex-post) higher-order optimism. ${ }^{27}$

Definition 4. The ex-post $\mathrm{h}^{\text {th }}$-order optimism of firms in island $i$ is defined recursively by

$$
\mathcal{O}_{i t}^{h} \equiv \mathbb{E}\left[\int_{0}^{1} \mathcal{O}_{j t}^{h-1} d j \mid \Omega_{i t}\right], \quad h=2,3,4, \cdots \quad \text { where } \mathcal{O}_{i t}^{1} \equiv \mathcal{O}_{i t}
$$

We also define the average ex-post higher-order optimism by

$$
\mathcal{O}_{t}^{h}=\int_{0}^{1} \mathcal{O}_{j t}^{h} d j .
$$

Equipped with this definition, we will now solve for the equilibrium. It is well known that the period-0 equilibrium is unique.

Lemma 6. In period 0, there is a unique equilibrium, in which firms choose

$$
y_{i 0}=\theta \cdot s_{i 0} \quad \text { where } \theta=\frac{(1-\alpha) \sigma_{p}^{2}}{(1-\alpha) \sigma_{p}^{2}+\sigma_{\xi}^{2}} \in(0,1)
$$

[^19]and hence the aggregate output is $y_{0}=\theta \cdot \varepsilon_{0}^{p}$.

For a given value of $\alpha$, high $\sigma_{p}^{2}$ or low $\sigma_{\xi}^{2}$ implies that signals are more informative about productivity. Firms then respond more to their signals. All else equal, the degree of strategic complementarity $\alpha$ reduces $\theta$ because it makes agents put more weight on higher-order beliefs, which are more anchored in their mean-zero prior.

What we are interested in, however, is not the period-0 equilibrium. ${ }^{28}$ Our focus is on how firms learn their own and others' noise terms and how this learning changes the effect of period-0 shocks on period-1 outcomes. Note that we can characterize the period-1 equilibrium without calculating firms' higher-order optimism or higher-order beliefs about the fundamental. Starting with a guess of a linear equilibrium, we can compute first-order beliefs about the endogenous aggregate output $y_{1}$, which gives the updated linear best response. The fixed point of this guess-and-verify process gives a unique linear equilibrium for period 1. The result is summarized in Lemma 7, which corresponds to Theorem 1 for the case with strategic complementarity.

Lemma 7. In period 1, there is a unique linear equilibrium in which the equilibrium output is given $b y^{29}$

$$
y_{1}=\gamma_{p} \varepsilon_{0}^{p}+\gamma_{u} \varepsilon_{0}^{u}+\gamma_{p}^{\prime} \varepsilon_{1}^{p}
$$

where

$$
\begin{aligned}
\gamma_{p} & =-\frac{\sigma_{u}^{2} \sigma_{\xi}^{2}}{(1-\alpha) \sigma_{p}^{2} \sigma_{u}^{2} \sigma_{p}^{2} \sigma_{\xi}^{2}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}} \\
\gamma_{u} & =\frac{\sigma_{p}^{2} \sigma_{\xi}^{2}}{(1-\alpha) \sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}} \\
\gamma_{p}^{\prime} & =\frac{(1-\alpha) \sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+\sigma_{u}^{2} \sigma_{\xi}^{2}}{(1-\alpha) \sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}},
\end{aligned}
$$

so $\gamma_{u}>0>\gamma_{p}$ and $\gamma_{p}^{\prime} \in(0,1)$.

This lemma shows that the intuition of the previous section is extended to a model with strategic complementarity: Unobserved shocks are propagated to period $1\left(\gamma_{u}>0\right)$, while partly-observed shocks have negative effects on period-1 outcomes ( $\gamma_{p}<0$ ). A natural question that follows is whether the strategic complementarity and resulting higher-order optimism strengthen or weaken our mechanism.

[^20]In order to answer this question and to fully understand the period-1 equilibrium, we need to keep track of higher-order optimism and its effects on higher-order beliefs about the productivity. We first characterize the (ex-post) higher-order optimism in Lemma 8.

Lemma 8. After observing $\left(s_{i 0}, a_{0}, s_{i 1}\right)^{\prime}$, higher-order optimism of firms in island $i$ is given by

$$
\begin{aligned}
\mathcal{O}_{i 1} & \equiv \xi_{i}-\mathbb{E}_{i 1}\left[\xi_{i}\right]=Q\left(\begin{array}{llll}
\varepsilon_{0}^{p} & \xi_{i} & \varepsilon_{0}^{u} & \varepsilon_{1}^{p}
\end{array}\right)^{\prime} \\
\mathcal{O}_{i 1}^{h} & \equiv \mathbb{E}_{i 1}\left[\int_{0}^{1} \mathcal{O}_{j 1}^{h-1} d j\right]=Q T^{h-1}\left(\begin{array}{llll}
\varepsilon_{0}^{p} & \xi_{i} & \varepsilon_{0}^{u} & \varepsilon_{1}^{p}
\end{array}\right)^{\prime}
\end{aligned}
$$

for some matrices $\underset{1 \times 4}{Q}$ and $\underset{4 \times 4}{T}$, where the sign of each element is

$$
Q=(-+\quad+\quad-) \text { and } Q T^{h-1}=(-\quad-\quad+\quad-) .
$$

For future reference, we also note that the second element of $Q, Q_{1,2}$, is decreasing in $\sigma_{\xi}^{2}$ and increasing in $\sigma_{p}^{2}$ and $\sigma_{u}^{2}$.

First of all, the first-order optimism is increasing in $\xi_{i}$ (see the sign of the second element of $Q$ ) because firms are unable to fully identify an increase in $\xi_{i}$ as they rationally confuse it with changes in $\varepsilon_{0}^{p}$ and $\varepsilon_{0}^{u}$. It is then immediate that $Q_{1,2}$ is decreasing in $\sigma_{\xi}^{2}$ and increasing in $\sigma_{p}^{2}$ and $\sigma_{u}^{2}$ as in $\operatorname{Part}(3)$ of Lemma 5.

Second, the first-order optimism is decreasing in $\varepsilon_{0}^{p}$ and increasing in $\varepsilon_{0}^{u}$ as in the previous section (see the first and third elements of $Q$ ). More importantly, higher-order optimism always moves in the same direction as the first-order optimism in response to $\varepsilon_{0}^{p}$ and $\varepsilon_{0}^{u}$ (see the signs of the first and third elements of $Q T^{h-1}$ ). To understand this, consider a firm in the average island $i$ in the sense that $\xi_{i}=0$. Suppose that there is a positive unit innovation in $\varepsilon_{0}^{u}$ and that all other aggregate shocks remain zero. Then, a firm in the island $i$ will observe higher-than-expected fundamental $a_{0}$ so her first-order optimism will be positive,

$$
\mathcal{O}_{i 1}=-\mathbb{E}_{i 1}\left[\xi_{i}\right]>0
$$

Since noise terms are symmetrically distributed around 0 , this inequality means that she expects that the noise terms of other islands are on average $\mathcal{O}_{i 1}$ units higher than her noise term. This in turn means that the first-order optimism of firms in other islands are on average $\mathcal{O}_{i 1} \cdot Q_{1,2}$ units higher than her first-order optimism. At the same time, from her perspective, she is the one who is expected to have zero optimism
(i.e., $\mathbb{E}_{i 1}\left[\mathcal{O}_{i 1}\right]=0$ ). Thus, we can conclude that her second-order optimism is given by $\mathcal{O}_{i 1}^{2}=\mathcal{O}_{i 1} \cdot Q_{1,2}$. This explains why the second-order optimism moves in the same direction as the first-order optimism in response to $\varepsilon_{0}^{u}$. In other words, firms who view $a_{0}$ as higher-than-expected will on average think that firms in other islands are likely to have higher noise terms than theirs, thereby being optimistic on average. Similar reasoning can be recursively applied to show that all the higher-order optimism is given by $\mathcal{O}_{i 1}^{h}=\mathcal{O}_{i 1} \cdot Q_{1,2}^{h-1}$, which also moves in the same direction. We can similarly see that higher-order optimism also moves in the same direction as the first-order optimism in response to $\varepsilon_{0}^{p}$.

A final observation is that, even though we start with the assumption that noise terms are i.i.d., the fact that agents try to correct their optimism by observing their signals makes their optimism comove, which generates non-trivial average higher-order optimism, as we claimed before.

Next question is why this higher-order optimism is important. How does it affect the outcome in period 1? We characterize the role of higher-order optimism in Lemma 9 and Corollary 2.

Lemma 9. Higher-order beliefs can be written as functions of $\varepsilon_{1}^{p}$ and cumulative sums of higher-order optimism:

$$
\begin{aligned}
\mathbb{E}_{i 1} \overline{\mathbb{E}}_{1}^{h-1}\left[a_{1}\right] & \left.=\varepsilon_{1}^{p}+\mathcal{O}_{i 1}+\mathcal{O}_{i 1}^{2}+\cdots+\mathcal{O}_{i 1}^{h} \quad \text { (with } \mathbb{E}_{i 1} a_{1}=\varepsilon_{1}^{p}+\mathcal{O}_{i 1}\right) \\
\overline{\mathbb{E}}_{1}^{h}\left[a_{1}\right] & =\varepsilon_{1}^{p}+\mathcal{O}_{1}+\mathcal{O}_{1}^{2}+\cdots+\mathcal{O}_{1}^{h}
\end{aligned}
$$

where we write $\overline{\mathbb{E}}_{1}[\cdot]=\int_{0}^{1} \mathbb{E}_{i 1}[\cdot]$ d $i$ and $\overline{\mathbb{E}}_{1}^{h}[\cdot]=\int_{0}^{1} \mathbb{E}_{i 1} \overline{\mathbb{E}}_{1}^{h-1}[\cdot] \mathrm{d} i$.

Corollary 2. The aggregate output in period 1 is a weighted average of higher-order beliefs, and hence is a weighted sum of higher-order optimism:

$$
\begin{align*}
y_{1} & =\sum_{h=1}^{\infty}(1-\alpha) \alpha^{h-1} \overline{\mathbb{E}}_{1}^{h}\left[a_{1}\right] \\
& =\varepsilon_{1}^{p}+\sum_{h=1}^{\infty} \alpha^{h-1} \mathcal{O}_{1}^{h} . \tag{6}
\end{align*}
$$

It is well known that aggregate output is determined by higher-order beliefs. Thus, Lemma 9 naturally leads to Corollary 2. In Lemma 8, we characterize how underlying shocks affect higher-order optimism, which in conjunction with Corollary 2 characterizes how underlying shocks affect aggregate output in period 1. This essentially gives the equivalent result of Lemma 7, but we have tracked higher-order
optimism and higher-order beliefs to understand the mechanism behind it. We are now ready to answer the main question of this section: do strategic complementarity and the resulting higher-order optimism strengthen or weaken our mechanism?

With $\alpha=0$, we return to the case without strategic complementarity where we have $y_{1}=\varepsilon_{1}^{p}+\mathcal{O}_{1}$. With $\alpha>0$, we have additional higher-order optimism terms in equation (6). In Lemma 8, we saw that these additional terms move in the same direction as first-order optimism. Thus, we can conclude that the presence of strategic complementarity and the resulting higher-order optimism always strengthen our mechanism relative to the case without strategic complementarity. In other words, when agents observe higher-than-expected outcomes, they become optimistic not only about their signals (first-order optimism) but also about others' optimism (higher-order optimism). Furthermore, higher $\alpha$ means higher coefficients on the first-order and higher-order optimism terms in equation (6). Therefore, the response of $y_{1}$ to the underlying shocks $\varepsilon_{0}^{p}$ and $\varepsilon_{0}^{u}$ is even higher when we have stronger strategic complementarity. This discussion is summarized in the following theorem, which is our second main result.

Theorem 2. The effects of period-0 shocks on period-1 outcome are increasing in the degree of strategic complementarity: ${ }^{30}$

$$
\frac{\partial}{\partial \alpha}\left(\frac{\partial y_{1}}{\partial \varepsilon_{0}^{u}}\right)>0 \quad \text { and } \quad \frac{\partial}{\partial \alpha}\left|\frac{\partial y_{1}}{\partial \varepsilon_{0}^{p}}\right|>0 .
$$

Thus, the strategic complementarity and the resulting higher-order optimism always strengthen the amplification and dampening we documented in Section 3.

Remark. This theorem is in stark contrast to the results in Woodford (2003), Morris and Shin (2002), and Angeletos and Pavan (2007), which instead document that the higher the degree of strategic complementarity is, the less responsive the agents are to underlying shocks. This can be clearly seen in Example 1 where we have $\frac{\partial}{\partial \alpha}\left(\frac{\partial y}{\partial a}\right)<0$. This is because higher strategic complementarity implies that the equilibrium actions of agents are more anchored to the common prior, so agents are less responsive to contemporaneous shocks. In our model, however, optimistic agents are on average expect that others are more optimistic than they are, so higher strategic complementarity makes agents more responsive to period 0 shocks.

[^21]

Figure 1. Effects of a Unit Increase in Unobserved Shocks


Figure 2. Effects of a Unit Increase in Partly-observed Shocks

We can illustrate our findings using a parametrized example. We set $\sigma_{u}^{2}=\sigma_{\xi}^{2}=1$ for the variance of the unobserved shock and noise terms, and $\sigma_{p}^{2}=2$ for the variance of the partly-observed shock. ${ }^{31}$ We then change the degree of strategic complementarity $\alpha$ from 0 to 1 . Figure 1 corresponds to unobserved shocks $\varepsilon_{0}^{u}$ and Figure 2 to partly-observed shocks $\varepsilon_{0}^{p}$. These figures clearly illustrate our findings: (i) higher-order optimism moves in the same direction as the first-order optimism (Lemma 8), (ii) higher-order beliefs are cumulative sums of higher-order optimism (Lemma 9), and (iii) the effects of underlying shocks are increasing in $\alpha$ (Theorem 2).

We conclude this section with comparative statics. We have seen so far that higher-order optimism determines higher-order beliefs, which in turn determine outcomes. Thus, we can focus on how the values of underlying parameters change the effects of shocks on higher-order optimism. The results are summarized in the following lemma.

[^22]Lemma 10. The effect of the period-0 unobserved shock on higher-order optimism, $\partial \mathcal{O}_{i 1}^{h} / \partial \varepsilon_{0}^{u}$, is
(i) Increasing in $\sigma_{p}^{2}$
(ii) Decreasing in $\sigma_{u}^{2}$ if $h$ is low (e.g., $h=1$ ), while increasing in $\sigma_{u}^{2}$ if $h$ is sufficiently high
(iii) Increasing in $\sigma_{\xi}^{2}$ if $h$ is low (e.g., $h=1$ ), while decreasing in $\sigma_{\xi}^{2}$ if $h$ is sufficiently high.

Similarly, the effect of period-0 partly-observed shock on higher-order optimism, $\left|\partial \mathcal{O}_{i 1}^{h} / \partial \varepsilon_{0}^{p}\right|$ is
(i) Increasing in $\sigma_{u}^{2}$
(ii) Decreasing in $\sigma_{p}^{2}$ if $h$ is low (e.g., $h=1$ ), while increasing in $\sigma_{p}^{2}$ if $h$ is sufficiently high
(iii) Increasing in $\sigma_{\xi}^{2}$ if $h$ is low (e.g., $h=1$ ), while decreasing in $\sigma_{\xi}^{2}$ if $h$ is sufficiently high.

Recall that we prove in Lemma 5 that the effect of the unobserved shock is increasing in the variance of the partly-observed shock and noise terms while decreasing in the variance of the unobserved shock. This explains the first part of Lemma 10 for the first-order optimism ( $h=1$ ). For comparative statics for higher-order optimism, we discussed in Lemma 8 that the effect of the unobserved shock on higher-order optimism can be decomposed into ${ }^{32}$

$$
\frac{\partial \mathcal{O}_{i 1}^{h}}{\partial \varepsilon_{0}^{u}}=\frac{\partial \mathcal{O}_{i 1}}{\partial \varepsilon_{0}^{u}} \cdot Q_{1,2}^{h-1} .
$$

The first term reflects the fact that higher-order optimism increases precisely because the first-order optimism increases. In addition, for a given increase in the first-order optimism, the second term determines the increase in higher-order optimism. Recall that this second term is increasing in both $\sigma_{p}^{2}$ and $\sigma_{u}^{2}$ and decreasing in $\sigma_{\xi}^{2}$. Why do we have different comparative statics for the first and second terms? Lemma 8 tells us that the first term originates from firm $i$ 's rational confusion between $\varepsilon_{0}^{u}$ and ( $\varepsilon_{0}^{p}, \xi_{i}$ ), while the second term is originated from other firms' rational confusion between their noise terms and $\left(\varepsilon_{0}^{p}, \varepsilon_{0}^{u}\right)$. Thus, the first term is decreasing in the relative variance of $\varepsilon_{0}^{u}$, and the second term is decreasing in the relative variance of $\xi_{i}$. If $h$ is low, then the effect of variance parameters on the first term dominates that on the second term so that $h^{t h}$-order optimism has the same comparative statics as the first-order optimism. On the other hand, for sufficiently high $h$, the effect of variance on the second

[^23]

Figure 3. Comparative Statics with Respect to Variance
term dominates that on the first term and $h^{\text {th }}$-order optimism is increasing in $\sigma_{p}^{2}$ and $\sigma_{u}^{2}$ and decreasing in $\sigma_{\xi}^{2}$. This explains the first part of Lemma 10, and we can apply the same argument for the second part. Figure 3 illustrates the results. We use the same parameter values as in the previous numerical exercise and change the value of each variance one by one. We then calculate the effects of underlying shocks on higher-order optimism.

The aggregate output in period 1 is a function of all orders of optimism, and variance parameters, $\sigma_{p}^{2}, \sigma_{u}^{2}, \sigma_{\xi}^{2}$, can have different effects depending on the order of optimism. Lemma 11, however, shows that the effects on the first-term above always dominate the effects on the second term when it comes to the aggregate output.

Lemma 11. The effect of period-0 unobserved shocks on the period-1 aggregate outcome $y_{1}$ is (i) increasing in $\sigma_{p}^{2}$, (ii) decreasing in $\sigma_{w}^{2}$, and (iii) increasing in $\sigma_{\xi}^{2}$. Likewise, the effect of period- 0 partly-observed shocks on the period-1 outcome is (i) increasing in $\sigma_{u}^{2}$, (ii) decreasing in $\sigma_{p}^{2}$, and (iii) increasing in $\sigma_{\xi}^{2}$.

To sum up, the presence of strategic complementarity and the resulting higher-order optimism strengthen our mechanism as a result of two facts: Higher-order beliefs are cumulative sums of higherorder optimism, and higher-order optimism always move in the same direction as the first-order optimism in response to underlying shocks.

### 4.1 Numerical Exercise: Infinite Period with Strategic Complementarity

In this section, we discuss the robustness of the results in Section 4. We relax the restrictive two-period assumptions and instead assume infinite periods. In order to prevent firms from fully learning their


Figure 4. Impulse Response of Aggregate Output


Figure 5. Comparative Statics with Respect to $\alpha$
noise terms, we assume as in Section 3 that noise terms follow an $\operatorname{AR}(1)$ process with $\rho \in(0,1)$ and $\sigma_{\eta}^{2}>0$. Except for these two assumptions, the model is the same as in Section 4.

We utilize the method of Woodford (2003) to solve for the equilibrium dynamics of the aggregate output; see Appendix B for details. We use the same parameters as in Section 4 with $\sigma_{\eta}^{2}=0.5$ and $\rho=0.9$ and numerically calculate the trajectory of the economy after innovations in the underlying shocks. These parameters are arbitrary, but they are neither implausible nor qualitatively essential for the results below. Figure 4 plots the impulse responses of aggregate output to positive innovations in partlyobserved and unobserved shocks. Figure 4a corresponds to the case without strategic complementarity, and Figure 4b corresponds to the case with strategic complementarity.

We can see that Lemma 7 continues to hold in this infinite horizon model: unobserved shocks are propagated to period 1 , while partly-observed shocks have negative effects on the next period outcome.

Also, comparing Figure 4 a and Figure 4 b , the effect of $\alpha$ is in line with Theorem 2: with higher degree of strategic complementarity, we seem to have stronger effects of period- $t$ shocks on the period- $(t+1)$ outcome. However, if we plot $\frac{\partial y_{t+1}}{\partial \varepsilon_{t}^{u}}$ and $\frac{\partial y_{t+1}}{\partial \varepsilon_{t}^{p}}$ as a function of $\alpha$ in Figure 5a, then it turns out that this is not the case for very high values of $\alpha$. In particular, both vanish as $\alpha$ converges to one. Does this mean that the intuition we obtain in the previous section is wrong? The answer is no. Note that the importance of underlying shocks goes to zero as $\alpha$ goes to 1 , which can be clearly seen by $\lim _{\alpha \rightarrow 1} \frac{\partial y_{t}}{\partial \varepsilon_{t}^{\nu}}=0$. For sufficiently high $\alpha$, this force is dominant, so that the effects of period- $t$ shocks on the period- $(t+1)$ output also go to zero. In Figure 5b, we plot the relative size of $\frac{\partial y_{t+1}}{\partial \varepsilon_{t}^{u}}$ and $\frac{\partial y_{t+1}}{\partial \varepsilon_{t}^{t}}$ compared to $\frac{\partial y_{t}}{\partial \varepsilon_{t}^{t}}$. We can observe that these relative effects are indeed increasing in the degree of strategic complementarity, which is indeed in line with the result of Theorem 2. In this sense, we can conclude that the main message of Section 4 does not rely on its simplifying assumptions.

## 5. Implication on Forecast Survey Data

What is the empirical content of our model? In this section, we consider an abstract version of the model in Section 3, in which $a_{i t}$ can be interpreted as any fundamental of interest. In Section 5.1, we first illustrate how this model provides an alternative interpretation of the survey data, while explaining the prominent empirical findings in the literature in a unified way. In Section 5.2, we show that the gap between consensus-level and individual-level overextrapolation helps distinguish our rational theory of overextrapolation from other behavioral theories. This result is reminiscent of Angeletos, Huo, and Sastry's (2020) finding that the gap between consensus-level underreaction and individual-level overreaction speaks to the role of information frictions.

Model. As in Section 3, the fundamental follows an $\operatorname{AR}(1)$ process $a_{i t+1}=\rho_{a} a_{i t}+\varepsilon_{i t+1}^{p}+\varepsilon_{i t+1}^{u}$, and agents observe signals $s_{i t+1}=\rho_{a} a_{i t}+\varepsilon_{i t+1}^{p}+\eta_{i t+1}$. Thus, the optimism follows the law of motion $\tilde{\mathcal{O}}_{i t+1}=\rho \gamma_{3} \tilde{\mathcal{O}}_{i t}-\rho \gamma_{1} \varepsilon_{i t}^{p}+\rho \gamma_{2} \varepsilon_{i t}^{u}+\eta_{i t+1}$. The forecast is then given by $\mathbb{E}_{i t}\left[a_{i t}\right]=\rho_{a}^{2} a_{i t-2}+\left(\rho_{a}-\right.$ $\left.\rho K \gamma_{1}\right) \varepsilon_{i t-1}^{p}+\left(\rho_{a}+\rho K \gamma_{2}\right) \varepsilon_{i t-1}^{u}+K \varepsilon_{i t}^{p}+K \eta_{i t}+\rho \gamma_{3} K \tilde{\mathcal{O}}_{i t-1}$. Note that our timing convention implies that when agent $i$ makes a forecast in period $t$, her information set $\Omega_{i t}=\left(\cdot, s_{i t-2}, a_{i t-2}, s_{i t-1}, a_{i t-1}, s_{i t}\right)$ does not contain the realized fundamental $a_{i t}$. Literature, however, often assumes that $a_{i t}$ is contained in the period- $t$ information set, so we introduce a notation to make our results comparable to the
literature: $\mathbb{F}_{i t}[\cdot] \equiv \tilde{\mathbb{E}}_{i t+1}[\cdot]=\mathbb{E}\left[\cdot \mid\left(\cdots, s_{i t-2}, a_{i t-2}, s_{i t-1}, a_{i t-1}, s_{i t}, a_{i t}\right)\right]$. We denote aggregate variables by either omitting $i$-index or using a bar over variables: $x_{t}=\int x_{i t} \mathrm{~d} i$ for $x \in\left\{a, \varepsilon^{p}, \varepsilon^{u}, \tilde{\mathcal{O}}\right\}, \overline{\mathbb{E}_{i t} a_{i t+k}}=$ $\int_{0}^{1} \mathbb{E}_{j t} a_{j t+k} \mathrm{~d} j$, and $\overline{\mathbb{F}_{i t} a_{i t+k}}=\int_{0}^{1} \mathbb{F}_{j t} a_{j t+k} \mathrm{~d} j$. We write $\sigma_{p}^{2}=\operatorname{Var}\left(\varepsilon_{i t}^{p}\right), \sigma_{u}^{2}=\operatorname{Var}\left(\varepsilon_{i t}^{u}\right), \bar{\sigma}_{p}^{2}=\operatorname{Var}\left(\varepsilon_{t}^{p}\right)$ and $\bar{\sigma}_{u}^{2}=\operatorname{Var}\left(\varepsilon_{t}^{u}\right)$. Note that we always have $\bar{\sigma}_{p}^{2} \leq \sigma_{p}^{2}$ and $\bar{\sigma}_{u}^{2} \leq \sigma_{u}^{2}$ since the shocks may have idiosyncratic components which are canceled out when we aggregate them. This means that the degrees of commonality defined below are always less than or equal to one.

Definition 5. We define the degrees of commonality of the partly-observed and unobserved shocks as

$$
\mathcal{C}_{p}=\frac{\bar{\sigma}_{p}^{2}}{\sigma_{p}^{2}} \text { and } \mathcal{C}_{u}=\frac{\bar{\sigma}_{u}^{2}}{\sigma_{u}^{2}} \text {, respectively. }
$$

On the one hand, if a shock is fully idiosyncratic and hence always take zero value when we integrate it across agents, the degree of commonality is zero. On the other hand, if a shock is common then the degree of commonality is one. The relative size of $\mathcal{C}_{p}$ and $\mathcal{C}_{u}$ plays a central role in Section 5.1. A special case is when agents share a common fundamental $a_{t}$, such as the inflation rate of the economy or GDP growth. This necessarily implies $\mathcal{C}_{p}=\mathcal{C}_{u}=1$. But, in the real world, even for such a common fundamental, forecast data can be better interpreted by a model with idiosyncratic fundamentals. To illustrate this, consider forecasters who form expectations about the US output growth. They have their own ways to view the US output growth, $a_{i t}$, which is not necessarily the same as the true US output growth, $a_{t}$, even if it is unbiased, $\int_{0}^{1} a_{i t} \mathrm{~d} i=a_{t}$. If this is the case, the feedback these forecasters receive is likely to be also in terms of their view of the US output growth, $a_{i t}$, not in terms of the true US output growth, $a_{t}$. Thus, we assume hereafter that $\mathcal{C}_{p}$ and $\mathcal{C}_{u}$ are not necessarily equal to one even when we consider common fundamentals.

### 5.1 Empirical Findings in the Literature

Many empirical papers use panel survey data to measure agents' expectations directly. These papers often assume that forecasters do not observe past realizations, even ex post, and dynamically learn fundamentals from signals. This assumption is necessary because observing past realizations makes learning essentially static in their settings and makes it difficult to explain the dynamic pattern of forecast data. The literature often relies on rational inattention to justify this assumption. But, it is unlikely that forecasters who made a prediction for a variable do not pay close attention to the realized value of it.

This paper gives a totally different way of interpreting dynamic forecast data. This paper views the same survey data as outputs of dynamic learning by forecasters, who can observe the past inflarion rates but are trying to learn how to interpret their own information; i.e., noise terms. Our model allows forecasters to observe past realizations ex post, while still being able to explain several empirical findings that have been explained using standard models. In this section, we first illustrate how our model explains the prominent empirical findings in the literature in a unified way. In particular, we consider the empirical findings of Coibion and Gorodnichenko (2015) (hereafter, CG), Kohlhas and Walther (2020) (hereafter, KW), and Angeletos, Huo, and Sastry (2020) (hereafter, AHS).

Coibion and Gorodnichenko (2015). We start with the finding of CG. They demonstrate the underreaction of the consensus forecast by showing that forecast errors are positively correlated with forecast revisions. They run the following regression

$$
a_{i t+k}-\mathbb{E}_{i t} a_{i t+k}=\alpha_{i}+\delta\left(\overline{\mathbb{E}_{i t} a_{i t+k}}-\overline{\mathbb{E}_{i t-1} a_{i t+k}}\right)+\text { error }_{i t}
$$

and obtain a positive coefficient estimate, $\hat{\delta}>0$. They explain this by the gradual adjustment of average forecasts. The same result can be obtained in our model, but here it is based instead on the gradual adjustment of average optimism.

Proposition 3. In our model, there exists a threshold $\lambda \in(0,1)$ such that $\frac{\mathcal{C}_{p}}{\mathcal{C}_{u}}>\lambda$ implies

$$
\operatorname{Cov}\left(a_{i t+k}-\mathbb{E}_{i t} a_{i t+k}, \overline{\mathbb{E}_{i t} a_{i t+k}}-\overline{\mathbb{E}_{i t-1} a_{i t+k}}\right)>0, \text { for } k \geq 1,
$$

This means that, unless partly observed shocks are mostly averaged out, we can obtain the underreaction of the consensus forecast as in CG.

Kohlhas and Walther (2020). KW show the coexistence of underreaction to new information and overextrapolation from recent realizations of the forecasted variable. The evidence for underreaction is the same as in CG, while for overextrapolation, they run the following regression for US output growth: ${ }^{33}$

$$
a_{t+k}-\overline{\mathbb{E}_{i t+1} a_{i t+k}}=\alpha+\gamma a_{t}+\text { error }_{t}
$$

[^24]and obtain a negative coefficient estimate, $\hat{\gamma}<0$. This directly implies that consensus forecast features overextrapolation to the recent realization. They show that this can happen if rational agents pay more attention to procyclical components of the variable. A simpler explanation is based on a behavioral overextrapolation model in which agents' perceived persistence of the output growth is higher than the true persistence. In the next proposition, we will argue that we can obtain the same result using our model, in which agents overextrapolate to recent realizations because of the endogenous change in optimism.

Proposition 4. Suppose that agents in our model are relatively well informed about idiosyncratic components of shocks in the sense that $\mathcal{C}_{p}<\mathcal{C}_{u}$. Then, we have

$$
\operatorname{Cov}\left(a_{t+k}-\overline{\mathbb{E}_{i t+1} a_{i t+k}}, a_{t}\right)<0, \text { for } k \geq 1
$$

Also note that the contemporaneous effect of $a_{t}$ on the forecast error is positive:

$$
\operatorname{Cov}\left(a_{t+k}-\overline{\mathbb{E}_{i t} a_{i t+k}}, a_{t}\right)>0 .
$$

As discussed in Assumption 2, it is often assumed in the literature that agents are relatively well informed about idiosyncratic shocks. First, idiosyncratic shocks are more agent-specific, hence, it is easier to get information about them. Also, idiosyncratic shocks are likely to be more volatile than the aggregate shocks. Agents thus rationally pay more attention to the idiosyncratic shocks. This necessarily implies $\mathcal{C}_{p}<\mathcal{C}_{u}$. The first part of Proposition 4 says that our model predicts the finding of KW under this condition. The second part says that there is a reversal of covariance, $\operatorname{Cov}\left(a_{t+k}-\overline{\mathbb{E}_{i t+1} a_{i t+k}}, a_{t}\right)<0<\operatorname{Cov}\left(a_{t+k}-\overline{\mathbb{E}_{i t} a_{i t+k}}, a_{t}\right)$. This is reminiscent of Theorem 1, which states that a component that does not affect the period- $t$ expectation has a larger effect on the period$(t+1)$ expectation. This combination of overextrapolation and information friction is essential in many papers in the literature to explain the finding of KW. AHS explain it with the combination of behavioral overextrapolation and information friction. Our model and the model of KW essentially embed rational mechanisms of overextrapolation-persistent noise and feedback in our model and asymmetric attention in KW—into information friction models.

Angeletos, Huo, and Sastry (2020). AHS document delayed overreaction of consensus forecastsconsensus forecasts initially underreact and overshoot later on. This finding is consistent with their model, which combines incomplete information and behavioral over-extrapolation. Since my model provides a rational theory of the overextrapolation of consensus forecasts, we can obtain the same result. In our model, expectations initially underreact due to incomplete information and overshoot later on when agents receive feedback. ${ }^{34}$

### 5.2 Distinguish the Rational Theory from Behavioral Theories

Not only our model but also many behavioral theories of overextrapolation can obtain Proposition 4. Moreover, as AHS pointed out, these theories, combined with information friction, can potentially explain Proposition 3 as well. How can we test our model against other behavioral overextrpolation models? Smoking gun evidence comes from exploiting the difference between the degree of overextrapolation in consensus and individual forecasts. For example, consider the following two regressions.

$$
\begin{array}{r}
a_{t+1}-\overline{\mathbb{E}_{i t+1} a_{i t+1}}=\beta_{0}+\beta_{\text {aggr }} a_{t}+\operatorname{error}_{t+1} \\
a_{i t+1}-\mathbb{E}_{i t+1} a_{i t+1}=\beta_{0}+\beta_{\text {ind }} a_{i t}+\operatorname{error}_{i t+1} \tag{8}
\end{array}
$$

Because $a_{i t}$ is contained in agent $i$ 's information set, our model can only generate overextrapolation at the consensus level, whereas in Proposition 5 we show that behavioral theories necessarily have the same coefficient for both regression specifications. We can compare the estimated coefficients of these regressions to distinguish our rational theory from behavioral theories. ${ }^{35}$

## Proposition 5. Suppose that the fundamental follows an $A R(1)$ process

$$
a_{i t}=\rho_{a} a_{i t-1}+\varepsilon_{i t}
$$

[^25]and agents receive signals about the fundamental with normally distributed noise terms
$$
s_{i t}=a_{i t}+\eta_{i t} .
$$

Consider the following three theories with behavioral elements

- Extrapolation: Agents observe $a_{i t}\left(\right.$ i.e., $\left.\operatorname{Var}\left(\eta_{i t}\right)=0\right)$ when they form expectations about $a_{i t+1}$, but perceived $A R(1)$ coefficient $\hat{\rho}_{a}$ is higher than the true one, $\rho_{a}$. We write $\mathbb{E}_{i t+1}[\cdot]=\mathbb{E}\left[\cdot \mid \cdots, a_{i t-1}, a_{i t}\right]$.
- AHS: Perceived $\operatorname{AR(1)}$ coefficient, $\hat{\rho}_{a}$, is higher than the true one, $\rho_{a}$, and perceived precision of $s_{i t}$ is higher than the true one.
- Diagnostic expectation: $\mathbb{E}_{i t} a_{i, t+k}=\mathbb{E}_{i t-1}^{\text {rational }} a_{i, t+k}+g_{k}\left(s_{i t}-\mathbb{E}_{i t-1}^{\text {rational }} a_{i t}\right)$ with $g_{k}>K \cdot \rho^{k}$ where $K$ is the Kalman gain.

We always have

$$
\widehat{\beta}_{\text {aggr }}=\widehat{\beta}_{\text {ind }} \text {. }
$$

In our model, suppose again that agents are relatively well informed about idiosyncratic components of shocks in the sense that $\mathcal{C}_{p}<\mathcal{C}_{u}$. Then, we have

$$
\widehat{\beta}_{\text {aggr }}<0 \quad \text { and } \quad \widehat{\beta}_{\text {ind }}=0 .
$$

Gennaioli, Ma, and Shleifer (2016) report both $\widehat{\beta}_{\text {aggr }}$ and $\widehat{\beta}_{\text {ind }}$ for CFOs' and analysts' expectations on earnings growth, which is copied in Table 4, although their focus is not on comparing the coefficients. The coefficients in panel (A) correspond to $\widehat{\beta}_{a g g r}$, and those in panel (B) correspond to $\widehat{\beta}_{\text {ind }}$. We can make two observations. First, analysts expectations feature a pattern consistent with Proposition 5; i.e., $\widehat{\beta}_{\text {aggr }}<0$ and $\widehat{\beta}_{\text {ind }} \approx 0$. Second, CFOs expectations give higher extrapolation both at the consensus level and at the individual level. But the differences between two are approximately the same. These two observations are suggestive of the interpretation that analysts expectations are approximately rational but overextrapolate from past realizations once we aggregate them to consensus expectations, and that CFOs expectations are additionally subject to behavioral overextrapolation. ${ }^{36}$ It is difficult, however, to formally map these estimates to the coefficients $\widehat{\beta}_{\text {aggr }}$ and $\widehat{\beta}_{\text {ind }}$ in Proposition 5 because Gennaioli, Ma, and

[^26]Table 4: Tables 8 and 9 of Gennaioli, Ma, and Shleifer (2016)

| A. Aggregate Evidence |  |  |
| :--- | :---: | :---: |
| Realized - Expected <br> Next 12m Earnings Growth |  |  |
| $(1)$ <br> Analyst | CFO |  |
| Past 12 m <br> earnings/asset (\%) | -0.0456 | -0.0881 <br> Observations |


| B. Firm-Level Evidence |  |  |
| :---: | :---: | :---: |
|  | Realized - Expected Next 12m Earnings Growth |  |
|  | (1) <br> Analyst | $\begin{gathered} \hline \text { (2) } \\ \text { CFO } \end{gathered}$ |
| Past 12 m earnings/asset (\%) | $\begin{aligned} & -0.0080 \\ & (-7.43) \end{aligned}$ | $\begin{aligned} & -0.0511 \\ & (-5.14) \end{aligned}$ |
| Firm fixed effects | Y | Y |
| Observations | 103,930 | 606 |

Notes: In panel (A), the dependent variable is aggregate earnings growth in the next 12 months minus aggregate expectations of earnings growth in the next 12 months. Independent variables include aggregate earnings/asset in the four quarters prior to quarter $t-1$. In panel (B), the dependent variable is firm-level earnings growth in the next 12 months minus expectations of earnings growth in the next 12 months. Independent variables include firm-level earnings/asset in the four quarters prior to quarter $t-1$. $t$-statistics in parentheses. See Gennaioli, Ma, and Shleifer (2016) for details.

Shleifer (2016) regress forecast errors of earning growth on past earnings per asset, not on past earnings growth. Thus, we redo their estimation using past earnings growth as independent variables. One should be cautious when choosing the length of time periods because our theory essentially implies initial underextrapolation and overextrapolation later on (See Proposition 4). Suppose that $a_{i t}$ denotes firmlevel earning growth over one year starting from time $t$. We experiment with various values of the length of time periods between $t$ and $t+1$, from four quarters $(i=4)$ to twelve quarters $(i=12) .{ }^{37}$ Figure 6 shows the estimated coefficients of the regression specifications (7) and (8). Reassuringly, this again features a pattern consistent with Proposition 5 for intermediate values of $i, 7 \leq i \leq 11$.

[^27]

Notes: This figure plots the estimated coefficients of specifications (7) and (8). We vary the length of a unit time period, from four quarters $(i=4)$ to twelve quarters $(i=12)$.

Remark. The experience effects are studied by Malmendier and Nagel $(2011,2016)$ and subsequent papers. Recent evidence suggests longlasting effects of past personal experiences on expectations and behaviors. For example, personal lifetime experiences in the stock market affect future stock market investment behavior. This is inconsistent with traditional economic models, in which there is no difference between personally experiencing an event and hearing about it. The literature on experience effects emphasizes the longlasting neuropsychology effects as a key mechanism. The following corollary provides a natural explanation of experience effects through the lens of our model.

Corollary 3. In our model, suppose again that agents are relatively well informed about idiosyncratic components of shocks in the sense that $\mathcal{C}_{p}<\mathcal{C}_{u}$. Then, when we run the following regression

$$
a_{i t+1}-\mathbb{E}_{i t+1} a_{i t+1}=\beta_{0}+\tilde{\beta}_{\text {aggr }} a_{t}+\widetilde{\operatorname{error}}_{i t+1},
$$

we have

$$
\widehat{\tilde{\beta}}_{\text {aggr }}=\widehat{\beta}_{\text {aggr }}<0 .
$$

Suppose you have experienced large negative stock market returns, $a_{t}<0$. Then Corollary 3 implies that you become pessimistic about the stock market, $a_{i t+1}-\mathbb{E}_{i t+1} a_{i t+1}>0$, being less likely to participate in it. Moreover, expectations adjust only for those who experience this negative shock, because this overextrapolation arises from agents evaluating their previous forecasts based on the
feedback they receive. Those who only hear about the negative shock have not had a chance to make a prediction, so they would not show overextrapolative behavior. In other words, our model provides a novel reason why the cognitive process of making a prediction and evaluating it affects the formation of future expectations.

## 6. Conclusion

We begin with two observations. First, noise in agents' signals is likely to be persistent regardless of its real-world counterpart. Second, in the real world, agents receive feedback on their past forecasts. With persistent noise and feedback, agents try to learn about the noise in their signals and the noise of others, and optimism arises endogenously. With this additional channel of learning, feedback on previous forecasts affects expectations about the noise, and shocks with different degrees of observability have different effects on the dynamics of aggregate outcomes through their different effects on optimism. We obtain a novel mechanism by which rational agents become overoptimistic after observing higher-thanexpected outcomes of the economy, and this optimism amplifies/propagates the underlying shocks. Here, optimism is not only about one's own signals but also about others' optimism when there is strategic complementarity. Our model gives us a new way to interpret forecast dynamics in survey data-learning how to interpret information rather than learning fundamentals. This interpretation is consistent with many empirical findings in the literature.

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## Appendix

## A. Proofs for Sections 2-4

Proof of Lemma 1. Signals of the form $s_{t}=a_{t}+\sigma \cdot \tilde{\xi}_{t}$ give a strictly positive object function unless $\sigma=0$, which violates the information constraint. Consider a signal of the form $s_{t}=a_{t}+\sigma \cdot \tilde{\xi}$ where $\sigma$ is sufficiently high to satisfy the information constraint. Since we know unconditional distribution of $a_{t}$, with an infinite number of realizations of $s_{t}$, we can exactly learn the realization of $\tilde{\xi}$, thereby having $\mathbb{E}\left[a_{t} \mid s^{t}\right]=a_{t}$ for all $t$.

Proof of Lemma 2. We have

$$
\left(1-\frac{1}{\eta}-\frac{1}{\theta}\right) y_{i j t}=\mathbb{E}_{i t}\left[-\frac{1}{\eta} y_{t}+\gamma y_{t}-\frac{1}{\theta} a_{i t}+\left(1-\frac{\sigma}{\eta}\right) \frac{1}{\sigma}\left(y_{i j t}-y_{t}\right)\right]
$$

or

$$
\left(1-\frac{1}{\sigma}-\frac{1}{\theta}\right) y_{i j t}=\mathbb{E}_{i t}\left[\left(\gamma-\frac{1}{\sigma}\right) y_{t}-\frac{1}{\theta} a_{i t}\right]
$$

or equivalently

$$
\begin{aligned}
y_{i j t} & =\left(\frac{1}{\theta}+\frac{1}{\sigma}-1\right)^{-1} \mathbb{E}_{i t}\left[\frac{1}{\theta} a_{i t}+\left(\frac{1}{\sigma}-\gamma\right) y_{t}\right] \\
& \equiv \mathbb{E}_{i t}\left[(1-\alpha) \tilde{a}_{i t}+\alpha y_{t}\right]
\end{aligned}
$$

which gives the desired result.

Proof of Proposition 1. Although we can prove this directly, this result can be seen as a special case of Theorem 1 with $\rho=0$.

Proof of Lemma 3. Right before observing $s_{i t}$, we have $\xi_{i t-1} \mid \tilde{\Omega}_{i t} \sim \mathcal{N}\left(m_{i t-1}, V_{t-1}\right)$, hence

$$
\xi_{i t} \mid \tilde{\Omega}_{i t} \sim \mathcal{N}\left(\rho m_{i t-1}, \rho^{2} V_{t-1}+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}\right) .
$$

On the other hand, the prior belief of $\tilde{a}_{i t} \equiv \rho_{a} a_{i t-1}+\varepsilon_{i t}^{p}$ is $\mathcal{N}\left(\rho_{a} a_{i t-1}, \sigma_{p}^{2}\right)$. Thus, Bayesian updating gives

$$
\mathbb{E}_{i t}\left[a_{i t}\right]=\mathbb{E}_{i t}\left[\tilde{a}_{i t}\right]=\rho_{a} \cdot a_{i t-1}+K_{t}\left(s_{i t}-\rho_{a} a_{i t-1}-\rho m_{i t-1}\right)
$$

where $K_{t}=\frac{\sigma_{p}^{2}}{\rho^{2} V_{t-1}+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}+\sigma_{p}^{2}} \in(0,1)$. Also note that

$$
s_{i t}-\rho_{a} a_{i t-1}-\rho m_{i t-1}=\varepsilon_{i t}^{p}+\xi_{i t}-\rho m_{i t-1}=\varepsilon_{i t}^{p}+\tilde{\mathcal{O}}_{i t} .
$$

Finally, we have

$$
\mathbb{E}_{i t}\left[a_{i t}\right]=\mathbb{E}_{i t}\left[\tilde{a}_{i t}\right]=\mathbb{E}_{i t}\left[s_{i t}-\xi_{i t}\right]=s_{i t}-\mathbb{E}_{i t}\left[\xi_{i t}\right]=\rho_{a} a_{i t-1}+\varepsilon_{i t}^{p}+\mathcal{O}_{i t} .
$$

Proof of Lemma 4. Consider the following state-space representation.

$$
\begin{aligned}
& \boldsymbol{x}_{t} \equiv\binom{\tilde{a}_{i t}}{\xi_{i t}} \sim \mathcal{N}(\binom{\rho_{a} a_{i t-1}}{\rho m_{t-1}}, \underbrace{\left(\begin{array}{cc}
\sigma_{p}^{2} & 0 \\
0 & \rho^{2} V_{t-1}+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}
\end{array}\right)}_{\Sigma}) \\
& \boldsymbol{y}_{t} \equiv\binom{s_{i t}}{a_{i t}}=\underbrace{\left(\begin{array}{ll}
1 & 1 \\
1 & 0
\end{array}\right)}_{G} \boldsymbol{x}_{t}+\binom{0}{e_{t}^{u}}
\end{aligned}
$$

The Kalman filter gives

$$
\boldsymbol{x}_{t} \left\lvert\, \boldsymbol{y}_{t} \sim \mathcal{N}\left(\binom{\rho_{a} a_{i t-1}}{\rho m_{t-1}}+K\left(\boldsymbol{y}_{t}-G\binom{\rho_{a} a_{i t-1}}{\rho m_{t-1}}\right), K R K^{\prime}+(I-K G) \Sigma(I-K G)^{\prime}\right)\right.
$$

where $K=\Sigma G^{\prime}(G \Sigma G+R)^{-1}$ and $R=\operatorname{Var}\binom{0}{\varepsilon_{t}^{u}}=\left(\begin{array}{cc}0 & 0 \\ 0 & \sigma_{u}^{2}\end{array}\right)$. This gives $\xi_{i t} \mid \tilde{\Omega}_{i t+1} \sim \mathcal{N}\left(m_{i t}, V_{t}\right)$ with

$$
\begin{aligned}
m_{i t} & =\left(\gamma_{1}+\gamma_{2}\right) s_{i t}+\gamma_{3} \rho m_{i t-1}-\rho_{1} \rho_{a} a_{i t-1}-\gamma_{2} a_{i t} \\
V_{t} & =\gamma_{3}\left(\rho^{2} V_{t-1}+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}\right)
\end{aligned}
$$

where

$$
\begin{aligned}
\gamma_{1} & =\frac{\sigma_{u}^{2}\left(\rho^{2} V_{t-1}+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}\right)}{\left(\sigma_{p}^{2}+\sigma_{u}^{2}\right)\left(\rho^{2} V_{t-1}+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}\right)+\sigma_{p}^{2} \sigma_{u}^{2}} \\
\gamma_{2} & =\frac{\sigma_{p}^{2}\left(\rho^{2} V_{t-1}+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}\right)}{\left(\sigma_{p}^{2}+\sigma_{u}^{2}\right)\left(\rho^{2} V_{t-1}+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}\right)+\sigma_{p}^{2} \sigma_{u}^{2}} \\
\gamma_{3} & =\frac{\sigma_{p}^{2} \sigma_{u}^{2}}{\left(\sigma_{p}^{2}+\sigma_{u}^{2}\right)\left(\rho^{2} V_{t-1}+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}\right)+\sigma_{p}^{2} \sigma_{u}^{2}}
\end{aligned}
$$

Thus, $\gamma_{1}, \gamma_{2}, \gamma_{3} \in(0,1)$ and $\gamma_{1}+\gamma_{2}+\gamma_{3}=1$.

Proof of Proposition 2. The law of motion for ex-ante optimism directly follows from Lemma 4. In the proof of Lemma 3, we have shown that

$$
\mathcal{O}_{i t}=K \tilde{\mathcal{O}}_{i t}-(1-K) \varepsilon_{i t}^{p},
$$

which gives the law of motion for ex-post optimism.

Proof of Lemma 5. We have

$$
V=\frac{\sigma_{p}^{2} \sigma_{u}^{2}\left(\rho^{2} V+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}\right)}{\left(\sigma_{p}^{2}+\sigma_{u}^{2}\right)\left(\rho^{2} V+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}\right)+\sigma_{p}^{2} \sigma_{u}^{2}}
$$

or equivalently

$$
\frac{1}{V}-\frac{1}{\rho^{2} V+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}}=\frac{1}{\sigma_{p}^{2}}+\frac{1}{\sigma_{u}^{2}}
$$

Since $\gamma_{1}=\frac{V}{\sigma_{p}^{2}}$, we can write

$$
\frac{1}{\gamma_{1}}-\frac{1}{\rho^{2} \gamma_{1}+\left(1-\rho^{2}\right) \frac{\sigma_{n}^{2}}{\sigma_{p}^{2}}}=1+\frac{\sigma_{p}^{2}}{\sigma_{u}^{2}}
$$

The left hand side is then increasing in $\sigma_{\eta}^{2}$ and decreasing in $\sigma_{p}^{2}$. Moreover, as it can be alternatively written as

$$
\frac{\left(1-\rho^{2}\right)\left(\frac{\sigma_{\eta}^{2}}{\sigma_{u}^{2}}-\gamma_{1}\right)}{\gamma_{1}\left(\rho^{2} \gamma_{1}+\left(1-\rho^{2}\right) \frac{\sigma_{\eta}^{2}}{\sigma_{p}^{2}}\right)},
$$

the left hand side is also decreasing in $\gamma_{1}$. Therefore, we can conclude that $\gamma_{1}$ is increasing in $\sigma_{u}^{2}$ and $\sigma_{\eta}^{2}$ while decreasing in $\sigma_{p}^{2}$. In a similar way, we can show that $\gamma_{2}$ is increasing in $\sigma_{p}^{2}$ and $\sigma_{\eta}^{2}$ while decreasing in $\sigma_{u}^{2}$. For the comparative statics for $\gamma_{3}$, define $W=\rho^{2} V+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}$. This implies
$V=\rho^{-2} W-\left(\rho^{-2}-1\right) \sigma_{\eta}^{2}$ and $\gamma_{3} \equiv \frac{V}{W}=\rho^{-2}-\left(\rho^{-2}-1\right) \frac{\sigma_{\eta}^{2}}{W}$. The last term $\frac{\sigma_{\eta}^{2}}{W}$ satisfies

$$
\frac{\left(\rho^{-2}-1\right)\left(1-\frac{W}{\sigma_{\eta}^{2}}\right)}{\frac{W}{\sigma_{\eta}^{2}}\left(\rho^{-2} \frac{W}{\sigma_{\eta}^{2}}-\left(\rho^{-2}-1\right)\right)}=\frac{\sigma_{\eta}^{2}}{\sigma_{p}^{2}}+\frac{\sigma_{\eta}^{2}}{\sigma_{u}^{2}} .
$$

The left hand side is increasing in $\frac{\sigma_{\eta}^{2}}{W}$. Thus, $\gamma_{3}$ is decreasing in $\sigma_{\eta}^{2}$ while increasing in $\sigma_{p}^{2}$ and $\sigma_{u}^{2}$.

Proof of Theorem 1. From Proposition 2 and the definition of optimism, we have

$$
\begin{aligned}
y_{i t+1} & =\rho_{a} a_{i t}+K\left(s_{i t+1}-\rho_{a} a_{i t}-\rho m_{i t}\right) \\
& =\rho_{a} a_{i t}+K\left(\varepsilon_{i t+1}^{p}+\xi_{i t+1}-\rho m_{i t}\right) \\
& =\rho_{a}^{2} a_{i t-1}+\left(\rho_{a}-\rho K \gamma_{1}\right) \varepsilon_{i t}^{p}+\left(\rho_{a}+\rho K \gamma_{2}\right) \varepsilon_{i t}^{u}+K \varepsilon_{i t+1}^{p}+K \eta_{i t+1}+\rho \gamma_{3} K \tilde{\mathcal{O}}_{i t} .
\end{aligned}
$$

We can use the relationship between ex-ante and ex-post optimism to derive the second result.

Proof of Lemma 6. Suppose that all agents except for $i$ use a strategy of the form $y_{j 0}=\theta s_{j 0}$. Then, we can calculate the best response of $i$ as

$$
\begin{aligned}
y_{i 0} & =(1-\alpha) \mathbb{E}_{i 0}\left[\varepsilon_{0}^{p}\right]+\alpha \mathbb{E}_{i 0}\left[y_{0}\right] \\
& =(1-\alpha+\alpha \theta) \mathbb{E}_{i 0}\left[\varepsilon_{0}^{p}\right] \\
& =(1-\alpha+\alpha \theta) \frac{\sigma_{p}^{2}}{\sigma_{p}^{2}+\sigma_{\xi}^{2}} s_{i 0} .
\end{aligned}
$$

Thus, the unique linear equilibrium is given by $y_{i 0}=\theta s_{i 0}$ where $\theta=\frac{(1-\alpha) \sigma_{p}^{2}}{(1-\alpha) \sigma_{p}^{2}+\sigma_{\xi}^{2}} \in(0,1)$. For the general uniqueness, see Morris and Shin (2002).

Proof of Lemma 7. Suppose that all agents except for $i$ use a strategy of the form $y_{j 1}=\theta_{1} s_{j 0}+\theta_{2} a_{0}+\theta_{3} s_{j 1}$, then these decisions aggregate into

$$
y_{1}=\theta_{1} \varepsilon_{0}^{p}+\theta_{2} a_{0}+\theta_{2} \varepsilon_{1}^{p} .
$$

Thus, the the best response of $i$ in period 1 is given by

$$
y_{i 1}=(1-\alpha) \mathbb{E}_{i 1} \varepsilon_{1}^{p}+\alpha \mathbb{E}_{i 1} y_{1}
$$

$$
=\left(1-\alpha+\alpha \theta_{3}\right) \mathbb{E}_{i 1} \varepsilon_{1}^{p}+\alpha \theta_{2} a_{0}+\alpha \theta_{1} \mathbb{E}_{i 1} \varepsilon_{0}^{p} .
$$

Consider the following state-space representation.

$$
\begin{aligned}
& \boldsymbol{x} \equiv\binom{\varepsilon_{0}^{p}}{\varepsilon_{1}^{p}} \sim \mathcal{N}(\mathbf{0}, \Sigma) \quad \text { where } \Sigma=\left(\begin{array}{cc}
\sigma_{p}^{2} & 0 \\
0 & \sigma_{p}^{2}
\end{array}\right) \\
& \boldsymbol{y} \equiv\left(\begin{array}{c}
s_{i 0} \\
a_{0} \\
s_{i 1}
\end{array}\right)=\underbrace{\left(\begin{array}{ll}
1 & 0 \\
1 & 0 \\
0 & 1
\end{array}\right)}_{G}\binom{\varepsilon_{0}^{p}}{\varepsilon_{1}^{p}}+\left(\begin{array}{c}
\xi_{i} \\
\varepsilon_{0}^{u} \\
\xi_{i}
\end{array}\right) .
\end{aligned}
$$

The Kalman filter gives

$$
\mathbb{E}[\boldsymbol{x} \mid \boldsymbol{y}]=K \boldsymbol{y} \quad \text { where } K=\Sigma G^{\prime}\left(G \Sigma G^{\prime}+R\right)^{-1} \quad \text { with } R=\left(\begin{array}{ccc}
\sigma_{\xi}^{2} & 0 & \sigma_{\xi}^{2} \\
0 & \sigma_{u}^{2} & 0 \\
\sigma_{\xi}^{2} & 0 & \sigma_{\xi}^{2}
\end{array}\right)
$$

Thus, we have

$$
y_{i 1}=\alpha \theta_{1}\left(\begin{array}{ll}
1 & 0
\end{array}\right) K \boldsymbol{y}+\left(1-\alpha+\alpha \theta_{3}\right)\left(\begin{array}{ll}
0 & 1
\end{array}\right) K \boldsymbol{y}+\alpha \theta_{2} a_{0}
$$

Matching coefficient, we have

$$
\begin{aligned}
& \theta_{1}=\left(\begin{array}{ll}
\alpha \theta_{1} & 1-\alpha+\alpha \theta_{3}
\end{array}\right) K\left(\begin{array}{l}
1 \\
0 \\
0
\end{array}\right) \\
& \theta_{2}=\frac{1}{1-\alpha}\left(\begin{array}{ll}
\alpha \theta_{1} & 1-\alpha+\alpha \theta_{3}
\end{array}\right) K\left(\begin{array}{l}
0 \\
1 \\
0
\end{array}\right) \\
& \theta_{3}=\left(\begin{array}{ll}
\alpha \theta_{1} & 1-\alpha+\alpha \theta_{3}
\end{array}\right) K\left(\begin{array}{l}
0 \\
0 \\
1
\end{array}\right)
\end{aligned}
$$

Let $B=\left(\begin{array}{ll}\alpha \theta_{1} & 1-\alpha+\alpha \theta_{3}\end{array}\right)$, then we can obtain $B$ by

$$
B=\left(\begin{array}{ll}
0 & 1-\alpha
\end{array}\right)+B K\left(\begin{array}{l}
1 \\
0 \\
0
\end{array}\right)\left(\begin{array}{ll}
\alpha & 0
\end{array}\right)+B K\left(\begin{array}{l}
0 \\
0 \\
1
\end{array}\right)\left(\begin{array}{ll}
0 & \alpha
\end{array}\right)
$$

$$
=\left(\begin{array}{ll}
0 & 1-\alpha
\end{array}\right)\left(I-K\left(\begin{array}{cc}
\alpha & 0 \\
0 & 0 \\
0 & \alpha
\end{array}\right)\right)^{-1}
$$

which in turn gives the values for $\theta_{1}, \theta_{2}$ and $\theta_{3}$. Thus, we can write

$$
y_{1}=\theta_{1} \varepsilon_{0}^{p}+\theta_{2}\left(\varepsilon_{0}^{p}+\varepsilon_{0}^{u}\right)+\theta_{3} \varepsilon_{1}^{p} \equiv \gamma_{p} \varepsilon_{0}^{p}+\gamma_{u} \varepsilon_{0}^{u}+\gamma_{p}^{\prime} \varepsilon_{1}^{p}
$$

where

$$
\begin{aligned}
\gamma_{p} & =-\frac{\sigma_{u}^{2} \sigma_{\xi}^{2}}{(1-\alpha) \sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}} \\
\gamma_{u} & =\frac{\sigma_{p}^{2} \sigma_{\xi}^{2}}{(1-\alpha) \sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}} \\
\gamma_{p}^{\prime} & =\frac{(1-\alpha) \sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+\sigma_{u}^{2} \sigma_{\xi}^{2}}{(1-\alpha) \sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}}
\end{aligned}
$$

Proof of Lemma 8. From the proof of Lemma 7, we can get

$$
\left.\begin{array}{rl}
\mathbb{E}_{i t}\left[\xi_{i}\right] & \equiv \mathbb{E}\left[\xi_{i} \left\lvert\,\left(\begin{array}{c}
s_{i 0} \\
a_{0} \\
s_{i 1}
\end{array}\right)\right.\right]=\mathbb{E}\left[s_{i 0}-\varepsilon_{0}^{p} \left\lvert\,\left(\begin{array}{c}
s_{i 0} \\
a_{0} \\
s_{i 1}
\end{array}\right)\right.\right] \\
& =\left[\begin{array}{lll}
1 & 0 & 0
\end{array}\right)-\left(\begin{array}{ll}
1 & 0
\end{array}\right) K
\end{array}\right]\left(\begin{array}{c}
s_{i 0} \\
a_{0} \\
s_{i 1}
\end{array}\right) .
$$

Note first that

$$
\mathcal{O}_{i 1} \equiv \xi_{i}-\mathbb{E}_{i 1} \xi_{i}=\underbrace{\left[\begin{array}{llll}
0 & 1 & 0 & 0
\end{array}\right)-L}_{Q}] \overrightarrow{\boldsymbol{z}}_{i} .
$$

Also note that

$$
\begin{aligned}
& \mathbb{E}_{i 1}\left[\int_{0}^{1} \overrightarrow{\boldsymbol{z}}_{j} d j\right]=\mathbb{E}_{i 1}\left[\left(\begin{array}{c}
\varepsilon_{0}^{p} \\
0 \\
\varepsilon_{0}^{u} \\
\varepsilon_{1}^{p}
\end{array}\right)\right]=\mathbb{E}_{i 1}\left[\left(\begin{array}{c}
s_{i 0}-\xi_{i} \\
0 \\
a_{0}-s_{i 0}+\xi_{i} \\
s_{i 1}-\xi_{i}
\end{array}\right)\right] \\
&=\underbrace{\left(\begin{array}{ccc}
1 & 1 & 0
\end{array}\right)-L}_{T} \begin{array}{lll}
\left(\begin{array}{llll}
0 & 0 & 0 & 0
\end{array}\right) \\
\left(\begin{array}{llll}
0 & -1 & 1 & 0
\end{array}\right)+L \\
\left(\begin{array}{llll}
0 & 1 & 0 & 1
\end{array}\right)-L
\end{array}) \\
& \overrightarrow{\boldsymbol{z}}_{i}
\end{aligned}
$$

Suppose that $\mathcal{O}_{i 1}^{h-1}=Q T^{h-2} \overrightarrow{\boldsymbol{z}}_{i}$ holds (This indeed holds for $h=2$ ). Then, we have

$$
\begin{aligned}
\mathcal{O}_{i 1}^{h} & =\mathbb{E}_{i 1}\left[Q T^{h-2} \int_{0}^{1} \overrightarrow{\boldsymbol{z}}_{j} d j\right] \\
& =Q T^{h-1} \overrightarrow{\boldsymbol{z}}_{i}
\end{aligned}
$$

Thus, we can inductively show that

$$
\mathcal{O}_{i 1}^{h}=Q T^{h-1} \overrightarrow{\boldsymbol{z}}_{i} .
$$

After some algebra, we can write $Q$ and $Q T^{h-1}$ as functions of underlying parameters:

$$
\begin{aligned}
Q & =\left(\begin{array}{cccc}
-\frac{\sigma_{u}^{2} \sigma_{\xi}^{2}}{\sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}} & \frac{\sigma_{p}^{2} \sigma_{u}^{2}}{\sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}} & \frac{\sigma_{p}^{2} \sigma_{\xi}^{2}}{\sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}} & -\frac{\sigma_{u}^{2} \sigma_{\xi}^{2}}{\sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}}
\end{array}\right) \\
Q T^{h-1} & =\left(\begin{array}{lllll}
-\frac{\left(\sigma_{p}^{2}\right)^{h-1}\left(\sigma_{u}^{2}\right)^{h} \sigma_{\xi}^{2}}{\left(\sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}\right)^{h}} & -\frac{\left(\sigma_{p}^{2}\right)^{h-1}\left(\sigma_{u}^{2}\right)^{h-1} \sigma_{\xi}^{2}\left(\sigma_{p}^{2}+2 \sigma_{u}^{2}\right)}{\left(\sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}\right)^{h}} & \frac{\left(\sigma_{p}^{2} h\left(\sigma_{u}^{2}\right)^{h-1} \sigma_{\xi}^{2}\right.}{\left(\sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}\right)^{h}} & -\frac{\left(\sigma_{p}^{2}\right)^{h-1}\left(\sigma_{u}^{2}\right)^{h} \sigma_{\xi}^{2}}{\left(\sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}\right)^{h}}
\end{array}\right) .
\end{aligned}
$$

Note that

$$
\begin{aligned}
Q_{1,2} & =\frac{\sigma_{p}^{2} \sigma_{u}^{2}}{\sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}} \\
& =\frac{1}{1+\frac{\sigma_{\xi}^{2}}{\sigma_{u}^{2}}+2 \frac{\sigma_{\xi}^{2}}{\sigma_{p}^{2}}}
\end{aligned}
$$

is decreasing in $\sigma_{\xi}^{2}$ and increasing in $\sigma_{u}^{2}$ and $\sigma_{p}^{2}$.

Proof of Lemma 9. First, we have

$$
\mathbb{E}_{i 1}\left[a_{1}\right]=\mathbb{E}_{i 1}\left[\varepsilon_{i 1}^{p}\right]=\mathbb{E}_{i 1}\left[s_{i 1}-\xi_{i}\right]=\varepsilon_{i 1}^{p}+\xi_{i}-\mathbb{E}_{i 1}\left[\xi_{i}\right]=\varepsilon_{i 1}^{p}+\mathcal{O}_{i 1} .
$$

Thus,

$$
\overline{\mathbb{E}}_{1} \varepsilon_{1}^{p}=\overline{\mathcal{O}}_{1} .
$$

Suppose that we have

$$
\begin{aligned}
\mathbb{E}_{i 1} \overline{\mathbb{E}}_{1}^{h-1}\left[a_{1}\right] & =\varepsilon_{1}^{p}+\mathcal{O}_{i 1}+\mathcal{O}_{i 1}^{2}+\cdots+\mathcal{O}_{i 1}^{h-1} \\
\overline{\mathbb{E}}_{1}^{h}\left[a_{1}\right] & =\varepsilon_{1}^{p}+\overline{\mathcal{O}}_{1}+\overline{\mathcal{O}}_{1}^{2}+\cdots+\overline{\mathcal{O}}_{1}^{h}
\end{aligned}
$$

for a given $h$. Then, we can obtain

$$
\begin{aligned}
\mathbb{E}_{i 1} \overline{\mathbb{E}}_{1}^{h}\left[a_{1}\right] & =\mathbb{E}_{i 1}\left[\varepsilon_{1}^{p}+\overline{\mathcal{O}}_{1}+\overline{\mathcal{O}}_{1}^{2}+\cdots+\overline{\mathcal{O}}_{1}^{h}\right] \\
& =\varepsilon_{1}^{p}+\mathcal{O}_{i 1}+\mathcal{O}_{i 1}^{2}+\cdots+\mathcal{O}_{i 1}^{h+1}
\end{aligned}
$$

hence

$$
\overline{\mathbb{E}}_{1}^{h+1}\left[a_{1}\right]=\varepsilon_{1}^{p}+\overline{\mathcal{O}}_{1}+\overline{\mathcal{O}}_{1}^{2}+\cdots+\overline{\mathcal{O}}_{1}^{h+1}
$$

Thus, we can inductively show Lemma 9.

Proof of Lemma 10. We have shown in the proof of Lemma 8 that

$$
\frac{\partial \overline{\mathcal{O}}_{1}^{h}}{\partial \varepsilon_{0}^{u}}=\frac{\left(\sigma_{p}^{2}\right)^{h}\left(\sigma_{u}^{2}\right)^{h-1} \sigma_{\xi}^{2}}{\left(\sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}\right)^{h}}, \text { for all } h \geq 1
$$

and that

$$
\frac{\partial \overline{\mathcal{O}}_{1}^{h}}{\partial \varepsilon_{0}^{p}}=-\frac{\left(\sigma_{p}^{2}\right)^{h-1}\left(\sigma_{u}^{2}\right)^{h} \sigma_{\xi}^{2}}{\left(\sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}\right)^{h}}, \text { for all } h \geq 1
$$

After some algebra, we can obtain the results.

Proof of Lemma 11. Recall that, in the proof of Lemma 7, we have

$$
y_{1}=\gamma_{p} \varepsilon_{0}^{p}+\gamma_{u} \varepsilon_{0}^{u}+\gamma_{p}^{\prime} \varepsilon_{1}^{p}
$$

where

$$
\begin{aligned}
\gamma_{p} & =-\frac{\sigma_{u}^{2} \sigma_{\xi}^{2}}{(1-\alpha) \sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}} \\
\gamma_{u} & =\frac{\sigma_{p}^{2} \sigma_{\xi}^{2}}{(1-\alpha) \sigma_{p}^{2} \sigma_{u}^{2}+\sigma_{p}^{2} \sigma_{\xi}^{2}+2 \sigma_{u}^{2} \sigma_{\xi}^{2}}
\end{aligned}
$$

Thus, the effect of $\varepsilon_{0}^{u}$ on $y_{1}$ (i.e., $\gamma_{u}$ ) is increasing in $\sigma_{p}^{2}$, decreasing in $\sigma_{u}^{2}$, and increasing in $\sigma_{\xi}^{2}$. Likewise, the effect of $\varepsilon_{0}^{p}$ on $y_{1}$ (i.e., $\left|\gamma_{p}\right|$ ) is increasing in $\sigma_{u}^{2}$, decreasing in $\sigma_{p}^{2}$, and increasing in $\sigma_{\xi}^{2}$.

## B. Details of the Numerical Exercise

We utilize the method of Woodford (2003) to solve for the equilibrium dynamics of the aggregate output, which exploits the fact that firms only need to track particular linear combinations of higher-order beliefs. The absence of endogenous signals permits us to do so; see Huo and Takayama (2015). We start from a guess that the relevant aggregate state can be summarized in

$$
\mathbf{x}_{t}=\left(\begin{array}{llll}
\varepsilon_{t}^{p} & \varepsilon_{t}^{u} & F_{t} & y_{t}
\end{array}\right)^{\prime}
$$

where ${ }^{38}$

$$
\begin{aligned}
F_{t} & =\sum_{k=1}^{\infty}(1-\alpha) \alpha^{k-1}{\overline{\mathbb{E}_{i t} \xi_{i t}}}^{k}=(1-\alpha) \overline{\mathbb{E}_{i t} \xi_{i t}}+\alpha \overline{\mathbb{E}}_{t} F_{t} \\
y_{t} & =\sum_{k=1}^{\infty}(1-\alpha) \alpha^{k-1} \overline{\overline{\mathbb{E}}_{i t} \varepsilon_{i t}^{p}} k=(1-\alpha) \overline{\mathbb{E}_{i t} \varepsilon_{i t}^{p}}+\alpha \overline{\mathbb{E}}_{t} y_{t}
\end{aligned}
$$

with (and similarly for $\varepsilon_{i t}^{p}$ )

$$
\overline{\mathbb{E}_{i t} \xi_{i t}}={\overline{\mathbb{E}}{ }_{i t} \xi_{i t}}^{1}=\int_{0}^{1} \mathbb{E}_{j t} \xi_{j t} \mathrm{~d} j \text { and } \overline{\mathbb{E}}_{i t} \xi_{i t}{ }^{k}=\int_{0}^{1} \mathbb{E}_{j t}{\overline{\mathbb{E}} i t \xi_{i t}}^{k-1} \mathrm{~d} j
$$

[^28]and the expectation operators are based on the information set $\Omega_{i t}=\left(\cdots, s_{i t-1}, a_{t-1}, s_{i t}\right)$. Firms in island $i$ then observe
\[

a_{t}=\left($$
\begin{array}{lllll}
0 & 1 & 1 & 0 & 0
\end{array}
$$\right) \mathbf{x}_{i t} and s_{i t+1}=\left($$
\begin{array}{lllll}
1 & 1 & 0 & 0 & 0
\end{array}
$$\right) \mathbf{x}_{i t+1} .
\]

We will guess and verify that $\mathbf{x}_{t}$ evolves according to the following law of motion

$$
\mathbf{x}_{t}=\mathbf{M} \mathbf{x}_{t-1}+\mathbf{m}\binom{\varepsilon_{t}^{p}}{\varepsilon_{t}^{u}}
$$

for some matrices $\mathbf{M} \in \mathbb{R}^{4 \times 4}$ and $\mathbf{m} \in \mathbb{R}^{4 \times 2}$. We can then solve for firms' signal extraction problem to obtain how firms update $\overline{\mathbb{E}}_{t+1}\left[\mathbf{x}_{t+1}\right]$ from $\overline{\mathbb{E}}_{t}\left[\mathbf{x}_{t}\right]$, taking the perceived law of motion assumed above as given. It turns out that $\binom{F_{t}}{y_{t}}$ is a linear combination of $\overline{\mathbb{E}}_{t}\left[\mathbf{x}_{t}\right]$, thus we can calculate $\binom{F_{t}}{y_{t}}$ as a function of the previous aggregate state $\mathbf{x}_{t-1}$ and innovation $\varepsilon_{t}^{p}$. This gives the actual law of motion of $\mathbf{x}_{t}$. The equilibrium is then characterized by a fixed point of mapping from the perceived law of motion to the actual law of motion.

## C. Proofs for Section 5

For future reference, we start with the following three lemmas.
Lemma A. 1 (Covariance). We have $\operatorname{Cov}\left(\overline{\tilde{\mathcal{O}}}_{t}, a_{t-1}\right)=-\frac{\rho V}{1-\rho \gamma_{3} \rho_{a}}\left(\frac{\bar{\sigma}_{p}^{2}}{\sigma_{p}^{2}}-\frac{\bar{\sigma}_{u}^{2}}{\sigma_{u}^{2}}\right)$.

## Proof of Lemma A.1.

$$
\begin{aligned}
\operatorname{Cov}\left(\overline{\tilde{\mathcal{O}}}_{t}, a_{t-1}\right) & =\operatorname{Cov}\left(\left(1-\rho \gamma_{3} L\right)^{-1}\left(-\rho \gamma_{1} \varepsilon_{t-1}^{p}+\rho \gamma_{2} \varepsilon_{t-1}^{u}\right),\left(1-\rho_{a} L\right)^{-1}\left(\varepsilon_{t-1}^{p}+\varepsilon_{t-1}^{u}\right)\right) \\
& =\frac{-\rho \gamma_{1} \bar{\sigma}_{p}^{2}+\rho \gamma_{2} \bar{\sigma}_{u}^{2}}{1-\rho \gamma_{3} \rho_{a}} \\
& =-\frac{\rho V}{1-\rho \gamma_{3} \rho_{a}}\left(\frac{\bar{\sigma}_{p}^{2}}{\sigma_{p}^{2}}-\frac{\bar{\sigma}_{u}^{2}}{\sigma_{u}^{2}}\right) .
\end{aligned}
$$

Lemma A. 2 (Coefficients). Let $\Sigma \equiv \rho^{2} V+\left(1-\rho^{2}\right) \sigma_{\eta}^{2}$, then

$$
\frac{1}{V}=\frac{1}{\Sigma}+\frac{1}{\sigma_{p}^{2}}+\frac{1}{\sigma_{u}^{2}}
$$

Moreover, we have

$$
K=\frac{\sigma_{p}^{2}}{\Sigma+\sigma_{p}^{2}} \quad \gamma_{1}=\frac{\sigma_{u}^{2} \Sigma}{\Psi} \quad \gamma_{2}=\frac{\sigma_{p}^{2} \Sigma}{\Psi} \quad \gamma_{3}=\frac{\sigma_{p}^{2} \sigma_{u}^{2}}{\Psi}
$$

where $\Psi \equiv \Sigma\left(\sigma_{p}^{2}+\sigma_{u}^{2}\right)+\sigma_{p}^{2} \sigma_{u}^{2}=\frac{\sigma_{p}^{2} \sigma_{u}^{2} \Sigma}{V}$. Thus,

$$
\gamma_{1}=\frac{V}{\sigma_{p}^{2}} \quad \gamma_{2}=\frac{V}{\sigma_{u}^{2}} \quad \gamma_{3}=\frac{V}{\Sigma} .
$$

Lemma A. 3 (Variables). We can write our variables of interest in terms of innovations and states:

$$
\begin{aligned}
& Y_{1} \equiv a_{t+1}-\overline{\mathbb{E}}_{t} a_{t+1} \\
& Y_{2} \equiv a_{a}\left((1-K) \varepsilon_{t}^{p}+\varepsilon_{t}^{u}-K \rho \gamma_{3} \overline{\tilde{\mathcal{O}}}_{t-1}+\rho \gamma_{1} K \varepsilon_{t-1}^{p}-\rho \gamma_{2} K \varepsilon_{t-1}^{u}\right)+\varepsilon_{t+1}^{p}+\varepsilon_{t+1}^{u} \\
&=\varepsilon_{t+1}^{u}+(1-K) \varepsilon_{t+1}^{p}+\rho K \gamma_{1} \varepsilon_{t}^{p}-\rho K \gamma_{2} \varepsilon_{t}^{u}-\rho \gamma_{3} K\left(\gamma_{3} \rho \overline{\tilde{\mathcal{O}}}_{t-1}-\rho \gamma_{1} \varepsilon_{t-1}^{p}+\rho \gamma_{2} \varepsilon_{t-1}^{u}\right) \\
& X^{c g} \equiv \overline{\mathbb{E}}_{t} a_{t+1}-\overline{\mathbb{E}}_{t-1} a_{t+1} \stackrel{\text { sgn }}{=}\left(\rho_{a}(1-K)-\rho K \gamma_{1}\right) \varepsilon_{t-1}^{p}+\left(\rho_{a}+\rho K \gamma_{2}\right) \varepsilon_{t-1}^{u}+K \varepsilon_{t}^{p}+\left(\rho \gamma_{3}-\rho_{a}\right) K \overline{\tilde{\mathcal{O}}}_{t-1} \\
& X^{k w} \equiv \quad a_{t}=\rho_{a}^{2} a_{t-2}+\varepsilon_{t}^{u}+\varepsilon_{t}^{p}+\rho_{a} \varepsilon_{t-1}^{p}+\rho_{a} \varepsilon_{t-1}^{u}
\end{aligned}
$$

## Proof of Lemma A.3.

$$
\begin{aligned}
& Y_{1} \equiv a_{t+1}-\overline{\mathbb{E}}_{t} a_{t+1}= \rho_{a}\left(a_{t}-\overline{\mathbb{E}}_{t} a_{t}\right)+\varepsilon_{t+1}^{p}+\varepsilon_{t+1}^{u} \\
&= \rho_{a}\left((1-K) \varepsilon_{t}^{p}+\varepsilon_{t}^{u}-K \overline{\tilde{\mathcal{O}}}_{t}\right)+\varepsilon_{t+1}^{p}+\varepsilon_{t+1}^{u} \\
&= \rho_{a}\left((1-K) \varepsilon_{t}^{p}+\varepsilon_{t}^{u}-K \rho \gamma_{3} \overline{\tilde{\mathcal{O}}}_{t-1}+\rho \gamma_{1} K \varepsilon_{t-1}^{p}-\rho \gamma_{2} K \varepsilon_{t-1}^{u}\right)+\varepsilon_{t+1}^{p}+\varepsilon_{t+1}^{u} \\
& Y_{2} \equiv a_{t+1}-\overline{\mathbb{E}}_{t+1} a_{t+1}= \varepsilon_{t+1}^{u}+(1-K) \varepsilon_{t+1}^{p}+\rho K \gamma_{1} \varepsilon_{t}^{p}-\rho K \gamma_{2} \varepsilon_{t}^{u}-\rho \gamma_{3} K \overline{\tilde{\mathcal{O}}}_{t} \\
&= \varepsilon_{t+1}^{u}+(1-K) \varepsilon_{t+1}^{p}+\rho K \gamma_{1} \varepsilon_{t}^{p}-\rho K \gamma_{2} \varepsilon_{t}^{u}-\rho \gamma_{3} K\left(\gamma_{3} \rho \overline{\tilde{\mathcal{O}}}_{t-1}-\rho \gamma_{1} \varepsilon_{t-1}^{p}+\rho \gamma_{2} \varepsilon_{t-1}^{u}\right) \\
& X^{c g} \equiv \overline{\mathbb{E}}_{t} a_{t+1}-\overline{\mathbb{E}}_{t-1} a_{t+1}= \rho_{a}\left(\overline{\mathbb{E}}_{t} a_{t}-\rho_{a} \overline{\mathbb{E}}_{t-1} a_{t-1}\right) \\
& \stackrel{\operatorname{sgn}}{=}\left(\rho_{a}^{2} a_{t-2}+\left(\rho_{a}-\rho K \gamma_{1}\right) \varepsilon_{t-1}^{p}+\left(\rho_{a}+\rho K \gamma_{2}\right) \varepsilon_{t-1}^{u}+K \varepsilon_{t}^{p}+\rho \gamma_{3} K \overline{\tilde{\mathcal{O}}}_{t-1}\right) \\
&-\rho_{a}\left(\rho_{a} a_{t-2}+K\left(\varepsilon_{t-1}^{p}+\overline{\tilde{\mathcal{O}}}_{t-1}\right)\right) \\
&=\left(\rho_{a}(1-K)-\rho K \gamma_{1}\right) \varepsilon_{t-1}^{p}+\left(\rho_{a}+\rho K \gamma_{2}\right) \varepsilon_{t-1}^{u}+K \varepsilon_{t}^{p}+\left(\rho \gamma_{3}-\rho_{a}\right) K \overline{\tilde{\mathcal{O}}}_{t-1} \\
& X^{k w} \equiv a_{t}= \rho_{a}^{2} a_{t-2}+\varepsilon_{t}^{u}+\varepsilon_{t}^{p}+\rho_{a} \varepsilon_{t-1}^{p}+\rho_{a} \varepsilon_{t-1}^{u}
\end{aligned}
$$

## Proof of Proposition 3.

- Case 1: $\operatorname{Common} \varepsilon_{t}^{p}: \operatorname{Var}\left(\varepsilon_{t}^{p}\right)=\sigma_{p}^{2}$

$$
\begin{aligned}
\operatorname{Cov}\left(Y_{2}, X^{c g}\right) & \stackrel{\operatorname{sgn}}{=} \rho K^{2} \gamma_{1} \sigma_{p}^{2}-\rho \gamma_{3} K\left(\rho \gamma_{3}\left(\rho \gamma_{3}-\rho_{a}\right) K \operatorname{Var}\left(\overline{\tilde{\mathcal{O}}}_{t-1}\right)-\rho \gamma_{1}\left(\rho_{a}(1-K)-\rho K \gamma_{1}\right) \sigma_{p}^{2}+\rho \gamma_{2}\left(\rho_{a}+\rho K \gamma_{2}\right) \sigma_{u}^{2}\right) \\
& \stackrel{\operatorname{sgn}}{=} K \Sigma-\left(\rho \gamma_{3}\left(\rho \gamma_{3}-\rho_{a}\right) K \operatorname{Var}\left(\overline{\tilde{\mathcal{O}}}_{t-1}\right)-\rho \gamma_{1}\left(\rho_{a}(1-K)-\rho K \gamma_{1}\right) \sigma_{p}^{2}+\rho \gamma_{2}\left(\rho_{a}+\rho K \gamma_{2}\right) \sigma_{u}^{2}\right) \\
& \stackrel{\operatorname{sgn}}{=} K \Sigma-\left(\rho \gamma_{3}\left(\rho \gamma_{3}-\rho_{a}\right) K \operatorname{Var}\left(\overline{\tilde{\mathcal{O}}}_{t-1}\right)-\rho V\left(\rho_{a}(1-K)-\rho K \gamma_{1}\right)+\rho V\left(\rho_{a}+\rho K \gamma_{2}\right)\right) \\
& \stackrel{\operatorname{sgn}}{=} K \Sigma-\rho \gamma_{3}\left(\rho \gamma_{3}-\rho_{a}\right) K \operatorname{Var}\left(\overline{\tilde{\mathcal{O}}}_{t-1}\right)-\rho V K\left(\rho_{a}+\rho \gamma_{2}+\rho \gamma_{1}\right) \\
& \stackrel{\operatorname{sgn}}{=} \Sigma-\rho \gamma_{3}\left(\rho \gamma_{3}-\rho_{a}\right) \operatorname{Var}\left(\overline{\tilde{\mathcal{O}}}_{t-1}\right)-\rho V\left(\rho_{a}+\rho \gamma_{2}+\rho \gamma_{1}\right)
\end{aligned}
$$

where $\operatorname{Var}\left(\overline{\tilde{\mathcal{O}}}_{t-1}\right)=\frac{\rho^{2}\left(\gamma_{1}^{2} \sigma_{p}^{2}+\gamma_{2}^{2} \sigma_{u}^{2}\right)}{1-\gamma_{3}^{2} \rho^{2}}$. Since we always have $\Sigma>\rho V\left(\rho_{a}+\rho \gamma_{2}+\rho \gamma_{1}\right)$, or

$$
1>\rho \gamma_{3}\left(\rho_{a}+\rho-\rho \gamma_{3}\right),
$$

a sufficient condition for $\operatorname{Cov}(Y, X)>0$ is to have $\rho_{a}>\rho \gamma_{3}$.
Moreover, we can show that $\operatorname{Cov}\left(Y_{2}, X^{c g}\right)>0$ always holds.

- Case 2: Fully Idiosyncratic $\varepsilon_{t}^{p}: \operatorname{Var}\left(\varepsilon_{t}^{p}\right)=0$ Then, since $\operatorname{Var}\left(\overline{\tilde{\mathcal{O}}}_{t}\right)=\frac{\rho^{2} \gamma_{2}^{2} \sigma_{u}^{2}}{1-\rho^{2} \gamma_{3}^{2}}$,

$$
\begin{aligned}
\operatorname{Cov}\left(Y_{2}, X^{c g}\right) & =-\rho \gamma_{3} K\left(\gamma_{3} \rho\left(\rho \gamma_{3}-\rho_{a}\right) K \operatorname{Var}\left(\overline{\tilde{\mathcal{O}}}_{t-1}\right)+\rho \gamma_{2}\left(\rho_{a}+\rho K \gamma_{2}\right) \sigma_{u}^{2}\right) \\
& \stackrel{\operatorname{sgn}}{=} \gamma_{3}\left(\rho_{a}-\rho \gamma_{3}\right) K \operatorname{Var}\left(\overline{\tilde{\mathcal{O}}}_{t-1}\right)-\gamma_{2}\left(\rho_{a}+\rho K \gamma_{2}\right) \sigma_{u}^{2} \\
& \stackrel{\operatorname{sgn}}{=}\left(\rho_{a}-\rho \gamma_{3}\right) K \operatorname{Var}\left(\overline{\tilde{\mathcal{O}}}_{t-1}\right)-\Sigma\left(\rho_{a}+\rho K \gamma_{2}\right) .
\end{aligned}
$$

This is linear in $\rho_{a}$, so it suffices to show $\operatorname{Cov}<0$ when $\rho_{a}=0$ and $\rho_{a}=1$. The former is obvious, the latter is:

$$
\begin{aligned}
\operatorname{Cov}\left(Y_{2}, X^{c g}\right) & \stackrel{\operatorname{sgn}}{=}\left(1-\rho \gamma_{3}\right) K \operatorname{Var}\left(\overline{\tilde{\mathcal{O}}}_{t-1}\right)-\Sigma\left(1+\rho K \gamma_{2}\right) \\
& \stackrel{\operatorname{sgn}}{=} \frac{\rho^{2} \gamma_{2}^{2} \sigma_{u}^{2} K}{1+\rho \gamma_{3}}-\Sigma\left(1+\rho K \gamma_{2}\right) \\
& <0
\end{aligned}
$$

- For the cases with $Y_{1}$

$$
\begin{aligned}
\operatorname{Cov}\left(Y_{1}, X^{c g}\right) & \stackrel{\operatorname{sgn}}{=}(1-K) K \bar{\sigma}_{p}^{2}-K \rho \gamma_{3}\left(\rho \gamma_{3}-\rho_{a}\right) K \operatorname{Var}\left(\tilde{\tilde{\mathcal{O}}}_{t-1}\right)+K \rho \gamma_{1}\left(\rho_{a}(1-K)-\rho K \gamma_{1}\right) \bar{\sigma}_{p}^{2}-K \rho \gamma_{2}\left(\rho_{a}+\rho K \gamma_{2}\right) \sigma_{u}^{2} \\
& \stackrel{\operatorname{sgn}}{=}(1-K) \bar{\sigma}_{p}^{2}-\rho \gamma_{3}\left(\rho \gamma_{3}-\rho_{a}\right) K \operatorname{Var}\left(\tilde{\mathcal{O}}_{t-1}\right)+\rho \gamma_{1}\left(\rho_{a}(1-K)-\rho K \gamma_{1}\right) \bar{\sigma}_{p}^{2}-\rho \gamma_{2}\left(\rho_{a}+\rho K \gamma_{2}\right) \sigma_{u}^{2}
\end{aligned}
$$

For $\bar{\sigma}_{p}^{2}=\sigma_{p}$, we have

$$
\begin{aligned}
\operatorname{Cov}\left(Y_{1}, X^{c g}\right) & \stackrel{\operatorname{sgn}}{=}(1-K) \sigma_{p}^{2}-\rho \gamma_{3}\left(\rho \gamma_{3}-\rho_{a}\right) K \operatorname{Var}\left(\overline{\tilde{\mathcal{O}}}_{t-1}\right)+\rho \gamma_{1}\left(\rho_{a}(1-K)-\rho K \gamma_{1}\right) \sigma_{p}^{2}-\rho \gamma_{2}\left(\rho_{a}+\rho K \gamma_{2}\right) \sigma_{u}^{2} \\
& =(1-K) \sigma_{p}^{2}-\rho \gamma_{3}\left(\rho \gamma_{3}-\rho_{a}\right) K \operatorname{Var}\left(\overline{\tilde{\mathcal{O}}}_{t-1}\right)+\rho V\left(\rho_{a}(1-K)-\rho K \gamma_{1}\right)-\rho V\left(\rho_{a}+\rho K \gamma_{2}\right) \\
& \stackrel{\operatorname{sgn}}{=} \frac{1-K}{K} \sigma_{p}^{2}-\rho \gamma_{3}\left(\rho \gamma_{3}-\rho_{a}\right) \operatorname{Var}\left(\overline{\tilde{\mathcal{O}}}_{t-1}\right)-\rho V\left(\rho_{a}+\rho \gamma_{1}+\rho \gamma_{2}\right) \\
& \stackrel{\operatorname{sgn}}{=} \operatorname{Cov}\left(Y_{2}, X^{c g}\right)
\end{aligned}
$$

For $\bar{\sigma}_{p}^{2}=0$, we have

$$
\begin{aligned}
\operatorname{Cov}\left(Y_{1}, X^{c g}\right) & \stackrel{\operatorname{sgn}}{=} \gamma_{3}\left(\rho_{a}-\rho \gamma_{3}\right) K \operatorname{Var}\left(\overline{\tilde{\mathcal{O}}}_{t-1}\right)-\gamma_{2}\left(\rho_{a}+\rho K \gamma_{2}\right) \sigma_{u}^{2} \\
& \stackrel{\operatorname{sgn}}{=} \operatorname{Cov}\left(Y_{2}, X^{c g}\right)
\end{aligned}
$$

## Proof of Proposition 4.

$$
\begin{aligned}
\operatorname{Cov}\left(Y_{2}, X^{k w}\right) & \stackrel{\operatorname{sgn}}{=} \gamma_{1} \bar{\sigma}_{p}^{2}-\gamma_{2} \bar{\sigma}_{u}^{2}-\gamma_{3}\left(-\rho \gamma_{1} \rho_{a} \bar{\sigma}_{p}^{2}+\rho \gamma_{2} \rho_{a} \bar{\sigma}_{u}^{2}\right)-\rho \gamma_{3}^{2} \rho_{a}^{2} \operatorname{Cov}\left(\overline{\tilde{\mathcal{O}}}_{t-1}, a_{t-2}\right) \\
& \stackrel{\operatorname{sgn}}{=} \frac{\bar{\sigma}_{p}^{2}}{\sigma_{p}^{2}}-\frac{\bar{\sigma}_{u}^{2}}{\sigma_{u}^{2}}<0 .
\end{aligned}
$$

$$
\operatorname{Cov}\left(Y_{1}, X^{k w}\right) \stackrel{\operatorname{sgn}}{=}(1-K) \bar{\sigma}_{p}^{2}+\bar{\sigma}_{u}^{2}-K \rho \gamma_{3} \rho_{a}^{2} \operatorname{Cov}\left(\overline{\tilde{\mathcal{O}}}_{t-1}, a_{t-2}\right)+K \rho \gamma_{1} \rho_{a} \bar{\sigma}_{p}^{2}-K \rho \gamma_{2} \rho_{a} \bar{\sigma}_{u}^{2}
$$

$$
\begin{aligned}
& \stackrel{\text { Lemma A.1 }}{=}(1-K) \bar{\sigma}_{p}^{2}+\bar{\sigma}_{u}^{2}+K \rho \gamma_{3} \rho_{a}^{2} \frac{\rho V}{1-\rho \gamma_{3} \rho_{a}}\left(\frac{\bar{\sigma}_{p}^{2}}{\sigma_{p}^{2}}-\frac{\bar{\sigma}_{u}^{2}}{\sigma_{u}^{2}}\right)+K \rho \rho_{a} V\left(\frac{\bar{\sigma}_{p}^{2}}{\sigma_{p}^{2}}-\frac{\bar{\sigma}_{u}^{2}}{\sigma_{u}^{2}}\right) \\
& \quad=(1-K) \bar{\sigma}_{p}^{2}+\bar{\sigma}_{u}^{2}+\frac{K \rho \rho_{a} V}{1-\rho \gamma_{3} \rho_{a}}\left(\frac{\bar{\sigma}_{p}^{2}}{\sigma_{p}^{2}}-\frac{\bar{\sigma}_{u}^{2}}{\sigma_{u}^{2}}\right) .
\end{aligned}
$$

This is linear in $\bar{\sigma}_{p}^{2}$ (note: $V$ and $\gamma^{\prime}$ s depend on $\sigma_{p}^{2}$, not $\bar{\sigma}_{p}^{2}$ ), so it suffices to show $\operatorname{Cov}>0$ when $\bar{\sigma}_{p}^{2}=0$ and $\bar{\sigma}_{p}^{2}=\sigma_{p}^{2}$. The latter is obvious, the former is:

$$
\operatorname{Cov}\left(Y_{1}, X^{k w}\right) \stackrel{\operatorname{sgn}}{=} \bar{\sigma}_{u}^{2}-\frac{K \rho \rho_{a} V}{1-\rho \gamma_{3} \rho_{a}} \frac{\bar{\sigma}_{u}^{2}}{\sigma_{u}^{2}}
$$

$$
\begin{aligned}
& \stackrel{\text { sgn }}{=} 1-\frac{K \rho \rho_{a} \gamma_{2}}{1-\rho \gamma_{3} \rho_{a}} \\
& \stackrel{\text { sgn }}{=} 1-\rho \rho_{a}\left(\gamma_{3}+K \gamma_{2}\right)>0 .
\end{aligned}
$$

Finally, $a_{t+1}-\overline{\mathbb{E}}_{t} a_{t+1}=\rho_{a}\left(a_{t}-\overline{\mathbb{E}}_{t} a_{t}\right)+\varepsilon_{t+1}^{p}+\varepsilon_{t+1}^{u}, \operatorname{so} \operatorname{Cov}\left(Y_{1}, X^{k w}\right) \stackrel{\operatorname{sgn}}{=} \operatorname{Cov}\left(L Y_{2}, X^{k w}\right)$.

Proposition A. 1 (Misspecification). When agent ithinks that her noise term follows an AR(1) process, $\xi_{i t}=\hat{\rho} \xi_{i t-1}+\eta_{i t}$ where $\eta_{i t} \sim \mathcal{N}\left(0,\left(1-\hat{\rho}^{2}\right) \sigma_{\xi}^{2}\right)$, while the truth is $\xi_{i t}=\rho \xi_{i t-1}+\eta_{i t}$ where $\eta_{i t} \sim$ $\mathcal{N}\left(0,\left(1-\rho^{2}\right) \sigma_{\xi}^{2}\right)$, we have ${ }^{39}$

$$
\operatorname{Cov}\left(a_{i t+h}-\mathbb{E}_{i t} a_{i t+h}, \mathbb{E}_{i t} a_{i t+h}-\mathbb{E}_{i t-1} a_{i t+h}\right)<0 \Longleftrightarrow \rho<\hat{\rho} .
$$

Proof. We can ignore the volatility from $\varepsilon^{p}, \varepsilon^{u}$. Modulo this volatility, we have

$$
\begin{aligned}
Y_{t} & =a_{i t+h}-\mathbb{E}_{i t} a_{i t+h} \\
& =\rho_{a}^{h}\left(a_{t}-\mathbb{E}_{i t} a_{i t}\right)+\varepsilon_{t, t+h} \\
& =\rho_{a}^{h}\left(\left(\rho_{a} a_{i t-1}+\varepsilon_{i t}^{p}+\varepsilon_{i t}^{u}\right)-\left(\rho_{a} a_{i t-1}+K\left(\varepsilon_{i t}^{p}+\xi_{i t}-\hat{\rho} m_{t-1}\right)\right)\right)+\varepsilon_{t, t+h} \\
& =\rho_{a}^{h}\left(-K \xi_{i t}+K \hat{\rho}\left(\left(\gamma_{1}+\gamma_{2}\right) \xi_{i t-1}+\gamma_{3} \hat{\rho} m_{t-2}\right)\right) \\
X_{t} & =\mathbb{E}_{i t} a_{i t+h}-\mathbb{E}_{i t-1} a_{i t+h} \\
& =\rho_{a}^{h}\left(\mathbb{E}_{i t} a_{i t}-\rho_{a} \mathbb{E}_{i t-1} a_{i t-1}\right) \\
& =\rho_{a}^{h}\left(\left(\rho_{a} a_{i t-1}+K\left(\varepsilon_{i t}^{p}+\xi_{i t}-\hat{\rho} m_{t-1}\right)\right)-\rho_{a}\left(\rho_{a} a_{i t-2}+K\left(\varepsilon_{i t-1}^{p}+\xi_{i t-1}-\hat{\rho} m_{t-2}\right)\right)\right) \\
& =\rho_{a}^{h}\left(\rho_{a}\left(\varepsilon_{i t-1}^{p}+\varepsilon_{i t-1}^{u}\right)+K \varepsilon_{i t}^{p}+K \xi_{i t}-K \hat{\rho} m_{t-1}-\rho_{a} K \varepsilon_{i t-1}^{p}-\rho_{a} K \xi_{i t-1}+\rho_{a} K \hat{\rho} m_{t-2}\right) \\
& =\rho_{a}^{h}\left(K \xi_{i t}-K \hat{\rho}\left(\left(\gamma_{1}+\gamma_{2}\right) \xi_{i t-1}+\gamma_{3} \hat{\rho} m_{t-2}\right)-\rho_{a} K \xi_{i t-1}+\rho_{a} K \hat{\rho} m_{t-2}\right)
\end{aligned}
$$

Thus, as $m_{t}=\gamma_{3} \hat{\rho} m_{t-1}+\left(\gamma_{1}+\gamma_{2}\right) \xi_{i t}$,

$$
\begin{aligned}
\tilde{Y}_{t} & \equiv \frac{Y_{t}}{K \rho_{a}^{h} \hat{\rho}\left(\gamma_{1}+\gamma_{2}\right)}=-\frac{1}{\hat{\rho}\left(\gamma_{1}+\gamma_{2}\right)} \xi_{i t}+\xi_{i t-1}+\frac{\gamma_{3} \hat{\rho}}{\gamma_{1}+\gamma_{2}} m_{t-2} \\
& =-\frac{1}{\hat{\rho}\left(\gamma_{1}+\gamma_{2}\right)} \xi_{i t}+\xi_{i t-1}+\gamma_{3} \hat{\rho} \xi_{i t-2}+\left(\gamma_{3} \hat{\rho}\right)^{2} \xi_{i t-3}+\cdots \\
\tilde{X}_{t} & \equiv \frac{X_{t}}{K \rho_{a}^{h} \hat{\rho}\left(\gamma_{1}+\gamma_{2}\right)}=\frac{1}{\hat{\rho}\left(\gamma_{1}+\gamma_{2}\right)} \xi_{i t}+\frac{\rho_{a}-\hat{\rho} \gamma_{3}}{\gamma_{1}+\gamma_{2}} m_{t-2}-\left(1+\frac{\rho_{a}}{\hat{\rho}\left(\gamma_{1}+\gamma_{2}\right)}\right) \xi_{i t-1}
\end{aligned}
$$

[^29]so, for $\theta \equiv \frac{1}{\hat{\rho}\left(\gamma_{1}+\gamma_{2}\right)}, \beta=\gamma_{3} \hat{\rho}$, and $\delta=\rho_{a}-\hat{\rho} \gamma_{3}$,
\[

\frac{\mathbb{E}\left[\tilde{Y}_{t} \tilde{X}_{t}\right]}{\sigma_{\eta}^{2}}=\left($$
\begin{array}{llllll}
-\theta & 1 & \beta & \beta^{2} & \beta^{3} & \ldots
\end{array}
$$\right)\left($$
\begin{array}{ccccc}
1 & \rho & \rho^{2} & \rho^{3} & \ldots \\
\rho & 1 & \rho & \rho^{2} & \ldots \\
\rho^{2} & \rho & 1 & \rho & \ldots \\
\rho^{3} & \rho^{2} & \rho & 1 & \ldots \\
\vdots & \vdots & \vdots & \vdots & \ddots .
\end{array}
$$\right)\left($$
\begin{array}{c}
\theta \\
-1-\rho_{a} \theta \\
\delta \\
\delta \beta \\
\delta \beta^{2} \\
\delta \beta^{3} \\
\vdots
\end{array}
$$\right)=(1)+(2)+(3)
\]

where $(1)=\delta \beta\left(\sum_{j, k \geq 0} \rho^{|j-k|} \beta^{j+k}\right)=\delta \beta\left(\frac{1}{1-\beta^{2}}+\sum_{t \geq 1} \rho^{t} 2 \frac{\beta^{t}}{1-\beta^{2}}\right)=\delta \beta\left(\frac{1}{1-\beta^{2}}+\frac{2}{1-\beta^{2}} \frac{\rho \beta}{1-\rho \beta}\right)$

$$
\begin{aligned}
& =\delta \beta \frac{1+\rho \beta}{\left(1-\beta^{2}\right)(1-\rho \beta)} \\
(2) & =-\theta\left(\theta-\rho\left(1+\rho_{a} \theta\right)+\frac{\delta \rho^{2}}{1-\beta \rho}\right)+\left(\rho \theta-1-\rho_{a} \theta+\frac{\delta \rho}{1-\beta \rho}\right) \\
(3) & =\theta \frac{\beta \rho^{2}}{1-\beta \rho}-\left(1+\rho_{a} \theta\right) \frac{\beta \rho}{1-\beta \rho}
\end{aligned}
$$

Finally, we can show that

$$
\frac{\partial((1)+(2)+(3))}{\partial \rho} \geq 0
$$

## Proof of Proposition 5.

Proof for our model. Note first that
$z_{t+1} \equiv a_{t+1}-\overline{\mathbb{E}}_{t+1} a_{t+1}=\rho \gamma_{3} z_{t}+\kappa_{t+1} \quad$ where $\kappa_{t+1}=-\rho\left(\gamma_{3}+K \gamma_{2}\right) \varepsilon_{t}^{u}+\varepsilon_{t+1}^{u}+(1-K) \varepsilon_{t+1}^{p}$ $a_{t}=\rho_{a} a_{t-1}+\mu_{t} \quad$ where $\mu_{t}=\varepsilon_{t}^{p}+\varepsilon_{t}^{u}$.

Thus,

$$
\begin{aligned}
\operatorname{Cov}\left(z_{t+1}, a_{t}\right) & =\frac{1}{1-\rho \gamma_{3} \rho_{a}}\left(\operatorname{Cov}\left(\kappa_{t+1}, \mu_{t}\right)+\rho \gamma_{3} \operatorname{Cov}\left(z_{t}, \mu_{t}\right)+\rho_{a} \operatorname{Cov}\left(\kappa_{t+1}, a_{t-1}\right)\right) \\
& =\frac{1}{1-\rho \gamma_{3} \rho_{a}}\left(-\rho\left(\gamma_{3}+K \gamma_{2}\right) \bar{\sigma}_{u}^{2}+\rho \gamma_{3}\left((1-K) \bar{\sigma}_{p}^{2}+\bar{\sigma}_{u}^{2}\right)\right) \\
& =\frac{\rho}{1-\rho \gamma_{3} \rho_{a}}\left(\gamma_{3}(1-K) \bar{\sigma}_{p}^{2}-K \gamma_{2} \bar{\sigma}_{u}^{2}\right)
\end{aligned}
$$

$$
=\frac{\rho K V}{1-\rho \gamma_{3} \rho_{a}}\left(\frac{\bar{\sigma}_{p}^{2}}{\sigma_{p}^{2}}-\frac{\bar{\sigma}_{u}^{2}}{\sigma_{u}^{2}}\right)
$$

Finally, we have $\operatorname{Var}\left(a_{t}\right)=\frac{\bar{\sigma}_{p}^{2}+\bar{\sigma}_{u}^{2}}{1-\rho_{a}^{2}}$.

## Proof for extrapolation.

$$
\begin{aligned}
\operatorname{Cov}\left(a_{t+1}-\bar{E}_{t+1} a_{t+1}, a_{t}\right) & =\operatorname{Cov}\left(\rho a_{t}+u_{t+1}-\hat{\rho} a_{t}, a_{t}\right)=(\rho-\hat{\rho}) \operatorname{Var}\left(a_{t}\right) \\
\operatorname{Cov}\left(a_{i t+1}-E_{i t+1} a_{i t+1}, a_{i t}\right) & =\operatorname{Cov}\left(\rho a_{i t}+u_{i t+1}-\hat{\rho} a_{i t}, a_{i t}\right)=(\rho-\hat{\rho}) \operatorname{Var}\left(a_{i t}\right) .
\end{aligned}
$$

Proof for diagnostic expectations. For diagnostic expectations with Kalman gain $g_{0}$, we have

$$
\widehat{\beta}_{\text {aggr }}=\widehat{\beta}_{\text {ind }}=\frac{\left(1-g_{0}\right) \rho\left(1-\rho^{2}\right)(1-K)}{1-\rho^{2}(1-K)} \stackrel{\operatorname{sgn}}{=}\left(1-g_{0}\right)
$$

We have

$$
\begin{aligned}
a_{i t+1}-\mathbb{E}_{i t+1} a_{i t+1} & =a_{i t+1}-\mathbb{E}_{i t}^{N R E} a_{i t+1}-g_{0}\left(z_{i t+1}-\mathbb{E}_{i t}^{N R E} a_{i t+1}\right) \\
& \equiv\left(1-g_{0}\right)\left(a_{i t+1}-\mathbb{E}_{i t}^{N R E} a_{i t+1}\right)
\end{aligned}
$$

Thus,

$$
\begin{aligned}
\widehat{\beta}_{\text {ind }} & =\left(1-g_{0}\right) \frac{\operatorname{Cov}\left(a_{i t+1}-\mathbb{E}_{i t}^{N R E} a_{i t+1}, a_{i t}\right)}{\operatorname{Var}\left(a_{i t}\right)} \\
& =\left(1-g_{0}\right) \rho \frac{\operatorname{Cov}\left(a_{i t}-\mathbb{E}_{i t}^{N R E} a_{i t}\right)}{\operatorname{Var}\left(a_{i t}\right)} \\
& =\left(1-g_{0}\right) \rho\left(1-\frac{K}{1-\rho^{2}(1-K)}\right) \\
& =\frac{\left(1-g_{0}\right) \rho\left(1-\rho^{2}\right)(1-K)}{1-\rho^{2}(1-K)}
\end{aligned}
$$

where the second to the last equality uses the fact that

$$
\begin{aligned}
\mathbb{E}_{i t}^{N R E} a_{i t} & =\mathbb{E}_{i t-1}^{N R E} a_{i t}+K\left(z_{i t}-\mathbb{E}_{i t-1}^{N R E} a_{i t}\right) \\
& =K z_{i t}+\rho(1-K) \mathbb{E}_{i t-1}^{N R E} a_{i t-1} \\
& =K \sum_{h \geq 0} \rho^{h}(1-K)^{h} z_{i t-h}
\end{aligned}
$$

hence

$$
\operatorname{Cov}\left(\mathbb{E}_{i t}^{N R E} a_{i t}, a_{i t}\right)=K \sum_{h \geq 0} \rho^{h}(1-K)^{h} \underbrace{\operatorname{Cov}\left(z_{i t-h}, a_{i t}\right)}_{=\rho^{h} \operatorname{Var}\left(a_{i t}\right)} .
$$

Second, we have

$$
a_{t+1}-\overline{\mathbb{E}}_{t+1} a_{t+1} \equiv\left(1-g_{0}\right)\left(a_{t+1}-\overline{\mathbb{E}}_{i t}^{N R E} a_{t+1}\right)
$$

hence

$$
\begin{aligned}
\widehat{\beta}_{\text {aggr }} & =\left(1-g_{0}\right) \frac{\operatorname{Cov}\left(a_{t+1}-\overline{\mathbb{E}}_{t}^{N R E} a_{t+1}, a_{t}\right)}{\operatorname{Var}\left(a_{t}\right)} \\
& =\left(1-g_{0}\right) \rho \frac{\operatorname{Cov}\left(a_{t}-\overline{\mathbb{E}}_{t}^{N R E} a_{t}, a_{t}\right)}{\operatorname{Var}\left(a_{t}\right)} \\
& =\left(1-g_{0}\right) \rho\left(1-\frac{K}{1-\rho^{2}(1-K)}\right) \\
& =\frac{\left(1-g_{0}\right) \rho\left(1-\rho^{2}\right)(1-K)}{1-\rho^{2}(1-K)}
\end{aligned}
$$

where the second to the last equality uses the fact that

$$
\overline{\mathbb{E}}_{t}^{N R E} a_{t}=K \sum_{h \geq 0} \rho^{h}(1-K)^{h} a_{t-h}
$$

hence

$$
\operatorname{Cov}\left(\overline{\mathbb{E}}_{t}^{N R E} a_{t}, a_{t}\right)=K \sum_{h \geq 0} \rho^{h}(1-K)^{h} \underbrace{\operatorname{Cov}\left(a_{t-h}, a_{t}\right)}_{=\rho^{h} \operatorname{Var}\left(a_{t}\right)} .
$$

Proof for AHS. We have

$$
\begin{aligned}
& a_{i t}=\rho a_{i t-1}+\varepsilon_{i t}(\text { perceived: } \hat{\rho}) \\
& z_{i t}=a_{i t}+\frac{1}{\sqrt{\tau}} u_{i t}, \\
&\text { (perceived: } \hat{\tau})
\end{aligned}
$$

we have

$$
\widehat{\beta}_{\text {aggr }}=\widehat{\beta}_{\text {ind }}=\rho-\hat{K} \rho-\frac{\hat{K} \hat{\rho}(1-\hat{K})}{1-\hat{\rho} \rho(1-\hat{K})} .
$$

As in above, we have

$$
\mathbb{E}_{i t} a_{i t}=\hat{K} \sum_{h \geq 0} \hat{\rho}^{h}(1-\hat{K})^{h} z_{i t-h}
$$

where $\hat{K} \in(0,1)$ is a function of $\hat{\rho}$ and $\hat{\tau}$. We then have

$$
a_{i t+1}-\mathbb{E}_{i t+1} a_{i t+1}=\sum_{h \geq 0} \rho^{h} \varepsilon_{i, t+1-h}-\hat{K} \sum_{h \geq 0} \hat{\rho}^{h}(1-\hat{K})^{h} z_{i, t+1-h}
$$

so

$$
\begin{aligned}
\operatorname{Cov}\left(a_{i t+1}-\mathbb{E}_{i t+1} a_{i t+1}, a_{i t}\right)= & \sum_{h \geq 0} \rho^{h} \operatorname{Cov}\left(\varepsilon_{i, t+1-h}, a_{i t}\right)-\hat{K} \sum_{h \geq 0} \hat{\rho}^{h}(1-\hat{K})^{h} \operatorname{Cov}\left(z_{i, t+1-h}, a_{i t}\right) \\
= & \rho \operatorname{Var}\left(\varepsilon_{i t}\right)+\rho^{3} \operatorname{Var}\left(\varepsilon_{i t}\right)+\rho^{5} \operatorname{Var}\left(\varepsilon_{i t}\right)+\cdots \\
& -\hat{K} \rho \operatorname{Var}\left(a_{i t}\right)-\hat{K} \hat{\rho}(1-\hat{K}) \operatorname{Var}\left(a_{i t}\right)-\hat{K} \hat{\rho}^{2}(1-\hat{K})^{2} \rho \operatorname{Var}\left(a_{i t}\right)-\cdots \\
= & \operatorname{Var}\left(a_{i t}\right)\left(\rho-\hat{K} \rho-\frac{\hat{K} \hat{\rho}(1-\hat{K})}{1-\hat{\rho} \rho(1-\hat{K})}\right) .
\end{aligned}
$$

where the last equality uses the fact that

$$
\left(1-\rho^{2}\right) \operatorname{Var}\left(a_{i t}\right)=\operatorname{Var}\left(\varepsilon_{i t}\right) .
$$

Thus, we have

$$
\widehat{\beta}_{\text {ind }}=\rho-\hat{K} \rho-\frac{\hat{K} \hat{\rho}(1-\hat{K})}{1-\hat{\rho} \rho(1-\hat{K})} .
$$

We have

$$
\begin{aligned}
\operatorname{Cov}\left(a_{t+1}-\overline{\mathbb{E}}_{t+1} a_{t+1}, a_{t}\right)= & \sum_{h \geq 0} \rho^{h} \operatorname{Cov}\left(\varepsilon_{t+1-h}, a_{t}\right)-\hat{K} \sum_{h \geq 0} \hat{\rho}^{h}(1-\hat{K})^{h} \operatorname{Cov}\left(a_{t+1-h}, a_{t}\right) \\
= & \rho \operatorname{Var}\left(\varepsilon_{t}\right)+\rho^{3} \operatorname{Var}\left(\varepsilon_{t}\right)+\rho^{5} \operatorname{Var}\left(\varepsilon_{t}\right)+\cdots \\
& -\hat{K} \rho \operatorname{Var}\left(a_{t}\right)-\hat{K} \hat{\rho}(1-\hat{K}) \operatorname{Var}\left(a_{t}\right)-\hat{K} \hat{\rho}^{2}(1-\hat{K})^{2} \rho \operatorname{Var}\left(a_{t}\right)-\cdots \\
= & \operatorname{Var}\left(a_{t}\right)\left(\rho-\hat{K} \rho-\frac{\hat{K} \hat{\rho}(1-\hat{K})}{1-\hat{\rho} \rho(1-\hat{K})}\right) .
\end{aligned}
$$

where the last equality uses the fact that

$$
\left(1-\rho^{2}\right) \operatorname{Var}\left(a_{t}\right)=\operatorname{Var}\left(\varepsilon_{t}\right) .
$$

Thus, we have

$$
\widehat{\beta}_{\text {aggr }}=\rho-\hat{K} \rho-\frac{\hat{K} \hat{\rho}(1-\hat{K})}{1-\hat{\rho} \rho(1-\hat{K})} .
$$

Proof for $K W$. We have

$$
\begin{aligned}
y_{i t} & =\sum_{j} x_{i j t} \\
x_{i j t} & =a_{j} \theta_{i t}+b_{j} u_{i j t} \\
\theta_{i t} & =\rho \theta_{i t-1}+\eta_{i t} \\
z_{i j t} & =x_{i j t}+q_{j} \cdot \varepsilon_{i j t}
\end{aligned}
$$

Then, we have $\widehat{\beta}_{\text {aggr }}<\widehat{\beta}_{\text {ind }}$ if and only if

$$
\frac{\operatorname{Var}\left(u_{j t}\right)}{\operatorname{Var}\left(\eta_{t}\right)}>\frac{\operatorname{Var}\left(u_{i j t}\right)}{\operatorname{Var}\left(\eta_{i t}\right)}
$$

Starting from (3), we have

$$
\begin{aligned}
\mathbb{E}_{i t}\left[\theta_{i t}\right] & =\mathbb{E}_{i t-1}\left[\theta_{i t}\right]+\sum_{j} g_{j}\left(z_{i j t}-\mathbb{E}_{i t-1} z_{i j t}\right) \\
& =\mathbb{E}_{i t-1}\left[\theta_{i t}\right]+\sum_{j} g_{j}\left(z_{i j t}-a_{j} \mathbb{E}_{i t-1} \theta_{i t}\right) \\
& =\rho\left(1-\sum_{j} g_{j} a_{j}\right) \mathbb{E}_{i t-1} \theta_{i t-1}+\sum_{j} g_{j}\left(a_{j} \theta_{i t}+b_{j} u_{i j t}+q_{j} \varepsilon_{i j t}\right) .
\end{aligned}
$$

Thus,

$$
\begin{aligned}
\theta_{i t}-\mathbb{E}_{i t} \theta_{i t} & =\left(1-\sum_{j} g_{j} a_{j}\right)\left(\rho \theta_{i t-1}+\eta_{i t}\right)-\rho\left(1-\sum_{j} g_{j} a_{j}\right) \mathbb{E}_{i t-1} \theta_{i t-1}-\sum_{j} g_{j} b_{j} u_{i j t}-\sum_{j} g_{j} q_{j} \varepsilon_{i j t} \\
& =\underbrace{\rho\left(1-\sum_{j} g_{j} a_{j}\right)\left(\theta_{i t-1}-\mathbb{E}_{i t-1} \theta_{i t-1}\right)+\underbrace{\left(1-\sum_{j} g_{j} a_{j}\right) \eta_{i t}-\sum_{j} g_{j} b_{j} u_{i j t}-\sum_{j} g_{j} q_{j} \varepsilon_{i j t}}_{\zeta_{i t}}}_{\Gamma} \begin{aligned}
& =\sum_{h \geq 0} \Gamma^{h} \zeta_{i t-h} .
\end{aligned}
\end{aligned}
$$

Thus, we have

$$
\begin{aligned}
y_{i t+1}-\mathbb{E}_{i t+1} y_{i t+1} & \equiv\left(\sum_{j} a_{j}\right)\left(\theta_{i t+1}-\mathbb{E}_{i t+1} \theta_{i t+1}\right) \\
& =\left(\sum_{j} a_{j}\right) \sum_{h \geq 0} \Gamma^{h} \zeta_{i, t+1-h} .
\end{aligned}
$$

and

$$
y_{i t}=\left(\sum_{j} a_{j}\right) \sum_{h \geq 0} \rho^{h} \eta_{i t-h}+\sum_{j} b_{j} u_{i j t} .
$$

Thus, the covariance between them is

$$
\operatorname{Cov}=-\left(\sum_{j} a_{j}\right) \Gamma \sum_{j} g_{j} b_{j}^{2} \operatorname{Var}\left(u_{i j t}\right)+\left(\sum_{j} a_{j}\right)^{2} \underbrace{\operatorname{Cov}\left(\sum_{h \geq 0} \Gamma^{h} \zeta_{i t-h}, \sum_{h \geq 0} \rho^{h} \eta_{i t-h}\right)}_{=\left(1-\sum_{j} g_{j} a_{j}\right) \frac{1}{1-\Gamma \rho} \operatorname{Var}\left(\eta_{i t}\right)}
$$

Thus,

$$
\widehat{\beta}_{\text {ind }}=\frac{\left(\sum_{j} a_{j}\right) \Gamma\left(\frac{\left(\sum_{j} a_{j}\right)\left(1-\sum_{j} g_{j} a_{j}\right)}{1-\Gamma \rho} \operatorname{Var}\left(\eta_{i t}\right)-\sum_{j} g_{j} b_{j}^{2} \operatorname{Var}\left(u_{i j t}\right)\right)}{\frac{\left(\sum_{j} a_{j}\right)^{2}}{1-\rho^{2}} \operatorname{Var}\left(\eta_{i t}\right)+\sum_{j} b_{j}^{2} \operatorname{Var}\left(u_{i j t}\right)} .
$$

On the other hand, we have

$$
\begin{aligned}
y_{t+1}-\overline{\mathbb{E}}_{t+1} y_{t+1} & =\left(\sum_{j} a_{j}\right) \sum_{h \geq 0} \Gamma^{h} \zeta_{t+1-h} \\
y_{t} & =\left(\sum_{j} a_{j}\right) \sum_{h \geq 0} \rho^{h} \eta_{t-h}+\sum_{j} b_{j} u_{j t} .
\end{aligned}
$$

hence

$$
\widehat{\beta}_{\text {aggr }}=\frac{\left(\sum_{j} a_{j}\right) \Gamma\left(\frac{\left(\sum_{j} a_{j}\right)\left(1-\sum_{j} g_{j} a_{j}\right)}{1-\Gamma \rho} \operatorname{Var}\left(\eta_{t}\right)-\sum_{j} g_{j} b_{j}^{2} \operatorname{Var}\left(u_{j t}\right)\right)}{\frac{\left(\sum_{j} a_{j}\right)^{2}}{1-\rho^{2}} \operatorname{Var}\left(\eta_{t}\right)+\sum_{j} b_{j}^{2} \operatorname{Var}\left(u_{j t}\right)} .
$$

Both beta hats are of the form (impose $\left.\operatorname{Var}\left(u_{j t}\right)=\operatorname{Var}\left(u_{j^{\prime} t}\right)\right)$

$$
\widehat{\beta}=\frac{b-a \kappa}{d+c \kappa} \quad \text { where } \kappa=\frac{\operatorname{Var}(u)}{\operatorname{Var}(\eta)}>0
$$

wherer $a, b, c, d>0$. We can easily show that $\widehat{\beta}$ is decreasing in $\kappa$. So we have $\widehat{\beta}_{\text {aggr }}<\widehat{\beta}_{\text {ind }}$ if and only if

$$
\frac{\operatorname{Var}\left(u_{j t}\right)}{\operatorname{Var}\left(\eta_{t}\right)}>\frac{\operatorname{Var}\left(u_{i j t}\right)}{\operatorname{Var}\left(\eta_{i t}\right)}
$$


[^0]:    *I am deeply indebted to George-Marios Angeletos and Stephen Morris for their guidance and support. I also thank Arnaud Costinot, Dave Donaldson, Basil Halperin, Ryungha Oh, and participants in the MIT Macro Lunch for their helpful comments. All errors are my own.
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[^1]:    ${ }^{1}$ Similarly, Angeletos and Lian (2019) study a confidence multiplier that varies endogenously and amplifies demand shocks.

[^2]:    ${ }^{2}$ For example, firms make decisions after receiving noisy information about some shocks that affect market demand, but realized market demand is also affected by some other shocks. Firms may be relatively well informed about shocks that are realized before they make forecasts, or about shocks that are idiosyncratic to firms, which may then be well reflected in the consumer survey. In contrast, firms are likely to be less well informed about shocks that are realized after the forecasts have been made, or about aggregate shocks, such as shocks to aggregate demand.

[^3]:    ${ }^{3}$ One crucial reason for this assumption is that with persistent variables that cannot be observed perfectly, we have to tackle the infinite regress problem as in Townsend (1983). A large number of works have explored how to solve the infinite regress problem using either guess-and-verify, approximation, or the frequency domain technique. A partial list of these works includes Sargent (1991), Kasa (2000), Nimark (2017), Rondina and Walker (2018), and Huo and Takayama (2018). Even in those works, it is often assumed that only fundamentals are persistent, while noise follows i.i.d. Notable exceptions are Huo and Takayama (2015, 2018), but their main focuses are on the methodological contribution rather than on economic implications of persistent noise terms.

[^4]:    ${ }^{4}$ This makes no difference in static settings as it only adds another layer of uncertainty about the stochastic relationship. To see this point, consider a signal $s=a+\xi$ subject to bias, $\xi=$ bias $+e$. An agent believes that the bias is distributed as bias $\sim F(\cdot)$ and that the (unbiased) error term is distributed as $e \sim G(\cdot)$. In static settings, it is isomorphic to the case in which the agent believes that the noise term $\xi$ follows a known distribution

    $$
    P(\xi \leq \hat{\xi})=\int F(\hat{\xi}-e) d G(e)
    $$

    In contrast, this additional layer of uncertainty is important in dynamic settings. If the bias in an information source is persistent, agents then have incentives to correct this bias over time. To see this clearly, consider a dynamic extension in which the agent uses the signal $s_{t}=a_{t}+\xi_{t}$ to form expectations about $a_{t}$ for two periods $t=0,1$. Suppose we assume that $\xi_{t}=$ bias $+e_{t}$ so that the bias is time-invariant. Assume further that the agent can observe the true realization of $a_{0}$ at the beginning of period 1 . The agent then makes another prediction about $a_{1}$ after observing $s_{1}$. Then, the agent tries to correct the bias by comparing the previous signal $s_{0}$ with the realization $a_{0}$.
    ${ }^{5}$ This is a generalized version as we consider $c_{t}(\cdot)$ instead of a time invariant function $c(\cdot)$.

[^5]:    ${ }^{6}$ This is costly in the original formulation of Sims (2003) and Mackowiak and Wiederholt (2009).
    ${ }^{7}$ This is obvious when agents receive feedback later on so the objective function changes to $\mathbb{E}\left[\left(\mathbb{E}\left[a_{t} \mid s^{t}, a^{t-1}\right]-a_{t}\right)^{2}\right]$. However, this also holds without such feedback because agents can ultimately learn the precise value of $\tilde{\xi}$ after observing an infinite number of signal realizations.

[^6]:    8 "Better the devil you know than the devil you don't."

[^7]:    ${ }^{9}$ Throughout the paper, we will use the letter $\xi$ to denote noise terms.
    ${ }^{10}$ In Section 4, we will define higher-order optimism when there are multiple agents who play a game with strategic complementarity.

[^8]:    ${ }^{11} \mathrm{We}$ do not need to distinguish nominal terms and real terms because we normalize $P_{t}=1$.

[^9]:    ${ }^{12}$ Another way of modeling uncertainty is to assume island-specific preference shocks and aggregate demand shocks. But it is more difficult to take this route because it entails endogenous signals.

[^10]:    ${ }^{13}$ In this section, we do not restrict their correlation structure across islands because it makes no difference in the absence of strategic interaction between firms in different islands.

[^11]:    ${ }^{14}$ Whether these noise terms are correlated across islands is irrelevant in this section as we will assume away strategic interaction between islands.
    ${ }^{15}$ One might argue that it is also natural to assume that firms and workers can learn from the commodity markets. Indeed firms and workers can fully learn the aggregate shock $\varepsilon_{t}^{u}$ from observing the prices and quantities in the commodity markets. However, we consider agents suffering a form of internal schizophrenia as in the vast majority of the literature. We think of the firms having two personalities. One choosing $Y_{i j t}$ is inattentive and do not learn from the commodity markets, and another, who does not communicate with the former, adjusts the price to clear the commodity market. See Angeletos and La'O (2009a) for trade-offs in this modeling choice.

[^12]:    ${ }^{16}$ Based on the literature on rational inattention such as Sims (2003) and Mackowiak and Wiederholt (2009), one might argue that even if the realized inflation rates are publicly revealed, the forecasters might not pay attention to them. However, it is unlikely that the forecasters who made a prediction for the inflation rate do not pay high attention to the realized value of it.
    ${ }^{17}$ Since Lucas (1972), the log linearization is frequently used in the literature as it allows a simple representation of the equilibrium with a signal extraction problem.

[^13]:    ${ }^{18}$ In the discussion below, the optimism means both ex ante and ex post optimism.

[^14]:    ${ }^{19}$ Recall, however, that we have assumed away the sluggish response of expectations to the innovation in productivity. Thus, a correct interpretation of this result is that the presence of persistent noise terms amplifies (dampens, respectively) the effect of unobserved (partly-observed, respectively) shocks compared to the case with i.i.d. noise terms.

[^15]:    ${ }^{20}$ Actually, with rational forecasts, the effect of one shock can be amplified precisely because the effect of another shock is dampened, and vice versa.
    ${ }^{21}$ For a prominent example, Mackowiak and Wiederholt (2009) calibrate their model by matching the price changes observed in data and conclude that firms pay more attention to idiosyncratic conditions than to aggregate conditions. This is because idiosyncratic conditions are more volatile than aggregate conditions. The theory of Kohlhas and Walther (2020) also relies on this asymmetry.

[^16]:    ${ }^{22}$ In general, we need another noisy signal about the true realization whose noise term is not much correlated with the first signal.
    ${ }^{23}$ Acharya, Benhabib, and Huo (2019) document a similar result.
    ${ }^{24}$ This is analogous to the literature on higher-order beliefs, where agents try to forecast beliefs of other agents in order to forecast others' actions.

[^17]:    ${ }^{25}$ We can alternatively allow the possibility that noise terms are positively correlated across agents. Then, agents try to learn this common component, which can generate additional channel through which underlying shocks affect the (higher-order) optimism.

[^18]:    ${ }^{26}$ We can assume instead that $a_{i t}=\varepsilon_{i t}^{p}+\varepsilon_{t}^{u}$ where $\int_{0}^{1} \varepsilon_{j t}^{p} \mathrm{~d} j=0$. In this case, however, a relevant comparative statics is changing $\alpha$ when agents' best response is given by $y_{i t}=\mathbb{E}_{i t} a_{i t}+\alpha \mathbb{E}_{i t} y_{t}$.

[^19]:    ${ }^{27}$ We can use ex-ante higher-order optimism instead, which is defined analogously. It turns out that ex-post higher-order optimism, however, is much easier to keep track of under the presence of strategic complementarity, so we focus only on ex-post ones in this section.

[^20]:    ${ }^{28}$ Actually, we do not even need to solve the period-0 equilibrium.
    ${ }^{29}$ The results below show that this is a unique equilibrium even if we allow for the possibility of a nonlinear equilibrium.

[^21]:    ${ }^{30}$ Recall that $\frac{\partial \mathcal{O}_{1}^{h}}{\partial \varepsilon_{0}^{u}}$ is positive while $\frac{\partial \mathcal{O}_{1}^{h}}{\partial \varepsilon_{0}^{D}}$ is negative for all orders $h$.

[^22]:    ${ }^{31}$ We set $\sigma_{p}^{2}$ higher than $\sigma_{u}^{2}$ according to the notion that agents are more concerned about volatile shocks; see footnote 21 .

[^23]:    ${ }^{32}$ Recall that we considered a unit innovation in $\varepsilon_{0}^{u}$, so we can interpret $\mathcal{O}_{i 1}^{h}$ there as $\frac{\partial \mathcal{O}_{i 1}^{h}}{\partial \varepsilon_{0}^{i}}$.

[^24]:    ${ }^{33}$ Their original specification has $a_{t+k}-\overline{\mathbb{E}}_{t} a_{t+k}$ on the left hand side. Under their timing convention, however, $a_{t}$ is in the agents' information set when they form the expectation about $a_{t+k}$; so it should be $\overline{\mathbb{E}}_{t+1} a_{t+k}$ under our timing convention.

[^25]:    ${ }^{34}$ They also show that behavioral over-extrapolation-misspecification in the stochastic process of fundamental-leads to the overreaction of individual forecasts as documented in Bordalo et al. (2020). Similarly, in our model, the misspecification in the stochastic process of noise terms leads to overreaction of individual forecasts. In particular, Proposition A. 1 states that when the perceived persistence of noise is greater than the true persistence, individual forecast errors are negatively correlated with forecast revisions, implying the individual-level overreaction.
    ${ }^{35}$ Consider an extended version of KW model with individual-specific fundamental. Agent $i$ has the fundamental $y_{i t}=\sum_{j} x_{i j t}$, where $j$-th component is determined by $x_{i j t}=a_{j} \theta_{i t}+u_{i j t}$ where $\theta_{i t}$ denotes a latent factor that follows an $\operatorname{AR}(1)$ process, $\theta_{i t}=\rho_{a} \theta_{i t-1}+\eta_{i t}$. Agent $i$ observes noisy signals $s_{i j t}=x_{i j t}+\varepsilon_{i j t}$. The shocks $u_{i j t}, \eta_{i t}$, and $\varepsilon_{i j t}$ are normally distributed, serially uncorrelated, and mutually independent. In this model, we have $\widehat{\beta}_{\text {aggr }}<\widehat{\beta}_{\text {ind }}$ if and only if $\frac{\operatorname{Var}\left(\int u_{i j t} \mathrm{~d} i\right)}{\operatorname{Var}\left(u_{i j t}\right)}>\frac{\operatorname{Var}\left(\int \eta_{i t} \mathrm{~d} i\right)}{\operatorname{Var}\left(\eta_{i t}\right)}$. But there is no reason to expect $\widehat{\beta}_{i n d}=0$.

[^26]:    ${ }^{36}$ Another interesting observation is that the differences between coefficients, $\widehat{\beta}_{\text {aggr }}-\widehat{\beta}_{\text {ind }}$, which measure the extra overextrapolation in the consensus forecasts, are almost identical for analyst expectation and CFO expectation.

[^27]:    ${ }^{37}$ Because $a_{i t}$ denotes yearly earnings growth, we set $i \geq 4$ to ensure that there is no overlap between $a_{i t}$ and $a_{i t+1}$.

[^28]:    ${ }^{38}$ Note that $\mathbb{E}_{i t}\left[\int_{0}^{1} \xi_{j t} \mathrm{~d} j\right]$ is always zero, but $\int_{0}^{1} \mathbb{E}_{j t} \xi_{i t} \mathrm{~d} j$ is not.

[^29]:    ${ }^{39}$ We have normalized the variance of innovation to have $\operatorname{Var}\left(\xi_{i t}\right)=\sigma_{\xi}^{2}$.

