

# FRBNY DSGE Model Documentation

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## 1 General Structure

The FRBNY DSGE model is a medium scale, one-sector dynamic stochastic general equilibrium model which is based on the New Keynesian model with financial frictions used in Del Negro et al. (2015). The core of the model is based on the work of Smets and Wouters (2007) (henceforth SW) and Christiano et al. (2005): It builds on the neo-classical growth model by adding nominal wage and price rigidities, variable capital utilization, costs of adjusting investment, habit formation in consumption. The model also includes credit frictions as in the *financial accelerator* model developed by Bernanke et al. (1999b) where the actual implementation of credit frictions follows closely Christiano et al. (2014), and accounts for forward guidance in monetary policy by including anticipated policy shocks as in Laseen and Svensson (2011).

The current version of the model has several features that improve upon the version presented in the FRBNY Staff Report no. 647. It features both a deterministic and a stochastic trend in productivity and allows for exogenous movements in risk premia; the inflation target is time-varying, following Del Negro and Schorfheide (2012); households preferences are non-separable in consumption and leisure; the Dixit-Stiglitz aggregator of intermediate goods has been replaced by the more flexible Kimball aggregator; we include indexation in the price and wage adjustment processes.

Here is a brief overview. The model economy is populated by eight classes of agents: 1) a continuum of households, who consume and supply differentiated labor; 2) competitive labor aggregators that combine labor supplied by individual households; 3) competitive final good-producing firms that aggregate the intermediate goods into a final product; 4) a continuum of monopolistically competitive intermediate good producing firms; 5) competitive capital producers that convert final goods into capital; 6) a continuum of entrepreneurs who purchase capital using both internal and borrowed funds and rent it to intermediate good producing firms; 7) a representative bank collecting deposits from the households and lending funds to the entrepreneurs; and finally 8) a government, composed of a monetary authority that sets short-term interest rates and a fiscal authority that sets public spending and collects taxes.

## 2 DSGE Model Specification

Growth in the economy is driven by technological progress. We specify a process for technology  $Z_t^*$  which includes both a deterministic and a stochastic trend, and a stationary component:

$$Z_t^* = e^{\frac{1}{1-\alpha}\tilde{z}_t} Z_t^p e^{\gamma t}, \quad (1)$$

where  $\gamma$  is the steady state growth rate of the economy,  $Z_t^p$  is a stochastic trend and  $\tilde{z}_t$  is the stationary component.

The *production function* is

$$Y_t(i) = \max\{e^{\tilde{z}_t} K_t(i)^\alpha (L_t(i)e^{\gamma t} Z_t^p)^{1-\alpha} - \Phi Z_t^*, 0\}, \quad (2)$$

where  $\Phi Z_t^*$  is a fixed cost.

Trending variables are divided by  $Z_t^*$  to express the model's equilibrium conditions in terms of the stationary variables. In what follows we present a summary of the log-linearized equilibrium conditions, where all variables are expressed in log deviations from their non-stochastic steady state.

### 2.1 The log-linear equilibrium conditions

The stationary component of productivity  $\tilde{z}_t$  evolves as:

$$\tilde{z}_t = \rho_z \tilde{z}_{t-1} + \sigma_z \varepsilon_{z,t}. \quad (3)$$

Since  $Z_t^p$  is a non stationary process, we define its growth rate as  $z_t^p = \log(Z_t^p/Z_{t-1}^p)$  and assume that it follows an AR(1) process:

$$z_t^p = \rho_{z^p} z_{t-1}^p + \sigma_{z^p} \epsilon_{z^p,t}, \quad \epsilon_{z^p,t} \sim N(0, 1). \quad (4)$$

It follows that

$$z_t \equiv \log(Z_t^*/Z_{t-1}^*) - \gamma = \frac{1}{1-\alpha}(\rho_z - 1)\tilde{z}_{t-1} + \frac{1}{1-\alpha}\sigma_z \epsilon_{z,t} + z_t^p, \quad (5)$$

where  $\gamma$  is the steady-state growth rate of the economy. Steady-state values are denoted by

\*-subscripts, and steady-state formulas are provided in the technical appendix of Del Negro and Schorfheide (2012), which is available online.

The *optimal allocation of consumption* satisfies the following consumption Euler equation:

$$c_t = -\frac{(1 - he^{-\gamma})}{\sigma_c(1 + he^{-\gamma})} (R_t - \mathbb{E}_t[\pi_{t+1}] + b_t) + \frac{he^{-\gamma}}{(1 + he^{-\gamma})} (c_{t-1} - z_t) + \frac{1}{(1 + he^{-\gamma})} \mathbb{E}_t [c_{t+1} + z_{t+1}] + \frac{(\sigma_c - 1)}{\sigma_c(1 + he^{-\gamma})} \frac{w_* L_*}{c_*} (L_t - \mathbb{E}_t[L_{t+1}]), \quad (6)$$

where  $c_t$  is consumption,  $L_t$  is labor supply,  $R_t$  is the nominal interest rate, and  $\pi_t$  is inflation. The exogenous process  $b_t$  drives a wedge between the intertemporal marginal utility of consumption and the riskless real return  $R_t - \mathbb{E}_t[\pi_{t+1}]$ , and is meant to capture risk-premium shocks.<sup>1</sup> This shock follows an AR(1) process with parameters  $\rho_b$  and  $\sigma_b$ . The parameters  $\sigma_c$  and  $h$  capture the degree of relative risk aversion and the degree of habit persistence in the utility function, respectively.

The *optimal investment decision* satisfies the following relationship between the level of investment  $i_t$ , measured in terms of consumption goods, and the value of capital in terms of consumption  $q_t^k$ :

$$i_t = \frac{q_t^k}{S'' e^{2\gamma} (1 + \bar{\beta})} + \frac{1}{1 + \bar{\beta}} (i_{t-1} - z_t) + \frac{\bar{\beta}}{1 + \bar{\beta}} \mathbb{E}_t [i_{t+1} + z_{t+1}] + \mu_t. \quad (7)$$

This relationship shows that investment is affected by investment adjustment costs ( $S''$  is the second derivative of the adjustment cost function) and by an exogenous process  $\mu_t$ , which we call “marginal efficiency of investment”, that alters the rate of transformation between consumption and installed capital (see Greenwood et al. (1998)). The shock  $\mu_t$  follows an AR(1) process with parameters  $\rho_\mu$  and  $\sigma_\mu$ . The parameter  $\bar{\beta}$  depends on the intertemporal discount rate in the household utility function,  $\beta$ , on the degree of relative risk aversion  $\sigma_c$ , and on the steady-state growth rate  $\gamma$ :  $\bar{\beta} = \beta e^{(1-\sigma_c)\gamma}$ .

The *capital stock*,  $\bar{k}_t$ , which we refer to as “installed capital”, evolves as

$$\bar{k}_t = \left(1 - \frac{i_*}{\bar{k}_*}\right) (\bar{k}_{t-1} - z_t) + \frac{i_*}{\bar{k}_*} i_t + \frac{i_*}{\bar{k}_*} S'' e^{2\gamma} (1 + \bar{\beta}) \mu_t, \quad (8)$$

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<sup>1</sup>In the code, the  $b_t$  shock is normalized to be in the same units as consumption, i.e., we estimate the shock  $\tilde{b}_t = -\frac{(1-he^{-\gamma})}{\sigma_c(1+he^{-\gamma})} b_t$ .

where  $i_*/\bar{k}_*$  is the steady state investment to capital ratio.

Capital is subject to variable capacity utilization  $u_t$ ; *effective capital* rented out to firms,  $k_t$ , is related to  $\bar{k}_t$  by:

$$k_t = u_t - z_t + \bar{k}_{t-1}. \quad (9)$$

The optimality condition determining the *rate of capital utilization* is given by

$$\frac{1 - \psi}{\psi} r_t^k = u_t, \quad (10)$$

where  $r_t^k$  is the rental rate of capital and  $\psi$  captures the utilization costs in terms of foregone consumption.

*Real marginal costs* for firms are given by

$$mc_t = w_t + \alpha L_t - \alpha k_t, \quad (11)$$

where  $w_t$  is the real wage and  $\alpha$  is the income share of capital (after paying mark-ups and fixed costs) in the production function.

From the optimality conditions of goods producers it follows that all firms have the same *capital-labor ratio*:

$$k_t = w_t - r_t^k + L_t. \quad (12)$$

We include financial frictions in the model, building on the work of Bernanke et al. (1999a), Christiano et al. (2003), De Graeve (2008), and Christiano et al. (2014). We assume that banks collect deposits from households and lend to entrepreneurs who use these funds as well as their own wealth to acquire physical capital, which is rented to intermediate goods producers. Entrepreneurs are subject to idiosyncratic disturbances that affect their ability to manage capital. Their revenue may thus turn out to be too low to pay back the loans received by the banks. The banks therefore protect themselves against default risk by pooling all loans and charging a spread over the deposit rate. This spread may vary as a function of entrepreneurs' leverage and riskiness.

The *realized return on capital* is given by:

$$\tilde{R}_t^k - \pi_t = \frac{r_*^k}{r_*^k + (1 - \delta)} r_t^k + \frac{(1 - \delta)}{r_*^k + (1 - \delta)} q_t^k - q_{t-1}^k, \quad (13)$$

where  $\tilde{R}_t^k$  is the gross nominal return on capital for entrepreneurs,  $r_*^k$  is the steady state

value of the rental rate of capital  $r_t^k$ , and  $\delta$  is the depreciation rate.

The *excess return on capital* (the spread between the expected return on capital and the riskless rate) can be expressed as a function of the entrepreneurs' leverage (i.e. the ratio of the value of capital to nominal net worth) and exogenous fluctuations in the volatility of entrepreneurs' idiosyncratic productivity:

$$E_t \left[ \tilde{R}_{t+1}^k - R_t \right] = b_t + \zeta_{sp,b} (q_t^k + \bar{k}_t - n_t) + \tilde{\sigma}_{\omega,t}, \quad (14)$$

where  $n_t$  is entrepreneurs' net worth,  $\zeta_{sp,b}$  is the elasticity of the credit spread to the entrepreneurs' leverage ( $q_t^k + \bar{k}_t - n_t$ ), and  $\tilde{\sigma}_{\omega,t}$  captures mean-preserving changes in the cross-sectional dispersion of ability across entrepreneurs (see Christiano et al. (2014)).  $\tilde{\sigma}_{\omega,t}$  follows an AR(1) process with parameters  $\rho_{\sigma_\omega}$  and  $\sigma_{\sigma_\omega}$ .

*Entrepreneurs' net worth*  $n_t$  evolves according to:

$$\begin{aligned} n_t = & \zeta_{n,\tilde{R}^k} \left( \tilde{R}_t^k - \pi_t \right) - \zeta_{n,R} (R_{t-1} - \pi_t + b_{t-1}) + \zeta_{n,qK} (q_{t-1}^k + \bar{k}_{t-1}) + \zeta_{n,n} n_{t-1} \\ & - \gamma_* \frac{v_*}{n_*} z_t - \frac{\zeta_{n,\sigma_\omega}}{\zeta_{sp,\sigma_\omega}} \tilde{\sigma}_{\omega,t-1}, \end{aligned} \quad (15)$$

where the  $\zeta$ 's denote elasticities, that depend among others on the entrepreneurs' steady-state default probability  $F(\bar{\omega})$ , where  $\gamma_*$  is the fraction of entrepreneurs that survive and continue operating for another period, and where  $v_*$  is the entrepreneurs' real equity divided by  $Z_t^*$ , in steady state.

The *production function* is

$$y_t = \Phi_p (\alpha k_t + (1 - \alpha) L_t), \quad (16)$$

where  $\Phi_p = \frac{y_* + \Phi}{y_*}$ , and the *resource constraint* is:

$$y_t = g_* g_t + \frac{c_*}{y_*} c_t + \frac{i_*}{y_*} i_t + \frac{r_*^k k_*}{y_*} u_t. \quad (17)$$

where  $g_t = \log\left(\frac{G_t}{Z_t^* y_* g_*}\right)$  and  $g_* = 1 - \frac{c_* + i_*}{y_*}$ .

*Government spending*  $g_t$  is assumed to follow the exogenous process:

$$g_t = \rho_g g_{t-1} + \sigma_g \varepsilon_{g,t} + \eta_{gz} \sigma_z \varepsilon_{z,t}.$$

The *price and wage Phillips curves* are, respectively:

$$\pi_t = \kappa mc_t + \frac{\iota_p}{1 + \iota_p \bar{\beta}} \pi_{t-1} + \frac{\bar{\beta}}{1 + \iota_p \bar{\beta}} \mathbb{E}_t[\pi_{t+1}] + \lambda_{f,t}, \quad (18)$$

and

$$\begin{aligned} w_t = \frac{(1 - \zeta_w \bar{\beta})(1 - \zeta_w)}{(1 + \bar{\beta}) \zeta_w ((\lambda_w - 1) \epsilon_w + 1)} (w_t^h - w_t) - \frac{1 + \iota_w \bar{\beta}}{1 + \bar{\beta}} \pi_t + \frac{1}{1 + \bar{\beta}} (w_{t-1} - z_t + \iota_w \pi_{t-1}) \\ + \frac{\bar{\beta}}{1 + \bar{\beta}} \mathbb{E}_t[w_{t+1} + z_{t+1} + \pi_{t+1}] + \lambda_{w,t}, \end{aligned} \quad (19)$$

where  $\kappa = \frac{(1 - \zeta_p \bar{\beta})(1 - \zeta_p)}{(1 + \iota_p \bar{\beta}) \zeta_p ((\Phi_p - 1) \epsilon_p + 1)}$ , the parameters  $\zeta_p$ ,  $\iota_p$ , and  $\epsilon_p$  are the Calvo parameter, the degree of indexation, and the curvature parameter in the Kimball aggregator for prices, and  $\zeta_w$ ,  $\iota_w$ , and  $\epsilon_w$  are the corresponding parameters for wages.  $w_t^h$  measures the household's marginal rate of substitution between consumption and labor, and is given by:

$$w_t^h = \frac{1}{1 - h e^{-\gamma}} (c_t - h e^{-\gamma} c_{t-1} + h e^{-\gamma} z_t) + \nu_l L_t, \quad (20)$$

where  $\nu_l$  characterizes the curvature of the disutility of labor (and would equal the inverse of the Frisch elasticity in the absence of wage rigidities). The mark-ups  $\lambda_{f,t}$  and  $\lambda_{w,t}$  follow exogenous ARMA(1,1) processes:

$$\lambda_{f,t} = \rho_{\lambda_f} \lambda_{f,t-1} + \sigma_{\lambda_f} \varepsilon_{\lambda_f,t} - \eta_{\lambda_f} \sigma_{\lambda_f} \varepsilon_{\lambda_f,t-1},$$

and

$$\lambda_{w,t} = \rho_{\lambda_w} \lambda_{w,t-1} + \sigma_{\lambda_w} \varepsilon_{\lambda_w,t} - \eta_{\lambda_w} \sigma_{\lambda_w} \varepsilon_{\lambda_w,t-1},$$

respectively.

Finally, the monetary authority follows a generalized *policy feedback rule*:

$$\begin{aligned} R_t = \rho_R R_{t-1} + (1 - \rho_R) \left( \psi_1 (\pi_t - \pi_t^*) + \psi_2 (y_t - y_t^f) \right) \\ + \psi_3 \left( (y_t - y_t^f) - (y_{t-1} - y_{t-1}^f) \right) + r_t^m. \end{aligned} \quad (21)$$

where  $y_t^f$  is the flexible price/wage output, obtained from solving the version of the model without nominal rigidities and markup shocks (that is, Equations (6) through (20) with

$\zeta_p = \zeta_w = 0$ , and  $\lambda_{f,t} = \lambda_{w,t} = 0$ ), and the residual  $r_t^m$  follows an AR(1) process with parameters  $\rho_{r^m}$  and  $\sigma_{r^m}$ .

In this version of the model we have replaced a constant inflation target with a time-varying inflation target  $\pi_t^*$ , to capture the rise and fall of inflation and interest rates in the estimation sample. Although time-varying target rates have been frequently used for the specification of monetary policy rules in DSGE model (e.g., Erceg and Levin (2003) and Smets and Wouters (2003), among others), we follow the approach of Aruoba and Schorfheide (2008) and Del Negro and Eusepi (2011) and include data on long-run inflation expectations as an observable for the estimation of the model. At each point in time, long-run inflation expectations essentially determine the level of the target inflation rate. To the extent that long-run inflation expectations at the forecast origin contain information about the central bank's objective function, e.g. the desire to stabilize inflation at 2%, this information is automatically included in the forecast.

The time-varying *inflation target* evolves according to:

$$\pi_t^* = \rho_{\pi^*} \pi_{t-1}^* + \sigma_{\pi^*} \epsilon_{\pi^*,t}, \quad (22)$$

where  $0 < \rho_{\pi^*} < 1$  and  $\epsilon_{\pi^*,t}$  is an iid shock. We model  $\pi_t^*$  as a stationary process, although our prior for  $\rho_{\pi^*}$  will force this process to be highly persistent. The assumption that the changes in the target inflation rate are exogenous is, to some extent, a short-cut. For instance, the learning models of Sargent (1999) or Primiceri (2006) imply that the rise in the target inflation rate in the 1970's and the subsequent drop is due to policy makers learning about the output-inflation trade-off and trying to set inflation optimally. We are abstracting from such a mechanism in our specification.

## 2.2 Anticipated Policy Shocks

This section describes the introduction of anticipated policy shocks in the model, which follows Laseen and Svensson (2011). We modify the exogenous component of the policy rule (21) as follows:

$$r_t^m = \rho_{r^m} r_{t-1}^m + \epsilon_t^R + \sum_{k=1}^K \epsilon_{k,t-k}^R, \quad (23)$$

where  $\epsilon_t^R$  is the usual contemporaneous policy shock, and  $\epsilon_{k,t-k}^R$  is a policy shock that is known to agents at time  $t - k$ , but affects the policy rule  $k$  periods later, that is, at time  $t$ . We assume that  $\epsilon_{k,t-k}^R \sim N(0, \sigma_{k,r}^2)$ , *i.i.d.*

In order to solve the model we need to express the anticipated shocks in recursive form. For this purpose, we augment the state vector  $s_t$  (described below) with  $K$  additional states  $\nu_t^R, \dots, \nu_{t-K}^R$  whose law of motion is as follows:

$$\begin{aligned}\nu_{1,t}^R &= \nu_{2,t-1}^R + \epsilon_{1,t}^R \\ \nu_{2,t}^R &= \nu_{3,t-1}^R + \epsilon_{2,t}^R \\ &\vdots \\ \nu_{K,t}^R &= \epsilon_{K,t}^R\end{aligned}$$

and rewrite the exogenous component of the policy rule (23) as<sup>2</sup>

$$r_t^m = \rho_r r_{t-1}^m + \epsilon_t^R + \nu_{1,t-1}^R.$$

## 2.3 State Space Representation

We use the method in Sims (2002) to solve the system of log-linear approximate equilibrium conditions and obtain the transition equation, which summarizes the evolution of the states  $s_t$ :

$$s_t = \mathcal{T}(\theta)s_{t-1} + \mathcal{R}(\theta)\epsilon_t. \quad (24)$$

where  $\theta$  is a vector collecting all the DSGE model parameters and  $\epsilon_t$  is a vector of all the structural shocks. The state-space representation for our vector of observables  $y_t$ , which we describe in the next section, is composed of the transition equation (24), and a system of measurement equations:

$$y_t = \mathcal{D}(\theta) + \mathcal{Z}(\theta)s_t, \quad (25)$$

mapping the states into the observables, which we describe in detail in the section 3. We assume that some of the variables are measured with “error”, that is, the observed value equals the model implied value plus an exogenous process, which evolves as an AR(1). We add this exogenous process to the vector of states  $s_t$ .

<sup>2</sup>It is easy to verify that  $\nu_{1,t-1}^R = \sum_{k=1}^K \epsilon_{k,t-k}^R$ , that is,  $\nu_{1,t-1}^R$  is a “bin” that collects all anticipated shocks that affect the policy rule in period  $t$ .

### 3 Data

The estimation of the model is based on data on real output growth (including both GDP and GDI measures), consumption growth, investment growth, real wage growth, hours worked, inflation (measured by core PCE and GDP deflators), short- and long- term interest rates, 10-year inflation expectations, credit spreads, and total factor productivity. Measurement equations relate the model variables that appear in Section 2 to the observables as follows:

$$\begin{aligned}
\text{GDP growth} &= 100\gamma + (y_t - y_{t-1} + z_t) + e_t^{gdp} - \mathcal{C}_{me}e_{t-1}^{gdp} \\
\text{GDI growth} &= 100\gamma + (y_t - y_{t-1} + z_t) + e_t^{gdi} - \mathcal{C}_{me}e_{t-1}^{gdi} \\
\text{Consumption growth} &= 100\gamma + (c_t - c_{t-1} + z_t) \\
\text{Investment growth} &= 100\gamma + (i_t - i_{t-1} + z_t) \\
\text{Real Wage growth} &= 100\gamma + (w_t - w_{t-1} + z_t) \\
\text{Hours} &= \bar{L} + L_t \\
\text{Core PCE Inflation} &= \pi_* + \pi_t + e_t^{pce} \\
\text{GDP Deflator Inflation} &= \pi_* + \delta_{gdpdef} + \gamma_{gdpdef} * \pi_t + e_t^{gdpdef} \\
\text{FFR} &= R_* + R_t \\
\text{10y Nominal Bond Yield} &= R_* + \mathbb{E}_t \left[ \frac{1}{40} \sum_{k=1}^{40} R_{t+k} \right] + e_t^{10y} \\
\text{10y Infl. Expectations} &= \pi_* + \mathbb{E}_t \left[ \frac{1}{40} \sum_{k=1}^{40} \pi_{t+k} \right] \\
\text{Spread} &= SP_* + \mathbb{E}_t \left[ \tilde{R}_{t+1}^k - R_t \right] \\
\text{TFP growth, demeaned} &= z_t + \frac{\alpha}{1-\alpha} (u_t - u_{t-1}) + e_t^{tfp}.
\end{aligned} \tag{26}$$

All variables are measured in percent. All the  $e_t^*$  processes follow exogenous AR(1) specifications, and can be thought of either measurement errors or some other unmodeled source of discrepancy between the model and the data (e.g., risk premia for the long term nominal rate). However, we introduce correlation in the measurement errors for GDP and GDI, which evolve as follows:

$$\begin{aligned}
e_t^{gdp} &= \rho_{gdp} \cdot e_{t-1}^{gdp} + \sigma_{gdp} \epsilon_t^{gdp}, \quad \epsilon_t^{gdp} \sim i.i.d.N(0, 1) \\
e_t^{gdi} &= \rho_{gdi} \cdot e_{t-1}^{gdi} + \varrho_{gdp} \cdot \sigma_{gdp} \epsilon_t^{gdp} + \sigma_{gdi} \epsilon_t^{gdi}, \quad \epsilon_t^{gdi} \sim i.i.d.N(0, 1).
\end{aligned}$$

We assume that  $\mathcal{C}_{me} = 1$ . The measurement errors for GDP and GDI are thus stationary in *levels*, and enter the observation equation in first differences (e.g.  $e_t^{gdp} - e_{t-1}^{gdp}$  and  $e_t^{gdi} - e_{t-1}^{gdi}$ ). GDP and GDI are also cointegrated as they are driven by a common stochastic trend. The

terms  $\pi_*$  and  $R_*$  measure respectively the net steady-state inflation rate and short-term nominal interest rate, expressed in percentage terms, and  $\bar{L}$  captures the mean of hours (this variable is measured as an index). The 10-year inflation expectations contain information about low-frequency movements of inflation and are obtained from the Blue Chip Economic Indicators survey and the Survey of Professional Forecasters. As spread variable we use a Baa Corporate Bond Yield spread over the 10-Year Treasury Note Yield at constant maturity. Details on the construction of the data set are provided in Appendix A.

In order to estimate the importance of anticipated shocks and their effect on the variables of interest, we follow Del Negro and Schorfheide (2012) and augment the measurement equation (25) with the expectations for the policy rate:

$$\begin{aligned} FFR_{t,t+1}^e &= R_* + \mathcal{Z}(\theta)_{R,\cdot} \mathcal{T}(\theta)^1 s_t, \\ &\vdots \\ FFR_{t,t+K}^e &= R_* + \mathcal{Z}(\theta)_{R,\cdot} \mathcal{T}(\theta)^K s_t, \end{aligned} \tag{27}$$

where  $FFR_{t,t+k}^e$  are the market's expectations for the FFR  $k$  quarters ahead, and  $\mathcal{Z}(\theta)_{R,\cdot}$  is the row of  $\mathcal{Z}(\theta)$  corresponding to the interest rate.

## 4 Inference, Prior and Posterior Parameter Estimates

We use Bayesian techniques for estimation, which require the specification of a prior distribution for the model parameters. For most of the parameters we use the same marginal prior distributions as Smets and Wouters (2007), with two important exceptions. First, the original prior for the quarterly steady state inflation rate  $\pi_*$  used by Smets and Wouters (2007) is tightly centered around 0.62% (which is about 2.5% annualized) with a standard deviation of 0.1%. We favor a looser prior, one that has less influence on the model's forecasting performance, that is centered at 0.75% and has a standard deviation of 0.4%. Second, for the financial frictions mechanism we specify priors for the parameters  $SP_*$ ,  $\zeta_{sp,b}$ ,  $\rho_{\sigma_\omega}$ , and  $\sigma_{\sigma_\omega}$ , while we fix the parameters corresponding to the steady state default probability and the survival rate of entrepreneurs, respectively. In turn, these parameters imply values for the parameters of (15).

Information on the priors is provided in Table 1, in the Appendix.

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## A Data Construction

Data on real GDP ( $GDPC$ ), the GDP deflator ( $GDPDEF$ ), core PCE inflation ( $PCEPILFE$ ), nominal personal consumption expenditures ( $PCEC$ ), and nominal fixed private investment ( $FPI$ ) are produced at a quarterly frequency by the Bureau of Economic Analysis, and are included in the National Income and Product Accounts (NIPA). Average weekly hours of production and nonsupervisory employees for total private industries ( $AWHNONAG$ ), civilian employment ( $CE16OV$ ), and the civilian non-institutional population ( $LNSINDEX$ ) are produced by the Bureau of Labor Statistics (BLS) at a monthly frequency. The first of these series is obtained from the Establishment Survey, and the remaining from the Household Survey. Both surveys are released in the BLS Employment Situation Summary. Since our models are estimated on quarterly data, we take averages of the monthly data. Compensation per hour for the non-farm business sector ( $COMPNFB$ ) is obtained from the Labor Productivity and Costs release, and produced by the BLS at a quarterly frequency. All data are transformed following Smets and Wouters (2007). The federal funds rate is obtained from the Federal Reserve Board's H.15 release at a business day frequency. We take quarterly averages of the annualized daily data and divide by four. Let  $\Delta$  denote the temporal difference operator. Then:

$$\begin{aligned} \text{Output growth} &= 100 * \Delta \text{LN}((GDPC)/LNSINDEX) \\ \text{Consumption growth} &= 100 * \Delta \text{LN}((PCEC/GDPDEF)/LNSINDEX) \\ \text{Investment growth} &= 100 * \Delta \text{LN}((FPI/GDPDEF)/LNSINDEX) \\ \text{Real wage growth} &= 100 * \Delta \text{LN}(COMPNFB/GDPDEF) \\ \text{Hours worked} &= 100 * \text{LN}((AWHNONAG * CE16OV/100)/LNSINDEX) \\ \text{GDP Deflator Inflation} &= 100 * \Delta \text{LN}(GDPDEF) \\ \text{Core PCE Inflation} &= 100 * \Delta \text{LN}(PCEPILFE) \\ \text{FFR} &= (1/4) * FEDERAL FUNDS RATE \end{aligned}$$

Long-run inflation expectations are obtained from the Blue Chip Economic Indicators survey and the Survey of Professional Forecasters available from the FRB Philadelphia's Real-Time Data Research Center. Long-run inflation expectations (average CPI inflation over the next 10 years) are available from 1991Q4 onward. Prior to 1991Q4, we use the 10-year expectations data from the Blue Chip survey to construct a long time series that begins in 1979Q4. Since the Blue Chip survey reports long-run inflation expectations only

twice a year, we treat these expectations in the remaining quarters as missing observations and adjust the measurement equation of the Kalman filter accordingly. Long-run inflation expectations  $\pi_t^{O,40}$  are therefore measured as

$$10y \text{ Infl Exp} = (10\text{-year average CPI inflation forecast} - 0.50)/4.$$

where 0.50 is the average difference between CPI and GDP annualized inflation from the beginning of the sample to 1992. We divide by 4 to express the data in quarterly terms.

We measure *Spread* as the annualized Moody's Seasoned Baa Corporate Bond Yield spread over the 10-Year Treasury Note Yield at Constant Maturity. Both series are available from the Federal Reserve Board's H.15 release. Like the federal funds rate, the spread data are also averaged over each quarter and measured at a quarterly frequency. This leads to:

$$\text{Spread} = (1/4) * (\text{Baa Corporate} - 10 \text{ year Treasury}).$$

Similarly,

$$10y \text{ Bond yield} = (1/4) * (10 \text{ year Treasury}).$$

Lastly, TFP growth is measured using John Fernald's TFP growth series, unadjusted for changes in utilization. That series is demeaned, divided by 4 to express it in quarterly growth rates, and divided by Fernald's estimate of  $(1 - \alpha)$  to convert it in labor augmenting terms:

$$\text{TFP growth, demeaned} = (1/4) * (\text{Fernald's TFP growth, unadjusted, demeaned}) / (1 - \alpha).$$

Table 1: Priors

	Dist	Mean	Std Dev		Dist	Mean	Std Dev
<i>Policy Parameters</i>							
$\psi_1$	Normal	1.50	0.25	$\rho_{r^m}$	Beta	0.50	0.20
$\psi_2$	Normal	0.12	0.05	$\sigma_{r^m}$	InvG	0.10	2.00
$\psi_3$	Normal	0.12	0.05	$\sigma_{ant1}$	InvG	0.20	4.00
$\rho_R$	Beta	0.75	0.10				
<i>Nominal Rigidities Parameters</i>							
$\zeta_p$	Beta	0.50	0.10	$\zeta_w$	Beta	0.50	0.10
$\iota_p$	Beta	0.50	0.15	$\iota_w$	Beta	0.50	0.15
$\epsilon_p$	-	10.00	0.00	$\epsilon_w$	-	10.00	0.00
<i>Other Endogenous Propagation and Steady State Parameters</i>							
$100\gamma$	Normal	0.40	0.10	$S''$	Normal	4.00	1.50
$\alpha$	Normal	0.30	0.05	$\psi$	Beta	0.50	0.15
$100(\beta^{-1} - 1)$	Gamma	0.25	0.10	$\pi_*$	-	0.50	0.00
$\sigma_c$	Normal	1.50	0.37	$\gamma_{gdpdef}$	Normal	1.00	2.00
$h$	Beta	0.70	0.10	$\delta_{gdpdef}$	Normal	0.00	2.00
$\nu_l$	Normal	2.00	0.75	$\bar{L}$	Normal	-45.00	5.00
$\delta$	-	0.03	0.00	$\lambda_w$	-	1.50	0.00
$\Phi_p$	Normal	1.25	0.12	$g_*$	-	0.18	0.00
<i>Financial Frictions Parameters</i>							
$F(\bar{\omega})$	-	0.03	0.00	$\zeta_{sp,b}$	Beta	0.05	0.00
$SP_*$	Gamma	2.00	0.10	$\gamma_*$	-	0.99	0.00
<i>Exogenous Process Parameters</i>							
$\rho_g$	Beta	0.50	0.20	$\sigma_g$	InvG	0.10	2.00
$\rho_b$	Beta	0.50	0.20	$\sigma_b$	InvG	0.10	2.00
$\rho_\mu$	Beta	0.50	0.20	$\sigma_\mu$	InvG	0.10	2.00
$\rho_z$	Beta	0.50	0.20	$\sigma_z$	InvG	0.10	2.00
$\rho_{\sigma_\omega}$	Beta	0.75	0.15	$\sigma_{\sigma_\omega}$	InvG	0.05	4.00
$\rho_{\pi_*}$	-	0.99	0.00	$\sigma_{\pi_*}$	InvG	0.03	6.00
$\rho_{z^p}$	Beta	0.50	0.20	$\sigma_{z^p}$	InvG	0.10	2.00
$\rho_{\lambda_f}$	Beta	0.50	0.20	$\sigma_{\lambda_f}$	InvG	0.10	2.00
$\rho_{\lambda_w}$	Beta	0.50	0.20	$\sigma_{\lambda_w}$	InvG	0.10	2.00
$\eta_{\lambda_f}$	Beta	0.50	0.20	$\eta_{gz}$	Beta	0.50	0.20
$\eta_{\lambda_w}$	Beta	0.50	0.20				
<i>Measurement Error Parameters</i>							
$\mathcal{C}_{me}$	-	1.00	0.00	$\varrho_{gdp}$	Normal	0.00	0.40
$\rho_{gdp}$	Normal	0.00	0.20	$\sigma_{gdp}$	InvG	0.10	2.00
$\rho_{gdi}$	Normal	0.00	0.20	$\sigma_{gdi}$	InvG	0.10	2.00

Note: For Inverse Gamma prior mean and SD,  $\tau$  and  $\nu$  reported.  
 $\sigma_{ant1}$  through  $\sigma_{ant12}$  all have the same distribution.

Table 1: Priors

	Dist	Mean	Std Dev		Dist	Mean	Std Dev
$\rho_{10y}$	Beta	0.50	0.20	$\sigma_{10y}$	InvG	0.75	2.00
$\rho_{tfp}$	Beta	0.50	0.20	$\sigma_{tfp}$	InvG	0.10	2.00
$\rho_{gdpdef}$	Beta	0.50	0.20	$\sigma_{gdpdef}$	InvG	0.10	2.00
$\rho_{pce}$	Beta	0.50	0.20	$\sigma_{pce}$	InvG	0.10	2.00

Note: For Inverse Gamma prior mean and SD,  $\tau$  and  $\nu$  reported.