HOW COMPLICATED DOES THE MODEL HAVE TO BE?
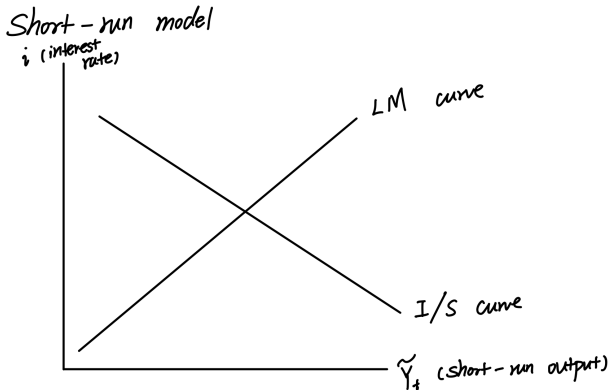
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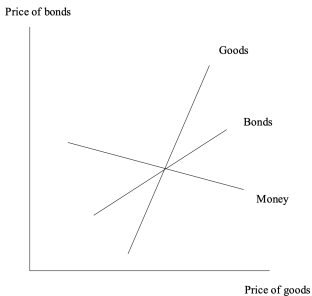## WHAT IS THE MAIN QUESTION ADDRESSED BY THIS PAPER?

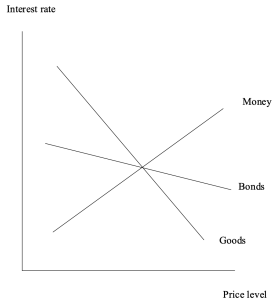- Should the ad hoc, simple model be driven out of the circulation?

ARGUMENT ON THE PERSISTENT AND COMPELLING FEATURES OF THE OLD-FASHIONED MODEL

- Revisiting the model (how it was formed)

Figure 2

Figure 3

DO WE REALLY KNOW IF THE MICRO-FOUNDED MODEL GENERATED MORE RELIABLE RESULTS THAN THE AD-HOC SIMPLE MODEL?

- Micro-foundations beneath Aggregate Supply
  - The Natural-rate Hypothesis: prices would be flexible in the long run, and the persistent inflation would get built into expectations.
  - The Lucas Project: "rational confusion": people cannot immediately distinguish between changes in their wage or price relative to others (both how to respond economy changes by changing the supply and how the overall price level changes)
  - The Great Schism: RBC (money neutrality); New Keynesian (non-neutrality)
- Where are we now? Ended up with something is almost as *ad hoc* as the original assumption of sticky prices

DO WE REALLY KNOW IF THE MICRO-FOUNDED MODEL GENERATED MORE RELIABLE RESULTS THAN THE AD-HOC SIMPLE MODEL?

- Micro-foundations beneath Aggregate Demand
  - The Keynesian consumption function: marginal propensity to consume substantially less than the average propensity
  - Rational Behaviour (permanent income/life cycle hypothesis): quasi-static framework dose not fit in dynamic, forward looking problem (should abandon ad-hoc consumption functions and base everything on intertemporal maximization)
  - "Random walk": predictable changes in income should not lead changes in consumption as the expectation should already be incorporated in the current level of consumption
- Intertemporal approach to aggregate demand did not offer a better predictive power

IN DEFENCE OF LITTLE MODELS

- Small, *ad-hoc* models
  - Easy to use
  - Provides qualitative clarification on the real issues
- To conclude, bigger, more micro-founded models have not lived up to their promise. We have not got the right model yet, small, *ad-hoc* models are still useful.