**NK\_GLSV07**

Gali et al. (2007) extend the standard New Keynesian model to allow for the presence of rule-of-thumb

consumers for which consumption equals labor income . This enables them to generate an increase in consumption in response to a rise in government spending, in a way consistent with much of the recent evidence. Rule-of-thumb consumers partly insulate aggregate demand from the negative wealth effects generated by the higher levels of (current and future) taxes needed to finance the fiscal expansion, while making it more sensitive to current disposable income.

• Aggregate demand: Households gain utility from consumption and leisure subject to appropriate budget constraints. A fraction 1 − λ of households have access to capital markets where they can trade a full set of contingent securities, and buy and sell physical capital (Ricardian households). The remaining fraction λ of households do not own any assets nor have any liabilities, and just consume their current labor income (rule-of-thumb households). Additionally, two alternative labor market structures are considered in the paper. The first one assumes a competitive labor market, with each household choosing the quantity of hours supplied given the market wage. Under the second labor market structure wages are set in a centralized manner by an economy-wide union. In that case hours are assumed to be determined by firms (instead of being chosen optimally by households), given the wage set by the union.

• Aggregate supply: Intermediate firms act under monopolistic competition and set nominal prices in a staggered fashion a la Calvo (1983). Their products are used as inputs by firms which produce final goods. Perfectly competitive final-good firms produce with a constant returns technology.

• Shocks: This paper presents responses to a government spending shock.

• Calibration/Estimation: The model is calibrated at quarterly frequency.