

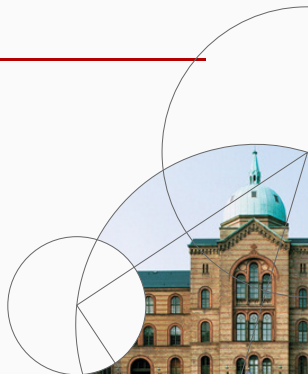


# BabyMAKRO

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- **MAKRO:** New model developed by *DREAM* and now in use by the *Danish Finance Ministry*.
  1. Framework for business cycle forecasts
  2. Medium and long-run projections
  3. Evaluations of potential economic policies and shocks
- Today **BabyMAKRO:** Model in the same style for students to use in *classes and theses* (bachelor + master).
  1. **Foundations:** Me (help from Peter Stephensen + Martin Bonde).
  2. **Alpha-version:** Bachelor thesis students fall 2022.

(Andreas Marius Laursen, Hans Christian Jul Lehmann, Mathias Held Berg, Nicholas Stampe Meier, Olivier Ding, Ufuk Yasin)
  3. **Beta-version:** RAs Anders Buch Jürs and Andreas Marius Laursen.
  4. **Further versions:** More student involvement. *You?*

1. Classes of Macro Models
2. MAKRO
3. BabyMAKRO
4. Solution method
5. Calibration
6. Government spending shock
7. Conclusion

# Classes of Macro Models

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## Reminder: Consumption behavior (chapter 16)

1. Maximize utility s.t. intertemporal budget constraint:

utility:  $u(C_1) + \frac{u(C_2)}{1+\phi}$

budget constraint:  $C_1 + \frac{C_2}{1+r} = V_1 + Y_1^d + \frac{(1+g)Y_1^d}{1+r}$

$\Rightarrow$  derive qualitative (signed) properties of optimal micro-behavior

2. Aggregate consumption function:  $C_1 = C(\underset{+}{Y_1^d}, \underset{+}{g}, \underset{(-)}{r}, \underset{+}{V_1})$
3. Estimate equation on aggregate data
4. Put equation into model

**Note:** Similar for investment (chapter 15).

# Classes of Macro Models

## 1. Old-style Keynesian macro-models (1950s-):

**Structure:** Aggregate equations »similar« to those in micro-theory

**Estimation:** Equation-by-equation on aggregate data

**In teaching:** AS-AD models

**In practice:** ADAM + MONA + SMEC

(»Den økonomiske genopretning 1976-1993«, Jørgen Røstved, 2021)

## 2. Micro-founded macro-models (1970s-):

**Structure:** Exactly the equations in micro-theory (in general equilibrium)

**Estimation:** Calibration vs. moment-matching vs. full-system

**In teaching:** *Dynamic Stochastic General Equilibrium Models* (DSGE)

RBC: Real Business Cycle (1980s-)

RANK: Representative Agent New Keynesian (1990s-)

HANK: Heterogeneous Agent New Keynesian (2010s-)

**In practice:** DREAM + DSGE at Nationalbanken + MAKRO

**Blanchard:** On the Need for (At Least) Five Classes of Macro Models

# MAKRO

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# Structure of small open economy

- **Agents:**
  1. **Unconstrained households** (»Ricardian«): One for each cohort
  2. **Hand-to-mouth households** (»HtM«): One for each cohort
  3. **Firms** (production, price setting, multiple sectors incl. housing)
  4. **Central bank** (fixed exchange-rate)
  5. **Government** (detailed sub-accounts)
  6. **Global foreign economy** (exogenous)
- **Expectations:** Perfect foresight
- **Market clearing:** Walras + sticky prices + search-and-match
- **Mathematically:** *Non-linear equation system*
  1. Behavioral equations in terms of first order conditions
  2. Accounting identities
  3. Market clearing
- **Code:** <https://github.com/DREAM-DK/MAKRO>



# Empirical strategy

1. **Levels:** Weights in production and utility functions.  
(directly observable in data, but changes over time...)
2. **Long-run relationships:** Substitution elasticities.
3. **Short-run dynamics:** Adjustment cost parameters.  
(especially focus on *convergence speed*)

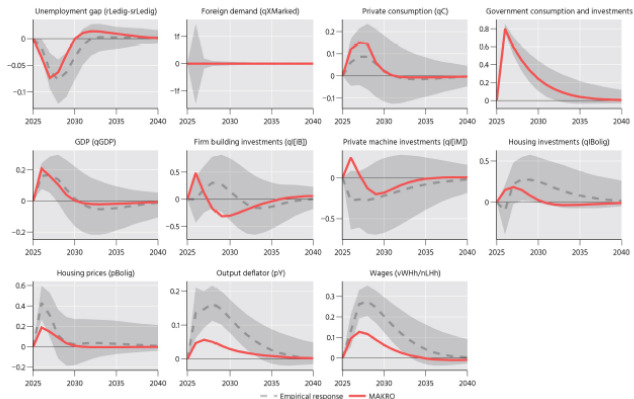
## Documentation:

Matching af impuls responser og øvrige kortsigtsmomenter (2021)

# Impulse-response functions (IRFs)

Figur 1

Stød til offentlige udgifter



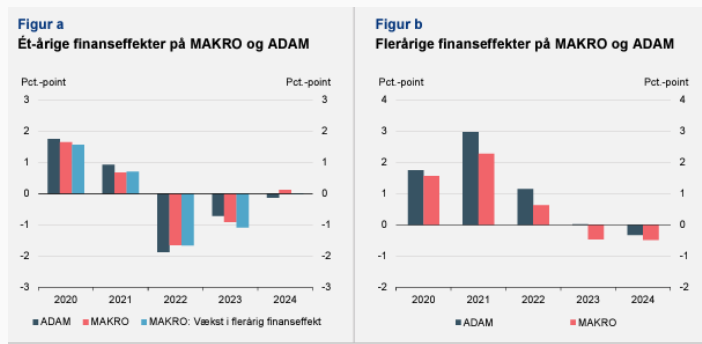
**Also:** Foreign demand, foreign interest rate, labor supply, oil price

Tabel 2

Yderligere relevant empiri til vurdering af MAKROs kortsigtsegenskaber

Analyse/moment	MAKRO og konsensus	Relevant litteratur
MPC ud af midlertidig/kortsigtet indkomst, første år	MAKRO: ca. 0,45 Litteratur: 0,4-0,6	Jørgensen & Kuchler (2017), Crawley & Kuchler (2020), Kreiner et al (2019), ADAM, SMEC
MPC ud af boligprisstigninger/formue, første år	MAKRO: ca. 0,05 Litteratur: 0,03-0,06	Hviid & Kuchler (2017), Andersen & Leth-Petersen (2021)
Fortrængning af tvungen pensionsopsparing for 30-55 årige, år 1 [år 10]	MAKRO: Ca. 0,35-0,55 [0,10-0,35] Litteratur: 0-0,5 [0-0,5]	Arnberg & Barslund (2012), Chetty m.fl. (2014), Andersen, Hansen & Kuchler (2021)
Rentefølsomhed, husholdningers <u>boligværdi</u> (stød til beskatning på aktie- og kapitalindkomst). Gns. 10 års-efekt.	MAKRO: knap -0,1 Litteratur: (-)0,25 – (-)0,18	Gruber, Jensen & Kleven (2021)*
Rentefølsomhed, husholdningers <u>formue</u> (stød til beskatning på aktie- og kapitalindkomst). 8-års effekt. [Langsigtet elasticitet]	MAKRO: ca. 0,2 [0,5] Litteratur: 0,2 – 0,4 [0,5 - 1]	Jakobsen, Jakobsen, Kleven & Zucman (2020)**

»Finanseffekt«: Is fiscal policy expansive or contractive wrt. GDP?



Kilde: Økonomisk Redegørelse, Marts 2023

**BabyMAKRO**

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# Small open economy in discrete time (annual freq., $t$ )

- **Demographics:** Overlapping generations (age,  $a$ )
- **Households:** Hands-to-mouth ( $\lambda$ ) and unconstrained  $(1 - \lambda)$  wrt. consumption-saving + supply labor exogenously
- **Foreign economy:** Fixed nominal rate of return + import goods at fixed prices + demand curve for the domestic export good.
- **Production:**
  1. *Production firms* rent *capital* + *labor* to produce the domestic output good.
  2. *Repacking firms* combine imported goods with the domestic output good to produce a consumption good, an investment good, and an export good.
  3. Capital is rented from a *capital agency*, which purchases the investment good to accumulate capital subject to adjustment costs.
  4. Labor is rented from a *labor agency*, which post vacancies a search-and-match labor market to purchase labor from the households.
- **Price of domestic output good:** Price adjustment costs.
- **Wage:** Ad hoc bargaining.
- **Central bank + government:** Fixed exchange rate + taxation.

- **Nominal interest rate:**  $r_t^{hh}$
- **Armington demand of the domestic exported good:**

$$X_t = \gamma^X X_{t-1} + (1 - \gamma^X) \chi_t \left( \frac{P_t^X}{P_t^F} \right)^{-\sigma^F}.$$

- **Import goods:**  $\bullet_t^M$  at prices  $P_t^\bullet$  for  $\bullet \in \{C, G, I, X\}$

# Demographic structure and population

- **Life-span:**  $\#$ , hereof working  $\#_{\text{work}}$
- **Number of households:**  $N_a$
- **Mortality rate:**  $\zeta_a$  (controlled by  $\zeta$ )

$$N_a = \begin{cases} 1 & \text{if } a = 0 \\ (1 - \zeta_{a-1})N_{a-1} & \text{if } a > 0 \end{cases}$$

$$\zeta_a = \begin{cases} 0 & \text{if } a < \#_{\text{work}} \\ \left( \frac{a+1-\#_{\text{work}}}{\#-\#_{\text{work}}} \right)^\zeta & \text{if } a < \# - 1 \\ 1 & \text{if } a = \# - 1 \end{cases}$$

$$N = \sum_{a=0}^{\#-1} N_a$$

$$N_{\text{work}} = \sum_{a=0}^{\#-1} 1_{\{a \geq \#_{\text{work}}\}} N_a.$$



- **Employed and unemployed:**  $L_{a,t}$  and  $U_{a,t} = N_a - L_{a,t}$
- **Job-separation and finding rate:**  $\delta_a^L$  and  $m_t^s$
- **Searchers** (everybody search = exogenous labor supply):

$$S_{a,t} = \begin{cases} 1 & \text{if } a = 0 \\ (1 - \zeta_{a-1}) [U_{a-1,t-1} + \delta_a^L L_{a-1,t-1}] & \text{if } a < \#_{\text{work}} \\ 0 & \text{if } a \geq \#_{\text{work}}. \end{cases}$$

- **Employed** (before and after matching):

$$\underline{L}_{a,t} = \begin{cases} 0 & \text{if } a = 0 \\ (1 - \zeta_{a-1})(1 - \delta_a^L)L_{a-1,t-1} & \text{if } a < \#_{\text{work}} \\ 0 & \text{if } a \geq \#_{\text{work}} \end{cases}$$

$$L_{a,t} = \underline{L}_{a,t} + m_t^s S_{a,t}.$$

# Search-and-matching

- **Vacancies:**  $v_t$
- **Searchers:**  $S_t = \sum_{a=0}^{\#-1} S_{a,t}$
- **Matches** by *matching function*:

$$\mathcal{M}_t = \frac{S_t v_t}{\left( S_t^{\frac{1}{\sigma^m}} + v_t^{\frac{1}{\sigma^m}} \right)^{\sigma^m}}.$$

- **Job-filling rate:**  $m_t^v = \frac{\mathcal{M}_t}{v_t}$
- **Job-finding rate:**  $m_t^s = \frac{\mathcal{M}_t}{S_t}.$

- **Unmodeled wage bargaining mechanism** give

$$W_t = W_{ss} \left( \frac{L_t}{L_{ss}} \right)^{\epsilon_w},$$

where the wage is increasing in the labor demand for  $\epsilon_w > 0$ .

- **Note:** Theoretically there is a bargaining set

1. Upper limit: Firm will fire worker
2. Lower limit: Household will leave firm

Often: Nash-bargaining = »surplus split from bargaining power«

1. **Post-tax labor income:**  $(1 - \tau_t) W_t \frac{L_{a,t}}{N_a}$
  2. **Post-tax unemployment benefits:**  $(1 - \tau_t) W^U W_{ss} \frac{U_{a,t}}{N_a}$
  3. **Post-tax retirement benefits:**  $(1 - \tau_t) W^R W_{ss} \frac{N_a - (L_{a,t} + U_{a,t})}{N_a}$
  4. **Equally divided inheritance:**  $\frac{A_t^q}{N}$
- The age specific income is

$$\begin{aligned} \text{inc}_{a,t} = & (1 - \tau_t) W_t \frac{L_{a,t}}{N_a} + (1 - \tau_t) W^U W_{ss} \frac{U_{a,t}}{N_a} \\ & + (1 - \tau_t) W^R W_{ss} 1_{\{a \geq \#_{\text{work}}\}} + \frac{A_t^q}{N}. \end{aligned}$$

# Hand-to-mouth households (HtM)

- **Consume all income:**

$$C_{a,t}^{\text{HtM}} = \frac{\text{inc}_{a,t}}{P_t^C}.$$

where the price of consumption goods is  $P_t^C$ .

- **No savings:**

$$A_{a,t}^{\text{HtM}} = 0.$$

# Unconstrained household (Ricardian) I

- **Utility from consumption:**

$$\frac{(C_{a,t}^R)^{1-\sigma}}{1-\sigma}, \quad \sigma > 0, \sigma \neq 1.$$

- **Utility from bequest:**

$$\zeta_a \mu^{A^q} \frac{\left( \frac{A_{a,t}^R}{P_t^C} \right)^{1-\sigma}}{1-\sigma}, \quad \mu^{A^q} > 0.$$

- **Discounting of future utility:**

$$\beta(1 - \zeta_a), \quad \beta > 0.$$

- **Budget constraint:**

$$A_{-1,t}^R = 0$$

$$A_{a,t}^R = (1 + r_t^{hh}) A_{a-1,t-1}^R + \text{inc}_{a,t} - P_t^C C_{a,t}^R.$$

# Unconstrained household (Ricardian) II

- **Cohort:**  $t_0$  (time of first decision)
- **Full problem**

$$V_{t_0} = \max_{\{C_{a,t}^R\}_{a=0}^{\#-1}} \sum_{a=0}^{\#-1} (\prod_{j=1}^a \beta (1 - \zeta_{j-1})) \left[ \frac{(C_{a,t}^R)^{1-\sigma}}{1-\sigma} + \zeta_a \mu^{A^q} \frac{\left( \frac{A_{a,t}^R}{P_t^C} \right)^{1-\sigma}}{1-\sigma} \right]$$

s.t.

$$t = t_0 + a$$

$$A_{-1,t}^R = 0$$

$$A_{a,t}^R = (1 + r_t^{hh}) A_{a-1,t-1}^R + \text{inc}_{a,t} - P_t^C C_{a,t}^R.$$

# Unconstrained household (Ricardian) III

- First order conditions:

$$C_{a,t}^R = \begin{cases} \left( \zeta_a \mu^{A^q} \left( \frac{A_{\#-1,t}^R}{P_t^C} \right)^{-\sigma} \right)^{-\frac{1}{\sigma}} & \text{if } a = \# - 1 \\ \left( \beta(1 - \zeta_a)^{\frac{1+r_{ss}^{hh}}{1+\pi_{ss}^{hh}}} (C_{a+1,ss}^R)^{-\sigma} + \zeta_a \mu^{A^q} \left( \frac{A_{a,ss}^R}{P_{ss}^C} \right)^{-\sigma} \right)^{-\frac{1}{\sigma}} & \text{elif } t = T - 1 \\ \left( \beta(1 - \zeta_a)^{\frac{1+r_{t+1}^{hh}}{1+\pi_{t+1}^{hh}}} (C_{a+1,t+1}^R)^{-\sigma} + \zeta_a \mu^{A^q} \left( \frac{A_{a,t}^R}{P_t^C} \right)^{-\sigma} \right)^{-\frac{1}{\sigma}} & \text{else} \end{cases}$$



- **Age:**

$$C_{a,t} = \lambda C_{a,t}^{\text{HtM}} + (1 - \lambda) C_{a,t}^R$$
$$A_{a,t} = \lambda A_{a,t}^{\text{HtM}} + (1 - \lambda) A_{a,t}^R,$$

- **Total:**

$$C_t = \sum_{a=0}^{\#-1} N_a C_{a,t}$$
$$A_t = \sum_{a=0}^{\#-1} N_a A_{a,t}.$$

- **Bequests:**

$$A_t^q = (1 + r^{hh}) \sum_{a=0}^{\#-1} \zeta_a N_a A_{a,t}.$$

# Production firms I

- **Capital:**  $K_{t-1}$ , at rental price  $r_t^K$
- **Labor:**  $\ell_t$ , at rental price  $r_t^\ell$
- **Output:**  $Y_t$ , with a CES technology, sold at  $P_t^{Y,0}$
- **Profit maximization** with prices taken as given

$$\Pi_t = \max_{K_{t-1}, \ell_t} P_t^{Y,0} Y_t - r_t^K K_{t-1} - r_t^\ell \ell_t$$

s.t.

$$Y_t = \Gamma \left( (\mu^K)^{\frac{1}{\sigma^Y}} K_{t-1}^{\frac{\sigma^Y-1}{\sigma^Y}} + (1 - \mu^K)^{\frac{1}{\sigma^Y}} \ell_t^{\frac{\sigma^Y-1}{\sigma^Y}} \right)^{\frac{\sigma^Y}{\sigma^Y-1}},$$

where  $\mu^K, \sigma^Y, \Gamma > 0$ ,  $\sigma^Y \neq 1$ .

- Free entry implies zero profit:

$$P_t^{Y,0} = \frac{1}{\Gamma} \left( \mu^K (r_t^K)^{1-\sigma^Y} + (1 - \mu^K) (r_t^\ell)^{1-\sigma^Y} \right)^{\frac{1}{1-\sigma^Y}}.$$

- First order condition for capital-labor ratio:

$$\frac{K_{t-1}}{\ell_t} = \frac{\mu_K}{1 - \mu_K} \left( \frac{r_t^\ell}{r_t^K} \right)^{\sigma^Y}$$

- **Investment good:**  $I_t$ , at price,  $P_t^I$ .
- **Capital:**  $K_t$ , rented out at rental rate  $r_{t+1}^K$  in the following period.
- **Adjustment costs:** Effective investment is  $\iota_t = I_t - \Psi(\iota_t, K_{t-1})$ .
- **Required internal rate of return:**  $r^{\text{firm}}$ .
- **Profit maximization:**

$$V_0^{\text{capital}}(K_{t-1}) = \max_{\{K_t\}} \sum_{t=0}^{\infty} (1 + r^{\text{firm}})^{-t} [r_t^K K_{t-1} - P_t^I (\iota_t + \Psi(\iota_t, K_{t-1}))]$$

s.t.

$$I_t = \iota_t + \Psi(\iota_t, K_{t-1})$$

$$K_t = (1 - \delta^K) K_{t-1} + \iota_t.$$

- **Functional form:**

$$\Psi(\iota_t, K_{t-1}) = \frac{\Psi_0}{2} \left( \frac{\iota_t}{K_{t-1}} - \delta^K \right)^2 K_{t-1}.$$

- **First order condition:**

$$0 = -P_t^I (1 + \Psi_\iota(\iota_t, K_{t-1})) + \frac{r_{t+1}^k + P_{t+1}^I (1 - \delta^K) (1 + \Psi_\iota(\iota_{t+1}, K_t)) - P_{t+1}^I \Psi_K(\iota_{t+1}, K_t)}{1 + r^{\text{firm}}}$$

- **Post vacancies:**  $v_t$  at cost  $\kappa^L$  (in units of labor).
- **Labor:** Hires  $L_t$  and rent out labor at rental price  $r_t^\ell$
- **Exogenous match destruction:**  $\delta_t^L$  (implied by  $\delta_{a,t}^L$  and  $L_{a,t-1}$ )
- **Exogenous wage:**  $W_t$
- **Profit maximization:**

$$V_0^{\text{labor}}(L_{t-1}) = \max_{\{v_t\}} \sum_{t=0}^{\infty} (1 + r^{\text{firm}})^{-t} [r_t^\ell \ell_t - W_t L_t]$$

s.t.

$$L_t = m_t^v v_t + (1 - \delta_t^L) L_{t-1}$$

$$\ell_t = L_t - \kappa^L v_t.$$

- First order condition:

$$r_t^\ell = \frac{1}{1 - \frac{\kappa^L}{m_t^v}} \left[ W_t - r_{t+1}^\ell \frac{1 - \delta_{t+1}^L}{1 + r^{\text{firm}}} \frac{\kappa^L}{m_{t+1}^v} \right]$$

- **Input price:**  $P_t^{Y,0}$
- **Output of differentiated goods:**  $y_t$  at  $p_t^Y$
- **Demand schedule:**  $y_t = \left(\frac{p_t^Y}{P_t^Y}\right)^{-\sigma_D} Y_t$
- **Aggregate:**  $Y_t$  with price index  $P_t^Y$
- **Profit maximization:**

$$V_t^{\text{intermediary}} = \max_{\{p_t^Y\}} \left( p_t^Y - P_t^{Y,0} \right) y_t - \vartheta_t + \frac{1}{1 + r^{\text{firm}}} V_{t+1}^{\text{intermediary}}$$

s.t.

$$\vartheta_t = \frac{\gamma}{2} \left[ \frac{p_t^Y / p_{t-1}^Y}{p_{t-1}^Y / p_{t-2}^Y} - 1 \right]^2 P_t^Y Y_t$$

$$y_t = \left( \frac{p_t^Y}{P_t^Y} \right)^{-\sigma_D} Y_t.$$



- **Assumption:** Symmetric firms
- **First order condition** (New Keynesian Phillips Curve):

$$P_t^Y = (1 + \theta)P_t^{Y,0} - \eta \left( \frac{P_t^Y / P_{t-1}^Y}{P_{t-1}^Y / P_{t-2}^Y} - 1 \right) \frac{P_t^Y / P_{t-1}^Y}{P_{t-1}^Y / P_{t-2}^Y} P_t^Y \\ + \frac{2\eta}{1 + r^{\text{firm}}} \frac{Y_{t+1}}{Y_t} \left( \frac{P_{t+1}^Y / P_t^Y}{P_t^Y / P_{t-1}^Y} - 1 \right) \frac{P_{t+1}^Y / P_t^Y}{P_t^Y / P_{t-1}^Y} P_{t+1}^Y$$

$$\theta \equiv \frac{1}{\sigma_D - 1}$$

$$\eta \equiv \theta\gamma.$$

# Repacking firms

- **Output goods:**  $\bullet_t^Y$  at prices  $P_t^\bullet$  for  $\bullet \in \{C, G, I, X\}$
- **Domestic input good:**  $Y_t$  at price  $P_t^Y$
- **Foreign input goods:**  $\bullet_t^M$  at prices  $P_t^\bullet$  for  $\bullet \in \{C, G, I, X\}$
- **Profit maximization with CES** production technology implies

$$P_t^\bullet = \left( \mu^{M,\bullet} \left( P_t^{M,\bullet} \right)^{1-\sigma^\bullet} + (1 - \mu^{M,\bullet}) \left( P_t^Y \right)^{1-\sigma^\bullet} \right)^{\frac{1}{1-\sigma^\bullet}}$$

$$\bullet_t^M = \mu^{M,\bullet} \left( \frac{P_t^\bullet}{P_t^{M,\bullet}} \right)^{\sigma^\bullet} \bullet_t$$

$$\bullet_t^Y = (1 - \mu^{M,\bullet}) \left( \frac{P_t^\bullet}{P_t^Y} \right)^{\sigma^\bullet} \bullet_t,$$

for  $\bullet \in \{C, G, I, X\}$

- Interest rate:  $r^B$
- Government consumption:  $G_t$
- Unemployment insurance expenses:  $E_t^U = W_U W_{ss} U_t$
- Retirement benefits expenses:  $E^R = W_R W_{ss} (N - N_{\text{work}})$
- Tax base:  $T_t = W_t L_t + E_t^U + E^R$
- Budget constraint:

$$B_t = (1 + r^B) B_{t-1} + P_t^G G_t + E_t^U + E^R - \tau_t T_t.$$

- Tax policy:

$$\tau_t = \tau_{ss} + \varepsilon_B \frac{\tilde{B}_t - B_{ss}}{T_t},$$

$$\tilde{B}_t = (1 + r^B) B_{t-1} + P_t^G G_t + E_t^U + E^R - \tau_{ss} T_t.$$

## 1. Demand for domestically produced goods:

$$Y_t = \sum_{\bullet \in \{C, G, I, X\}} \bullet_t^Y.$$

## 2. Imports add up:

$$M_t = \sum_{\bullet \in \{C, G, I, X\}} \bullet_t^M.$$

*Not necessary to specify*

*Not specified yet*

## **Solution method**

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# Targets and unknowns

- **Goal:** Find the *equilibrium path* in the economy.
- **Equilibrium path:** A set of paths for all variables where
  1. Optimal firm and household behavior in terms of FOCs.
  2. Accounting identities.
  3. Market clearing.
- **Target equations:** Must *be zero on the equilibrium path*.
- **Unknown variables:**
  1. Chosen by model-builder.
  2. All other variables must be derived from these.
  3. Target equations can be evaluated.
- **Order series of *blocks*:**

**Inputs:** Unknown and exogenous variables or outputs of previous blocks

**Outputs:** Variables and errors in target equations
- **Truncation:** Assume back in steady state after  $T$  periods.

# Exogenous variables

1.  $\Gamma_t$ , technology
2.  $G_t$ , public spending
3.  $\chi_t$ , *foreign* demand shifter («market size»)
4.  $P_t^{M,C}$ , import price of *private* consumption good
5.  $P_t^{M,G}$ , import price of *public* consumption good
6.  $P_t^{M,I}$ , import price of *investment* good
7.  $P_t^{M,X}$ , import price of *export* good
8.  $P_t^F$ , *foreign* price level
9.  $r_t^{hh}$ , *foreign* interest rate



# Unknowns in practice

1.  $A_t^q$ , inheritance flow ( $T$  unknowns)
2.  $A_t^{\text{death}}$ , wealth of households at  $a = \# - 1$  ( $T$  unknowns)
3.  $K_t$ , capital ( $T$  unknowns)
4.  $L_t$ , labor supply ( $T$  unknowns)
5.  $r_t^K$ , rental price for capital ( $T$  unknowns)
6.  $P_t^Y$ , price of domestic output ( $T$  unknowns)

$\Rightarrow$  *all other variables in model can be derived and target equations can be evaluated (see code)*

- **Solve with Newton's method:**

1.  $x$  is a  $6 \times T$  vector containing all 6 unknown in all  $T$  periods.
2.  $f$  is a  $6 \times T$  vector containing all 6 target in all  $T$  periods.
3.  $\mathcal{J}$  is the Jacobian of  $f$  (the derivative of  $f$ ) eval. in steady state.

Compute next guess,  $x_{n+1}$ , as

$$x_{n+1} = x_n - \frac{f(x_n)}{\mathcal{J}_n}.$$

Initial guess: Steady state

Converges to solution,  $f(x^*) = 0$ , as  $n$  grows.

- **Implementation:** In Python
- **Course:** [Introduction to Programming and Numerical Analysis](#)

# Calibration

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- **Goals:**

1. National account shares and ratios.
2. Unemployment level and labor market flows.
3. Life-cycle profiles of income, consumption and savings.

**Simplify:** Zero inflation, zero growth and constant demography.

- **Notebooks:**

- 0 - steady state - aggregate.ipynb
- 0 - steady state - households.ipynb

- **Status:** *Very ad hoc still.*

- **Substitution elasticities:** Use those from MAKRO
- **Impulse-responses:** Match to data independently
- **Status:** *Not done → today example of government spending shock*

## **Government spending shock**

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- **An *impulse response*:**

1. The economy starts at steady state.
2. Some exogenous variables *temporarily* deviate from steady state.
3. The impulse responses: How variables respond to the shock.

- **Shock to government spending,  $G_t$ :**

$$G_t = G_{ss} + shock_t$$

$$shock_t = \begin{cases} G_{ss} \cdot size \cdot persistence^{t-T_{start}} & \text{if } T_{start} \leq t < T_{end} \\ 0 & \text{else} \end{cases}$$

*size* = 1.01: Initial deviation from steady state at 1 pct.

shock starts in  $T_{start} = 0$  and ends in  $T_{end} = 50$ .

*persistence* = 0.8 (shock fades as  $t$  grows)

- **Repacking firms:** Demand for domestically produced goods  $Y \uparrow$  and imported goods  $M \uparrow$ .
- **Production firms:** Increases inputs to increase production  $Y \uparrow$ .  
Capital  $K \uparrow$  (limited by adjustment costs) and labor  $\ell \uparrow$ .
- **Households:** More income, greater consumption  $C \uparrow$ .  
Real wage  $W \uparrow$  due to increased labor demand.  
Hand-to-mouth  $C^{HtM} \uparrow$ : Increase proportional to increase in  $W$ .  
Ricardian  $C^R \downarrow$ : Due to consumption smoothing.
- **Prices:** Higher input prices causes higher prices  $P \uparrow$ :  
 $W \uparrow$  and  $r^K \uparrow$  drives up marginal costs  $P^{Y,0} \uparrow$ .  
Output prices  $P^Y \uparrow$  (limited by adjustment costs).  
Causes higher repacking prices  $P^\bullet \uparrow$  for  $\bullet \in \{C, I, G, X\}$ .
- **Foreign economy:** Exports  $X \downarrow$  due to increasing prices  $P^X \uparrow$ .



- **Labor agency:** Employment  $L \uparrow$  and rents  $\ell \uparrow$  to production firms.  
Job vacancies  $v \uparrow$  to meet higher labor demand.  
Number of matches  $\mathcal{M} \uparrow$ , »gross« labor  $L \uparrow$ .  
Labor  $\ell \uparrow$  (limited by adjustment costs).
- **Capital agency:** Investments  $I \uparrow$  to accumulate capital  $K \uparrow$ .  
Expensive investments:  $P^I \uparrow$   
Greater return:  $r^K \uparrow$

- **Government:**

Government spending  $G \downarrow$  by assumption.

Tax rate  $\tau \uparrow$  to finance growing government debt  $B \uparrow$ .

- **Repacking firms:**

Demand for domestic goods  $Y \downarrow$  and imports  $M \downarrow$ .

Prices  $P \downarrow$ .

- **Production firms:**

Drop in production inputs, labor  $\ell \downarrow$  and capital  $K \downarrow$ .

- **Households:**

$\ell \downarrow$  causes wages  $W \downarrow$ .

Higher taxes from  $\tau \uparrow$ .

Leads to less disposable income and thus  $C \downarrow$ .

- **Foreign economy:**

Exports  $X \uparrow$  due to falling prices  $P^X \downarrow$ .

# Conclusion

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- **Your takeaways:**

1. How a micro-founded macro-model is structured
2. Despite their complexity you can (soon) work with such models
3. Requires both analytical and numerical skills to master

- **Open source:** [github.com/JeppeDrue Dahl/BabyMAKRO](https://github.com/JeppeDrue Dahl/BabyMAKRO)

*Will you participate in improving it?*

- **Related courses:**

Macro III

[Introduction to Programming and Numerical Analysis](#)

[Advanced Macroeconomics: Heterogenous Agent Models](#)

# Tasks

1. Clarify steady state calibration.
2. Perform impulse-response matching.
3. Improve detailed accounting of main shocks.
4. Add technology growth, population growth, and trend inflation.
5. Add financial flows accounts wrt. to the foreign economy.
6. Add more government with taxes and spending.
7. Add endogenous labor supply.
8. Add multiple sector and input-output structure.
9. Make the model quarterly.