Lecture 6
Solving Models with Idiosyncratic and Aggregate Risks

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Projection-Perturbation Approach

1. Provide a finite representation of the economy

   – Polynomial interpolations of value functions / Euler equations, and policy functions (lec 3)

   – Finite approximate the distribution (lec 5)

2. Compute the deterministic steady state of the economy. This step yields a finite representation of the steady-state value functions, the steady-state policy functions, and the invariant distribution. (lec 3-4)

3. Compute a first-order perturbation of all these variables around the steady state. (lec 6)