Macroeconomics After Lucas[*]

Thomas J. Sargent[†]

June 3, 2024

Abstract

This sequel to Lucas and Sargent (1978) tells how equilibrium Markov processes underlie macroeconomics and much of applied dynamic economics today. It recalls how Robert E. Lucas, Jr. saw Keynesian and rational expectations revolutions as interconnected transformations of economic and econometric theories and quantitative practices. It describes rules that Lucas used to guide and constrain his research. Lucas restricted himself to equilibrium Markov processes. He respected and conserved quantitative successes achieved by previous researchers, including those attained by quantitative Keynesian macroeconometric modelers.

Keywords: simultaneous equations, rational expectations, cross-equation restrictions, Markov processes, dynamic programming, causality, direct problem, inverse problem.

1 Introduction

For more than a decade, economists had mostly ignored two papers (Muth (1960, 1961)) that showed how to use optimal linear prediction theory to model economic agents' beliefs about the future within coherent probabilistic settings. In the early 1970s, Robert E. Lucas, Jr. used Muth's ideas to make the artificial people who live inside the dynamic simultaneous equations econometric models of Koopmans (1950), Hood and Koopmans (1953), Marschak (1950), and Hurwicz (1966) solve well-posed intertemporal optimization problems. Lucas resolved pressing theoretical issues, reduced dimensions of parameter spaces, and created a research program that has been pursued fruitfully in macroeconomics, industrial organization, public finance, labor economics, and other applied fields. I have published accounts of how Lucas accomplished that.[1] Here I expand the legacy list with which I concluded Sargent (1996, Sec. 6).

Section 2 describes how Lucas acquired tools and prejudices. Section 3 describes rules that constrained and guided Lucas's research. Section 4 describes how Lucas interpreted the Keynesian revolution and how he started another revolution by formulating equilibrium Markov processes. Section 5 recalls what Lucas meant by "rational expectations" and how other uses of that phrase annoyed him. Section 6 explains how economists who want to advise monetary and fiscal policy makers think about causality, and also how the artificial people who live inside an equilibrium Markov process think about it. Section 7 lists examples of equilibrium Markov processes. Section 8 describes how planners who choose among alternative equilibrium Markov processes assume a communism of statistical models. Section 9 describes how equilibrium Markov processes are accompanied by non-linear impulse response functions, many uses of which Lucas found uninteresting. Section 10 describes the "rational expectations econometrics" implied by the likelihood function induced by an equilibrium Markov process. Section 11 describes connections between techniques for approximating equilibrium Markov processes numerically and limiting behaviors of models in which some of the artificial agents inside a model are statistically learning about objects that agents inside an equilibrium Markov model already know. Section 12 describes how, like Copernicus, Lucas thought that a beautiful simple model that fits less well than a more complicated ugly model is somehow closer to the truth. It also describes how his preference for simplicity along with constraints imposed by his section 3 rules for research limited Lucas's use of rational expectations econometrics. Section 13 illustrates commotions that Lucas's writings provoked by citing his opinions about price rigidities, macro-labor models,

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[1]See Lucas and Sargent (1978), Lucas and Sargent (1981, pp.xi–xl), Manuelli and Sargent (1988), and Sargent (1981, 1982, 1996, 2015, 2022, 2024).

reconciling Phelps islands and Arrow-Debreu complete markets models, ways to implement Ramsey plans, and heterogeneous agent New Keynesian (HANK) models. Section 14 offers concluding remarks about how Lucas responded to economists who didn't like equilibrium Markov processes.

Lucas was an extraordinarily gifted writer, not just compared to other economists. I shall quote Lucas (1987) often.

2   Influences and Actions

Milton Friedman's tools, research questions, and prejudices influenced Lucas. Milton Friedman accomplished much partly because when young he had mastered much of what had then been known about probability theory and statistics. He thought hard about uses and limits of Neyman and Pearson's frequentist approach to testing hypotheses and about parameter identification as exclusion restrictions in system of simultaneous equations. He was cautious about interpreting "causality" in general equilibrium settings. Through his interactions with Harold Hotelling and Abraham Wald, he helped invent sequential likelihood ratio tests for statistical model selection. He created models of decisions makers having both subjective and objective expected utilities. He thought about decision theoretic consequences of misspecified statistical models. He worked on stochastic approximation and learning. He appealed to survival of the fittest to justify what later came to be called rational expectations. In work with Savage, he laid foundations of "machine learning" when he proposed an early version of stochastic approximation to maximize an unknown function by statistical sampling. He foresaw possibilities for spectral analysis of economic time series.

Armed with those techniques, Friedman approached macroeconomics with personal prior probabilities over models, i.e., a set of prejudices, that included an affection for Burns-Mitchell NBER reference-cycle techniques; a present-value-equalization model of professional incomes that he deployed in his PhD thesis and that he eventually published jointly with Simon Kuznets; consumption-smoothing models and associated Euler equations he had learned from reading Irving Fisher; a plan to assemble US data that would let him complete Irving Fisher's statistical verification of the quantity theory of money; the principle that intertemporal government budget balance means that monetary and fiscal policies are either consolidated or coordinated that he acquired from Simons and Mints; and an exponential smoothing statistical model for forecasting, i.e., adaptive expectations.

Constrained by thoe tools and prejudices, Friedman proceeded to interpret Burns-Mitchell business cycle patterns with statistical models whose parameters encode the demand and supply curves of Marshall's "representative agents;" to extend Irving Fisher's "Statistical

Verification" of Quantity Theory of Money by using the accounting framework of Appendix B of Friedman and Schwartz to measure monetary aggregates; to formalize "short-run" versus "long-run" distinctions; to convert "perfect foresight" models into statistical models of vector stochastic processes by using adaptive expectations and imposing long run restrictions; to put micro-foundations underneath Phillips curve; to take randomness and model ambiguity into account in framing monetary and fiscal policies; to acknowledge "long and variable" distributed lags while professing ignorance about their sources; to practice a "neo-classical synthesis" that separates redistribution and social insurance from macroeconomic stabilization; and to express ambiguity about "narrow banking" versus "free banking" in his work on the optimal quantity of money and paying interest on reserves.[2]

Lucas learned the mathematical tools that had empowered Milton Friedman, adopted many of Friedman's prejudices, and worked on many of the same topics. He deepened and altered Friedman's findings. To help him do that, Lucas learned tools that Friedman either hadn't known about or had chosen not to use. These included dynamic programming and optimal control theory; Markov chains and optimal prediction theory; general competitive equilibria and separating hyperplanes (a.k.a. "welfare theorems"); stochastic discount factors; Samuelson's overlapping generations model; the Cass-Koopmans optimal growth model; game theory; Chicago-Yale-Cowles Commission econometric methods for estimating systems of simultaneous linear difference equations that rest on sharp distinctions between structural statistical models, on the one hand, and the reduced forms models whose parameters are functions of the parameters of a particular structural model, on the other hand; the Phelps island model; and a communism of statistical models called the rational expectations hypothesis. Lucas used those tools to remake much of applied economic dynamics. He followed rules.

3 Research Rules

Lucas constrained himself (1) to preserve quantitative successes of earlier theories, (2) to construct equilibrium stochastic processes, and (3) to make a theory and an econometrics fit together. Other scientists and artists had used similar rules.

> ... the constraints that artists and theoretical physicists have to respect, how they make our craft difficult, and how they also make it possible. ... often the most important constraint on a new theory is not that it should survive this or that new experimental test, but that it should agree with the body of past

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[2]Friedman emphasized that it matters how those interest payments were to be financed.

observations, as crystallized in former theories. ... New theories ... must not throw out all the successes of former theories. This sort of thing makes the work of the theorist far more conservative than is often thought. The wonderful thing is that the need to preserve successes of the past is not only a constraint, but also a guide.

Weinberg (2018, ch. 24)

Lucas insisted on preserving past successes that included cross-country and historical evidence about inflation that quantity theory of money fit well; apparent money supply and price level "non-neutralities;" Burns-Mitchell NBER reference cycle characterizations of business cycles; Friedman-Schwartz evidence pointing to monetary shocks as sources of business cycles; good fits to US business cycles of Klein-Goldberger and other Keynesian econometric models; and statistical evidence about stock prices and expectations theories of the term structure of interest rates.[3]

Lucas confined himself to building models that contain artificial people who solve constrained optimization problems; binding those artificial people together with an equilibrium concept that enforces coherence; and mposing rational expectations to economize on free parameters. That meant assuming common joint probability distributions, though not necessarily common information sets.

4   Two Revolutions

Lucas emphasized similarities between Keynesian and Rational Expectations revolutions.

The Keynesian Revolution was, in the form in which it succeeded in the United States, a revolution in method. ... if one does not view the revolution in this way, it is impossible to account for some of its most important features: the evolution of macroeconomics into a quantitative, scientific discipline, the development of explicit statistical descriptions of economic behavior, the increasing reliance of government officials on technical economic expertise, and the introduction of the use of mathematical control theory to manage an economy. It is the fact that Keynesian theory lent itself so readily to the formulation of explicit econometric models which accounts for the dominant scientific position it attained by the

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[3]Aspects of rational expectations and optimal prediction theory were implicit in regression equations that Meiselman (1962) used to implement the expectations theory of the term structure of interest rates. Bob Lucas told me that the term structure was an ideal laboratory for rational expectations. When I first met him in his office at Carnegie Tech in November 1966, Bob was reading a preprint of Wallace (1967).

1960s. As a consequence of this, there is no hope of understanding either the success of the Keynesian Revolution or its eventual failure at the purely verbal level at which Keynes himself wrote. It will be necessary to know something of the way macroeconometric models are constructed and the features they must have in order to "work" as aids in forecasting and policy evaluation.

"After Keynesian Macroeconomics," 1978.

The two revolutions shared objects of interest and purposes. A system of simultaneous stochastic difference equations is shared object of interest.

... economic data are generated by systems of relations that are, in general, stochastic, dynamic, and simultaneous. ... these very relations constitute economic theory and knowledge of them is needed for economic practice. ... Hypotheses about economic structure are also known as economic theories. They try to state relations that describe the behavior and environment of men and determine the values taken at any time by economic variables such as prices, output, and consumption of various goods and services, and the prices and amounts of various assets. As there are several variables the economic structure must involve several simultaneous relations to determine them.

Marschak (1953)

A common purpose was to isolate parameters that are invariant to a set of historically unprecedented possible government policies.[4]

The economist's objectives are similar to those of an engineer but his data are like those of a meterologist. The economist is often required to estimate the effects of a given (intended or expected) change in the "economic structure," i.e., in the very mechanism that produced his data. None of these changes can he produce beforehand, as in a laboratory experiment; and since some of the changes envisaged have never happened before, the economist often has to estimate the results of changes he has never observed. ... The economist can do this if his past observations suffice to estimate the relevant structural constants prevailing before the change. Having estimated the past structure the economist can estimate the effects of varying it. He can thus help to choose those variations of structure that

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[4]Footnote 13 below describes Lucas's opinion about Christopher Sims's opinion about this "utopian" project.

would produce – from a given point of view – the most desirable results. That is, he can advise on policies (of a government or a firm).

Marschak (1953)

The flaw "fatal to the purposes of the empirical study of economic time series" was that Keynesian statistical models weren't equilibrium Markov models, a class of objects that now transcends much of applied dynamic economics.[5]

Definition 4.1. *An equilibrium Markov process has these components: (1) a collection of decision makers, (2) an associated coherent collection of Markov decision problems defined over a common state space, and (3) budget and resource constraints that bind decision makers' MDP's together.*

In equilibrium Markov models, parameters of the dynamic demand and supply curves that Keynesian macroeconometric models assume to be invariant to interventions are themselves functions of some of the parameters that an historically unprecedented policy intervention would alter. Analyzing those interventions requires knowing how parameters of dynamic supply and demand depend on deeper parameters describing preferences, technologies, and timing protocols. An equilibrium Markov model pins down functions that describe those dependencies.

To create equilibrium Markov processes for macroeconomic applications, Lucas used Markov processes, Markov decision problems (MDPs), the max-min separating hyperplane theorem, [6] and rational expectations.[7]

5   Rational expectations

Equilibrium Markov processes assign a rational expectations assumption critical roles in (1) building in coherence, and (2) economizing on free parameters.

The term 'rational expectations', as Muth used it, refers to a consistency axiom for economic models, so it can be given precise meaning only in the context of specific models. I think this is why attempts to define rational expectations in

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[5]Lucas (1987, Sect. I) and Lucas and Sargent (1981, pp.xi–xl) described components and features of this equilibrium concept.

[6]The max-min theorem implies the two fundamental theorems of welfare economics as well as related useful results in implementation theory.

[7]As remarked in section 2, Milton tools Friedman either hadn't known these tools or hadn't used them in ways that Lucas did.

a model-free way tend to come out either vacuous ('People do the best they can with the information they have') or silly ('People know the true structure of the world they live in').

Models of Business Cycles, 1987, p. 13.

What is "wrong" with [adaptive expectations] is not [expressing] forecasts of future variables as distributed lags of current and lagged variables. The future must be forecast on the basis of the past, and it is surely acceptable to simplify things by modeling agents as using linear forecasting rules. (These points are obvious enough, but are so widely misunderstood as to warrant emphasis here.) The difficulty lies not in postulating forecasts which are linear functions of history but rather in introducing the coefficients in these linear functions as so many additional "free parameters," unrestricted by theory. That this practice is unnecessary, and in an important way fatal to the purposes of the empirical study of economic time series, is the message of [Muth (1961).

Lucas and Sargent (1981, pp. xv–xvi)

To economize on parameters, a rational expectations assumption imposes a communism of statistical models that manifests itself both in constructing models and in inferring parameters. Thus, a rational expectations assumption makes all decision makers inside a model share a vector stochastic process with each other and with the theorist who built the model. Decision makers use that stochastic process to form the conditional distributions that appear in Euler equations that restrict their decision rules. Rational expectations econometrics extends the sharing of statistical models to include a "sharing with nature" that is an essential input into making maximum likelihood or the generalized method of moments be a good estimator.

6   Causality

Statements about causality boil down to assertions that some parameters of a statistical model are invariant with respect to a class of possible interventions.[8] Which parameters are

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[8]My recollection of a personal conversation I had with Leo Hurwicz after a 1975 Minneapolis Fed seminar at which Neil Wallace and I presented a preprint of Sargent and Wallace (1976) convinces me that my account here is compatible with Hurwicz (1966). Like Marschak (1953), Hurwicz wanted parameters (states?) that are invariant under policy interventions to be analyzed, parameters that describe agents' preferences, technologies, information sets, market structures, and timing protocols.

invariant depends on the class of interventions under consideration and who is considering those interventions. When a model's author and the people inside it are concerned about different interventions, they disagree about which parameters are invariant. Because it is a coherent collection of Markov Decision problems, an equilibrium Markov model reconciles those distinct ideas about about "causality" – i.e, about parameters that are invariant.

A well posed Markov Decision Problem (MDP) includes a specification of (1) vectors of states and decisions (a.k.a. controls), and (2) a partition of a state space into controllable and uncontrollable subspaces. Each such specification forms a theory of causes and effects. An MDP describes how decisions shape trajectories through a controllable subspace. It does so by fixing parameters in a controlled Markov transition equation that tells the decision maker how future payoffs are affected by alternative feasible choices of controls. The controlled Markov transition law is "causal" in the sense that it is invariant across a set of admissible controls. An MDP also implies a joint probability density over sequences of states in an uncontrollable subspace and an associated theory of optimal prediction.[9]

Thus, an equilibrium Markov process contains as many assumptions about causality – i.e., about invariance of parameters – as there are decision makers. These include the author of the model and the individual agents who live inside it.

Other meanings of "causality"

Other senses of the word "causality" occur in economics, including a concept used by Wiener, Granger, and Sims that is about the structure of joint conditional distributions of a fixed stationary vector stochastic process. The control-theoretic sense of causality that applies to MDPs within an equilibrium Markov model is instead about comparisons across alternative vector stochastic processes indexed by alternative choices of rules for a control vector.[10] The dynamic control theoretic sense of "causality" differs from "causal inferences" drawn from R.A. Fisher hypothesis tests of agricultural fertilizer treatments that assume fixed regressors in repeated samples.

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[9]To bring out links to rational expectations, Lucas and Sargent (1981, pp.xi–xl) use the "certainty equivalence" property of linear quadratic MDP's possess to highlight the theory of optimal prediction that MDP's provide.

[10]Lucas and Sargent (1981, pp. 405-452) offer an example from Germany during the early 1920s in which inflation Granger caused money growth according to the joint probability distribution that emerged from an equilibrium Markov model. But that joint distribution was not invariant to monetary-fiscal policy interventions that altered the money growth process.

7   Examples of Equilibrium Markov Processes

Equilibrium Markov processes pervade modern applied dynamic economics. They include representative agent recursive competitive equilibria with their "Big K, little k" distinctions; Markov perfect equilibria; Ramsey (a.k.a. Stackelberg) equilibria in which the leader's problem is a to "dynamic programming squared" problem with state variables that include followers' continuation values; models of credible public policies like ones studied by Stokey (1989, 1991); Atkeson-Lucas models of redistribution dynamics in which the state includes joint cross section distribution of continuation values and a Markov operator $T_{\#}$ that maps a cross section at t into a cross section at $t+1$; Kantorovich optimal transportation models; Hopenhayn models of firm dynamics; mean field games in which states include cross section distributions of wealth or consumption or continuation values (these can be viewed as extensions of Lucas and Prescott (1971) "Big K-little k" models); as well as single-agent robust decision problems that include adversarial control and actor-critic systems.

That all of these are equilibrium Markov models extends Lucas's 1989 observation that

> Complete market economies are all alike but each incomplete market economy is incomplete in its own individual way.

> Robert E. Lucas, Jr. (1989)

"All alike" means that each complete market model belongs to a class of models; a particular model, i.e., an "instance of the class," is pinned down by a commodity space, a price system, a list of decision makers together with their preferences and technologies, and a definition of equilibrium that applies to all members of the class. By specifying a new set of components, one gets a new complete markets model.[11] You cannot get an incomplete markets model simply by redesigning those standard components; and a model can fail to have those components in many ways. But when they can be cast as equilibrium Markov models, incomplete markets models can be viewed as alike too, being constructed just by redefining their components. That a large number of superficially different models are all equilibrium Markov models has helped to organize and tighten applied dynamic economics.

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[11]Hansen and Sargent (2013) deploy this insight over and over again. Lucas's remark illustrates Poincare's dictum that "Mathematics is the art of giving the same name to different things."

8 Rational expectations and optimal government policies

Ramsey planners like Lucas and Stokey's (1983) evaluate choices and associated outcomes along many historically unprecedented paths. A Ramsey planner assumes a common joint distribution (rational expectations) as he searches across alternative possible plans, taking into account how a plan influences a joint distribution. The Ramsey planner seeks the best among possible such joint distributions. Self-confirming equilibria impose much less, namely, that decision makers share with the planner only marginal joint densities over events that occur infinitely often. The difference between rational expectations and self-confirming equilibria plays a substantial role in some models of learning that we shall discuss in section 11.[12]

9 Impulse response functions

Lucas was skeptical about using fixed impulse response functions to study macroeconomic policy choices.

> ... one cannot usefully think about economic policy - about the strategies of government, another 'player' in this game - in terms of current policy decisions only. Private agents necessarily have to make inferences about the way future fiscal and monetary policy will be conducted. If we discuss policy as though it involved only what government does today - that is, if we discuss policy in the terms that dominate current political discussion - then we are leaving the most important aspects of policy undiscussed and their consequences unanalyzed.
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> *Modeling Business Cycles*, 1987, pp. 102

Associated with every equilibrium Markov process is a (non-linear) vector impulse response function that records transient and enduring responses to surprises. Many of the questions that impulse response functions answer didn't interest Lucas. Thus, for fixed impulse response functions, one can study how responses of different variables to different innovations unfold. This approach is followed in "event studies", e.g., about "quantitative easing." Many equilibrium Markov models tell us that responses to large and small shocks differ. Because surprises can't be systematically chosen *ex ante*, fixed impulse response functions are of little use in designing improved policies. Nevertheless, they are salient features

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[12]Self-confirming equilibria appear in alternative accounts of US inflation dynamics in the 1970s and 1980s. See Sargent (1999).

of Gallant and Tauchen (1996) auxiliary models for constructing moments for Generalized Methods of Moments estimators of free parameters of equilibrium Markov models whose likelihood functions cannot be written down.

A more ambitious application characterizes impulse response functions as functionals of (parameterized) government policy rules for a manifold of equilibrium Markov models. Such characterizations are essential inputs to evaluating outcomes under the historically unprecedented policies that a "utopian" (according to Sims (1982)) Ramsey planner wants to understand.[13]

10   Rational Expectations Econometrics

Rational expectations econometrics requires numerically solving two problems that reverse what is known and unknown. A "direct problem" takes a vector of parameters as known and computes an equilibrium Markov process. A solution of this problem lets you simulate the model, i.e., draw random samples from a joint probability distribution. In this way, the model generates an artificial data set. An "inverse problem" exchanges knowns and unknowns. It takes an observed data set as known and extracts information about unknown parameters. Thus, a direct problem takes known parameters as inputs and computes fake data. An inverse problem takes genuine data set as inputs and infers parameter values.

Via the direct problem, an equilibrium Markov process induces a joint probability distribution over sequences of prices, quantities, and information sets indexed by a vector of parameters. "Likelihood function" is a synonym for "equilibrium Markov process." Therefore, an equilibrium Markov process makes possible two varieties of "rational expectations econometrics." An econometrician can pretend to be a frequentist and use the method maximum likelihood to infer parameters. An econometrician can instead pretend to be a Bayesian, put a prior over the parameter vector, merge the prior and the likelihood to form a joint distribution, and then use laws of inverse probability to approximate a posterior distribution for parameters.

As emphasized in section 4, the econometric aspect of the rational expectations revolution owes much to the Koopmans-Marschak-Hurwicz Cowles Commission approach to macroe-

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[13] "Sims criticizes the 'rational expectations revolution' for 'destroying or discarding much that was valuable in the name of utopian ideology." (Lucas (1987, footnote 1, p. 8)). Section 4 above confirms that Sims's characterization applies equally to Koopmans's and Marschak's aspiration to use structural stochastic dynamic simultaneous equation models models to analyze consequences of historically unprecedented policies. Call it utopian if you want, but understanding a macroeconomic capable of avoiding the disasters associated with the Great Depression of the 1930s was a noble enterprise. For Lucas's perspective on tensions between positive and normative economics, read all of Lucas (1987, footnote 1).

conometrics, sharing purposes and objects of interest. The shared purpose is to estimate structural parameters that are invariant to the proposed macroeconomic policy changes that the model is designed to study. Reduced form parameters aren't invariant with respect to the interventions that Keynesian macroeconometrians and rational expectations macroeconometricians both wanted to study.[14] A shared object of interest is a system of simultaneous stochastic difference equations with (reduced form) parameters that are functions of deeper parameters that govern aspects of behavior invariant to a range of possible policy interventions. Pre and post rational expectations structural models also share R.A. Fisher's notion of "parameter identification" as statements about the condition number of the Hessian of a log likelihood function evaluated at parameter values that maximize log likelihood function.

Nevertheless, Lucas (1976) argued that a rational expectations equilibrium subverts many Cowles Commission exclusion restrictions for parameter identification.[15] In their place, via a system of stacked Bellman equations, an equilibrium Markov process imposes extensive "cross-equation" restrictions across equilibrium decision rules and agent-specific conditional probability densities for agent-specific uncontrollable state variables. This technical point is the "revolution" part of rational expectations that helped make Lucas unpopular at Martha's Vineyard in 1978 (see Solow (1978)).

11   Equilibrium computation and learning

Using an equilibrium Markov model to do quantitative macroeconomic analysis requires being able compute an equilibrium for fixed parameter values. Solving the section 10 direct and indirect problems requires doing that, and the faster, the better.

I use "compute" as a synonym for "approximate." A fixed point of a mapping from perceived laws of motion to actual laws of motion is associated with an equilibrium. That brings connections between equilibrium computation algorithms and non rational expectations models in which agents inside a model learn about laws of motion and perhaps also price functions. Such models differ in terms of who is learning and what they are learning. Sometimes the person learning is a model builder who is outside the model who wants to learn

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[14]Similarly, impulse response functions aren't invariant to the interventions that a Ramsey planner contemplates.

[15]For the 50th anniversary of the presentation of Lucas (1976) at the inaugural Carnegie-Rochester conference I wrote Sargent (2024) to describe its vast ramifications for macroeconomics. Sims (1980) and Sargent and Sims (1977) doubted plausibility of the Cowles Commission exclusion restrictions for a variety of reasons. Instead of seeking substitutes for those restrictions, they had recommended backing off from the Marschak-Koopmans program of using quantitative macro models to analyze the alternative historically unprecedented monetary and fiscal policy rules that Marschak (1953) wanted to study. Thus, Sims's accusation against "utopian" macroeconomic model builders who pretend to have identified the invariant parameters that required extended far beyond rational expectations. Again see Lucas (1987, footnote 1, p. 8).

about a fixed point. In other settings, agents inside a model are learning about transition equations that govern evolution of the uncontrollable states that they have misspecified.[16]

Techniques for analyzing convergence of least squares learning to a rational expectations equilibrium have contributed algorithms for approximating equilibrium Markov models. Connections between models of learning and equilibrium computation are intermediated through a mathematical tool called "stochastic approximation", early contributions to which were made by Milton Friedman (see Friedman and Savage (1947)) and his teacher Harold Hotelling (Hotelling (1941)). Sean Meyn (2022, ch. 5) links recent developments to "machine learning" algorithms for approximating functions.

12   Approximating models

Lucas agreed with Copernicus that

> ... a simple and beautiful theory that agrees well with observation is often closer to the truth than a complicated ugly theory that agrees better with observation.
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> Weinberg (2015, ch. 6)

That "a simple and beautiful theory that agrees well with observation is often closer to the truth than a complicated ugly theory that agrees better with observation" collides with rational expectations econometrics. Bayesian and frequentist statisticians know a manifold of parameterized joint probability distributions (i.e., likelihood functions); they just don't know parameter values. Regarding an equilibrium Markov process (a.k.a. a likelihood function) as an approximation forces a model's author to think about inference and decision making in the presence of misspecified statistical models. It also raises questions about how to evaluate approximating models.

> Kydland and Prescott do not say much about which questions they hope their model could simulate accurately, or with what level of accuracy. ... Whether [Kydland and Prescott's] results are viewed as 'good' or 'bad' is a difficult question, as is the related question of which comparisons of theoretical to sample moments are most interesting. One could obtain a formal sharpening of these questions by using the discipline of classical hypothesis testing ... ... but the

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[16]See Lucas (1986) for an early analysis in which an agent inside the model is learning. Bray and Kreps (1987) draw a distinction between models of learning "within" a rational expectations equilibrium and models of learning "about" a rational expectations equilibrium. There is a connection with Hansen's (2014) distinction between uncertainties "outside" and "inside" models.

interesting question raised by the Kydland and Prescott model is surely not whether it can be accepted as 'true' when nested within some broader class of models. Of course the model is not 'true': this much is evident from the axioms on which it is constructed. We know from the outset in an enterprise like this (I would say, in any effort in positive economics) that what will emerge - at best - is a workable approximation that is useful in answering a limited set of questions.

Modeling Business Cycles, 1987, p. 91

A quantitative analysis who confesses a systematic and unknown gap between his model and nature's loses guidance from rational expectations econometrics. [17] Macroeconomists have responded to this difficulty in various ways. Calibrators who follow Kydland and Prescott (1982, 1996) still rely heavily on the section 10 direct problem, but much less on the inverse problem. Instead they condition on known parameters, assume conditions sufficient to make an equilibrium Markov model induce a stationary and ergodic process, and use associated laws of large numbers.[18] After importing some parameters from extraneous sources, they "calibrate" other parameters by finding other parameters that make their model's population moments match particular sample moments. Before computing those moments, calibrators sometimes decide that their model is designed to be a better approximation to some frequencies than others, so they filter data to attenuate some frequencies and amplify others.[19]. Sometimes they "filter" data by conditioning only on events that they had designed the model to explain, for example by excluding data during "sales" for a model in which firms are choosing how to set prices, as in Golosov and Lucas (2007).

Rather than discriminating against particular frequencies, sometimes a calibrator discriminates against particular variables, e.g., against prices in favor of quantities in an equilibrium Markov model that jointly determines them. Lucas (1987, Sec. III) and Lucas (2003) relied on the value function for his asset pricing model Lucas (1978) to measure benefits from attenuating post WWII US business cycles. Because they are subgradients of that value

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[17]Bob told me that "anything is an approximation to anything else." A model can be wrong, i.e., an approximation, in an infinite number of ways. You sometimes know neither an approximation criterion nor what you're trying to approximate.

[18]For generations of calibrators, Stokey et al. (1989) has been a source of those conditions.

[19]Doing that alters information content of the theories and disrupts rational expectations cross-equation restrictions. By distinguishing "parameters of interest" and "nuisance" parameters, Hansen and Sargent (1993) and Sims (1993) convert that disruption into an advantage in the context seasonality. They construct examples in which seasonal adjustment improves estimates of preference and technology parameters – the parameters of interest – while degrading "nuisance parameters" that describe evolution of information variables in agents' uncontrollable subspaces. Their analysis could be extended to other frequencies. Hansen and Singleton (1991) describe how a partitioned inverse formula obeyed by covariances requires taking nuisance parameters into account when inferring parameters of interest.

function, asset prices contain information that measures that.[20] A rational expectations econometrician who regards Lucas (1978) as an adequate approximation to a joint quantity-price process would use that information. But Lucas thought that his model was not a good one; Hansen and Singleton (1982, 1983) had convinced him of that. They had combined inverse problems for the Lucas (1978) model with US data on consumption and asset prices to construct specification test statistics. That forced Lucas into difficult compromises.[21] He imported an extraneous estimate of a coefficient of relative risk aversion and of the parameters of an exogenous consumption process and used them to quantify a value function that measures the costs of business cycles.[22] To justify that calibration strategy, Lucas (2003) said that it is implausible to impute big equity premia to a representative agent's high aversion to risk, and that sources of behavior other than risk aversion not included in his model are required to explain the equity premium and other asset pricing facts that, from the perspective of f the Lucas (1978) model, appear to be anomalies. Are there other sources behavior that preserve most of the quantity implications of Lucas (1978) that Lucas had relied on to measure costs of business cycles, while realigning asset prices closer to data? Yes.

Hansen et al. (1999) and Tallarini (2000) found that adding concerns about model mis-specification to a representative agent's risk-aversion would improve fits to equity risk premia while leaving quantities unaltered. The agents inside the equilibrium Markov model of Hansen et al. (2008) regard it as an approximation. Hansen et al. use robust control and filtering techniques to represent how those agents express concerns about statistical model specifications and also about appropriate priors to put on alternative statistical models.[23] Doing that requires finding a practical substitute for the sharing of statistical models presumed by rational expectations, in particular, the sharing of statistical models among a model's authors, the decision makers inside the model, and nature. Can you replace that "communism" assumption with another that does not increase the number of free parameters fatally? An approach described by Hansen (2014) assumes that a model builder presents to the decision makers inside a model a good l model of variables that those decision makers want to forecast in order to make good decisions.[24] Decision makers inside the model re-

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[20]See Hansen et al. (1999) and Alvarez and Jermann (2004).

[21]Those compromises were unpleasant for Lucas because Lucas (1976) had advocated imposing the cross-equation and cross-frequency restrictions brought by an equilibrium Markov model. A model brought a package of quantitative implications, among which its author was not free to pick and choose.

[22]Kuh and Meyer (1957) assessed the pros and cons of importing parameters from extraneous sources.

[23]Hansen distinguished between concerns about model misspecification, which he called uncertainty, and doubts about a prior to put over alternative statistical models, which he called "ambiguity". Also see Hansen and Sargent (2022).

[24]Gallant and Tauchen (1996) call such a good-fitting model an "auxiliary model." It plays a different role in the analysis of Hansen et al. (2008), Hansen (2014) than it does in Gallant and Tauchen's simulation procedure for estimating parameters of a Markov decision model whose likelihood function cannot be written

gard that statistical model as an approximation and therefore design robust Markov decision problems to protect themselves from their concerns that the approximating model is misspecified. Although agents inside the models of Hansen (2014) share their model builders' approximating models, they distrust them. By bringing to life a market price of model uncertainty distinct from the market price of risk in the Lucas (1978) model, those models help explain the asset pricing anomalies that made Lucas abandon some of his model's quantitative implications when he simultaneously relied on other of its implications to measure the costs of business cycles.

When people who share a common model respond to their specification doubts by solving robust Markov decision problems, *ex post* they can appear to have different statistical models.[25] Although they share a common approximating model, each decision maker behaves "as if" he or she puts probability 1 on a "worst-case model." Because they have different purposes, "worst-case" models of different decision makers differ. This situation opens disciplined ways of modeling apparent belief heterogeneity.[26]

13 Lucas's opinions

The following subsections recall how Lucas thought about nominal price rigidities; macrolabor; reconciling Phelps island and Arrow-Debreu models; implementing Ramsey plans; and HANK models.

Price rigidities

> . . . the term rigidity does not refer to some characteristic of nominal price or wage series by themselves, but rather to the behavior of these series relative to the way they would have been predicted to behave under a particular class of models. . . . The problem with price rigidities is that they seem to come and go. Sometimes monetary changes that 'ought' to be pure units effects seem to be just that; sometimes they seem to have large non neutral effects. . . . the futility of theorizing by postulating that the behavior of agents is what it is without trying to locate the reasons for this behavior in preferences, technology, or the structure of the underlying game.

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down analytically.

[25]After I presented a joint paper with Lars Hansen about robustness at the Minneapolis Fed, Bob asked me "why should the people in our models be like us?" According to the Muth (1961) paper that got Bob started, shouldn't they be like us?

[26]Assuming a common approximating model provides "discipline" in the sense of economizing on free parameters.

Turning first to models that don't "locate the reasons for this behavior in preferences, technology, or the structure of the underlying game," Calvo (1983) and Rotemberg (1982) constructed models that explain observed individual firms' price, quantity paths within settings in which monetary rules and shocks affect allocations. To do that, they imposed socially improvable price-setting policies on firms, then proceeded to deduce monetary-fiscal policy functions that correct collateral damage from firms' price-setting policies

In contrast to Calvo-Rotemberg models, firms inside the models of Golosov-Lucas and Alvarez-Lippi choose how sticky to make prices. Impulse responses are non-linear and depend partly on shock volatilities.

Does a Golosov and Lucas (2007) or Alvarez-Lippi model looks more like a Calvo-Rotemberg model or a flexible price model. "More like" in response to what? To small shocks? To big shocks? To changes in the monetary-fiscal policy functions that equilibrium Markov models are designed to study?

Answers are that Golosov-Lucas or Alvarez-Lippi models look more like Calvo-Rotemberg models for small shocks, more like flexible price model for large shocks, and more like flexible price model for change in systematic monetary-fiscal policies. Thus, in models in which firms choose stickiness:

> ... for small shocks the nature of the friction is irrelevant, that is, the propagation of the nominal shock is the same in state- and time-dependent models provided that the models are fit to the same steady-state moments. ... the inherent nonlinear nature of decision rules of SD models implies that for aggregate shocks above a minimum size, the economy displays full price flexibility. Thus, for SD models the impact effect of the shock depends on their size.

> "Are State- and Time-Dependent Models Really Different?" Alvarez, Lippi, and Passadore, NBER Macro Annual, 2017, pp. 380- 381.

In the spirit of Stephen Weinberg's rules as guides for research, models in which firms choose stickiness preserve the following past successes:

- Cross-country and historical evidence about inflation that the quantity theory of money fit well
- Apparent money supply "non-neutralities"
- Friedman-Schwartz evidence pointing to monetary shocks as sources of business cycles

Macro-labor

Lucas preferred models of aggregate wages, interest rates, and employment without jobs. But he preferred models of unemployment with jobs. For modeling aggregate employment, aggregate inflation, interest rates, and GDP and its composition, he said that modeling flows into and out of unemployment is a side show.

> What we mean, in ordinary usage, by 'unemployment' is exactly disruptions in, or difficulties in forming, employer-employee relationships. Simply hamstringing the auctioneer in a Walrasian framework that assigns no role at all to such a relationship is not going to give us the understanding we want. If we are serious about obtaining a theory of unemployment, we want a theory about unemployed people, not unemployed 'hours of labor services about people who look for jobs, hold them, lose them, people with all the attendant feelings that go along with these events. Walras's powerfully simple scenario, at least with the most obvious choice of 'commodity space', cannot give us this, with cleared markets or without them.
>
> *Modeling Business Cycles*, 1987, p. 66.

Nevertheless, Lucas asked

> ... whether modeling aggregative employment in a competitive way as in the Kydland and Prescott model (and hence lumping unemployment together with 'leisure' and all other non-work activities) is a serious strategic error in trying to account for business cycles.
>
> *Modeling Business Cycles*, 1987, p. 66.

Lucas answered

> I see no reason to believe that it is. If the hours people work - choose to work - are fluctuating it is because they are substituting into some other activity. For some purposes - designing an unemployment compensation scheme, for example - it will clearly be essential to break non-work hours into finer categories, including as one 'activity' unemployment. But such a finer breakdown need not substantially alter the problem Kydland and Prescott have tried to face of finding a parameterization of preferences over goods and hours that is consistent with observed employment movements.

Many macroeconomists have agreed with Lucas that to understand aggregate employment, aggregate inflation, interest rates, and GDP and its composition, modeling flows into and out of unemployment is a side show. Lucas and Rapping (1969), Hansen (1985), Hansen (1985), Prescott (2002) and many real and monetary business cycle models include no employer-employee relationships interpretable as jobs. Neither did most pre-rational expectations models. Instead, they assumed spot markets (e.g., "hiring halls") for labor that continuously equate supply and demand for labor.

Combining features of Phelps Islands and Arrow-Debreu models

Lucas artfully constructed models in a 20th century macro tradition that embraced what Samuelson called a neoclassical synthesis that separates microeconomic policies for redistribution and insurance for macro polices aimed at attenuating business cycles and promoting economic growth. He did this by incorporating components of Arrow-Debreu and Phelps island models.

> In a real general equilibrium model like Kydland and Prescott's, exchange occurs in centralized markets, so that goods are valued only if they are valued in use (consumption or production) by someone. To model a monetary economy, one thus needs to imagine that trading is decentralized in some way. My preference is to do this in a way that does minimal violence to the original, real theory that is being modified, so as not to discard altogether the theory's considerable ability to account for important real observations. ... By postulating an individual with specific preferences over cash and credit goods, and by being specific as well about the timing with which information gets revealed, we can derive all of classical monetary theory by just thinking through the margins on which an agent operates in this world of centralized/ decentralized markets. ... Everything that is valid in the traditional quantity theory of money can be extracted from these two marginal conditions, as can much that is new.
>
> *Models of Business Cycles*, 1987, pp. 76, 78, 88

Lucas combined components of Arrow-Debreu and search-island models while insisting on preserving versions of most complete markets Euler equations for consumption, labor supplies, and asset prices. Examples of combined models include Lucas and Prescott (1974) and Alvarez and Veracierto (1999, 2012) island search models as well as Lucas and Stokey (1987) cash-in-advance models.

Implementations

It is challenging to motivate governments to adhere to an optimal plan.[27] Here Lucas made decisive contributions by again demonstrating that finding the state is an art. Examples are (1) Lucas and Stokey's (1983) implementation of a Ramsey plan via commitment to a carefully designed continuation debt maturity structure, and (2) Atkeson and Lucas's (1992) implementations of incentive compatible social insurance arrangements that feature barriers to entry, contract exclusivities, and pecking orders among insurance contracts.

HANK models?

> The pooling of earnings-risk predicted by [a complete markets model] is not at all what we observe. Consumption of similarly skilled workers is not at all well correlated and certainly varies with employment status. Moreover workers in occupations with high earnings variability command a premium that would not exist in a perfectly-insured environment. We used to label this situation as one of 'imperfect capital markets' and leave it at that, but simply giving an unsuccessful theory a high-sounding label does not produce a better theory. It has proved more fruitful to ask why these obviously useful earnings-insurance markets are not present in reality, as they are in the model. The most interesting recent work focuses on the informational assumptions of this model, on its key assumption that each worker's situation is 'common knowledge'.
>
> *Models of Business Cycles*, 1987, pp. 60-61.

Lucas contrasted that approach to ones that ask monetary policies to redistribute income and provide social insurance in addition to, or maybe instead of, promoting price level stability.

> Policies that deal with the very real problems of society's less fortunate - wealth redistribution and social insurance - can be designed in total ignorance of the nature of business-cycle dynamics (as many such useful programs have been), and the discovery of better business cycle theories will contribute little or nothing to improved design. There is a real and dangerous hypocrisy involved in discussing [high] unemployment rates ... as though they raise a temporary problem that can be dealt with by fiscal deficits or monetary expansions. .... This is not a problem of year-to-year fine tuning, and it does no service to unemployed people to talk about it as though it were.

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[27]This is the message of Kydland and Prescott (1977) and Calvo (1978).

14   Concluding Remarks

Although I celebrate them here, not everybody likes the equilibrium Markov processes that Lucas promoted. Summers (1991) did not. He asserted that "progress is unlikely as long as macroeconomists require the armor of a stochastic pseudo-world before doing battle with the real one." It puzzles me why some technically sophisticated economists also didn't like the way Lucas practiced macroeconomics.

> Deep down I really wish I could believe that Lucas ... is right, because the one thing I know how to do well is equilibrium economics. The trouble is I feel so embarrassed at saying things that I know are not true.
>
> It is plain as the nose on my face that the labor market and many markets for produced goods do not clear in any meaningful sense.
>
>   Solow (1978)

Solow was responding to the following statements:

> In recent years, the meaning of the term equilibrium has changed so dramatically that a theorist of the 1930s would not recognize it. An economy following a multivariate stochastic process is now routinely described as being in equilibrium, by which is meant nothing more than that at each point in time, postulates (a) [markets clear] and (b) [agents act in their self interest] are satisfied. This development, which stemmed mainly from work by Arrow (1964) and Debreu (1959), implies that simply to look at any economic time series and conclude that it is a disequilibrium phenomenon is a meaningless observation. Indeed, a more likely conjecture, on the basis of recent work by Sonnenschein (1973), is that the general hypothesis that a collection of time series describes an economy in competitive equilibrium is without content.
>
>   Lucas and Sargent (1978, p. 304)

Equilibrium Markov processes acquire content only by imposing more restrictions on prices and quantities than Sonnenschein (1973) had.[28] For over 35 years, Stokey et al. (1989) has been our handbook for constructing stationary and ergodic equilibrium Markov

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[28]Brown and Matzkin (1996) specify primitives of general equilibrium models that restrict data on prices, quantities, and endowments.

processes amenable to econometric implementations. That book tells us how to economize on free parameters and expand data sets enough to make an equilibrium Markov process become econometrically restrictive.

Before being too hard on Solow (1978), we should remember how Lucas (1987, Sec. III), Lucas (2003) tempered his initial enthusiasm about rational expectations econometrics after likelihood ratio and Chi-square specification test statistics rejected some of his favorite equilibrium Markov models. Those adverse findings pushed Lucas into the wilderness of calibration. The informal Kydland and Prescott (1982, 1996) quantitative techniques that Lucas came to favor resembled informal parameter selection method that Solow had used.

Despite Lucas's misgivings, rational expectations econometrics flourishes today, including at the Central Banks and Treasuries that Lucas (1976) had aimed to influence. The "utopian" projects criticized by Sims (1982) are alive and well. Herbst and Schorfheide (2016) and Dynare manuals are bibles in many research departments. The coherence between economic theory and econometric practice that rational expectations econometrics brings is as attractive as ever. It is much easier to practice rational expectations econometrics today than it was in the1970s. And since then, more types of behaviors have been brought into the rational expectations tent. Thus, Kreps and Porteus (1978, 1979), Lucas and Stokey (1984), Epstein and Zin (1991), Gul and Pesendorfer (2001, 2004) broadened the range of behaviors that Markov decision problems can incorporate. We now understand how these can cast as what Bertsekas (2022) calls "abstract dynamic programs." Abstract dynamic programming exploits connections between conditions for existence of solutions of Bellman equations and the stability of optimally controlled Markov processes. It extends our Stokey et al. (1989) toolkit and the phenomena that we can use equilibrium Markov models to interpret.[29]

Section 2 described how Lucas learned tools that constrained and guided him, and how extensively Milton Friedman had influenced his choices about topics to study in mathematics, statistics, and economics. Backward induction induced me to describe Milton Friedman's technical tools and the questions that he used them to answer. I could also have told how thoroughly Irving Fisher had influenced Milton Friedman, both tools to acquire and macroeconomic questions to study. That would strengthen my message about how the mathematical tools they mastered had constrained and empowered Friedman and Lucas.[30] Lucas got far-

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[29]Sargent and Stachurski (2024, ch. 9) provides an elementary account confined to finite state spaces.

[30]As in some modern labor and macro growth models, during the early part of his career as a student and practitioner of economics, Lucas spent many hours and much effort mastering ideas that Friedman and other great economists of the generation before him had mastered and had deployed productively. A macro growth theorist might describe this as the "imitation" phase of Lucas's growth process. What Lucas had learned in that phase constrained and empowered his achievements during the subsequent "innovation" phase that we celebrate here.

ther than Friedman partly because he acquired more mathematical and probability tools than Friedman. He confronted more constraints and had better guides.

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