

# 1 A Behavioral Model

Let's ignore the first two equations since they are the same as (28) and (29), that will be explained later.

## 1.1 Introduction

**Equation 1**

$$x_t = M \cdot \mathbb{E}_t [xt + 1 - \sigma(i_t - \mathbb{E}_t [\pi_{t+1}] - r_t^n)] \quad (1)$$

**Equation 2**

$$\pi_t = \beta \cdot M^f \mathbb{E}_t [\pi_{t+1}] + \kappa \cdot x_t \quad (2)$$

## 1.2 Basic Setup and the Household's Problem

**Equation 3**

$$U = \mathbb{E}_t \left[ \sum_{t=0}^{\infty} \beta^t \left( \frac{c_t^{1-\gamma} - 1}{1-\gamma} - \frac{N_t^{1+\phi}}{1+\phi} \right) \right] \quad (3)$$

Equation (3) is just the flow utility of the Household, with :

- $\beta$  the discount factor
- $c_t$  the consumption of the household at time  $t$
- $N_t$  the work of the household at time  $t$
- $\gamma$  determines the concavity of the utility function with respect to the consumption, i.e. the importance of consumption in the utility function
- $\phi$  determines the concavity of the utility function with respect to work, i.e. the importance of work in the utility function

**Equation 4**

$$k_{t+1} = (1 + r_t)(k_t - c_t + y_t) \quad (4)$$

Equation (4) is the law of motion of the real financial wealth of the household, where :

- $k_t$  is the real financial wealth of the household at time  $t$
- $r_t$  is the real interest rate
- $w_t$  is the real wage
- $y_t$  is the agent's real income, defined as  $y_t = w_t \cdot N_t + y_t^f$ , with  $y_t^f$  the profit income (or the income from firms) at time  $t$

### Equation 5

$$\mathbf{X}_{t+1} = \mathbf{G}^X(\mathbf{X}_t, \epsilon_{t+1}) \quad (5)$$

Equation (5) describes the evolution of macroeconomic variables, where :

- $\mathbf{X}_t$  is the state vector, including several macroeconomic variables of time  $t$ , like  $\zeta_t$  the aggregate TFP, and the announced actions in monetary and fiscal policy
- $\mathbf{G}^X$  the equilibrium transition function, i.e. the function that gives the macroeconomic variables at time  $t + 1$  from the macroeconomic variables at the previous period
- $\epsilon_t$  is the innovation in the economy at time  $t$ , with  $\mathbb{E}_t[\epsilon_{t+1}] = 0$ , that depends on the equilibrium policies of the agent and of the government

### Equation 6

$$k_{t+1} = G^k(c_t, N_t, k_t, \mathbf{X}_t) := (1 + \bar{r} + \hat{r}(\mathbf{X}_t))(k_t + \bar{y} + \hat{y}(N_t, \mathbf{X}_t) - c_t) \quad (6)$$

Equation (6) is the application of the consideration of a set of macroeconomic variables on the law of motion of real financial wealth  $k_t$ , where :

- $\bar{r}$  is the steady state value of the real interest rate, that does not depend on time
- $\hat{r}(\mathbf{X}_t)$  is the value of the deviation from the steady state of the real interest rate, that depends on the state vector  $\mathbf{X}_t$  at time  $t$
- $\bar{y}$  is the steady state value of the agent's real income, that does not depend on time
- $\hat{y}(N_t, \mathbf{X}_t)$  is the deviation from the steady state of the agent's real income, that depends on the number of hours worked at time  $t$  and on the state vector at time  $t$
- $c_t$  is the aggregate consumption level at time  $t$  of the agent

### Equation 7

$$\mathbf{X}_{t+1} = \mathbf{\Gamma} \mathbf{X}_t + \epsilon_{t+1} \quad (7)$$

Equation (7) describes the linear version of the equilibrium transition function, it is the linearization of the law of motion, where :

- $\mathbf{\Gamma}$  is a squared matrix that multiplies the state vector
- $\mathbf{X}_t$  is the state vector at time  $t$
- $\epsilon_t$  is the innovation shock

**Equation 8 (Assumption 1)**

$$\mathbf{X}_{t+1} = \bar{m} \cdot \mathbf{G}^{\mathbf{X}}(\mathbf{X}_t, \epsilon_{t+1}) \quad (8)$$

Equation (8) describes the Cognitive Discounting of the State Vector, i.e. the perception by behavioural agents of the law of motion of the macroeconomic variables, where :

- $\bar{m} \in [0, 1]$  is the cognitive discount factor measuring the attention to the future

**Equation 9**

$$\mathbf{X}_{t+1} = \bar{m}(\mathbf{\Gamma}\mathbf{X}_t + \epsilon_{t+1}) \quad (9)$$

Equation (9) is just the linearized version of the perception by behavioral agents of the law of motion of the state vector.

**Equation 10**

$$\mathbb{E}_t^{BR}[\mathbf{X}_{t+k}] = \bar{m}^k \mathbb{E}_t[\mathbf{X}_{t+k}] \quad (10)$$

Equation (10) defines the expectation of behavioral agents in function of the rational perception of the law of motion of the state vector, where :

- $k \geq 0$  a time period in discrete context
- $\mathbb{E}_t^{BR}[\mathbf{X}_{t+k}]$  is the expected value of the state vector at time  $t + k$  by behavioral agents (or subjective/behavioral expectation operator)
- $\bar{m}^k$  is the cognitive discounting effect at period  $t + k$
- $\mathbb{E}_t[\mathbf{X}_{t+k}]$  is the rational expectation of the state vector at time  $t + k$

**Equation 11 (Lemma 1)**

$$\mathbb{E}_t^{BR}[z(\mathbf{X}_{t+k})] = \bar{m}^k \mathbb{E}_t[z(\mathbf{X}_{t+k})] \quad (11)$$

Equation (11) defines in the general case the behavioral expectation operator, for any function of the state vector, where :

- $k \geq 0$  a time period in discrete context
- $z(\cdot)$  is a function, such that  $z(0) = 0$
- $\mathbb{E}_t^{BR}[z(\mathbf{X}_{t+k})]$  is the expected value of the image of the state vector by the function  $z(\cdot)$  at time  $t + k$  by behavioural agents
- $\bar{m}^k$  is the cognitive discounting effect at period  $t + k$
- $\mathbb{E}_t[z(\mathbf{X}_{t+k})]$  is the rational expectation of the image of the state vector by the function  $z(\cdot)$  at time  $t + k$

### Equation 12

$$\mathbb{E}_t^{BR} [\bar{r} + \hat{r}(\mathbf{X}_{t+k})] = \bar{r} + \bar{m}^k \mathbb{E}_t [\hat{r}(\mathbf{X}_{t+k})] \quad (12)$$

Equation (12) is an example of the Lemma 1 applied to the interest rate, where :

- $k \geq 0$  a time period in discrete context
- $\bar{r}$  the steady state level of the real interest rate, that does not depend on time,
- $\hat{r}(\mathbf{X}_{t+k})$  is the equilibrium transition function defining the value of the deviation from the steady state of the real interest rate in the function of the state vector at time  $t+k$
- $\bar{r} + \hat{r}(\mathbf{X}_t) = r_t(\mathbf{X}_t)$  is the value of the real interest rate at time  $t$
- $\mathbb{E}_t^{BR} [\bar{r} + \hat{r}(\mathbf{X}_{t+k})]$  is the expected value of the real interest at time  $t+k$  by behavioural agents
- $\mathbb{E}_t [\hat{r}(\mathbf{X}_{t+k})]$  is the rational expectation of the value of the deviation of the real interest rate from the steady state at time  $t+k$

### 1.3 The Firm's problem

#### Equation 13

$$P_t = \left( \int_0^1 P_{it}^{1-\varepsilon} di \right)^{\frac{1}{1-\varepsilon}} \quad (13)$$

Equation (13) describes the aggregate price level, where :

- $P_t$  is the aggregate price level of the economy at time  $t$
- $i \in [0, 1]$  is the firm index
- $\varepsilon$  is the elasticity of substitution between goods

#### Equation 14

$$v^0(q_{i\tau}, \mu_\tau, c_\tau) := (e^{q_{i\tau}} - (1 - \tau_f)e^{-\mu_\tau}) e^{-\varepsilon q_{i\tau}} c_\tau \quad (14)$$

Equation (14) describes the profit of the firm before the lump sum tax of the government, where :

- $v$  is the real profit of the firm
- $q_{i\tau} = \ln \left( \frac{P_{i\tau}}{P_\tau} \right) = p_{i\tau} - p_\tau$  is the real log price at time  $\tau$
- $\tau_f = \frac{1}{\varepsilon}$  it the corrective wage subsidy from the government, funded by the lump sum tax

- $\mu_\tau = \zeta_t - \ln(\omega_t)$  is the labor wedge, which is zero at efficiency
- $\varepsilon$  is the elasticity of substitution between goods
- $c_\tau$  is the aggregate level of consumption

**Equation 15**

$$v(q_{it}, \mathbf{X}\tau) := v^0(q_{it} - \Pi(\mathbf{X}\tau), \mu(\mathbf{X}\tau), c(\mathbf{X}\tau)) \quad (15)$$

Equation 15 describes the flow profit of the firm in function of the real log price and of the extended macro state vector, where :

- $q_{it} = \ln\left(\frac{P_{it}}{P_t}\right) = p_{it} - p_t$  is the real log price
- $\mathbf{X}\tau = (\mathbf{X}^{\mathcal{M}\tau}, \Pi_\tau)$  is the extended macro state vector, with  $\mathbf{X}^{\mathcal{M}\tau}$  the vector of macro variables, including  $\zeta\tau$  and possible announcements about future policy
- $\Pi(\mathbf{X}\tau) := p\tau - p_t = \pi_{t+1} + \dots + \pi_\tau$  is the inflation between times  $t$  and  $\tau$
- $q_{it} - \Pi(\mathbf{X}\tau) = q_{i\tau}$  is the real price of the firm if they didn't change its price between  $t$  and  $\tau$
- $\mu(\mathbf{X}\tau)$  is the aggregate labor wedge in function of the extended state vector at time  $t$
- $c(\mathbf{X}\tau)$  is the aggregate consumption level in function of the extended state vector at time  $t$

**Equation 16**

$$\max_{q_{it}} \mathbb{E}_t \sum_{\tau=t}^{\infty} (\beta\theta)^{\tau-t} \frac{c(\mathbf{X}\tau)^{-\gamma}}{(\mathbf{X}_t)^{-\gamma}} v(q_{it}, \mathbf{X}\tau) \quad (16)$$

Equation (16) describes the maximisation program of the firm given that they have a Calvo-like probability of  $\theta$  of being able to change their price at each period, where :

- $t$  is the initial period
- $\tau$  is the time period index
- $q_{it}$  is the real log price of the firm at time  $t$
- $\beta$  is the discount factor
- $\theta$  is the Calvo like probability that the firm can change its price at any period
- $\frac{c(\mathbf{X}\tau^{-\gamma})}{c(\mathbf{X}_t^{-\gamma})}$  is the adjustment in the stochastic discount factor/pricing kernel between times  $t$  and  $\tau$

### Equation 17

$$\max_{q_{it}} \mathbb{E}_t^{BR} \left[ \sum_{\tau=t}^{\infty} (\beta\theta)^{\tau-t} \frac{c(\mathbf{X}_{\tau}^{-\gamma})}{c(\mathbf{X}_t^{-\gamma})} v(q_{it}, \mathbf{X}_{\tau}) \right] \quad (17)$$

Equation 17 describes the maximisation program of the behavioral firm, i.e. such that it is maximisation the behavioral expectation operator of the flow profit, where :

- $\mathbb{E}_t^{BR}$  is the behavioral/subjective expected value operator
- $t$  is the initial period
- $\tau$  is the time period index
- $q_{it}$  is the real log price of the firm at time  $t$
- $\beta$  is the discount factor
- $\theta$  is the Calvo like probability that the firm can change its price at any period
- $\frac{c(\mathbf{X}_{\tau}^{-\gamma})}{c(\mathbf{X}_t^{-\gamma})}$  is the adjustment in the stochastic discount factor between times  $t$  and  $\tau$  and it is approximately 1 when linearised around deterministic steady state.

## 1.4 Model solution

### Equation 18

$$\hat{c}_t = \mathbb{E}_t \left[ \hat{c}_{t+1} - \frac{1}{\gamma R} \hat{r}_t \right] \quad (18)$$

Equation (18) is the linearized version of the Euler equation obtained from the presented model. It is also called the investment-savings (IS) curve, where :

- $\hat{c}_t$  is the value of the deviation from the steady state of the aggregate consumption at time  $t$
- $\mathbb{E}_t [\hat{c}_{t+1}]$  is the rational expectation of the value of the deviation from the steady state of the aggregate consumption at time  $t + 1$
- $\gamma$  is the factor of the importance of consumption
- $R := 1 + \bar{r}$  is defined from the real interest rate at the steady state (cf. page 7 of the article)

**Equation 19**

$$\hat{c}_t = M \cdot \mathbb{E}_t [\hat{c}_{t+1}] - \sigma \hat{r}_t \quad (19)$$

Equation (19) is the application of Lemma 1 (equation (11)) on the previous Euler equation, i.e. a cognitively discounted aggregate Euler equation, where :

- $M$  is the macro parameter of attention, such that  $M = \bar{m}$  here
- $\sigma = \frac{1}{\gamma R}$

**Equation 20**

$$N_t^\phi = \omega_t c_t^\gamma \quad (20)$$

Equation (20) the result of the static First Order Condition for labor supply, where :

- $N_t$  is the quantity of labor provided at time  $t$
- $\omega_t$  is the real wage at time  $t$
- $c_t$  is the aggregate quantity of consumption at time  $t$
- $\gamma$  is the consumption importance in the utility

**Equation 21**

$$\hat{c}_t^n = \frac{1 + \phi}{\gamma + \phi} \zeta_t \quad (21)$$

Equation (21) is the equation giving us the consumption in a natural economy where there are no frictions in prices i.e. flexible price economy. where :

- $\hat{c}_t^n$  is the flexible price/natural economy consumption
- $\gamma$  is the the elasticity of substitution between goods.
- $\phi$  is the Frisch elasticity of labour
- $\zeta_t$  is the Total Factor productivity

We calculate this natural economy consumption the same way we calculated the flexible price economy consumption using the log-linearised version of the natural economy price, first-order condition for labour supply, and market clearing condition for consumption and income.

is the flexible price/natural economy consumption

**Equation 22**

$$\hat{c}_t^n = M \cdot \mathbb{E}_t [\hat{c}_{t+1}^n] - \sigma \hat{r}_t^n \quad (22)$$

Equation (22) is the application of Lemma 1 (equation (11)) on the previous Euler equation, i.e. a cognitively discounted aggregate Euler equation for the natural economy where there are no price frictions. Here :

- $M$  is the macro parameter of attention, such that  $M = \bar{m}$  here
- $\sigma = \frac{1}{\gamma R}$
- $\hat{r}_t^n$  is the real interest rate for the natural economy

**Equation 23**

$$r_t^{n0} = \bar{r} + \frac{1 + \phi}{\sigma(\gamma + \phi)} (M \cdot \mathbb{E}_t [\zeta_{t+1}] - \zeta_t) \quad (23)$$

Equation (23) is the equation for the pure natural rate of interest: this is the interest rate that prevails in an economy without pricing frictions, and undisturbed by government policy (in particular, budget deficits). In this equation :

- $r_t^{n0}$  is pure natural rate of interest
- $\gamma$  is the the elasticity of substitution between goods.
- $\phi$  is the Frisch elasticity of labour
- $\sigma = \frac{1}{\gamma R}$
- $M$  is the macro parameter of attention, such that  $M = \bar{m}$  here
- $\zeta_t$  and  $\zeta_{t+1}$  is the Total Factor productivity in time  $t$  and  $t+1$  respectively

This pure natural interest rate is calculated by isolating the  $\hat{r}_t^n$  in Equation (22) and then replacing  $\hat{c}_t^n = \frac{1+\phi}{\gamma+\phi} \zeta_t$ ,  $\hat{c}_{t+1}^n = \frac{1+\phi}{\gamma+\phi} \zeta_{t+1}$  and  $\hat{r}_t^n = r_t^n - \bar{r}$  and by assuming  $r_t^n = r_t^{n0}$  which holds when there are no budget deficits.

**Equation 24**

$$x_t = M \cdot \mathbb{E}_t [x_{t+1}] - \sigma(\hat{r}_t - \hat{r}_t^n) \quad (24)$$

Equation (24) is the equation for the behavioural discounted Euler equation where :

- $x_t$  is the output gap at period  $t$
- $x_{t+1}$  is the output gap at period  $t+1$
- $M$  is the macro parameter of attention, such that  $M = \bar{m}$  here



- $\sigma = \frac{1}{\gamma R}$
- $\hat{r}_t$  is the deviation of the real interest rate from the steady state.
- $\hat{r}_t^n$  is the deviation of the real interest rate from the steady state for the natural economy.

This is calculated by subtracting the expression  $\hat{c}_t = M \cdot \mathbb{E}_t [\hat{c}_{t+1}] - \sigma \hat{r}_t$  i.e. Equation (19) and  $\hat{c}_t^n = M \cdot \mathbb{E}_t [\hat{c}_{t+1}^n] - \sigma \hat{r}_t^n$  i.e. Equation (22)

#### Equation 25

$$x_t = M \cdot \mathbb{E}_t [x_{t+1}] - \sigma (i_t - \mathbb{E}_t [\pi_{t+1}] - r_t^n) \quad (25)$$

Equation (25) is the behavioural discounted Euler equation after replacing the equation for Fisher equation where  $\hat{r}_t = r_t - \bar{r} = (i_t - \mathbb{E}_t [\pi_{t+1}] - r_t^n)$

- $i_t$  is the nominal interest rate
- $\mathbb{E}_t [\pi_{t+1}]$  is the expected inflation in the future
- $M = \bar{m}$
- $\sigma = \frac{1}{\gamma R}$

#### Equation 26

$$x_t = -\sigma \sum_{k \geq 0} M \cdot \mathbb{E}_t [\hat{r}_{t+k} - \hat{r}_{t+k}^n] \quad (26)$$

Equation (26) iteratively using Equation (24) reduces to this equation. It indicates that changes in the interest rate in the 1000<sup>th</sup> period will have a discounted impact on the output gap. Therefore, the effect of changes in interest rates on the output gap diminishes over time, with changes in the 1000<sup>th</sup> period having a smaller impact compared to changes in the 1<sup>st</sup> period.

#### Equation 27

$$p_t^* = p_t + (1 - \beta\theta) \sum_{k=0}^{\infty} (\beta\theta\bar{m})^k \cdot \mathbb{E}_t [\pi_{t+1} + \dots + \pi_{t+k} - \mu_{t+k}] \quad (27)$$

Equation (27) is the optimal price for a behavioural firm resetting its price

- $p_t^*$  is the the price a behavioural firm will reset its price to.
- $\bar{m}$  is the cognitive discounting factor.
- $p_t^* = q_{it} + p_t$  where  $q_{it}$  is the linearised version of the maximisation solution to problem 17.  $q_{it}$  is the price for the firms that can adjust their prices and  $p_t$  is the price of the firms that can't adjust their prices.

**Equation 28 - Proposition 2, the first equation**

$$x_t = M \cdot \mathbb{E}_t [xt + 1] - \sigma(i_t - \mathbb{E}_t [\pi_{t+1}] - r_t^n) \quad (28)$$

Equation (28) is the Behavioural IS Curve. Essentially we are representing the Euler equation in terms of the output gap and also using the Fisher Equation.

**Equation 29 - Proposition 2, second equation**

$$\pi_t = \beta \cdot M^f \mathbb{E}_t [\pi_{t+1}] + \kappa \cdot x_t \quad (29)$$

Equation (29) is the Behavioural Phillips curve where:

- $M^f$  is the aggregate attention parameter for firms and  $M^f = \bar{m} \left( \theta + \frac{1-\beta\theta}{1-\beta\theta\bar{m}}(1-\theta) \right)$
- $\kappa = \tilde{\kappa}$  is the slope of the Phillips curve and  $\tilde{\kappa} = \frac{(1-\theta)(1-\beta\theta)}{\theta}(\gamma + \phi)$  which is the slope obtained from fully rational firms.

**Equation 30**

$$\begin{cases} M = \bar{m} \\ \sigma = \frac{1}{\gamma R} \\ M^f = \bar{m} \left( \theta + \frac{1-\beta\theta}{1-\beta\theta\bar{m}}(1-\theta) \right) \end{cases} \quad (30)$$

Equation (30) defines the parameters in Proposition 2.