

# TOPICS IN MACROECONOMICS

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# ABOUT US

# THE MODERN MACROECONOMIST

- A jack of all trades:
    - ▶ Simple theoretical models.
    - ▶ Quantitative models.
    - ▶ Cross-sectional identification.
    - ▶ Time-series identification.
  - Why? Identification problems massive:
    - ▶ Fed lowers interest rates in 2008. What do we learn about effects of monetary policy?
- ⇒ Attack problem from many different angles.

# THIS CLASS

- Research advice & econometrics review, & identification in macro (1 class)
- Cross-sectional identification and aggregation (4 classes)
- Macro models with micro heterogeneity (4 classes)
- Student presentations (1 class)

# COURSE REQUIREMENTS

## ① Required reading and participation (35%).

- ▶ Read \* papers on syllabus before class.
- ▶ We will often pause for discussion.
- ▶ Insufficient participation  $\Rightarrow$  Midterm / Final

## ② Paper draft (65%)

- ▶ Paper should connect micro data with macro model.
- ▶ Does not have to be a completed paper.
- ▶ Needs to be original.

# PAPER DRAFT

- The paper should contain two parts:
  - ① A new micro data fact or causal effect.
    - ★ Ok to build on (but not copy!) other work.
  - ② A (simple) macro model that connects the micro data fact to macroeconomic outcomes.
    - ★ Should have computational component (unless waived).
- At the end of class you need to submit the paper and code.
  - ▶ If we cannot replicate the paper figures and tables with one click or command, we will ask you to resubmit.
  - ▶ Submit by giving us read access to your GitHub repository.

# PAPER DRAFT DEADLINES

- ① 5/1/2022: Submit New micro data fact / causal effect.
  - ▶ Submission = giving us read access to your GitHub repository.
- ② Week 6: meeting for feedback.
- ③ 6/1/2022: Presentation in class.
- ④ 6/8/2022: Paper draft due.

# OUTLINE

- 1 INTRODUCTION
- 2 RESEARCH ADVICE
- 3 ORGANIZING APPLIED WORK
- 4 ECONOMETRICS REVIEW
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# SEMINARS, LUNCHESES, ETC<sup>1</sup>

- Attending seminar and lunch is an important part of your PhD.
  - ▶ Allows you to see cutting edge research, help improve peer's research, become part of research community.
  - ▶ See how the sausage is made.
  - ▶ In grad school I learned a lot from others' questions.
  - ▶ Even if the topic is outside your immediate research area there are large spillovers from learning about techniques, data, and presentational skills.
- Great line-up of external speakers this quarter:
  - ▶ Atif Mian, Sanjay Singh, Janice Eberly, John Mondragon, Diego Perez, Ricardo Reis, Kim Ruhl, Cecile Gaubert, Amy Handlan, Nick Bloom.
- If macro is a secondary field, fine to only attend seminar and lunch for your primary field. But should attend something!

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<sup>1</sup>This section is based on Adam Guren's slides.

# RESEARCH ADVICE

- Becoming a researcher is hard.
  - ▶ Requires learning by doing. Only so much one can explain.
- *Persistence* is key.
  - ▶ *Every* paper hits a roadblock that initially appears fatal.
  - ▶ *Every* idea is related to something else and has a moment where someone says "that sounds like [insert citation here]."
  - ▶ *Every* researcher has days (or weeks or months) where they work extremely hard and have nothing to show for it.
- The key is being able to wake up and work just as hard and be just as dogged on the 10th day (or 30th or 100th) as you were on the first.
  - ▶ Work on something you love that motivates you.
  - ▶ Every paper has boring parts or frustrating parts. Learn to love the challenge.
  - ▶ Use habit formation to your advantage.

# WORKING TOGETHER

- I personally love to work with others.
  - ▶ More fun.
  - ▶ Fewer dead ends, less of an echo chamber.
  - ▶ Motivate each other, give each other deadlines.
- Talk to each other. Co-author if you come up with an interesting idea.
- You will learn as much from your peers as from the faculty.
  - ▶ Get to know each other!
  - ▶ Help each other with research. Workshop ideas. Talk economics. Have fun together.
  - ▶ My PhD classmates are some of my best friends.
  - ▶ I continue to learn from my classmates today.

# HOW TO COME UP WITH IDEAS

- Most difficult part of research.
- DON'T just sit there waiting for an idea.
  - ▶ Work on something. You will bump into things.
- Talk to others! Often papers come out of conversations.
- Read a lot, and read critically.
  - ▶ Look for connections between topics.
  - ▶ Look for holes in literature, reasons to doubt papers.
- Play with data, look for facts.
- Go through *lots* of ideas. Discard aggressively.
  - ▶ Market rewards the max of all your ideas.
  - ▶ When you do come up with something, ask: “What is the best case scenario for this paper if everything works out?”
  - ▶ If not good enough, move on.
  - ▶ Try to get a sense within 1-2 weeks if it is worth continuing.
  - ▶ Can always return later if you see a way to get a more promising outcome.
- Work on what you love.

# MY JMP

- Came out of a conversation with a classmate over coffee.
- Standard New Keynesian model predicted that Japan would be booming after Earthquake.
  - ▶ Did it really?
- Spent about one year gathering other evidence. Most of it discarded on the way of writing the paper and some more in the publication process. Only test with oil supply shocks made it into the final paper.

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# ORGANIZING RESEARCH

- In my view, the following tools are indispensable for organizing research:
  - 1 Git
  - 2 Make
  - 3 Tasks
- Invest in these now and you will reap benefits for years.
- For more details and step-by-step instructions, see <https://github.com/johanneswieland/Research-Manual/>



# GIT

- Git solves three problems:
  - ① Easily work on code with collaborators and share journals.
  - ② Back-up of your code and writing.
  - ③ Back-up of previous *versions* of your code and writing.
- Do you find yourself carrying multiple versions of a file?
  - “chapter1.tex,”
  - “chapter1J\_final.tex,”
  - “chapter1final\_comments.tex,”
  - “chapter1\_comments\_conflict\_final.tex”(Which is final?)
- With Git you only see one version (the newest!) of your code. But you can always revert to previous versions of your code.

# WHY GIT AND NOT DROPBOX?

- While you work on your code, the code that collaborators have is undisturbed. You can try out major changes without disrupting their work.
- Git stores a snapshot of all your work. If you want to revert to a previous working version of your code all it takes is one command.
  - ▶ Great for tracking why results changed.
  - ▶ “Why is that coefficient now 0.8?”
- It has a learning curve (command line based), but you will earn back the time invested in 3 months max.
- Knowing Git is a requirement in technology jobs.

# MAKE

- Make is one answer to the replication crisis.
- It is a versatile tool which can run commands to read files, process these files in some way (such as compiling and linking them), and write out the processed files.
- I now set up my projects so that one command—*make*—processes all the data, generates all the empirical results based on the generated, solves the model targeting the empirical moments, and compiles the latex paper and presentation.
- Anyone can take my code, type *make* and replicate the paper exactly.
- Make can be very cryptic to start with, but you will earn back the time invested in 3 months max. And you will sleep better.

# MAKE BASICS

- You should think of a *makefile* as a cooking recipe.
  - 1 You want an output, “table1.tex”.
  - 2 “table1.tex” is built using data from “maindataset.csv” and the script “createtable.py.”
  - 3 In *make* you type:  
table1.tex: createtable.py maindataset.csv  
python createtable.py
- The general syntax is:  
output: dependencies  
steps to generate output from dependencies
- It is straightforward to chain makefiles together to perform tasks in sequence.

# WHY MAKE?

- *Make* will only execute the code if it sees that the current output (“table1.tex”) is older than the dependencies (the python file or the csv file have changed).
- Chaining makefiles removes errors from manual execution order.
- Makefiles are documentation. The makefile tells you how “table1.tex” is generated. It is much more reliable documentation than keeping script headers updated.
  - ▶ Helpful for both you (if you have not worked on the project for a few weeks) and your co-authors.
- Can easily handle multiple programs (python, matlab, stata, R) and shell commands.

# TASKS

- A typical organization of empirical work is by type of document. In a project folder you will see folders such as “Data”, “Stata”, “Matlab”, etc.
- I now believe this organization is unhelpful as the relationship between the different files is not clear.
- Instead, I now organize my work by Task. The folders in my directory are called “downloaddata”, “createhousepriceindex”, “aggregateACSdata”.
- In each folder performs a dedicated task, which should be fairly evident from the title of the folder.
- Each task folder has at three subfolders: “input”, “code”, “output”.
- Can you guess how the subfolders are related?

# WHY TASKS?

- Automatic documentation: the code transforms the input into output. You do not need to write a pdf explaining how the files are related.
- Straightforward to feed in output from one tasks as input in another by using symbolic links in makefiles.
- Easy to audit, as only need to check that a specific task is performed correctly.
- Simple to port tasks to another project.
- I find it much easier to return to a task based project after a few months.

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# KEY CONCEPTS<sup>2</sup>

- Data Generating Process
- Identification
- Causal Effect / Treatment Effect
- Moment

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<sup>2</sup>This material draws on Pat Kline's Econ 244 notes.

# DATA GENERATING PROCESS

- A *data generating process* (DGP) is a complete specification of the stochastic process generating the observed data.
- Equivalently, a specification of the probability  $P_{\theta}(\mathbf{y})$  of observing any possible vector valued realization of the data  $\mathbf{Y}$ .
- Example: A DGP for  $(Y_i, X_i)$  is

$$Y_i = X_i + \varepsilon_i$$
$$(X_i, \varepsilon_i) \sim N(0, I_2)$$

- In general a DGP is something you should be able to program in your computer and draw a sample from.

# DATA GENERATING PROCESS

- The DGP is assumed to belong to some family  $\mathcal{F}$ .
- A set of restrictions indexing a particular DGP in  $\mathcal{F}$  is called a *structure*  $\mathcal{S}$ .
- A *model*  $\mathcal{M}$  is a family of possible structures.
- Example of a *model*:

$$Y_i = \beta_0 + \beta_1 X_i + \varepsilon_i$$
$$(X_i, \varepsilon_i) \sim N \begin{pmatrix} \mu_1 & \sigma_1^2 & \sigma_{12}^2 \\ \mu_2 & \sigma_2^2 & \sigma_{12}^2 \end{pmatrix}$$
$$\boldsymbol{\theta} = (\beta_0, \beta_1, \mu_1, \mu_2, \sigma_1^2, \sigma_2^2, \sigma_{12})$$

- Example of a *structure*:  $\boldsymbol{\theta} = (0, 0, 0, 0, 1, 1, 0)$

# IDENTIFICATION

- What is it?

# IDENTIFICATION

- The problem of determining the structure from the joint distribution of the data in the population.
- Population  $\Rightarrow$  What is knowable in infinite datasets.
- Tells us whether it is worth constructing estimators for use in real datasets.
- Two structures  $\theta'$  and  $\theta''$  are *observationally equivalent* if  $P_{\theta'}(\mathbf{y}) = P_{\theta''}(\mathbf{y})$ .
- The structure  $\theta'$  is *globally point identified* if there is no other  $\theta$  in the model space with which it is observationally equivalent.

## EXAMPLES

$$Y_i \sim N(\mu, \sigma^2)$$

$$\boldsymbol{\theta} = (\mu, \sigma^2)$$

- Is  $\boldsymbol{\theta}$  identified? How?

$$Y_i = \beta_1 X_i + \varepsilon_i$$

$$(X_i, \varepsilon_i) \sim N\left(\begin{pmatrix} 0 \\ 0 \end{pmatrix}, \begin{pmatrix} \sigma_1^2 & 0 \\ 0 & \sigma_2^2 \end{pmatrix}\right)$$

$$\boldsymbol{\theta} = (\beta_1, \sigma_1^2, \sigma_2^2)$$

- Is  $\boldsymbol{\theta}$  identified? How?
- Neoclassical growth model. Identified? How?

# LANGUAGE

- In econometrics you can either identify the structure  $\theta$  (think parameters) in the model  $\mathcal{M}$  or you cannot.
- “Identifying assumptions” are restrictions on the model  $\mathcal{M}$  (family of DGPs) such that  $\theta$  is identified.
- Don’t run a regression if you can’t describe the model  $\mathcal{M}$  under which the parameter(s) of interest are identified.

# CAUSALITY

- Identification by itself has nothing to do with causality.
- Structural models postulate functional relationships for how endogenous variables are generated from exogenous variables. E.g.:

$$Y_i = f(S_i, X_i, U_i)$$
$$(s, x, u) \in \Omega_s \times \Omega_x \times \Omega_u$$

with  $(Y, S, X)$  observed and  $U$  unobserved.

- If  $S$  can be varied independently of  $X$  and  $U$ , then the model implies a set of *counterfactual* values that the outcome  $y = f(s, x, u)$  would take under various values of the treatment  $s$ .
- The *causal effect* or *treatment effect* of changing  $s$  from  $s'$  to  $s''$  is

$$\Delta_i = f(s'', x_i, u_i) - f(s', x_i, u_i)$$



## POTENTIAL OUTCOMES

- Microeconomists will often use potential outcome notation for specifying causal questions.
- An advantage of this framework is that it forces the researcher to be very explicit about the counterfactual.
- $D_i \in [0, 1]$  is the treatment indicator.
- $Y_i$  is the observed data,  $Y_i^0$  the outcome under treatment  $D_i = 0$ , and  $Y_i^1$  the outcome under treatment  $D_i = 1$ ,

$$Y_i = D_i Y_i^1 + (1 - D_i) Y_i^0$$

- The causal / treatment effect is

$$\Delta_i = Y_i^1 - Y_i^0$$

# AVERAGE TREATMENT EFFECT

- We are often interested in the *average treatment effect* (ATE),  $E(\Delta_i)$ .
- If treatment is independent of potential outcomes,

$$D_i \perp (Y_i^1, Y_i^0)$$

then a simple difference in means uncovers the ATE:

$$\begin{aligned} E(Y_i^1 | D_i = 1) - E(Y_i^0 | D_i = 0) &= E(Y_i^1) - E(Y_i^0) \\ &= E(Y_i^1 - Y_i^0) \\ &= E(\Delta_i) \end{aligned}$$

- Independence is an identifying assumption. This condition is sometimes called “unconfoundedness.”

# CONDITIONAL INDEPENDENCE

- It is rare in (macro-)economics that the independence assumption is reasonable.
- Most of empirical we will see in this class will assume

$$D_i \perp (Y_i^1, Y_i^0 | X_i)$$

- $X$  could be a set of controls, in which case this will be termed “conditional independence assumption” or “selection on observables”.
- $X$  could also be an instrument that is correlated with the treatment.

# POTENTIAL OUTCOMES AND STRUCTURAL MODELS

- Any model of potential outcomes can be written as a degenerate structural model and any structural model implies a set of potential outcomes.
- Example:  $Y_i = \beta_0 + \beta_{i1}D_i + \varepsilon_i$ ,  $E(\beta_{i1}) = \mu$  implies potential outcomes

$$Y_i^0 = \beta_0 + \varepsilon_i$$

$$Y_i^1 = \beta_0 + \beta_{i1} + \varepsilon_i$$

- Independence implies  $E(\varepsilon_i|D_i) = 0$ . This is a restriction on the model. The parameter (structure) we are identifying is  $\mu$ .
- Key result: Under (conditional) independence, a difference in (conditional) means will identify the ATE regardless of the underlying DGP.

# SUTVA

- Potential outcomes are not commonly used in macroeconomics.
- I believe this is because the *stable unit treatment value assumption* (SUTVA) is less plausible.
- SUTVA:
  - ① The potential outcome is unaffected by the mechanism by which treatment is assigned.
  - ② The potential outcome is unaffected by the treatment exposure of all other individuals.
- In macro we often worry about “spillovers” through general equilibrium price changes, migration, etc, which would violate (2).
- If SUTVA is invalid then the (conditional) difference in means no longer identifies the ATE.
- This is closely related to the aggregation problem from micro to macro.

# MOMENTS

- Identification and causality are population-level concepts.
- A *moment* is a statistic of the data, either in population or in a finite sample.
- Examples:
  - ▶  $E(Y_i^1|D_i = 1) - E(Y_i^0|D_i = 0)$ .
  - ▶ Every estimator is a moment.
- Causal effects are moments, parameters are population moments.
- But not all moments are causal effects, parameters, etc.

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# CLASSIC MACRO QUESTIONS

- ① What are the sources of business cycle fluctuations?
- ② How does monetary policy affect the economy?
- ③ How does fiscal policy affect the economy?
- ④ Why do some countries grow faster than others?
  - Why are we still asking the same questions?
  - Nakamura-Steinsson: Identification in macro is hard.



# ENDOGENEITY PROBLEM

- Example: Monetary Policy
- Federal Reserve changes interest rates for a reason.
- Quickly lowered interest rates in early 2020.
- Regress

$$\text{Output Growth}_t = \beta_0 + \beta_1 \text{FFR}_t + \varepsilon_t$$

will yield  $\beta_1 > 0$ ...

- Does this mean increasing interest rates raises GDP growth?

# EXTERNAL VALIDITY PROBLEM

- Even if we can identify a causal effect, the information content is limited.
  - E.g., does not answer “raise the FFR by 25bp today vs next month.”
  - ① High dimensionality of policy: Raise rates now? Later? Announcements or actions.
  - ② Causal effect depends on reaction of other policy variables: e.g., fiscal, monetary.
  - ③ Impact may be state-dependent: e.g., recession vs boom.
  - ④ Is policy anticipated or a surprise?
- ⇒ Paucity of evidence relative to dimensionality of policy means macroeconomics tends to rely more on structural modeling.

# COMBINING MODEL AND DATA: CALIBRATION

- The calibration approach uses select micro and macro moments to discipline model parameters.
- Examples:
  - ▶ Exponent on production function from factor shares.
  - ▶ Labor supply elasticity from labor literature.
  - ▶ Equity premium.
- Essentially GMM without standard errors (exactly identified).
- Which moments to select? How informative are they?

# COMBINING MODEL AND DATA: STRUCTURAL ESTIMATION

- Bayesian estimation of structural model:
  - ▶ Match time series: Smets and Wouters (2007)
  - ▶ Match IRF to monetary policy shock: Christiano, Eichenbaum and Evans (2005)
- Mapping from data to model not always transparent.
- How important are priors?
- How important is model misspecification?

# COMBINING MODEL AND DATA: CAUSAL EFFECTS

- Nakamura and Steinsson advocate for the use of causal effects (“identified moments”) in distinguishing between competing models of the macroeconomy.
  - ⇒ Use causal effects in moment matching / structural estimation.
- Why causal effects?
  - ▶ Portable: Statistics that can be used over and over again to discipline and test different models. (What statistic is not portable?)
  - ▶ Informative: Help discipline particular causal mechanism of model. Invariant to changes in other model “blocks.”

# EXAMPLES OF CAUSAL EFFECTS

- Real effect of monetary policy.
- Gali (1999) Basu-Fernald-Kimball (2006) responses of output and hours to identified productivity shock reject RBC.
- MPC out of tax rebates useful to discipline “consumption block” of models.
- Mian-Sufi-Rao: Causal effect of house prices on consumption reject complete market models in favor of incomplete markets/life-cycle models.
- Labor supply elasticity.

# AGGREGATE VERSUS CROSS-SECTIONAL IDENTIFICATION

- Estimating convincing casual effects in the aggregate (time-series) is extremely difficult.
- Identification arguments are generally more plausible in the cross-section:
  - ▶ Control for confounding observables.
  - ▶ Difference out unknown confounding variation that is common across units with time fixed effects.
  - ▶ Deep dive next lecture.
- Fiscal multipliers:
  - ▶ Wide range of aggregate multipliers (e.g., Blanchard and Perotti 2002, Rameym 2011)
  - ▶ Cross-sectional multipliers cluster around 1.5-2 (Chodorow-Reich, 2019).

# AGGREGATION

- Key challenge:
  - ▶ Cross-sectional responses don't directly answer key aggregate questions.
  - ▶ How to go from cross-sectional responses to aggregate responses?
- Need to build model for the aggregation step.
  - ▶ Focus of lecture 3.
- Success is that the cross-sectional causal effect tells us something important about the aggregate economy.
  - ▶ E.g., aggregate effect, set identification of model...
- The modern macroeconomists needs to do both a labor economists and a micro theorists.
  - ▶ Is life unfair?



# DOES MONETARY POLICY HAVE REAL EFFECTS?

- NS close by discussing evidence on the real effects of monetary policy:
  - ① Large shocks: Friedman and Schwartz (1963), Volcker Recession
  - ② Discontinuity-Based Identification: Mussa (1986).
  - ③ Narrative approach: Romer and Romer (1989).
  - ④ Controlling for observables: structural VARs, Romer and Romer (2004).
- Which approaches are more convincing?
- What do they have in common?

## REIS (2018)

“Is Something Really Wrong With Macroeconomic?”

*Asking an active researcher in macroeconomics to consider what is wrong with macroeconomics today is sure to produce a biased answer. The answer is simple: everything is wrong with macroeconomics. Every hour of my workday is spent identifying where our knowledge falls short and how can I improve it. Researchers are experts at identifying the flaws in our current knowledge and in proposing ways to fix them. That is what research is. So, whenever you ask me what is wrong with any part of economics, I am trained by years on the job to tell you many ways in which it is wrong. With some luck, I may even point you to a paper that I wrote proposing a way to fix one of the problems.*

## NEXT WEEK:

- Deep dive into cross-sectional econometrics.
- Applying what we learned to fiscal multiplier estimation by Nakamura and Steinsson (2014).