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Expectations as a Source of Macroeconomic Persistence: Evidence from Survey Expectations in a Dynamic Macro Model

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Abstract:

Embedding survey expectations in a standard DSGE model helps to identify key slope parameters in standard relationships; dramatically reduces the need for lagged dependent variables, often motivated by price-indexation and habit formation; and obviates the need for autocorrelated structural shocks in the key equations. Formal statistical tests demonstrate that much of the persistence in aggregate data is better accounted for by slow-moving expectations, rather than by habits, indexation and autocorrelated structural shocks.

JEL Classifications: E32, E52

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1. Introduction

Macroeconomic models have followed two long-standing traditions. The first, typified by vector autoregressions (VARs), aims to achieve empirical fit while imposing minimal theoretical restrictions. The second is the DSGE tradition, which derives micro-founded models, imposing tight theoretical restrictions, while still hoping to obtain reasonable empirical success. In between these two strands are models like the Federal Reserve Board staff's FRB/US model, which embodies theory-based structural relationships, but also employs numerous empirically-motivated additions to the theory-model core. Curiously, most DSGE models, while beginning from sound theoretical foundations, have also added a number of empirically-motivated add-ons, to address significant counterfactual implications of the earlier versions of these models (see for example Estrella and Fuhrer 2002, Rudd and Whelan 2005). The additions of habit formation, price indexation (for which there is scant microeconomic evidence), adjustment costs,

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