Contents

Preface vii

Chapter 1 Introduction 1

The idea of Representative Agents and Lifespan 3
Teaching DSGE models in undergraduate and graduate courses 4
Dynare 5
The structure of the book 6

PART I Basic principles

Chapter 2 Real Business Cycle (RBC) model 11

Brief theoretical review: Real Business Cycles 11
Model with two "goods": consumption and leisure 12
Dynamic structure of consumption-savings 22
Input markets 29
The model 33
Households 33
Firms 37
The model's equilibrium conditions 40
Steady state 41
Log-linearization (Uhlig's method) 48
Productivity shock 52

Chapter 3 Basic New-Keynesian (NK) model 59

Brief theoretical review: New-Keynesians 60
Differentiated Products and the Consumption Aggregator 60
Firms in monopolistic competition 62
Price stickiness 64
The model 66

Households 66
Firms 66
The model's equilibrium condition 74
Steady state 75
Log-linearization (Uhlig's method) 79
Productivity shock 83
Chapter 4 New-Keynesian model with wage stickiness 89
Brief theoretical review: wage stickiness 89
Why would wages be rigid in the short term? 90
The model 93
Households 93
Firms 97
The model's equilibrium condition 98
Steady state 98
Log-linearization (Uhlig's method) 104
Productivity shock 106
Is there an interpretation problem related to the assumption of the presence or absence of frictions in the model's prices and wages? 108
PART II Extensions
Chapter 5 New-Keynesian model with habit formation and non-Ricardian agents 117
Brief theoretical review: household rigidity 118
Habit formation 118
Non-Ricardian agents 121
The model 123
Households 123
Firms 128
The model's equilibrium conditions 129
Steady state 130
Log-linearization (Uhlig's method) 136
Productivity shock 141

Is there an interpretation problem related to the presence or absence of household frictions (habit formation and non-Ricardian agents)? 143
Chapter 6 New Keynesian Model with adjustment costs on investment and the under-utilization of maximum installed capacity 151
A brief theoretical review: adjustment costs on investment and the under-utilization of maximum installed capacity 152
Adjustment Cost on Investment 152
Cost of under-utilization of maximum installed capacity 154
The model 157
Households 157
Firms 161
The model's equilibrium condition 162
Steady state 162
Log-linearization (Uhlig's method) 167
Productivity Shock 173
Chapter 7 New-Keynesian Model with government 179
A brief theoretical review: Government 179
Introducing taxes into the DSGE models 180
Government budget constraints 181
Public investment 188
Alternative forms of government in the DSGE models 188
Taylor's Rule 191
The model 192
Households 192
Firms 198
Government 199
Model's equilibrium condition 201
Steady state 203
Log-linearization (Uhlig's Method) 214
Monetary and fiscal policy productivity shocks and analysis of the Laffer curve 227

Productivity and monetary shocks 228
Fiscal policy shocks 230
Using taxation for fiscal adjustment 235
The Laffer curve 236
References 243
Appendix A Mathematical Tools 253
Lagrange Optimization 253
Example 254
Operations with matrices and eigenvalues 255
Adding and subtracting matrices 255
Multiplication of matrices 256
Calculation of the inverse matrix 256
Eigenvalues 258
Appendix B Basic ideas about DSGE 259
Calibration 259
Blanchard-Kahn (BK) unique solution and stability condition 260
An example from the book: RBC model in Chapter 2 263