Comments: Modern DSGE Models

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Much Progress over 40 Years

- Ad-hoc IS-LM models
- Replaced by DSGEs with
  - Optimizing households and firms
  - Forward-looking agents
  - Market-clearing prices

$\Rightarrow$ Designed to analyze policy

Two Progress Reports

- Eichenbaum:
  - DSGEs are used by *and* useful for central bankers
- Uhlig:
  - DSGEs are not yet useful for central bankers

DSGE: Achievement

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  - Early RBC models
    - No money
    - Frictionless markets
    - Missed key properties of data
  - Early NK models
    - More qualitative than quantitative

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  - Are these models useful for policy analysis?

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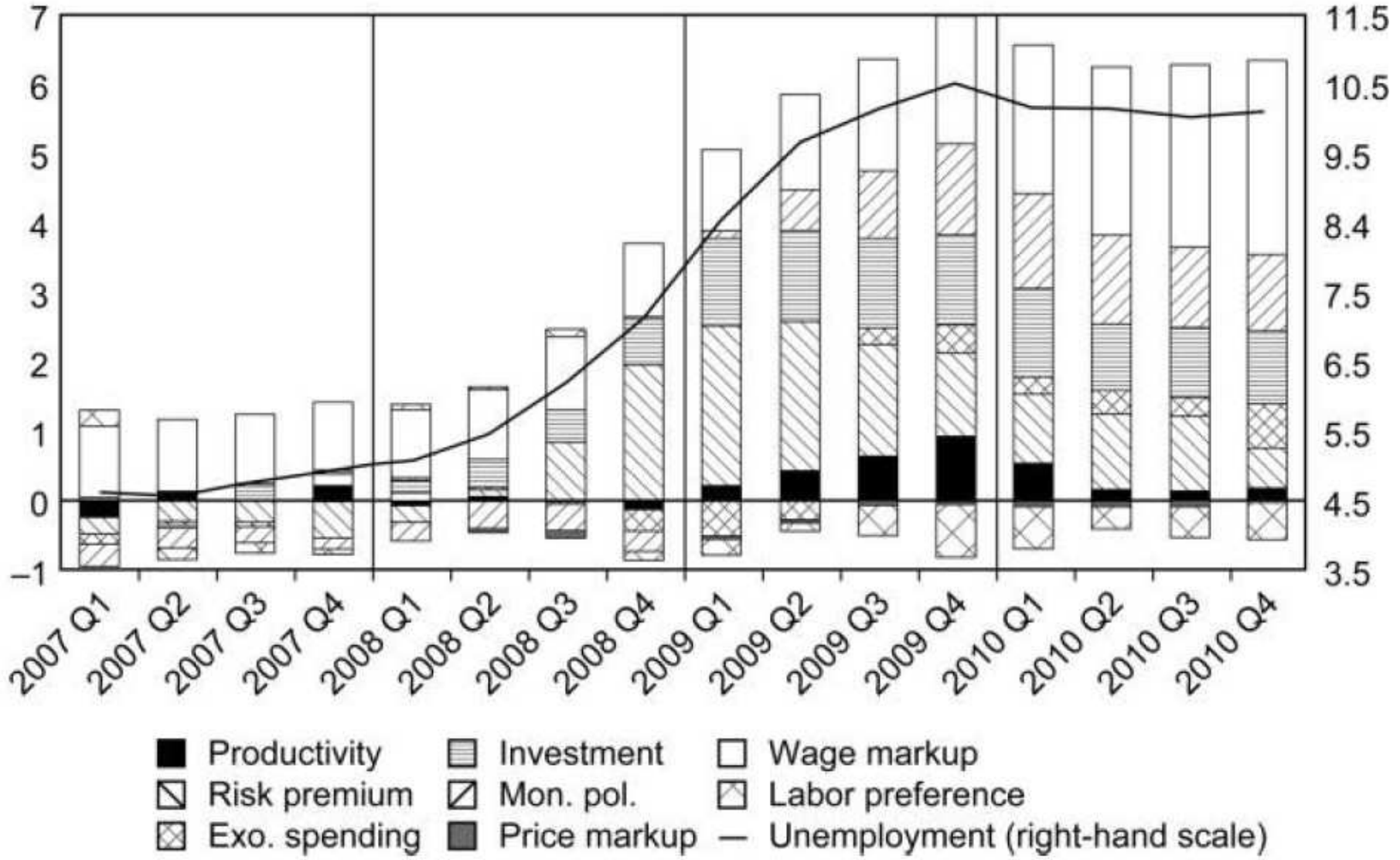
. . . Next, consider evidence for key labor market variables

Unemployment (Gali, Smets, Wouters)



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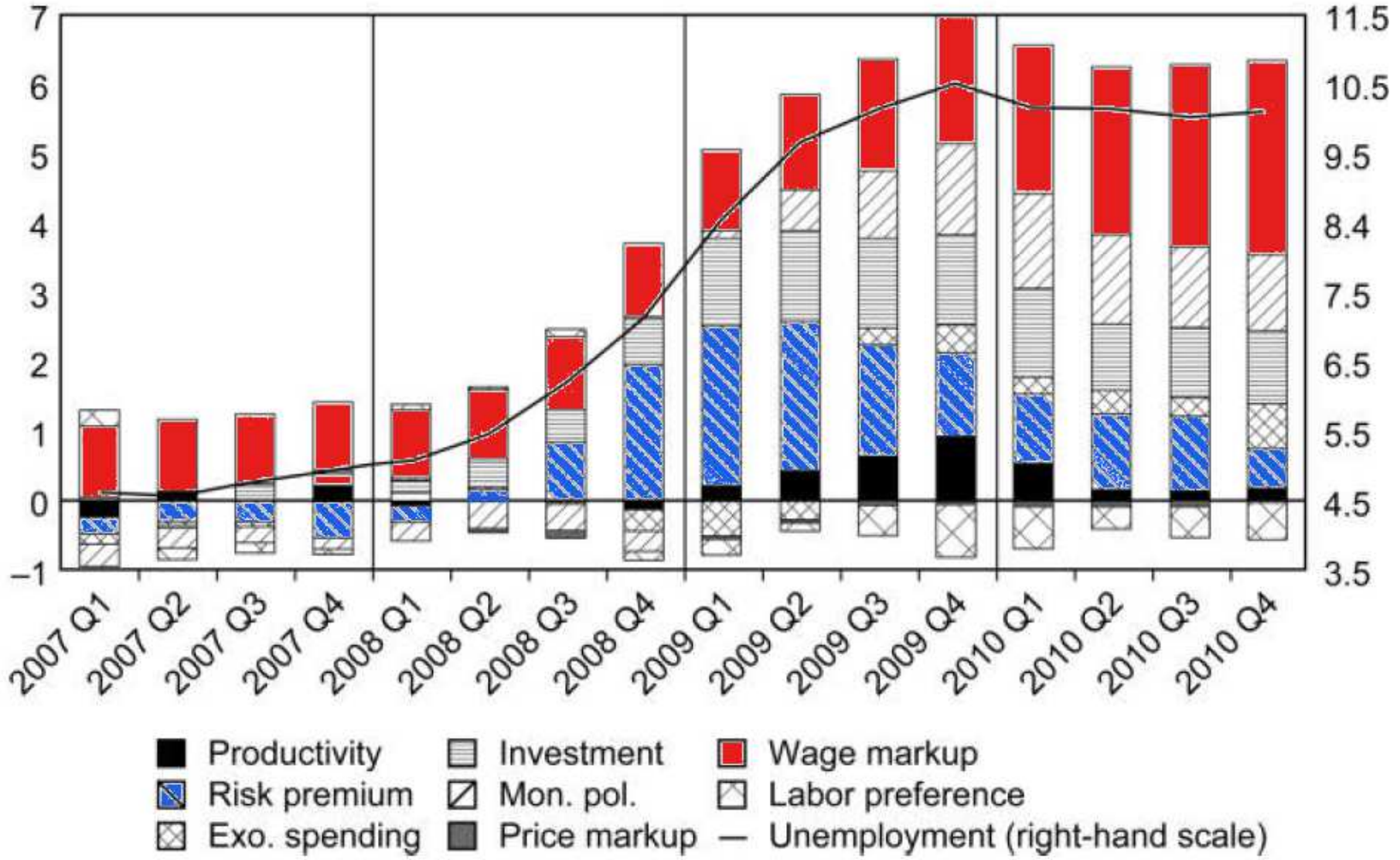
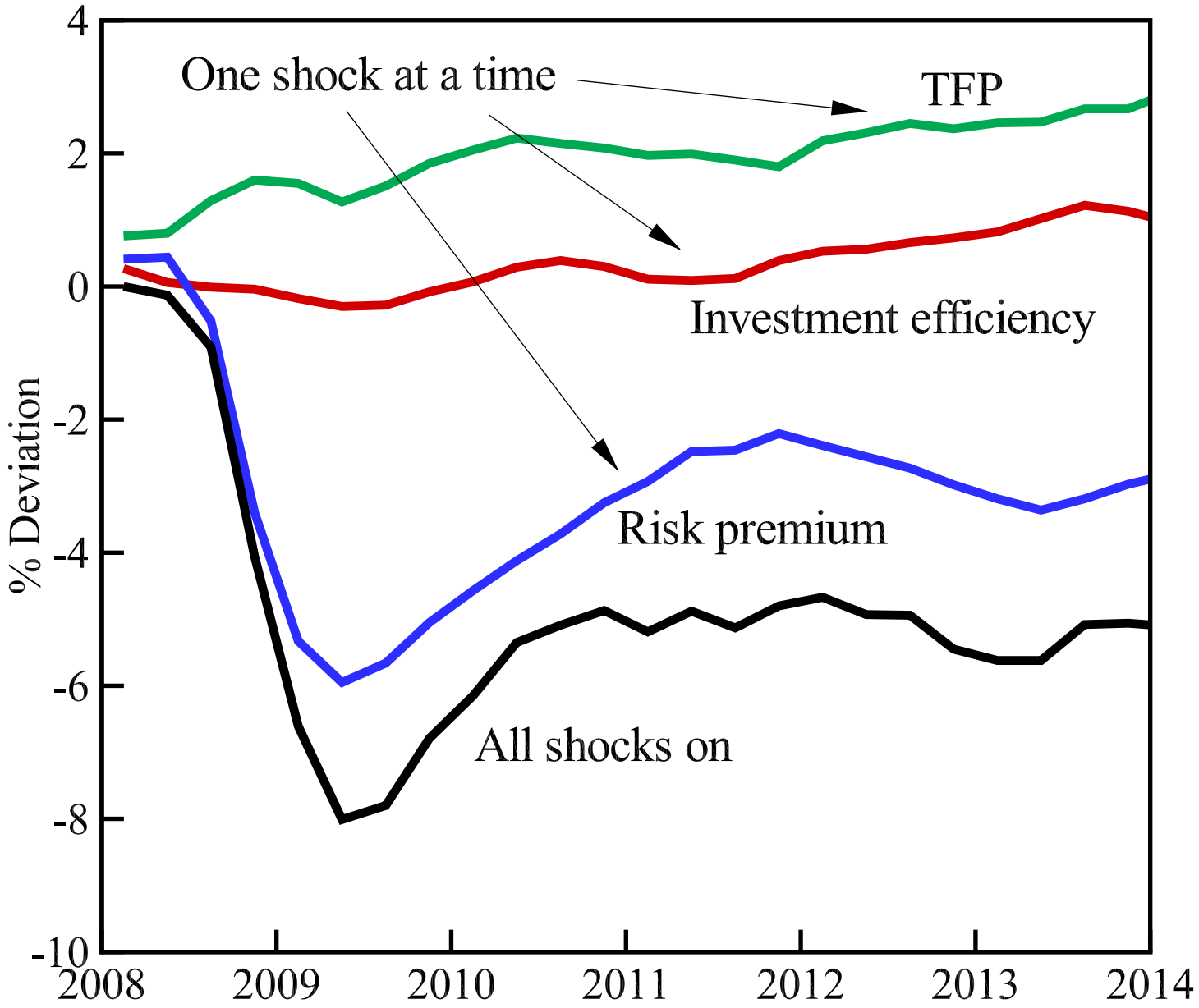


Hours (Gust, Herbst, Lopez-Salido, Smith)



Shocks or Wedges?

- Invariant to monetary policy?
  - Wage markups:
    - Preference shocks?
    - Monopoly power shocks?
  - Risk premia:
    - Flight-to-quality shocks?
    - External financing cost shocks?
    - Capital quality shocks?
- Without structure, summarizes extent of our ignorance

A Way Forward

- To do policy analysis, need to:
  - Identify which wedges most important
  - Use findings to identify promising DSGE models with
    - Micro-founded frictions
    - Primitive, interpretable shocks
  - Discipline analyses with micro evidence
- So far, have only done step 1

A Better Way Forward

- More emphasis on designing rules and institutions
- Lots of examples from the Minneapolis Fed, eg,
  - Wallace, "A Modigliani-Miller Theorem for O-M Ops"
    $\Rightarrow$ Relevant for Quantitative Easing
  - Sargent-Wallace, "Unpleasant Monetartist Arithmetic"
    $\Rightarrow$ Relevant for current Euro crisis
  - Kareken-Wallace, "Deposit Insurance and Bank Reg"
    $\Rightarrow$ Relevant for Too Big to Fail
- Which were seeds of later quantitative DSGE analyses