

Contents

Preface	xvii
Acknowledgments	xxiii
I Dynamical Systems	1
1 Deterministic Difference Equations	3
1.1 Scalar First-Order Linear Equations	3
1.2 Lag Operators	8
1.3 Scalar Second-Order Linear Equations	8
1.4 First-Order Linear Systems	11
1.4.1 Nonsingular System	12
1.4.2 Singular System	17
1.5 Phase Diagrams	20
1.6 Nonlinear Systems	21
1.7 Numerical Solutions Using Dynare	24
1.8 Exercises	30
2 Stochastic Difference Equations	33
2.1 First-Order Linear Systems	33
2.2 Scalar Linear Rational Expectations Models	35
2.2.1 Lag Operators	35
2.2.2 Method of Undetermined Coefficients	38
2.3 Multivariate Linear Rational Expectations Models	38
2.3.1 Blanchard–Kahn Method	39
2.3.2 Klein Method	41
2.3.3 Sims Method	43
2.4 Nonlinear Rational Expectations Models	48
2.5 Numerical Solutions Using Dynare	53
2.6 Exercises	62

3	Markov Processes	63
3.1	Markov Chains	64
3.1.1	Classification of States	67
3.1.2	Stationary Distribution	70
3.1.3	Countable-State Markov Chains	73
3.2	General Markov Processes	75
3.3	Convergence	78
3.3.1	Strong Convergence	79
3.3.2	Weak Convergence	81
3.4	Exercises	85
4	Ergodic Theory and Stationary Processes	87
4.1	Ergodic Theorem	87
4.2	Application to Stationary Processes	91
4.3	Application to Stationary Markov Processes	95
4.4	Exercises	98
II	Dynamic Optimization	99
5	Markov Decision Process Model	101
5.1	Model Setup	101
5.2	Examples	107
5.2.1	Discrete Choice	107
5.2.2	Optimal Stopping	108
5.2.3	Bandit Model	111
5.2.4	Optimal Control	114
5.3	Exercises	115
6	Finite-Horizon Dynamic Programming	117
6.1	A Motivating Example	117
6.2	Measurability Problem	120
6.3	Principle of Optimality	121
6.4	Optimal Control	128
6.5	Maximum Principle	134
6.6	Applications	138
6.6.1	Secretary Problem	138
6.6.2	A Consumption-Saving Problem	139
6.7	Exercises	141

7	Infinite-Horizon Dynamic Programming	143
7.1	Principle of Optimality	143
7.2	Bounded Rewards	152
7.3	Optimal Control	154
7.3.1	Bounded Rewards	154
7.3.2	Unbounded Rewards	157
7.4	The Maximum Principle and Transversality Conditions	162
7.5	Euler Equations and Transversality Condition	165
7.6	Exercises	170
8	Applications	173
8.1	Option Exercise	173
8.2	Discrete Choice	176
8.3	Consumption and Saving	178
8.3.1	Deterministic Income	180
8.3.2	Stochastic Income	187
8.4	Consumption/Portfolio Choice	195
8.5	Inventory	197
8.5.1	Finite-Horizon Problem	199
8.5.2	Infinite-Horizon Problem	203
8.6	Investment	208
8.6.1	Neoclassical Theory	208
8.6.2	Q Theory	209
8.6.3	Augmented Adjustment Costs	211
8.7	Exercises	217
9	Linear-Quadratic Models	221
9.1	Controlled Linear State-Space System	221
9.2	Finite-Horizon Problems	223
9.3	Infinite-Horizon Limits	226
9.3.1	Value Function Iteration	229
9.3.2	Policy Improvement Algorithm	230
9.3.3	Lagrange Method	230
9.4	Optimal Policy under Commitment	231
9.5	Optimal Discretionary Policy	237
9.6	Robust Control	241
9.6.1	Belief Distortions and Entropy	241
9.6.2	Two Robust Control Problems	243
9.6.3	Recursive Formulation	244

9.6.4	<i>Linear-Quadratic Model with Gaussian Disturbances</i>	245
9.6.5	<i>Relative Entropy and Normal Distributions</i>	247
9.6.6	<i>Modified Certainty Equivalence Principle</i>	248
9.7	<i>Exercises</i>	248
10	Control under Partial Information	251
10.1	<i>Filters</i>	251
10.1.1	<i>Kalman Filter</i>	251
10.1.2	<i>Hidden Markov Chain</i>	258
10.1.3	<i>Hidden Markov-Switching Model</i>	260
10.2	<i>Control Problems</i>	261
10.3	<i>Linear-Quadratic Control</i>	263
10.4	<i>Exercises</i>	265
11	Numerical Methods	267
11.1	<i>Numerical Integration</i>	267
11.1.1	<i>Gaussian Quadrature</i>	267
11.1.2	<i>Multidimensional Quadrature</i>	269
11.2	<i>Discretizing AR(1) Processes</i>	270
11.2.1	<i>Tauchen (1986) Method</i>	270
11.2.2	<i>Tauchen-Hussey (1991) Method</i>	271
11.2.3	<i>Simulating a Markov Chain</i>	272
11.3	<i>Interpolation</i>	273
11.3.1	<i>Orthogonal Polynomials</i>	274
11.3.2	<i>Splines</i>	278
11.3.3	<i>Multidimensional Approximation</i>	280
11.4	<i>Perturbation Methods</i>	283
11.5	<i>Projection Methods</i>	285
11.6	<i>Numerical Dynamic Programming</i>	290
11.6.1	<i>Discrete Approximation Methods</i>	291
11.6.2	<i>Smooth Approximation Methods</i>	293
11.7	<i>Exercises</i>	296
12	Structural Estimation	297
12.1	<i>Generalized Method of Moments</i>	297
12.1.1	<i>Estimation</i>	298
12.1.2	<i>Asymptotic Properties</i>	300
12.1.3	<i>Weighting Matrix and Covariance Matrix Estimation</i>	302
12.1.4	<i>Overidentifying Restrictions</i>	303
12.1.5	<i>Implementation</i>	304
12.1.6	<i>Relation to Other Estimation Methods</i>	305

12.2	Maximum Likelihood	305
12.2.1	Estimation	305
12.2.2	Asymptotic Properties	306
12.2.3	Hypothesis Testing	307
12.3	Simulation-Based Methods	308
12.3.1	Simulated Method of Moments	309
12.3.2	Simulated Maximum Likelihood	311
12.3.3	Indirect Inference	311
12.4	Exercises	315
III	Equilibrium Analysis	317
13	Complete Markets Exchange Economies	319
13.1	Uncertainty, Preferences, and Endowments	319
13.2	Pareto Optimum	320
13.3	Time 0 Trading	321
13.3.1	Equilibrium Computation	323
13.3.2	Two Welfare Theorems	323
13.3.3	Asset Pricing	325
13.4	Sequential Trading	326
13.4.1	Investment Opportunities	326
13.4.2	Ponzi Scheme and Portfolio Constraints	327
13.4.3	Radner Equilibrium	328
13.4.4	Arbitrage and State Prices	329
13.4.5	Complete Markets	331
13.4.6	Equilibrium with Transversality Condition	332
13.4.7	Natural Debt Limit	334
13.5	Equivalence of Equilibria	334
13.6	Asset Price Bubbles	337
13.7	Recursive Formulation	342
13.8	Asset Pricing	344
13.8.1	Capital Asset-Pricing Model	345
13.8.2	Factor-Pricing Model	345
13.8.3	Consumption-Based Capital Asset-Pricing Model	346
13.9	Exercises	348
14	Neoclassical Growth Models	353
14.1	Deterministic Models	353
14.1.1	A Basic Ramsey Model	353
14.1.2	Incorporating Fiscal Policy	362

14.2	A Basic RBC Model	365
14.2.1	Steady State	366
14.2.2	Calibration	367
14.2.3	Log-Linearized System	367
14.2.4	Business Cycle Statistics and Model Results	372
14.2.5	Impact of a Permanent TFP Shock	375
14.2.6	Impact of a Temporary TFP Shock	376
14.2.7	Effects of Persistence and Critiques of the RBC Model	377
14.3	Extensions of the Basic RBC Model	378
14.3.1	Various Utility Functions	378
14.3.2	Capacity Utilization	383
14.3.3	Capital or Investment Adjustment Costs	384
14.3.4	Stochastic Trends	389
14.3.5	Other Sources of Shocks	391
14.4	Exercises	394
15	Bayesian Estimation of DSGE Models Using Dynare	397
15.1	Principles of Bayesian Estimation	398
15.2	Bayesian Estimation of DSGE Models	399
15.2.1	Numerical Solution and State-Space Representation	400
15.2.2	Evaluating the Likelihood Function	401
15.2.3	Computing the Posterior	403
15.3	An Example	405
15.3.1	Dynare Codes	405
15.3.2	Dynare Output	409
15.3.3	Stochastic Trends	410
15.4	Exercises	411
16	Overlapping Generations Models	413
16.1	Exchange Economies	413
16.1.1	A Special Case and Multiple Equilibria	415
16.1.2	Existence and Efficiency	420
16.2	Production Economies	425
16.2.1	Multiple Equilibria	427
16.2.2	Dynamic Efficiency	431
16.3	Asset Price Bubbles	432
16.4	Exercises	436
17	Incomplete Markets Models	439
17.1	Production Economies	439
17.1.1	Income Fluctuation Problem	440
17.1.2	Production	441

17.1.3	<i>Stationary Recursive Equilibrium</i>	442
17.1.4	<i>Computation and Implications</i>	443
17.2	Endowment Economies	447
17.2.1	<i>Risk-Free Rate</i>	447
17.2.2	<i>Fiat Money</i>	449
17.2.3	<i>Interest on Currency</i>	449
17.2.4	<i>Seigniorage</i>	452
17.3	Aggregate Shocks	454
17.3.1	<i>Recursive Equilibrium</i>	454
17.3.2	<i>Krusell-Smith Method</i>	455
17.4	Exercises	457
18	Search and Matching Models of Unemployment	459
18.1	A Basic DMP Model	460
18.1.1	<i>Steady State</i>	462
18.1.2	<i>Transitional Dynamics</i>	464
18.1.3	<i>Large Firms</i>	466
18.1.4	<i>Efficiency</i>	468
18.2	Endogenous Job Destruction	469
18.2.1	<i>Steady State</i>	472
18.2.2	<i>Transitional Dynamics</i>	475
18.3	Unemployment and Business Cycles	475
18.3.1	<i>Households</i>	475
18.3.2	<i>Firms</i>	477
18.3.3	<i>Nash Bargained Wages</i>	479
18.3.4	<i>Equilibrium</i>	480
18.4	Exercises	480
19	Dynamic New Keynesian Models	481
19.1	A Basic DNK Model	482
19.1.1	<i>Households</i>	482
19.1.2	<i>Final Goods Firms</i>	483
19.1.3	<i>Intermediate Goods Firms</i>	484
19.1.4	<i>Central Bank</i>	486
19.1.5	<i>Sticky-Price Equilibrium</i>	486
19.1.6	<i>Flexible-Price Equilibrium</i>	487
19.1.7	<i>Log-Linearized System</i>	488
19.2	Monetary Policy Design	493
19.2.1	<i>Efficient Allocation</i>	493
19.2.2	<i>Quadratic Approximation to Utility</i>	494
19.2.3	<i>Commitment versus Discretion</i>	498

19.3	Fiscal Stimulus	501
19.3.1	A Neoclassical Model	502
19.3.2	Monopolistic Competition	503
19.3.3	A DNK Model	504
19.3.4	Zero-Interest-Rate Lower Bound	507
19.3.5	Duration of Fiscal Stimulus	511
19.3.6	Government Purchases and Welfare	514
19.4	A Medium-Scale DSGE Model	517
19.4.1	Households	518
19.4.2	Firms	521
19.4.3	Monetary and Fiscal Policies	523
19.4.3	Aggregation and Equilibrium	523
19.5	Exercises	524
IV	Further Topics	525
20	Recursive Utility	527
20.1	Deterministic Case	528
20.1.1	Koopmans's Utility	528
20.1.2	Construction	530
20.2	Stochastic Case	533
20.2.1	Epstein–Zin Preferences	533
20.2.2	Ambiguity Aversion	539
20.2.3	Temporal Resolution of Uncertainty	546
20.3	Properties of Recursive Utility	549
20.3.1	Concavity	549
20.3.2	Risk Aversion	550
20.3.3	Utility Gradients and Pricing Kernels	550
20.4	Portfolio Choice and Asset Pricing	554
20.4.1	Optimality and Equilibrium	554
20.4.2	Log-Linear Approximation	557
20.4.3	Long-Run Risk	563
20.5	Pareto Optimality	569
20.5.1	Lucas–Stokey Approach	570
20.5.2	Dumas–Wang–Uppal Approach	572
20.6	Exercises	573
21	Dynamic Games	575
21.1	Repeated Games	576
21.1.1	Perfect Monitoring	576

21.1.2	<i>Equilibrium Payoff Set</i>	578
21.1.3	<i>Computation</i>	581
21.1.4	<i>Simple Strategies</i>	583
21.1.5	<i>Imperfect Public Monitoring</i>	583
21.2	<i>Dynamic Stochastic Games</i>	587
21.3	<i>Application: The Great Fish War</i>	588
21.4	<i>Credible Government Policies</i>	591
21.4.1	<i>One-Period Economy</i>	591
21.4.2	<i>Infinitely Repeated Economy</i>	593
21.4.3	<i>Equilibrium Value Set</i>	595
21.4.4	<i>Best and Worst SPE Values</i>	597
21.4.5	<i>Recursive Strategies</i>	599
21.5	<i>Exercises</i>	601
22	<i>Recursive Contracts</i>	603
22.1	<i>Limited Commitment</i>	604
22.1.1	<i>A Dynamic Programming Method</i>	605
22.1.2	<i>A Lagrangian Method</i>	607
22.1.3	<i>An Alternative Characterization</i>	608
22.2	<i>Hidden Action</i>	609
22.3	<i>Hidden Information</i>	615
22.3.1	<i>Characterizations</i>	617
22.3.2	<i>Long-Run Poverty</i>	621
22.4	<i>Exercises</i>	622
	<i>Mathematical Appendices</i>	625
A	<i>Linear Algebra</i>	627
B	<i>Real and Functional Analysis</i>	633
C	<i>Convex Analysis</i>	643
D	<i>Measure and Probability Theory</i>	651
	<i>References</i>	661
	<i>Matlab Index</i>	683
	<i>Name Index</i>	685
	<i>Subject Index</i>	691