Rapid estimation of nonlinear DSGE models

Hall, Jamie

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Jamie Hall*

School of Economics

University of New South Wales

jamie1212@gmail.com

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Abstract

This article describes a new approximation method for dynamic stochastic general equilibrium (DSGE) models. The method allows nonlinear models to be estimated efficiently and relatively quickly with the fully-adapted particle filter. The article demonstrates the method by estimating, on US data, a nonlinear New Keynesian model with a zero lower bound on the nominal interest rate.

Keywords: DSGE, nonlinear, particle filter.

1   Introduction

Nonlinear models of the macroeconomy can include a variety of interesting features that are off limits to linear models, such as time-varying volatility or policy regime switching. These models have been explored in simulation studies over recent years, but estimation remains rare. This is largely because of the computational difficulties involved. Finding an accurate nonlinear solution to a dynamic stochastic general equilibrium (DSGE) model can be time-consuming, and in order to estimate the model we must solve it many times over.

This paper describes a method for taking nonlinear DSGE models to the data. The method is based on local linearisation, that is, a linearisation of the model's policy function conditional on the current state. Conditional linearity implies that the model's prediction density has full support over the

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space of possible observations, which is not true of (for instance) a second-order approximation. While that issue causes no difficulty in simulation, it can be a critical issue in estimating the model, as described below. Additionally, a conditionally linear model with Gaussian shocks is fully adapted in the sense of Pitt & Shephard (1999), which makes estimation very efficient. (Note that while this paper assumes the structural shocks are Gaussian, mixtures of Gaussians are also fully adapted.)

This is not the only possible answer: one could also use a higher-order local approximation, or a global approximation. In Sections 1.1 and 1.2, I outline these alternatives and argue that a local linearisation is also worth considering. Section 2 describes the method in general terms, and Section 3 shows how it fits into a particle filtering framework. Since these general discussions are fairly abstract, Section 4 provides a worked example based on the neoclassical growth model. Finally, in Section 5, I report some estimation results for a nonlinear New Keynesian model.

1.1 Why not use a second-order approximation?

Simulation studies of nonlinear DSGE models often use a second-order Taylor approximation to the model solution (Schmitt-Grohé & Uribe 2004, Kim, Kim, Schaumburg & Sims 2008). That is to say, the law of motion of the model's state variables is approximated by an autoregression with linear terms, squares, and cross-products. Since this approximation has proven satisfactory for simulation studies, why not use it for estimation?

One reason is illustrated in Figure 1. This graph shows the possible values of the observed variable (growth in the price-dividend ratio) as a function of the structural consumption shock ν_t, in an asset pricing model with external habits (Campbell & Cochrane 1999). The precise details of the model are not important for this illustration; see Appendix A for a full explanation. The three lines in the graph correspond to three possible approximations: linear, quadratic, and quartic. The quartic approximation is fairly close to the exact solution, while the linear approximation is quite inaccurate. The important thing to notice is that the quadratic approximation bends back on itself for $\nu_t < 0.007$ (a little over one standard deviation away from zero). In other words, conditional on the given value of the state x_{t-1}, it is impossible for the second-order approximation to generate an observation lower than -6%. This is not a problem of misspecification, since all three approximations in the chart are calculated using the same parameters and the same model. Suppose that the model and parameters used to make this graph represented the true data generating process. Then the quartic

approximation indicates that the exact solution would generate a value of $\Delta \log y_t$ lower than -6% with a reasonable probability. Thus, even though the second-order approximation uses the correct model and the correct parameters, it would estimate the probability of that observation to be zero (in the absence of a noise term in the observation equation).
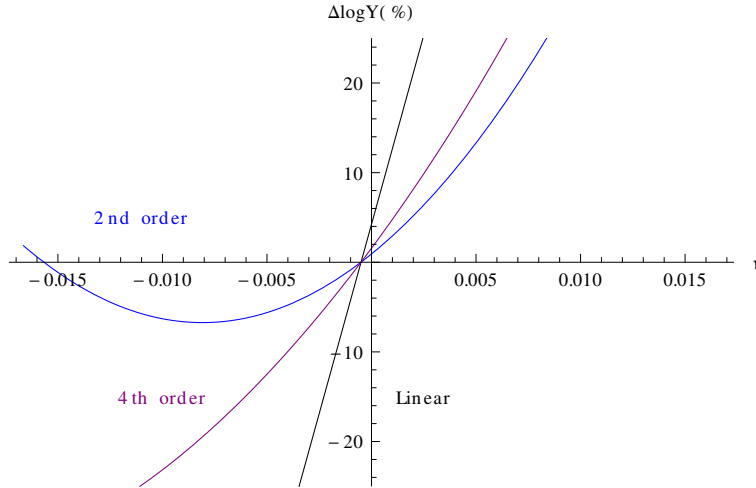

Figure 1: $\log y_t$ as a function of ν_t for a given x_{t-1} and θ: linear, quadratic, and quartic approximations. See Appendix A for details.

In general, quadratic functions can approximate a curved function accurately on a neighbourhood of the origin, but the location and size of this neighbourhood depend on the model's parameters, making estimation difficult. Additionally, as illustrated in Figure 1, the even nature of a quadratic function can make it useless for estimation, because it is not absolutely continuous with respect to the process that generates the observations, even when both the parameters and the model are correct.

It would be possible to continue using second-order approximations by acting as if the data series were observed with a large amount of noise. This would be worth pursuing if no alternatives were available. The next section briefly discusses some possible alternatives, and the rest of the paper presents another one.

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1.2 Why not use better global methods?

Recent work on DSGE models has employed more exotic approximation methods, which promise far greater accuracy than the first- or second-order Taylor approximations can deliver. This class of methods includes Smolyak polynomials (Fernández-Villaverde, Gordon, Guerrón-Quintana & Rubio-Ramírez 2012), as well as Chebyshev polynomials and other projection methods (Judd 1998, Heer & Maußner 2009).[1]

Although these methods promise greater sophistication and accuracy, it is still worth considering locally linear approximations, for two reasons. The first is speed. Those global methods can be somewhat time-consuming, even using modern high-performance computing. This makes them unappealing for use in estimation, where the solution to the model might be recalculated many thousands of times. The second reason for maintaining an interest in a locally linear approximation is that the latter is well-suited for use with the auxiliary particle filter, whereas global methods may not be.[2] The use of the auxiliary particle filter is discussed further in Section 3, and illustrated in Section 5.

Intuitively, the sequential Monte Carlo framework of particle filtering relies on representing the model's likelihood function with the product of a series of conditional likelihoods:

$$p(y_{1:T}|\theta) = \prod_{t=1}^{T} p(y_t|\theta, y_{1:(t-1)})$$

Therefore, the approximate solution of the model at time t does not need to be unconditionally accurate for all time. It only needs to maintain its validity into time $(t+1)$, at which point it can be recalculated. Thus the locally linear approach can attain higher accuracy close to the current state, at the cost of a larger discrepancy in other areas of the state space—but those areas are unlikely to be reached in a single step.

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[1]Specially tailored solutions for particular situations are also possible, such as that of Amisano & Tristani (2011) for heteroscedastic models.

[2]This also applies to second-order local approximations. While it is possbile to use a variation on the auxiliary particle filter specially tailored for this case (Hall, Pitt & Kohn 2012), this cannot attain the efficiency of a fully adapted filter.

2   General setup

In general, an economic model with optimising agents and rational expectations can be written in the form

$$\mathbb{E}_t F(c_{t+1}, c_t, k_t, k_{t-1}, z_t) = 0 \tag{1}$$

where $\mathbb{E}_t$ denotes an expectation conditional on date t information, c_t is a vector of choice variables (including forward-looking variables and jump variables), k_t is a vector of endogenous predetermined variables, and z_t is a vector of exogenous forcing variables. The vector-valued function F includes the law of motion of z_t, the equations determining k_t, and the equations that implicitly determine c_t as a function of k_{t-1} and z_t.

   The goal is to find a corresponding expression for the model in state-space form, which can then be estimated. That is, we need functions of the form

$$c_t = \sigma(k_{t-1}, z_t) \tag{2}$$
$$k_t = \rho(k_{t-1}, z_t) \tag{3}$$

with the property that, when these values are used in F, equation (1) is satisfied. In general, these functions are not available in closed form, and need to be approximated.

2.1   Assumptions

To apply the method described in this paper, it is necessary to split the function F into its separate components, and make some assumptions about their structure. First, I assume that the law of motion of z_t can be written in log-linear form:

$$\log z_t = d + T_t \log z_{t-1} + R_t \epsilon_t \tag{4}$$

Here T_t and R_t are coefficient matrices which are assumed to be fixed, conditional on the vector of structrual parameters θ and the values of z_{t-1} and k_{t-1}. The time subscripts indicate that the matrices are not assumed to be functions of θ alone. For example, time-varying volatility can be accommodated by including functions of z_{t-1} and/or k_{t-1} in the components of R_t. I assume that ϵ_t is a multivariate standard normal distribution: $\epsilon_t \sim N(0, I)$.[3]

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[3]The methods described below can be generalised to allow each component of ϵ_t to be a finite mixture of distributions from the exponential family.

To describe the equations determining the endogenous variables, we need the following notation: for each variable x_t, define $\widetilde{x}$ as the log-deviation of x_t from its nonstochastic steady state $\overline{X}$, i.e.

$$x_t = \overline{X} \exp(\widetilde{x}_t)$$

The second assumption I make is that each endogenous predetermined variable can be written as an explicit function g of last period's predetermined variables, the current period's exogenous processes, and the choice variables:

$$k_t = g(\widetilde{k}_{t-1}, \widetilde{z}_t, \widetilde{c}_t) \tag{5}$$

The structure of a model will usually make the function g available in a natural way. If not, it could be calculated implicitly or approximated.

The final assumption concerns the equations that characterise the choice variables. In general, they can be written in the form

$$\mathbb{E}_t \left\{ f(\widetilde{k}_{t-1}, \widetilde{z}_t, \widetilde{c}_t, \widetilde{k}_t, \widetilde{z}_{t+1}, \widetilde{c}_{t+1}) \right\} = 0 \tag{6}$$

where f is some $\mathbb{R}^{n_c}$-valued function with the indicated arguments, and $\mathbb{E}_t$ denotes expectation conditional on date-t information. I assume that f can be re-expressed, approximately if necessary, to give an exponential function of the vector c_t as a weighted sum of N_c exponential terms:

$$A_0 \circ \exp\left(D_0 \widetilde{c}_t\right) = \mathbb{E}_t \sum_{j=1}^{N_c} A_j \circ \exp\left(B_j \widetilde{k}_{t-1} + C_j \widetilde{z}_t + D_j \widetilde{c}_t \right.$$
$$\left. + E_j \widetilde{k}_t + F_j \widetilde{z}_{t+1} + G_j \widetilde{c}_{t+1} \right) \tag{7}$$

Here, $\circ$ denotes the Hadamard product (elementwise multiplication) and the exponential is understood to operate elementwise. Thus the coefficient matrix D_0 is $n_c \times n_c$ dimensional, the vector A_i is $n_c \times 1$ dimensional, the matrix B_i is $n_k \times n_k$ dimensional, and similarly for the others. While the vector $\widetilde{c}_t$ can appear on both the left and right hand sides of equation (7), I assume that it is written so that the left-hand coefficient matrix D_0 is full rank. In the case of jump variables, which are determined by intratemporal optimality conditions only, the coefficients on the $(t+1)$-dated variables in (7) will be zero.

The approximation in equation (7) differs from the log-linearisation frequently used in macroeconomics in two ways. First, the approximation is

not calculated at the nonstochastic steady state, but rather conditional on the values of k_{t-1} and z_t. Second, while the form of the equation may appear similar to the exponential of a loglinear structural model, the right-hand side of the equation is a weighted sum of exponential terms, rather than a single exponential of a sum. In other words, if the function f consists of several terms, then each term is loglinearised separately, conditional on k_{t-1} and z_t.

In many cases, the approximation in equation (7) will in fact be exact. This is true of all the equations in the examples below. If this type of exactness is not possible, the approximation can be calculated by log-differentiating the function f.

2.2   The approximate solution

In general, the solution of the model (1) involves expressing the choice variables c_t as determined by a policy function σ:

$$c_t = \sigma(z_t, k_{t-1}) \tag{8}$$

The function σ, which is intractable in general, is characterised by the fact that it satisfies (1) when substituted for c:

$$\mathbb{E}_t F(\sigma(z_{t+1}, k_t), \sigma(z_t, k_{t-1}), k_t, k_{t-1}, z_t) = 0$$

Now, suppose we approximate the unknown σ by expressing the vector of choice variables c_t as a log-affine function of $\widetilde{z}_t$ and $\widetilde{k}_{t-1}$:

$$c_t \approx \overline{C} \exp\left(\xi_t + \Omega_t \widetilde{z}_t + \Phi_t \widetilde{k}_{t-1}\right) \tag{9}$$

$$c_{t+1} \approx \overline{C} \exp\left(\xi_t + \Omega_t \widetilde{z}_{t+1} + \Phi_t \widetilde{k}_t\right) \tag{10}$$

where the vector ξ_t and the matrices Ω_t and Φ_t are functions of θ, z_t and k_{t-1}, to be described below. I assume that unique initial values for Ω and Φ are available by log-linearising the model around its nonstochastic steady state using standard methods (Klein 2000, Sims 2001). In other words, I take it for granted that these matrices exist, that it is feasible to compute them, and that they are unique. The first contribution of this paper is to describe an efficient method for updating these approximations.

Suppose we use equations (9) and (10) to approximate equation (7). We

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can then substitute it into the right-hand side of equation (7).

$$A_0 \circ \exp\left(D_0\xi_t + D_0\Omega_t\widetilde{z}_t + D_0\Phi_t\widetilde{k}_t\right) \approx \mathbb{E}_t \sum_{j=1}^{N_c} A_j \circ \exp\left(B_j\widetilde{k}_{t-1} + C_j\widetilde{z}_t + D_j\xi_t + D_j\Omega_t\widetilde{z}_t\right.$$

$$\left. + D_j\Phi_t\widetilde{k}_{t-1} + E_j\widetilde{k}_t + F_j\widetilde{z}_{t+1} + G_j\xi_t + G_j\Omega_t\widetilde{z}_{t+1} + G_j\Phi_t\widetilde{k}_t\right) \tag{11}$$

We can then use the law of motion for z, equation (4), to replace $\widetilde{z}_{t+1}$ in (11):

$$A_0 \circ \exp\left(D_0\xi_t + D_0\Omega_t\widetilde{z}_t + D_0\Phi_t\widetilde{k}_t\right)$$

$$\approx \mathbb{E}_t \sum_{j=1}^{N_c} A_j \circ \exp\left(B_j\widetilde{k}_{t-1} + C_j\widetilde{z}_t + D_j\xi_t + D_j\Omega_t\widetilde{z}_t + D_j\Phi_t\widetilde{k}_{t-1}\right.$$

$$\left. + E_j\widetilde{k}_t + G_j\xi_t\left[F_j + G_j\Omega_t\right]T_t\widetilde{z}_t + \left[F_j + G_j\Omega_t\right]R_t\epsilon_{t+1} + G_j\Phi_t\widetilde{k}_t\right) \tag{12}$$

Conditional on date-t information, the only stochastic part in equation (12) is ϵ_{t+1}. So we can factor it as

$$A_0 \circ \exp\left(D_0\xi_t + D_0\Omega_t\widetilde{z}_t + D_0\Phi_t\widetilde{k}_t\right)$$

$$\approx \sum_{j=1}^{N_c} A_j \circ \exp\left(\left[B_j + D_j\Phi_t\right]\widetilde{k}_{t-1} + \left[D_j + G_j\right]\xi_t\right.$$

$$\left. + \left[C_j + D_j\Omega_t + F_jT_t + G_j\Omega_tT_t\right]\widetilde{z}_t + \left[E_j + G_j\Phi_t\right]\widetilde{k}_t\right)$$

$$\circ \mathbb{E}_t \exp\left(\left[F_j + G_j\Omega_t\right]R_t\epsilon_{t+1}\right) \tag{13}$$

Each component of the expectation part is now in the form $\mathbb{E}(q'\epsilon_{t+1})$, where q' is a row of $\left[F_j + G_j\Omega_t\right]R_t$. In other words, it is equal to a value of the moment generating function of ϵ_{t+1}. Since ϵ is multivariate normal, the moment generating function is given by

$$\mathbb{E}\exp\left(q'\epsilon\right) = \exp\left(\frac{1}{2}q'q\right) \tag{14}$$

Using (14) in (13), we obtain the following:

$$A_0 \circ \exp\left(D_0\xi_t + D_0\Omega_t\widetilde{z}_t + D_0\Phi_t\widetilde{k}_t\right)$$

$$\approx \sum_{j=1}^{N_c} A_j \circ \exp\left([B_j + D_j\Phi_t]\,\widetilde{k}_{t-1} + [D_j + G_j]\,\xi_t \right.$$

$$+ [C_j + D_j\Omega_t + F_jT_t + G_j\Omega_tT_t]\,\widetilde{z}_t + [E_j + G_j\Phi_t]\,\widetilde{k}_t$$

$$\left. + \frac{1}{2}K\,[F_j + G_j\Omega_t]\,R_tR_t'\,[F_j + G_j\Omega_t]' \right) \qquad (15)$$

where K is the $n_c \times n_c^2$ matrix that selects the diagonal elements of an $n_c \times n_c$ matrix.

The coefficient matrices T_t and R_t are assumed to be known at the start of time t, while the other coefficient matrices are determined by the economic equations defining the model (and given the value of the structural parameter vector θ). Taking the values of k_t as given, the only free parameters are in the c_t-approximation.

The values of of the coefficients in equation (9) are characterised by the fact that it is a first-order approximation of the policy function σ. We can therefore identify Ω and Φ by log-differentiating equation (15), and approximate ξ_t by ensuring that (15) holds with equality (to within a tolerable accuracy).

For notational convenience, let the vectors S_j be defined as

$$S_j = (A_j/A_0) \circ \exp\left([B_j + D_j\Phi]\,\widetilde{k}_{t-1} + [D_j + G_j]\,\xi_t + [C_j + D_j\Omega + F_jT_t + G_j\Omega T_t]\,\widetilde{z}_t \right.$$

$$\left. + [E_j + G_j\Phi]\,\widetilde{k}_t + \frac{1}{2}K\,[F_j + G_j\Omega_t]\,R_tR_t'\,[F_j + G_j\Omega_t]' \right)$$

$$(16)$$

That is, we rewrite equation (15) in the form $\exp(D_0\widetilde{c}_t) = \sum_{j=1}^{N_c} S_j$.

Log differentiating then gives the following expressions.

$$\Omega_t = D_0^{-1}\sum_{j=1}^{N_c} \frac{S_j}{\sum_{m=1}^{N_c} S_m}\left[C_j + D_j\Omega_t + F_jT_t + G_j\Omega_tT_t + (E_j + G_j\Phi_t)\left(\frac{\partial\widetilde{k}_t}{\partial\widetilde{z}_t'} + \frac{\partial\widetilde{k}_t}{\partial\widetilde{c}_t'}\Omega_t\right)\right]$$

$$(17)$$

$$\Phi_t = D_0^{-1}\sum_{j=1}^{N_c} \frac{S_j}{\sum_{m=1}^{N_c} S_m}\left[B_j + D_j\Phi_t + (E_j + G_j\Phi_t)\left(\frac{\partial\widetilde{k}_t}{\partial\widetilde{k}_{t-1}'} + \frac{\partial\widetilde{k}_t}{\partial\widetilde{c}_t'}\Phi_t\right)\right]$$

$$(18)$$

Finally, the vector ξ_t can be calculated from

$$\xi = D_0^{-1} \log \left(\sum_{j=1}^{N_c} S_j \right) - \Omega z_t - \Phi k_{t-1} \tag{19}$$

These three equations define a continuous self-map on the elements of the coefficient matrices. In computations, it is possible to update Ω, Φ and ξ by iterating the last three equations until convergence is achieved. Note that although the first two equations have some similarity to the forward-looking linear structures taken as inputs by the algorithms of Klein (2000) and Sims (2001), those methods are not applicable here, since the S_j factors are functions of the reduced-form solutions, and the final terms in equations (17) and (18) are quadratic functions of Ω and Φ.

In practice, I used Anderson acceleration to speed up the convergence of the fixed-point iterations (Anderson 1965). See Appendix B for more details.

2.3   Constraints on predetermined variables

It is often of interest to consider constraints on the endogenous predetermined variables of the form

$$C_1 \widetilde{k}_t \geq C_2 \tag{20}$$

Based on the standard Kuhn-Tucker conditions, the choice variables $\widetilde{c}_t$ will be determined by the unconstrained Euler equation (7) when the constraint (20) is slack; but when it is binding, some or all of the choice variables will be determined by their feasibility conditions. The nature of those feasibility conditions will vary from model to model, but I assume they can be written as

$$P_c \widetilde{c}_t = P_c \xi_c + P_c \Omega_c \widetilde{z}_t + P_c \Phi_c \widetilde{k}_{t-1} \tag{21}$$

where P_c is a projection onto certain coordinates of $\widetilde{c}$, and the coefficients in Ω_c and Φ_c are known (conditional on the structural parameters θ).

Solving the Euler equation (11) now requires allowing for the possibility that the constraint (20) may bind next period. To address this, I make the additional assumption that the g function that determines the unconstrained value of $\widetilde{k}_t$ (via equation 5) can be written, or at least approximated, in the

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form

$$\widetilde{k}_t = \sum_{j=1}^{N_k} A_j^k \circ \exp\left(B_j^k \widetilde{k}_{t-1} + C_j^k \widetilde{z}_t + D_j^k \widetilde{c}_t\right) \tag{22}$$

$$\approx \left(\sum_{j=1}^{N_k} \frac{S_j^k}{\sum_{m=1}^{N_k} S_m^k} B_j^k\right) \widetilde{k}_{t-1} + \left(\sum_{j=1}^{N_k} \frac{S_j^k}{\sum_{m=1}^{N_k} S_m^k} C_j^k\right) \widetilde{z}_t + \left(\sum_{j=1}^{N_k} \frac{S_j^k}{\sum_{m=1}^{N_k} S_m^k} D_j^k\right) \widetilde{c}_t$$

$$= \Psi_t \widetilde{k}_{t-1} + \Gamma_t \widetilde{z}_t + \Upsilon_t \widetilde{c}_t \tag{23}$$

The values of the matrices Ψ_t, Γ_t and Υ_t can be calculated given $\widetilde{k}_{t-1}$, $\widetilde{z}_t$ and θ. Forwarding this equation one period, and substituting it into (20), we get

$$C_1 \Psi_t \widetilde{k}_t + C_1 \Gamma_t T \widetilde{z}_t + C_1 \Gamma_t R \epsilon_{t+1}$$
$$+ C_1 \Upsilon_t \xi_t + C_1 \Upsilon_t \Omega T \widetilde{z}_t + C_1 \Upsilon_t \Omega_t R \epsilon_{t+1} + C_1 \Upsilon_t \Phi_t \widetilde{k}_t \geq C_2$$

That is,

$$[C_1 \Gamma R + C_1 \Upsilon \Omega R]\, \epsilon_{t+1} \geq C_2 - C_1\left(\Psi + \Upsilon \Phi_t\right)\widetilde{k}_t$$
$$- C_1\left(\Gamma + \Upsilon \Omega\right) T \widetilde{z}_t - C_1 \Upsilon \xi_t$$

or more compactly,

$$M\epsilon_{t+1} \geq p \tag{24}$$

Thus, conditional on values for ξ_t, Ω_t and Φ_t, the constraint (20) will be slack in the next period if the shock vector ϵ_{t+1} is in the region defined by (24).

The approximate law of motion for $\widetilde{c}_{t+1}$ is now

$$c_{t+1} \approx \begin{cases} \overline{C} \exp\left(\begin{array}{l}(I - P_c)\xi_t + (I - P_c)\Omega_t \widetilde{z}_{t+1} + (I - P_c)\Phi_t \widetilde{k}_t \\ + P_c\xi_c + P_c\Omega_c \widetilde{z}_{t+1} + P_c\Phi_c \widetilde{k}_t\end{array}\right) & \text{if (20) binds next period} \\ \overline{C} \exp\left(\xi_t + \Omega_t \widetilde{z}_{t+1} + \Phi_t \widetilde{k}_t\right) & \text{otherwise} \end{cases} \tag{25}$$

with the values of ξ_t, Ω_t and Φ_t to be determined.

The moment generating function part of equation (13) can be calculated using a generalisation of equation (14), for Gaussian random variables subject to inequality constraints (Tallis 1965). One can then derive analogous expressions to (17) and (18) by log-differentiating the Euler equation. See Appendix C for the derivation and results.

In summary, the approximation for $\widetilde{c}_t$ in the form (9), when $\widetilde{k}_t$ has a boundary, can be calculated in the following steps.

- Take $\widetilde{z}_t$ and $\widetilde{k}_{t-1}$ as given.

- Find the fixed points ξ_t, Ω_t and Φ_t of (69), (70) and (71) in Appendix C). These define the solution for $\widetilde{c}_t$, consistent with (25), on the assumption that $\widetilde{k}_t$ is not constrained in period t.

- Calculate $\widetilde{k}_t$ using equation (5) and the unconstrained approximation. If (20) holds, stop.

- Otherwise, set $P_c\widetilde{c}_t$ using equation (21) and find the fixed point of (69), (70) and (71) for the remaining coefficients.

3 Estimation method

While any nonlinear state-space algorithm could apply to the approximation described in Section 2, its locally linear quality makes it particularly well suited to the fully-adapted particle filter (Pitt & Shephard 1999). The standard particle filter approximates the posterior filtering density $p(x_t|y_t, x_{t-1})$ by sampling from the transition density $p(x_t|x_{t-1})$ and then reweighting by $p(y_t|x_t)$. The fully-adapted version samples directly from $p(x_t|y_t, x_{t-1})$. This is only possible if $p(x_t|x_{t-1})$ and $p(y_t|x_t)$ are conjugate in x. When it is possible, it can be several orders of magnitude more efficient than the standard particle filter, particularly when the observations y_t are highly informative about the underlying state x_t (Pitt, Silva, Giordani & Kohn 2012). In this section I describe how to modify the approximation algorithm to take advantage of those features.

The locally linear approximation of $\widetilde{c}_t$ and $\widetilde{k}_t$ gives a system in the following form:

$$\widetilde{c}_t = \xi_t + \Omega_t\widetilde{z}_t + \Phi_t\widetilde{k}_{t-1} \tag{9}$$

$$\widetilde{k}_t = g\left(\widetilde{c}_t, \widetilde{z}_t, \widetilde{k}_{t-1}\right) \tag{5}$$

$$\widetilde{z}_t = T_t\widetilde{z}_{t-1} + R_t\epsilon_t \tag{4}$$

The coefficient matrices T_t and R_t are assumed to be given (conditional on last period's information), but the others depend on $\widetilde{z}_t$. Since changes in these coefficients in a single period are likely to be small, the previous period's values can serve as approximations to them. Additionally, we can take a linear approximation of $g()$ conditional on $\widetilde{z}_{t-1}$ and $\widetilde{k}_{t-1}$. This gives

the following system:

$$\widehat{c}_t \approx \xi_{t-1} + \Omega_{t-1}\widetilde{z}_t + \Phi_{t-1}\widetilde{k}_{t-1} \tag{26}$$

$$\widehat{k}_t \approx \kappa_{t-1} + J_{t-1}\left(\widetilde{z}_t - \widetilde{z}_{t-1}\right) \tag{27}$$

where $\kappa_{t-1} = g\left(\varsigma_{t-1}, \widetilde{z}_{t-1}, \widetilde{k}_{t-1}\right)$, $\varsigma_{t-1} = \xi_{t-1} + \Omega_{t-1}\widetilde{z}_{t-1} + \Phi_{t-1}\widetilde{k}_{t-1}$, and $J = \left(\frac{\partial g}{\partial c'}\Omega_{t-1} + \frac{\partial g}{\partial z'}\right)$.

Suppose that the observation vector y_t consists of elements of $\widetilde{c}_t$ and $\widetilde{k}_t$ selected by projection matrices Z^c and Z^k, that is,

$$y_t = \left[\begin{array}{c} Z^c\widetilde{c}_t \\ Z^k\widetilde{k}_t \end{array} \right]$$

Using the approximations just derived gives

$$y_t = \underbrace{\left[\begin{array}{c} Z^c\xi_{t-1} + Z^c\Phi_{t-1}\widetilde{k}_{t-1} \\ Z^k\kappa_{t-1} - Z^k J_{t-1}z_{t-1} \end{array} \right]}_{\mathbf{d_t}} + \underbrace{\left[\begin{array}{c} Z^c\Omega_{t-1} \\ Z^k J_{t-1} \end{array} \right]}_{\mathbf{Z_t}} \widetilde{z}_t \tag{28}$$

which can be used as the observation in equation for a one-step Kalman filter, using the law of motion for $\widetilde{z}_t$ as the state equation (Harvey 1991). Thus the updated estimate of $\widetilde{z}_t$, given last period's state and the observation y_t, is

$$\widehat{z}_t = T_t\widetilde{z}_{t-1} + R_t R_t'\mathbf{Z_t}'\left(\mathbf{Z_t}R_t R_t'\mathbf{Z_t}' + H\right)^{-1}\left(y_t - \mathbf{Z_t}T_t\widetilde{z}_{t-1} - \mathbf{d_t}\right) \tag{29}$$

where H is the covariance matrix of measurement noise in y_t. The covariance of this estimate is given by

$$P_t = R_t R_t'\left[I - \mathbf{Z}_t'\left(\mathbf{Z_t}R_t R_t'\mathbf{Z_t}' + H\right)^{-1}\mathbf{Z_t}R_t R_t'\right] \tag{30}$$

The one-step-ahead forecast error and forecast covariance are given by

$$v_t = y_t - \mathbf{Z_t}T_t\widetilde{z}_{t-1} - \mathbf{d_t} \tag{31}$$

and

$$F_t = \left(\mathbf{Z_t}R_t R_t'\mathbf{Z_t}' + H\right) \tag{32}$$

Based on an estimate $\widehat{z}_t$, the implied values of the endogenous variables are given by (26) and (27). When H is small, so that observations are very informative about some elements of $\widetilde{c}_t$ and $\widetilde{k}_t$, the resulting values of $\widehat{c}_t$ and

$\widehat{k}_t$ will match the observed y_t, but will not in general be equal to the values of $\widetilde{c}_t$ and $\widetilde{k}_t$ given by (9) and (5)—that is, after the coefficient matrices ξ, Ω and Φ are updated conditional on $\widetilde{z}_t = \widehat{z}_t$. However, this inaccuracy will be of second-order importance. To see this, note that

$$\widetilde{c}_t(\widehat{z}_t) - \widehat{c}_t = \xi(\widehat{z}_t) - \xi_{t-1} + [\Omega(\widehat{z}_t) - \Omega_{t-1}]\,\widehat{z}_t + [\Phi(\widehat{z}_t) - \Phi_{t-1}]\,\widetilde{k}_{t-1}$$

$$\approx \frac{\partial \xi}{\partial z'}(\widehat{z}_t - \widetilde{z}_{t-1}) + o\left(\widetilde{z}^2\right)$$

Since the Taylor approximation of the policy function σ has an error of magnitude $o\left(\Delta\widetilde{z}^2\right)$, the change $\frac{\partial \xi}{\partial z'}\Delta z$ will be of a similar order of magnitude.

To recapitulate, these considerations suggest that a fully adapted particle filter can be implemented using the following steps at each time t:

1. Begin with values for $\widetilde{z}_{t-1}^{(m)}$, $\widetilde{k}_{t-1}^{(m)}$, $\xi_{t-1}^{(m)}$, $\Omega_{t-1}^{(m)}$ and $\Phi_{t-1}^{(m)}$ for particles indexed by $m = 1, \ldots, M$. Denote this information set as $\mathcal{F}_{t-1}^{(m)}$.

2. Calculate $v_t^{(m)}$ and $F_t^{(m)}$ from (31) and (32) for each particle, then re-sample the particles using weights given by $p(y_t | \mathcal{F}_t^{(m)}) = N(v_t^{(m)}, F_{t-1}^{(m)})$.

3. Calculate $\widehat{z}_t$ and P_t from (29) and (30), then draw $\widetilde{z}_t^{(m)} \sim N(\widehat{z}_t^{(m)}, P_t^{(m)})$.

4. Calculate ξ_t, Ω_t and Φ_t using equations (17), (18) and (19) from Section 2. Update $\widetilde{k}_t$ via equation (5).

An unbiased estimate of the likelihood is given by $\ell = \prod_{t=1}^T \frac{1}{M} \sum_{m=1}^M p(y_t | \mathcal{F}_{t-1}^{(m)})$. For proofs of its unbiasedness, as well as other properties, see Del Moral (2004) and Pitt et al. (2012).

In the case where some elements of $\widetilde{k}_t$ are constrained (Section 2.3), the approximation for $\widetilde{c}_{t+1}$ is in the form of a finite mixture of linear Gaussian transitions. It is straightforward to extend the fully adapted particle filter to cover these cases, by conditioning on the forecast probabilities that the constraint on $\widetilde{k}_t$ will bind.

4   Example 1: Neoclassical growth

In this section, I consider a basic neoclassical growth model. I choose this model because it is a useful and simple benchmark for solving and estimating DSGEs, used for example by Schmitt-Grohé & Uribe (2004) and Gomme & Klein (2011). The model is based on the decisions of a representative

household, which chooses between consumption c_t and investment in next period's capital stock k_t.

I begin by showing how the model is written in the general framework of Section 2. I then evaluate the accuracy of the resulting approxmimations.

4.1 The model

The household's goal is to maximise discounted lifetime utility, given by

$$U = \sum_{t=0}^{\infty} \beta^t \frac{c_t^{1-\gamma}}{1-\gamma}$$

subject to a feasibility constraint

$$c_t + k_t = A_t k_{t-1}^{\alpha} + (1-\delta)k_{t-1} \ , \tag{33}$$

where $\delta \in [0,1]$, and a productivity shock

$$\log A_t = \rho \log A_{t-1} + \epsilon_t \qquad \epsilon_t \sim N(0, \sigma_{\epsilon}^2) \ . \tag{34}$$

where $\rho \in (0,1)$. The solution of the model consists of equations (33) and (34) plus a consumption Euler equation,

$$c_t^{-\gamma} = \beta \mathbb{E}_t \left\{ c_{t+1}^{-\gamma} \left[\alpha A_{t+1} k_t^{\alpha-1} + 1 - \delta \right] \right\} \tag{35}$$

4.2 Approximation

In terms of the notation in Section 2, here the choice variable is c_t, the endogenous predetermined variable is k_t, and the exogenous forcing variable is A_t. Equation (34) is exactly in the form of equation (4); thus $d = 0$, $T_t = T = \rho$, and $R_t = R = \sigma_{\epsilon}$. Note that the nonstochastic steady state of A is 1, so that $\tilde{a}_t = \log A_t$. Equation (33) corresponds to equation (5):

$$\overline{K} \exp(\widetilde{k}_t) = \overline{K}^{\alpha} \exp(\widetilde{a}_t + \alpha\widetilde{k}_{t-1}) + (1-\delta)\overline{K} \exp(\widetilde{k}_{t-1}) - \overline{C} \exp(\widetilde{c}_t) \tag{36}$$

Equation (35) corresponds to (7):

$$\exp\left(-\gamma\widetilde{c}_t\right) = \mathbb{E}\beta\alpha \left(\overline{K}\right)^{(\alpha-1)} \exp\left[-\gamma\widetilde{c}_{t+1} + (\alpha-1)\widetilde{k}_t + \widetilde{a}_{t+1}\right]$$
$$+ \mathbb{E}\beta(1-\delta)\exp\left(-\gamma\widetilde{c}_{t+1}\right) \tag{37}$$

Thus, in the notation of equation (7), $A_0 = 1$, $A_1 = \beta\alpha \left(\overline{K}\right)^{(\alpha-1)}$, $A_2 = \beta(1-\delta)$, $B_1 = B_2 = 0$, $C_1 = C_2 = 0$, $D_0 = -\gamma$, $D_1 = D_2 = 0$, $E_1 = (\alpha-1)$, $E_2 = 0$, $F_1 = 1$, $F_2 = 0$, $G_1 = G_2 = -\gamma$.

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Using the Gaussian mgf (14) and the linear approximations (9) and (10) then gives

$$\exp\left(-\gamma\xi_t \; -\gamma\Omega_t\widetilde{a}_t - \gamma\Phi_t\widetilde{k}_{t-1}\right) =$$

$$\beta\alpha\left(\overline{K}\right)^{(\alpha-1)}\exp\left[-\gamma\xi_t + (1-\gamma\Omega_t)\rho\widetilde{a}_t + (\alpha - 1 - \gamma\Phi_t)\widetilde{k}_t + \frac{\sigma^2\left(1-\gamma\Omega_t\right)^2}{2}\right]$$

$$+ \beta(1-\delta)\exp\left(-\gamma\xi_t - \gamma\Omega_t\rho\widetilde{a}_t - \gamma\Phi_t\widetilde{k}_t + \frac{\sigma^2\gamma^2\Omega_t^2}{2}\right) \qquad (38)$$

which is equal to equation (15).

The constraint is

$$\widetilde{k}_t = \log\left[\overline{K}^{(\alpha-1)}\exp(\widetilde{a}_t + \alpha\widetilde{k}_{t-1}) + (1-\delta)\exp(\widetilde{k}_{t-1})\right.$$

$$\left. - \frac{\overline{C}}{\overline{K}}\exp(\xi_t + \Omega_t\widetilde{a}_t + \Phi_t\widetilde{k}_{t-1})\right] \qquad (39)$$

4.3   Results

How accurate is the approximation described in Section 4.2? I performed a simulation study to compare it to several other benchmarks. I chose standard values for most of the parameters: $\beta = 0.96$, $\alpha = 1/3$, $\rho = 0.9$, $\delta = 0.05$, and $\sigma_\epsilon = 0.02$. For the risk-aversion parameter γ, I chose the rather low value of 0.5, to place more emphasis on the nonlinear character of the model. If γ is large, then the model is almost log-affine and accurate approximation is less important. I made this choice because the intention is to demonstrate a method that can be usefully applied to more complex models with stronger nonlinear features.

Since this model has only one shock, it is possible to calculate the expectation in equation (35) numerically, given a policy function $\widetilde{c}_t = \sigma(\widetilde{z}_t, \widetilde{k}_{t-1})$, and therefore to estimate the policy functions Euler error. (This procedure is of course not feasible for larger models.) I used a 50×50-point grid on $z_t \in [-0.2, 0.2]$ and $\widetilde{k}_{t-1} = [-0.6, 0.6]$ to do so.

I applied this method to calculate the Euler errors for three different methods: the locally linear approximation proposed in this paper, a log-linearisation, and a second-order perturbation. The loglinearisation can be calculated using standard methods (Klein 2000, Sims 2001). The second-order perturbation is described in Schmitt-Grohé & Uribe (2004), Kim et al. (2008) and Gomme & Klein (2011).

Figure 2 shows the squared Euler errors for each approximation method, on a logarithmic scale. The quadratic approximation is comparable to the

locally linear one at certain points of the grid close to the origin. However, the quadratic approximation does not maintain this accuracy in the tails of the state variables. The upper left and lower right panels of the Figure are evaluated at values of $\widetilde{k}_{t-1}$ around 5 standard deviations away from the steady state. They illustrate one advantage of the local linearisation method: while these values of the state variable would rarely be encountered in a simulation, they would be more common in estimation, since the level of the nonstochastic steady state is a function of the structural parameters. Thus, while searching through the parameter space using a given series of real observations, it is advantageous to maintain accuracy throughout the state space.

The *average* Euler errors are summarised in Table 1. The average squared errors, in the first column of results, were estimated with respect to the stationary distributions of z and k. The $\|\eta\|_\infty$ estimates were calculated with the state variables restricted to a distance of three standard deviations from their steady states.

Method	$\mathbb{E}\eta^2$	$\|\eta\|_\infty$
Loglinear	4.8×10^{-8}	2.3×10^{-3}
Second-order	9.2×10^{-10}	1.4×10^{-4}
Locally linear	1.1×10^{-13}	6.7×10^{-7}

Table 1: Average Euler errors for different approximation methods

5   Example 2: A basic New Keynesian model

In this section, I consider a baseline New Keynesian macro model. There are many possible variations on the basic structure. I use a simplified version of the model based on Amisano & Tristani (2010) and Fernández-Villaverde et al. (2012).[4] It includes a representative household with a utility function separable in consumption c_t and hours worked l_t; a continuum of profit-maximising goods producers in monopolistic competition, with sticky prices; and a government sector that sets the interest rate through a Taylor rule, subject to a zero lower bound. Investment is not modelled, with the capital stock instead being taken as fixed.

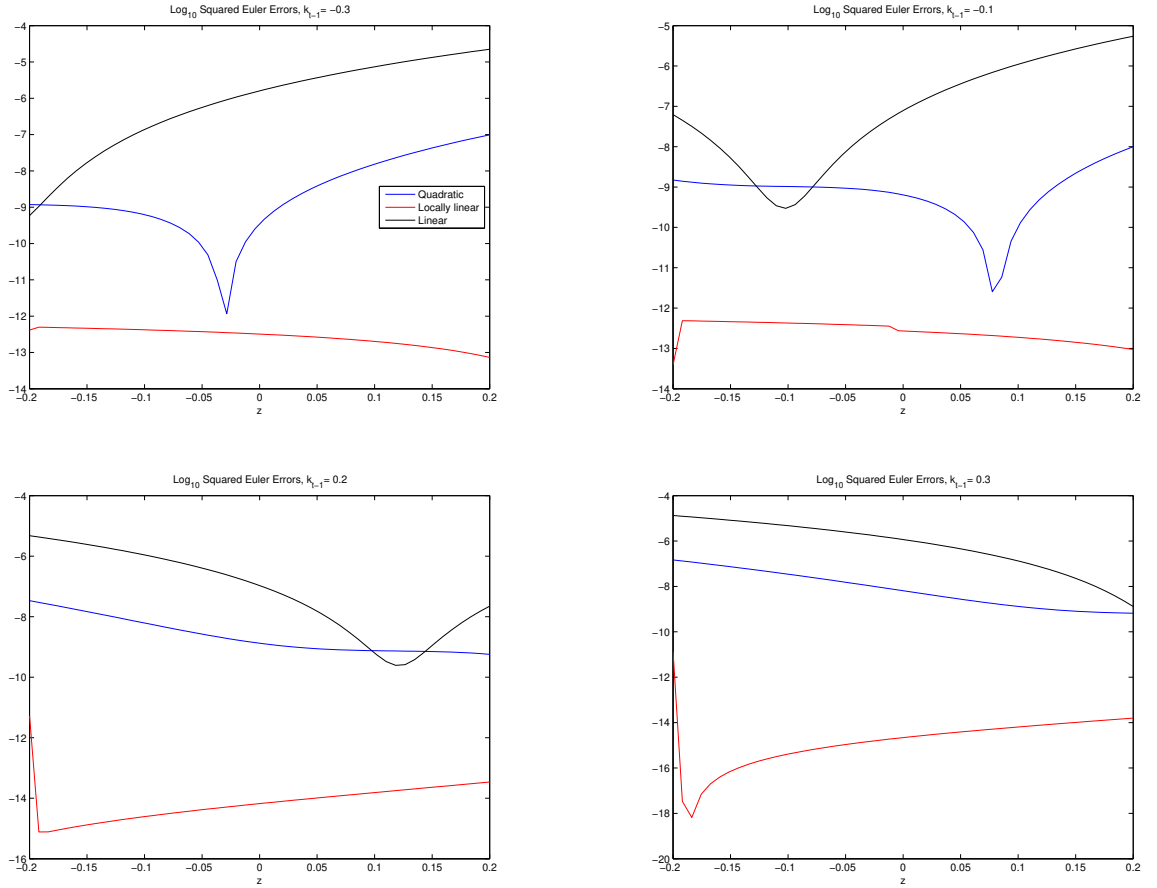[4]See also Woodford (2003) and Galí (2008) for further details and background.

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Figure 2: Squared Euler errors for the growth model (log scale), shown as a function of z_t, calculated for various values of k_{t-1}, using linear (black), quadratic (blue) and locally linear (red) approximation methods.

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5.1   The model

The household's objective is to maximise utility, given by

$$U_t = \sum_{h=0}^{\infty} \beta^h e^{b_{t+h-1}} \left(\frac{C_{t+h}^{1-\gamma}}{1-\gamma} - e^{e_{t+h}} \frac{1}{1+\phi} l_{t+h}^{1+\phi} \right) \tag{40}$$

where C_t is consumption, l_t is hours worked, b_t is an exogenous disturbance representing demand-side shocks, and e_t is an exogenous disturbance representing labour-supply shocks. The maximisation is subject to a budget constraint

$$P_t C_t + B_t = W_t l_t + R_{t-1} B_{t-1} \tag{41}$$

The household's income is derived from a nominal wage W_t and a gross return R_{t-1} paid on risk-free nominal bonds B_{t-1}. This can be spent on consumption and on saving for next period. P_t is the level of the consumer price index in period t. To keep the model simple, I assume that taxes and transfers offset any profits accruing to the household.

The resulting first-order conditions of the household are

$$\lambda_t = \mathbb{E}_t \beta e^{b_t} \lambda_{t+1} \frac{R_t}{\Pi_{t+1}} \tag{42}$$

$$C_t^{-\gamma} = \lambda_t \tag{43}$$

$$\frac{W_t}{P_t} \lambda_t = e^{e_t} l_t^{\phi} \tag{44}$$

Equation (42) is an intertemporal consumption Euler equation, connecting the marginal utility of consumption λ_t with its expected value next period, deflated by a time preference factor $\beta \in (0,1)$ and the expected real interest rate. Π_{t+1} is the ratio of the consumer price index in period $t+1$ and period t.

Equation (44) is an intratemporal optimality condition, equating the marginal disutility of labour (l_t^{ϕ}) to the marginal benefit of increased consumption ($\frac{W_t}{P_t} \lambda_t$).

There is a continuum of firms in a monopolistically competitive market. The production function of the representative firm is

$$Y_t(i) = A_t l_t(i)^{\alpha} \tag{45}$$

Here A_t is a technology shock and $l_t(i)$ is the amount of labour hired by firm i. It follows that real marginal cost for the representative firm is given by

$$MC_t = \frac{W_t / P_t}{A_t} \tag{46}$$

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I make the standard assumption that firms are able to change their price with fixed probability θ_p each period (Calvo 1983). The firm's problem is to choose a price in order to maximise expected profits subject to this constraint, and subject to a constant elasticity of demand θ. Let the auxiliary variables $G_{1,t}$ and $G_{2,t}$ equal the present values of marginal cost and marginal revenue. The profit maximisation conditions are then given by

$$\theta G_{1,t} = (\theta - 1)G_{2,t} \tag{47}$$

$$G_{1,t} = \lambda_t MC_t Y_t + \beta e^{b_t}\theta_p \mathbb{E}_t \Pi_{t+1}^{\theta} G_{1,t+1} \tag{48}$$

$$G_{2,t} = \Pi_t^{\star}\left(\lambda_t Y_t + \beta e^{b_t}\theta_p \mathbb{E}_t \frac{\Pi_{t+1}^{\theta-1}}{\Pi_{t+1}^{\star}} x_{2,t+1}\right) \tag{49}$$

Aggregate CPI inflation is given by

$$1 = \theta_p \Pi_t^{\theta-1} + (1 - \theta_p)(\Pi_t^{\star})^{1-\theta} \tag{50}$$

If the model is loglinearised around its nonstochastic steady state, with steady-state inflation $\log \Pi = 0$, then equations (47) to (50) collapse into the familiar New Keynesian Phillips curve.

The market clearing conditions are

$$Y_t = C_t \tag{51}$$

$$B_t = 0 \tag{52}$$

Interest rate policy is set according to

$$R_t = \max\left\{1, R^{1-\rho_r} R_{t-1}^{\rho_r}\left[\left(\frac{\Pi_t}{\Pi}\right)^{\phi_\pi}\left(\frac{y_t}{y}\right)^{\phi_y}\right]^{1-\rho_r} m_t \eta_{r,t}\right\} \tag{53}$$

This is a standard Taylor Rule for monetary policy, constrained by the zero lower bound. The exogenous process m_t is a persistent monetary-policy shock (similar to a time-varying inflation target) and $\eta_{r,t}$ is a transitory one.

The model is closed by specifying the laws of motion for the exogenous processes. These are assumed to be as follows:

$$A_t = A^{1-\rho_A} A_t^{\rho_a} \exp(\sigma_a \epsilon_{a,t}) \tag{54}$$

$$b_t = \rho_b b_{t-1} + \sigma_b \epsilon_{b,t} \tag{55}$$

$$m_t = \rho_m m_{t-1} + \sigma_m \epsilon_{m,t}) \tag{56}$$

$$e_t = \rho_e e_{t-1} + \sigma_e \epsilon_{e,t}) \tag{57}$$

$$\eta_{r,t} = \sigma_r \epsilon_{r,t}) \tag{58}$$

5.2 Approximation

It is straightforward to express this model in the form used in Section 2. As in the growth model example, the expressions in equations (7) and (5) are exact in this case. While the algebra involved in these expressions is not difficult, it is not as compact as in the previous example, so is reported in Appendix D. In brief, the choice variables of the model are $\widetilde{c}_t = (\widetilde{\pi}_t, \widetilde{\pi}_t^\star, \widetilde{G}_{1,t}, \widetilde{G}_{2,t}, \widetilde{\lambda}_t, \widetilde{l}_t, \widetilde{MC}_t, \widetilde{y}_t)$, the predetermined variables are $\widetilde{k}_t = (\widetilde{r}_t)$, the exogenous variables are $\widetilde{z}_t = (\widetilde{b}_t, \widetilde{a}_t, \widetilde{m}_t, \widehat{e}_t, \eta_{r,t})$, and the shocks are $\epsilon_t = (\epsilon_{a,t}, \epsilon_{b,t}, \epsilon_{m,t}, \epsilon_{e,t}, \epsilon_{r,t})$.

When the interest rate $\log R_t$ is at the zero lower bound, the Euler equation for consumption (42) becomes slack, with consumption instead being pinned down by the household budget constraint (41). Substituting the market-clearing condition (52), this is

$$C_t = \frac{W_t}{P_t} l_t = Y_t^\gamma l_t^{\phi+1} \exp(e_t) = A_t^{\frac{-(\phi+1)}{\alpha}} Y_t^{\gamma + \frac{\phi+1}{\alpha}} \exp(e_t)$$

$$\text{so } Y_t = A_t^{\frac{-(\phi+1)}{\alpha(1-\gamma)-(1+\phi)}} \exp\left(\frac{\alpha}{\alpha(1-\gamma)-(1+\phi)} e_t\right) \tag{59}$$

using (45), (51), and (44). All other equations of the model, including the forward-looking equations determining inflation (48) & (49), remain valid. In periods where the zero lower bound was binding, I replaced the relevant coefficients in the previously estimated locally linear approximation with those given by (59), (43), (45) and (46), in the interests of speed.

For each set of parameter values considered, the locally linear approximation was recalculated at each time period. The iterations of the Anderson method (Appendix B) were continued until all coefficients were stable to at least three decimal places. Because the coefficients were very similar across the particle swarm at each time period, I updated the approximation only once each period, at the previous period's mean value of $\widetilde{z}_{t-1}$ and $\widetilde{k}_{t-2}$—that is, the sample mean of the particle swarm after the resampling step. This produced loglikelihood estimates that were indistinguishable from the case where the approximation was updated individually for each particle, and enabled a considerable improvement in speed.

5.3 Estimation

I used a fully-adapted particle filter, as described in Section 3, to estimate the model on US data, using 50 particles. For comparison, I estimated a loglinearised version of the model using the Kalman filter. I chose the

number of particles for the nonlinear estimation by taking repeated estimates of the loglikelihood at the estimated mode of the linear approximation. With 50 particles, the estimates of the loglikelihood had a standard deviation of around 0.9, which is optimal for a Metropolis Hastings run (Pitt et al. 2012).

In the linear case, the parameters of the model are β, θ, θ_p, ϕ, ϕ_π, ϕ_y, Π, ρ_r, ρ_b, σ_b, α, γ, ρ_a, σ_a, ρ_e, σ_e, σ_r, ρ_m, and σ_m, a total of 19 free parameters.[5] For the nonlinear model, one β_i and γ_i GARCH coefficient for each exogenous shock adds ten additional parameters. I chose independent prior distributions for these parameters based on those used in Smets & Wouters (2003), Smets & Wouters (2007), and Amisano & Tristani (2010). They are summarised in Table 5.3.

The observable variables are $\log y_t$, $\Delta \log \Pi_t$ and R_t. I used quarterly data from 1984Q4 to 2011Q4 in the FRED (Federal Reserve Economic Data) database from the Federal Reserve Bank of St. Louis. For $\log y_t$, I used quarterly chain-volume GDP (code GDPC1); for $\Delta \log \Pi_t$, quarterly CPI inflation for all urban consumers, excluding energy (code CPILFESL_PCH); and for R_t, the Federal Funds rate (code FEDFUNDS).[6] Following Smets & Wouters (2003) and Amisano & Tristani (2010), I substracted a loglinear trend from the GDP series prior to estimation. The other two series were estimated relative to the steady state implied by each draw of the parameter vector. All data series were seasonally adjusted prior to estimation.

I assumed that the data series were observed with a small amount of noise. Specifically, each observation was assumed to be affected by a mean-zero iid Gaussian shock with variance 10^{-8}. (This is negligible compared to the size of the structural shocks; it is simply a convenient device for avoiding stochastic singularity.)

For both the linear and nonlinear estimation, the parameters were estimated using an adaptive random walk Metropolis Hastings algorithm (Haario, Saksman & Tamminen 2001). The MCMC chains for both models were initialised at the estimated mode of the linear model. In both cases, I took 100,000 draws, discarding the first 50,000 as a burn-in, with adaptation beginning after 1000 draws.

The code for both estimation methods was written predominantly in MATLAB, with some parts of both methods written in C++. The loglinear approximation was carried out using Dynare (Adjemian, Bastani, Karamé, Juillard, Maih, Mihoubi, Perendia, Ratto & Villemot 2012). I ran the code

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[5]The steady-state level of technology, A, was calibrated to 1.

[6]I used the ex-energy CPI series because the rapid change in energy prices in late 2008 is difficult to account for in a simple DSGE model.

on an Intel Core i7-880 workstation.

Parameter	Interpretation	Distribution	Mean	Std. dev
Demand-side parameters				
β	Discount factor	Beta	0.99	0.01
γ	Consumption elasticity	Gamma	1	0.2
ρ_b	Demand shock persistence	Beta	0.8	0.05
σ_b	Demand shock volatility	Gamma	0.01	0.005
Supply-side parameters				
ϕ	Labour supply elasticity	Gamma	1	0.5
α	Labour share of output	Beta	0.7	0.1
θ_p	Price stickiness	Beta	0.7	0.05
θ	Degree of imperfect competition	Gamma	7	2
ρ_a	TFP persistence	Beta	0.8	0.05
σ_a	TFP shock volatility	Gamma	0.01	0.005
ρ_e	Supply shock persistence	Beta	0.6	0.2
σ_e	Supply shock volatility	Gamma	0.01	0.005
Policy parameters				
ρ_r	Interest rate smoothing	Beta	0.5	0.2
ϕ_π	Central bank inflation response	Gamma	1.2	0.2
ϕ_y	Central bank output response	Gamma	0.5	0.2
Π	Steady-state gross inflation	Normal	1.005	0.0005
ρ_m	Policy shock persistence	Beta	0.6	0.2
σ_m	Policy shock volatility	Gamma	0.01	0.005
σ_r	Interest-rate shock volatility	Gamma	0.01	0.005

Table 2: Prior distributions for New Keynesian model

5.4 Results

Using the locally linear approximation method, the estimation run took around 75 times longer than in the linear case (Table 3). This is in the vicinity of the fastest possible time; with 50 particles, we must perform a one-step Kalman filter calculation 50 times per observation. The additional overhead, which is mainly due to having to update the nonlinear approximation, could perhaps be reduced by redesigning the model, for instance by substituting out some of the jump variables. I chose not to do that in this case, in order to demonstrate that this paper's nonlinear approximation method is feasible to use on a reasonably sized multivariate model.

Turning to the results, we see that the nonlinear model fits the data considerably better (Table 4). Its marginal logposterior is around 12 points higher than the linear model's, indicating that a Bayes Factor ratio would decisively prefer it.[7] The Table also reports the Deviance Information Criterion (DIC), which rewards parsimony by penalising the difference between the mean logposterior and the logposterior of the mean (Spiegelhalter, Best, Carlin & Van Der Linde 2002). This criterion also indicates that the nonlinear model fits better.[8]

The posterior estimates for individual parameters are somewhat different for the linear and nonlinear models (Table 5.4). The nonlinear model's estimates are more precise for most components. But its estimates of other components, notably θ and ϕ, are significantly more diffuse.

6   Conclusion

A locally linear approximation of a DSGE model has two features that can make it useful in estimation. Because it can be recalculated at each value of the latent state vector, it maintains a high degree of accuracy throughout the possible state space. And, because it is conditionally linear, it fits naturally into the framework of fully-adapted particle filtering.

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[7]I estimated the marginal logposteriors of both models using the method of Gelfand & Dey (1994), as implemented by Geweke (1999).

[8]The Akaike Information Criterion (Akaike 1974) and the Bayesian Information Criterion (Schwarz 1978) both favour the nonlinear model, since the latter has a higher marginal logposterior and both models have the same number of free parameters.

Method	Total time	Time per 100 draws
Linear	25 min	1.5 s
Nonlinear	32 hrs	116 s

Table 3: Estimation time for New Keynesian model

Method	Marginal logposterior	DIC
Loglinear	1564.8	-3246.7
Locally linear	1577.2	-3317.5

Table 4: Estimation results for New Keynesian model

Parameter	Linear		Nonlinear	
	Mean	90% CI	Mean	90% CI
Demand-side parameters				
β	0.992	[0.99,0.99]	0.992	[0.99,0.99]
γ	1.83	[1.5,2.2]	1.53	[1.2,1.9]
ρ_b	0.854	[0.83,0.88]	0.887	[0.86,0.91]
σ_b	0.00273	[0.0022,0.0032]	0.00214	[0.0018,0.0026]
Supply-side parameters				
ϕ	0.669	[0.23,1.2]	1.43	[0.68,2.2]
α	0.703	[0.54,0.84]	0.881	[0.8,0.95]
θ_p	0.786	[0.71,0.86]	0.65	[0.59,0.71]
θ	7.09	[5,10]	5.9	[3.5,8.7]
ρ_a	0.794	[0.75,0.83]	0.8	[0.75,0.84]
σ_a	0.00196	[0.00079,0.0037]	0.00125	[0.00055,0.002]
ρ_e	0.988	[0.97,1]	0.992	[0.98,1]
σ_e	0.0065	[0.0044,0.0088]	0.00938	[0.0067,0.012]
Policy parameters				
ρ_r	0.902	[0.81,0.97]	0.902	[0.82,0.97]
ϕ_π	1.59	[1.3,1.9]	1.7	[1.4,2]
ϕ_y	0.279	[0.15,0.45]	0.146	[0.084,0.22]
Π	1.005	[1.004,1.006]	1.0051	[1.004,1.006]
ρ_m	0.923	[0.88,0.96]	0.962	[0.92,0.99]
σ_m	0.00244	[0.0018,0.0031]	0.00173	[0.0012,0.0024]
σ_r	0.000673	[0.00039,0.00095]	0.00138	[0.001,0.0017]

Table 5: Posterior estimates for New Keynesian model

A The model used for Figure 1

Figure 1 is based on the model described in Campbell & Cochrane (1999). The model assumes that the representative agent's consumption process is

$$\Delta \log C_t = g + \nu_t \tag{60}$$

where $\nu \sim N(0, \sigma^2)$. The agent's utility function is given by

$$U_t = E_t \sum_{t=0}^{\infty} \beta^t \frac{(C_t - X_t)^{1-\gamma}}{1 - \gamma} \tag{61}$$

where X_t is the (external) habit stock, interpreted as the minimum level of consumption required to maintain a well-defined utility (i.e., the household must ensure that $C_t > X_t$). The surplus consumption ratio S_t is defined by

$$S_t = \frac{C_t - X_t}{C_t}$$

and $\widetilde{s}_t = \log S_t - \log \overline{S}$ is the deviation of $\log S_t$ from its mean $\overline{S}$.

The law of motion of $\widetilde{s}_t$ is assumed to be

$$\widetilde{s}_t = \phi \widetilde{s}_{t-1} + \left(\frac{1}{\overline{S}} \sqrt{1 - 2\widetilde{s}_{t-1}} - 1 \right) \nu_t \tag{62}$$

where the disturbance ν_t is the same as the consumption innovation in equation (60), and the steady-state level of S_t is given by

$$\overline{S} = \sigma \sqrt{\frac{\gamma}{1 - \phi}} \tag{63}$$

On that basis, it can be shown that the equilibrium price-dividend ratio of a financial asset satisfies

$$\frac{P_t}{D_t} = \beta_t \mathbb{E}_t \left[\exp \left[\gamma(\widetilde{s}_t - \widetilde{s}_{t+1}) + (1 - \gamma)(g + \nu_{t+1}) \right] \left(1 + \frac{P_{t+1}}{D_{t+1}} \right) \right] \tag{64}$$

Figure 1 shows an approximation to the solution for $\Delta \log \frac{P_t}{D_t}$ as a function of ν_t, conditional on $\widehat{s}_{t-1} = -.45$. This point is well below the steady state, but has a reasonable chance of being observed. (Close to the steady state, the first- and second-order approximations will work much better, by construction.) The parameter values used are $r^f = 0.0025$, $g = .00444$, $\sigma = .00555$, $\gamma = 2.372$, $\phi = 0.97$.

B   Computation of ξ, Ω and Φ

I computed the locally linear approximations using Anderson acceleration applied to the fixed-point equations (17), (18) and (19) (or 69, 70 and 71). Briefly, Anderson acceleration is similar to Newton's method for root-finding; the Jacobian is estimated by regressing previous fixed-point residuals on the corresponding fixed-point outputs. The algorithm provides quadratic convergence, like Newton's method, but is often more robust.

Write $x_k = (\xi_k, \text{vec}\,\Omega_k, \text{vec}\,\Phi_k)$ for the kth estimate of the fixed point, g_{k+1} for the output of the fixed-point equations applied to x_k, and let $f_{k+1} = g_{k+1} - x_k$ be the residual. Let F_{k+1} be the matrix with columns given by $f_i - f_{k+1}$, for $i = (k - m_k), \ldots, k$; the number of columns, m_k, is given by $\min(k, m)$, where m is a control parameter of the algorithm. After some experimentation, I chose $m = 5$. Let G_{k+1} be the similar-sized matrix with columns given by g_{k-m_k-1} to g_{k+1}, and X_{k+1} consist of x_{k-m_k-1} to x_{k+1}.

The next iterate is then given by solving the least-squares problem

$$\vartheta = \left(X'_{k+1} X_{k+1} \right)^{-1} X'_{k+1} f_k \tag{65}$$

then setting $\alpha = (\frac{1}{1+\sum \vartheta}, \frac{\vartheta_1}{1+\sum \vartheta}, \ldots)$, and calculating the next iterate as

$$x_{k+1} = \beta G_{k+1} \alpha + (1 - \beta) X_{k+1} \alpha$$

where $\beta \in (0, 1]$ controls the speed of adjustment. I used $\beta = 1$.

There are various methods for computing equation (65); see Fang & Saad (2009) and Walker & Ni (2011); I used the QR decomposition. Following those two sources, I restarted the iterations whenever the condition number of the R matrix exceeded 10^5 (indicating that the accuracy of the least-squares solution had degraded) and whenever $\|f_k\| > 0.2\|f_{k-1}\|$.

C   Derivation of constrained approximations

Let π equal the probability that the constraint (20) will bind in the period $t + 1$. Applying the result from Tallis (1965),

$$\mathbb{E}\left(\exp q'\epsilon \mid M\epsilon_{t+1} \geq p\right) = \frac{1}{1-\pi} \exp\left(\frac{1}{2}q'q\right) \boldsymbol{\Phi}\left(\frac{Mt - p}{\sqrt{M'M}}\right) \tag{66}$$

$$\mathbb{E}\left(\exp q'\epsilon \mid M\epsilon_{t+1} < p\right) = \frac{1}{\pi} \exp\left(\frac{1}{2}q'q\right) \boldsymbol{\Phi}\left(\frac{p - Mt}{\sqrt{M'M}}\right) \tag{67}$$

where $\boldsymbol{\Phi}$ is the standard normal CDF, $M = [C_1\Gamma R + C_1\Upsilon\Omega R]$, and

$$p = C_2 - C_1\left(\Psi + \Upsilon\Phi_t\right)\widetilde{k}_t - C_1\left(\Gamma + \Upsilon\Omega\right)T\widetilde{z}_t - C_1\Upsilon\xi_t$$

Setting $q = 0$ in (66), it follows that

$$\pi = \boldsymbol{\Phi}\left(\frac{p}{\sqrt{M'M}}\right) \tag{68}$$

These formulas apply in cases where the restriction matrix C_1 has only one row. Solutions for multiple restrictions are provided by Tallis (1965).

Using (66) and (67) in (12), we can separate the constrained and unconstrained cases using the linearity of the expectations operator and the tower property of conditional expectations. Doing so gives the following:

$$
A_0 \circ \exp\left(D_0\xi_t + D_0\Omega_t\widetilde{z}_t + D_0\Phi_t\widetilde{k}_t\right)
$$

$$
\approx \mathbb{E}_t \sum_{j=1}^{N_c} A_j \circ \exp\left(B_j\widetilde{k}_{t-1} + C_j\widetilde{z}_t + D_j\xi_t + D_j\Omega_t\widetilde{z}_t + D_j\Phi_t\widetilde{k}_{t-1}\right.
$$

$$
\left. + E_j\widetilde{k}_t + G_j\xi_t + [F_j + G_j\Omega_t]\,T_t\widetilde{z}_t + [F_j + G_j\Omega_t]\,R_t\epsilon_{t+1} + G_j\Phi_t\widetilde{k}_t\right)
$$

$$
= \sum_{j=1}^{N_c} (1-\pi)A_j \circ \exp\left(B_j\widetilde{k}_{t-1} + C_j\widetilde{z}_t + D_j\xi_t + D_j\Omega_t\widetilde{z}_t + D_j\Phi_t\widetilde{k}_{t-1}\right.
$$

$$
\left. + E_j\widetilde{k}_t + G_j\xi_t + [F_j + G_j\Omega_t]\,T_t\widetilde{z}_t + G_j\Phi_t\widetilde{k}_t\right)
$$

$$
\cdot \mathbb{E}\left[\exp\left([F_j + G_j\Omega_t]\,R_t\epsilon_{t+1}\right) \mid M\epsilon_{t+1} \ge p\right]
$$

$$
+ \sum_{j=1}^{N_c} \pi A_j \circ \exp\left(B_j\widetilde{k}_{t-1} + C_j\widetilde{z}_t + D_j\xi_t + D_j\Omega_t\widetilde{z}_t + D_j\Phi_t\widetilde{k}_{t-1}\right.
$$

$$
+ E_j\widetilde{k}_t + G_j\left[(I-P_c)\xi_t + P_c\xi_c\right]
$$

$$
\left. + [F_j + G_j\left[(I-P_c)\Omega_t + P_c\Omega_c\right]]\,T_t\widetilde{z}_t + G_j\left[(I-P_c)\Phi_t + P_c\Phi_c\right]\widetilde{k}_t\right)
$$

$$
\cdot \mathbb{E}\left[\exp\left([F_j + (I-P_c)\Omega_t + P_c\Omega_c]\,R_t\epsilon_{t+1}\right) \mid M\epsilon_{t+1} < p\right]
$$

$$= \sum_{j=1}^{N_c} A_j \circ \exp\left([B_j + D_j\Phi_t]\,\widetilde{k}_{t-1} + D_j\xi_t + [C_j + D_j\Omega_t + F_jT_t]\,\widetilde{z}_t + E_j\widetilde{k}_t\right)$$

$$\cdot \left(\mathbf{\Phi}\left(\frac{Mt_1 - p}{\sqrt{M'M}}\right)\exp\left(G_j\xi_t + G_j\Phi_t\widetilde{k}_t + G_j\Omega_tT\widetilde{z}_t\right.\right.$$

$$\left. + \frac{1}{2}K\left[F_j + G_j\Omega_t\right]R_tR_t'\left[F_j + G_j\Omega_t\right]'\right)$$

$$+ \mathbf{\Phi}\left(\frac{p - Mt_2}{\sqrt{M'M}}\right)\exp\left(G_j\left[(I - P_c)\xi_t + P_c\xi_c\right]\right.$$

$$+ G_j\left[(I - P_c)\Phi_t + P_c\Phi_c\right]\widetilde{k}_t + G_j\left[(I - P_c)\Omega_t + P_c\Omega_c\right]T\widetilde{z}_t$$

$$\left.\left.+ \frac{1}{2}K\left[F_j + G_j\left[(I - P_c)\Omega_t + P_c\Omega_c\right]\right]R_tR_t'\left[F_j + G_j\left[(I - P_c)\Omega_t + P_c\Omega_c\right]\right]'\right)\right)$$

where

$$t_1 = \left[F_j + G_j\Omega_t\right]R_t$$

and

$$t_2 = \left[F_j + G_j\left[(I - P_c)\Omega_t + P_c\Omega_c\right]\right]R_t$$

Log-differentiating with respect to $\widetilde{z}_t$ and $\widetilde{k}_t$ then gives analogous expressions to (17) and (18). First we rewrite this expression more compactly:

$$\exp\left(D_0\xi_t + D_0\Omega_t\widetilde{z}_t + D_0\Phi_t\widetilde{k}_t\right) = \sum_{j=1}^{N_c} S_j$$

$$= \sum_{j=1}^{N_c} W_j^0 \circ \left[\mathbf{\Phi}\left(\frac{Mt_1 - p}{\sqrt{M'M}}\right)W_j^1 + \mathbf{\Phi}\left(\frac{p - Mt_2}{\sqrt{M'M}}\right)W_j^2\right]$$

Then log-differentiating gives

$$\Omega_t = D_0^{-1}\sum_{j=1}^{N_c}\frac{S_j}{\sum_{m=1}^{N_c}S_m}\frac{\partial\log W_j^0}{\partial\widetilde{z}_t'}$$

$$+ D_0^{-1}\sum_{j=1}^{N_c}\frac{1}{\sum_{m=1}^{N_c}S_m}W_j^0 \circ \left[-\frac{\partial p}{\partial\widetilde{z}_t'}\phi\left(\frac{Mt_1 - p}{\sqrt{M'M}}\right)W_j^1 + \frac{\partial p}{\partial\widetilde{z}_t'}\phi\left(\frac{p - Mt_2}{\sqrt{M'M}}\right)W_j^2\right.$$

$$\left.+ \mathbf{\Phi}\left(\frac{Mt_1 - p}{\sqrt{M'M}}\right)\frac{\partial W_j^1}{\partial\widetilde{z}_t'} + \mathbf{\Phi}\left(\frac{p - Mt_2}{\sqrt{M'M}}\right)\frac{\partial W_j^2}{\partial\widetilde{z}_t'}\right] \tag{69}$$

where

$$W_j^0 = A_j \circ \exp\left([B_j + D_j\Phi_t]\,\widetilde{k}_{t-1} + D_j\xi_t + [C_j + D_j\Omega_t + F_jT_t]\,\widetilde{z}_t + E_j\widetilde{k}_t\right)$$

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$$W_j^1 = \exp\left(G_j\xi_t + G_j\Phi_t\widetilde{k}_t + G_j\Omega_t T\widetilde{z}_t + \frac{1}{2}K\left[F_j + G_j\Omega_t\right]R_tR_t'\left[F_j + G_j\Omega_t\right]'\right)$$

$$W_j^2 = \exp\Big(G_j\left[(I - P_c)\xi_t + P_c\xi_c\right]$$
$$+ G_j\left[(I - P_c)\Phi_t + P_c\Phi_c\right]\widetilde{k}_t + G_j\left[(I - P_c)\Omega_t + P_c\Omega_c\right]T\widetilde{z}_t$$
$$+\frac{1}{2}K\left[F_j + G_j\left[(I - P_c)\Omega_t + P_c\Omega_c\right]\right]R_tR_t'\left[F_j + G_j\left[(I - P_c)\Omega_t + P_c\Omega_c\right]\right]'\Big)$$

$$M = \left[C_1\Gamma R + C_1\Upsilon\Omega R\right]$$
$$p = C_2 - C_1\left(\Psi + \Upsilon\Phi_t\right)\widetilde{k}_t - C_1\left(\Gamma + \Upsilon\Omega\right)T\widetilde{z}_t - C_1\Upsilon\xi_t$$
$$t_1 = \left[F_j + G_j\Omega_t\right]R_t$$
$$t_2 = \left[F_j + G_j\left[(I - P_c)\Omega_t + P_c\Omega_c\right]\right]R_t$$
$$\frac{\partial\log W_j^0}{\partial\widetilde{z}_t'} = C_j + D_j\Omega_t + F_jT_t + E_j\left(\Gamma + \Upsilon\Omega_t\right)$$
$$\frac{\partial p}{\partial\widetilde{z}_t'} = -C_1\left(\Gamma + \Upsilon\Omega_t\right)T - C_1\left(\Psi + \Upsilon\Phi_t\right)\left(\Gamma + \Upsilon\Omega_t\right)$$
$$\frac{\partial W_j^1}{\partial\widetilde{z}_t'} = W_j^1G_j\Omega_tT + W_j^1G_j\Phi_t\left(\Gamma + \Upsilon\Omega_t\right)$$

$$\frac{\partial W_j^2}{\partial\widetilde{z}_t'} = W_j^2G_j\left[(I - P_c)\Omega_t + P_c\Omega_c\right]T + W_j^2G_j\left[(I - P_c)\Phi_t + P_c\Phi_c\right]\left(\Gamma_t + \Upsilon_t\Omega_t\right)$$

Likewise,

$$\Phi_t = D_0^{-1}\sum_{j=1}^{N_c}\frac{S_j}{\sum_{m=1}^{N_c}S_m}\frac{\partial\log W_j^0}{\partial\widetilde{k}_{t-1}'}$$
$$+ D_0^{-1}\sum_{j=1}^{N_c}\frac{1}{\sum_{m=1}^{N_c}S_m}W_j^0\circ\left[-\frac{\partial p}{\partial\widetilde{k}_{t-1}'}\phi\left(\frac{Mt_1 - p}{\sqrt{M'M}}\right)W_j^1 + \frac{\partial p}{\partial\widetilde{k}_{t-1}'}\phi\left(\frac{p - Mt_2}{\sqrt{M'M}}\right)W_j^2\right.$$
$$\left. + \mathbf{\Phi}\left(\frac{Mt_1 - p}{\sqrt{M'M}}\right)\frac{\partial W_j^1}{\partial\widetilde{k}_{t-1}'} + \mathbf{\Phi}\left(\frac{p - Mt_2}{\sqrt{M'M}}\right)\frac{\partial W_j^2}{\partial\widetilde{k}_{t-1}'}\right] \qquad (70)$$

where

$$\frac{\partial\log W_j^0}{\partial\widetilde{k}_{t-1}'} = B_j + D_j\Phi_t + E_j\left(\Psi_t + \Upsilon_t\Phi_t\right)$$

$$\frac{\partial p}{\partial \widetilde{k}'_{t-1}} = -C_1 \left(\Psi_t + \Upsilon_t \Phi_t \right) \left(\Psi_t + \Upsilon_t \Phi_t \right)$$

$$\frac{\partial W_j^1}{\partial \widetilde{k}'_{t-1}} = W_j^1 G_j \Phi_t \left(\Psi_t + \Upsilon_t \Phi_t \right)$$

$$\frac{\partial W_j^2}{\partial \widetilde{k}'_{t-1}} = W_j^2 G_j \left[(I - P_c)\Phi_t + P_c\Phi_c \right] \left(\Psi_t + \Upsilon_t \Phi_t \right)$$

Finally, we can update ξ in the same way as before:

$$\xi = D_0^{-1} \log \left(\sum_{j=1}^{N_c} S_j \right) - \Omega z_t - \Phi k_{t-1} \tag{71}$$

D   New Keynesian example

The New Keynesian model used in Section 5 is characterised by 8 equations for the choice variables: (47), (48), (49), (43), (42), (50), (45) and (44); one equation for the endogenous predetermined variable (53); and three equations for the exogenous shocks (54), (55) and (56).

Using the notation of Section 2, the components of the state vector are

$$\widetilde{c}_t = \begin{bmatrix} \widetilde{g}_{1,t} \\ \widetilde{g}_{2,t} \\ \widetilde{\pi}_t^\star \\ \widetilde{\lambda}_t \\ \widetilde{y}_t \\ \widetilde{\pi}_t \\ \widetilde{l}_t \\ \widetilde{mc}_t \end{bmatrix} \qquad \widetilde{k}_t = [\widetilde{r}_t] \qquad \widetilde{z}_t = \begin{bmatrix} \widetilde{a}_t \\ \widetilde{b}_t \\ \widetilde{m}_t \\ \widetilde{e}_t \\ \eta_{r,t} \end{bmatrix}$$

and the model's coefficient matrices are

$$A_0 = \begin{bmatrix} (\theta - 1)G_2 \\ G_1 \\ \frac{G_1}{\Pi^\star} \\ Y^{-\gamma} \\ 1 \\ \theta_p \Pi^{\theta-1} \\ l \\ MC \end{bmatrix} \qquad D_0 = \begin{bmatrix} 0 & 1 & 0 & 0 & 0 & 0 & 0 & 0 \\ 1 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 1 & -1 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & -\gamma & 0 & 0 & 0 \\ 0 & 0 & 0 & 1 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & (\theta - 1) & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 1 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 1 \end{bmatrix}$$

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$$A_1 = \begin{bmatrix} \theta G_1 \\ \lambda MCY \\ \lambda Y \\ \lambda \\ 1 \\ -(1-\theta_p)(\Pi^\star)^{1-\theta} \\ Y^{\frac{1}{\alpha}} \\ l^\phi/\lambda \end{bmatrix} \qquad B_1 = \mathbf{0}_{8\times1} \qquad C_1 = \begin{bmatrix} 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 \\ 0 & 1 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 \\ -\frac{1}{\alpha} & 0 & 0 & 0 & 0 \\ -1 & 0 & 0 & 1 & 0 \end{bmatrix}$$

$$D_1 = \begin{bmatrix} 1 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 1 & 1 & 0 & 0 & 1 \\ 0 & 0 & 0 & 1 & 1 & 0 & 0 & 0 \\ 0 & 0 & 0 & 1 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & (1-\theta) & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & \frac{1}{\alpha} & 0 & 0 & 0 \\ 0 & 0 & 0 & -1 & 0 & 0 & \phi & 0 \end{bmatrix} \qquad E_1 = \begin{bmatrix} 0 \\ 0 \\ 0 \\ 0 \\ 1 \\ 0 \\ 0 \\ 0 \end{bmatrix} \qquad F_1 = \mathbf{0}_{8\times5}$$

$$G_1 = \begin{bmatrix} 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 1 & 0 & -1 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \end{bmatrix}$$

$$A_2 = \begin{bmatrix} 0 \\ \beta\theta_p\left(\Pi^\theta\right)G1 \\ \beta\theta_p\left(\Pi^{\theta-1}\right)\frac{G2}{\Pi^\star} \\ 0 \\ 0 \\ 1 \\ 0 \\ 0 \end{bmatrix} \qquad B_2 = \mathbf{0}_{8\times1} \qquad C_2 = \begin{bmatrix} 0 & 0 & 0 & 0 & 0 \\ 0 & 1 & 0 & 0 & 0 \\ 0 & 1 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 \end{bmatrix} \qquad D_2 = \mathbf{0}_{8\times8} \qquad E_2 = \mathbf{0}_{8\times1}$$

$$F_2 = \mathbf{0}_{8\times 5} \quad G_2 = \begin{bmatrix} 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 1 & 0 & 0 & 0 & 0 & \theta & 0 & 0 \\ 0 & 1 & -1 & 0 & 0 & (\theta-1) & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \end{bmatrix}$$

When the constraint on the interest rate is binding, the matrices for equation (21) are given by

$$P_c = \begin{bmatrix} 0 & 0 & 0 & 1 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 1 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 1 & 0 \\ 0 & 0 & 0 & 0 & 0 & 0 & 0 & 1 \end{bmatrix} \quad \Omega_c = \begin{bmatrix} -\gamma Y_a & 0 & 0 & -\gamma Y_e & 0 \\ Y_a & 0 & 0 & Y_e & 0 \\ \frac{1}{\alpha}(Y_a-1) & 0 & 0 & \frac{Y_e}{\alpha} & 0 \\ (\gamma+\frac{\phi}{\alpha})Y_a - 1 + \frac{\phi}{\alpha} & 0 & 0 & (\gamma+\frac{\phi}{\alpha})Y_e + 1 & 0 \end{bmatrix}$$

and

$$\Phi_c = \mathbf{0}_{4\times 1}$$

where

$$Y_a = -\frac{(\phi+1)}{\alpha(1-\gamma) - (1+\phi)} \quad \text{and} \quad Y_e = \frac{-\alpha}{\phi+1}Y_a$$

The coefficients in equation (23) are

$$A_k = 1 \quad B_k = \rho_r \quad C_k = [0,0,1,0,1] \quad D_k = [0,0,0,0,\phi_y,\phi_\pi,0,0]$$

and the coefficients in equation (20) are $C_1 = 1$, $C_2 = -\log R$.

Finally, the steady state of the model is:

$$R = \frac{\Pi}{\beta} \qquad \Pi^\star = \left(\frac{1-\theta_p\Pi^{\theta-1}}{1-\theta_p}\right)^{\frac{1}{1-\theta}}$$

$$Y = \left[\Pi^{\star \frac{(\theta-1)}{\theta}} \frac{1-\beta\theta_p\Pi^\theta}{(1-\beta\theta_p\Pi^{\theta-1})^{\frac{1}{\frac{\phi}{\alpha}+\gamma}}}\right]$$

$$\lambda = Y^{-\gamma} \qquad l = Y^{\frac{1}{\alpha}} \qquad MC = Y^{\frac{\phi}{\alpha}+\gamma}$$

$$G_1 = \frac{Y^{1+\frac{\phi}{\alpha}}}{1-\beta\theta_p\Pi^\theta} \qquad G_2 = \frac{\theta}{\theta-1}G_1$$

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