Persistency and Money Demand Distortions in a
Stochastic DGE Model with Sticky Prices

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Abstract

Recently macroeconomists have intensified their efforts to develop models that are able to generate persistent reactions of real variables to monetary shocks in stochastic DGE models with nominal rigidities. This has proven to be quite difficult in models with price staggering only. Most papers show that output is above steady state only as long as prices are fixed for the firms. In this article particular attention is given to the role of money demand and to the form of the utility function. I consider cash-in-advance- (CIA) as well as money-in-the-utility-function- (MIU) models, with CRRA and GHH preferences, to evaluate their ability to generate persistence. Persistent reactions emerge only with a high value of the elasticity of labor supply with respect to the real wage and an interest rate sensitive money demand function. CIA-models generally create more persistency than MIU-models. In the CIA-setup a CRRA utility function generates more persistence than GHH preferences. The results highlight the importance of the way money is introduced in a New Neoclassical Synthesis model.

JEL classification: E52
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1 Introduction

Can monetary shocks generate persistent responses of inflation and output? This question has been addressed in a battery of papers in the last few years. The most prominent paper is the one of [5, Chari/Kehoe/McGrattan (2000)] who conclude that standard models with staggered prices generate only a positive output reaction for the time of exogenous price stickiness. Several attempts have been made to challenge this result.

Recently [6, Christiano/Eichenbaum/Evans (2001)] developed a DGE model that is capable of generating the observed persistence of monetary shocks in US data. With an average duration of two to three quarters wage contracts are the critical nominal friction, not price contracts. If inertia in inflation and output persistence is the main goal to match then they show that variable capacity utilization is most important. To explain the reaction of all variables they include habit persistence in consumption as well as adjustment costs in investment. It should be noted that these authors use a limited information econometric strategy that is not yet common in the literature so that the results are difficult to compare to existing studies.

[9, Dotsey/King (2001)] stress the importance of variable capacity utilization as well. They demonstrate that persistence is possible even in a sticky price model that features labor supply variability through changes in employment and incorporates produced inputs as intermediate goods. All these three ingredients together produce a flat reaction of real marginal costs to a money growth shock. In turn this reduces the extent of price adjustments of the firms. Unfortunately this gradual adjustment of the price level is responsible for the rise in the nominal interest rate: the model does not display the liquidity effect.

[2, Bergin/Feenstra (2000)] use a modified DGE model with intermediate goods and so called translog preferences which is essentially a non-CES aggregator for intermediate goods that replaces the [8, Dixit/Stiglitz (1977)] aggregator. They show that intermediates in production are very important to generate persistent output responses but they also find a strengthening role for the translog preferences: The higher the share of intermediates in production the higher the persistence.

Intermediates also play an important role in the work of [17, Huang/Liu/Phaneuf (2001)]. They evaluate the performance of staggered wage models in relation to staggered price models. They show that only a model with intermediates, staggered price and staggered wage setting can explain persistent
responses of output and, depending on the share of intermediates in production, a weak but slightly positive response of the real wage to a monetary shock, as is observed empirically in the postwar period.

In a model with a vertical input-output structure and only price staggering [15, Huang/Liu (2001a)] demonstrate that the higher the number of stages of production the more persistent the output response. With a sufficient number of stages the response can even be arbitrarily large, given that the share of intermediates is one at all stages of production.

In recent research [16, Huang/Liu (2001b)] demonstrate the importance of such an input-output structure in a two-country model to explain the significant cross-country correlations in aggregate output and the persistent deviations of real exchange rates from purchasing power parity.

[7, Dib/Phaneuf (2001)] discuss a model with price staggering instead of wage staggering. In a variant of the model with a nominal rigidity through costly price adjustment and a real rigidity through adjusting the labor input output, hours and real wages show a persistent reaction to a monetary shock. Moreover, the model can explain the decline in hours worked after a productivity shock, as observed in US postwar data.

In this paper special attention is given to the way money is introduced and to the form of the utility function to account for persistency. To do so CIA- as well as MIU-models are proposed. The importance of the way money demand is modeled in a DGE model has not yet been accomplished by the papers summarized above. There is also no detailed analysis of the role played by the utility function. The results obtained here speak in favor of the setup. First, it turns out that the specific form of the utility function has important effects on the model outcomes. In the CIA-setup a CRRA utility function generates more persistence than GHH preferences. Second, persistent output and inflation responses depend only in part on the value of the elasticity of labor supply with respect to the real wage. Third, persistency depends also crucially upon the implied money demand function. Persistent output reactions emerge only in the MIU-model with GHH preferences and a high value for the elasticity of labor with respect to the real wage. In a CIA-model this result does not hold. Forth, CIA-models generally create more persistency than MIU-models. These results emerge from a model with price staggering only and with no other real or nominal rigidities, challenging results of [6, Christiano/Eichenbaum/Evans (2001)] or [9, Dotsey/King (2001)]. Neither variable capacity utilization nor labor supply variability through changes in employment nor wage staggering nor a vertical input-output structure are
necessary to generate persistent output responses here. In addition the paper shows that [5, Chari/Kehoe/McGrattan’s (2000)] contract multiplier has to be interpreted carefully as they only analyze a MIU-model. The multiplier seems to be different in a CIA-economy. To uncover the different reactions of labor inputs and firm’s outputs I do not study a symmetric equilibrium. Instead, I look at firm specific labor inputs and outputs, as in [22, King/Wolman (1999)].

The paper is organized as follows: Section 2 describes in detail the different models, the steady state and the calibration. In section 3 impulse responses are discussed for the CIA- and the MIU-model. Section 4 concludes and gives some suggestions for future research.

2 The Models

2.1 The Household

The representative household is assumed to have preferences over consumption \( c_t \) and leisure \( (1 - n_t) \). I consider two different sets of functions under two different setups. In the one setup, CIA-models are considered while in the other MIU-models are evaluated. Both will be calculated through for special utility functions. Since they differ for the setups they will be discussed separately below. The first momentary utility function considered under CIA is the one used by [22, King/Wolman (1999)] and is given by

\[
\begin{align*}
    u (c_t, n_t, a_t) &= \left[ c_t - \frac{a_t \theta}{1+\gamma} n_t^{1+\gamma} \right]^{1-\sigma} - 1 / (1 - \sigma) 
\end{align*}
\]

Here \( a_t \) is a preference shock that also acts like a productivity shock. \( \theta \) and \( \gamma \) are positive parameters, \( \sigma \) governs the degree of risk aversion. This function is familiar from the analysis of [14, Greenwood/Hercowitz/Huffman (1988)] and accordingly labeled GHH preferences. It has the special property that hours worked only depend upon the real wage and not upon consumption (no wealth effects).

The second utility function analyzed under CIA is the standard constant relative risk aversion function (CRRA) used in many Real Business Cycle models. \( \zeta \) measures the relative weight of consumption for the representative
agent.

\[ u(c_t, n_t, a_t) = \frac{a_t c_t^\zeta (1 - n_t)^{1-\zeta}}{1 - \sigma} - 1 \]  

(2)

It should be noted that in contrast to the standard use of this utility function there is a disturbance \( a_t \) acting like a preference shock.\(^1\)

Under a MIU-specification the corresponding GHH function to (1) is given by

\[ u\left(c_t, \frac{M_t}{P_t}, n_t, a_t\right) = \frac{\left[ a_t \left( \eta c_t^\nu + (1 - \eta) \left( \frac{M_t}{P_t}\right)^\nu \right)^\frac{1}{\nu} - a_t \zeta \right]^{1-\sigma}}{1 - \sigma} - 1 \]  

(3)

The MIU-specification was - among others - proposed by [24, Sidrauski (1967)]. Consumers are supposed to have preferences over real money balances \( \frac{M_t}{P_t} \) since they facilitate transactions. They are introduced using a CES function together with consumption. This expression replaces the consumption term in (1). \( \eta \) is a share parameter and \( \nu \) will be shown to determine the interest elasticity of the implied money demand function. In case of CRRA preferences the specification in the CES form is embedded in a Cobb-Douglas structure with labor where \( \zeta \) again acts as a weighting parameter.

\[ u\left(c_t, \frac{M_t}{P_t}, n_t, a_t\right) = \frac{\left[ a_t \left( \eta c_t^\nu + (1 - \eta) \left( \frac{M_t}{P_t}\right)^\nu \right)^\frac{1}{\nu} - a_t \zeta \right]^{1-\sigma}}{1 - \sigma} - 1 \]  

(4)

Note that for \( \nu = \eta = 1 \) both specifications collapse to their CIA-counterparts. The nonseparability allows to consider the influence of the money demand distortions on the dynamic evolution of consumption and labor.

The intertemporal optimization problem for the household is to maximize lifetime utility subject to an intertemporal budget constraint. In the case of utility function (1) and (2) it also faces a CIA-constraint. The household is

\[^1\text{[22, King/Wolman (1999)] argue that it is necessary in (1) to have } a_t \text{ affecting equally production and preferences in order to achieve balanced growth. This is doubtful because the model does not explicitly account for growth aspects as, e.g., in [18, King/Plosser/Rebelo (1988)].}\]
assumed to have access to a bond market and to hold money. Its budget constraint is therefore given by

\[ P_t c_t + M_t + B_t = P_t w_t n_t + M_{t-1} + (1 + R_{t-1}) B_{t-1} + M_t^s \]  

The uses of wealth are nominal consumption \( P_t c_t \), holdings of money balances \( M_t \) and bonds \( B_t \). The household has several sources of its wealth. It earns money working in the market at the real wage rate \( w_t (P_t w_t n_t) \) and can spend its money holdings carried over from the previous period \( (M_{t-1}) \). There are also previous period bond holdings including the interest on them \( (1 + R_{t-1}) (B_{t-1}) \). Finally the household receives a monetary transfer \( M_t^s \) from the government or the monetary authority, respectively.\(^2\) This transfer is equal to the change in money balances, i.e.

\[ M_t^s = M_t - M_{t-1} \]  

For utility functions (1) and (2) the household faces a CIA-constraint. It can consume only out of cash balances it has received before. This condition is therefore given by\(^3\)

\[ P_t c_t \leq M_{t-1} + M_t^s \]  

The Lagrangian for the household in case of utility function (1) and (2) (index H1) (CIA-model) can then be written as follows:

\[ L_{H1} = E_0 \left[ \sum_{t=0}^{\infty} \beta^t u (c_t, n_t, a_t) + \sum_{t=0}^{\infty} \beta^t \lambda_t \left( w_t n_t + m_{t-1} \frac{P_{t-1}}{P_t} + m_t^s + (1 + R_{t-1}) b_{t-1} \frac{P_{t-1}}{P_t} - c_t - m_t - b_t \right) + \sum_{t=0}^{\infty} \beta^t \Omega_t \left( m_{t-1} \frac{P_{t-1}}{P_t} + m_t^s - c_t \right) \right] \]

\(^2\)The household also receives profits from the intermediate goods firms. Since these profits will be zero in the equilibrium they are not explicitly included in the budget constraint here.

\(^3\)The formulation of the CIA-constraint, the monetary transfer and the intertemporal budget constraint is consistent with [26, Walsh (1998)], pp. 100-102.
Here small variables indicate real quantities, i.e. for example $m_t = M_t / P_t$. Households optimize over $c_t, n_t, m_t$ and $b_t$ taking prices and the initial values of the price level $P_0$ as well as the outstanding stocks of money $M_0$ and bonds $B_0$ as given. The first order conditions for an interior solution are reported below.

$$\frac{\partial L_{H1}}{\partial c_t} = \beta^t \frac{\partial u(c_t, n_t, a_t)}{\partial c_t} - \beta^t \lambda_t - \beta^t \Omega_t = 0$$ (9)

$$\frac{\partial L_{H1}}{\partial n_t} = \beta^t \frac{\partial u(c_t, n_t, a_t)}{\partial n_t} + \beta^t \lambda_t w_t = 0$$ (10)

$$\frac{\partial L_{H1}}{\partial m_t} = -\beta^t \lambda_t + E_t \beta^{t+1} \lambda_{t+1} \frac{P_t}{P_{t+1}} + E_t \beta^{t+1} \Omega_{t+1} \frac{P_t}{P_{t+1}} = 0$$ (11)

$$\frac{\partial L_{H1}}{\partial b_t} = -\beta^t \lambda_t + E_t \beta^{t+1} \lambda_{t+1} (1 + R_t) \frac{P_t}{P_{t+1}} = 0$$ (12)

The derivatives with respect to $\lambda_t$ and $\Omega_t$ are omitted since they are equal to the budget constraint and the CIA-constraint, respectively. It should be noted that these conditions result from the more general Kuhn-Tucker conditions assuming that all variables and multipliers are strictly positive. This implies especially that - given $\Omega_t > 0$ - the CIA-constraint is always binding and that the nominal interest rate $R_t$ is positive. Otherwise (11) and (12) will not be compatible. In addition the household’s optimal choices must also satisfy the transversality conditions:

$$\lim_{t \to \infty} \beta^t \lambda_t x_t = 0 \quad \text{for} \quad x = m, b$$ (13)

The familiar result that the first two efficiency conditions imply the equality of the marginal rate of substitution between consumption and labor and the real wage does not hold here because of the CIA-constraint. Instead one gets

$$w_t = -\frac{1}{\beta} E_t \left( \frac{\partial u(c_{t+1}, n_{t+1}, a_{t+1})}{\partial c_{t+1}} \frac{P_{t+1}}{P_{t+1}} \right)$$ (14)

This equation can be derived by eliminating $\Omega_t$ in the efficiency condition for consumption using the efficiency condition for money. There is a different
timing of the marginal utility of consumption and labor which alters the
dynamics of the real wage. In addition there is a direct influence of inflation.
The efficiency condition for bond holdings establishes a relation between the
nominal interest rate and the price level. Rearranging terms yields

$$ (1 + R_t) = E_t \left( \frac{\lambda_t}{\lambda_{t+1}} \frac{1}{\beta} \frac{P_{t+1}}{P_t} \right) $$  \hspace{1cm} (15)

Supposed the Fisher equation is valid the real interest rate $r_t$ is implicitly
defined as

$$ (1 + r_t) = E_t \left( \frac{\lambda_t}{\lambda_{t+1}} \frac{1}{\beta} \right) $$  \hspace{1cm} (16)

because $P_{t+1}/P_t$ equals one plus the rate of expected inflation which is ap-
proximated by the ex-post-inflation rate.

In case of the MIU-model the CIA-constraint is dropped since money
demand will be determined endogenously through the derivative with respect
to $m_t$. In this case $m_t$ shows up in the utility function, of course. So the
Lagrangian (index $H_2$) will be given by

$$ L_{H_2} = E_0 \left[ \sum_{t=0}^{\infty} \beta^t u(c_t, m_t, n_t, a_t) \right. \\
+ \left. \sum_{t=0}^{\infty} \beta^t \lambda_t \left( w_t n_t + m_{t-1} \frac{P_{t-1}}{P_t} + m^*_t \\
+ (1 + R_{t-1}) b_{t-1} \frac{P_{t-1}}{P_t} - c_t - m_t - b_t \right) \right] $$  \hspace{1cm} (17)

In order to compare both setups the first order conditions are again reported.

$$ \frac{\partial L_{H_2}}{\partial c_t} = \beta^t \frac{\partial u(c_t, m_t, n_t, a_t)}{\partial c_t} - \beta^t \lambda_t = 0 $$  \hspace{1cm} (18)

$$ \frac{\partial L_{H_2}}{\partial n_t} = \beta^t \frac{\partial u(c_t, m_t, n_t, a_t)}{\partial n_t} + \beta^t \lambda_t w_t = 0 $$  \hspace{1cm} (19)

$$ \frac{\partial L_{H_2}}{\partial m_t} = \beta^t \frac{\partial u(c_t, m_t, n_t, a_t)}{\partial m_t} - \beta^t \lambda_t + E_t \beta^{t+1} \lambda_{t+1} \frac{P_t}{P_{t+1}} = 0 $$  \hspace{1cm} (20)
\[
\frac{\partial L_{H2}}{\partial b_t} = -\beta^t \lambda_t + E_t \beta^{t+1} \lambda_{t+1} (1 + R_t) \frac{P_t}{P_{t+1}} = 0
\]

(21)

The derivatives with respect to \( n_t \) and \( b_t \) are essentially the same as for \( H1 \). As before, \( P_0, M_0 \) and \( B_0 \) are given and the transversality conditions hold. In the consumption Euler equation the influence of the second Lagrange multiplier \( \Omega_t \) disappears whereas in the efficiency condition for money the marginal utility of real balances has to be considered. This derivative determines the endogenous money demand function. Combining the optimum conditions for consumption, bonds and money yields the following equation:

\[
\frac{\partial u \left( c_t, m_t, n_t, a_t \right)}{\partial m_t} = \frac{\partial u \left( c_t, m_t, n_t, a_t \right)}{\partial c_t} \frac{R_t}{1 + R_t}
\]

(22)

This specification allows to estimate an empirical money demand function. A detailed description will be presented in the calibration section. For the Taylor approximations see Appendix A.

Two important implications come out right here. First, the real wage rate will be determined by the usual marginal rate of substitution between consumption and labor, in contrast to the additional dynamics in the CIA-model (see (14)). Second, the implied money demand function is independent of the specific form of the monetary transfer \( M^s_t \) and, in addition, it depends directly upon the nominal interest rate (see (22)).

### 2.2 The Finished Goods Producing Firm

The firm producing the final good \( c_t = y_t \) in the economy uses \( c_{j,t} \) units of each intermediate good \( j \in [0,1] \) purchased at price \( P_{j,t} \) to produce \( c_t \) units of the finished good. The production function is assumed to be a CES aggregator as in [8, Dixit/Stiglitz (1977)] with \( \epsilon > 1 \).

\[
c_t = \left( \int_0^1 c_{j,t}^{(\epsilon-1)/\epsilon} dj \right)^{\epsilon/(\epsilon-1)}
\]

(23)

The firm maximizes its profits over \( c_{j,t} \) given the above production function and given the price \( P_t \). So the problem can be written as

\[
\max_{c_{j,t}} \left[ P_t c_t - \int_0^1 P_{j,t} c_{j,t} dj \right] \text{ s.t. } c_t = \left( \int_0^1 c_{j,t}^{(\epsilon-1)/\epsilon} dj \right)^{\epsilon/(\epsilon-1)}
\]

(24)
The first order conditions for each good $j$ imply

$$c_{j,t} = \left( \frac{P_{j,t}}{P_t} \right)^{-\epsilon} c_t$$

where $-\epsilon$ measures the constant price elasticity of demand for each good $j$. Since the firm operates under perfect competition it does not make any profits. Inserting the demand function into the profit function and imposing the zero profit condition reveals that the only price $P_t$ that is consistent with this requirement is given by

$$P_t = \left( \int_0^1 P_{j,t}^{(1-\epsilon)} dj \right)^{1/(1-\epsilon)}$$

In case that prices are fixed for just two periods and assuming that all price adjusting producers in a given period choose the same price the consumption aggregate can be written as

$$c_t = c\left(c_{0,t}, c_{1,t}\right) = \left( \frac{1}{2} c_{(\epsilon-1)/\epsilon,0,t} + \frac{1}{2} c_{(\epsilon-1)/\epsilon,1,t} \right)^{\epsilon/(\epsilon-1)}$$

where $c_{j,t}$ can then be interpreted as the quantity of a good consumed in period $t$ whose price was set in period $t-j$. Similarly in the two period price setting case to be explored in detail in the next section the price equation simplifies. With prices set for two periods half of the firms adjust their price in period $t$ and half do not. Moreover all adjusting firms choose the same price. Then $P_{j,t}$ is the nominal price at time $t$ of any good whose price was set $j$ periods ago and $P_t$ is the price index at time $t$ and is given by

$$P_t = \left( \frac{1}{2} P_{0,t}^{1-\epsilon} + \frac{1}{2} P_{1,t}^{1-\epsilon} \right)^{1/(1-\epsilon)}$$

### 2.3 The Intermediate Goods Producing Firm

Intermediate good firms produce with a technology that is linear in labor $n_{j,t}$ and subject to random productivity shocks $a_t$.

$$y_{j,t} = c_{j,t} = a_t n_{j,t}$$
Here $n_{j,t}$ is the labor input employed in period $t$ by a firm who set the price in period $t - j$. Firms always meet the demand for their product, that is $y_{j,t} = c_{j,t}$. Those who do not adjust their prices in a given period can be interpreted as passive while those who do adjust do so optimally.

Firms set their prices to maximize the present discounted value of their profits. Before they can do that they have to minimize their costs given the production function. In case of the models considered here there is no capital so the costs are solely given by the wage bill. Thus minimizing $P_t w_t n_{j,t}$ with respect to $n_{j,t}$ subject to the production function implies for the total cost function $TC_{j,t}$:

$$TC_{j,t} = \frac{P_t w_t c_{j,t}}{a_t} \quad (30)$$

With only one factor of production one can just express the labor input by manipulating the production function so that $n_{j,t} = c_{j,t} / a_t$ and insert this into the wage bill equation. It is useful for further calculations to define nominal marginal cost as $\Psi_t$ which is equal to $(\partial TC_{j,t} / \partial c_{j,t}) = P_t w_t / a_t$. Thus real marginal costs are given by $\psi_t = w_t / a_t$. With a relative price defined by $p_{j,t} = P_{j,t} / P_t$ real profit $z_{j,t}$ for a firm of type $j$ is equal to

$$z_{j,t} = p_{j,t} c_{j,t} - w_t n_{j,t} \quad (31)$$

Using the demand function for the intermediate goods ($c_{j,t} = p_{j,t} c_t = a_t n_{j,t}$) and the definition of real marginal costs given above the profit function can be rewritten as

$$z_{j,t} = z (p_{j,t}, c_t, \psi_t) = p_{j,t} c_{j,t} - \psi_t c_{j,t} = c_{j,t} (p_{j,t} - \psi_t) = p_{j,t} c_t (p_{j,t} - \psi_t) \quad (32)$$

In the case in which prices are not sticky the firm can just set prices on a period by period basis optimizing the profit function (32) with respect to $p_{j,t}$. The result of this exercise would be that relative prices will have to be set according to

$$p_{j,t} = \frac{\epsilon}{\epsilon - 1} \psi_t \quad (33)$$

\textsuperscript{4}The model deviates in this respect from the standard textbook model in which profits are maximized over the quantity.

\textsuperscript{5}It should be noticed that the wage is perfectly flexible in a competitive input market. So there is no index $j$ for $w_t$ and $P_t$ which means that they are not firm-specific.
But when prices are fixed for two periods the firm has to take into account the effect of the price chosen in period $t$ on current and future profits. The price in period $t + 1$ will be affected by the gross inflation rate $\Pi_{t+1}$ between $t$ and $t + 1$ ($\Pi_{t+1} = P_{t+1}/P_t$).

$$p_{1,t+1} = \frac{p_{0,t}}{\Pi_{t+1}}$$

(34)

If there is positive inflation, $p_{1,t+1}$ will fall because nominal prices are fixed for two periods. As the nominal price in period $t$ is defined by $P_{0,t}$ and in period $t + 1$ by $P_{1,t+1}$, one has $P_{0,t} = P_{1,t+1}$, so that $p_{0,t} = P_{0,t}/P_t$ and $p_{1,t+1} = P_{1,t+1}/P_{t+1} = (P_{0,t}/P_t) (P_t/P_{t+1})$ which is what is stated in (34). So the optimal relative price has to balance the effects due to inflation between profits today and tomorrow. This intertemporal maximization problem is formally given by

$$\max_{p_{0,t}} E_t \left[ z(p_{0,t}, c_t, \psi_t) + \beta \frac{\lambda_{t+1}}{\lambda_t} z(p_{1,t+1}, c_{t+1}, \psi_{t+1}) \right]$$

s.t. $p_{1,t+1} = \frac{p_{0,t}}{\Pi_{t+1}}$

(35)

The term $\lambda_{t+1}/\lambda_t$ is equal to the ratio of future to current marginal utility of labor and the respective real wage ratio (derived in the household’s optimization problem) and considered to be - in conjunction with $\beta$ - the appropriate discount factor for real profits. This is a consequence of the assumption that households own the production factor labor and rent it to the firms. They also own a diversified portfolio of claims to the profits earned by the firms. Although there will be no asset accumulation in equilibrium $\lambda_t$ can be used to determine the present value of profits.\(^6\) The efficiency condition for this problem is given by

$$0 = \frac{\partial z(p_{0,t}, c_t, \psi_t)}{\partial p_{0,t}} + \beta E_t \left( \frac{\lambda_{t+1}}{\lambda_t} \frac{\partial z(p_{1,t+1}, c_{t+1}, \psi_{t+1})}{\partial p_{1,t+1}} \frac{1}{\Pi_{t+1}} \right)$$

(36)

Multiplying this equation by $p_{0,t}$ and $\lambda_t$ produces a more symmetric form of the efficiency condition that will be more convenient to derive the model solution later.

$$0 = \lambda_t p_{0,t} \frac{\partial z(p_{0,t}, c_t, \psi_t)}{\partial p_{0,t}} + \beta E_t \left( \lambda_{t+1} p_{1,t+1} \frac{\partial z(p_{1,t+1}, c_{t+1}, \psi_{t+1})}{\partial p_{1,t+1}} \right)$$

(37)

\(^6\)More details on this can be found in [11, Dotsey/King/Wolman (1999)], p. 659-665 as well as in [10, Dotsey/King/Wolman (1997)], p. 9-13.
Using (32) one can solve this condition for the optimal price to be set in period $t$ which corresponds to the optimal price in case that prices are flexible derived before. This yields a forward-looking form of the price equation and is in that respect similar to the one in [25, Taylor (1980)].

$$p_{0,t} = \frac{\epsilon}{\epsilon - 1} \frac{\lambda t c_t \psi_t + \beta E_t \lambda_{t+1} (P_{t+1}/P_t)^\epsilon c_{t+1} \psi_{t+1}}{\lambda t c_t + \beta E_t \lambda_{t+1} (P_{t+1}/P_t)^{\epsilon-1} c_{t+1}}$$  \hfill (38)

The optimal relative price $p_{0,t}$ depends upon the current and future real marginal costs, the gross inflation rate, current and future consumption as well as today’s and tomorrow’s interest rates (through the influence of the $\lambda$-terms). It is thus fundamentally different from the one derived under fully flexible prices on a period-by-period basis (see (33)). (38) can be manipulated in a way that yields a form which is exactly equal to the one studied in [26, Walsh (1998)], p. 197, when using (15) for the interest rate factor. To derive the Taylor approximation in the Appendix it is useful to write (38) as

$$P_{0,t} = \frac{\epsilon}{\epsilon - 1} \frac{\lambda t P_t c_t \psi_t + \beta E_t \lambda_{t+1} P_{t+1}^{\epsilon} c_{t+1} \psi_{t+1}}{\lambda t P_t^{\epsilon-1} c_t + \beta E_t \lambda_{t+1} P_{t+1}^{\epsilon-1} c_{t+1}}$$  \hfill (39)

Finally, aggregate labor demand must be equal to the aggregate labor supply of the household.$^7$

$$n_t = \frac{1}{2} n_{0,t} + \frac{1}{2} n_{1,t}$$  \hfill (40)

### 2.4 Market Clearing Conditions and Other Equations

It is well known that models like the one at hand imply multiple equilibria and sunspots because bonds are not determined. To escape this problem the household budget constraint is dropped and bonds are set to zero: $b_t = 0$ for all $t$.$^8$ Note that due to Walras’ law the intertemporal budget constraint will also hold in equilibrium.

In the CIA-model the implicit money demand function is derived by substituting $M_t^\rho$ in the CIA-constraint - holding with equality. This implies:

$$M_t = P_t c_t$$  \hfill (41)

$^7$The factor 0.5 shows up because $n_{j,t}$ is labor hired per $j$-type firm and half the firms are of each type.

$^8$See [12, Flodén (2000)], p. 1413. He argues that bonds are introduced to determine the nominal interest rate.
It is essentially a quantity theoretic type of money demand. It is important to stress that it depends crucially upon the form of the monetary transfer $M_t^s$. [3, Carlstrom/Fuerst (1998)] include bond holdings in their CIA-constraint. Using this specification, including bond holdings also in $M_t^s$, leads to multiple equilibria.

In the MIU-model the efficiency condition for money determines the money demand function, of course (see the discussion of (22)).

The markup $\mu_t$ is just the reciprocal of real marginal cost so that

$$\mu_t = \frac{1}{\psi_t} \quad (42)$$

### 2.5 The Monetary Authority

The model is closed by adding a monetary policy rule. Therefore an exogenous process for the money growth rate is assumed. To achieve persistent but non permanent effects the level of money follows an AR(2)-process which implies that the growth rate follows an AR(1)-process. That means for the level of money

$$\hat{M}_t = (1 + \rho M_2) \hat{M}_{t-1} - \rho M_2 \hat{M}_{t-2} + \epsilon_M \quad (43)$$

whereas for the growth rate one gets

$$\left( \hat{M}_t - \hat{M}_{t-1} \right) = \rho M_2 \left( \hat{M}_{t-1} - \hat{M}_{t-2} \right) + \epsilon_M \quad (44)$$

A hat (\hat{\quad}) represents the relative deviation of the respective variable from its steady state (see the Appendix). $\epsilon_M$ is an i.i.d. sequence of shocks that hit the growth rate. This formulation is equivalent to the standard assumption that money grows at a factor $g_t$:

$$M_t = g_t M_{t-1} \quad (45)$$

Suppose $\hat{g}_t$ follows an AR(1)-process $\hat{g}_t = \rho M_2 \hat{g}_{t-1} + \epsilon_M$ then it is easy to show that (44) is valid. Note that inflation is zero in the steady state so also money growth is zero there ($g = 1$, see the next Section).

There is another shock in the model, namely the productivity shock $a_t$. As is clear from the utility functions this shock can also act as a taste shock. So one can easily analyze the model’s impulse responses to this productivity/taste shock. Under these circumstances $\hat{a}_t$ follows an AR(1)-process

$$\hat{a}_t = \rho a \hat{a}_{t-1} + \epsilon_a \quad (46)$$

with $\epsilon_a$ white noise.
2.6 The Steady State

Imposing the condition of constancy of the price level in the steady state \((P_t = P_{t-1} = P)\) on the nominal interest rate equation reveals the familiar condition from RBC models that \(\beta = 1/(1 + R)\). In addition, as there is no steady state inflation, \(R = r\). The two period price setting of the firms implies \(P_0 = P_1\). Using this in the price index reveals that \(P_0 = P_1 = P\).

Then the demand functions for \(c_0\) and \(c_1\) (25) imply \(c_0 = c_1\). Inserting this in the Dixit/Stiglitz-aggregator (27) one gets the result that all consumption levels are equal: \(c_0 = c_1 = c\). For the markup it follows \(\mu = 1/\psi\) while \(\psi\) is determined by the steady state of the efficiency condition for maximizing profits, (38). This amounts to \(\psi = (\epsilon - 1)/\epsilon\). Then the real wage is given by \(w = a \psi = a/\mu\). Finally the production functions for \(c_0\) and \(c_1\) imply that \(n_0 = n_1\). In the aggregate this implies \(n = n_0 = n_1\) using equation (40) and also \(c = an\). In case of the CIA-model (14) is used to pin down the preference parameter, which is either \(\theta\) or \(\zeta\). This implies \(\theta = \beta(1/\mu)(1/n^\gamma)\) and \(\zeta = c/[\beta(w - wn) + c]\).

For the MIU-model with CRRA preferences the marginal rate of substitution between consumption and labor can also be used to calculate the preference parameter \(\zeta\). Using (22) the ratio of \(m\) over \(c\) depends only upon \(\beta, \eta\) and \(\nu\).

\[
m = c \left[ \frac{\eta}{1 - \eta} (1 - \beta) \right]^{1/\nu} \tag{47}
\]

In turn \(\zeta\) can be determined as a function of these parameters and \(c, w\) and \(n\).

\[
\zeta = \frac{c}{(1 - n)} \Theta \left[ w + \frac{c}{1 - n} \Theta \right]^{-1} \tag{48}
\]

with

\[
\Theta = 1 + (1 - \beta)^{\frac{\nu}{\nu - 1}} \left( \frac{\eta}{1 - \eta} \right)^{\frac{1}{\nu - 1}} \tag{49}
\]

\(^9\)Remember that this ratio is not the same as (14) but the standard formula which results from combining the efficiency conditions for consumption and labor.
In the MIU-model with GHH preferences $m$ is also given by (47). Then $\theta$ changes to

$$
\theta = \frac{1}{\mu n^\gamma} \left[ \phi^\nu \left( \eta + (1 - \eta) \left( (1 - \beta) \frac{\eta}{1 - \eta} \right)^{\frac{\nu}{1 - \nu}} \right) \right]^{\frac{1}{1 - \nu}} \eta c^{\nu - 1} \quad (50)
$$

### 2.7 Calibration

To compute impulse responses the parameters of the model have to be calibrated. Some parameters depend upon the specific utility function used so it is useful to look at first at the parameters which are independent of these.

It is possible to either specify $\beta$ or $r$ exogenously. Here $\beta$ will be set to 0.99 implying a value of $r$ of about 0.0101 per quarter which is in line with other values used for the real interest rate in the literature. $\psi$ and $\mu$ can be determined by fixing a value for the elasticity of the demand functions for the differentiated products. This elasticity being equal to 4 causes the static markup $\mu = \epsilon/(\epsilon - 1)$ to be 1.33 which is in line with the study of [23, Linnemann (1999)] about average markups. In order to determine the steady state real wage $w$ the productivity shock $a$ has to be specified. As there is no information available about that parameter it is arbitrarily set at 10.\(^\text{10}\)

As can be seen from Section 2.6 either $n$ or $c$ have to be set exogenously to calculate $c = an$. Because more information is available about hours worked, $n$ is specified to be equal to 0.25 implying that agents work 25% of their non-sleeping time.

In the benchmark case, $\sigma$, the parameter governing the degree of risk aversion, is set to 2 in all models. For GHH preferences $\gamma$ has to be specified. To make results comparable to the CRRA utility function $\gamma$ is set to 1.3 which implies the same elasticity of labor supply with respect to the real wage. In the sensitivity analysis the value will be changed to 0.1. The implied value of $\theta$ under CIA is 4.7146.

Using the CRRA preference specification under CIA the parameter $\zeta$ can be calculated using equation (14) which implies $\zeta = 0.3098$, a value that is reasonably in line with other studies.

In the MIU-model, both for CRRA and GHH preferences, the parameters $\nu$ and $\eta$ are calibrated by estimating an empirical money demand function

\(^{10}\)In contrast to the well known basic neoclassical model of [18, King/Plosser/Rebelo (1988)] there is no escape from specifying parameters such as $a$ at the steady state. The system cannot be reduced until only deep parameters remain to be calibrated.
the form of which is implied by the efficiency conditions of the household. This functional form is obtained by solving (22) for \( m_t \) and taking logarithms:

\[
\ln m_t = \frac{1}{\nu - 1} \ln \frac{\eta}{1 - \eta} + \frac{1}{\nu - 1} \ln \left( \frac{R_t}{1 + R_t} \right) + \ln c_t \tag{51}
\]

Estimates of [5, Chari/Kehoe/McGrattan (2000)] reveal that \( \eta = 0.94 \) and \( \nu = -1.56 \). They use US data from Citibase covering 1960:1-1995:4 regressing the log of consumption velocity on the log of the interest rate variable \( R_t/(1 + R_t) \). Since the focus is on the qualitative results of the model the money demand function is not estimated for specific German or other data. For CRRA utility the implied value of \( \zeta \) changes slightly to 0.3121 while \( m/c \) is equal to 2.06. Under GHH preferences \( \theta = 4.7916 \).

For the exogenous money growth process \( \rho_{Mz} = 0.5 \) is used. As the focus of the paper is on persistency of money shocks productivity shocks will not be considered. But they can be used to check whether the model displays reasonable impulse responses to technology shocks.

3 Impulse Response Functions

The solution is conducted using an extended version of the algorithm of [19, King/Plosser/Rebelo (1990)] which allows for singularities in the system matrix of the reduced model. The theoretical background of this algorithm is developed in [21, King/Watson (1999)] whereas computational aspects and the implementation are discussed in [20, King/Watson (1997)].

3.1 CIA-Model

Because results differ it is useful to subdivide this subsection in two further sections containing results for the GHH preferences and for the standard CRRA utility function.

3.1.1 GHH Preferences

Here the impulse responses of the model variables to a 1% shock to the money growth rate will be discussed. Figures 1-4 display the reaction of selected variables to this shock in the benchmark calibration. The reactions of \( \hat{c}_{0,t} \) and \( \hat{h}_{0,t} \) and of the prices are the most persistent ones of the variables
under observation. The real wage, the markup, real marginal costs as well as consumption and labor of non-adjusting firms show a cyclical reaction which is counterfactual. Aggregate consumption and labor rise on impact and fall immediately below the steady state in the next period. They display some persistence after the initial positive impact. Unfortunately the persistence consists of a tendency of aggregate consumption and labor to remain below their steady state levels for several successive periods. This is a feature not empirically observed either. Real marginal costs display a strong increase which amounts to a quite strong rise in the price firms set when they are allowed to do so. But it takes some 7 or 8 periods for the price level to reach the new equilibrium value so one can conclude that prices show at least some persistence. Inflation shows a hump as it does empirically. The decline in the real interest rate is more than three times the rise in the nominal rate. As for many DGE models with sticky prices also this one fails to generate the liquidity effect (a falling nominal interest rate). But the nominal rate reacts quite persistently.

In the literature several authors argue in favor of models generating flat marginal cost curves because then there is little incentive for firms to raise prices. In turn money growth shocks can have persistent effects on output. The GHH utility function implies an elasticity of real marginal cost with respect to output that is constant and equal to $\gamma$ which was calibrated to be 1.3 in the benchmark case. Changing this value to 0.1 would considerably reduce this elasticity and would probably enhance the persistence effects of money growth shocks in the model (see Figures 5-8). But a low value for this elasticity implies at the same time a high elasticity of labor supply with respect to the real wage which is given by $1/\gamma = 10$. In light of empirical estimates of the labor supply elasticity this value may be regarded as too high. But in spite of this implication there is not much more persistency in the aggregate consumption and labor reactions, although $\hat{c}_{0,t}$ and $\hat{n}_{0,t}$ show considerably more persistence than before. Real marginal costs $\hat{\psi}_t$ react stronger than 0.1%. Note that the price level overshoots its new equilibrium value of 2 quite strongly.

The reason why even the variant of the model with a low elasticity of real marginal costs with respect to output fails to generate a persistent output reaction seems to be the implied money demand function, which is essentially of a quantity theoretic type here. Real marginal costs are more reactive to a money growth shock because of the additional dynamics in the model which
work through $\Omega_t$ in the efficiency condition for consumption. This shadow price of money generates a dynamic relation between the shadow price of wealth $\lambda_{t-1}$ and the marginal utility of consumption and leisure. This will be different in the MIU-model. But before exploring this preference specification in the MIU-model let’s turn to the CRRA utility function first.

### 3.1.2 CRRA Preferences

Figures 9-12 summarize the impulse responses in the model with CRRA preferences (see (2)). At first glance these graphs seem to be very similar to those under GHH preferences. But there are some small interesting differences. First, note that no variable besides aggregate consumption and labor (and real money balances) falls below its steady state value even though its reaction is sometimes cyclical as under GHH. Nevertheless aggregate consumption and employment rise only on impact and approach their steady state from below. Second, the reaction of $\hat{c}_{0,t}$ and $\hat{n}_{0,t}$ is smoother showing no kink as under GHH utility. The same holds for prices and inflation (compare Figures 9 and 1 as well as 12 and 4).

This is an interesting result pointing out the role played by the utility function. For the CRRA utility function the elasticity of labor supply with respect to the real wage rate depends only on the value of hours worked at the steady state, $n$, and is given by $1 - n$. This implies a value of 0.75 which is the same as in case of benchmark GHH preferences. Similarly the elasticity of real marginal cost with respect to output can be shown to be $1/(1 - n)$ which is equal to 1.3 in the stationary equilibrium and equal to $\gamma$ under GHH. Now in the CIA-setup this leads to overall a bit more persistent reactions under CRRA preferences than under GHH utility. Under GHH a high labor supply elasticity is needed to generate more persistence than under CRRA. So it makes a difference which type of utility function is used in DGE models with sticky prices, even in the benchmark case with empirically plausible values for the respective elasticities.

### 3.2 MIU-Model

Similar to the CIA-case results differ in the MIU-model so there will be two subsections to treat each utility function separately.
3.2.1 GHH Preferences

Figures 13-16 visualize the impulse responses for the MIU-model with GHH preferences in the benchmark case. A first inspection of the impulses reveals that now all variables but the nominal interest behave cyclical: a positive (negative) reaction is followed by an immediate negative (positive) one which reverts to positive (negative) behavior again. This is certainly counterfactual and not observed empirically. A second important result is the complete absence of persistence in the reactions of the variables, with the exception of the nominal interest rate which rises persistently. Third, price adjusting firms react very strongly in the first period so that the price level overshoots considerably. Even the behavior of prices shows no persistence at all. Forth, real money balances decline on impact and then approach the steady state from below, a reaction which is also not observed empirically. A very low value of the risk aversion parameter $\sigma$ creates extremely cyclical impulse responses with humps and dips for several periods. On the other hand high values of $\sigma$ dampen the peaks and troughs.\footnote{This is not shown in the Figures. Results are available from the author upon request.}

Obviously it makes a big difference how money is introduced in DGE models. Since the benchmark models have been calibrated the same way the absence of persistence must be due to the implied money demand function. So it can be concluded that in a MIU-model where money demand is interest rate sensitive persistent reactions to money growth shocks cannot be explained. An implied quantity theoretic type of money demand seems to be a more appropriate formulation if the aim is to achieve persistent output reactions in a sticky price model.

But can GHH preferences with a low value for the elasticity of real marginal costs with respect to output generate more persistent reactions than in a CIA-setup? The results of the experiment are shown in Figures 17-20. Surprisingly, now all variables display very strong persistency after a money growth shock. Results are completely different to the CIA-outcome. Intermediate as well as aggregate consumption and labor react strongly and stay above (or below) the steady state value for more than 8 quarters after the shock. Real marginal costs are flat, showing only a 0.12% deviation from the equilibrium value. Real money balances rise all the time, due to the smooth and moderate price level increase. Intermediate goods firms raise their prices accordingly very slowly. Inflation displays a hump as observed empirically. Unfortunately the nominal interest rate counterfactually rises again. Thus,
just changing from a CIA-setup to a MIU-model leads to completely different model outcomes. A low marginal cost elasticity is obviously not enough to generate persistency in output. It must be combined with an interest rate sensitive money demand function which is implied by a MIU-model.

3.2.2 CRRA Preferences

Finally Figures 21-24 show the results for the MIU-model with CRRA preferences. Compared to the GHH version the outcome does not differ very much. But as in the CIA-setup there are some small differences. First, the reactions are all weaker than under GHH preferences. Second, the strength of the cyclical behavior is less, i.e. the dips and humps are smaller in size. Lowering the value of \( \sigma \) to 0.1, for example, leads to more pronounced dips and humps whereas a higher risk aversion makes them smaller.

Again, the MIU-model version generates considerably less persistent reactions than the CIA-setup. This is especially the case for \( \hat{c}_{0,t} \) and \( \hat{n}_{0,t} \) as well as the prices. As the models are again calibrated the same way the loss of persistency is due to the different implied money demand functions. This leads to the conclusion that two conditions have to be fulfilled in order to enable a DGE model with sticky prices only to generate persistent output and inflation responses: first, the elasticity of labor supply with respect to the real wage must be high, and second, the money demand function has to be interest rate sensitive. Only one of these ingredients is not enough to generate persistency. This refines results in the literature, for example of [1, Ascari (2001)] who only looks at MIU-specifications and concludes that a high labor supply elasticity plays the most important role for persistent output reactions in a price staggering model. Similarly [5, Chari/Kehoe/McGrattan (2000)] study a MIU-model and investigate a similar utility function to the GHH specification in their sensitivity analysis. They also point out only the role of a high labor elasticity for a persistent output reaction.

4 Conclusions

In light of the main question of the paper it must be concluded that persistent reactions of output and inflation to money growth shocks can only be explained in a MIU-model with GHH preferences and a high labor supply elasticity. All other economies considered fall short of reaching persistency.
An interesting future direction of research is to look at models that are
generalized to include capital accumulation considerations. Results of [5,
Chari/Kehoe/McGrattan (2000)] are very discouraging. They find almost
no persistence in models with capital. It would be interesting to see how the
results change in a CIA-model.

Another promising line of research is to analyze open economy models.
Recently [13, Ghironi (2002)] has shown that once openness is taken into
account as sticky price model can generate endogenous output persistence.\(^\text{12}\)
This depends crucially on incomplete asset markets. It would be interesting
to generalize the model at hand to such a framework.

### Appendix

#### A.1 Household’s Equations: CIA-Model

The efficiency condition for aggregate consumption results in

\[-D_1 u (c, n, a) \hat{P}_{t+1} + n D_{12} u (c, n, a) \hat{n}_{t+1} + c D_{11} u (c, n, a) \hat{c}_{t+1} (52)\]

\[= D_1 u (c, n, a) \hat{\lambda}_t - D_1 u (c, n, a) \hat{P}_t - a D_{13} u (c, n, a) \hat{a}_{t+1} \]

using \(\Omega_t\) from the derivative with respect to \(m_t\).

A hat (\(^\wedge\)) represents the relative deviation of the respective variable from
its steady state \((\hat{v} = (v_t - a) / a)\). \(D_i u (\cdot)\) denotes the first partial derivative
of the \(u\)-function with respect to the \(i\)-th argument. Similarly \(D_{ij} u (\cdot)\) de-
notes the partial derivative of \(D_i u (\cdot)\) with respect to the \(j\)-th argument, all
evaluated at the steady state. For aggregate labor one gets

\[0 = n D_{22} u (c, n, a) \hat{n}_t + c D_{21} u (c, n, a) \hat{c}_t - D_{2} u (c, n, a) \hat{\lambda}_t - D_{2} u (c, n, a) \hat{w}_t + a D_{23} u (c, n, a) \hat{a}_t (53)\]

The cyclical behavior of money demand can be deduced from (41).

\[\hat{M}_t = \hat{c}_t + \hat{P}_t (54)\]

The nominal interest rate follows, according to (15),

\[-\hat{P}_{t+1} + \hat{\lambda}_{t+1} = -\hat{P}_t - \frac{R}{1 + R} \hat{R}_t + \hat{\lambda}_t (55)\]

\(^{12}\) See also [4, Cavallo/Ghironi (2002)].
in the approximated form, with $R$ (respective $r$ for the real rate) as the steady state values. The real rate $r_t$ was deduced via the Fisher equation (see (16)) so that the approximated equation is given by

$$\hat{\lambda}_{t+1} = -\frac{r}{1+r} \hat{r}_t + \hat{\lambda}_t$$  \hfill (56)

### A.2 Household’s Equations: MIU-Model

In the MIU-model the following three equations replace the first three in Appendix A.1.

$$0 = -mD_{12} u(c,m,n,a) \hat{P}_t + nD_{13} u(c,m,n,a) \hat{n}_t + cD_{11} u(c,m,n,a) \hat{c}_t - D_{1} u(c,m,n,a) \hat{\lambda}_t$$  \hfill (57)

Optimal labor is determined by

$$0 = -D_3 u(c,m,n,a) \hat{\lambda}_t - -D_{3} u(c,m,n,a) \hat{\lambda}_t$$  \hfill (58)

The efficiency condition for money now determines the respective money demand function. So one gets

$$\beta D_1 u(c,m,n,a) \hat{P}_{t+1} = \beta D_1 u(c,m,n,a) \hat{\lambda}_{t+1}$$

$$= cD_{21} u(c,m,n,a) \hat{c}_t + mD_{22} u(c,m,n,a) \hat{M}_t + nD_{23} u(c,m,n,a) \hat{n}_t - D_{1} u(c,m,n,a) \hat{\lambda}_t$$  \hfill (59)

The equations for the nominal and real interest rate stay the same.

### A.3 Finished Goods Firm’s Equations

It is possible to combine the demand functions for the differentiated products $c_0$ and $c_1$ (see (25)) to arrive at

$$\hat{P}_{0,t} = -\frac{1}{\epsilon} \hat{c}_{0,t} + \frac{1}{\epsilon} \hat{c}_{1,t} + \hat{P}_{1,t}$$  \hfill (60)
The consumption aggregator (27) implies

\[ 0 = \frac{1}{2} \hat{c}_{0,t} + \frac{1}{2} \hat{c}_{1,t} - \hat{c}_t \]  

(61)

The price level is uniquely determined since \( P_{1,t} \) is predetermined and \( P_{0,t} \) is given by (60). Using (28) one gets

\[ 0 = \frac{1}{2} \hat{P}_{0,t} + \frac{1}{2} \hat{P}_{1,t} - \hat{P}_t \]  

(62)

A.4 Intermediate Goods Firm’s Equations

In contrast to the household’s conditions the equations of the firms to not change under different utility functions. The production functions for the differentiated goods must obey

\[ 0 = \hat{n}_{0,t} - \hat{c}_{0,t} + \hat{a}_t \]  

(63)

\[ 0 = \hat{n}_{1,t} - \hat{c}_{1,t} + \hat{a}_t \]  

(64)

As discussed earlier firms are unable to change their prices for two periods so \( P_{0,t-1} = P_{1,t} \). The Taylor approximation for this condition is given by

\[ 0 = -\hat{P}_{0,t-1} + \hat{P}_{1,t} \]  

(65)

The condition for optimal two period pricing is given in (38). Its Taylor approximation can be written as

\[ \beta [\epsilon \psi - (\epsilon - 1)] \hat{\lambda}_{t+1} + \beta [\epsilon^2 \psi - (\epsilon - 1)^2] \hat{P}_{t+1} + \beta [\epsilon \psi - (\epsilon - 1)] \hat{c}_{t+1} \\
+ \beta \epsilon \psi \hat{\psi}_{t+1} = (\epsilon - 1) (1 + \beta) \hat{P}_{0,t} + [(\epsilon - 1) - \epsilon \psi] \hat{\lambda}_t \\
+ [(\epsilon - 1)^2 - \epsilon^2 \psi] \hat{P}_t + [(\epsilon - 1) - \epsilon \psi] \hat{c}_t - \epsilon \psi \hat{\psi}_t \]  

(66)

Real marginal cost \( \psi_t \) is given by the ratio of the real wage \( w_t \) over the productivity shock \( a_t \). Since the markup \( \mu_t \) is determined by the ratio of price over nominal marginal cost (\( \mu = P/(P\psi) \) and as there is no inflation it follows that \( \mu_t = a_t/w_t \). So the Taylor approximations can be written as

\[ 0 = \hat{\mu}_t + \hat{\omega}_t - \hat{a}_t \]  

(67)

\[ 0 = \hat{\mu}_t + \hat{\psi}_t \]  

(68)

The Taylor approximation of the labor market clearing condition amounts to

\[ 0 = \hat{n}_t - \frac{1}{2} \hat{n}_{0,t} - \frac{1}{2} \hat{n}_{1,t} \]  

(69)
A.5 Monetary Authority’s and Other Equations

To close the model one needs to assume some exogenous process for money supply. Here it will be assumed that money $\hat{M}_t$ follows an AR(2)-process (see the discussion in the main text). This implies that the growth rate of $\hat{M}_t$ follows an AR(1)-process. In order to model this properly one has to add the equation

$$0 = \hat{M}_t - \hat{g}_{M_t}$$  \hspace{1cm} (70)

where $\hat{g}_{M_t}$ is the exogenous stochastic process that will have the same characteristics as $\hat{M}_t$, that is, follows the same AR(2)-process which is specified in Section 2.5.

As it is interesting to study the implications for the inflation rate $\Pi$ this equation is further added to the system:

$$0 = -\hat{\Pi}_t + \hat{P}_t - \hat{P}_{t-1}$$  \hspace{1cm} (71)

There are now 19 variables $\hat{c}_{0,t}, \hat{c}_{1,t}, \hat{c}_{t}, \hat{\lambda}_t, \hat{\bar{n}}_{0,t}, \hat{\bar{n}}_{1,t}, \hat{n}_t, \hat{w}_t, \hat{\psi}_t, \hat{\nu}_t, \hat{R}_t, \hat{\bar{P}}_t, \hat{\bar{P}}_{t-1}, \hat{P}_{0,t}, \hat{P}_{0,t-1}, \hat{P}_{1,t}, \hat{\Pi}_t, \hat{M}_t$ but only 17 equations so two tautologies must be added to the model. These are

$$\hat{\bar{P}}_{0,t} = \hat{P}_{0,t}$$  \hspace{1cm} (72)
$$\hat{\bar{P}}_t = \hat{P}_t$$  \hspace{1cm} (73)

References


[22] King, Robert G. and Alexander L. Wolman, 1999, What Should the Monetary Authority do When Prices are Sticky? in: Taylor, John B.


Figure 1: Impulse Response Functions for $\hat{c}_{0,t}, \hat{c}_{1,t}, \hat{c}_t, \hat{n}_t$, CIA-model, GHH preferences
Figure 2: Impulse Response Functions for $\hat{w}_t$, $\hat{r}_t$, $\hat{\mu}_t$, $\hat{R}_t$, CIA-model, GHH preferences
Figure 3: Impulse Response Functions for $\hat{n}_{0,t}, \hat{\psi}_t, \hat{M}_t - \hat{P}_t, \hat{n}_{1,t}$, CIA-model, GHH preferences
Figure 4: Impulse Response Functions for $\widehat{H}_t$, $P_{0,t}$, $\widehat{P}_t$, $\widehat{P}_{1,t}$, CIA-model, GHH preferences
Figure 5: Impulse Response Functions for $\hat{c}_{0,t}$, $\hat{c}_{1,t}$, $\hat{c}_t$, $\hat{n}_t$, CIA-model, GHH preferences, high labor supply elasticity
Figure 6: Impulse Response Functions for $\hat{w}_t$, $\hat{r}_t$, $\hat{\mu}_t$, $\hat{R}_t$, CIA-model, GHH preferences, high labor supply elasticity
Figure 7: Impulse Response Functions for $\hat{n}_{0,t}, \psi_t, \hat{M}_t - \hat{P}_t, \hat{n}_{1,t}$, CIA-model, GHH preferences, high labor supply elasticity
Figure 8: Impulse Response Functions for $\hat{\Pi}_t$, $\hat{P}_0,t$, $\hat{P}_t$, $\hat{P}_{1,t}$, CIA-model, GHH preferences, high labor supply elasticity
Figure 9: Impulse Response Functions for $\hat{c}_{0,t}, \hat{c}_{1,t}, \hat{c}_t, \hat{n}_t$, CIA-model, CRRA preferences
Figure 10: Impulse Response Functions for $\hat{w}_t, \hat{r}_t, \hat{\mu}_t, \hat{R}_t$, CIA-model, CRRA preferences
Figure 11: Impulse Response Functions for $\hat{n}_{0,t}, \hat{\psi}_t, \hat{M}_t - \hat{P}_t, \hat{n}_{1,t}$, CIA-model, CRRA preferences
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