

**A Model of  
Macroeconomic  
Activity**

**Volume I:  
The Theoretical Model**



# **A Model of Macroeconomic Activity**

**Volume I:  
The Theoretical Model**

**Ray C. Fair**

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## Table of Contents

	<b>List of Tables</b>	ix
	<b>Preface</b>	xiii
<b>Chapter One</b>	<b>Introduction</b>	1
1.1	The Purpose of the Study	1
1.2	An Outline of the Model	3
1.3	The Methodology of the Study	12
1.4	Suggestions to the Reader	16
<b>Chapter Two</b>	<b>Banks</b>	19
2.1	The Basic Equations	19
2.2	The Formation of Expectations	22
2.3	Behavioral Assumptions	25
2.4	The Solution of the Control Problem	29
2.5	Some Examples of Solving the Control Problem of Bank $i$	29
2.6	The Condensed Model for Banks	35
<b>Chapter Three</b>	<b>Firms</b>	39
3.1	The Basic Equations	39

3.2	The Formation of Expectations	45
3.3	Behavioral Assumptions	49
3.4	The Solution of the Control Problem	54
3.5	Some Examples of Solving the Control Problem of Firm $i$	56
3.6	The Condensed Model for Firms	64
<b>Chapter Four</b>	<b>Households</b>	<b>75</b>
4.1	The Basic Equations	75
4.2	The Formation of Expectations	78
4.3	Behavioral Assumptions	79
4.4	The Solution of the Control Problem	81
4.5	Some Examples of Solving the Control Problems of the Households	82
4.6	The Condensed Model for Households	88
<b>Chapter Five</b>	<b>The Government and the Bond Dealer</b>	<b>97</b>
5.1	The Government	97
5.2	The Bond Dealer	98
5.3	The Condensed Model for the Government and the Bond Dealer	101
<b>Chapter Six</b>	<b>The Dynamic Properties of the Model</b>	<b>103</b>
6.1	The Complete Set of Equations for the Model	103
6.2	The Response of the Model to Shocks from a Position of Equilibrium	116
6.3	The Effects of Policy Changes from a Disequilibrium Position	147
6.4	The Long-Run Properties of the Model	149
6.5	Price and Wage Responses	152
6.6	The Relationship Between Demand Deposits and Aggregate Output	153
<b>Chapter Seven</b>	<b>A Static-Equilibrium Version of the Model</b>	<b>157</b>
7.1	Introduction	157
7.2	The Static-Equilibrium Version	158
7.3	The Solution of the Static Model	168
7.4	A Comparison of the Static Model to the Textbook Model	177

<b>Chapter Eight</b>	<b>Conclusion</b>	181
8.1	Summary	181
8.2	Possible Extensions of the Model	186
8.3	Empirical Implications of the Model	190
8.4	Concluding Remarks	194
<b>Appendix</b>	<b>The Non-Condensed Version of the Model</b>	195
	<b>References</b>	219
	<b>Index</b>	223
	<b>About the Author</b>	225





## List of Tables

2-1	Notation for Banks in Alphabetic Order	20
2-2	Parameter Values and Initial Conditions for the Control Problem of Bank $i$	30
2-3	Results of Solving the Control Problem of Bank $i$	32
2-4	Bank Equations for the Condensed Model	36
3-1	Notation for Firms in Alphabetic Order	40
3-2	Parameter Values and Initial Conditions for the Control Problem of Firm $i$	57
3-3	Results of Solving the Control Problem of Firm $i$	58
3-4	Firm Equations for the Condensed Model	65
4-1	Notation for Households in Alphabetic Order	76
4-2	Parameter Values and Initial Conditions for the Control Problems of Households 1 and 2	83
4-3	Results of Solving the Control Problem of Household 1	84

4-4	Results of Solving the Control Problem of Household 2	85
4-5	Results of Solving the Control Problems of Households 1 and 2 Based on a Cobb-Douglas Utility Function	87
4-6	Household Equations for the Condensed Model	88
5-1	Notation for the Government and the Bond Dealer in Alphabetic Order	98
5-2	The Government and Bond Dealer Equations for the Condensed Model	102
6-1	The Complete Notation for the Condensed Model in Alphabetic Order	104
6-2	The Complete Set of Equations for the Condensed Model	106
6-3	Flow-of-Funds Accounts for the Condensed Model: Stocks of Assets and Liabilities	114
6-4	National Income Accounts for the Condensed Model	116
6-5	Parameter Values, Initial Conditions, and Government Values for the Base Run in Table 6-6	119
6-6	Results of Solving the Condensed Model	120
7-1	Notation for the Static-Equilibrium Model in Alphabetic Order	159
7-2	The Equations of the Static-Equilibrium Model	160
7-3	Equations of the Static-Equilibrium Model by Blocks	166
7-4	Parameter Values, Government Values, and Values of $LF$ , $LH$ , and $SD$ for the Base Run in Table 7-5	169
7-5	Results of Solving the Static-Equilibrium Model for the Endogenous VBG Case	171

7-6	Results of Solving the Static-Equilibrium Model for the Endogenous $d_3$ Case	175
7-7	The Equations of the Textbook Model	178
A-1	The Complete Notation for the Non-Condensed Model in Alphabetic Order	195
A-2	The Complete Set of Equations for the Non-Condensed Model	199
A-3	Flow-of-Funds Accounts for the Non-Condensed Model: Stocks of Assets and Liabilities	206
A-4	National Income Accounts for the Non-Condensed Model	207
A-5	Parameter Values, Initial Conditions, and Government Values for the Base Run in Table A-6	210
A-6	Results of Solving the Non-Condensed Model	212



## Preface

The work in this volume grew out of both my dissatisfaction with the standard static-equilibrium model that is found in most macroeconomic textbooks and my interest in the problem of basing macroeconomic theory on more solid microeconomic foundations. I was also interested in trying to incorporate into a general model of macroeconomic activity the recent work in economic theory that has been done on relaxing the assumptions of perfect information and the existence of *tâtonnement* processes that clear markets every period.

It soon became apparent as I began working on this project that the model that I had in mind would not be capable of being analyzed by standard analytic methods. I wanted to develop a macroeconomic model that was general, was based on solid microeconomic foundations, and was not based on the assumptions of perfect information and the existence of *tâtonnement* processes. I also wanted the model to account for wealth effects, capital gains effects, and all flow-of-funds constraints. Because of the likely complexity of any model of this sort, I decided at an early stage of the project to use computer simulation techniques to help analyze the properties of the model. The methodology that I followed is described in section 1.3.

One of the main dangers in building a model that is only feasible to analyze using computer simulation techniques is that the model becomes too detailed or complex for anyone other than the model builder to want to spend the time that it takes to understand the model. I clearly face this danger in the present case. However, I have tried to write this volume to make the model as intelligible as possible in as simple a way as possible. First, I have constructed a "condensed" version of the basic model, with the aim of making the model easier to understand. Second, I have constructed a "static-equilibrium" version

of the model, with the hope that this will put the basic model in a better perspective. Third, I have organized the discussion so that the different sectors are each discussed individually before the overall model is put together. The discussion of each sector is fairly self-contained, so that the reader can concentrate at first on the properties of each sector without having to comprehend the complete model. (I have, however, given a brief outline of the overall model in Chapter One.) Finally, I have relied heavily on the use of tables to present the model and have tried to make the tables fairly self-contained from the discussion in the text. One should be able to get a good picture of the overall model from a careful reading of the tables. The tables should also be useful for reference purposes.


There are, as discussed in Chapter Eight, many ways in which the present model might be extended. In many cases these extensions were not carried out here because of the desire not to increase the complexity of the model anymore than already existed. In future work, if the model does not turn out to be too unwieldy to comprehend, it would be of interest to carry out many of the extensions.

This volume is one of two. In Volume II an empirical model will be developed that is based on the theoretical model found in this volume. Because there is no unique way to specify an empirical version of the theoretical model, it seemed best to present the theoretical and empirical models in two separate volumes. The present volume can be read without reference to Volume II.

Neither volume has been written specifically as a textbook. It is possible, however, that either or both volumes could be used as texts in a graduate level macroeconomics course. Because of my unhappiness with the standard textbook model, I have used for the past two years parts of the present volume in a graduate level macroeconomics course that I have taught at Princeton.

I would like to thank a number of people for their helpful comments on an earlier draft of this volume. These include Alan S. Blinder, Gregory C. Chow, Robert W. Clower, Kenneth D. Garbade, Herschel I. Grossman, Edwin Kuh, and Michael Rothschild. I am also grateful to the National Science Foundation for financial support.

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# Index

- Alchian, Armen A., 17, 219  
Amemiya, Takeshi, 194, 219  
Athans, Michael, 13, 219
- banks, 19-37  
Barro, Robert J., 2, 17, 194, 219  
behavioral assumptions  
  banks, 25-29  
  bond dealer, 98-101  
  firms, 49-54  
  government, 97  
  households, 79-81  
Blinder, Alan S., xiv  
bond dealer, 98-102  
Branson, William H., 177, 180, 219  
Brechling, F.P.R., 219  
Brinner, Roger, 194, 220
- Chow, Gregory C., xiv  
Christ, Carl F., 17, 158, 176, 180, 219  
Clower, Robert W., xiv, 1, 17, 219  
Coen, Robert M., 10, 220  
constrained decisions, 8, 182  
constraints  
  goods, 8, 9, 52  
  hours, 8, 9, 52  
  loan, 8, 9, 45  
control problems, solution of  
  banks, 29  
  firms, 54-56  
  households, 81, 82
- decision variables  
  of banks, 5, 19  
  of the bond dealer, 6, 98  
  of firms, 5, 39  
  of the government, 4, 97  
  of households, 6, 75  
Diamond, Peter A., 17, 220  
distributional issues, 7, 14, 188
- Eckstein, Otto, 194, 220  
empirical implications, 190-194  
equations of model  
  condensed, 36, 65-67, 88-90, 102, 106-109  
  non-condensed, 21-23, 42-47, 77, 78, 97-101, 199-205  
  static, 160, 161  
excess capital, 11, 51, 63, 64  
excess labor, 11, 51, 63, 64  
excess reserves, 8  
expectations, formation of  
  banks, 22-25  
  firms, 45-49  
  households, 78, 79
- firms, 39-73  
fiscal policy, 149  
Fisher, Franklin M., 17, 220  
flow-of-funds accounts, 114, 206  
flow-of-funds constraints, 10, 113
- Garbade, Kenneth D., xiv,  
Gauss-Seidel algorithm, 16, 168  
Gepts, S., 17, 220  
Goldfeld, Stephen M., 194, 220  
Gordon, Donald F., 17, 220  
Gordon, Robert J., 194, 220  
government, 97, 98, 101, 102

- government budget constraint, 4, 97  
 Grossman, Herschel I., xiv, 1, 2, 17, 219, 220
- Hahn, F.H., 219  
 Hay, George A., 10, 220  
 Henderson, James M., 95, 220  
 Hickman, Bert G., 10, 220  
 Holt, Charles C., 10, 221  
 households, 75-95  
 Hynes, Allan, 17, 220
- information flows, 4, 7-9
- Jaffee, Dwight M., 194, 220
- Kelejian, Harry H., 194, 220  
 Keynes, John Maynard, 1, 157, 221  
 Korliras, Payayotis G., 2, 17, 221, 222  
 Kuh, Edwin, xiv
- Leijonhufvud, Axel, 1, 17, 221  
 long-run properties, 149-152  
 Lucas, Robert E., Jr., 10, 17, 221
- Maccini, Louis J., 2, 10, 11, 17, 182, 221  
 Maddala, G.S., 194, 221  
 methodology, 12-17  
 Mills, Edwin S., 10, 221  
 Modigliani, Franco, 10, 221  
 monetary policy, 149  
 Mortensen, Dale T., 11, 17, 182, 221  
 Muth, John F., 10, 221
- Nadiri, M. Ishag, 10, 221  
 national income accounts, 116, 207, 208  
 Nelson, Forest D., 194, 221  
 Nordhaus, William D., 17, 221
- objective function  
 of banks, 4, 16  
 of the bond dealer, 6, 99-101  
 of firms, 4, 49  
 of households, 4, 79
- parameter values, 30, 57, 83, 119, 169, 210  
 Patinkin, Don, 1, 221  
 Phelps, Edmund S., 1, 2, 11, 17, 182, 221  
 price and wage responses, 152, 153  
 properties of model  
   condensed, 116-155  
   non-condensed, 211-217  
   static, 170-177
- Quandt, Richard E., 95, 194, 220, 221
- Rapping, Leonard A., 17, 221  
 Rosen, Sherwin, 10, 221  
 Rothschild, Michael, xiv, 17, 222
- Simon, Herbert A., 10, 221  
 simulation results  
   banks, 31-35  
   condensed model, 116-147  
   firms, 57-64  
   households, 82-88  
   non-condensed model, 211-217  
   static model, 168-177
- Solow, Robert M., 2, 17, 222  
 Stigler, George J., 1, 222  
 Stiglitz, Joseph E., 2, 17, 222  
 summaries of model, 3-12, 35, 62-64, 146, 147, 181-186
- technology, 10, 39, 42-44  
 textbook model, 177-179  
 Tucker, Donald P., 2, 17, 222
- unconstrained decisions, 8, 182  
 unemployment rate, 115
- variables in model  
   condensed, 104-106  
   non-condensed, 195-198  
   static, 159
- Winter, Sidney S., Jr., 11, 17, 182, 221

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