A Model of Macroeconomic Activity
To My Parents
# Table of Contents

List of Tables  xi

List of Figures xv

Preface xvii

## Chapter One

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1</td>
<td>A Brief Summary</td>
<td>1</td>
</tr>
<tr>
<td>1.2</td>
<td>Four General Remarks About the Specification of the Empirical Model</td>
<td>11</td>
</tr>
<tr>
<td>1.3</td>
<td>Linking the National Income Accounts with the Flow-of-Funds Accounts by Sector</td>
<td>13</td>
</tr>
</tbody>
</table>

## Chapter Two

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.1</td>
<td>Introduction</td>
<td>31</td>
</tr>
<tr>
<td>2.2</td>
<td>A Discussion of Table 2-2</td>
<td>55</td>
</tr>
<tr>
<td>2.3</td>
<td>A Discussion of Table 2-1</td>
<td>67</td>
</tr>
</tbody>
</table>

vii
<table>
<thead>
<tr>
<th>Chapter Three</th>
<th>Econometric Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1</td>
<td>Introduction</td>
</tr>
<tr>
<td>3.2</td>
<td>The Treatment of Serial Correlation Problems</td>
</tr>
<tr>
<td>3.3</td>
<td>The Computation of the Two Stage Least Squares Estimates</td>
</tr>
<tr>
<td>3.4</td>
<td>The Computation of the Full Information Maximum Likelihood Estimates</td>
</tr>
<tr>
<td>3.5</td>
<td>The Solution of the Model</td>
</tr>
<tr>
<td>3.6</td>
<td>A Possible Estimator for Future Use</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter Four</th>
<th>The Household Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.1</td>
<td>Introduction</td>
</tr>
<tr>
<td>4.2</td>
<td>The Determination of the Unconstrained Decisions</td>
</tr>
<tr>
<td>4.3</td>
<td>The Treatment of the Constraints</td>
</tr>
<tr>
<td>4.4</td>
<td>The Estimates of the Equations for the Household Sector</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter Five</th>
<th>The Firm Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.1</td>
<td>Introduction</td>
</tr>
<tr>
<td>5.2</td>
<td>The Technology of the Firm Sector and the Measurement of Excess Labor and Excess Capital</td>
</tr>
<tr>
<td>5.3</td>
<td>An Outline of the Empirical Model of the Firm Sector</td>
</tr>
<tr>
<td>5.4</td>
<td>The Estimates of the Equations for the Firm Sector</td>
</tr>
<tr>
<td>5.5</td>
<td>A Review of the Model of the Firm Sector</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter Six</th>
<th>The Financial Sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.1</td>
<td>Introduction</td>
</tr>
<tr>
<td>6.2</td>
<td>Equation 45 and the Four Stochastic Equations in the Financial Sector</td>
</tr>
<tr>
<td>6.3</td>
<td>The Treatment of the Loan Constraints</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Chapter Seven</th>
<th>The Foreign and Government Sectors</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.1</td>
<td>The Foreign Sector</td>
</tr>
<tr>
<td>7.2</td>
<td>The Government Sector</td>
</tr>
</tbody>
</table>
# Table of Contents

## Chapter Eight

8.1 Introduction

8.2 A Comparison of the Forecasting Model with Other Models

8.3 A Comparison of the Empirical Model and the Forecasting Model

8.4 Further Results on the Predictive Accuracy of the Empirical Model

## Chapter Nine

9.1 Introduction

9.2 A Brief Review of the Model

9.3 The Response of the Model to Changes in Various Exogenous Variables

9.4 The Properties of the Model that Relate to Five Issues in Macroeconomics

## Chapter Ten

10.1 Introduction

10.2 The Computation of the Optimal Controls

10.3 The Results

## Chapter Eleven

Conclusion

## Appendix A

Some Results for the Alternative Technology

## Appendix B

The Forecasting Model Used for Comparison Purposes

References

Index

About the Author
# List of Tables

<table>
<thead>
<tr>
<th>Table</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1–1</td>
<td>The Five Sectors of the Model</td>
<td>14</td>
</tr>
<tr>
<td>1–2</td>
<td>The Data from the National Income Accounts by Sector</td>
<td>16</td>
</tr>
<tr>
<td>1–3</td>
<td>The Data from the Flow-of-Funds Accounts by Sector</td>
<td>23</td>
</tr>
<tr>
<td>2–1</td>
<td>The Complete List of Variables in the Model in Alphabetic Order</td>
<td>32</td>
</tr>
<tr>
<td>2–2</td>
<td>The List of Equations in the Model</td>
<td>42</td>
</tr>
<tr>
<td>2–3</td>
<td>TSLS and FIML Estimates of the 26 Stochastic Equations</td>
<td>46</td>
</tr>
<tr>
<td>4–1</td>
<td>Matching of Dependent Variables in the Theoretical and Empirical Models for the Household Sector</td>
<td>90</td>
</tr>
<tr>
<td>4–2</td>
<td>Matching of Explanatory Variables in the Theoretical and Empirical Models for the Household Sector</td>
<td>92</td>
</tr>
<tr>
<td>Table Number</td>
<td>Description</td>
<td>Page</td>
</tr>
<tr>
<td>--------------</td>
<td>------------------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>5-1</td>
<td>Matching of Dependent Variables in the Theoretical and Empirical Models for</td>
<td>108</td>
</tr>
<tr>
<td></td>
<td>the Firm Sector</td>
<td></td>
</tr>
<tr>
<td>7-1</td>
<td>The Exogenous Variables in the Government Sector</td>
<td>144</td>
</tr>
<tr>
<td>8-1</td>
<td>The Ranking of the Forecasting Model Against Eight Other Quarterly Models</td>
<td>147</td>
</tr>
<tr>
<td>8-2</td>
<td>The Predictive Accuracy of the Empirical Model versus the Forecasting Model</td>
<td>151</td>
</tr>
<tr>
<td>8-3</td>
<td>Further Results on the Predictive Accuracy of the Empirical Model</td>
<td>154</td>
</tr>
<tr>
<td>8-4</td>
<td>Predicted and Actual Values for Five Variables for the 1955I–1962IV Period</td>
<td>158</td>
</tr>
<tr>
<td>8-5</td>
<td>Predicted and Actual Values for Five Variables for the 1968I–1974I Period</td>
<td>160</td>
</tr>
<tr>
<td>8-6</td>
<td>Predicted and Actual Values for Five Variables for the 1974III–1975I Period</td>
<td>161</td>
</tr>
<tr>
<td>9-1</td>
<td>Detailed Experimental Results</td>
<td>170</td>
</tr>
<tr>
<td>9-2</td>
<td>Detailed Experimental Results</td>
<td>174</td>
</tr>
<tr>
<td>9-3</td>
<td>Detailed Experimental Results</td>
<td>178</td>
</tr>
<tr>
<td>9-4</td>
<td>Detailed Experimental Results</td>
<td>180</td>
</tr>
<tr>
<td>9-5</td>
<td>Detailed Experimental Results</td>
<td>182</td>
</tr>
<tr>
<td>9-6</td>
<td>Summary Results for 26 Experiments</td>
<td>184</td>
</tr>
<tr>
<td>10-1</td>
<td>Control Results for the Eisenhower Administrations</td>
<td>204</td>
</tr>
<tr>
<td>10-2</td>
<td>Control Results for the Kennedy-Johnson Administrations</td>
<td>206</td>
</tr>
<tr>
<td>Table Number</td>
<td>Description</td>
<td>Page</td>
</tr>
<tr>
<td>--------------</td>
<td>----------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>10-3</td>
<td>Control Results for the Nixon-Ford Administrations</td>
<td>208</td>
</tr>
<tr>
<td>A-1</td>
<td>Estimates of the Investment Equation for the Two Technologies</td>
<td>218</td>
</tr>
<tr>
<td>A-2</td>
<td>Estimates of the Employment Equation for the Two Technologies</td>
<td>219</td>
</tr>
<tr>
<td>A-3</td>
<td>Estimates of the Hours Equation for the Two Technologies</td>
<td>218</td>
</tr>
<tr>
<td>B-1</td>
<td>The List of Variables in the Forecasting Model in Alphabetic Order by Sector</td>
<td>222</td>
</tr>
<tr>
<td>B-2</td>
<td>The List of Equations in the Forecasting Model by Sector</td>
<td>224</td>
</tr>
</tbody>
</table>
List of Figures

<table>
<thead>
<tr>
<th>Figure</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>4-1</td>
<td>Desired Shape of $ZJ_t$ as a Function of $J_t^*$</td>
<td>95</td>
</tr>
<tr>
<td>4-2</td>
<td>Desired Shape of $ZR_t$ as a Function of $RBILL_t^*$</td>
<td>96</td>
</tr>
<tr>
<td>5-1</td>
<td>Desired Shape of $ZZJ_t'$ as a Function of $1 - UR_t$</td>
<td>118</td>
</tr>
<tr>
<td>5-2</td>
<td>Expected Relationship Between $HPFO_t$ and $HPF_t$</td>
<td>131</td>
</tr>
</tbody>
</table>
The work described in this volume is a continuation of my effort to try to improve the specification of macroeconomic models. The model presented in this volume is an empirical version of the theoretical model developed in Volume I. Three important features of the theoretical model that distinguish it from earlier models are that it is based on solid microeconomic foundations, it accounts explicitly for disequilibrium effects, and it accounts for all flows of funds in the system. These three features have been carried over to the empirical model.

The methodology of this study is unusual enough to require some explanation. There is, first of all, no unique way to specify an empirical version of the theoretical model; the model is simply too abstract for this to be possible. Thus, although I have been guided closely by the theoretical model in my empirical specification, it will be clear in what follows that my particular specification is not the only one that could be said to be consistent with the theoretical model.

If there is no unique empirical version of the theoretical model, the question immediately arises as to how the theoretical model is to be judged. My answer to this question occurs on page 16 of Volume I:

The author looks on a theoretical model of the sort developed in this study as not so much true or false as useful or not useful. The model is useful if it aids in the specification of empirical relationships that one would not already have thought of from a simpler model and that are in turn confirmed by the data. It is not useful if it either does
not aid in the specification of empirical relationships that one would not have thought of from a simpler model or aids in the specification of empirical relationships that are in turn refuted by the data.

I argue in Chapter Eight that the present empirical model is confirmed by the data in the sense of its being more accurate than other models. It is also the case that I do not think that I would have been led to the present empirical specifications had I not had the theoretical model as a guide. Consequently, my conclusion is that as of this writing the theoretical model is useful. Whether this conclusion holds up as new models are developed, new tests performed, and new data collected is, of course, unknown. One can never rule out the possibility that a more accurate empirical model will be developed that is based on a different theoretical model.

One of the key assumptions of the theoretical model is that economic agents engage in maximizing behavior. In particular, each of the main behavioral units in the model makes its decisions on the basis of the solution to an optimal control problem. This is what is meant by the statement that the model is based on solid microeconomic foundations. It is true, of course, that economic agents do not actually solve optimal control problems explicitly in making their decisions. The assumption that they do so is used here as it is used in most of microeconomics: as a possibly useful approximation. As just mentioned, my way of testing whether assumptions such as this are useful for macroeconomic model building is to specify a theoretical model based on them, use the theoretical model as a guide to the specification of an empirical model, and then test the empirical model in standard ways. The results that I have obtained so far suggest that the maximizing assumption is useful for the specification of macroeconomic models. Additional tests are needed, however, before one can place too much confidence on this conclusion.

Another basic feature of the theoretical model is that expectations play an important role in influencing people's decisions (i.e., in influencing the solutions to the optimal control problems). For the simulation work in Volume I, most of these expectations were assumed to be formed in simple ways on the basis of past data. This is also true for the work in this volume, in the sense that lagged endogenous and lagged exogenous variables are used as explanatory variables in the stochastic equations to try to capture expectational effects.

It would have been possible for the simulation work in Volume I to use more sophisticated mechanisms of expectation formation. It could have been assumed, for example, that each behavioral unit estimates its own relevant econometric model each period, and uses this model to forecast the future values of the variables that it needs to know in order to solve its control problem. Assumptions similar to this were in fact made for some of
the expectations formed by the banks, the firms, and the bond dealer. (See in particular the discussion on pages 205, 208, and 209 in Volume I.) Banks, firms, and the bond dealer were assumed to estimate from past data some of the key parameters that influence their expectations. Although I have not carried out such experiments, I doubt that the properties of the theoretical model would be changed very much if more of these types of assumptions were made. What is a crucial characteristic of the model, however, is the assumption that behavioral units do not have perfect foresight. This is one of the four characteristics listed on page 3 of Volume I that the model was deliberately designed to have.

Even if more sophisticated mechanisms of expectation formation had been postulated in Volume I, expectations would still have been based on past data. Consequently, I would probably still have been led to use lagged values in the empirical model to try to capture expectational effects. It is true, however, that if expectations of behavioral units are fairly accurate, one might expect actual future values to be better proxies for these expectations than are current and lagged values. I did in fact do some experimentation in the initial development of the empirical model to see if future values of some of the key explanatory variables (e.g., prices, wage rates, and interest rates) explained the current values of the decision variables better than did the current and lagged values of the explanatory variables. This empirical work did not support the use of future values, however, and in the end no future values were used as explanatory variables in any of the equations of the empirical model. The treatment of expectations in the empirical model is discussed in section 1.2 of Chapter One of this volume.

In a model building effort of this sort there are a number of detailed decisions that have to be made about how certain variables are to be treated and about what kinds of data are to be used. Realizing that not everyone is as interested in these details as I am, I have tried to write this volume so that the discussion of these details can be easily skipped or skimmed. In particular, I have relegated most of this discussion to section 1.3 of Chapter One and to Chapter Two. Most of the discussion of econometric issues is contained in Chapter Three, and this material can also be easily skipped or skimmed by readers who are not particularly interested in such things.

The first section of Chapter One, section 1.1, contains a summary of the central features and properties of the empirical model and of the major conclusions reached in this study. For those who are primarily interested in getting a general ideal of the properties of the model and of how it differs from other models, reading this section should be enough. Section 1.2 contains a discussion of some of the basic principles that guided the empirical specification, and section 1.3 contains a discussion of the linking of the national income accounts with the flow-of-funds accounts by sector. Although the details in section 1.3 can be skipped without much loss of continuity, it
should be stressed that the linking of the two accounts is an important part of the present empirical work and has an important effect on the properties of the model.

The complete model is presented in Chapter Two, except for the discussion of the individual stochastic equations. The stochastic equations are explained in Chapters Four, Five, Six, and Seven. These latter four chapters are important in understanding the model, and by considering most of the data and econometric issues in Chapters Two and Three, I have tried to keep Chapters Four through Seven relatively free from discussion other than that directly related to the specification of the stochastic equations. The complete model is presented in tabular form in Tables 2-1, 2-2, and 2-3 in Chapter Two, and these tables are used for reference purposes throughout the rest of the text.

The predictive accuracy of the model is examined in Chapter Eight, and the properties of the model are examined in detail in Chapters Nine and Ten. The properties of the model are examined in Chapter Ten via the computation of optimal controls. Chapter Eleven contains some brief concluding remarks.

This volume can be read without a detailed knowledge of Volume I. One should, however, have some understanding of the theoretical model before reading this volume. At a minimum, Chapters One and Eight (Introduction and Conclusion) in Volume I should be read to get a general idea of the theoretical model.

I would like to stress that the empirical model presented here is not in any direct sense an expanded or revised version of my earlier forecasting model [14]. My interest in developing the forecasting model was to see if an econometric model could be developed that produced reasonably accurate forecasts when used in as mechanical a way as possible. My interest in Volume I, on the other hand, was theoretical and was to develop a general, dynamic macroeconomic model that was based on solid microeconomic foundations and that was not based on the restrictive assumptions of perfect information and the existence of tâtonnement processes that clear markets every period. My interest in this volume, although empirical, is more of an extension of my interest in Volume I than of my interest in the forecasting model. (The forecasting model does, however, provide a good basis of comparison for other models in terms of prediction accuracy, and it has been used for this purpose in Chapter Eight.)

Although my earlier work with the forecasting model has not had a direct effect on the specification of the present model, some of my work with monthly three-digit industry data has. This work is described in references [23], [21], and [15]. The results in these three studies have had an influence on my specification of both the theoretical and empirical models. Some of the links between my work with the monthly three-digit industry data and my work here are discussed in Chapter Five.
I am indebted to a number of people who have commented on my model building effort during the past few years. I would particularly like to thank Gregory Chow, Robert Hall, Donald Hester, Sharon Oster, and James Tobin for comments that led to important additions to this volume. I reluctantly assume responsibility for any errors. Most of this study was financed by grants from the National Science Foundation and the Ford Foundation to the Cowles Foundation for Research in Economics at Yale University.

Ray C. Fair
October 1975
A Model of Macroeconomic Activity
References

A Model of Macroeconomic Activity


References


aggregation question, 11, 12
Aliber, Robert Z., 229
Amemiya, Takeshi, 79, 120, 229
asymmetries in model, 186, 187
bank borrowing equation, 137
bill rate, determination of, 6, 66, 67, 138, 139
bond rate equation, 137
Brainard, William C., 21, 229
Brayton, Robert K., 87, 229
Brittain, John A., 129, 229
Bureau of Economic Analysis, 111, 112, 231
capital gains equation, 137, 138
capital-labor substitution, 114
Chow, Gregory, xix, 77, 80, 87, 229
Cochrane, D., 79, 229
constrained decisions
firm sector, 1, 2, 115-121
household sector, 1, 2, 93-99
constraints
hours, 2, 3, 5, 94-99, 101, 103, 115-121
labor, 4, 5, 115-121
loan, 2, 3, 5, 95-99, 104, 138, 139
consumption, 2, 3, 99-143
Cooper, Richard N., 142, 229
data, 7, 13-28, 67-74
demand deposit equations
firm sector, 131, 132
household sector, 102
Durbin-Watson statistic, 80
employment equation, 126-128
equations of model, 55-67, 99-102, 121-132, 135-138, 141-143
excess capital, 4, 5, 108-114, 125, 126, 217-220
excess labor, 4, 5, 108-114, 126, 127, 217-220
expectations, xvi, xvii, 11, 12
Federal Reserve, 10, 195
financial sector, 135-139
firm sector, 107-134
fiscal policy, 9, 10, 195
flow-of-funds questions, 5, 6, 13-29, 66, 67, 98
forecasting model, xviii, 146-153, 221-227
foreign sector, 141, 142
Fromm, Gary, 146, 147, 149, 230
full information dynamic estimator, 85-87, 156, 213
full information maximum likelihood estimator, 7, 81-83, 153, 156, 213
Gauss-Seidel technique, 84, 85
government budget constraint, 5, 64, 66, 142, 143
government sector, 142-144
Gustavson, Fred G., 87, 229
Hall, Robert, xix
Harkins, Claudia, 74, 231
Hester, Donald, xix
hours equation, 126-128
household sector, 89-105
housing investment, 99-105
Howrey, E. Philip, 84, 230
Huang, H.Y., 82, 230
IBM, 82, 230
import equation, 141
interest rates, effects of, 100–104, 121, 122, 132, 133, 166
inventory investment, 5, 123, 124
investment equation, 124–126
investment tax credit, effects of, 121, 122, 133, 189
Jaffee, Dwight M., 104, 120, 221, 230
Kelejian, Harry H., 84, 120, 230
Klein, Lawrence R., 86, 146, 147, 149, 230
labor force, 2, 3, 8, 99–103
Loftus, Shirley F., 73, 230
long run results, 193–194
macroeconomic issues, 7–10, 194–196
Maddala, G.S., 120, 230
Malinvaud, E., 85, 231
marginal personal income tax rate, computation of, 58–60
market share considerations, 4
McNees, Stephen K., 145, 163, 231
methodology, xv, xvi, 11–13
monetary policy, 9, 10, 195
mortgage rate equation, 137
Musgrave, John C., 73, 231
Nelson, Forest D., 120, 230
Nordhaus, William, 57, 231
Okun's law, 9
optimal controls
computation of, 198–203
results, 203–211
Orcutt, G.H., 79, 229
Öster, Sharon, xix
overtime hours equation, 130, 131
Phillips curve, 8
Powell, M.J.D., 82, 231
predictive accuracy
empirical model, 149–163
forecasting model, 146–153
price controls, 122
price equation, 121–122
production equation, 123–124
properties of model, 165–195
regimes, 2, 115–121
robust estimation, 87
serial correlation, 76, 77
Shavell, Henry, 73, 231
Shoven, John, 57, 231
solution of model, 84, 85
sparse matrices, 82, 86
tax rates, effects of, 8, 100–102, 166, 188–190, 192
technology, 4, 108–114, 217–220
Tobin, James, xix, 21, 229
t-statistic, 79, 80
two stage least squares, 7, 77–80, 153
unconstrained decisions,
firm sector, 1, 2, 115–121
household sector, 1, 2, 89–93
unemployment rate, 7–9, 65, 118–119, 209
variables in model, 32–41
wage equation, 128–130
Willoughby, Ralph A., 87, 229
Young, Allan H., 73, 231
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