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# HIGH-DIMENSIONAL DSGE MODELS: POINTERS ON PRIOR, ESTIMATION, COMPARISON, AND PREDICTION\*

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## ABSTRACT

Presently there is growing interest in DSGE models that have more parameters, endogenous variables, exogenous shocks, and observables than the Smets and Wouters (2007) model, and substantial additional complexities from non-Gaussian distributions and the incorporation of time-varying volatility. The popular DYNARE software package, which has proved useful for small- and medium-scale models is, however, not capable of handling such models, thus inhibiting the formulation and estimation of more realistic DSGE models. A primary goal of this paper is to introduce a user-friendly MATLAB software program designed to reliably estimate high-dimensional DSGE models. It simulates the posterior distribution by the tailored random block Metropolis-Hastings (TaRB-MH) algorithm of Chib and Ramamurthy (2010), calculates the marginal likelihood by the method of Chib (1995) and Chib and Jeliazkov (2001), and includes various post-estimation tools that are important for policy analysis, for example, functions for conducting impulse response and variance decomposition analyses, and point and density forecasts. Another goal is to provide pointers on the fitting of these DSGE models. An extended version of the new Keynesian model of Leeper, Traum and Walker (2017) that has 51 parameters, 21 endogenous variables, 8 exogenous shocks, 8 observables, and 1,494 non-Gaussian and nonlinear latent variables is considered in detail.

**Keywords:** Bayesian inference; MCMC; Metropolis-Hastings; Marginal likelihood; Tailored proposal densities; Random blocks; Student- $t$  shocks; Stochastic volatility.

**JEL Classification:** C11, C15, C32, E37, E63

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# 1 Introduction

Over the past 20 years or so, dynamic stochastic general equilibrium (DSGE) models have become the mainstay of macroeconomic policy analysis and forecasting. Presently there is growing interest in DSGE models that have more parameters, endogenous variables, exogenous shocks, and observables than the Smets and Wouters (2007) model and substantial additional complexities from non-Gaussian distributions, as in Chib and Ramamurthy (2014) and Cúrdia, Del Negro and Greenwald (2014), and the incorporation of time-varying volatility, as in Justiniano and Primiceri (2008).<sup>1</sup> This is because these higher-dimensional DSGE models are more realistic and have the potential to provide better statistical fit to the data. Despite wide spread use of Bayesian estimation techniques, based on Markov chain Monte Carlo (MCMC) simulation methods [see Chib and Greenberg (1995) and Herbst and Schorfheide (2016) for further details about these methods], the estimation of high-dimensional DSGE models is challenging. The popular DYNARE software package, which has proved useful for small- and medium-scale models is, however, currently not capable of handling the preceding DSGE models, thus inhibiting the formulation, estimation and comparison of such models for policy analysis and prediction.

A primary goal of this paper is to introduce a user-friendly MATLAB software program for estimating high-dimensional DSGE models that contain Student- $t$  shocks and stochastic volatility. Estimation of such models is recognized to be challenging because of the complex mapping from the structural parameters to those of the state space model that emerges from the rational expectations solution of the equilibrium conditions. Our package relies on the tailored random block Metropolis-Hastings (TaRB-MH) algorithm of Chib and Ramamurthy (2010) to deal with these challenging models. Recent applications of this algorithm to DSGE models include, e.g., Born and Pfeifer (2014), Rathke, Straumann and Woitek (2017), Kulish, Morley and Robinson (2017) and Kapetanios et al. (2019), while applications to other problems in economics include Kim and Kang (2019) and Mele (2020), amongst many others. Two defining features of this algorithm are worth mentioning. One is the random clustering of the structural parameters  $\theta^S$  at every iteration into an arbitrary number of blocks. Each block is then sequentially updated through an M-H step. Another is the adaptation of the proposal density to the location and curvature of the posterior distribution for a given block using a mix of simulated annealing and a deterministic optimizer. The TaRB-MH algorithm may appear to require work, but random blocking and tailoring are central to generating efficient exploration of the posterior distribution. The TaRB-MH algorithm is also available in

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<sup>1</sup>See also, e.g., Dave and Malik (2017), Chiu, Mumtaz and Pinter (2017), Franta (2017), and Liu (2019) for macroeconomic implications of fat-tailed shocks and stochastic volatility.

DYNARE, but only for models without Student- $t$  shocks and stochastic volatility. Even there, however, we have found in experiments that its implementation is not as efficient as the one in our package.

The marginal likelihood (the integral of the sampling density over the prior of the parameters) plays a central role in Bayesian model comparisons. In our package we calculate this quantity by the method of Chib (1995) and Chib and Jeliazkov (2001). The marginal likelihood is also available in DYNARE, but it is obtained by a modified version of the Gelfand and Dey (1994) method (also see, for example, Justiniano and Primiceri (2008) and Cúrdia, Del Negro and Greenwald (2014), for use of this method in DSGE models with Student- $t$  shocks and stochastic volatility). The latter method, however, is not as reliable as the Chib and Jeliazkov (2001) method. It is subject to upward finite-sample bias in models with latent variables and runs the risk of misleading model comparisons [see Sims, Waggoner and Zha (2008) and Chan and Grant (2015) for such examples]. As this point is not well recognized in the DSGE model literature, we document its performance in simulated examples. It is shown to mistakenly favor models with fatter tails and incorrect time-varying variance dynamics. Finally, our package includes various post-estimation tools that are important for policy analysis, for example, functions for conducting impulse response and variance decomposition analyses, and point and density forecasts.

Another goal is to provide pointers on dealing with high-dimensional DSGE models that promote more reliable estimation and that are incorporated by default in our package. Due to the complex mapping from the structural parameters to those of the state space form, standard prior assumptions about structural parameters may still imply a distribution of the data that is strongly at odds with actual observations. To see if this is the case, we sample the prior many times, solve for the equilibrium solution, and then sample the endogenous variables. Second, we suggest the use of a training sample to fix the hyperparameters. Although training sample priors are common in the vector autoregression (VAR) literature, they are not typically used in the DSGE setting. We also suggest the use of the Student- $t$  family of distributions as the prior family for the location parameters. This tends to further mitigate the possibility of prior-sample conflicts and leads to more robust results. Finally, we invest in the most efficient way of sampling the different blocks, for example, sampling the non-structural parameters and the latent variables by the integration sampler of Kim, Shephard and Chib (1998).

The rest of the paper is organized as follows. The next section specifies a prototypical high-dimensional DSGE model for the subsequent analysis. Section 3 provides pointers on prior formulation, posterior sampling, and model comparison accompanied by both empirical results and simulation evidence. Section 4 conducts an out-of-sample forecast analysis. Section 5 concludes. The appendix contains a detailed summary of the implied equilibrium and steady state relations (Appendix A), a practical user guide on

how to run our MATLAB package called ‘TaRB-t-SV’ (Appendix B), and a description of the small-scale DSGE model used in Section 4 (Appendix C).<sup>2</sup>

## 2 High-Dimensional DSGE Model

As a template, consider the new Keynesian model of Leeper, Traum and Walker (2017) that fills fiscal details into an otherwise standard medium-scale DSGE model presented in Christiano, Eichenbaum and Evans (2005) and Smets and Wouters (2007). To make this model more realistic, we introduce fat-tailed shocks and time-varying volatility. The resulting model is high-dimensional, consisting of 51 parameters, 21 endogenous variables, 8 exogenous shocks, 8 observables, and 1,494 non-Gaussian and nonlinear latent variables. This section outlines the model structure briefly to conserve space. Unless otherwise noted, we let  $\hat{x}_t \equiv \ln x_t - \ln x$  denote the log-deviation of a generic variable  $x_t$  from its steady state  $x$ . We also divide a non-stationary variable  $X_t$  by the level of technology  $A_t$  and express the detrended variable as  $x_t = X_t/A_t$ .

### 2.1 Firms

The production sector consists of firms that produce intermediate and final goods. A perfectly competitive final goods producer uses intermediate goods supplied by a continuum of intermediate goods producers indexed by  $i$  on the interval  $[0, 1]$  to produce the final goods. The production technology  $Y_t \leq \left( \int_0^1 Y_t(i)^{1/(1+\eta_t^p)} di \right)^{1+\eta_t^p}$  is constant-return-to-scale, where  $\eta_t^p$  is an exogenous price markup shock,  $Y_t$  is the aggregate demand of final goods, and  $Y_t(i)$  is the intermediate goods produced by firm  $i$ .

Each intermediate goods producer follows a production technology  $Y_t(i) = K_t(i)^\alpha (A_t L_t^d(i))^{1-\alpha} - A_t \Omega$ , where  $K_t(i)$  and  $L_t^d(i)$  are the capital and the amount of ‘packed’ labor input rented by firm  $i$  at time  $t$ , and  $0 < \alpha < 1$  is the income share of capital.  $A_t$  is the labor-augmenting neutral technology shock and its growth rate  $u_t^a \equiv \ln(A_t/A_{t-1})$  equals  $\gamma > 0$  when  $A_t$  evolves along the balanced growth path. The parameter  $\Omega > 0$  represents the fixed cost of production.

Intermediate goods producers maximize their profits in two stages. First, they take the input prices, i.e., nominal wage  $W_t$  and nominal rental rate of capital  $R_t^k$ , as given and rent  $L_t^d(i)$  and  $K_t(i)$  in perfectly competitive factor markets. Second, they choose the prices that maximize their discounted real profits. Here we introduce the Calvo-pricing mechanism for nominal price rigidities. Specifically, a fraction  $0 < \omega_p < 1$  of firms cannot change their prices each period. All other firms can only partially index their prices

<sup>2</sup>The toolbox is publicly available at <https://sites.google.com/a/slu.edu/tanf>.

by the rule  $P_t(i) = P_{t-1}(i) (\pi_{t-1}^{\chi_p} \pi^{1-\chi_p})$ , where  $P_{t-1}(i)$  is indexed by the geometrically weighted average of past inflation  $\pi_{t-1}$  and steady state inflation  $\pi$ . The weight  $0 < \chi_p < 1$  controls the degree of partial indexation.

The production sector can be summarized by four log-linearized equilibrium equations in terms of six parameters  $(\alpha, \Omega, \beta, \omega_p, \chi_p, \eta^p)$ , seven endogenous variables  $(\hat{y}_t, \hat{k}_t, \hat{L}_t, \hat{r}_t^k, \hat{w}_t, \widehat{m}c_t, \hat{\pi}_t)$ , and one exogenous shock  $\hat{u}_t^p$ :

$$\text{Production function: } \hat{y}_t = \frac{y + \Omega}{y} \left[ \alpha \hat{k}_t + (1 - \alpha) \hat{L}_t \right] \quad (2.1)$$

$$\text{Capital-labor ratio: } \hat{r}_t^k - \hat{w}_t = \hat{L}_t - \hat{k}_t \quad (2.2)$$

$$\text{Marginal cost: } \widehat{m}c_t = \alpha \hat{r}_t^k + (1 - \alpha) \hat{w}_t \quad (2.3)$$

$$\text{Phillips equation: } \hat{\pi}_t = \frac{\beta}{1 + \beta \chi_p} \mathbb{E}_t \hat{\pi}_{t+1} + \frac{\chi_p}{1 + \beta \chi_p} \hat{\pi}_{t-1} + \kappa_p \widehat{m}c_t + \hat{u}_t^p \quad (2.4)$$

where  $\kappa_p \equiv [(1 - \beta \omega_p)(1 - \omega_p)] / [\omega_p(1 + \beta \chi_p)]$ ,  $\hat{\eta}_t^p \equiv \ln(1 + \eta_t^p) - \ln(1 + \eta^p)$ ,  $\hat{\eta}_t^p$  is normalized to  $\hat{u}_t^p \equiv \kappa_p \hat{\eta}_t^p$ , and  $\mathbb{E}_t$  represents mathematical expectation given information available at time  $t$ .

## 2.2 Households

The economy is populated by a continuum of households indexed by  $j$  on the interval  $[0, 1]$ . Each optimizing household  $j$  derives utility from composite consumption  $C_t^*(j)$ , relative to a habit stock defined in terms of lagged aggregate composite consumption  $hC_{t-1}^*$  where  $0 < h < 1$ . The composite consumption consists of private  $C_t(j)$  and public  $G_t$  consumption goods, i.e.,  $C_t^*(j) \equiv C_t(j) + \alpha_G G_t$ , where  $\alpha_G$  governs the degree of substitutability of the consumption goods. Each household  $j$  also supplies a continuum of differentiated labor services  $L_t(j, l)$  where  $l \in [0, 1]$ . Households maximize their expected lifetime utility  $\mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t u_t^b [\ln(C_t^*(j) - hC_{t-1}^*) - L_t(j)^{1+\xi} / (1 + \xi)]$ , where  $0 < \beta < 1$  is the discount rate,  $\xi > 0$  is the inverse of Frisch labor supply elasticity, and  $u_t^b$  is an exogenous preference shock.

Households have access to one-period nominal private bonds  $B_{s,t}$  that pay one unit of currency at time  $t + 1$ , sell at price  $R_t^{-1}$  at time  $t$ , and are in zero net supply. They also have access to a portfolio of long-term nominal government bonds  $B_t$ , which sell at the price  $P_t^B$  at time  $t$ . Maturity of these zero-coupon bonds decays at the constant rate  $0 < \rho < 1$  to yield the average duration  $(1 - \rho\beta)^{-1}$ . Households receive bond earnings, labor and capital rental income, lump-sum transfers from the government  $Z_t$ , and profits from firms  $\Pi_t$ . They spend income on consumption, investment  $I_t$ , and bonds. The nominal flow budget

constraint for household  $j$  is given by

$$(1 + \tau^C)P_t C_t(j) + P_t I_t(j) + P_t^B B_t(j) + R_t^{-1} B_{s,t}(j) = (1 + \rho P_t^B) B_{t-1}(j) + B_{s,t-1}(j) \\ + (1 - \tau^L) \int_0^1 W_t(l) L_t(j, l) dl + (1 - \tau^K) R_t^k v_t(j) \bar{K}_{t-1}(j) - \Psi(v_t) \bar{K}_{t-1}(j) + P_t Z_t(j) + \Pi_t(j)$$

where  $W_t(l)$  is the nominal wage charged by the household for type  $l$  labor service. Consumption and labor income are, in nominal terms, subject to a sales tax  $\tau^C > 0$  and a labor income tax  $\tau^L > 0$ , respectively.

Effective capital  $K(j)$ , which is subject to a rental income tax  $\tau^K > 0$ , is related to physical capital  $\bar{K}(j)$  via  $K_t(j) = v_t(j) \bar{K}_{t-1}(j)$ , where  $v_t(j)$  is the utilization rate of capital chosen by households and incurs a nominal cost of  $\Psi(v_t)$  per unit of physical capital.<sup>3</sup> Physical capital is accumulated by households according to  $\bar{K}_t(j) = (1 - \delta) \bar{K}_{t-1}(j) + u_t^i \left( 1 - S \left( \frac{I_t(j)}{I_{t-1}(j)} \right) \right) I_t(j)$ , where  $0 < \delta < 1$  is the depreciation rate,  $S(\cdot)I_t$  is an investment adjustment cost and  $u_t^i$  is an exogenous investment-specific efficiency shock.<sup>4</sup>

There are perfectly competitive labor packers that hire a continuum of differentiated labor inputs  $L_t(l)$ , pack them to produce an aggregate labor service and then sell it to intermediate goods producers. The labor packer uses the Dixit-Stiglitz aggregator for labor aggregation  $L_t^d = \left( \int_0^1 L_t(l)^{1/(1+\eta_t^w)} dl \right)^{1+\eta_t^w}$ , where  $L_t^d$  is the aggregate labor service demanded by intermediate goods producers,  $L_t(l)$  is the  $l$ th type labor service supplied by all the households and demanded by the labor packer, and  $\eta_t^w$  is an exogenous wage markup shock.

For the optimal wage setting problem, we adopt the Calvo-pricing mechanism for nominal wage rigidities. Specifically, of all the types of labor services within each household, a fraction  $0 < \omega_w < 1$  of wages cannot be changed each period. The wages for all other types of labor services follow a partial indexation rule  $W_t(l) = W_{t-1}(l) (\pi_{t-1} e^{u_{t-1}^a})^{\chi_w} (\pi e^\gamma)^{1-\chi_w}$ , where  $W_{t-1}(l)$  is indexed by the geometrically weighted average of the growth rates of nominal wage in the past period and in the steady state, respectively. The weight  $0 < \chi_w < 1$  controls the degree of partial indexation.

The household sector can be summarized by ten log-linearized equilibrium equations in terms of seventeen parameters ( $h, \gamma, \alpha_G, \rho, \tau^C, \tau^K, \tau^L, \psi, \beta, \gamma, s, \delta, \xi, \omega_w, \chi_w, \rho_a, \eta^w$ ), fifteen endogenous variables ( $\hat{\lambda}_t, \hat{c}_t^*, \hat{c}_t, \hat{g}_t, \hat{R}_t, \hat{\pi}_t, \hat{P}_t^B, \hat{r}_t^k, \hat{v}_t, \hat{q}_t, \hat{i}_t, \hat{k}_t, \hat{\bar{k}}_t, \hat{w}_t, \hat{L}_t$ ), and four exogenous shocks ( $\hat{u}_t^a, \hat{u}_t^b, \hat{u}_t^i, \hat{u}_t^w$ ):

$$\text{Optimal consumption:} \quad \hat{\lambda}_t = \hat{u}_t^b - \frac{h}{e^\gamma - h} \hat{u}_t^a - \frac{e^\gamma}{e^\gamma - h} \hat{c}_t^* + \frac{h}{e^\gamma - h} \hat{c}_{t-1}^* - \frac{\tau^C}{1 + \tau^C} \hat{\tau}_t^C \quad (2.5)$$

$$\text{Composite consumption:} \quad \hat{c}_t^* = \frac{c}{c + \alpha_G g} \hat{c}_t + \frac{\alpha_G g}{c + \alpha_G g} \hat{g}_t \quad (2.6)$$

<sup>3</sup>Define the parameter  $0 < \psi < 1$  such that  $\frac{\Psi''(1)}{\Psi'(1)} \equiv \frac{\psi}{1-\psi}$ .

<sup>4</sup> $S(\cdot)$  satisfies  $S'(e^\gamma) = 0$  and  $S''(e^\gamma) \equiv s > 0$ .

$$\text{Consumption Euler: } \hat{\lambda}_t = \hat{R}_t + \mathbb{E}_t \hat{\lambda}_{t+1} - \mathbb{E}_t \hat{\pi}_{t+1} - \mathbb{E}_t \hat{u}_{t+1}^a \quad (2.7)$$

$$\text{Bond pricing: } \hat{R}_t + \hat{P}_t^B = \frac{\rho P^B}{1 + \rho P^B} \mathbb{E}_t \hat{P}_{t+1}^B = \frac{\rho}{R} \mathbb{E}_t \hat{P}_{t+1}^B \quad (2.8)$$

$$\text{Optimal capital utilization: } \hat{r}_t^k - \frac{\tau^K}{1 - \tau^K} \hat{\tau}_t^K = \frac{\psi}{1 - \psi} \hat{v}_t \quad (2.9)$$

$$\begin{aligned} \text{Optimal physical capital: } \hat{q}_t &= \mathbb{E}_t \hat{\lambda}_{t+1} - \hat{\lambda}_t - \mathbb{E}_t \hat{u}_{t+1}^a + \beta e^{-\gamma} (1 - \tau^K) r^k \mathbb{E}_t \hat{r}_{t+1}^k \\ &\quad - \beta e^{-\gamma} \tau^K r^k \mathbb{E}_t \hat{\tau}_{t+1}^K + \beta e^{-\gamma} (1 - \delta) \mathbb{E}_t \hat{q}_{t+1} \end{aligned} \quad (2.10)$$

$$\begin{aligned} \text{Optimal investment: } \hat{i}_t &= -\frac{1}{1 + \beta} \hat{u}_t^a + \frac{1}{(1 + \beta) s e^{2\gamma}} \hat{q}_t + \hat{u}_t^i + \frac{\beta}{1 + \beta} \mathbb{E}_t \hat{i}_{t+1} \\ &\quad + \frac{\beta}{1 + \beta} \mathbb{E}_t \hat{u}_{t+1}^a + \frac{1}{1 + \beta} \hat{i}_{t-1} \end{aligned} \quad (2.11)$$

$$\text{Effective capital: } \hat{k}_t = \hat{v}_t + \hat{k}_{t-1} - \hat{u}_t^a \quad (2.12)$$

$$\begin{aligned} \text{Capital law of motion: } \hat{k}_t &= [1 - (1 - \delta) e^{-\gamma}] ((1 + \beta) s e^{2\gamma} \hat{u}_t^i + \hat{i}_t) \\ &\quad + (1 - \delta) e^{-\gamma} (\hat{k}_{t-1} - \hat{u}_t^a) \end{aligned} \quad (2.13)$$

$$\begin{aligned} \text{Wage equation: } \hat{w}_t &= -\kappa_w \left[ \hat{w}_t - \xi \hat{L}_t - \hat{u}_t^b + \hat{\lambda}_t - \frac{\tau^L}{1 - \tau^L} \hat{\tau}_t^L \right] + \frac{1}{1 + \beta} \hat{w}_{t-1} \\ &\quad + \frac{\beta}{1 + \beta} \mathbb{E}_t \hat{w}_{t+1} + \frac{\chi_w}{1 + \beta} \hat{\pi}_{t-1} - \frac{1 + \beta \chi_w}{1 + \beta} \hat{\pi}_t + \frac{\beta}{1 + \beta} \mathbb{E}_t \hat{\pi}_{t+1} \\ &\quad + \frac{\chi_w}{1 + \beta} \hat{u}_{t-1}^a - \frac{1 + \beta \chi_w - \rho_a \beta}{1 + \beta} \hat{u}_t^a + \hat{u}_t^w \end{aligned} \quad (2.14)$$

where  $\kappa_w \equiv [(1 - \beta \omega_w)(1 - \omega_w)] / [\omega_w(1 + \beta)(1 + (1/\eta^w + 1)\xi)]$ ,  $\hat{\eta}_t^w \equiv \ln(1 + \eta_t^w) - \ln(1 + \eta^w)$ ,  $\hat{\eta}_t^w$  is normalized to  $\hat{u}_t^w \equiv \kappa_w \hat{\eta}_t^w$ ,  $\hat{u}_t^i$  is normalized to  $\hat{u}_t^i \equiv \frac{1}{(1 + \beta) s e^{2\gamma}} \hat{u}_t^i$ , and  $\lambda_t$  is the Lagrange multiplier associated with the household's budget constraint. We set the capital, labor, and consumption tax rates to their constant steady states so that  $\hat{\tau}_t^K = \hat{\tau}_t^L = \hat{\tau}_t^C = 0$ .

## 2.3 Monetary and Fiscal Policy

The central bank implements monetary policy according to a Taylor-type interest rate rule. The government collects revenues from capital, labor, and consumption taxes, and sells nominal bond portfolios to finance its interest payments and expenditures. The fiscal choices must satisfy the government budget constraint  $P_t^B B_t + \tau^K R_t^K K_t + \tau^L W_t L_t + \tau^C P_t C_t = (1 + \rho P_t^B) B_{t-1} + P_t G_t + P_t Z_t$ , where we have assumed the lump sum transfers are equal across households, i.e.,  $\int_0^1 Z_t(j) dj = Z_t$ , and fiscal instruments follow the simple rules specified below.

The government sector can be summarized by seven log-linearized equilibrium equations in terms of thirteen parameters  $(\tau^C, \tau^K, \tau^L, \beta, \gamma, \rho, \rho_r, \rho_g, \rho_z, \phi_\pi, \phi_y, \gamma_g, \gamma_z)$ , sixteen endogenous variables  $(\hat{b}_t, \hat{r}_t^k, \hat{k}_t, \hat{w}_t, \hat{L}_t,$



$\hat{c}_t, \hat{\pi}_t, \hat{P}_t^B, \hat{g}_t, \hat{z}_t, \hat{y}_t, \hat{i}_t, \hat{v}_t, \hat{R}_t, \hat{s}_t^b, \hat{s}_t$ ), and four exogenous shocks ( $\hat{u}_t^a, \hat{u}_t^m, \hat{u}_t^g, \hat{u}_t^z$ ):

$$\begin{aligned} \text{Government budget constraint: } & \frac{b}{y} \hat{b}_t + \tau^K r^k \frac{k}{y} \left[ \hat{\tau}_t^K + \hat{r}_t^k + \hat{k}_t \right] + \tau^L w \frac{L}{y} \left[ \hat{\tau}_t^L + \hat{w}_t + \hat{L}_t \right] \\ & + \tau^C \frac{c}{y} (\hat{\tau}_t^C + \hat{c}_t) = \frac{1}{\beta} \frac{b}{y} \left[ \hat{b}_{t-1} - \hat{\pi}_t - \hat{P}_{t-1}^B - \hat{u}_t^a \right] \\ & + \frac{b}{y} \frac{\rho}{\pi e^\gamma} \hat{P}_t^B + \frac{g}{y} \hat{g}_t + \frac{z}{y} \hat{z}_t \end{aligned} \quad (2.15)$$

$$\text{Aggregate resource constraint: } \hat{y}_t = \frac{c}{y} \hat{c}_t + \frac{i}{y} \hat{i}_t + \frac{g}{y} \hat{g}_t + \psi'(1) \frac{k}{y} \hat{v}_t \quad (2.16)$$

$$\text{Monetary policy rule: } \hat{R}_t = \rho_r \hat{R}_{t-1} + (1 - \rho_r) (\phi_\pi \hat{\pi}_t + \phi_y \hat{y}_t) + \hat{u}_t^m \quad (2.17)$$

$$\text{Fiscal policy rule: } \hat{g}_t = \rho_g \hat{g}_{t-1} - (1 - \rho_g) \gamma_g \hat{s}_{t-1}^b + \hat{u}_t^g \quad (2.18)$$

$$\hat{z}_t = \rho_z \hat{z}_{t-1} - (1 - \rho_z) \gamma_z \hat{s}_{t-1}^b + \hat{u}_t^z \quad (2.19)$$

$$\begin{aligned} \text{Real primary surplus: } & \hat{s}_t = \tau^K r^k \frac{k}{s} \left( \hat{\tau}_t^K + \hat{r}_t^k + \hat{k}_t \right) + \tau^L w \frac{L}{s} \left( \hat{\tau}_t^L + \hat{w}_t + \hat{L}_t \right) \\ & + \tau^C \frac{c}{s} (\hat{\tau}_t^C + \hat{c}_t) - \frac{g}{s} \hat{g}_t - \frac{z}{s} \hat{z}_t \end{aligned} \quad (2.20)$$

$$\text{Debt-to-output ratio: } \hat{s}_t^b = \hat{b}_t - \hat{y}_t \quad (2.21)$$

where  $s_{t-1}^b \equiv \frac{P_{t-1}^B B_{t-1}}{P_{t-1} Y_{t-1}}$  denotes the market value of the debt-to-GDP ratio,  $s = \tau^K r^k k + \tau^L w L + \tau^C c - g - z$ ,  $0 < \rho_r, \rho_g, \rho_z < 1$  measure policy smoothness,  $\phi_\pi, \phi_y > 0$  and  $\gamma_g, \gamma_z$  are policy parameters, and  $(\hat{u}_t^m, \hat{u}_t^g, \hat{u}_t^z)$  are exogenous policy shocks.

Following Leeper, Traum and Walker (2017), we consider two distinct regions of the policy parameter space  $(\phi_\pi, \gamma_g, \gamma_z)$  that deliver unique bounded rational expectations equilibria. The conventional active monetary/passive fiscal policy regime, or regime-M, has the monetary authority to raise the nominal rate aggressively in response to inflation and the fiscal authority to adjust expenditures and tax rates to stabilize debt. The alternative passive monetary/active fiscal policy regime, or regime-F, has monetary policy respond weakly to inflation while fiscal instruments adjust weakly to debt.

## 2.4 Exogenous Processes

All exogenous shocks follow autoregressive processes

$$\hat{u}_t^s = \rho_{es} \hat{u}_{t-1}^s + \epsilon_t^s, \quad s \in \{a, b, i, p, w, m, g, z\} \quad (2.22)$$

where  $\rho_{es} \in (0, 1)$  and the innovations  $\epsilon_t^s$  are serially uncorrelated and independent of each other at all leads and lags. We complete the model by assuming a multivariate Student- $t$  distribution for the shock

innovations collected in an  $8 \times 1$  vector  $\epsilon_t$ , i.e.,  $\epsilon_t \sim t_\nu(0, \Sigma_t)$ , where  $\nu$  denotes the degrees of freedom and  $\Sigma_t$  is an  $8 \times 8$  diagonal matrix with time-varying volatility  $\sigma_{s,t}^2$  of  $\epsilon_t^s$  on its main diagonal.<sup>5</sup> For estimation convenience, it is useful to represent each element of  $\epsilon_t$  as a mixture of normals by introducing a Gamma distributed random variable  $\lambda_t$ ,

$$\epsilon_t^s = \lambda_t^{-1/2} e^{h_t^s/2} \varepsilon_t^s, \quad \lambda_t \sim \mathbb{G}\left(\frac{\nu}{2}, \frac{\nu}{2}\right), \quad \varepsilon_t^s \sim \mathbb{N}(0, 1) \quad (2.23)$$

where, following Kim, Shephard and Chib (1998), the logarithm of each volatility  $h_t^s = \ln \sigma_{s,t}^2$  collected in an  $8 \times 1$  vector  $h_t$  evolves as a stationary ( $|\phi_s| < 1$ ) process:

$$h_t^s = (1 - \phi_s)\mu_s + \phi_s h_{t-1}^s + \eta_t^s, \quad \eta_t^s \sim \mathbb{N}(0, \omega_s^2). \quad (2.24)$$

## 2.5 Taking Model to Data

Define the private sector's one-step-ahead endogenous forecast errors as

$$\eta_t^x \equiv \hat{x}_t - \mathbb{E}_{t-1} \hat{x}_t, \quad x \in \{\lambda, \pi, i, q, r^k, w, P^B\}. \quad (2.25)$$

The model consists of 36 log-linearized equilibrium equations and can be cast into the rational expectations system

$$\underbrace{\begin{bmatrix} \Gamma_0^{ee} & \Gamma_0^{ez} & \Gamma_0^{ed} \\ \mathbf{0} & I & \mathbf{0} \\ [\mathbf{0}, I] & \mathbf{0} & \mathbf{0} \end{bmatrix}}_{\Gamma_0(\theta^S)} \underbrace{\begin{bmatrix} x_t^e \\ x_t^z \\ x_t^d \end{bmatrix}}_{x_t} = \underbrace{\begin{bmatrix} \Gamma_1^{ee} & \Gamma_1^{ez} & \mathbf{0} \\ \mathbf{0} & P & \mathbf{0} \\ \mathbf{0} & \mathbf{0} & I \end{bmatrix}}_{\Gamma_1(\theta^S)} \underbrace{\begin{bmatrix} x_{t-1}^e \\ x_{t-1}^z \\ x_{t-1}^d \end{bmatrix}}_{x_{t-1}} + \underbrace{\begin{bmatrix} \mathbf{0} \\ I \\ \mathbf{0} \end{bmatrix}}_{\Psi} \underbrace{\epsilon_t}_{(8 \times 1)} + \underbrace{\begin{bmatrix} \mathbf{0} \\ \mathbf{0} \\ I \end{bmatrix}}_{\Pi} \underbrace{\eta_t}_{(7 \times 1)} \quad (2.26)$$

where  $I$  denotes the identity matrix,  $P = \text{diag}(\rho_{ea}, \rho_{eb}, \rho_{ei}, \rho_{ep}, \rho_{ew}, \rho_{em}, \rho_{eg}, \rho_{ez})$ ,

$$x_t^e = [\hat{y}_t, \hat{c}_t^*, \hat{c}_t, \hat{k}_t, \hat{k}_t, \hat{v}_t, \hat{L}_t, \hat{m}c_t, \hat{b}_t, \hat{g}_t, \hat{z}_t, \hat{R}_t, \hat{s}_t^b, \hat{s}_t, \hat{\lambda}_t, \hat{\pi}_t, \hat{i}_t, \hat{q}_t, \hat{r}_t^k, \hat{w}_t, \hat{P}_t^B]_{(21 \times 1)}$$

are the endogenous variables,

$$x_t^z = [\hat{u}_t^a, \hat{u}_t^b, \hat{u}_t^i, \hat{u}_t^p, \hat{u}_t^w, \hat{u}_t^m, \hat{u}_t^g, \hat{u}_t^z]_{(8 \times 1)}$$

<sup>5</sup>It is straightforward to introduce an independent Student- $t$  distribution with different degrees of freedom for each shock innovation. For exhibition ease, we do not consider this generalization.

are the exogenous shocks,

$$x_t^d = [\mathbb{E}_t \hat{\lambda}_{t+1}, \mathbb{E}_t \hat{\pi}_{t+1}, \mathbb{E}_t \hat{i}_{t+1}, \mathbb{E}_t \hat{q}_{t+1}, \mathbb{E}_t \hat{r}_{t+1}^k, \mathbb{E}_t \hat{w}_{t+1}, \mathbb{E}_t \hat{P}_{t+1}^B]_{(7 \times 1)}$$

are the conditional expectations of the last seven elements of  $x_{t+1}^e$ ,

$$\epsilon_t = [\epsilon_t^a, \epsilon_t^b, \epsilon_t^i, \epsilon_t^p, \epsilon_t^w, \epsilon_t^m, \epsilon_t^g, \epsilon_t^z]'_{(8 \times 1)}$$

are the shock innovations, and

$$\eta_t = [\eta_t^\lambda, \eta_t^\pi, \eta_t^i, \eta_t^q, \eta_t^{r^k}, \eta_t^w, \eta_t^{PB}]'_{(7 \times 1)}$$

are the forecast errors.

Here the first row of (2.26) stacks the 21 structural equations (2.1)–(2.21), the second row stacks the 8 shock processes (2.22), and the third row stacks the 7 definitional equations (2.25). The unknown parameters  $\theta$  consist of the structural parameters

$$\theta^S = [100\gamma, \xi, h, \alpha_G, \psi, s, \omega_p, \omega_w, \chi_p, \chi_w, \phi_\pi, \phi_y, \gamma_g, \gamma_z, \rho_r, \rho_g, \rho_z, \rho_{ea}, \rho_{eb}, \rho_{ei}, \rho_{ep}, \rho_{ew}, \rho_{em}, \rho_{eg}, \rho_{ez}, \bar{L}, \bar{\pi}]_{(27 \times 1)}$$

and the volatility parameters

$$\theta^V = [\mu_a, \mu_b, \mu_i, \mu_p, \mu_w, \mu_m, \mu_g, \mu_z, \phi_a, \phi_b, \phi_i, \phi_p, \phi_w, \phi_m, \phi_g, \phi_z, \omega_a^2, \omega_b^2, \omega_i^2, \omega_p^2, \omega_w^2, \omega_m^2, \omega_g^2, \omega_z^2]_{(24 \times 1)}$$

Conditional on  $\theta^S$  and independent of the volatility processes, the above structural system can be solved by the procedure of Sims (2002) to deliver a linear solution of the form

$$x_t = \underset{(36 \times 36)}{G(\theta^S)} x_{t-1} + \underset{(36 \times 8)}{M(\theta^S)} \epsilon_t \quad (2.27)$$

which is then estimated over a vector  $y_t$  of 8 observables stacked in  $y_{1:T} = [y_1, \dots, y_T]'$ , including log differences (denoted dl) of consumption, investment, real wage, government spending, and government debt; log (denoted l) hours worked, inflation, and nominal interest rate.<sup>6</sup> The observables are linked to the

<sup>6</sup>See the Online Appendix of Leeper, Traum and Walker (2017) for details on data construction.

model variables  $x_t$  via the following measurement equations:

$$\begin{bmatrix} \text{dlConst}_t \\ \text{dlInv}_t \\ \text{dlWage}_t \\ \text{dlGovSpend}_t \\ \text{dlGovDebt}_t \\ \text{lHours}_t \\ \text{lInfl}_t \\ \text{lFedFunds}_t \end{bmatrix} = \begin{bmatrix} 100\gamma \\ 100\gamma \\ 100\gamma \\ 100\gamma \\ 100\gamma \\ \bar{L} \\ \bar{\pi} \\ \bar{\pi} + 100(\gamma/\beta - 1) \end{bmatrix} + \begin{bmatrix} \hat{c}_t - \hat{c}_{t-1} + \hat{u}_t^a \\ \hat{i}_t - \hat{i}_{t-1} + \hat{u}_t^a \\ \hat{w}_t - \hat{w}_{t-1} + \hat{u}_t^a \\ \hat{g}_t - \hat{g}_{t-1} + \hat{u}_t^a \\ \hat{b}_t - \hat{b}_{t-1} + \hat{u}_t^a \\ \hat{L}_t \\ \hat{\pi}_t \\ \hat{R}_t \end{bmatrix}. \quad (2.28)$$

Let  $\lambda_{1:T} = [\lambda_1, \dots, \lambda_T]'$  contain all non-Gaussian latent states and  $h_{1:T} = [h'_1, \dots, h'_T]'$  contain all nonlinear latent states. Further collect them in  $z_{1:T} = [\lambda'_{1:T}, h'_{1:T}]'$ , which in our empirical application ( $T = 166$ ) has a total of 1,494 elements. In conjunction with the shock volatility specifications (2.23) and (2.24), equations (2.27) and (2.28) form a state space representation of the DSGE model whose conditional likelihood function  $f(y_{1:T}|\theta, z_{1:T})$  can be evaluated with the Kalman filter.

### 3 Estimation

The general framework for estimating DSGE models, employing Bayesian tools, is by now quite well established. The state space model (2.27)–(2.28) is supplemented by a prior distribution  $\pi(\theta)$  summarizing the researcher's initial views of the model parameters. This prior information is updated with the sample information via Bayes' theorem,

$$\pi(\theta, z_{1:T}|y_{1:T}) \propto f(y_{1:T}, z_{1:T}|\theta) \cdot \pi(\theta) \cdot \mathbb{1}\{\theta \in \Theta_D\}$$

where  $f(y_{1:T}, z_{1:T}|\theta)$  is the joint likelihood function and the joint posterior distribution  $\pi(\theta, z_{1:T}|y_{1:T})$  characterizing the researcher's updated beliefs is calculated up to the normalization constant. Moreover,  $\mathbb{1}\{\theta \in \Theta_D\}$  is an indicator function that equals one if  $\theta$  is in the determinacy region  $\Theta_D$  and zero otherwise. This posterior distribution is typically summarized by MCMC methods, but in the current high-dimensional context, there is still little experience on how an MCMC sampling procedure should be implemented to estimate the model.

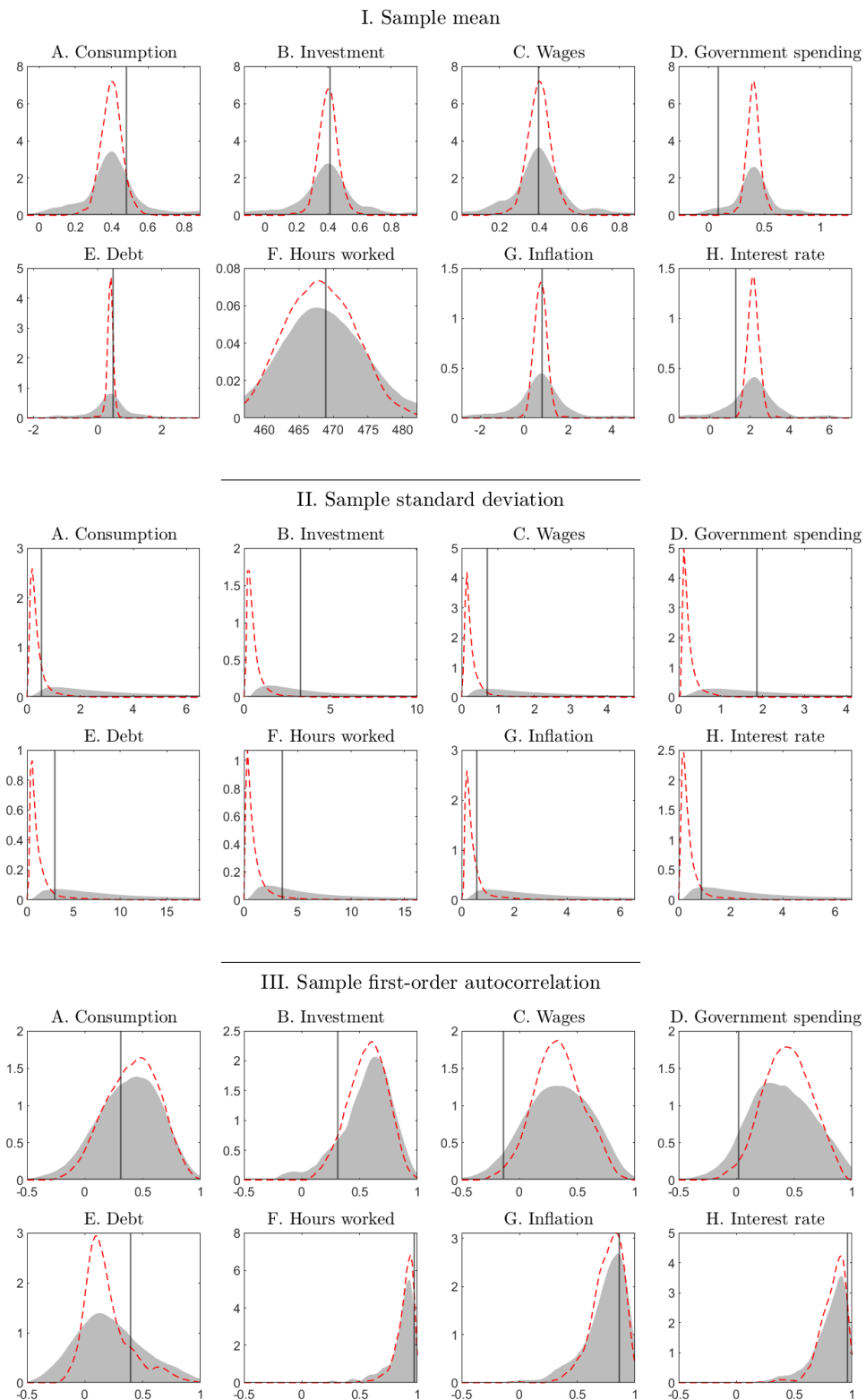


Figure 1: Distributions of simulated selected quantities obtained by sampling the prior, and then the outcomes given drawings from the prior. Notes: Each panel compares the resulting densities under Gaussian shocks with constant volatility (red dashed line) with that under Student- $t$  shocks with stochastic volatility (shaded area). Vertical lines denote the real data counterparts.

### 3.1 Prior Distribution

Table A.1 of Appendix A lists the marginal prior distributions for all model parameters.<sup>7</sup> The priors on the structural parameters follow closely Leeper, Traum and Walker (2017), and those on the volatility parameters imply a fairly persistent volatility process for each shock innovation. In the Bayesian estimation of DSGE models, an informative prior distribution (such as those on the policy parameters  $\phi_\pi, \gamma_g, \gamma_z$ ) can play an important role in shifting the posterior distribution toward regions of the parameter space that are economically meaningful. It can also introduce curvature into the posterior surface that facilitates numerical optimization and MCMC simulations (such as the tailoring of proposal densities in the TaRB-MH algorithm).

When it comes to high dimensions, however, developing an appropriate prior becomes increasingly difficult due to the complex mapping from the structural parameters to those of the state space form. Consequently, a reasonable prior for the structural parameters may still imply a distribution of the data that is strongly at odds with actual observations. For instance, Figure 1 shows the implied distributions for selected sample moments under the original regime-M prior and model specification of Leeper, Traum and Walker (2017) (red dashed lines). Most notably, this prior places little or no mass in the neighborhood of the actual mean of government spending and the actual standard deviations of investment, government spending, debt, and hours worked (vertical lines). After taking the model to data, we also find that the posterior mass for several parameters (e.g., the habit parameter  $h$ , the nominal rigidity parameters  $\omega_p$  and  $\omega_w$ , and the government spending persistence  $\rho_g$ ) lies entirely in the far tail of the corresponding prior, thereby introducing fragility to the inferences. To cope with these issues, we suggest a two-step approach for constructing the prior that can avoid such prior-sample conflict.

#### 3.1.1 Sampling the Prior

The first step follows the sampling the prior approach in, e.g., Geweke (2005) and Chib and Ergashev (2009). In particular, start with a standard prior for the structural parameters. Here we take that to be the prior in Leeper, Traum and Walker (2017). Alongside, specify an initial prior for the volatility parameters  $\theta^V$ . Then sample this joint prior a large number of times (say 1,000) and simulate a data set  $y^{(g)}$  for each parameter draw  $\theta^{(g)}$ ,  $g = 1, \dots, G$ , under which the model has a unique bounded solution. Finally, compute the implied distributions for various functions of the data (such as the sample mean, standard deviation, and autocorrelation) and check whether these are close to corresponding values in

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<sup>7</sup>Because some parameters are held fixed under each regime, effectively,  $\theta$  has 49 elements and  $\theta^S$  has 25 elements.

the actual data. If not, adjust some or all marginal components of the prior for  $\theta$  and repeat the above process.<sup>8</sup>

It is clear from Figure 1 that under the adjusted prior, reported in Table A.1 of Appendix A, the Leeper, Traum and Walker (2017) model extended with Student- $t$  shocks and stochastic volatility implies distributions of the data that capture the corresponding real data quantities in their relatively high density regions (represented by the shaded areas).

### 3.1.2 Training Sample Prior

In the second step, given the adjusted prior from the first step, use the TarB-MH algorithm to estimate the DSGE model on the initial 50 observations running from 1955:Q1 to 2008:Q4. The posterior draws from this run are used to form the prior. Specifically, keep the prior type of each parameter unchanged but set its location (dispersion) to the corresponding mean (twice standard deviation). At this point, we suggest that each location parameter  $\mu_s$ ,  $s \in \{a, b, i, p, w, m, g, z\}$  of the volatility process be assigned a Student- $t$  distribution with 2.1 degrees of freedom. This two-step construction tends to avoid any stark conflict between the prior and the likelihood.

## 3.2 Sampling Steps

We use two primary steps to sample the posterior distribution. These are executed in the program `tarb_full.m`. The first step samples the 25 structural parameters in  $\theta^S$  from the conditional posterior  $\pi(\theta^S | y_{1:T}, \theta^V, \lambda_{1:T}, h_{1:T})$  by the Chib and Ramamurthy (2010) TarB-MH algorithm, and the second step samples the remaining blocks, including the 24 volatility parameters in  $\theta^V$ , the 166 non-Gaussian latent variables in  $\lambda_{1:T}$ , and the 1,328 nonlinear latent variables in  $h_{1:T}$ , from the conditional posterior  $\pi(\theta^V, \lambda_{1:T}, h_{1:T} | y_{1:T}, \theta^S)$  by the Kim-Shephard and Chib (1998) method. Iterating the above cycle until convergence produces a sample from the joint posterior  $\pi(\theta, z_{1:T} | y_{1:T})$ . We provide a brief summary of these steps and refer readers to the original papers for further details.

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<sup>8</sup>In the Leeper, Traum and Walker (2017) setting with Gaussian shocks and constant volatility, this step suggests that the original prior for the standard deviation parameters  $100\sigma_s$ ,  $s \in \{a, b, i, p, w, m, g, z\}$ , each of which follows an Inverse-Gamma type-2 distribution with mean 0.1 and standard deviation 1, should be adjusted. Alternatively, one could also adjust some or all marginal components of the prior for  $\theta^S$ .

### 3.2.1 Sampling Structural Parameters

The first step entails sampling  $\theta^S$  from

$$\pi(\theta^S | y_{1:T}, \theta^V, z_{1:T}) \propto f(y_{1:T} | \theta^S, z_{1:T}) \cdot \pi(\theta^S) \cdot \mathbb{1}\{\theta \in \Theta_D\} \quad (3.1)$$

using the TaRB-MH algorithm. To fix ideas, consider the  $g$ th iteration where a random partition of  $B$  blocks from a permuted sequence of  $\theta^S$  has been formed, i.e.,  $\theta^S = (\theta_1^S, \dots, \theta_B^S)$ . Specifically, we initialize  $\theta_1^S$  with the first element of this shuffled sequence, and start a new block with every next element with probability  $1 - p$ . As a result, the average size of a block is given by  $(1 - p)^{-1}$ . In our benchmark setting, we set  $p = 0.7$  so that each block contains three to four parameters on average. This effectively breaks a 25-dimensional sampling problem into about seven smaller ones. The random block feature is also useful as the researcher typically does not have a priori knowledge about the correlation pattern of  $\theta^S$ . Now suppose the blocks  $\theta_{1:b-1}^{S,(g)} = (\theta_1^{S,(g)}, \dots, \theta_{b-1}^{S,(g)})$  have been updated in the current iteration, whereas the remaining blocks  $\theta_{b:B}^{S,(g-1)} = (\theta_b^{S,(g-1)}, \dots, \theta_B^{S,(g-1)})$  and  $z^{(g-1)}$  take values in the previous iteration. In summary:

1. Use the simulated annealing (SA) optimization method (available as a MATLAB built-in function `simulannealbnd`) to obtain an initial solution to

$$\hat{\theta}_b^S = \arg \min_{\theta_b^S} - \ln f(y_{1:T} | \theta_{1:b-1}^{S,(g)}, \theta_b^S, \theta_{b+1:B}^{S,(g-1)}, z^{(g-1)}) \cdot \pi(\theta_b^S).$$

This SA version of the posterior mode is further used to initiate the BFGS quasi-Newton method (available as a MATLAB function `csminwel` written by Chris Sims) that refines the initial solution. `csminwel` also approximates the inverse of the Hessian matrix evaluated at  $\hat{\theta}_b^S$ , denoted by  $\hat{V}_b$ , and returns it as a byproduct.<sup>9</sup>

2. Generate a candidate draw from the tailored Student- $t$  proposal density

$$\theta_b^{S,(g)} \sim t_\nu(\hat{\theta}_b^S, \hat{V}_b)$$

where the degrees of freedom parameter is set to  $\nu = 15$ . The local tailoring feature allows for sizable moves from the neighborhood of the current parameter draw.

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<sup>9</sup>The same optimization procedure, executed in the program `chain_init.m`, is repeated multiple times to obtain a starting value  $\theta^{S,(0)}$  for the chain.



3. Accept  $\theta_b^{S,(g)}$  as the updated value of  $\theta_b^S$  with probability

$$\alpha = \min \left\{ 1, \frac{f(y_{1:T} | \theta_{1:b-1}^{S,(g)}, \theta_b^{S,(g)}, \theta_{b+1:B}^{S,(g-1)}, z^{(g-1)}) \cdot \pi(\theta_b^{S,(g)})}{f(y_{1:T} | \theta_{1:b-1}^{S,(g)}, \theta_b^{S,(g-1)}, \theta_{b+1:B}^{S,(g-1)}, z^{(g-1)}) \cdot \pi(\theta_b^{S,(g-1)})} \cdot \frac{t_\nu(\theta_b^{S,(g-1)} | \hat{\theta}_b^S, \hat{V}_b)}{t_\nu(\theta_b^{S,(g)} | \hat{\theta}_b^S, \hat{V}_b)} \right\}.$$

We also introduce a new procedure, i.e., tailoring at random frequency, to accelerate the TaRB-MH algorithm. The idea is similar in essence to grouping the structural parameters into random blocks. Because the tailored proposal density in the current iteration may remain efficient for the next few iterations, there is typically no need to re-tailor the proposal density in every iteration. Nevertheless, there is still a chance that the re-tailored proposal density will be quite different from the recycled one. Therefore, randomizing the number of iterations before new blocking and tailoring ensures that the proposal density remains well-tuned on average. The reciprocal of this average number, which we call the tailoring frequency  $\omega$ , as well as a number of optional user inputs (e.g., the blocking probability  $p$ ), can be specified flexibly in the program `tarb_spec.m`. In our benchmark setting, we set  $\omega = 0.5$  so that each proposal density is tailored every second iteration on average. In general, we suggest setting  $p \in [0.6, 0.9]$  and  $\omega \in [0.2, 1.0]$  to maintain a good balance between runtime and simulation efficiency.

### 3.2.2 Sampling Latent Variables and Volatility Parameters

The second step involves augmenting the remaining blocks with 1,328 shock innovations  $\epsilon_{1:T} = [\epsilon'_1, \dots, \epsilon'_T]'$  and then sampling the joint posterior  $\pi(\theta^V, \epsilon_{1:T}, \lambda_{1:T}, h_{1:T} | y_{1:T}, \theta^S)$ . To this end, Gibbs sampling is applied to the following conditional densities

$$\pi(\epsilon_{1:T} | y_{1:T}, \theta, \lambda_{1:T}, h_{1:T}), \quad \pi(\lambda_{1:T} | y_{1:T}, \theta, \epsilon_{1:T}, h_{1:T}), \quad \pi(\theta^V, h_{1:T} | y_{1:T}, \theta^S, \epsilon_{1:T}, \lambda_{1:T}) \quad (3.2)$$

using the steps below:

1. Sample  $\epsilon_{1:T}$  from the first density in (3.2)

$$\pi(\epsilon_{1:T} | y_{1:T}, \theta, \lambda_{1:T}, h_{1:T}) = \pi(\epsilon_{1:T} | y_{1:T}, \theta^S, \lambda_{1:T}, h_{1:T})$$

with the disturbance smoother of Durbin and Koopman (2002) applied to the state space form (2.27)–(2.28), where each  $\epsilon_t^s \sim \mathbb{N}(0, e^{h_t^s}/\lambda_t)$ ,  $s \in \{a, b, i, p, w, m, g, z\}$ , due to the gamma-normal representation (2.23).

2. Sample  $\lambda_{1:T}$  from the second density in (3.2)

$$\pi(\lambda_{1:T}|y_{1:T}, \theta, \epsilon_{1:T}, h_{1:T}) \propto \prod_{t=1}^T f(\epsilon_t|\lambda_t, h_t) \cdot \pi(\lambda_t)$$

by independently sampling each  $\lambda_t$  from

$$\lambda_t \sim \mathbb{G}\left(\frac{\nu + n_\epsilon}{2}, \frac{\nu + \epsilon_t' \Sigma_t^{-1} \epsilon_t}{2}\right), \quad \Sigma_t = \text{diag}(e^{h_t})$$

as in Chib and Ramamurthy (2014), where  $n_\epsilon = 8$  is the dimension of  $\epsilon_t$ .

3. Following Kim, Shephard and Chib (1998), the nonlinear measurement equation (2.23) can be transformed into a linear one by squaring and taking logarithm. In conjunction with the volatility state equation (2.24), this leads to the state space model

$$\begin{aligned} h_t^s &= (1 - \phi_s)\mu_s + \phi_s h_{t-1}^s + \eta_t^s \\ \tilde{\epsilon}_t^s &= h_t^s + e_t^s \end{aligned}$$

for  $s \in \{a, b, i, p, w, m, g, z\}$ , where  $\tilde{\epsilon}_t^s = \ln \lambda_t (\epsilon_t^s)^2$  and  $e_t^s = \ln(\epsilon_t^s)^2$ . Practically, we set  $\tilde{\epsilon}_t^s = \ln[\lambda_t (\epsilon_t^s)^2 + c]$  with  $c = 10^{-5}$  being an offset constant, and accurately approximate the distribution of  $e_t^s$  by the 10-component mixture normal density proposed by Omori et al. (2007),

$$p(e_t^s) = \sum_{k=1}^{10} q_k \cdot p_{\mathbb{N}}(e_t^s | s_t^s = k)$$

where  $s_t^s$  is an indicator variable and  $p_{\mathbb{N}}(\cdot | s_t^s = k)$  denotes a normal density function with mean  $m_k$ , variance  $v_k^2$ , and component probability  $q_k$ . Now, to sample the last density in (3.2), we further augment the remaining blocks with 1,328 indicator variables  $s_{1:T} = [s_1', \dots, s_T']$ , where  $s_t = [s_t^a, s_t^b, s_t^i, s_t^p, s_t^w, s_t^m, s_t^g, s_t^z]$ , and sample the joint posterior  $\pi(s_{1:T}, \theta^V, h_{1:T}|y_{1:T}, \theta^S, \epsilon_{1:T}, \lambda_{1:T})$  by sampling the conditional densities

$$\begin{aligned} &\pi(s_{1:T}|y_{1:T}, \theta, \epsilon_{1:T}, \lambda_{1:T}, h_{1:T}) \\ \pi(\theta^V, h_{1:T}|y_{1:T}, \theta^S, \epsilon_{1:T}, \lambda_{1:T}, s_{1:T}) &= \pi(\theta^V|y_{1:T}, \theta^S, \epsilon_{1:T}, \lambda_{1:T}, s_{1:T}) \cdot \pi(h_{1:T}|y_{1:T}, \theta, \epsilon_{1:T}, \lambda_{1:T}, s_{1:T}) \end{aligned}$$

using these steps:

(a) Sample each  $s^s = [s_1^s, \dots, s_T^s]'$ ,  $s \in \{a, b, i, p, w, m, g, z\}$ , independently from

$$\pi(s^s | y, \theta, \epsilon, \lambda, h) \propto \prod_{t=1}^T f(\tilde{\epsilon}_t^s | h_t^s, s_t^s) \cdot \pi(s_t^s)$$

where  $f(\cdot | h_t^s, s_t^s = k)$  is a normal density function with mean  $h_t^s + m_k$  and variance  $v_k^2$ , and  $\pi(s_t^s = k) = q_k$ ,  $k = 1, \dots, 10$ .

(b) Sample  $\theta^V$  marginalized over  $h_{1:T}$  (the ‘integration sampler’ in Kim, Shephard and Chib (1998)) by sampling each triplet  $(\mu_s, \phi_s, \omega_s^2)$ ,  $s \in \{a, b, i, p, w, m, g, z\}$ , independently from

$$\pi(\mu_s, \phi_s, \omega_s^2 | y, \theta^S, \epsilon, \lambda, s) \propto f(\tilde{\epsilon}^s | \mu_s, \phi_s, \omega_s^2, s^s) \cdot \pi(\mu_s, \phi_s, \omega_s^2)$$

using a tailored proposal density, where  $\tilde{\epsilon}^s = [\tilde{\epsilon}_1^s, \dots, \tilde{\epsilon}_T^s]'$  and  $f(\tilde{\epsilon}^s | \mu_s, \phi_s, \omega_s^2, s^s)$  is available from the Kalman filter, followed by the sampling of each  $h^s = [h_1^s, \dots, h_T^s]'$ ,  $s \in \{a, b, i, p, w, m, g, z\}$ , using the ‘filter-forward-sample-backward’ method of Carter and Kohn (1994).

### 3.2.3 Results

We apply the above steps as coded in our MATLAB package to estimate our high-dimensional DSGE model based on the post-training sample of 166 quarterly observations from 1967:Q3 to 2008:Q4. With the ultimate goal of forecasting in mind, we present the estimation results for the model of best fit among all competing specifications. This specification stands out from an extensive model search based on a marginal likelihood comparison, as described in the next section. It has regime-M in place and features heavy-tailed shocks with  $\nu = 5$  degrees of freedom and persistent volatilities.

Because the TaRB-MH algorithm is simulation efficient, a large MCMC sample is typically not required. We consider a simulation sample size of 11,000 draws, of which the first 1,000 draws are discarded as the burn-in phase. Figure 2 provides a graphical comparison of the prior and posterior distributions of each structural parameter. The Bayesian learning is clear from the graphs. In particular, the data imply quite high habit formation and relatively high degrees of price and wage stickiness. See also Table A.2 of Appendix A for a detailed summary of the posterior parameter estimates.

Figure 3 plots the estimated historical log-volatility series for 1967:Q3 to 2008:Q4 based on the  $h$  draws. Overall, these estimates display clear countercyclical time variation, with pronounced increases in volatility accompanying the recessions. For several shock innovations, volatility becomes lower by historical standards since the 1980s so that the Great Moderation is also evident.

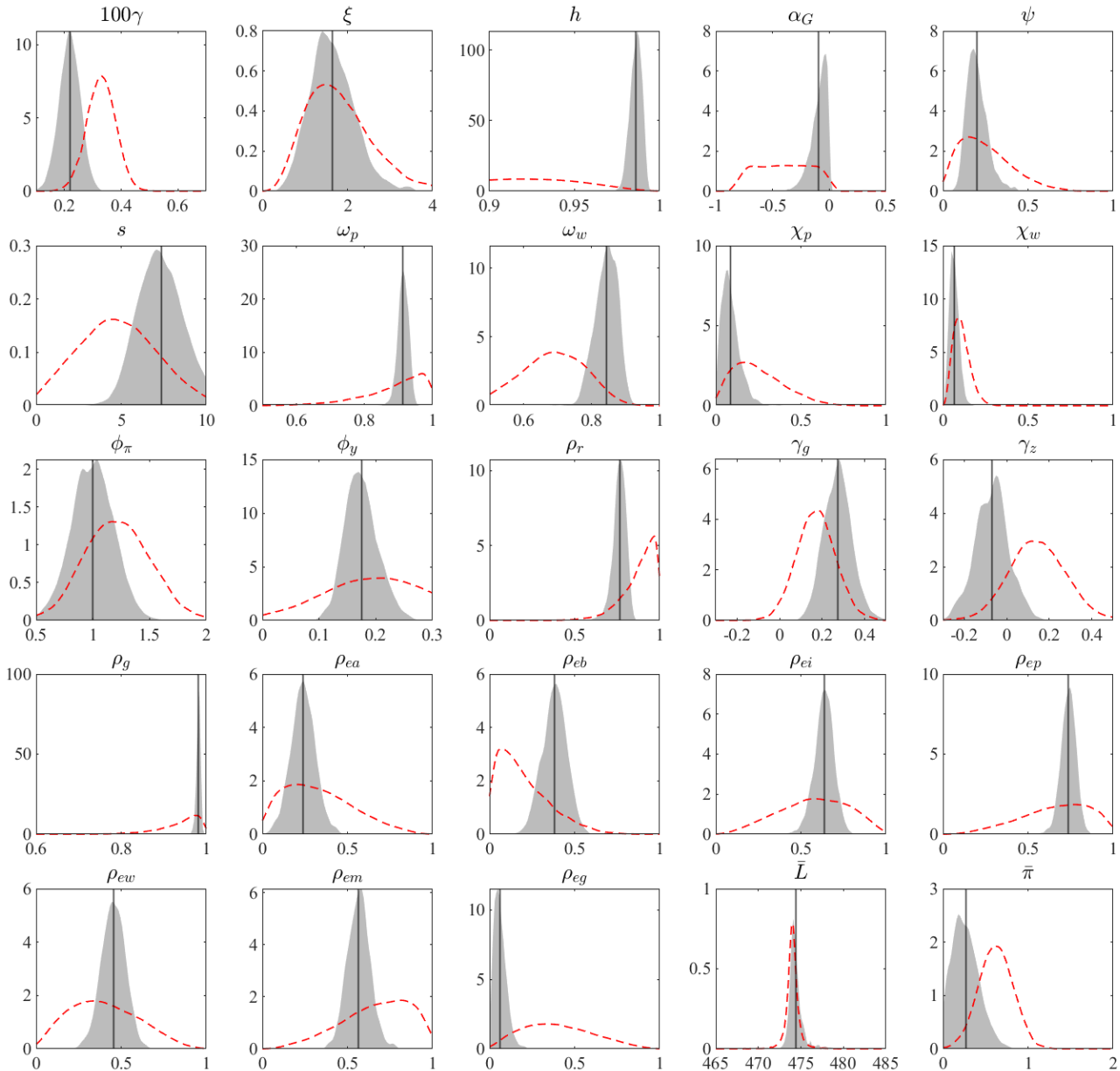


Figure 2: Marginal prior and posterior distributions of each structural parameter. Notes: Each panel compares the prior (red dashed line) with the posterior (shaded area). Vertical lines denote posterior means. The kernel smoothed posterior densities are estimated using 10,000 TaRB-MH draws.

### 3.2.4 Simulation Evidence

We also estimate the same high-dimensional DSGE model based on a simulated data set that is generated under fat-tailed shocks with  $\nu = 15$  degrees of freedom and persistent volatilities. We set the sample size to 200, which is meant to be 50 years of quarterly observations, and use the initial 50 observations to construct a training sample prior. Table A.1 of Appendix A lists the parameter values used for the

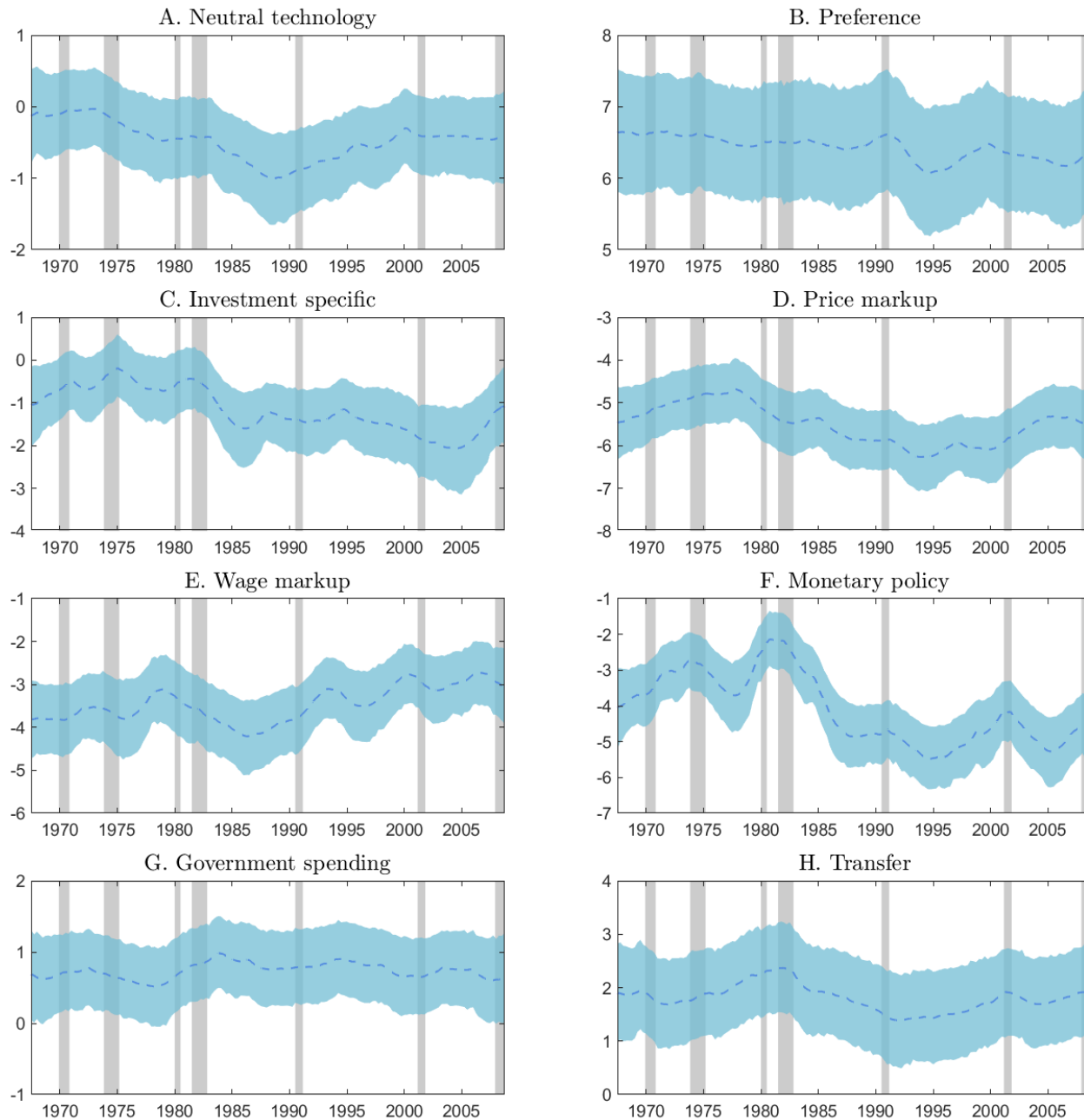


Figure 3: Stochastic volatility of each shock innovation. Notes: Blue dashed lines denote median estimates, while blue shaded areas delineate 90% highest posterior density bands. Vertical bars indicate recessions as designated by the National Bureau of Economic Research.

data generating process under regime-M (column ‘DGP’).<sup>10</sup> Figure A.3 provides a graphical comparison of priors and posteriors. For most parameters, the posterior mass concentrates around the corresponding true value. Figure A.4 further reveals that the estimated log-volatility series largely captures the level and

<sup>10</sup>The DGPs for the structural parameters correspond to their full sample (1955:Q1–2014:Q2) regime-M estimates reported in Leeper, Traum and Walker (2017).

all major trends of the true series for each shock innovation. These plots are relegated to Appendix A.

### 3.3 Marginal Likelihood

Given the output of the efficient TaRB-MH algorithm, we suggest calculating the marginal likelihood by the method of Chib (1995), as modified for M-H chains in Chib and Jeliazkov (2001). This method is implemented in the program `tarb_reduce.m`. We show the use of the marginal likelihoods in comparing regime-M with Student- $t$  shocks with regime-F with stochastic volatility. Other models could be of interest as we discuss below.

Recall that the marginal likelihood is the quantity

$$m(y_{1:T}|\mathcal{M}) = \frac{1}{c} \int f(y_{1:T}|\mathcal{M}, \theta) \cdot \pi(\theta|\mathcal{M}) \cdot \mathbb{1}\{\theta \in \Theta_D\} d\theta$$

where  $\mathcal{M}$  denotes the model label and  $c = \int_{\theta \in \Theta_D} \pi(\theta|\mathcal{M}) d\theta$ . In the Chib (1995) approach, this is computed via the identity

$$m(y_{1:T}|\mathcal{M}) = \frac{\frac{1}{c} f(y_{1:T}|\mathcal{M}, \theta) \cdot \pi(\theta|\mathcal{M}) \cdot \mathbb{1}\{\theta \in \Theta_D\}}{\pi(\theta|\mathcal{M}, y_{1:T})}$$

where the right-hand-side terms are evaluated at a single high density point  $\theta^*$ . We obtain the likelihood ordinate by a mixture version of the Kalman filter introduced by Chen and Liu (2000), as facilitated by the conditionally Gaussian and linear structure of the DSGE model solution. In our application, we find that 10,000 particles are sufficient to deliver a robust estimate of  $f(y_{1:T}|\mathcal{M}, \theta^*)$ . We obtain the high-dimensional ordinate in the denominator after decomposing it as

$$\pi(\theta^*|\mathcal{M}, y_{1:T}) = \pi(\theta_1^*|\mathcal{M}, y_{1:T}) \cdot \pi(\theta_2^*|\mathcal{M}, y_{1:T}, \theta_1^*) \cdots \pi(\theta_B^*|\mathcal{M}, y_{1:T}, \theta_1^*, \dots, \theta_{B-1}^*)$$

where  $B$  refers to the number of blocks (that is under our control), and then estimate each of these reduced ordinates from the MCMC output of reduced runs (see Chib (1995) and Chib and Jeliazkov (2001) for further details).

An interesting point is that these reduced runs are independent of each other and can be done in parallel. Thus, all reduced ordinates can be estimated at the cost of one reduced run, regardless of the size of  $B$ . This parallel computation is built into our MATLAB package. In our application, we set the total number of blocks to  $B = 15$ , including seven almost equally sized blocks for  $\theta^S$  arranged first, followed by eight blocks  $(\mu_s, \phi_s, \omega_s^2)$ ,  $s \in \{a, b, i, p, w, m, g, z\}$ , for  $\theta^V$ . All ordinates are then simultaneously estimated using MATLAB's multi-core processing capacity via its Parallel Computing Toolbox.

## 3.3.1 Reliability

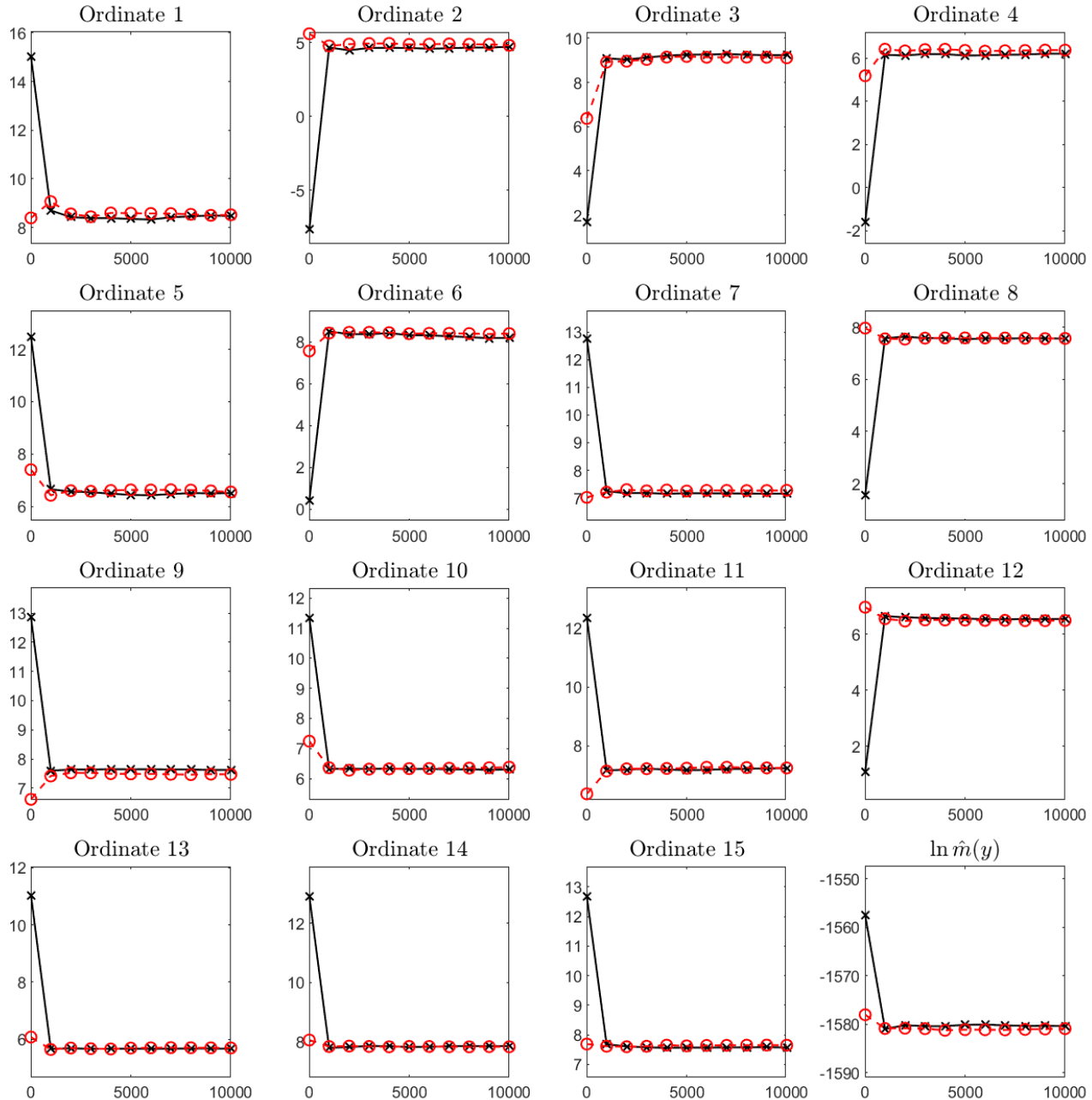


Figure 4: Recursive posterior ordinates and marginal likelihood. Notes: Ordinates 1–7 (8–15) correspond to structural (volatility) parameters. The last panel depicts the estimated marginal likelihood. Black solid lines (with cross marker) correspond to the benchmark setting ( $p = 0.7$ ,  $\omega = 0.5$ ). All estimates are in logarithm scale.

We recommend the Chib and Jeliazkov (2001) method because it is reliable and because other methods do not generalize to our large-scale DSGE models with non-Gaussian and/or nonlinear latent variables.<sup>11</sup>

<sup>11</sup>For instance, the modified harmonic mean (MHM) estimator of Gelfand and Dey (1994), used, for example, in Justiniano and Primiceri (2008) and Cúrdia, Del Negro and Greenwald (2014) in medium-scale DSGE models with Student- $t$  shocks

As shown in Chib and Ramamurthy (2010), efficient MCMC estimation automatically delivers an efficient estimate of the conditional posterior ordinate  $\pi(\theta_b, \dots, \theta_B, z_{1:T} | \mathcal{M}, y_{1:T}, \theta_1^*, \dots, \theta_{b-1}^*)$  from the output of the reduced MCMC simulation in which  $\theta_b$  is a fixed block and the remaining structural parameters, if any, form random blocks.<sup>12</sup> Figure 4 displays the sequence of posterior ordinate and marginal likelihood estimates from the best fit model, as functions of the number of MCMC draws, for efficient and (relatively) less efficient TaRB-MH implementations. These estimates settle down quickly (after say 1,000 draws are made) and converge to the same limit point, leading to an estimated log marginal likelihood of about  $-1579.65$  with a numerical standard error of about 0.12. This underscores the point that, since the Chib (1995) method is underpinned by whatever MCMC algorithm is used in the posterior simulation, the efficiency of the MCMC simulator is germane to the calculation of the marginal likelihood.

### 3.3.2 Regime Comparison

Because regimes M and F of the Leeper, Traum and Walker (2017) model imply completely different mechanisms for price level determination and therefore different policy advice, identifying which monetary-fiscal regime produced the real data is key to making good policy choices. While it is difficult to explore the entire model space, we perform extensive regime comparisons by estimating the marginal likelihood for both regimes with four choices of  $\nu \in \{2.1, 5, 15, 30\}$  and three choices of  $\phi_s \in \{0.1, 0.5, 0.95\}$ ,  $s \in \{a, b, i, p, w, m, g, z\}$ . The resulting model space contains a total of 24 relevant models that are simultaneously confronted with the data over the period from 1967:Q3 to 2008:Q4, similar in spirit to the Bayesian model scan framework proposed by Chib and Zeng (2019).<sup>13</sup>

Two aspects of the marginal likelihood estimates reported in Table 1 are worth highlighting. First, the data systematically prefer regime-M over regime-F in all cases, which corroborates the regime ranking found by Leeper, Traum and Walker (2017) with Gaussian shocks and constant volatility.<sup>14</sup> The small numerical standard errors point to the numerical accuracy of the marginal likelihood estimates. Second, reading the table by row (column) for each regime suggests that the data exhibit quite strong evidence in favor of heavy-tailed shocks (persistent volatility process). Indeed, each feature is important for improving

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and stochastic volatility, always favors a model specification with stronger latent features, e.g., shocks with fatter tails or volatilities with more persistence. This extreme result emerges even when the true model exhibits weak evidence of these features, such as those considered in Section 3.3.3.

<sup>12</sup>In contrast, Justiniano and Primiceri (2008, p. 636) and Herbst and Schorfheide (2016, p. 97) estimate the posterior ordinate in a single block, with the random-walk M-H, both detrimental to getting reliable and efficient marginal likelihood estimates, as already documented in Chib and Jeliazkov (2001).

<sup>13</sup>All computations performed in this section are executed on the High Performance Computing Cluster maintained by Saint Louis University (<https://sites.google.com/a/slu.edu/atg/home>).

<sup>14</sup>We also find the reversed regime ranking with the inclusion of the recent financial crisis sample, a period of nearly zero policy rate and unprecedented fiscal stimulus that regime-F policy rules embody. See Section 4 for more details.



Table 1: Log marginal likelihood estimates

$\nu$	$\phi_s = 0.1$ (weak)		$\phi_s = 0.5$ (moderate)		$\phi_s = 0.95$ (strong)	
	M	F	M	F	M	F
30 (light)	-1640.73 (0.15)	-1650.03 (0.15)	-1627.24 (0.14)	-1638.81 (0.15)	-1597.72 (0.12)	-1609.69 (0.13)
15 (fat)	-1622.26 (0.14)	-1631.66 (0.14)	-1612.62 (0.13)	-1624.22 (0.13)	-1586.70 (0.12)	-1596.68 (0.13)
5 (heavy)	-1605.77 (0.15)	-1616.95 (0.14)	-1600.18 (0.14)	-1611.05 (0.13)	-1579.65 (0.12)	-1593.11 (0.12)
2.1 (heavy)	-1622.31 (0.15)	-1629.38 (0.15)	-1618.37 (0.14)	-1630.84 (0.12)	-1602.76 (0.11)	-1615.60 (0.12)

NOTES: Numerical standard errors are reported in parentheses. All estimates are obtained using 15 reduced TaRB-MH runs under the benchmark setting ( $p = 0.7$ ,  $\omega = 0.5$ ), including 7 runs for the structural parameters and 8 runs for the volatility parameters. 10,000 posterior draws are made for each reduced run.

Table 2: Number of picks for each model specification

$\nu$	DGP 1: regime-M with $\nu = 15$		DGP 2: regime-F with $\phi = 0.5$		
	regime-M	regime-F	$\phi$	regime-M	regime-F
30 (light)	4	0	0.1 (weak)	0	9
15 (fat)	15	0	0.5 (moderate)	0	10
5 (heavy)	1	0	0.9 (strong)	0	1

NOTES: The shock innovations have constant volatility under DGP 1 and follow Gaussian distribution under DGP 2. The number of simulations performed for each DGP is 20.

the fit, even after accounting for the other, and the model that fits best is regime-M with  $\nu = 5$  and  $\phi_s = 0.95$ .

### 3.3.3 Simulation Evidence

This section furnishes additional evidence that demonstrates the reliability of the Chib (1995) method. For each regime, we generate 20 data sets of 100 quarterly observations using the subsample parameter estimates reported in Leeper, Traum and Walker (2017), which are also reproduced in Table A.3 of Appendix A. We then estimate three versions of each regime model that differ in the volatility specification. Based on the marginal likelihood estimates, we count the number of times that each of the six regime-volatility specifications is picked across the 20 simulated data sets. Table 2 summarizes the simulation results.

The first data generating process assumes that regime-M is in place and the shock innovations follow a multivariate Student- $t$  distribution with fat tails, i.e.,  $\nu = 15$ , and constant volatility. For each regime, we fit the model with three degrees of freedom:  $\nu = 30$  (light),  $\nu = 15$  (fat), and  $\nu = 5$  (heavy). As can be seen from the left panel of Table 2, the correct degrees of freedom in 15 times. The correct policy regime is always picked.<sup>15</sup>

The second data generating process assumes that regime-F is in place and the shock innovations follow a multivariate Gaussian distribution with moderate time-varying volatility, i.e.,  $\phi_s = 0.5$  for  $s \in \{a, b, i, p, w, m, g, z\}$ . For each regime, we fit the model with three degrees of persistence in volatility:  $\phi_s = 0.1$  (weak),  $\phi_s = 0.5$  (moderate), and  $\phi_s = 0.9$  (strong). As shown in the right panel of Table 2, with only one exception, the data overwhelmingly favor weak to moderate degree of persistence in volatility under the true regime, which is preferred by all data sets over the alternative regime.<sup>16</sup>

## 4 Prediction

Because a good understanding of the current and future state of the economy is essential to develop and implement sound economic policies, generating a predictive distribution for the future path of the economy constitutes an important part of the policy analysis. To facilitate this goal, our toolbox also produces, as a byproduct of the efficient TaRB-MH algorithm and the marginal likelihood computation by the Chib (1995) method, the joint predictive distribution for all observable variables at any forecasting horizon. For illustration purposes, Section 4.1 presents such a predictive distribution based on the best fitting model that is selected by the marginal likelihood comparison. Using the predictive distribution for wages as an example, Section 4.2 highlights the importance of allowing for non-Gaussian structural shocks with time-varying variances in the context of out-of-sample prediction. Finally, Section 4.3 evaluates the predictive performance by comparing the accuracy of point and density forecasts between a small-scale DSGE model and our high-dimensional DSGE model.

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<sup>15</sup>Although not reported here, we have also computed the marginal likelihood by the MHM method as implemented in Justiniano and Primiceri (2008). Using a larger set of grid points for  $\nu$ , we find that nearly all data sets favor the lowest value of  $\nu$ . On the other hand, the computation based on the Chib (1995) method continues to find the correct value of  $\nu$ .

<sup>16</sup>Like the case of regime-M with Student- $t$  shocks, the computation based on the MHM method always overestimates the importance of stochastic volatility and selects  $\phi_s = 0.9$ . This result emerges despite the fact that all data sets are relatively short-lived and generated by a model with ‘close’ to constant volatility process.

## 4.1 Sampling the Predictive Distribution

Let  $y_{1:T}$  be the data used to perform estimation, inference, and model selection. In addition, denote  $y_{T+1:T+h}$  the future path of the observables in the model economy. Then the predictive distribution is defined as

$$p(y_{T+1:T+h}|y_{1:T}) = \int p(y_{T+1:T+h}|y_{1:T}, \theta) \cdot p(\theta|y_{1:T})d\theta$$

where the above integration is numerically approximated by first sampling the posterior  $p(\theta|y_{1:T})$  a large number of times by the TaRB-MH algorithm and then simulating a future path  $y_{T+1:T+h}^{(g)}$  for each parameter draw. This amounts to moving model variables forward with  $\theta$  and  $y_{1:T}$ . We call  $p(y_{i,T+h}|y_{1:T})$  the  $h$ -step-ahead predictive distribution for the  $i$ th variable generated in period  $T$ .

Now we generate the one-quarter-ahead predictive distribution for all eight observables based on the best fitting model as measured by the marginal likelihood. Throughout the entire forecasting horizon, this model operates under regime-M model and has Student- $t$  shocks with stochastic volatilities. The first predictive distribution is generated using observations from the third quarter of 1967 to the fourth quarter of 2008, which is about six months before the Business Cycle Dating Committee of the National Bureau of Economic Research announces the end of the Great Recession. The forecasting horizon starts from the first quarter of 2009 and ends at the second quarter of 2014, covering the whole economic recovery period from the Great Recession. Figure 5 displays the median forecasts with 90% credible bands computed from the predictive distribution of regime-M over the full forecasting horizon. Overall the model performs quite well in tracking the recovery path of most observables.

## 4.2 Importance of Non-Gaussian Shocks

As the marginal likelihood comparison reveals, one needs a flexible way to model structural shocks in the model economy to explain the U.S. macroeconomic variables. The need of flexible distributional assumptions, such as Student- $t$  shocks with stochastic volatility, can also be seen from our generated predictive densities as well. The left panel of Figure 6 plots the 90% credible sets for wages based on two predictive distributions: one under Gaussian shocks with constant variance and another under Student- $t$  shocks with time-varying variance. It is noticeable that the uncertainty bands are much wider for the model under Student- $t$  shocks with time-varying variance. To understand this stark difference, the right panel of Figure 6 plots the time series of wages over the full sample. As pointed out by Champagne and Kurmann (2013), wages in the U.S. have become more volatile over the past 20 years. For example, the standard deviation of wages was 0.55 between 1955:Q1 and 1999:Q4, and 1.05 between 2000:Q1 and

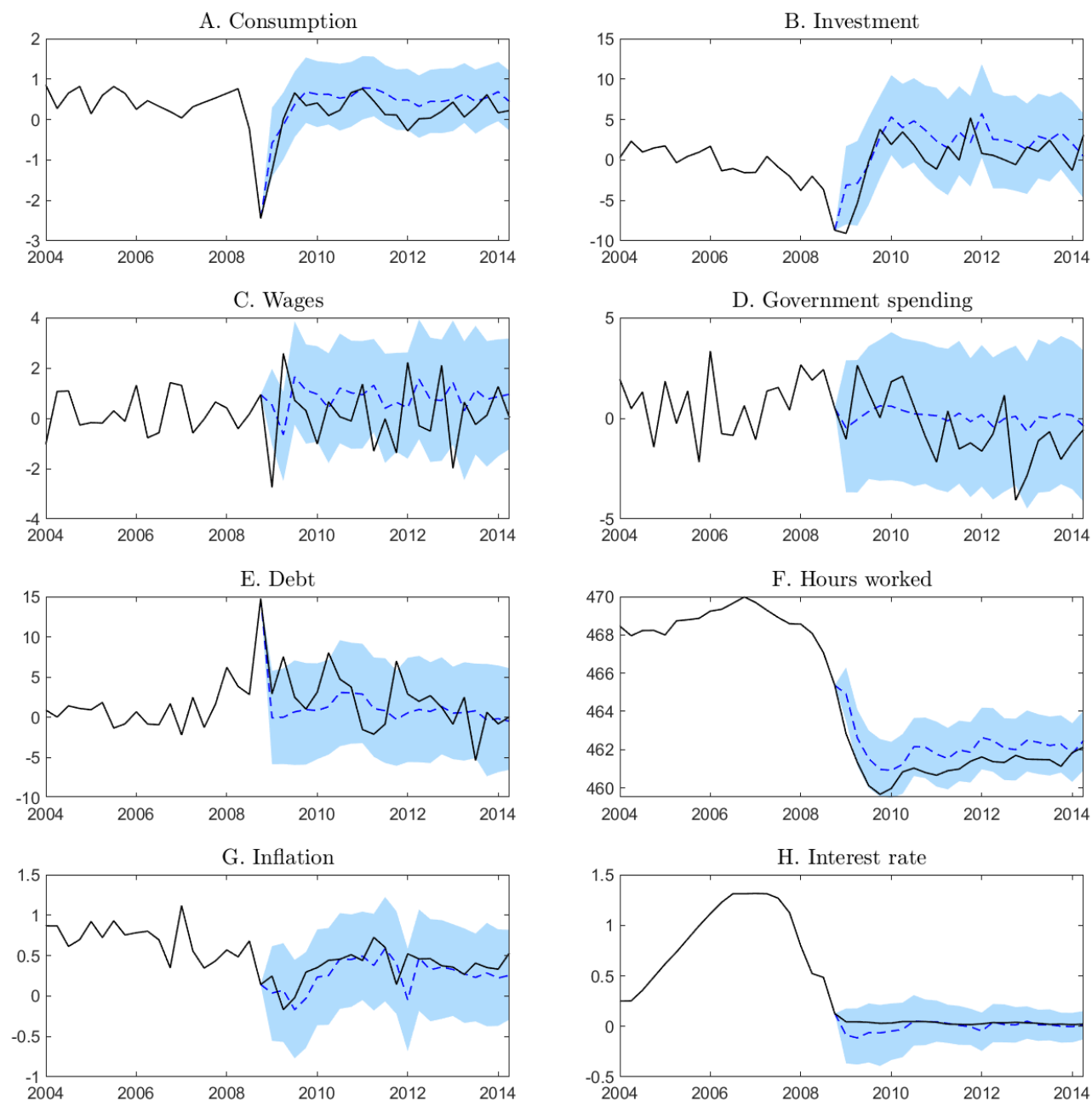


Figure 5: DSGE-model forecast of each observable. Notes: Each panel compares the one-quarter-ahead posterior forecast of regime M with real data (black solid lines). Blue dashed lines denote median forecasts, while blue shaded areas delineate 90% highest predictive density bands.

2014:Q2. The heightened volatility of wages after 2000 is captured by the model with stochastic volatility, which adaptively widens the predictive distribution for wages. On the other hand, the model with constant variance misses this important change in volatility. In turn, its predictive distribution of wages is too narrow, underestimating the uncertainty in the future path of wages. In general, allowing for time-varying volatility produces similar improvements in the quality of DSGE-based interval and density forecasts

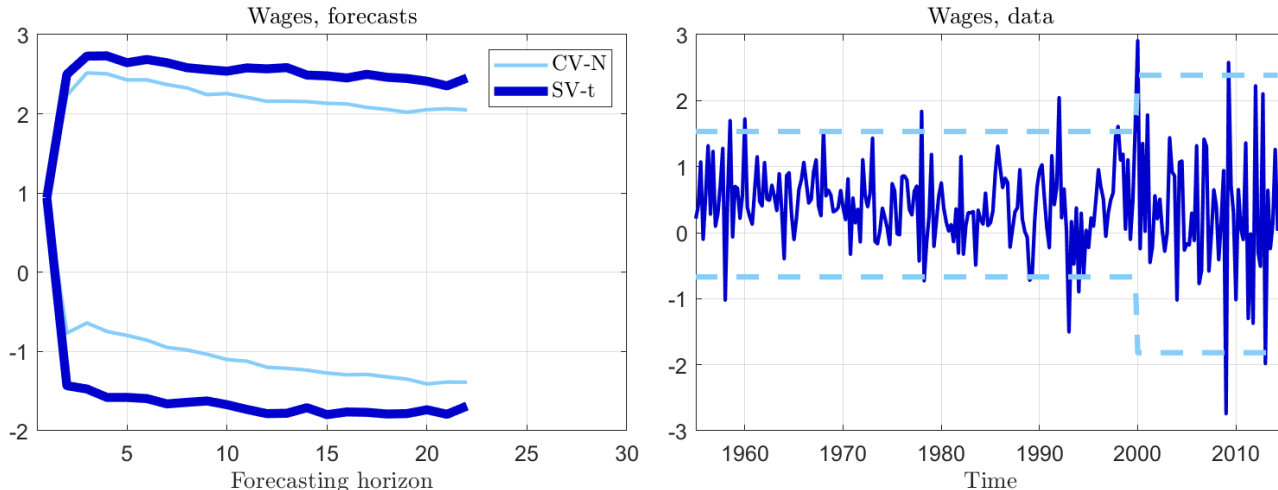


Figure 6: Predictive distribution and data for wages. Notes: Predictive distributions are constructed using data up to 2008:Q4. The one-step-ahead prediction corresponds to 2009:Q1. The left panel plots 90% prediction intervals of regime-M under Gaussian shocks with constant variance (labeled ‘CV-N’, thick line) and Student- $t$  shocks with time-varying variance (labeled ‘SV-t’, thin line). The right panel plots the time series of wages (solid line). Dashed lines delineate two standard deviations from the mean for two sub-samples, i.e., pre- and post-2000.

(see, e.g., Diebold, Schorfheide and Shin (2017)). Thus, we expect that our toolbox, by making it easy to incorporate non-Gaussian errors and time-varying variances, will be useful for researchers and policymakers interested in better out-of-sample performance of DSGE models.

### 4.3 Predictive Performance Comparison

Although regime-M yields a higher marginal likelihood relative to regime-F, one may still be interested in knowing how the two policy regimes compare in terms of the quality of point and density forecasts over the forecasting horizon. It is also interesting to compare the forecasts from a medium-scale DSGE model with those from a small-scale one when both models are equipped with Student- $t$  shocks and stochastic volatility. Specifically, we compare the point and density forecasts generated from regimes M and F, and a small-scale DSGE model described in Appendix C. Starting from the first quarter of 2009, we recursively estimate the three models and generate one-quarter-ahead to two-year-ahead point and density forecasts until the second quarter of 2014, which results in 22 quarters of evaluation points for the one-quarter-ahead prediction. Since the small-scale model contains fewer observables, our evaluation exercise only considers the common set of observables: consumption growth, inflation rate, and federal funds rate. The aim of this comparison is to get information about the strengths and weaknesses of DSGE model elaborations.

In each model, for each observable and forecasting horizon, the point prediction is the mean of the corresponding predictive distribution. Let  $\hat{y}_{i,t+h|t}$  denote the  $h$ -step-ahead point prediction for the  $i$ th

Table 3: Point forecast comparison, RMSE

Model	$h = 1Q$	$h = 2Q$	$h = 4Q$	$h = 8Q$
(a) Consumption growth				
Small-scale	0.32	0.28	0.25	0.28
Regime-M	0.44 (0.06)	0.48 (0.20)	0.50 (0.22)	0.48 (0.12)
Regime-F	0.40 (0.23)	0.39 (0.16)	0.36 (0.38)	0.37 (0.11)
(b) Inflation rate				
Small-scale	0.26	0.32	0.46	0.58
Regime-M	0.24 (0.40)	0.28 (0.31)	0.37 (0.12)	0.44 (0.04)
Regime-F	0.34 (0.00)	0.53 (0.08)	0.86 (0.10)	1.14 (0.14)
(c) Federal funds rate				
Small-scale	0.21	0.38	0.64	0.94
Regime-M	0.06 (0.00)	0.12 (0.01)	0.19 (0.01)	0.42 (0.01)
Regime-F	0.06 (0.00)	0.12 (0.02)	0.18 (0.02)	0.22 (0.01)

NOTES: Each entry reports the RMSE based on the point forecast with the  $p$ -value of Diebold-Mariano (DM) tests of equal MSE in parentheses, obtained using the fixed- $b$  critical values. The standard errors entering the DM statistics are computed using the equal-weighted cosine transform (EWC) estimator with the truncation rule recommended by Lazarus et al. (2018).

variable generated at time  $t$ . To compare the quality of point forecasts, we report the root mean squared error (RMSE) for the point prediction

$$\text{RMSE}(\hat{y}_{i,t+h|t}, y_{i,t+h}) = \sqrt{\frac{1}{22-h} \sum_{t=2009:Q1}^{2014:Q2-h} (y_{i,t+h} - \hat{y}_{i,t+h|t})^2}$$

where 2014:Q2- $h$  denotes  $h$ -quarters before 2014:Q4 and  $y_{i,t+h}$  is the actual value for the  $i$ th variable at time  $t+h$ . The model with a smaller RMSE is preferred as the smaller forecast error is desirable. To compare the precision of predictive densities, we compute the continuous ranked probability score (CRPS), which is defined as

$$\text{CRPS}(F_{i,t+h|t}(z), y_{i,t+h}) = \int_{\mathbb{R}} (F_{i,t+h|t}(z) - 1\{y_{i,t+h} \leq z\})^2 dz$$

where  $F_{i,t+h|t}(z)$  is the  $h$ -step-ahead predictive cumulative distribution of the  $i$ th variable generated at time  $t$ . The CRPS is one of the proper scoring rules, and the predictive distribution with a smaller CRPS

Table 4: Density forecast comparison, average CRPS

Model	$h = 1Q$	$h = 2Q$	$h = 4Q$	$h = 8Q$
(a) Consumption growth				
Small-scale	0.21	0.2	0.19	0.2
Regime-M	0.26 (0.08)	0.28 (0.28)	0.29 (0.31)	0.28 (0.20)
Regime-F	0.23 (0.40)	0.22 (0.41)	0.21 (0.72)	0.22 (0.46)
(b) Inflation rate				
Small-scale	0.15	0.18	0.26	0.34
Regime-M	0.14 (0.48)	0.17 (0.53)	0.23 (0.29)	0.28 (0.11)
Regime-F	0.20 (0.00)	0.31 (0.03)	0.52 (0.05)	0.69 (0.08)
(c) Federal funds rate				
Small-scale	0.13	0.24	0.43	0.67
Regime-M	0.04 (0.00)	0.07 (0.02)	0.13 (0.01)	0.27 (0.01)
Regime-F	0.04 (0.00)	0.07 (0.02)	0.12 (0.02)	0.19 (0.01)

NOTES: Each entry reports the average CRPS over the evaluation period with the  $p$ -value of Diebold-Mariano (DM) tests of equal CRPS in parentheses, obtained using the fixed- $b$  critical values. The standard errors entering the DM statistics are computed using the equal-weighted cosine transform (EWC) estimator with the truncation rule recommended by Lazarus et al. (2018).

is preferred as this measure can be viewed as the divergence between the given predictive distribution and the unattainable oracle predictive distribution that puts a probability mass only on the realized value. Tables 3 and 4 report the RMSE and average CRPS, respectively, of consumption growth, inflation rate, and federal funds rate based on all three models.

Forecasts from the medium-scale models are significantly more accurate for the federal funds rate at all horizons. On the other hand, forecasts from the small-scale model are more accurate for the consumption growth at all horizons although the difference is only statistically significant at the one-quarter-ahead horizon. The major difference between regimes M and F lies in the inflation forecasts, and the model under regime-M produces forecasts with lower RMSEs (CRPSs). The RMSE (CRPS) gaps get wider as the forecasting horizon extends, and the RMSE (CRPS) from regime-M becomes more than half of that from regime-F. In contrast, the forecasts from regime-F fare slightly better for the consumption growth at all horizons and are most accurate for the federal funds rate at the two-year-ahead horizon.

In sum, there is no clear winner in this comparison. The small-scale model performs better for fore-

casting the consumption growth. The medium-scale model, on the other hand, performs the best under regime-M for forecasting the inflation rate but does not generate better forecasts under regime-F except for forecasting the federal funds rate in the long run. Although the evaluation period is too short-lived to draw a definite conclusion, the results from this out-of-sample forecasting exercise indicate that there is still room for improvement even for the more complex models.

## 5 Concluding Remarks

We have given pointers on the fitting and comparison of high-dimensional DSGE models with latent variables and shown that the TaRB-MH algorithm of Chib and Ramamurthy (2010) allows for the efficient estimation of such models. We emphasize the importance of training sample priors, which is new in the DSGE context, and the use of the Student- $t$ , as opposed to the normal family, as the prior distribution for location-type parameters. In addition, we show that the method of Chib (1995) and Chib and Jeliazkov (2001), in conjunction with a parallel implementation of the required reduced MCMC runs, can be used to get reliable and fast estimates of the marginal likelihood. With the help of a user-friendly MATLAB package, these methods can be readily employed in academic and central bank applications to conduct DSGE model comparisons, impulse response and variance decomposition analyses, and to generate point and density forecasts. Finally, in ongoing work, we are applying this toolkit, without modification and any erosion in performance, to open economy DSGE models that contain more than twice as many parameters and latent variables as the model showcased in this paper. Findings from this analysis will be reported elsewhere.

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# Appendix

Siddhartha Chib, Minchul Shin, and Fei Tan

## Appendix A Leeper-Traum-Walker Model

### A.1 Equilibrium System

Since the economy features a stochastic trend induced by the permanent technology shock  $A_t$ , some variables are not stationary. To induce stationarity, we therefore detrend these variables as:  $y_t \equiv \frac{Y_t}{A_t}$ ,  $c_t^* \equiv \frac{C_t^*}{A_t}$ ,  $c_t \equiv \frac{C_t}{A_t}$ ,  $k_t \equiv \frac{K_t}{A_t}$ ,  $\bar{k}_t \equiv \frac{\bar{K}_t}{A_t}$ ,  $i_t \equiv \frac{I_t}{A_t}$ ,  $g_t \equiv \frac{G_t}{A_t}$ ,  $z_t \equiv \frac{Z_t}{A_t}$ ,  $b_t \equiv \frac{P_t^B B_t}{P_t A_t}$ ,  $w_t \equiv \frac{W_t}{P_t A_t}$ ,  $\lambda_t \equiv \Lambda_t A_t$ . The model's equilibrium system in terms of the detrended variables can be summarized as follows.

Production function:

$$y_t \Delta_t^p = k_t^\alpha (L_t^d)^{1-\alpha} - \Omega \quad (\text{A.1})$$

Capital-labor ratio:

$$\frac{k_t}{L_t^d} = \frac{w_t}{r_t^k} \frac{\alpha}{1-\alpha} \quad (\text{A.2})$$

Real marginal cost:

$$mc_t = (1-\alpha)^{\alpha-1} \alpha^{-\alpha} (r_t^k)^\alpha w_t^{1-\alpha} \quad (\text{A.3})$$

Intermediate goods producer's optimal price:

$$\mathbb{E}_t \left[ \sum_{k=0}^{\infty} (\beta \omega_p)^k \lambda_{t+k} \bar{y}_{t+k} \left( \pi_t^* \prod_{s=1}^k \left( \frac{\pi_{t+s-1}}{\pi} \right)^{\chi_p} \frac{\pi}{\pi_{t+s}} - (1 + \eta_{t+k}^p) mc_{t+k} \right) \right] = 0 \quad (\text{A.4})$$

Evolution of aggregate price index:

$$1 = (1 - \omega_p) (\pi_t^*)^{-\frac{1}{\eta_t^p}} + \omega_p \left[ \left( \frac{\pi_{t-1}}{\pi} \right)^{\chi_p} \frac{\pi}{\pi_t} \right]^{-\frac{1}{\eta_t^p}} \quad (\text{A.5})$$

Optimal consumption:

$$\lambda_t(1 + \tau_t^C) = \frac{u_t^b}{c_t^* - \theta c_{t-1}^* e^{-u_t^a}} \quad (\text{A.6})$$

Composite consumption:

$$c_t^* = c_t + \alpha_G g_t \quad (\text{A.7})$$

Consumption Euler equation:

$$\lambda_t = \beta R_t \mathbb{E}_t \left[ \frac{\lambda_{t+1} e^{-u_{t+1}^a}}{\pi_{t+1}} \right] \quad (\text{A.8})$$

Bond pricing relation:

$$P_t^B = \mathbb{E}_t \left[ \frac{1 + \rho P_{t+1}^B}{R_t} \right] \quad (\text{A.9})$$

Optimal capital utilization:

$$(1 - \tau_t^K) r_t^k = \psi'(v_t) \quad (\text{A.10})$$

Optimal physical capital:

$$q_t = \beta \mathbb{E}_t \left[ \frac{\lambda_{t+1}}{\lambda_t} e^{-u_{t+1}^a} \left( (1 - \tau_{t+1}^K) r_{t+1}^k v_{t+1} - \psi(v_{t+1}) + (1 - \delta) q_{t+1} \right) \right] \quad (\text{A.11})$$

where  $q_t$  is the real price of capital in terms of consumption goods (i.e., Tobin's Q).

Optimal investment:

$$1 = q_t \tilde{u}_t^i \left( 1 - S \left( \frac{i_t e^{u_t^a}}{i_{t-1}} \right) - S' \left( \frac{i_t e^{u_t^a}}{i_{t-1}} \right) \frac{i_t e^{u_t^a}}{i_{t-1}} \right) + \beta \mathbb{E}_t \left[ q_{t+1} \frac{\lambda_{t+1} e^{-u_{t+1}^a}}{\lambda_t} \tilde{u}_{t+1}^i S' \left( \frac{i_{t+1} e^{u_{t+1}^a}}{i_t} \right) \left( \frac{i_{t+1} e^{u_{t+1}^a}}{i_t} \right)^2 \right] \quad (\text{A.12})$$

Effective capital:

$$k_t = v_t \bar{k}_{t-1} e^{-u_t^a} \quad (\text{A.13})$$

Law of motion for capital:

$$\bar{k}_t = (1 - \delta)e^{-u_t^a} \bar{k}_{t-1} + \tilde{u}_t^i \left( 1 - S \left( \frac{i_t e^{u_t^a}}{i_{t-1}} \right) \right) i_t \quad (\text{A.14})$$

Optimal wage:

$$\mathbb{E}_t \left[ \sum_{k=0}^{\infty} (\beta \omega_w)^k \lambda_{t+k} \bar{L}_{t+k} \left( w_t^* \prod_{s=1}^k \left( \frac{\pi_{t+s-1} e^{u_{t+s-1}^a}}{\pi e^\gamma} \right)^{\chi_w} \frac{\pi e^\gamma}{\pi_{t+s} e^{u_{t+s}^a}} - \frac{(1 + \eta_{t+k}^w) u_{t+k}^b \bar{L}_{t+k}^\xi}{(1 - \tau_{t+k}^L) \lambda_{t+k}} \right) \right] = 0 \quad (\text{A.15})$$

where

$$\bar{L}_{t+k} = \left[ \frac{w_t^*}{w_{t+k}} \prod_{s=1}^k \left( \frac{\pi_{t+s-1} e^{u_{t+s-1}^a}}{\pi e^\gamma} \right)^{\chi_w} \frac{\pi e^\gamma}{\pi_{t+s} e^{u_{t+s}^a}} \right]^{-\frac{1 + \eta_{t+k}^w}{\eta_{t+k}^w}} L_{t+k}^d \quad (\text{A.16})$$

Evolution of aggregate wage index:

$$w_t^{-\frac{1}{\eta_t^w}} = (1 - \omega_w) (w_t^*)^{-\frac{1}{\eta_t^w}} + \omega_w \left[ \left( \frac{\pi_{t-1} e^{u_{t-1}^a}}{\pi e^\gamma} \right)^{\chi_w} \left( \frac{\pi e^\gamma}{\pi_t e^{u_t^a}} \right) w_{t-1} \right]^{-\frac{1}{\eta_t^w}} \quad (\text{A.17})$$

Government budget constraint:

$$b_t + \tau_t^K r_t^k k_t + \tau_t^L w_t L_t + \tau_t^C c_t = \frac{1 + \rho P_t^{PB}}{P_{t-1}^{PB}} \frac{b_{t-1}}{\pi_t e^{u_t^a}} + g_t + z_t \quad (\text{A.18})$$

Aggregate resource constraint:

$$y_t = c_t + i_t + g_t + \psi(v_t) \bar{k}_{t-1} e^{-u_t^a} \quad (\text{A.19})$$

## A.2 Steady States

To solve for the steady states, we calibrate  $\beta = 0.99$ ,  $\alpha = 0.33$ ,  $\delta = 0.025$ , the average maturity of government bond portfolio  $AD = 20$ ,  $\eta^w = \eta^p = 0.14$ ,  $g/y = 0.11$ ,  $b/y = 1.47$ ,  $\tau^C = 0.023$ ,  $\tau^K = 0.218$ , and  $\tau^L = 0.186$ . By assumption,  $v = 1$ ,  $\psi(v) = 0$ , and  $S(e^\gamma) = S'(e^\gamma) = 0$ . The remaining steady states can be solved as follows.

From  $AD$ :

$$\rho = \left( 1 - \frac{1}{AD} \right) \frac{1}{\beta} \quad (\text{A.20})$$

From (A.8):

$$R = \frac{e^\gamma \pi}{\beta} \quad (\text{A.21})$$

From (A.9):

$$P^B = \frac{\beta}{e^\gamma \pi - \rho \beta} \quad (\text{A.22})$$

From  $\tilde{u}^i = 1$  and (A.12):

$$q = 1 \quad (\text{A.23})$$

From (A.11):

$$r^k = \frac{\frac{e^\gamma}{\beta} - (1 - \delta)}{1 - \tau^K} \quad (\text{A.24})$$

From (A.10):

$$\psi'(1) = r^k (1 - \tau^K) \quad (\text{A.25})$$

From (A.4):

$$mc = \frac{1}{1 + \eta^p} \quad (\text{A.26})$$

From (A.3):

$$w = [mc(1 - \alpha)^{1-\alpha} \alpha^\alpha (r^k)^{-\alpha}]^{\frac{1}{1-\alpha}} \quad (\text{A.27})$$

From (A.2):

$$\frac{k}{L} = \frac{\alpha}{1 - \alpha} \frac{w}{r^k} \quad (\text{A.28})$$

From  $\Delta^p = 1$ , the final goods producer's zero profit condition, and (A.1):

$$\frac{\Omega}{L} = \left(\frac{k}{L}\right)^\alpha - r^k \frac{k}{L} - w \quad (\text{A.29})$$

From (A.29):

$$\frac{y}{L} = \left(\frac{k}{L}\right)^\alpha - \frac{\Omega}{L} \quad (\text{A.30})$$

From (A.13):

$$\bar{k} = ke^\gamma \quad (\text{A.31})$$

From (A.14):

$$\frac{i}{L} = [1 - (1 - \delta)e^{-\gamma}] e^\gamma \frac{k}{L} \quad (\text{A.32})$$

From (A.19):

$$\frac{c}{L} = \frac{y}{L} \left(1 - \frac{g}{y}\right) - \frac{i}{L} \quad (\text{A.33})$$

From (A.18):

$$\frac{z}{L} = \left[ \left(1 - \frac{R}{\pi e^\gamma}\right) \frac{b}{y} - \frac{g}{y} \right] \frac{y}{L} + \tau^C \frac{c}{L} + \tau^L w + \tau^K r^k \frac{k}{L} \quad (\text{A.34})$$

From (A.7):

$$\frac{c^*}{L} = \frac{c}{L} + \alpha_G \frac{g}{y} \frac{y}{L} \quad (\text{A.35})$$

From (A.15) and (A.17):

$$L = \left[ \frac{w(1 - \tau^L)}{(1 + \tau^C)(1 + \eta^w)} \frac{1}{(1 - \theta e^{-\gamma}) \frac{c^*}{L}} \right]^{\frac{1}{\xi+1}} \quad (\text{A.36})$$

from which all level variables can be calculated from the steady state ratios given above.

### A.3 Tables and Figures

- Table A.1 lists the marginal prior distributions and the true values for the high-dimensional DSGE model under regime-M.
- Table A.2 summarizes the posterior parameter estimates for the model of best fit.
- Table A.3 reproduces the subsample posterior parameter estimates reported in Leeper, Traum and



Walker (2017), which are used to generate the simulated data sets in Section 3.3.3.

- Figures A.1–A.2 display the autocorrelation function for each model parameter.
- Figures A.3–A.4 compare the model’s estimated parameters and volatilities with their true values, respectively.

## Appendix B Guide to MATLAB Package

We provide a library of numerical subroutines called ‘TaRB-t-SV’ that implements the TaRB-MH algorithm discussed in the main text. All of the subroutines are programmed in MATLAB or compiled as executable (MEX) functions. The MEX versions of these subroutines are included in the subfolders ‘mex/mac’ (for Mac OS users) and ‘mex/win’ (for Windows OS users) to improve computational time. The subfolder ‘utils’ contains various supporting packages that will be utilized by the main programs below.

The TaRB-MH algorithm can be broken down into a sequence of easily implementable steps. These steps can be executed with the following set of functions in the main folder ‘TaRB-t-SV’, which are extensively annotated:

- `tarb_demo.m`—main function that estimates one of the DSGE models specified under the subfolder ‘user’.
- `tarb_spec.m`—admits all user-specified optional settings for the TaRB-MH algorithm. Like MATLAB built-in functions, each setting is entered in as a string-value pair.
- `chain_init.m`—finds the posterior mode and its associated inverse Hessian matrix.
- `tarb_full.m`—implements the full MCMC run for parameter estimation.
- `tarb_reduce.m`—implements the reduced MCMC runs for marginal likelihood estimation.
- `readme.m`—displays general information about TaRB-t-SV.
- `test_bench.m`—preliminary DSGE model analysis.

The subfolder ‘user/ltw17’ contains the following files for the Leeper-Traum-Walker model, which can be modified as needed for alternative model specifications:

- `data.txt`—prepared in matrix form where each row corresponds to the observations for a given period.

- `user_parvar.m`—defines the model parameters, variables, shock innovations, forecast errors, and observables.
- `user_mod.m`—defines the model and measurement equations.
- `user_ssp.m`—defines the steady state, implied, and/or fixed parameters.
- `user_svp.m`—defines the stochastic volatility parameters.

To estimate the Leeper-Traum-Walker model with Student- $t$  shocks and stochastic volatility, for example, simply set the MATLAB current directory to the main folder ‘TaRB-t-SV’ and run the following blocks of code in `tarb_demo.m`.

1. Specify the model, data, and save directories and generate, if needed, the required MEX files that are compatible with the user machine.

```

%}
%% Housekeeping
clear
close all
clc
readme

%% User search path & mex files
modpath = ['user' filesep 'ltw17'];
datapath = ['user' filesep 'ltw17' filesep 'data.txt'];
savepath = ['user' filesep 'ltw17'];
spec = tarb_spec([], 'modpath', modpath, 'datapath', datapath, 'savepath', savepath);

OneFileToMexThemAll
%{

```

2. Find the posterior mode and evaluate the corresponding inverse of the Hessian matrix.

```

%}
%% Find posterior mode
sa_spec = optimoptions(@simulannealbnd, ... % simulated annealing
    'TemperatureFcn', @temperaturefast, ...
    'InitialTemperature', 2, ...
    'TolFun', 1e-3, ...
    'MaxTime', 10, ...
    'Display', 'iter', ...
    'DisplayInterval', 10);
dof = 5; % Shock degrees of freedom

```

```

spec = tarb_spec(spec, 'sdof', dof, 'sa', sa_spec);

chi = 0;           % tuning parameter
npd = 1000;       % number of prior draws
nopt = 2;        % number of optimizations
chain_init(chi, npd, nopt, spec)
%{

```

3. Sample the posterior distribution by the TaRB-MH algorithm of Chib and Ramamurthy (2010). The estimation results will be stored in the MATLAB data file `tarb_full.mat`, which is saved to the subfolder ‘user/ltw17’.

```

%}
%% MCMC (full run)
p = 0.7;          % blocking probability
w = 0.5;          % tailoring frequency
spec = tarb_spec(spec, 'prob', p, 'freq', w, 'sa', []);

M = 11000;        % number of draws including burn-in
burn = 1000;      % number of burn-in
tarb_full(M, burn, spec)
%{

```

4. Conditional on the estimated latent variables, find the posterior mode again and evaluate the corresponding inverse of the Hessian matrix.

```

%}
%% Find posterior mode again
load([savepath filesep 'tarb_full.mat'])

if exist('chain_lamb', 'var')
    lamb = mean(chain_lamb); % t shock: gamma precisions
    spec = tarb_spec(spec, 'lamb', lamb, 'sa', sa_spec);
end

if exist('chain_h', 'var')
    h = mean(chain_h, 3); % sv: log volatilities
    spec = tarb_spec(spec, 'h', h, 'sa', sa_spec);
end

chain_init(chi, npd, nopt, spec)
%{

```

5. Compute the marginal likelihood by the Chib (1995) and Chib and Jeliazkov (2001) method. The estimation results will be stored in the MATLAB data file `tarb_reduce.mat`, which is saved to the subfolder ‘user/lw17’.

```

%}
%% Marginal likelihood (reduced run)
spec = tarb_spec(spec, 'sa', []);

B = 7;           % number of blocks
tarb_reduce(M, burn, B, spec)
%{
    
```

## Appendix C Small-Scale DSGE Model

A log-linear approximation to the model’s equilibrium conditions around the steady state can be summarized as follows:

$$\text{Dynamic IS equation:} \quad \hat{c}_t = \mathbb{E}_t \hat{c}_{t+1} - \frac{1}{\tau} (\hat{R}_t - \mathbb{E}_t \hat{\pi}_{t+1} - \mathbb{E}_t \hat{z}_{t+1}) \quad (\text{C.1})$$

$$\text{New Keynesian Phillips curve:} \quad \hat{\pi}_t = \beta \mathbb{E}_t \hat{\pi}_{t+1} + \kappa \hat{c}_t \quad (\text{C.2})$$

$$\text{Monetary policy:} \quad \hat{R}_t = \rho_R \hat{R}_{t-1} + (1 - \rho_R) [\psi_1 \hat{\pi}_t + \psi_2 (\hat{c}_t + \hat{g}_t)] + \epsilon_{R,t} \quad (\text{C.3})$$

$$\text{Technology shock:} \quad \hat{z}_t = \rho_z \hat{z}_{t-1} + \epsilon_{z,t} \quad (\text{C.4})$$

$$\text{Government spending shock:} \quad \hat{g}_t = \rho_g \hat{g}_{t-1} + \epsilon_{g,t} \quad (\text{C.5})$$

Here  $\tau > 0$  is the coefficient of relative risk aversion,  $0 < \beta < 1$  is the discount factor,  $\kappa > 0$  is the slope of the new Keynesian Phillips curve,  $\psi_1 > 0$  and  $\psi_2 > 0$  are the policy rate responsive coefficients, and  $0 \leq \rho_R, \rho_z, \rho_g < 1$ . Moreover,  $c_t$  is the detrended consumption,  $\pi_t$  is the inflation between periods  $t - 1$  and  $t$ ,  $R_t$  is the nominal interest rate,  $z_t$  is an exogenous shock to the labor-augmenting technology that grows on average at the rate  $\gamma$ , and  $g_t$  is an exogenous government spending shock. Finally, the shock innovations  $\epsilon_t = [\epsilon_{R,t}, \epsilon_{z,t}, \epsilon_{g,t}]'$  follow a multivariate Student- $t$  distribution, i.e.,  $\epsilon_t \sim t_\nu(0, \Sigma_t)$ , where  $\Sigma_t = \text{diag}(e^{h_t})$  and each element of  $h_t = [h_t^R, h_t^z, h_t^g]'$  follows a stationary process

$$h_t^s = (1 - \phi_s) \mu_s + \phi_s h_{t-1}^s + \eta_t^s, \quad \eta_t^s \sim \text{N}(0, \omega_s^2), \quad s \in \{R, z, g\}. \quad (\text{C.6})$$

The model is estimated over three observables, including log difference of consumption, log inflation, and log nominal interest rate. The observables are linked to the model variables via the following measurement

equations,

$$\begin{bmatrix} \text{dIConst}_t \\ \text{IIInfl}_t \\ \text{IFedFunds}_t \end{bmatrix} = \begin{bmatrix} \gamma^{(Q)} \\ \pi^{(Q)} \\ \pi^{(Q)} + r^{(Q)} + \gamma^{(Q)} \end{bmatrix} + \begin{bmatrix} \hat{c}_t - \hat{c}_{t-1} + \hat{z}_t \\ \hat{\pi}_t \\ \hat{R}_t \end{bmatrix} \quad (\text{C.7})$$

where  $(\gamma^{(Q)}, \pi^{(Q)}, r^{(Q)})$  are connected to the model's steady states via  $\gamma = 1 + \gamma^{(Q)}/100$ ,  $\beta = 1/(1 + r^{(Q)}/100)$ , and  $\pi = 1 + \pi^{(Q)}/100$ . Table A.4 lists the marginal prior distributions for the small-scale DSGE model parameters.

Table A.1: Priors and true values for high-dimensional DSGE model parameters

Structural parameters			Volatility parameters		
Name	Density (1, 2)	DGP	Name	Density (1, 2)	DGP
$100\gamma$	$\mathbb{N}(0.40, 0.05)$	0.25	$\mu_a$	$t_\nu(-7.0, 2.0)$	-4.6
$\xi$	$\mathbb{G}(2.00, 0.50)$	1.77	$\mu_b$	$t_\nu(-7.0, 2.0)$	-4.6
$h$	$\mathbb{B}(0.50, 0.20)$	0.99	$\mu_i$	$t_\nu(-7.0, 2.0)$	-4.6
$\alpha_G$	$\mathbb{U}(-1.75, 1.75)$	-0.25	$\mu_p$	$t_\nu(-7.0, 2.0)$	-4.6
$\psi$	$\mathbb{B}(0.60, 0.15)$	0.16	$\mu_w$	$t_\nu(-7.0, 2.0)$	-4.6
$s$	$\mathbb{N}(6.00, 1.50)$	5.46	$\mu_m$	$t_\nu(-7.0, 2.0)$	-4.6
$\omega_p$	$\mathbb{B}(0.50, 0.20)$	0.92	$\mu_g$	$t_\nu(-7.0, 2.0)$	-4.6
$\omega_w$	$\mathbb{B}(0.50, 0.20)$	0.91	$\mu_z$	$t_\nu(-7.0, 2.0)$	-4.6
$\chi_p$	$\mathbb{B}(0.50, 0.20)$	0.06	$\phi_a$	$\mathbb{B}(0.95, 0.01)$	0.99
$\chi_w$	$\mathbb{B}(0.50, 0.20)$	0.18	$\phi_b$	$\mathbb{B}(0.95, 0.01)$	0.99
$\phi_\pi$ , regime-M	$\mathbb{N}(1.50, 0.20)$	0.90	$\phi_i$	$\mathbb{B}(0.95, 0.01)$	0.99
$\phi_\pi$ , regime-F	$\mathbb{B}(0.50, 0.15)$	n/a	$\phi_p$	$\mathbb{B}(0.95, 0.01)$	0.99
$\phi_y$	$\mathbb{N}(0.125, 0.05)$	0.10	$\phi_w$	$\mathbb{B}(0.95, 0.01)$	0.99
$\rho_r$	$\mathbb{B}(0.50, 0.20)$	0.71	$\phi_m$	$\mathbb{B}(0.95, 0.01)$	0.99
$\gamma_g$ , regime-M	$\mathbb{N}(0.15, 0.10)$	0.26	$\phi_g$	$\mathbb{B}(0.95, 0.01)$	0.99
$\gamma_z$ , regime-M	$\mathbb{N}(0.15, 0.10)$	-0.11	$\phi_z$	$\mathbb{B}(0.95, 0.01)$	0.99
$\rho_g$	$\mathbb{B}(0.50, 0.20)$	0.98	$\omega_a^2$	$\mathbb{IG-2}(2.00, 0.05)$	0.10
$\rho_z$ , regime-F	$\mathbb{B}(0.50, 0.20)$	n/a	$\omega_b^2$	$\mathbb{IG-2}(2.00, 0.05)$	0.10
$\rho_{ea}$	$\mathbb{B}(0.50, 0.20)$	0.23	$\omega_i^2$	$\mathbb{IG-2}(2.00, 0.05)$	0.10
$\rho_{eb}$	$\mathbb{B}(0.50, 0.20)$	0.40	$\omega_p^2$	$\mathbb{IG-2}(2.00, 0.05)$	0.10
$\rho_{ei}$	$\mathbb{B}(0.50, 0.20)$	0.69	$\omega_w^2$	$\mathbb{IG-2}(2.00, 0.05)$	0.10
$\rho_{ep}$	$\mathbb{B}(0.50, 0.20)$	0.74	$\omega_m^2$	$\mathbb{IG-2}(2.00, 0.05)$	0.10
$\rho_{ew}$	$\mathbb{B}(0.50, 0.20)$	0.18	$\omega_g^2$	$\mathbb{IG-2}(2.00, 0.05)$	0.10
$\rho_{em}$	$\mathbb{B}(0.50, 0.15)$	0.39	$\omega_z^2$	$\mathbb{IG-2}(2.00, 0.05)$	0.10
$\rho_{eg}$	$\mathbb{B}(0.50, 0.15)$	0.13			
$\rho_{ez}$ , regime-F	$\mathbb{B}(0.50, 0.15)$	n/a	Fixed parameters		
$\bar{L}$	$\mathbb{N}(468, 5.00)$	481.12	Regime-M: $\rho_z = 0.98, \rho_{ez} = 0.80$		
$\bar{\pi}$	$\mathbb{N}(0.75, 0.25)$	0.60	Regime-F: $\gamma_g = \gamma_z = 0$		

NOTES: Density (1, 2) refer to Gamma ( $\mathbb{G}$ ), Normal ( $\mathbb{N}$ ), Beta ( $\mathbb{B}$ ), and Student- $t_\nu$  ( $\nu = 2.1$  degrees of freedom) distributions with means and standard deviations indicated in parentheses; Uniform ( $\mathbb{U}$ ) distribution with lower and upper bounds; Inverse-Gamma type-1 ( $\mathbb{IG-1}$ ) distribution with parameters  $\nu$  and  $s$ , where  $p(\sigma)\alpha\sigma^{-\nu-1}\exp(-\frac{\nu s^2}{2\sigma^2})$ ; Inverse-Gamma type-2 ( $\mathbb{IG-2}$ ) distribution with parameters  $\alpha$  and  $\beta$ , where  $p(\omega^2)\alpha(\omega^2)^{-\alpha-1}\exp(-\frac{\beta}{\omega^2})$ . The effective priors are truncated at the boundary of the determinacy region.

Table A.2: Posterior summary of DSGE model parameters

Structural parameters				Volatility parameters			
Name	Mean	90% HPD	Ineff	Name	Mean	90% HPD	Ineff
$100\gamma$	0.22	[0.16, 0.28]	4.4	$\mu_a$	-0.33	[-0.74, 0.08]	4.9
$\xi$	1.65	[0.77, 2.41]	12.3	$\mu_b$	6.41	[5.73, 7.06]	69.0
$h$	0.99	[0.98, 0.99]	103.6	$\mu_i$	-0.93	[-1.56, -0.35]	5.8
$\alpha_G$	-0.09	[-0.19, -0.00]	5.2	$\mu_p$	-5.55	[-6.02, -5.04]	9.9
$\psi$	0.20	[0.11, 0.29]	9.0	$\mu_w$	-3.63	[-4.27, -2.98]	13.7
$s$	7.35	[5.14, 9.57]	6.2	$\mu_m$	-4.59	[-5.46, -3.76]	2.7
$\omega_p$	0.91	[0.89, 0.94]	20.9	$\mu_g$	0.79	[0.45, 1.18]	5.1
$\omega_w$	0.84	[0.79, 0.89]	13.6	$\mu_z$	1.78	[1.09, 2.46]	43.0
$\chi_p$	0.09	[0.01, 0.16]	6.3	$\phi_a$	0.95	[0.94, 0.97]	2.0
$\chi_w$	0.07	[0.02, 0.11]	3.4	$\phi_b$	0.95	[0.93, 0.96]	2.0
$\phi_\pi$	1.00	[0.71, 1.31]	20.6	$\phi_i$	0.95	[0.94, 0.97]	1.7
$\phi_y$	0.17	[0.13, 0.22]	7.2	$\phi_p$	0.95	[0.93, 0.97]	1.9
$\rho_r$	0.76	[0.70, 0.82]	15.7	$\phi_w$	0.95	[0.93, 0.97]	1.7
$\gamma_g$	0.27	[0.16, 0.37]	17.8	$\phi_m$	0.95	[0.94, 0.97]	2.0
$\gamma_z$	-0.07	[-0.20, 0.07]	39.9	$\phi_g$	0.95	[0.93, 0.96]	2.3
$\rho_g$	0.98	[0.97, 0.99]	12.0	$\phi_z$	0.95	[0.93, 0.97]	2.0
$\rho_{ea}$	0.24	[0.12, 0.35]	3.5	$\omega_a^2$	0.02	[0.01, 0.04]	15.0
$\rho_{eb}$	0.38	[0.26, 0.50]	4.5	$\omega_b^2$	0.02	[0.01, 0.04]	14.1
$\rho_{ei}$	0.64	[0.54, 0.73]	15.1	$\omega_i^2$	0.05	[0.01, 0.10]	13.1
$\rho_{ep}$	0.74	[0.66, 0.80]	24.0	$\omega_p^2$	0.03	[0.01, 0.06]	8.7
$\rho_{ew}$	0.45	[0.35, 0.58]	31.1	$\omega_w^2$	0.05	[0.01, 0.08]	12.6
$\rho_{em}$	0.57	[0.46, 0.68]	16.1	$\omega_m^2$	0.10	[0.03, 0.17]	7.5
$\rho_{eg}$	0.06	[0.01, 0.11]	3.9	$\omega_g^2$	0.02	[0.01, 0.03]	24.9
$\bar{L}$	474.43	[473.31, 475.50]	23.9	$\omega_z^2$	0.03	[0.01, 0.05]	19.2
$\bar{\pi}$	0.27	[0.00, 0.47]	3.4				

NOTES: The posterior means and 90% highest probability density (HPD) intervals are computed using 10,000 posterior draws from the TaRB-MH algorithm. The estimated model has regime-M in place and Student- $t$  shocks with  $\nu = 5$  degrees of freedom.

Table A.3: True values for DSGE model parameters

Name	Regime-M	Regime-F	Name	Regime-M	Regime-F
$100\gamma$	0.34	0.27	$\rho_{ea}$	0.23	0.30
$\xi$	1.78	2.25	$\rho_{eb}$	0.47	0.22
$h$	0.96	0.96	$\rho_{ei}$	0.76	0.47
$\alpha_G$	-0.24	-0.38	$\rho_{ep}$	0.48	0.61
$\psi$	0.35	0.31	$\rho_{ew}$	0.36	0.20
$s$	7.08	3.47	$\rho_{em}$	0.52	0.87
$\omega_p$	0.94	0.95	$\rho_{eg}$	0.16	0.29
$\omega_w$	0.81	0.74	$\rho_{ez}$	0.80	0.90
$\chi_p$	0.21	0.11	$100\sigma_a$	0.80	1.18
$\chi_w$	0.19	0.06	$100\sigma_b$	14.54	16.95
$\phi_\pi$	1.34	0.19	$100\sigma_i$	0.44	1.30
$\phi_y$	0.16	0.21	$100\sigma_p$	0.09	0.13
$\rho_r$	0.79	0.37	$100\sigma_w$	0.27	0.23
$\gamma_g$	0.25	0	$100\sigma_m$	0.15	0.21
$\gamma_z$	-0.06	0	$100\sigma_g$	1.63	2.05
$\rho_g$	0.97	0.95	$100\sigma_z$	3.57	0.78
$\rho_z$	0.98	0.97			
$\bar{L}$	470.67	468.98			
$\bar{\pi}$	0.70	0.75			

NOTES: The DGPs under regimes M and F correspond to their post-Volcker (1955:Q1–1979:Q4) and pre-Volcker (1982:Q1–2007:Q4) estimates reported in Leeper, Traum and Walker (2017), respectively.



Table A.4: Priors for small-scale DSGE model parameters

Structural parameters		Volatility parameters	
Name	Density (1, 2)	Name	Density (1, 2)
$\tau$	$\mathbb{G}$ (2.00, 0.50)	$\mu_R$	$t_\nu$ (-5.0, 2.0)
$\kappa$	$\mathbb{G}$ (0.20, 0.10)	$\mu_\zeta$	$t_\nu$ (-5.0, 2.0)
$\psi_1$	$\mathbb{N}$ (1.50, 0.20)	$\mu_g$	$t_\nu$ (-5.0, 2.0)
$\psi_2$	$\mathbb{G}$ (0.125, 0.05)	$\phi_R$	$\mathbb{B}$ (0.95, 0.01)
$\gamma^{(Q)}$	$\mathbb{N}$ (0.40, 0.05)	$\phi_\zeta$	$\mathbb{B}$ (0.95, 0.01)
$\pi^{(Q)}$	$\mathbb{G}$ (0.75, 0.25)	$\phi_g$	$\mathbb{B}$ (0.95, 0.01)
$\rho_R$	$\mathbb{B}$ (0.50, 0.20)	$\omega_R^2$	$\text{IG-2}$ (2.00, 0.05)
$\rho_z$	$\mathbb{B}$ (0.50, 0.20)	$\omega_\zeta^2$	$\text{IG-2}$ (2.00, 0.05)
$\rho_g$	$\mathbb{B}$ (0.50, 0.20)	$\omega_g^2$	$\text{IG-2}$ (2.00, 0.05)

NOTES: See Table A.1.

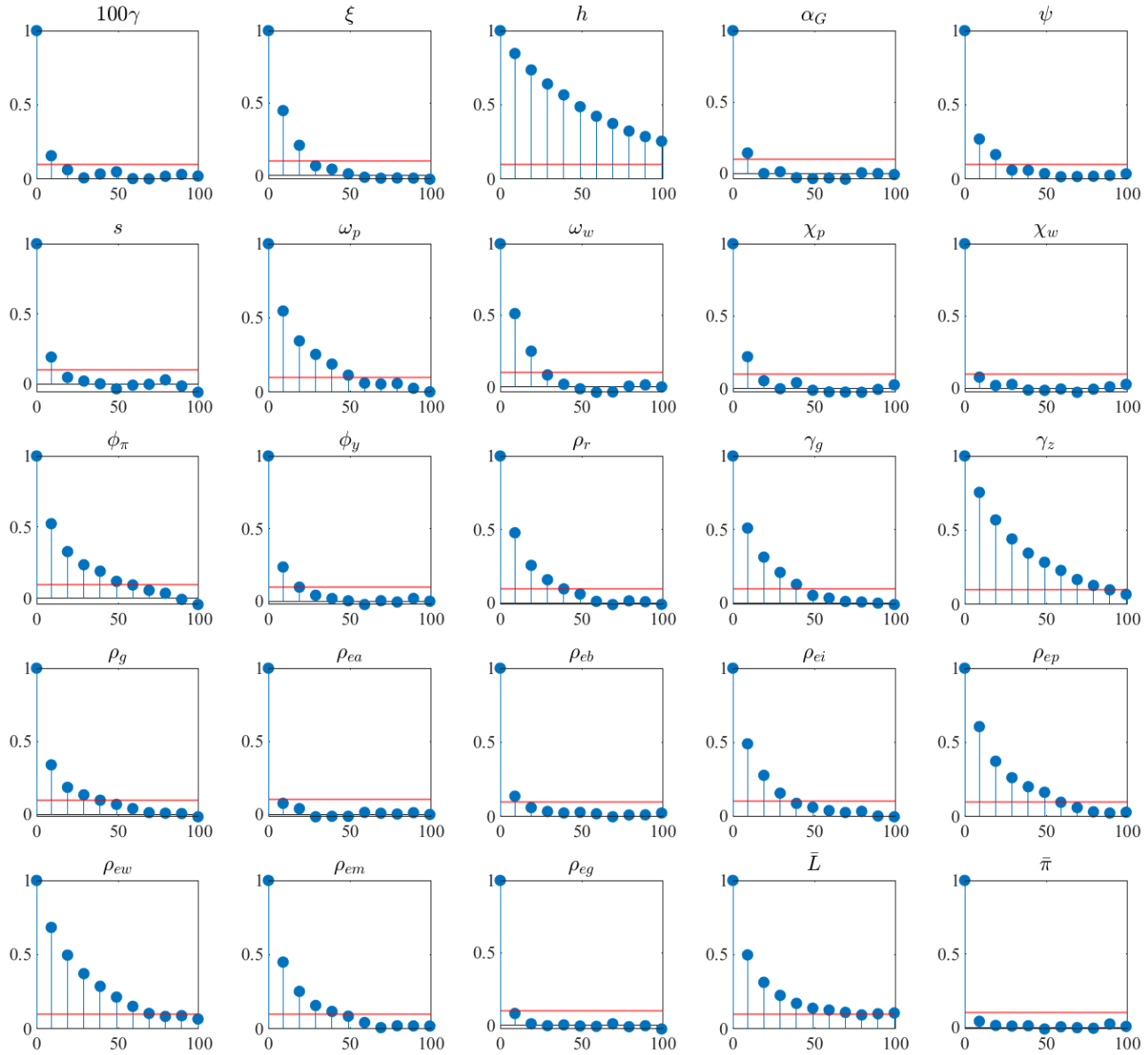


Figure A.1: Autocorrelation function of each structural parameter. Notes: Red horizontal lines correspond to an autocorrelation of 0.1.

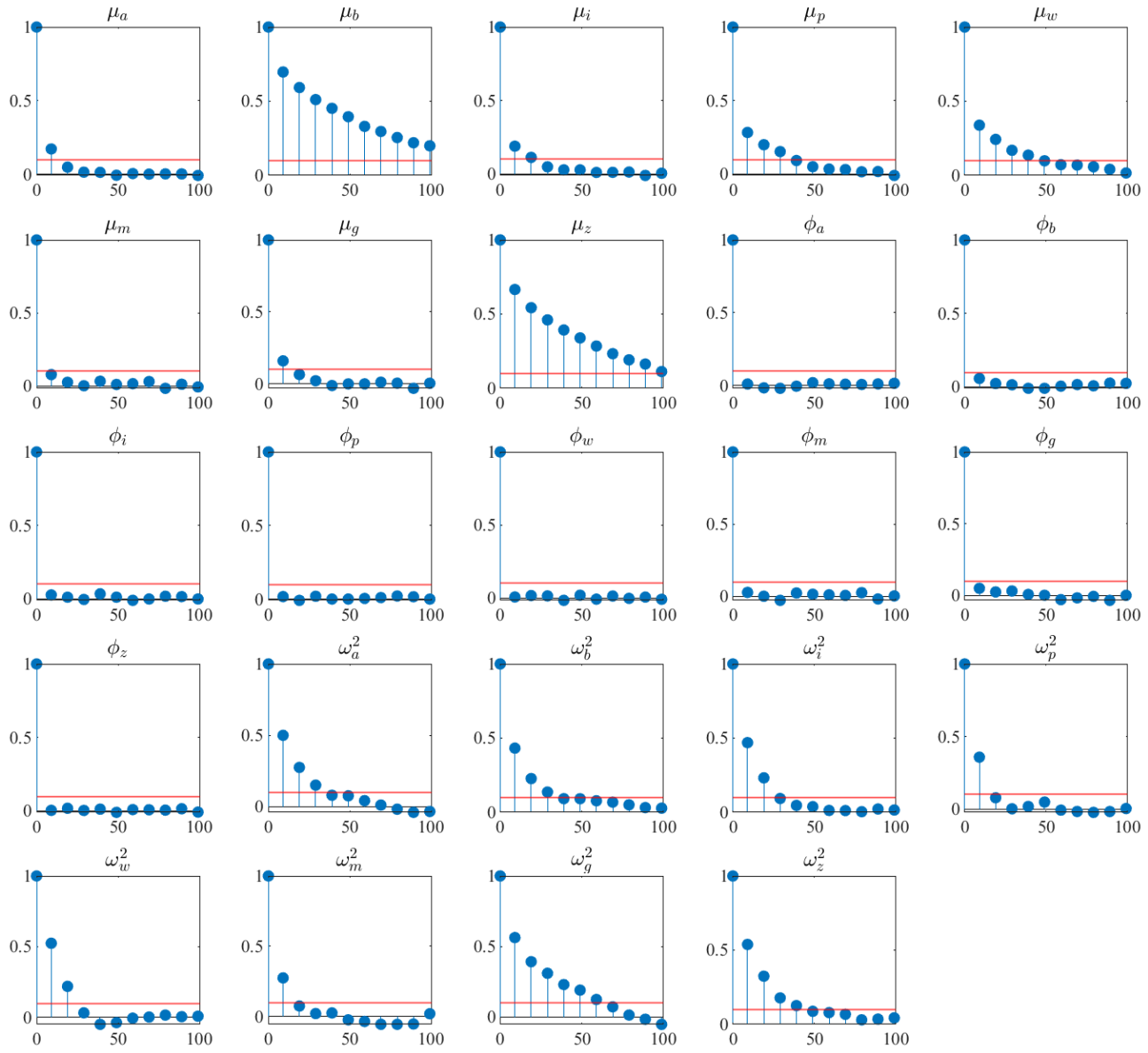


Figure A.2: Autocorrelation function of each volatility parameter. Notes: See Figure A.1.

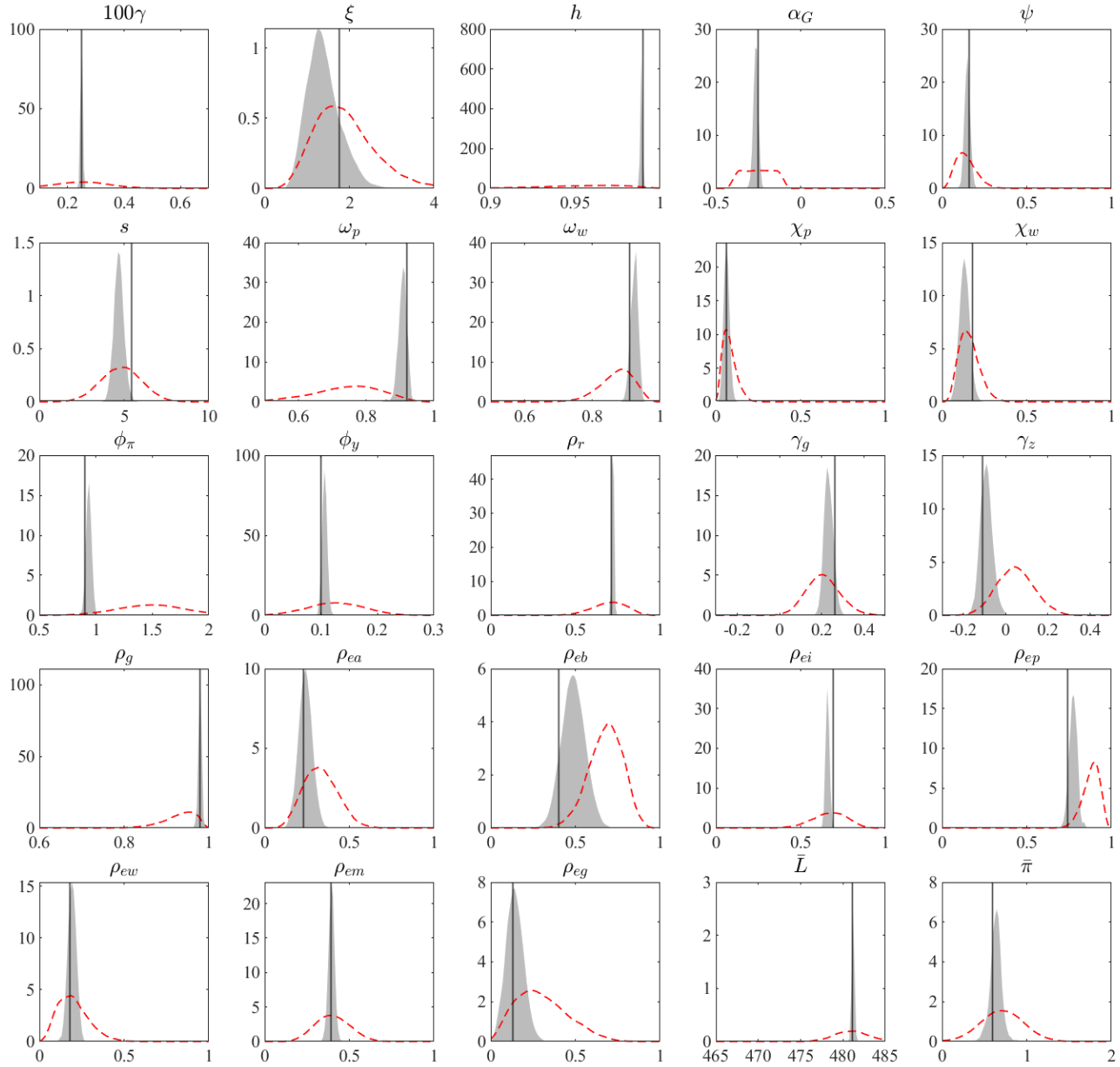


Figure A.3: Marginal prior and posterior distributions of each structural parameter. Notes: Each panel compares the prior (red dashed line) with the posterior (shaded area). Vertical lines denote the true parameter values. The kernel smoothed posterior densities are estimated using 10,000 TaRB-MH draws.

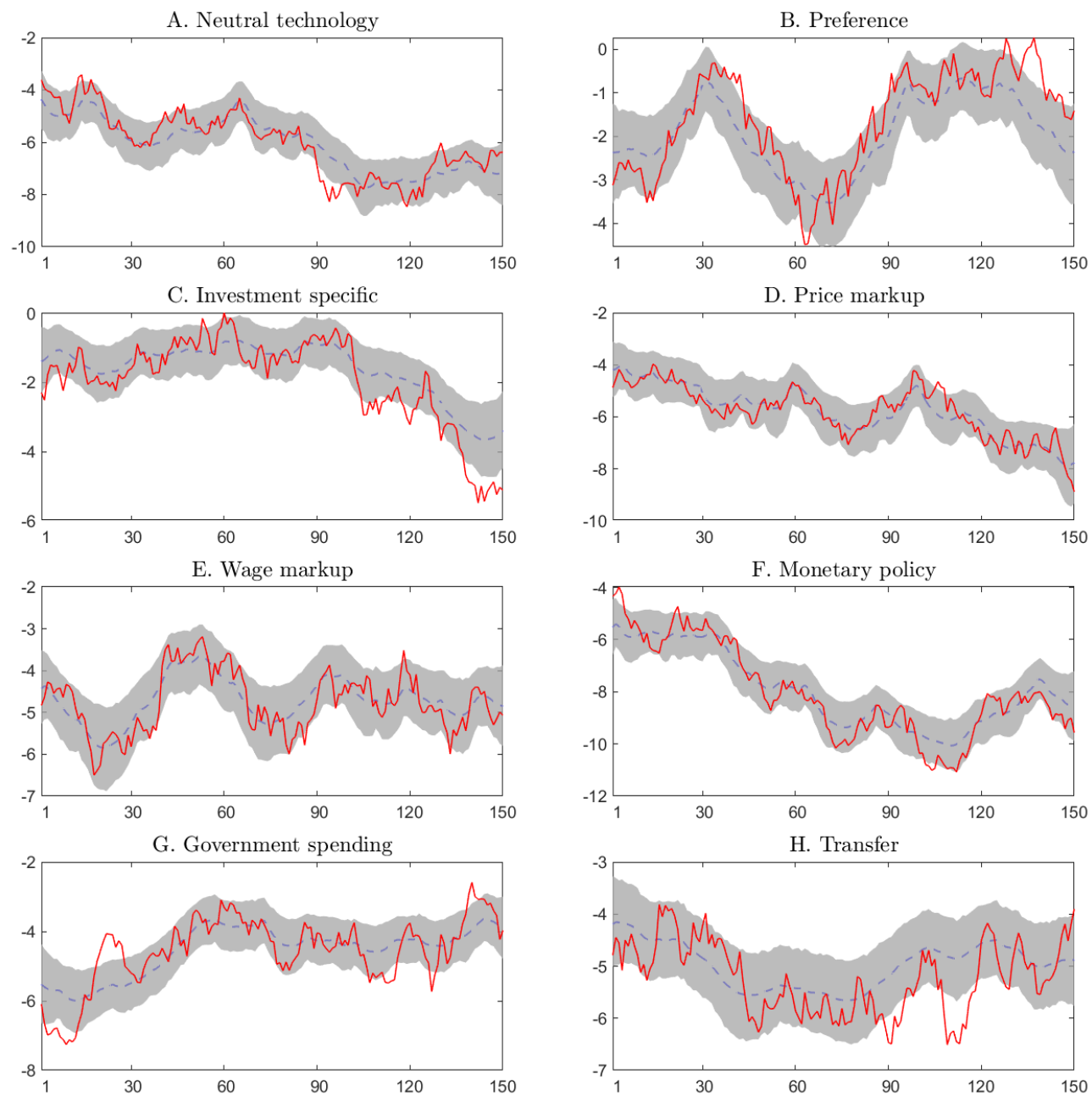


Figure A.4: Stochastic volatility of each shock innovation. Notes: Each panel compares the model's estimated log-variances with their true values (red solid line). Blue dashed lines denote median estimates, while shaded areas delineate 90% highest posterior density bands.