

1 **Expectations, Learning and Macroeconomic Persistence**

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5 Received September 28, 2005; Revised May 5, 2006; Revised October 17, 2006.

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11 Monetary DGSE models under rational expectations typically require large degrees of  
12 features as habit formation in consumption and inflation indexation to match the inertia of  
13 macroeconomic variables.

14 This paper presents an estimated model that departs from rational expectations and nests  
15 learning by economic agents, habits, and indexation. Bayesian methods facilitate the joint  
16 estimation of the learning gain coefficient together with the 'deep' parameters of the economy.

17 The empirical results show that when learning replaces rational expectations, the  
18 estimated degrees of habits and indexation drop closer to zero, suggesting that persistence arises  
19 in the model economy mainly from expectations and learning.

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24 *Keywords:* persistence, constant-gain learning, expectations, habit formation, inflation inertia,  
25 Bayesian econometrics, New-Keynesian model.

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27 *JEL classification:* C11, D84, E30, E50, E52.

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<sup>2</sup>I am greatly indebted to Michael Woodford for his guidance and advice. I am grateful to the editor of this journal, Robert King, an anonymous referee, Lars Svensson, Chris Sims, Klaus Adam, Francesco Belviso, Pierpaolo Benigno, Jean Boivin, Bill Branch, Jon Faust, Carlo Favero, Marc Giannoni, Michael Kiley, Athanasios Orphanides, Bruce Preston, Giorgio Primiceri, Ricardo Reis, John Roberts, Andrea Tambalotti, Noah Williams, Luis-Felipe Zanna, my discussants Enrico Berardi and Eric Swanson, and all seminar participants at Columbia University, ECB-University of Frankfurt-Bundesbank, Federal Reserve Board, Federal Reserve of Cleveland Conference on "Empirical Methods and Applications for Dynamic Stochastic General Equilibrium Models and Factor Models", Federal Reserve of New York, North Carolina State University, Princeton University, SUNY Stony Brook, University of Bologna IV Workshop on "Dynamic Macroeconomics: Theory and Applications", University of California - Irvine, University of California - Riverside, University of Pennsylvania IUSC, and the 2005 World Congress of the Econometric Society, for comments and useful discussions. I would also like to thank Columbia University and the Federal Reserve Board for their hospitality during part of this project.

1 **1. Introduction**

2           Dynamic stochastic general equilibrium (DSGE) models have become a popular tool for  
3 the analysis of the monetary transmission mechanism.<sup>3</sup> These models are built under the  
4 hypothesis of *rational expectations* and assume intertemporal optimizing behavior by economic  
5 agents. Being derived from explicit microeconomic foundations, they facilitate policy evaluation  
6 in terms of the welfare of private agents. Unfortunately, the canonical monetary models with  
7 rational expectations often cannot match the observed behavior of macroeconomic variables,  
8 and, in particular, they fail to match the **persistence** of aggregate output and inflation.

9           Economists have therefore proposed a number of extensions to the standard framework  
10 by embedding potential sources of endogenous persistence. They have incorporated features such  
11 as habit formation in consumption, indexation to lagged inflation in price-setting, rule-of-thumb  
12 behavior, or various adjustment costs. Christiano, Eichenbaum, and Evans (2005) incorporate  
13 several of these extensions and can account for the inertia in the data. Smets and Wouters (2003,  
14 2005) estimate similar models by Bayesian methods, incorporating a mix of frictions and  
15 persistent structural shocks, and obtain a remarkable fit of the data. Also, Boivin and Giannoni  
16 (2005) and Giannoni and Woodford (2003), in smaller models, but which still incorporate  
17 additional sources of persistence, derive impulse responses that approximate those derived from  
18 VARs. The cited extensions essentially improve the empirical fit by adding lags in the model  
19 equations. Researchers estimating these rich models under the assumption of rational  
20 expectations typically find that substantial degrees of habit persistence and inflation indexation  
21 are supported by the data. Those additional sources of persistence appear, therefore, necessary to  
22 match the inertia of macroeconomic variables.

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<sup>3</sup>Clarida, Gali, and Gertler (1999), Goodfriend and King (1997), McCallum and Nelson (1999), and Woodford (2003) are standard examples describing dynamic general equilibrium models for monetary policy analysis.

1 **1.1 Contribution of the paper**

2 This paper suggests a different direction, by revisiting the expectations formation of the  
3 agents. The paper departs from the conventional rational expectations assumption. Agents in the  
4 model form expectations using correctly-specified economic models, but they do not have  
5 knowledge about the model parameters. They use historical data to learn those parameters over  
6 time, updating their beliefs through constant-gain learning. The paper then evaluates the potential  
7 for **learning** as a mechanism that can endogenously generate persistence in the economy and  
8 improve the fit of current monetary DSGE models. More in detail, the paper aims to disentangle  
9 the role of learning versus 'mechanical' sources of persistence,<sup>4</sup> such as habits and indexation, in  
10 generating persistence in macroeconomic variables.

11 The paper starts by taking an agnostic view. The model *nests* different sources of  
12 persistence: learning by private agents along with the 'mechanical' sources of persistence, such  
13 as habit formation in consumption and indexation to past inflation in price-setting, which are  
14 essential under rational expectations to account for the observed persistence. It is left to the data  
15 to disentangle the role of the various sources. The scope is to test whether those mechanical  
16 sources of persistence are still necessary to match the data when the assumption of rational  
17 expectations is relaxed in favor of learning.

18 The model is estimated using likelihood-based Bayesian methods. The econometric  
19 approach allows me to *jointly* estimate the coefficients describing agents' learning, such as the  
20 gain coefficient (indicating their learning speed), together with the 'deep' parameters of the  
21 economy. This strategy responds to a potential criticism of models with learning, in which the

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<sup>4</sup> The paper refers to them as 'mechanical' since in the case of habits, researchers need to alter the consumers' utility function to imply dependence on lagged consumption, and in the case of indexation, they posit a rule to induce inertia through the assumption that a fraction of firms simply adjust prices automatically, according to the past observed inflation rate.

1 results might depend on the parameters that need to be chosen by the researcher. Here the  
2 learning speed is, instead, jointly estimated with the rest of the system.

3 In providing an empirical analysis of the importance of learning, the paper builds on previous  
4 literature on adaptive learning in macroeconomics. Not many studies have analyzed the  
5 empirical implications of adaptive learning. At the earlier stages, this literature was mainly  
6 theoretical and focused on convergence of the models to the Rational Expectations Equilibrium  
7 (REE).<sup>5</sup> More recently, a number of papers<sup>6</sup> have employed learning to analyze the evolution of  
8 U.S. inflation and monetary policy. These papers share the use of learning as a tool that can help  
9 in understanding some particular historical episodes, which are often harder to explain under  
10 rational expectations.

11         The present paper tries, instead, to provide a more general empirical study of the effects  
12 of learning. Its scope is akin to the work by Williams (2003), who studies the implications of  
13 learning for persistence and volatility in simple calibrated real and monetary business cycle  
14 models. The present paper shares his scope of studying the effects of learning, but it exploits,  
15 instead, actual time series data. This allows me to verify if learning is supported by the empirical  
16 evidence and to compare the model with learning with alternative descriptions of the economy.

17 The paper is also related to the recent work by Adam (2005), who likewise assumes that  
18 economic agents use simple econometric models to forecast macroeconomic variables and shows  
19 how deviations from rational expectations may strengthen the internal propagation mechanism of  
20 a simple business cycle model.

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<sup>5</sup>Evans and Honkapohja (2001), Bullard and Mitra (2002), and Preston (2005) are examples that verify the learnability of the REE in monetary models.

<sup>6</sup>Branch et al. (2004), Bullard and Eusepi (2005), Orphanides and Williams (2005b), Primiceri (2003), Sargent (1999), and Sargent, Williams and Zha (2004), among others.

1 Similarly to recent empirical papers in macroeconomics,<sup>7</sup> this paper adopts Bayesian methods in  
2 the estimation. The techniques are similar to those used by Schorfheide (2000, 2005) and Lubik  
3 and Schorfheide (2004, 2005), among others. But Schorfheide (2000), as well as several papers  
4 that share the same techniques, estimate DSGE models under rational expectations.<sup>8</sup> The current  
5 paper, instead, provides the first example of the use of Bayesian methods to estimate a DSGE  
6 model with non-fully rational expectations and learning. This represents a methodological  
7 contribution of the paper. Bayesian methods are appealing in this context because they facilitate  
8 the joint estimation of the learning parameters together with the rest of the system.

9 A potential criticism of models with adaptive learning, also discussed in Marcet and Nicolini  
10 (2003), emphasizes the arbitrary choices, often available to the researcher, which render the  
11 model hardly falsifiable. Milani (2004a), for example, shows how estimates strongly vary over  
12 the range of possible gain coefficients. In the present paper, instead, the gain coefficient is also  
13 estimated, leaving less room for arbitrariness.

14 More generally, by estimating a DSGE model with learning, the paper provides an example of a  
15 'Non-Rational Expectations Econometrics', which Ireland (2003) judged as missing from the  
16 branch of the literature that studies, usually theoretically, the impact of learning in  
17 macroeconomics.

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## 19 **1.2 Results**

20 The empirical results show that the essential role of mechanical sources of persistence  
21 (habits, indexation) in DSGE monetary models rests on the assumption of rational expectations.

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<sup>7</sup>An and Schorfheide (2006) provide a first review of this literature.

<sup>8</sup>Schorfheide (2005) assumes an incomplete information model in which agents need to update their beliefs about the inflation target using a Bayesian learning rule. In his model, however, agents still form fully-rational expectations.