The Japanese Economic Model (JEM)

Ippei Fujiwara, Naoko Hara, Yasuo Hirose, and Yuki Teranishi

In this paper, we set out the Japanese Economic Model (JEM), a large-scale macroeconomic model of the Japanese economy. Although the JEM is a theoretical model designed with a view to overcoming the Lucas (1976) critique of traditional large-scale macroeconomic models, it can also be used for both projection and simulation analysis. This is achieved by embedding a mechanism within which “short-run dynamics,” basically captured by a vector autoregression model, eventually converge to a “short-run equilibrium,” which is defined using a dynamic general equilibrium-type model.

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The views in this paper should not be taken as those either of the BOJ, or any of its respective monetary policy or other decision-making bodies. Further, any errors remain our sole responsibility.
I. Introduction

In this paper, we construct the Japanese Economic Model (JEM), a large-scale macro-economic model of the Japanese economy, which proves to be a very useful tool for analyzing the current Japanese economic situation as well as projecting the future.

The JEM has two features in common with other modern large-scale macro-economic models. The first is that, since the JEM is a theoretical model designed with a view to overcoming the Lucas (1976) critique of traditional large-scale macro-economic models for their lack of microfoundations, the macroeconomic dynamics in the JEM are governed by deep parameters which are not affected by policy changes. Therefore, we can conduct realistic and theoretically consistent policy simulations using model-consistent expectations. Explicit treatment of expectations based on models with rigid microfoundations has become one of the most intensively researched areas in macroeconomics. Indeed, Woodford (2003), in his seminal research on monetary policy implementation, states, "successful monetary policy is not so much a matter of effective control of overnight interest rates as it is of shaping market expectations of the way in which interest rates, inflation, and income are likely to evolve over the coming year and later." He thus describes "central banking as management of expectations." This is all the more important in the current situation in Japan, where after hitting the zero bound on nominal interest rates, the BOJ needs to rely more on expectations through the "policy duration effect."2

The second feature is the JEM’s suitability for projection. This is achieved by embedding a mechanism within which the “short-run dynamics,” captured by the vector autoregression (VAR) model, eventually converge to the above-mentioned “short-run equilibrium,” defined by using a dynamic general equilibrium (DGE)-type model. These short-run dynamics enable the JEM to follow actual economic developments more closely, facilitating prediction and also giving a more realistic flavor to the simulation exercises.

In this paper, we will describe the JEM and how it can be used to analyze the Japanese economy. We begin by illustrating the basic structure of the JEM and its underlying philosophy, as well as providing a detailed description, grounded in rigorous macroeconomic theory, of how to derive the equations on which the JEM is based. Then, by looking at the properties of the JEM in response to typical shocks faced by the Japanese economy, we demonstrate that the JEM’s shock responses are

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1. This modeling approach is often referred to as the “core/non-core approach.” As explained below, the core portion is the “short-run equilibrium” model, while the non-core portion is the “short-run dynamics.” Although this has been the standard approach to date when constructing large-scale dynamic macroeconomic models, a new approach has recently emerged (see, for example, Smets and Wouters (2003)), in which an integrated model with persistent shocks is estimated using Bayesian methods.

2. “Policy duration effect” is the term originally used in Fujiki, Okina, and Shiratsuka (2001). According to Okina and Shiratsuka (2004), “Even though short-term interest rates decline to virtually zero, a central bank can produce further easing effects by a policy commitment. A central bank can influence market expectations by making an explicit commitment as to the duration it holds short-term interest rates at virtually zero. If it succeeds in credibly extending its commitment duration, it can reduce long-term interest rates. We call this mechanism the ‘policy duration effect,’ following Fujiiki and Shiratsuka (2002).”

Our related papers, Fujiwara et al. (2003), Fujiwara, Hara, Teranishi, Watanabe, and Yoshimura (2004), and Fujiwara, Hara, Watanabe, and Yoshimura (2004), analyze the effectiveness of history-dependent monetary policy that induces the policy duration effect.
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reasonable both empirically and theoretically, and hence may be considered a very good approximation of the Japanese economy. A further interesting challenge when modeling the current Japanese economy is the need to solve the model when the zero constraint on the nominal interest rate is binding. We therefore report our approach to tackling this problem. Moreover, as one of the most significant advantages of the JEM over other theoretical models is its suitability for projections, we demonstrate how such projections are produced.

This paper is organized as follows. In Section II, we review recent developments in macroeconomic modeling, explaining our initial decision to construct the JEM. We then outline the structure of the JEM in Section III. We go on to show the following derivations: of the short-run equilibrium model, based on the optimizing behavior of economic agents, in Section IV; of the steady state in Section V; and of short-run dynamics in Section VI. In addition, we demonstrate in Section VII that the JEM reproduces macroeconomic dynamics quite similar to those observed in the actual Japanese economy. We then turn in Section VIII to the ongoing problem facing the Japanese economy, namely, the binding of the zero nominal interest rate constraint. Since one of the main advantages of the JEM is that it can be used for practical simulation, in Section IX we demonstrate how to construct projections that are both theoretically consistent and realistic. Model evaluation is then conducted in Section X. Finally, in Section XI the contents of this paper are summarized and possible future extensions of the JEM are discussed.

II. Recent Developments in Macroeconomic Modeling

The past decade has witnessed significant innovations in both the theory surrounding monetary policy implementation and the associated computational issues. Hence, the approaches to analyzing monetary policy that are now available are more scientific than previously. Current research on monetary policy needs to make use of models based on rigorous optimizing behavior so that model-consistent expectations can be derived. However, at the same time, for arguments to be empirically relevant, we also need to employ large-scale macromodels that can be used for projections. In this regard, large-scale macromodels of the “new neoclassical synthesis” type advocated by Goodfriend and King (1997), which have recently become the standard approach in macroeconomic modeling, are indispensable.

The problem of time inconsistency proposed by Kydland and Prescott (1977) and Barro and Gordon (1983) emphasizes the importance of central bank credibility and had led a number of central banks around the world to employ an “inflation target” as a possible countermeasure. To examine monetary policy under an inflation targeting scheme, it is essential to employ a model with forward-looking behavior
and firm microfoundations, since an inflation targeting policy operates via agents’ expectations. Similar arguments apply to the analysis of fiscal policy, since people naturally expect a fiscal deficit eventually to be resolved using future tax income. For these expectations to be concrete, persuasive, and realistic, it is necessary to posit a model with rigid microfoundations. It is only in this way that expectations can be computed in a model-consistent manner, and without recourse to exogenous derivation or ad hoc assumptions. With noteworthy progress having been made in both computer technology and monetary economic theory during the last decade, central banks have been introducing models with these desirable characteristics, including the Quarterly Projection Model (QPM) of the Bank of Canada and the Forecasting and Policy System (FPS) of the Reserve Bank of New Zealand. Even some central banks that choose not to employ inflation targeting nevertheless make use of these new types of macromodel. For example, the U.S. Federal Reserve Board (FRB) uses a new-style model that emphasizes the importance of intertemporal substitution.

Traditional macromodels, which are often lumped together under the heading of the “Cowles Commission Approach,” have been criticized in seminal papers by Lucas (1976), insisting on the importance of expectations, and Sims (1980), for their implausible identification. In response to these critiques, the identified VAR and DGE models have been heavily used for macroeconomic analysis. The former is useful for projection and forecasting as well as for impulse response analyses. On the other hand, the latter is more suitable for qualitative analyses, such as policy simulations. This is partly because by maintaining strict “stock-flow consistency” it manages to exclude the possibility that agents can enjoy a “free lunch,” in other words, that their decisions on current expenditures have no repercussions for future expenditure. In this way, it eventually ensures a well-defined steady state (in which “well-defined” means consistency within the steady state), thus allowing model-consistent expectations to be obtained.

In this sense, the VAR and the DGE may be seen as complementary modern macroeconomic methodologies. The new-style macromodels referred to above, however, should ideally possess the properties of both methodologies, since they are proposed as vehicles for both projection and policy simulation. This presents a dilemma that is mitigated by combining the two approaches. This involves setting up a mechanism whereby short-run dynamics captured by the VAR eventually converge to the short-run equilibrium, which is in turn defined by a DGE-type model. Although this methodology cannot escape the critiques completely, it nevertheless provides an extremely powerful tool for both policy simulation and projection. Here, we construct a large-scale DGE model of this type, which we call the JEM. The aim is to improve the analysis of monetary policy, allowing projection that is not only empirically relevant but also theoretically sound.

6. For details, see the series of papers published by the Bank of Canada such as Black et al. (1994), Armstrong et al. (1995), Coletti et al. (1996), and Butler (1996).
7. For details, see Black et al. (1997).
8. For details, see Brayton et al. (1997).
9. This name is taken from Favero (2001), which provides a useful summary of developments in macromodeling.
10. This is indeed the nature of the core/non-core approach.
11. In particular, the VAR is employed in the JEM more with a view to generating realistic model properties than in response to the Sims (1980) critique regarding implausible identification.
III. Outline of the Model

In the JEM, each economic variable evolves through three stages: the short-run dynamics, the short-run equilibrium, and the steady state.

The last of these stages is the steady state in which all the real variables grow at the same rate, namely, the rate of potential GDP growth. Nominal variables grow at this rate plus the target level of inflation set by the central bank. Before reaching the steady state, however, there is an intermediate stage: the short-run equilibrium. Equations determining the short-run equilibrium are derived by extending standard real business cycle (RBC) theory, as seen, for example, in King, Plosser, and Rebelo (1988). Accordingly, households decide their consumption level according to the permanent income hypothesis, and firms maximize dividends facing the installation costs while preserving strict stock-flow consistency. Neoclassical dynamics, which involves convergences to the steady state, are depicted in the short-run equilibrium. Prior to this, however, there is an initial stage of short-run dynamics. Short-run dynamics may be considered in terms of a VAR model around the short-run equilibrium. Such short-run dynamics allow for temporary deviations from equilibrium, as found in the actual macroeconomic data. However, it should be emphasized that all such departures from equilibrium or the steady state are temporary in nature, and that all variables are finally made to converge to the steady state (Figure 1). This allows us to attain model-consistent expectations and conduct analysis accordingly.

One of the crucial defects of the theoretically neat DGE model, which has now become the central tool for analyzing macroeconomic dynamics, is the difficulty of applying it for projection or forecasting purposes. Several measures have been taken to overcome this difficulty and obtain realistic and persistent responses: in particular, Fuhrer (2000) appeals to habit formation; Roberts (1995) makes use of a new Keynesian Phillips curve; and Rotemberg and Woodford (1997) employ a policy reaction function derived from VAR estimation. Christiano, Eichenbaum, and Evans (2005) incorporate variable capacity utilization. The point is that if, as now, there is a pressing need for serviceable analysis of the current state of the economy, the model employed needs to perform well in projections and forecasting. Analysis, therefore, of movements around the steady state, as seen in a DGE model, may not be sufficiently close to reality since the latter may, after all, find itself far from the steady state from time to time. On the other hand, VARs are often used not only for deriving impulse responses but also for projections and forecasts. In short, while in the DGE we have model-consistent expectations that allow us to conduct policy analysis,

12. In contrast to the conventional method based on Blanchard and Kahn (1980), in the analysis below, the uniqueness of the equilibrium path is not guaranteed. Our model is solved using TROLL, which means that the dynamic model is solved numerically by applying the stacked-time method on the Newton-Raphson algorithm. Since the nonlinear model is solved numerically, it is almost impossible to determine the uniqueness of the solution. However, when we linearize the JEM around the steady state, the model seems to be determinate with plausible values for the fudge factor according to the AIM algorithm advocated by Anderson and Moore (1985) and the TROLL command, LKROOTS. For details, see Pauletto (1995), Armstrong et al. (1995), or Hollinger (1996).

13. Kozicki and Tinsley (2002) examine several controversial features of typical small-scale dynamic stochastic general equilibrium (DSGE) models and suggest dynamic specifications to improve data-based realism while preserving the intuition and simplicity of the original DSGE models. Furthermore, Smets and Wouters (2004) seek a way to use the DGE model for forecasting with Bayesian techniques.
the VAR is highly valued for its applicability to projections and forecasts and its ability to reproduce the tendencies usually observed in the data, especially the hump-shaped responses of most macroeconomic variables to shocks. Therefore, by combining these preferred features of the DGE and VAR, we can obtain a powerful dynamic macromodel that can be used not only for projection but also for analysis of monetary policy under zero nominal interest rates, as in Japan today.

Although the JEM is based on macroeconomic models employed at the central banks, we have added several new features to allow for more realistic modeling:

(1) A life-cycle income profile as in Faruqee, Laxton, and Symansky (1997) is embedded so that fiscal policy in the model should be more non-Ricardian.
(2) Following Mankiw (1982), and Burda and Gerlach (1992), housing investment is endogenized by considering the housing stock as a durable good. This induces more real rigidity.
(3) CES production technology increases generality and allows sensitivity analysis of the effect of the interest rate on investment.
(4) Monopolistic competition as in Blanchard and Kiyotaki (1987) is introduced to achieve a more realistic steady state and theoretical consistency with the existence of relative prices.
(5) Calibration with a firmer empirical grounding improves confidence in using the JEM for policy analysis.

14. Most calibration is based on estimated parameters.
(6) The JEM can be used for both projection and policy simulation even under the non-negativity constraint on the nominal interest rate. For this purpose, we employ a new algorithm to solve the model and numerical methods.

In the following sections, we first explain the short-run equilibrium model. We then turn to the steady state, which is attained as the terminal condition of the short-run equilibrium model. Finally, the short-run dynamics, which allow variables to depart temporarily from equilibrium, are described.

IV. Short-Run Equilibrium Model

In this section, to understand the basic dynamics in the short-run equilibrium model, we examine each agent’s optimizing behavior and use this to derive the equations that drive the model. As deriving all the equations employed in the JEM is not only very time-consuming but also tends to obscure the overall picture, we will focus on the derivation of the basic equations, especially ones derived from households’ and firms’ optimizing behavior, abstracting from details, such as taxes and deflators.

A. The Household Sector

The dynamics of the household sector’s decision making plays the core role in the short-run equilibrium of the JEM.

In the JEM, following the analytical framework advocated by Campbell and Mankiw (1989), there exist two types of consumers: “rule-of-thumb (ROT)” consumers and “permanent-income-hypothesis (PIH)” consumers. ROT consumers simply consume what they earn in each period and save nothing. Therefore, each ROT consumer’s consumption equals his or her individual disposable income. On the other hand, PIH consumers decide their relative expenditure on consumption and housing investment via intertemporal optimization. Introducing two types of consumers allows household expenditure to respond more realistically to shocks, in line with what is often referred to as the “excess sensitivity” or “excess smoothness” observed in consumption dynamics.

Furthermore, the household’s equations are based on the Blanchard (1985)-Buiter (1988)-Weil (1989)-Yaari (1965) overlapping-generations (OLG) model, which is very popular among rational expectations macromodels, as it generates a unique steady-state consumption level and displays non-Ricardian equivalence in the equilibrium relationship. Despite its popularity in application, this framework has difficulty in capturing the consumption behavior of retirees and of young liquidity-constrained consumers, in other words, aggregate consumption behavior with demographic changes. Since it fails

15. All the equations employed in the JEM are shown in Appendix 1. An $\text{eq}$ superscript indicates that a variable belongs in the short-run equilibrium model, whereas an $\text{ss}$ superscript indicates a steady-state value.
16. We employ rather different mathematical notations for equations derived from households’ and firms’ optimizing behavior so that derivations become clearer from those for other equations in Appendix 1.
17. ROT consumers cannot afford to buy houses.
18. This is one of the explanations for the rejection of the random-walk hypothesis of consumption advocated by Hall (1978). These are well summarized in Muellbauer and Lattimore (1995).
19. As temporal deviations from equilibrium are admitted in the JEM, it is natural to have non-Ricardian equivalence in the model as a whole.
to engage with these life-cycle considerations, which can play a more substantial role in
inducing non-Ricardian equivalence, Evans (1991) claims that the Blanchard-Yaari OLG model expresses just an approximate Ricardian equivalence. Recent works by Faruqee, specifically, Faruqee, Laxton, and Symansky (1997), Faruqee and Laxton (2000), Faruqee and Muehleisen (2001), and Faruqee (2002), are among the first attempts to include life-cycle considerations in the Blanchard-Buiter-Weil-Yaari OLG model. The model considered here extends Faruqee’s work to incorporate durable goods consumption. By considering durable goods consumption as housing investment, we can endogenize the building of the housing stock and this, in turn, results in the persistency of the GDP dynamics observed to some extent in the actual data.

Here, we first look at the derivations of the equations for PIH consumers before turning to the ROT consumers’ consumption decision. Finally, by combining these two consumption choices, we attain the aggregate level of consumption and the housing investment function.

1. PIH consumers
As the model employed here is the OLG model, we look first at individuals’ decision making.

a. Individuals

1. Derivation of the Euler equation
Each PIH consumer is assumed to have the additively separable utility from PIH consumption, \(CFL\), and the stock value of his or her house, \(D\), where subscripts \(a, t\) denote the individual born at time \(a\)’s action at time \(t\):

\[
U_{a,t} = E_t \sum_{s=0}^{\infty} [(1 - \gamma) \beta] \left[ \frac{CFL_{a,s,t}}{1 - \sigma^{-1}} + \theta \frac{D_{a,s,t}}{1 - \sigma^{-1}} \right],
\]

\(U\): utility,

1 - \(\gamma\): the survival rate,

\(\beta\): the subjective discount rate,

\(\sigma\): the elasticity of intertemporal substitution,

\(\theta\): the taste parameter.
As only \((1 - \gamma)\) consumers will exist in the next period, the utility is necessarily discounted further by this factor.

If we focus more on the flow of durable goods consumption, a budget constraint can be expressed as follows:\textsuperscript{24}

\[
FA_{a,t} = \frac{1 + \tau_{a,t}}{1 - \gamma} FA_{a,t-1} + W_t(1 - l)x_{a,t} - CFL_{a,t} - pd_t[D_{a,t} - (1 - dh)D_{a,t-1}] + RISK_{a,t},
\]

\(dh\): depreciation rate for housing stock,
\(pd\): the relative price of housing investment goods,\textsuperscript{25}
\(FA\): financial assets,
\(x\): the weight defined as below,
\(RISK\): the residual income including dividends, etc.,\textsuperscript{26}
\(r\): (real) interest rate,
\(W\): wage,
\(l\): leisure.

Implicitly, as is popular in the Blanchard-Yaari framework, the existence of a nonprofit life insurance company is assumed. As a result, the percentage insurance income equals to \(\gamma\) and the competitive lender charges the rate, \(1 + r/1 - \gamma\).\textsuperscript{27}

Following Faruqee, a weight function is introduced to induce the hump-shaped profile of labor income, namely, the life-cycle income profile:

\[
x_{a,t} = \frac{\kappa}{(1 + \alpha_1)^{r - a + 1}} + \frac{1 - \kappa}{(1 + \alpha_2)^{r - a + 1}},
\]

\(\alpha_1, \alpha_2, \kappa\): parameters.\textsuperscript{28}

Now we are ready to derive the structural equations from household decision making. To optimize equation (1) subject to equations (2) and (3), we begin by assuming certainty equivalence\textsuperscript{29} and writing down the Lagrangian. The latter is denoted by \(\Phi\) where the Lagrange multiplier is \(\lambda\):

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\textsuperscript{24} Here, we follow the treatment of durable goods in Obstfeld and Rogoff (1996). For the moment, to keep the argument simple, we ignore tax collection.

\textsuperscript{25} This is measured by the price of consumption goods.

\textsuperscript{26} For example, when the interest rate on net foreign asset holding is higher than that on the domestic capital stock, the profit from this difference is counted as risk income and allocated to PH consumers. Corporate profits are also included in this risk income, since these are also eventually allocated to consumers.

\textsuperscript{27} For detailed discussions on the existence of nonprofit competitive insurance companies, see Frenkel, Razin, and Yuen (1996).

\textsuperscript{28} In the JEM, the hump-shaped profile of income is expressed not by the two terms indicated here, but by three terms.

\textsuperscript{29} In the JEM, certainty equivalence, namely perfect foresight, is always assumed when solving the model.
From the first-order conditions, we obtain the equations below:

\[
CFL_{a,t+1} = [\beta(1 + r_i)]^t CFL_{a,t}, \tag{4}
\]

\[
CFL_{a,t} = \left(\frac{u_t}{\theta}\right)^{w} D_{a,t}. \tag{5}
\]

Equation (4) is the consumption Euler equation,\textsuperscript{30} and equation (5) is an equation relating consumption and the stock value of housing where \( i \) is the marginal rate of substitution (MRS) between consumption and housing investment defined as below:

\[
pd - \frac{(1 - \gamma)(1 - dh)}{1 + r_i} pd_{t+1} \equiv u_i. \tag{6}
\]

2. Definition of wealth

Here, we first iterate forward the budget constraint in equation (2) so that we can define total wealth, human wealth, and financial wealth. Then, the intertemporal budget constraint becomes

\[
\sum_{j=0}^{\infty} \frac{(1 - \gamma)^j}{\prod_{j=0}^{\infty}(1 + r_{i,j})} (CFL_{a,t+1, i} + \lambda D_{a,t+1}) = \frac{1 + r_{i-1}}{1 - \gamma} FA_{a,t-1} + pd_i (1 - dh) D_{a,t-1} + \sum_{j=0}^{\infty} \frac{(1 - \gamma)^j}{\prod_{j=0}^{\infty}(1 + r_{i,j})} W_{t+i}(1 - l) \frac{\kappa}{(1 + \alpha_i)^{i-\gamma+i+1}}
\]

\[
+ \sum_{j=0}^{\infty} \frac{(1 - \gamma)^j}{\prod_{j=0}^{\infty}(1 + r_{i,j})} W_{t+i}(1 - l) \frac{1 - \kappa}{(1 + \alpha_2)^{i-\gamma+i+1}}
\]

\[
+ \sum_{j=0}^{\infty} \frac{(1 - \gamma)^j}{\prod_{j=0}^{\infty}(1 + r_{i,j})} RISK_{t+i}, \tag{7}
\]

\textsuperscript{30} Note that this is a standard form of the Euler equation. The existence of the survival rate produces no distortion in the consumption Euler equation.
which is derived with the transversality condition,

$$\lim_{i \to \infty} \left[ \frac{(1 - \gamma)^i}{\Pi_j(1 + r_{ij})} \right] FA_{a,t+i} = 0.$$ 

Further, we define total wealth, human wealth, and financial wealth as follows:

**Total wealth**: $TW_{a,t} = \sum_{i=0}^{\infty} \frac{(1 - \gamma)^i}{\Pi_{j=0}^{i-1}(1 + r_{ij})} (CFL_{a,t+i} + \ell_{i} D_{a,t+i})$.

**Human wealth**: $H_{a,t} = H_{a,t}^1 + H_{a,t}^2$,

$$H_{a,t}^1 = \sum_{i=0}^{\infty} \frac{(1 - \gamma)^i}{\Pi_{j=0}^{i-1}(1 + r_{ij})} W_{ti} (1 - l) \frac{\kappa}{(1 + \alpha_{i})^{i+1}},$$

$$H_{a,t}^2 = \sum_{i=0}^{\infty} \frac{(1 - \gamma)^i}{\Pi_{j=0}^{i-1}(1 + r_{ij})} W_{ti} (1 - l) \frac{1 - \kappa}{(1 + \alpha_{i})^{i+1}},$$

**Financial wealth**: $FA_{a,t} = \sum_{i=0}^{\infty} \frac{(1 - \gamma)^i}{\Pi_{j=0}^{i-1}(1 + r_{ij})} RISK_{i+1}$.

With these definitions of wealth, the intertemporal budget constraint in equation (7) now becomes

$$TW_{a,t} = \sum_{i=0}^{\infty} \frac{(1 - \gamma)^i}{\Pi_{j=0}^{i-1}(1 + r_{ij})} (CFL_{a,t+i} + \ell_{i} D_{a,t+i})$$

$$= \frac{1 + r_{i-1}}{1 - \gamma} FA_{a,t-1} + pd_i(1 - db) D_{a,t-1} + H_{a,t} + F_{a,t},$$

which is also expressed as an Euler equation.

$$TW_{a,t} = (CFL_{a,t} + \ell_{t} D_{a,t}) + \frac{1 - \gamma}{1 + r_t} TW_{a,t+1}. \quad (8)$$

### 3. Marginal propensity to consume

Now we are ready to derive the marginal propensity to consume, $\phi$. First, we conjecture that the solved consumption takes the following form:

$$CFL_{a,t} = \phi.TW_{a,t}. \quad (9)$$

By substituting equations (4), (5), and (8) into equation (9), we obtain the marginal propensity to consume for each individual PIH consumer:
\[
\frac{1}{\phi_t} = \frac{1}{\phi_{t+1}} \beta^\sigma (1 + r_t)^{\sigma - 1} (1 - \gamma) + 1 + \theta^\sigma \nu_t^\sigma. \tag{10}
\]

4. Aggregation

So far, we have just analyzed individual behavior. However, what we need to discover is aggregate behavior. Here, we aggregate behavior by individual households with different birth dates to derive the aggregate consumption and housing investment equation.

To obtain the aggregate variables, we first assume that the birth rate is \( (1 - \text{survival rate}) \), namely \( \gamma \). This means that the population is always the same size, and therefore that the model may be expressed on a per capita basis. Hence, the number of people born at \( a \) is

\[ N_a = \gamma (1 - \gamma)^{\alpha}. \]

The individual budget constraint in equation (2) may then be transformed into the aggregate budget constraint: \(^{32}\)

\[
f_a = (1 + r_{t-1}) f_{a_{t-1}} + w \sum_{a=0}^{t} x_{a,t} (1 - l) \gamma (1 - \gamma)^{\alpha} - cfl, \]

\[- pd, [d, - (1 - dh) d_{t-1}] + risk,\]

where small capitals denote per capita values.

Since macro-level labor income is defined via the first-order condition of the production function, to be discussed below, the following condition must be satisfied:

\[
w \sum_{a=0}^{t} \left( \frac{\kappa}{(1 + \alpha_1)^{\alpha + 1}} + \frac{1 - \kappa}{(1 + \alpha_2)^{\alpha + 1}} \right) (1 - l) \gamma (1 - \gamma)^{\alpha} = \omega_t (1 - l). \]

This reduces to the condition specified below, which is the condition the parameters are set to satisfy:

\[ 1 = \frac{\kappa \gamma}{\alpha_1 + \gamma} + \frac{(1 - \kappa) \gamma}{\alpha_2 + \gamma}. \]

Given these parameter settings, households’ aggregate budget constraint is now

\[
f_a = (1 + r_{t-1}) f_{a_{t-1}} + w, (1 - l) - cfl, - pd_t [d, - (1 - dh) d_{t-1}] + risk. \tag{11}
\]

31. Specifically, \( \sum_{a=0}^{t} N_a = 1 \). The method proposed in Faruqee and Muehleisen (2001) enables the consideration of population dynamics. However, following the Faruqee and Muehleisen method would require us to abandon the per capita economy paradigm. This topic will be covered in future extensions of the JEM.

32. By definition, \( FA_t \), for example, represents the aggregation of \( FA_a \) across all cohorts.
Next, we derive the aggregate equations for human wealth. By definition, they are expressed as follows:

$$\sum_{s=0}^{t} h_{a,s}^{1} (1 - \gamma)^{-a} = \omega \sum_{s=0}^{t} \frac{\kappa(1 - l)}{(1 + \alpha_{s})^{r-a+1}} \gamma(1 - \gamma)^{-a}$$

$$+ \sum_{s=0}^{t} \frac{1 - \gamma}{(1 + r_{s})(1 + \alpha_{s})} b_{a,s+1}^{1} \gamma(1 - \gamma)^{-a+1},$$

$$\sum_{s=0}^{t} h_{a,s}^{2} (1 - \gamma)^{-a} = \omega \sum_{s=0}^{t} \frac{(1 - \kappa)(1 - l)}{(1 + \alpha_{s})^{r-a+1}} \gamma(1 - \gamma)^{-a}$$

$$+ \sum_{s=0}^{t} \frac{1 - \gamma}{(1 + r_{s})(1 + \alpha_{s})} b_{a,s+1}^{2} \gamma(1 - \gamma)^{-a+1}.$$ 

These are also expressed as Euler equations:

$$h_{a}^{1} = \frac{\kappa \gamma - w_{s}(1 - l)}{\alpha_{s} + \gamma} + \frac{1 - \gamma}{(1 + r_{s})(1 + \alpha_{s})} b_{a,s+1}^{1},$$

$$h_{a}^{2} = \frac{(1 - \kappa) \gamma - w_{s}(1 - l)}{\alpha_{s} + \gamma} + \frac{1 - \gamma}{(1 + r_{s})(1 + \alpha_{s})} b_{a,s+1}^{2}.$$ 

As for financial wealth, from the definition of financial wealth, the Euler equation for the dynamics of financial wealth becomes

$$f_{a,s} = \text{risk} + \frac{1 - \gamma}{1 + r_{s}} f_{a,s+1}. \quad (12)$$

With the definitions above, the aggregate consumption function may be written as follows:

$$c_{fl} = \phi_{b}[(1 + r_{s}) f_{a,s+1} + pd_{s}(1 - dh_{s})d_{s-1} + h_{s} + f_{s}]. \quad (13)$$

The housing stock, meanwhile, is derived via a simple per capita expression for equation (5):

$$d_{s} = \left( \frac{\nu_{s}}{\theta} \right)^{-\sigma} c_{fl}. \quad (14)$$

Further, housing investment is defined as the change in the housing stock:

$$i_{h} = d_{s} - (1 - dh) d_{s-1}. \quad (15)$$
2. ROT consumers
So far, we have analyzed consumers who make decisions according to intertemporal optimization. Here, we introduce ROT consumers, who are liquidity constrained and thus spend all they obtain. It is assumed that in each cohort, \( \eta_1, \eta_2 \in [0, 1] \) of consumers are liquidity constrained and cannot borrow. Therefore, the dynamic equations for human wealth are now transformed into

\[
h_1 = (1 - \eta_1) \frac{\kappa \gamma}{\alpha_1 + \gamma} \omega (1 - l) + \frac{1 - \gamma}{(1 + r)(1 + \alpha_1)} h_{1t+1},
\]

and

\[
h_2 = (1 - \eta_2) \frac{(1 - \kappa) \gamma}{\alpha_2 + \gamma} \omega (1 - l) + \frac{1 - \gamma}{(1 + r)(1 + \alpha_2)} h_{2t+1}.
\]

\( \eta \) should be constrained by the weight function in equation (3). Denoting the oldest age at which a consumer may remain credit constrained by \( z \), then \( \eta \) should satisfy the following conditions:

\[
\eta_1 = 1 - \frac{\kappa}{(1 + \alpha_1)^{\alpha_1 - z}},
\]

\[
\eta_2 = 1 - \frac{1 - \kappa}{(1 + \alpha_2)^{\alpha_2 - z}}.
\]

As all their incomes are spent, consumption made by ROT consumers \( crt \) is determined by

\[
crt = \eta_1 \frac{\kappa \gamma}{\alpha_1 + \gamma} \omega (1 - l) + \eta_2 \frac{(1 - \kappa) \gamma}{\alpha_2 + \gamma} \omega (1 - l).
\]

Finally, aggregate consumption is now determined by the sum of the consumption levels of the two types of consumer:

\[
c_t = crt + cfl_t.
\]

Equations (6), (10), (11), (12), (13), (14), (15), (16), (17), (18), and (19) constitute the fundamental dynamic equations describing households' decision making.

B. The Corporate Sector
The treatment of the corporate sector in the JEM is fairly standard. Following Dixit and Stiglitz (1977) and Blanchard and Kiyotaki (1987), each firm seeks to maximize its instantaneous dividend in a monopolistically competitive market, subject to the constraints imposed by a CES production function and an installation cost. The latter takes the form of the “time-to-build constraint” advocated by Hall and Jorgenson (1967).
Under these circumstances, the objective of each firm, denoted by \( j \), is to maximize the following dividend:\(^{33}\)

\[
\Pi_{j,t} = (1 - tk) \left[ \frac{P_{j,t} Y_{j,t}}{P_{t}} - W_t (1 - l) N_{j,t} \right] - pi I_{j,t} + dt I_{j,t},
\]

(20)

\( tk \): tax rate on corporate profits,
\( \Pi \): dividend,
\( Y \): GDP,
\( pi \): relative price of investment goods,
\( I \): investment,
\( P \): price of consumption goods.\(^{34}\)

As obvious from the equation above, only the consumption goods market is monopsonistically competitive, while \( dt \) is the rate of depreciation allowance to investment and is defined as

\[
dt = \frac{dt_{r,t}(1 - \delta) + \delta q.tk}{1 + r},
\]

(21)

\( \delta \): the capital depreciation rate,
\( q \): the price of the capital stock that will be defined later as the shadow price.

Since investment is compiled as a stock, investment today secures a depreciation allowance not only for the next period but also into the future. If we multiply both sides of equation (21) by \( I \), the first term becomes the present value of the depreciation allowance obtained from today’s investment in the next period, while the second term captures the value of the depreciation allowance to the firm in the next period.

Firms’ technology takes the form of a CES production function with Harrod-neutral technology:\(^{35}\)

\[
Y_{j,t} = \left\{ (1 - \alpha) [A_t (1 - l) N_{j,t}]^{\phi} + \alpha (KP_{j,t-1})^{\psi} \right\}^{\frac{1}{\psi}},
\]

(22)

\( \alpha \): capital share,
\( \psi \): elasticity of substitution between labor and capital stock,
\( Y \): output,
\( A \): technology,
\( KP \): operating stock.

\(^{33}\) \( W \) denotes the real wage as used in equation (2).
\(^{34}\) Consumption goods are assumed to be final goods in this subsection.
\(^{35}\) For an advanced economy like Japan, it may be desirable to have a model with multiple sectors. We are currently working on the multiple sector model as an alternative to the JEM following the Global Economy Model (GEM) of the International Monetary Fund (IMF) as summarized in Laxton and Pesenti (2003).
Each firm faces a time-to-build constraint, meaning that the capital stock cannot be operative right after installation. This can be considered as one form of adjustment cost:

\[ KP_{jt} = (1 - b)K_{jt} + bK_{jt-1}, \]

\[ b: \text{parameter.} \]

The standard law of motion for the capital stock is still valid:

\[ K_{jt} = (1 - \delta)K_{jt-1} + I_{jt}. \]

The above two constraints may be integrated and expressed as a single constraint:

\[ KP_{jt} = (1 - \delta)KP_{jt-1} + (1 - b)I_{jt} + bI_{jt-1}. \] (23)

As mentioned, monopolistic competition is assumed in the corporate sector. Each firm produces slightly different products. Here, the composite goods are assumed to be the Dixit-Stiglitz (1977) aggregate of a multiplicity of differentiated goods indexed by \( i \in [0, 1] \). Under these settings, the composite consumption and price index are defined as follows:

\[ C_t = \left[ \int_0^1 C_t(i) di \right]^{1/\rho}, \]

\[ P_t = \left[ \int_0^1 P_t(i) di \right]^{1/\rho}. \]

Following Blanchard and Kiyotaki (1987), a demand function for each good becomes as follows:

\[ \frac{P_{jt}}{P_t} = \left( \frac{Y_{jt}}{Y_t} \right)^{(1-\rho)}. \] (24)

Combining equations (20), (22), (23), and (24), each firm’s optimization problem may be solved by finding the solution to the Lagrangian problem set out below:

\[ \Psi = \sum_{i=0}^{\infty} \frac{1}{\Pi_{i=0}^{\infty}(1 + r_{ni})} \left[ (1 - tk)(1 - \alpha)[A_i(1 - l)N_{jt}]\alpha + \alpha(KP_{jt})^\rho \right] \]

\[ -W_{jt}(1 - l)N_{jt} - P_{jt}I_{jt} + dtI_{jt} - q_{ej}(KP_{jt+1}) - (1 - \delta)KP_{jt+1}, \]

\[ - (1 - b)I_{jt+1} - bI_{jt-1}. \]

36. Although in the JEM the operating capital stock is assumed to be the weighted sum of the physical capital stock for the past eight periods, here, to make the model easily understood, we look only at the case for the previous period.
From the first-order conditions, the following equations are derived:

\[ p_i = dt + q_i (1 - b) + \frac{b}{1 + r_i} q_{i+1}, \]

\[ \frac{(1 + r_i) q_i - (1 - \delta) q_{i+1}}{1 - t_k} = Y_i^{1-\phi} \rho Y_{j,t}^{\phi} \alpha(KP_{j,t})^{\phi-1}, \]

\[ Y_i^{1-\phi} \rho Y_{j,t}^{\phi} (1 - \alpha)[(1 - l)N_{j,t}]^{\phi-1} A_{j,t} = W_{j,t}. \quad (25) \]

Here, we assume a symmetric equilibrium so that \( Y_{j,t} = Y, KP_{j,t} = KP, \) and \( W_{j,t} = W. \) Then, the latter two are transformed as

\[ \frac{(1 + r_i) q_i - (1 - \delta) q_{i+1}}{1 - t_k} = \alpha \rho \left( \frac{Y_{i+1}}{KP_i} \right)^{1-\phi}, \]

and

\[ W_i = (1 - \alpha) \rho A_i \left[ \frac{Y_i}{(1 - l)N_i} \right]^{1-\phi}. \]

To be consistent with the household equations, we need to express the firm side equations in per capita form as well. By definition, as \( y_i = y_i/N_i \) and \( kp_i = KP_i/N_i, \) the above two equations may be expressed in the following per capita forms:

\[ \frac{(1 + r_i) q_i - (1 - \delta) q_{i+1}}{1 - t_k} = \alpha \rho \left( \frac{y_{i+1}}{kp_i} \right)^{1-\phi}, \quad (26) \]

\[ w_i = (1 - \alpha) \rho A_i \left[ \frac{y_i}{(1 - l)} \right]^{1-\phi}. \quad (27) \]

The production function, investment, and the time-to-build constraint may also be rewritten in per capita forms:

\[ y_i = \left\{ (1 - \alpha) [A_i (1 - l)]^{\phi} + \alpha (kp_{i-1})^{\phi} \right\}^{\frac{1}{\phi}}, \quad (28) \]

\[ k_i = (1 - \delta) k_{i-1} + i, \quad (29) \]

\[ kp_i = (1 - b) k_i + bk_{i-1}. \quad (30) \]

Equations (21), (25), (26), (27), (28), (29), and (30) constitute the fundamental dynamic equations governing firms’ decision making.
C. The Government Sector
In contrast to some recent works such as Benigno and Woodford (2003), the government sector in the JEM is not considered to be an optimizing agent. There are target levels for government debt\[^{37}\] and for government expenditure. To achieve this target, the government collects tax on labor income, corporate tax, indirect tax, and tariffs.\[^{38}\]

In each period, government should satisfy the budget constraint:

\[
gb_t = (1 + r)gb_{t-1} + g - rtd_t - rtk_t - rti_t,
\]

- $gb$: government debt,
- $g$: government expenditure,
- $rtd$: revenue from labor tax,
- $rtk$: revenue from corporate tax,
- $rti$: revenue from indirect tax and tariffs.

As with the corporate tax rate, the indirect tax and tariff rates are exogenously set, and the labor tax rate is adjusted so that the government budget constraint should be satisfied in the short-run equilibrium.\[^{39}\] A brief explanation of the tax-collecting system is as follows.

Since the tax on labor income is imposed directly on labor income, revenue is that proportion of labor income:

\[
rtd_t = td_w(1 - l),
\]

- $td$: tax rate on labor income.

The revenue from corporate tax is, similarly, just the corresponding proportion of corporate profits:

\[
rtk_t = tk[y - w(1 - l) - \delta q_{t-1} - k_{t-1}],
\]

- $tk$: corporate tax rate.

Revenue from indirect tax and tariffs are collected by including these in deflators. All the equations for deflators, except for those of imports, exports, and inventory, are determined in a similar fashion. Here, therefore, we look only at the identity for the consumption deflator as an example to aid understanding of the indirect tax collection system:

---

\[^{37}\]As explained later, the target is the ratio of government debt to GDP when running the model.

\[^{38}\]It may seem contrary to the consensus that the government adjusts labor income tax to satisfy the government budget constraint instead of indirect tax rates such as consumption tax. However, when conducting projections, we carefully monitor the developments in the income tax rate so that it moves reasonably.

\[^{39}\]In the short-run dynamics, which will be explained later, the amount of government debt is adjusted so that the instantaneous budget constraint is always satisfied.
\[ \begin{align*} 
pc_c &= (1 + tic)[pcd(c, -cm) + (1 + ticm)pcm, cm], 
\end{align*} \] 

\( pc \): consumption deflator,
\( tic \): indirect tax rate on consumption,
\( pcd \): domestic consumption deflator at factor cost,
\( cm \): imports of consumption goods,
\( ticm \): tariff rate on imported consumption goods,
\( pcm \): deflator for imported consumption goods at factor cost.

As a result, indirect tax and tariffs from consumption are defined as

\[ tic \cdot pcd(c, -cm) + tic \cdot pcm, cm + ticm \cdot pcm, cm + tic \cdot ticm \cdot pcm, cm. \]

All these indirect tax and tariff rates are summarized in the average indirect tax rate denoted by \( tiy \). This gives us the identity below:

\[ pyty = (1 + tiy)pfcty, \]

\( py \): GDP deflator,
\( pfct \): factor cost price for GDP.\(^{40}\)

\( pfct \) is then determined simultaneously, using the above equation and the following:

\[ pyty = (1 + tiy)[pcd(c, -cm) + pihd(ih, -ihm) + pid(i, -im) + pgd(g, -gm) + px, x + pii, ii], \]

\( pihd \): domestic housing investment deflator at factor cost,
\( ihm \): imports of housing investment goods,
\( pid \): domestic investment deflator at factor cost,
\( im \): imports of investment goods,
\( pgd \): domestic government deflator at factor cost,
\( gm \): imported government goods,
\( px \): exports deflator,
\( x \): exports,
\( pii \): inventory deflator,
\( ii \): inventories.

The right-hand side of this equation, excluding \( 1 + tiy \), describes nominal GDP minus total indirect taxes. The latter are subtracted because the domestic demand component deflators, such as \( pcd \), exclude indirect taxes and tariffs. For this reason, \( pfct \) is taken to be the factor cost price deflator, while \( tiy \) is the average indirect tax rate including indirect taxes and tariffs.

\(^{40}\) This is the deflator excluding indirect taxes and tariffs.
As a result, the total revenue from indirect taxes and tariffs may be defined as follows:

\[ r_{ti} = t_{i}y_{p}f_{c}y. \]

D. The External Sector

As is usually the case for large-scale macromodels, a small open economy is assumed in the JEM. Therefore, in the long run, it is supposed that the domestic interest rate converges to the world interest rate. Temporary differences between domestic and world interest rates induce financial asset shifts, but net exports are determined so that the identity for the foreign sector is always satisfied.

As explained above, since the core dynamics of the short-run equilibrium in the JEM are driven by the Blanchard-Buiter-Yaari-Weil OLG model rather than the more typical DGE model, the inclusion of a survival rate means that the subjective discount rate can depart from the reciprocal of the steady-state real interest rate. The result of this difference is the existence of net exports and nonzero net foreign assets even in the steady state where the domestic and world interest rates are equal. \(^{41}\)

Let the variables with a superscript \( * \) denote those denominated in foreign currencies. We may then express the identity that will always hold for trade and net foreign assets as follows:

\[ n_{fa} = (1 + r_{*})n_{fa_{t-1}} + x_{m*}, \]

\( x_{m} \): net exports.

This is transformed into a domestic currency base by defining \( n_{fa} = n_{fa_{t}}z_{t} \), giving

\[ n_{fa_{t}} = (1 + r_{*})\frac{z_{t-1}}{z_{t}}n_{fa_{t-1}} + x_{m_{t}}, \]

\( z_{t} \): real effective exchange rate.

The real effective exchange rate is determined to satisfy the financial market clearing condition:

\[ f_{a} = p_{ka}k + g_{b} + n_{fa_{t}}, \]

\( p_{ka} \): price of capital stock.

Exports and imports are then determined by the following equations. However, as the above identity always needs to be satisfied, prices and exchange rates are adjusted either directly or indirectly. Exports are simply determined by the world GDP, \( y^{*} \), and export prices where the latter are of course sensitive to exchange rates:

\(^{41}\) For details on the existence of net trade even in the steady state in the Blanchard-Buiter-Yaari-Weil framework, see Blanchard (1985) and Frenkel, Razin, and Yuen (1996).
\[ x_t = x_0 + x_1 y_t^* + x_2 px_t, \]

\[ x_0, x_1, x_2: \text{parameters}. \]

Imports, on the other hand, are determined in two stages. The same structure is always employed for all the GDP components except for exports and inventories (assumed to be non-tradable). We select the case for consumption as an example.

At the first stage, import prices are determined as the weighted average of their past values and prices abroad expressed in terms of the domestic currency:

\[ pcm_t = (1 - pcm_t)pcm_{t-1} + pcm_t(pcr ow_t z_t), \quad (32) \]

\[ pcm_t: \text{parameter}, \]

\[ pcr ow_t: \text{price of consumption goods in the rest of the world}. \]

Then, the ratio of imported consumption goods to overall consumption is fixed as the relative price of imported goods to domestic goods:

\[ cm_c = cm_c_0 + cms_2(1 + ticm) pcm_t \times pcd_t, \]

\[ cm_c_0, cms_2: \text{parameters}, \]

\[ cm_c: \text{the ratio of imported consumption goods to overall consumption}. \]

Essentially, the underlying dynamics of these equations are similar to those found in open economy models with rigorous microfoundations, established by Obstfeld and Rogoff (1995) and known as the “new open-economy macroeconomics (NOEM).”

E. Financial Intermediary

Recently, financial market imperfections have been increasingly considered one of the major causes of business cycles, influenced by models such as the “financial accelerator model” of Bernanke, Gertler, and Gilchrist (1999) and the “credit cycle model” of Kiyotaki and Moore (1997). However, in the JEM, no explicit mechanism for financial market imperfection is embedded. Hence, the financial intermediary is just an artificial entity. The risk-neutral and nonprofit financial intermediary’s role, therefore, is simply to provide funds and allocate these optimally among different economic agents.

42 In the NOEM, monopolistic competition is assumed for both domestic and imported goods, and as a result, the following demand equation for imported goods is derived.

\[ cm_t = \frac{(1 + ticm)pcm_t}{pc_c_t} \cdot \epsilon_t. \]

43 For a quantitative forecast, it is more common to use an exogenously determined risk premium than to endogenize financial market imperfection. We are, however, currently working on incorporating a financial accelerator model à la Bernanke, Gertler, and Gilchrist (1999) into the JEM.
However, looking at movements in actual financial markets, we observe that, in contrast to the predictions of the small open-economy model, the domestic real interest rate is not that close to the foreign interest rate, although a tendency toward convergence has been more evident recently. Furthermore, the presence of a risk premium means that interest rates governing firms’ investment tend to be higher than those for government bonds even when maturities are the same.

Reflecting these stylized facts, the JEM adopts an \textit{ad hoc} risk premium\textsuperscript{44} that allows us to mimic actual movements in the data. For example, firms are assumed to face an interest rate comprising the risk-free long-term interest rate plus a risk premium:

\[ r_{k} = r_{l} + r_{k_{rl}} , \]

\( r_{k} \): interest rate for corporate lending,
\( r_{l} \): long-term interest rate,
\( r_{k_{rl}} \): risk premium on the corporate lending rate.

\section*{F. Prices}

So far, we have abstracted the detailed construction of price levels. All demand components have individual deflators, as expressed in equations (31) and (32). Eventually, however, deflators for GDP components always need to satisfy the following condition:

\[ p_{yt} = p_{ct} + p_{ti} + p_{ih_{t}} + p_{g_{t}} + p_{ii_{t}} + p_{x_{t}} - p_{m_{t}}. \]  

\textbf{(33)}

\section*{V. Steady State}

The steady state in the JEM describes a situation in which all real variables are growing at the potential growth rate. Nominal variables grow at this speed plus the target level of inflation set by the central bank. By having this well-defined steady state as a terminal condition, we can include model-consistent expectations in our analytical framework.\textsuperscript{45}

The easiest way to understand the steady state is to think of the steady-state value obtained by eliminating time, that is, the subscript \( t \), from the equations above. For example, the steady-state representation of equation (33) is simply

\[ p_{y} \cdot y = p_{c} \cdot c + p_{i} \cdot i + p_{ih} \cdot i_{h} + p_{g} \cdot g + p_{ii} \cdot ii + p_{x} \cdot x - p_{m} \cdot m. \]

However, if the equation includes lagged variables, the above method is only valid when the potential growth rate is zero or technology growth is zero within the

\textsuperscript{44} Incorporating a time-varying term premium computed from an affine transformation of state variables is being examined.

\textsuperscript{45} The JEM is solved using TROLL. In TROLL, having set the initial condition and the terminal condition (expressed by the steady state), a large nonlinear model like the JEM is solved by applying a stacked-time algorithm to the Newton-Raphson method.
per capita model setting. This is rather unrealistic. Therefore, in the JEM, all real variables are expressed as ratios to potential GDP, $yp$, allowing us to obtain a well-defined steady state.

For example, dividing both sides of equation (29) by $yp$ gives us

$$\frac{k_i}{yp} = (1 - \delta) \frac{k_{i-1}}{yp} + \frac{i_t}{yp}.$$  

If we define $k_i = \frac{k_i}{yp}$ as in the JEM, then the relationship between investment and the capital stock changes as follows:

$$k_i = (1 - \delta) \frac{yp_{i-1}}{yp} k_{i-1} + \frac{i_t}{yp}$$

$$= (1 - \delta) \frac{k_{i-1}}{1 + ydot} + \frac{i_t}{yp}.$$

$ydot$: potential growth rate.

Thus, the steady-state relationship between investment and the capital stock becomes

$$\frac{ydot + \delta}{1 + ydot} k = i.$$  

Similarly, all nominal variables are expressed as ratios to potential GDP multiplied by the GDP deflator, namely, nominal potential GDP. By repeating the above approach, we can obtain a well-defined steady state for each variable.

A. Growth Accounting

Since all variables in the JEM are thus strictly stationary, the steady state is defined in terms of fixed values. Then, this together with the CES production function with Harrod-neutral technology specified in equation (22) guarantees that the JEM is consistent with a balanced growth equilibrium:

$$1 + ydot = (1 + qdot)(1 + ndot),$$

$ndot$: trend population growth rate,  
$qdot$: trend growth in labor-augmenting technical progress.

Both trend population growth and growth in labor-augmenting technical progress are exogenous. To meet transversality conditions, they are set so that the potential growth rate becomes smaller than the real equilibrium interest rate.

---

46. Potential GDP is estimated as in Hirose and Kamada (2002). Further, in a per capita model setting, the potential growth rate depends solely on the technology growth rate.
B. Deep Parameters
Here, we set out the representative structural parameters that determine the dynamics in both the short-run equilibrium and steady state (Table 1). Note that all the values given here are on an annual basis.

Table 1 Representative Structural Parameters

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Definition</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1 - \gamma$</td>
<td>Survival rate</td>
<td>0.98</td>
</tr>
<tr>
<td>$\beta$</td>
<td>Subjective discount rate</td>
<td>0.99</td>
</tr>
<tr>
<td>$\sigma$</td>
<td>Intertemporal elasticity of substitution</td>
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</tr>
<tr>
<td>$\theta$</td>
<td>Taste parameter</td>
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</tr>
<tr>
<td>$d_h$</td>
<td>Depreciation rate for housing stock</td>
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</tr>
<tr>
<td>$\alpha$</td>
<td>Capital share</td>
<td>0.37</td>
</tr>
<tr>
<td>$\psi$</td>
<td>Elasticity of substitution</td>
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</tr>
<tr>
<td>$\rho$</td>
<td>Demand elasticity</td>
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</tr>
<tr>
<td>$\delta$</td>
<td>Capital depreciation rate</td>
<td>0.06</td>
</tr>
<tr>
<td>$r^*$</td>
<td>World interest rate</td>
<td>0.01</td>
</tr>
</tbody>
</table>

Notes: 1. The survival rate is set according to MULTIMOD, the large-scale international macromodel of the IMF. Details on the current MULTIMOD (Mark III) are described in Laxton et al. (1998).
2. The subjective discount rate is determined endogenously in the JEM by setting the steady-state net foreign asset position exogenously.
3. The intertemporal elasticity of substitution is set according to the estimation results for nondurable goods consumption in Nishiyama (2002).
4. The taste parameter that weights the utility from consumption and the stock value of housing is fixed to ensure that the steady-state levels of consumption and housing investment, which are already expressed as ratios to potential GDP in the JEM, are empirically reasonable.
5. The depreciation rate for housing stock, the capital share, and the capital depreciation rate are set at broadly their historical SNA averages.
6. The elasticity of substitution between labor and the capital stock is set so that the production function approximates a Cobb-Douglas function, following the estimation results in Kamada and Masuda (2001).
7. The demand elasticity determines the steady-state level of corporate profits, since its reciprocal is the steady-state markup. Therefore, this is basically set at its historical average computed from the SNA data.
8. The world interest rate is set rather subjectively to track recent developments in short-term real interest rates in industrialized countries.

VI. Short-Run Dynamics

Up to this point, we have introduced the short-run equilibrium (SREQ) model, and the steady state (SS) as the terminal condition of the SREQ. Although the SREQ itself can be used to analyze the Japanese economy, three further points need to be addressed to complete the JEM: (1) the SREQ cannot account for deviations from the equilibrium value frequently observed in actual data; (2) the SREQ framework fails to provide any means of determining the inflation rate; and (3) there is no explicit mechanism for bringing the economy back to the steady state, nor is the role of the monetary policy rule in achieving stability specified within the model.

The introduction of the short-run dynamics (SRD) allows variables to deviate temporarily from the equilibrium values determined by agents’ optimizing behavior.
above. Furthermore, the SRD also includes a Phillips curve for inflation determination as well as endogenizing monetary policy by incorporating a monetary policy rule. The addition of the SRD to the SREQ completes the JEM. Consequently, all variables evolve through SRD → SREQ → SS, meaning that not only are projection and shock simulation highly realistic but also theoretical analysis is possible as the model retains a well-defined steady state (Figure 1).

In this section, we first provide an outline of these short-run dynamics, and then present the Phillips curve and monetary policy rule that are embedded in the JEM.

A. Outline of Short-Run Dynamics

As is already mentioned in the introduction, the JEM can be considered as a mixture of the VAR and DGE models. The SREQ plays the part of the DGE, while the SRD takes on the role of the VAR or vector error correction model (VECM).

Here, as an example, we look at the short-run dynamics of $cfl$ around its SREQ, which is henceforth denoted by superscript $eq$:

$$
cfl_t = cfl_{eq}^{t} + cv_1 \left( \frac{ydt^{t-2}pct^{t-2}}{ydt^{eq}pct^{eq}} - 1 \right)
- [cv_{21}(r_{t-2} - r_{eq}^{t-2}) + cv_{22}(rl_{t-2} - rl_{eq}^{t-2})]cfl_{eq}^{t-2}
+ cv_3 \left( \frac{nfa_{t}}{pc_{t}} - \frac{nfa_{eq}^{t}}{pc_{eq}^{t}} \right) - cfladj^{t}, \quad (34)
$$

$cv_1$, $cv_{21}$, $cv_{22}$, $cv_3$: parameters,
$yd$: nominal disposable income.

The second, third, and fourth terms on the right-hand side determine the extent of the “short-run dynamics” effect on PIH consumption caused by temporary deviations in these economic variables. This may have an impact on short-run consumption behavior, resulting in what are sometimes termed disequilibrium movements.

The term $cfladj$ defines the polynomial adjustment cost (PAC) described by Pesaran (1991) and Tinsley (1993, 2002), which is popular in large-scale DGE models because it allows adjustments with leads and lags to be obtained from optimizing behavior. Concerning consumption dynamics, a second-order PAC is employed and $cfladj$ is expressed as follows:

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47. Variables that are determined by minimizing PAC are PIH consumption, the ratio of imported consumer goods to consumption, the ratio of imported government goods to government spending, housing investment, the ratio of imported housing investment goods to housing investment, inventory investment, the ratio of imported investment goods to investment, capital stock, the deflator on domestic consumer goods, the deflator on imported consumer goods, the deflator on domestic government goods, the deflator on imported government goods, the deflator of domestic housing investment goods, the deflator of imported housing investment goods, the deflator of imported investment goods, the deflator on exported goods, the unemployment rate, and exports.
\[ cfl_{adj} = cd1[cfl_t - cfl_{t-1} - cb1(cfl_{t+1} - cfl_t)] \\
+ cd2[(cfl_t - cfl_{t-2}) - cb1^2(cfl_{t+2} - cfl_t)], \]

cd1, cd2, cb1: parameters.

Combining these after some manipulation gives us a generalized error correction model that includes leads and lags:

\[ \Delta cfl_t = -\frac{1}{cd1 + cd2} (cfl_t - cfl_{t-1}^{\pi}) + \frac{cd1cb1 - cd2}{cd1 + cd2} \Delta cfl_{t-1} \\
- \frac{cd2cb1^2}{cd1 + cd2} \Delta cfl_{t+1} - \frac{cd2cb1^2}{cd1 + cd2} \Delta cfl_{t+2}. \]

This specification of the equilibrium (error) correction mechanism has the very favorable property that equation (34) is derived from agents’ optimizing behavior. Denoting the target or desired level of consumption by PIH consumers as \( cfl_t^{\pi} \), which is the right-hand side of equation (34) excluding the PAC term, we obtain equation (34) by minimizing the loss defined below:

\[ L = \left[ \sum_{t=0}^{\infty} (cfl_{t+1} - cfl_{t+1}^{\pi})^2 + \sum_{j=0}^{\pi} \beta [A(L)cfl_{t+1}^{\pi}] \right], \quad (35) \]

\( \beta \): parameter, \( A(L) \): lag operator.

In the above specification, \( n \) is set at two. The theory behind this loss, \( L \), is that PIH consumers suffer both because of the deviation from their desired level of consumption and from changes in the consumption level. Under these circumstances, PIH consumers try to smooth consumption by gradually narrowing the gap between the present level and their desired level of consumption.

In this sense, although the short-run dynamics may be considered to constitute an ad hoc non-core approach, they can be still interpreted as being derived from agents’ maximizing behavior. In the JEM, economic agents are assumed to conduct two-stage optimization.\(^{48}\) Agents first derive the equilibrium level by solving the standard optimization problem in the SREQ model. Then, after deciding their target level based on this equilibrium value, they face the loss minimization problem expressed in equation (35). In this sense, if the parameters determining the target level are considered to be deep, the JEM as a whole can escape the Lucas (1976) critique, since all the parameters employed in the JEM are structural.

We apply this PAC to several variables, although not to all. For example, if the SRD of wages, \( w \), is derived by applying the PAC, then it is redundant to

\(^{48}\) The existence of the bundlers implicitly assumed in the monopolistic competition suggests the possibility of three-stage optimization.

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further smooth the ROT consumption, \( c_{rt} \). By utilizing the PAC appropriately, we can attain a realistic but theoretically consistent long-run dynamic path for each macroeconomic variable.

Most of the SRD parameters are estimated using instrumental variables (IV). Parameters for external sectors are mainly calibrated\(^49\) so that the impulse responses to certain shocks in the JEM are similar to those in the VAR.\(^90\)

**B. Phillips Curve**

Inflation dynamics are one of the predominant drivers of short-run dynamics. They induce sticky prices, which are thought to be one of the most important factors behind the business cycle. In the JEM, inflation is determined via a Phillips curve for domestically produced goods. Several forms of the new Keynesian Phillips curve,\(^51\) which may be considered a Phillips curve with microfoundations, have been introduced in a number of influential pieces of research in this field, such as, for example, the seminal work by Taylor (1979) and Calvo (1983). In the JEM, the hybrid new Keynesian Phillips curve advocated by Fuhrer and Moore (1995) is employed. It includes leads and lags of inflation, the sum of the coefficients on which is unity so that the dynamic homogeneity condition or non-accelerating inflation rate of unemployment (NAIRU) condition holds.\(^52\) When this dynamic homogeneity condition holds, we obtain the property that inflation neither accelerates nor decelerates when GDP equals potential GDP, in other words, when the output gap is zero. As a result, in the steady state where the output gap is zero, inflation is solely determined by the central bank’s adopted target.

In the JEM, the Phillips curve is specified as follows:

\[
pdot_t = p_{df} p_{dot} + (1 - p_{df}) p_{dot-1} + p_d \left( \frac{y_t}{y_p} - 1 \right),
\]

\(p_{df}, p_d\): parameters,
\(p_{dot}\): inflation rate for domestically produced goods,
\(p_{dot}\): expected inflation rate.

Parameters in the above equation are set in line with the estimation results for the hybrid new Keynesian Phillips curve in Japan obtained by Kimura and Kurozumi (2004).

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49. Orcutt (1950) discusses how an aggregation bias, simultaneity bias, and other factors could lead a naive econometrician to find a low trade elasticity even when this elasticity is quite high, and indeed that it is not difficult to obtain a reasonable elasticity which adequately satisfies the Marshall-Lerner condition. Concerning the trade elasticity, Obstfeld (2002) states that “the elasticities are no doubt significantly higher today than they were at the start of the floating-rate period.”
50. However, this check is based on an informal “eyeball check.”
51. Developments in the new Keynesian Phillips curve are well summarized in Roberts (1995).
52. To be strict, the hybrid new Keynesian Phillips curve in this form is derived with microfoundations when the subjective discount rate equals unity, which contradicts the SREQ setting in the JEM. In deriving the hybrid new Keynesian Phillips curve, we implicitly assume that the subjective discount rate can be considered to approximate unity.
C. Monetary Authority

Recent progress in monetary economics during the last decade has been especially noteworthy in the field of optimal monetary policy. With the publication of the seminal paper by Taylor (1993), which established the famous “Taylor Rule,” a substantial body of work has been devoted to identifying optimal policy rules either to reduce the variability of the output gap and inflation or to raise the expected utility of the representative agent. All told, monetary policy and monetary policy rules are now considered to play the most critical role in economic stabilization, namely, leading the economy to its steady state.

In the JEM, the monetary policy rule is given the explicit task of economic stabilization:

$$ r_{nt} = \text{smooth} \left[ \rho_{nt}^0 + rsl_4(tpdot_{t+1} - pdottar_{t+1}) + rsl_5(tpdot_{t+5} - pdottar_{t+5}) ight] + (1 - \text{smooth})r_{nt-1}, \quad (36) $$

$$ rsl_4, rsl_5, rsl_6: \text{parameters,} $$

$$ \text{smooth}: \text{interest rate smoothing parameter,} $$

$$ r_{nt}: \text{call rate,} $$

$$ tpdot: \text{weighted average of consumer price index (CPI) inflation and } pdot, $$

$$ pdottar: \text{target level of the inflation rate.} $$

Parameters are estimated using instrumental variables. As the lag of the call rate is included, this can be considered a form of the “history dependent monetary policy rule” whose importance is stressed by Giannoni (2000) and Woodford (2003).

VII. Diagnostic Simulation

Up to this point, we have focused on establishing the structure of the model. Although as much estimation as possible is employed to obtain the parameters, the model properties should be evaluated in terms of their overall performance. Recently, there has been a tendency to insist upon a “top-down” approach when constructing large-scale macroeconomic models, so that the model as a whole should display reasonable and realistic properties in projections and impulse response analyses. Following this approach, parameters are usually set by calibration. This alternative is to refine the estimation of each equation using cutting-edge econometric techniques. This approach is sometimes referred to as the “bottom-up” approach. However,

53. Although indeterminacy when using the forecast-based rule has been pointed out by such research as Svensson and Woodford (2003), Batini and Pearlman (2002), and Batini, Levine, and Pearlman (2004), the superior performance of the forecast-based rule in the JEM is verified by Fujiwara et al. (2003).

54. In monetary DGE models, the instrument rule, which attains the lowest social loss, is usually employed. Although such an optimal rule is obtained in Fujiwara, Hara, Teranishi, Watanabe, and Yoshimura (2004), we employ the estimated rule in the basic JEM for better forecasting performance. It is common in the field of large-scale DGE models to apply an empirical rule such as the base rule.
due to non-exogeneity, simultaneous bias, misspecification, and so on, it is almost impossible to obtain reasonable overall model properties using the approach alone.

In the JEM, we make substantive use of the bottom-up approach since we try to obtain parameters by estimation. However, we also pay close attention to the properties of the model as a whole, as we believe that this is where large-scale macroeconomic models have the most to offer. Therefore, several parameters are calibrated.\textsuperscript{55} Having done this, we are ready to conduct some diagnostic simulations.

In this section, we conduct several diagnostic shock simulations that are thought to capture the most important disturbances facing the Japanese macroeconomy. To begin with, to confirm whether the impulse responses obtained in the JEM are consistent with theory and our intuition, we carry out eight shock simulations: (1) a permanent increase in domestic productivity; (2) a permanent decrease in the government’s debt-to-income target; (3) a shift in the composition of taxes; (4) a change to the inflation target; (5) an autonomous demand shock; (6) a temporary real exchange rate appreciation; (7) a permanent improvement in the terms of trade; and (8) a monetary policy shock.\textsuperscript{56}

At the same time, we have checked whether the shock responses change significantly as the simulation period becomes longer. This is following the concept of “Type III iteration” advocated by Fair and Taylor (1983). Since shock responses do not change significantly with extended horizon, we can conclude that the simulation period is long enough to attain convergence.

A. A Permanent Increase in Domestic Productivity

Figure 2 shows the impulse responses to a permanent increase of 1 percentage point in domestic productivity.

The technology shock raises not only output but also the desired capital stock. Hence, investment also increases. As the higher marginal productivity of labor causes wages also to rise, consumption increases. However, consumption evinces life-cycle behavior and investment is bound by the time-to-build constraint, so aggregate demand does not rise as much as output. The result is that the output gap widens. This wider output gap leads to a lower inflation rate. In response to this, the central bank lowers the nominal interest rate. A decrease in the nominal interest rate brings about a lower user cost of capital, with the result that investment increases further and the output gap becomes smaller. As for the foreign exchange rate, households need to sell off their net foreign assets to support the increase in the domestic capital stock. Consequently, the exchange rate appreciates as net exports necessarily decrease with the decline in the net foreign asset position.

\textsuperscript{55} Recently, there has been increasing interest in methodologies that aim to bridge the gap between these two approaches, as, for example, in Geweke (1999) and Smets and Wouters (2003). Such papers employ Bayesian estimation techniques, enabling them to retain reasonable overall model properties in an estimating context. We aim to employ this method in our future research.

\textsuperscript{56} With the current version of the JEM, we cannot conduct simulation concerning price changes in oil or other raw materials, since the production function consists only of labor and capital. In our new project with the IMF, we are working on a model with multiple sectors in which it is possible to analyze effects through raw materials.
Figure 2  A Permanent Increase in Domestic Productivity

[1] Capital Stock
[2] Investment
[3] Real Wage
[4] Consumption
[5] Output Gap
[6] CPI Inflation Rate
[7] Nominal Interest Rate
[8] Real Exchange Rate
B. A Permanent Decrease in the Government’s Debt-to-Income Target

Figure 3 shows the impulse responses to a permanent decrease in the government’s debt-to-income target of 10 percentage points.

To decrease debt, the government needs to increase the tax rate on labor income so that the government budget constraint is satisfied. This causes decreases in disposable income and consumption as well as GDP. A decrease in GDP exerts downward pressure on investment, and this results in a wider output gap. As a consequence, the inflation rate falls and the central bank lowers the nominal interest rate. On the other hand, a decrease in government debt brings an increase in net foreign assets. This causes the exchange rate to depreciate so that exports increase and imports decrease. These developments in the external sector are further enhanced by the decrease in the nominal interest rate mentioned above, causing an increase in investment as well. Eventually, the government’s interest expenses on its debt fall and the tax rate on labor income is gradually able to recover to around its level before the shock.

C. A Shift in the Composition of Taxes

Figure 4 shows the impulse responses to a permanent increase of 2 percentage points in the indirect tax on consumption.

As the government budget constraint must always be satisfied, an increase in the indirect tax reduces the tax rate on labor income. However, as the labor income tax is only gradually adjusted, in the meantime the government lowers its outstanding debt. Hence, the short-run effect from the increase in the indirect tax rate is to reduce consumption. This eventually lowers CPI inflation, following an initial temporary rise due to the tax increase, during which the output gap widens. Meanwhile, the initial spurt of inflation causes the central bank to increase the nominal interest rate. After a temporary appreciation, therefore, the exchange rate ends up depreciating.

D. A Change to the Inflation Target

Figure 5 shows the impulse responses to a permanent increase of 1 percentage point in the inflation target.

Raising the inflation target induces a lower nominal interest rate, and therefore increases investment as a result of the lower cost of capital, as well as increasing exports due to the exchange rate depreciation. This in turn increases the output gap, the inflation rate, and inflation expectations. The central bank then reverses its position, raising the nominal interest rate to reduce the output gap. Finally, the economy converges to a new steady state in which the inflation rate and nominal interest rate have increased by exactly as much as the inflation target.
Figure 3  A Permanent Decrease in the Government’s Debt-to-Income Target
Figure 4  A Shift in the Composition of Taxes

[1] Tax Rate on Labor Income
[2] Ratio of Government Debt to Output

[3] Consumption
[4] Output Gap

[5] Exports and Imports
[6] CPI Inflation Rate

[7] Nominal Interest Rate
[8] Real Exchange Rate
Figure 5  A Change to the Inflation Target


E. An Autonomous Demand Shock

Figure 6 shows the impulse responses to a temporary demand shock to consumption and investment.

As the increases in consumption and investment are just temporary, the production level does not change significantly. The output gap, therefore, becomes positive. Consequently, inflation rises and the central bank raises the nominal interest rate. The exchange rate then appreciates in line with the increase in the nominal interest rate. This causes import prices to decrease, putting downward pressure on the CPI. Since net exports fall as a result of the currency appreciation, the output gap contracts. This results in lower inflation and nominal interest rates. Consequently, all the variables return to their initial levels as we would expect following a temporary shock.

**Figure 6  An Autonomous Demand Shock**

![Graph showing impulse responses to a temporary demand shock](image)
F. A Temporary Real Exchange Rate Appreciation

Figure 7 shows the impulse responses to a temporary positive shock to the real exchange rate of 1 percentage point.

The appreciation in the exchange rate increases imports but decreases exports. These developments result in a widening of the output gap. Furthermore, import prices and therefore CPI inflation fall. This results in a rise in consumption due to an increase in the real purchasing power. Lower inflation decreases the nominal interest rate via the monetary policy rule. This has some limited positive impact on investment, but investment is also affected by the lower level of net exports. Overall, investment falls for a while. However, as the shock is only temporary, the economy gradually returns to its initial state, following the same mechanism as above but in the reverse direction.

G. A Permanent Improvement in the Terms of Trade

Figure 8 shows the impulse responses to a permanent improvement in the terms of trade: a permanent decrease of 5 percentage points in imported goods prices around the globe.

A decrease in the price of imported goods improves the terms of trade and naturally induces domestic deflation. Responding to these developments, the central bank cuts the interest rate by more than the percentage change in the CPI inflation rate. This results in a decrease in the domestic real interest rate, so that the real exchange rate depreciates to satisfy the uncovered interest parity (UIP) condition.

As for real activities, although the depreciation leads to an increase in exports, net exports decrease because of the increase in domestic purchases of the cheaper imported goods. Real consumption increases as a result of a decrease in the consumption deflator. However, there is also a simultaneous and permanent rise in the level of consumption thanks to the increased production capacity that results from a larger capital stock: the lower price of imported capital goods reduces the cost of capital and therefore increases the desired level of capital stock.

H. A Monetary Policy Shock

Figure 9 shows the impulse responses to a temporary increase in the call rate of 1 percentage point.

A positive shock to the nominal interest rate increases the cost of capital and thus reduces investment. It therefore causes the exchange rate to appreciate and exports to decline. Reflecting these developments, the output gap widens and consumption decreases as a result of weak demand, which also induces lower imports. A wider output gap lowers inflation and inflation expectations. This causes a reduction of the nominal interest rate by the central bank. Eventually, investment, exports, and the output gap recover their initial levels.57

57. Our results show output composition of the monetary transmission mechanism similar to the one in Fujiwara (2004).
Figure 7  A Temporary Real Exchange Rate Appreciation

[1] Real Exchange Rate

[2] Imports

[3] Exports

[4] Output Gap

[5] CPI Inflation Rate

[6] Consumption

[7] Nominal Interest Rate

[8] Investment

The Japanese Economic Model (JEM)
Figure 8  A Permanent Improvement in the Terms of Trade

[1] Terms of Trade
Percentage points

[2] CPI Inflation Rate
Percentage points

[3] Nominal Interest Rate
Percentage points

[4] Real Exchange Rate
Percent

[5] Exports and Imports
Percent
Exports
Imports

[6] Consumption
Percent

[7] Capital Stock
Percentage points

[8] Output Gap
Percentage points
Figure 9  A Monetary Policy Shock

[1] Nominal Interest Rate
[2] Investment

[3] Real Exchange Rate
[4] Exports

[5] Imports
[6] Output Gap

[7] Consumption
[8] CPI Inflation Rate
VIII. Diagnostic Simulation under the Zero Nominal Interest Rate Floor

Since the raison d’être of the JEM is to produce realistic projections and policy simulations for the Japanese economy, the non-negativity constraint on the nominal interest rate should always be considered. Therefore, we here review how the zero floor on the nominal interest rate affects the Japanese economy by simulating a temporary but deterministic shock. The standard cases typically dealt with in the DGE literature are considered: a demand shock and an inflationary shock (cost-push shock), both of which can be considered typical shocks occurring in the real economy.

When the JEM is actually used for projection, policy simulation, etc., the zero nominal interest rate is introduced by rewriting equation (36) with a max function as follows:

\[
\begin{align*}
    r_{nt} = & \max\{0, \text{smooth} \left[ r_{nt}^{eq} + rsl_4(tpdot_{t+4} - pdottart_{t+4}) + rsl_5(tpdot_{t+5} - pdottart_{t+5}) \\
    & + rsl_6(tpdot_{t+6} - pdottart_{t+6}) \right] + (1 - \text{smooth})r_{nt-1}\}. 
\end{align*}
\]

(37)

With this modification, we can obtain a non-negative call rate and therefore a non-negative nominal interest rate, as equation (37) is the core equation of interest rate determination. However, there exists one crucial defect in equation (37). The derivatives of the equation around a zero call rate are not continuous. This may have very important implications when solving the model using TROLL. In TROLL, a large nonlinear dynamic model is solved via the Newton-Raphson method using a

58. Pioneering work by Benhabib, Schmitt-Grohé, and Uribe (2002) points to the possibility of multiple equilibria once the zero bound on the nominal interest rate is taken into account. If the central bank follows a simple Taylor rule, the interest rate is raised when the inflation exceeds the target, at the point where the inflation rate is close to its target. Naturally, the interest rate feedback rule and the Fisher equation intersect when the inflation rate equals the target level of inflation. This point may be called the target equilibrium, TE in the standard terminology.

However, at the same time, this together with the existence of a non-negativity constraint on the nominal interest rate necessarily implies another point where these two lines intersect. At this second point, the inflation rate is low and possibly negative, the nominal interest rate is zero, and monetary policy is passive. This is the so-called below-target equilibrium (BTE), which is sometimes stationary (BTSE), and sometimes non-stationary (BTNE). In flexible price setting where inflation instantaneously adjusts so that the Fisher equation is always satisfied, Benhabib, Schmitt-Grohé, and Uribe (2002) show that although the BTE is indeterminate, the inflation rate and the nominal interest rate close to the TE converge gradually to the BTE.

Although such steady-state multiple equilibria are an interesting phenomenon, we choose to follow Jung, Teranishi, and Watanabe (2005) and not take the BTE into consideration in this paper. Here, we solve for the rational expectations solutions using TROLL. In TROLL, when solving the model, we first need to compute the steady state as the terminal condition and then the rational expectations path is computed using a stacked-time algorithm. As the BTE will usually be non-stationary, especially in a large-scale macromodel such as the JEM, we cannot designate the BTE as the terminal condition. However, in some cases, even if we set the terminal condition as the TE, no solution is obtained. These developments may suggest not an explosive path, but that the economy is stuck at the BTE.

59. A larger shock is applied than in the above experiment so that the zero nominal interest rate floor becomes a binding constraint.

60. Another typical shock is that on the exchange rate. However, as long as temporary one-off shocks are being considered, the size of shock needed for the zero nominal interest rate constraint to bind is implausibly high. Furthermore, such a simulation finds nothing that was not already suggested by the two experiments above.

61. The call rate determined in equation (37) is used to compute longer-term interest rates by adding exogenously set risk premiums and according to the term structure defined by the forward-looking solution.
stacked-time algorithm.  When applying the Newton-Raphson algorithm, TROLL obtains the Jacobian matrix as the “symbolic derivative,” with which derivatives are computed analytically and logically, for example, \( \frac{\partial \log(x)}{\partial x} = \frac{1}{x} \). Under this solution system, if the iteration process encounters a point where \( r_n = 0 \) for the largest deviation of inflation from its target, the symbolic derivative is simply incomputable, with the result that the Newton-Raphson iteration process simply stops. The model therefore cannot be solved in such cases, even if it can conceivably be solved in another way.

One measure to tackle this discontinuous derivative without abandoning the Newton-Raphson method entirely is to use dumping. By lessening the Newton gain, the iteration may not fall into the kink as \( r_n = 0 \) even if it falls there without dumping. Another approach to this problem is to approximate equation (37) using a numerical method so that the equation is not only continuous but also almost non-negative (see Appendixes 2 and 3).

Given today’s significant advances in computer processing power, function approximation is used heavily in solving dynamic programming problems whose value function may not be solved analytically. Of the several methods advocated, we choose to employ function approximation with polynomial interpolation based on the Weierstrass Theorem. This states the following:

Any continuous real-valued function \( f \) defined on a bounded interval \([a, b]\) of the real line can be approximated to any degree of accuracy using polynomial.

In this paper, equation (37) is approximated by a 10th-order polynomial interpolation to analyze the impact of the zero floor on the nominal interest rate. As the approximation is extremely long, we will not show it here.

In the following, we present the results both from the max function and from the numerically approximated function. You will see that the JEM can run under the zero bound and employing the max function is sufficient.

A. An Autonomous Demand Shock

Figure 10 shows the impulse responses to a temporary negative demand shock to consumption and investment.

1. Without the zero nominal interest rate floor

In the short run, since shocks that decrease consumption and investment are only temporary, production does not decrease significantly. This results in a negative output gap, and the central bank therefore lowers the nominal interest rate as the inflation rate falls. Meanwhile, the exchange rate depreciates in accordance with the decrease in the nominal interest rate. However, as shocks are only temporary, all the variables return to their initial levels.

62. For details on the Newton-Raphson method using the stacked-time algorithm, see Hollinger (1996).
63. For details on the numerical method, see Judd (1998), Marimon and Scott (1999), Ljungqvist and Sargent (2000), and Miranda and Fackler (2002).
64. It is available upon request.
65. Cases without the zero nominal interest rate floor are basically the same as those shown in Section VII.
2. With the zero nominal interest rate floor
As the nominal interest rate cannot fall below zero, the recession produced by the negative shocks is prolonged. The output gap widens, and deflation lasts for longer than when a negative nominal rate is allowed. A striking difference can be found in the external sector. With the zero nominal interest rate floor in place, the real interest rate rises as soon as the economy hits this bound. Since the real exchange rate in the JEM is determined via the UIP condition, the result is that the real exchange
rate appreciates,\footnote{Intuition suggests that the currency of a country coming up against the zero nominal interest rate bound is likely to depreciate, reflecting its negative prospects for the future. However, this kind of channel is not embedded in the JEM.} in direct contrast with the case without the zero floor where it depreciated. Exports then decrease in response.

This underlines the severity of the problem caused by the zero nominal interest floor. Not only is there less freedom to alleviate domestic deflationary pressure, but also we are denied a boost from the external sector.

B. A Deflationary Shock

Figure 11 shows the impulse responses to a temporary deflationary shock\footnote{Shocks are applied to $\dot{p}_{dt}$.} of 1 percentage point.

1. \textbf{Without the zero nominal interest rate floor}

Deflationary shocks raise real wages temporarily and therefore consumption increases. This factor and the lowered nominal interest rate caused by deflation enhance investment. Therefore, the output gap becomes positive and imports are boosted. A lower nominal interest rate causes the currency to depreciate. Hence, exports also increase.

2. \textbf{With the zero nominal interest rate floor}

Even if the zero nominal interest rate floor is explicitly included as a constraint, consumption still increases as the mechanism described above remains functional. However, investment and exports suffer because the existence of the lower bound prevents the real interest rate from falling sufficiently to alleviate the deflationary pressure. All told, the economy takes longer to return to its initial state.\footnote{At the NBER/CEPR/CIRJE/EIJS Japan Project Meeting held on September 1–2, 2004, model responses and the effectiveness of several policy schemes under the zero bound constraint were compared using three different macroeconomic models, the FRBUS of the Board of Governors of the Federal Reserve System, the AWM of the European Central Bank, and the JEM of the BOJ. Responses to some shocks that drive the economy into a liquidity trap were quite similar among the three models.}
Figure 11  A Deflationary Shock

[1] Real Wage

[2] Nominal Wage Growth Rate

[3] Output Gap

[4] Consumption

[5] Investment

[6] CPI Inflation Rate

[7] Nominal Interest Rate

[8] Real Exchange Rate

Without zero nominal interest rate floor

With zero nominal interest rate floor (max)

With zero nominal interest rate floor (numerical)
IX. Projection

One of the largest advantages to using the JEM is its capability to produce not only theoretically consistent but also realistic projections. The process of projection may be viewed as one in which the economy is exposed to multiple shocks (mimicking those that have actually occurred in Japan), and we chart the impulse responses as the economy moves back toward its steady state. The following steps are necessary before projections can be made:

1. Setting up the database.
2. Setting the paths of the exogenous variables.
3. Solving for the steady state.
4. Proxying a learning mechanism.
5. Solving the model.
6. Transforming relative variables into levels.

A. Setting Up the Database

The first step is naturally to set up a database. As described above, all variables except for variables that are defined as rates, such as the interest and inflation rates, are in per capita form and are further normalized by being expressed as ratios to potential GDP. In addition, for analytical convenience, all price variables, namely the deflators, are expressed as ratios to the price of domestically produced and consumed goods at factor cost.

As for the potential GDP, this is derived as the level of GDP consistent with the time-varying NAIRU, as specified in Hirose and Kamada (2002). Using this definition of potential GDP, the price of domestically produced and consumed goods at factor cost, and the labor force, we are able to express all variables as relative values in per capita form.

B. Setting the Paths of the Exogenous Variables

In contrast with some of the cutting-edge research, such as Benigno and Woodford (2003), since the government sector in the JEM is not an optimizing agent, most of the fiscal variables are exogenous. Exogenous fiscal variables include the corporate tax rate, indirect tax rates, government expenditure, government transfers (including net social security payments), and the size of the government debt. On the other hand, the income tax rate is an endogenous variable determined to satisfy the government budget constraint.69 We set these exogenous variables based on publications by governmental institutions such as the Economic Advisory Council, the Ministry of Finance, and the Ministry of Health, Labour and Welfare.

Besides fiscal variables, foreign prices and total factor productivity (TFP) are also determined exogenously. It would be possible to endogenize TFP by expressing this as a function of some sort of research and development investment or social capital.

69. The tax rate was chosen over government debt to satisfy the government budget constraint solely for reasons of analytical tractability. In any case, since both are monitored to ensure reasonable performance in projection, the decision makes almost no difference so far as the projection itself is concerned.
(infrastructure) as summarized in Grossman and Helpman (1991), Aghion and Howitt (1998), and Barro and Sala-i-Martín (2003). However, although theoretically neat, it is uncertain whether the incorporation of endogenous growth theory would make it easier to obtain reasonable projections. For the time being, we continue to treat TFP as exogenous. The incorporation of endogenous growth theory in the JEM is left as a topic for future research.

C. Solving for the Steady State
Before solving the model, steady-state values are computed by eliminating leads and lags from the JEM. As mentioned, TROLL solves the model as a finite horizon problem with a well-defined steady state. Throughout the projection process, the steady state is treated almost like exogenous variables.

D. Proxying a Learning Mechanism
It has been argued that rational expectations require strong assumptions. Indeed, Evans and Honkapohja (2001) state, “The rational expectations approach presupposes that economic agents have a great deal of knowledge about the economy. Even in our simple examples, in which expectations are constant, computing these constants require the full knowledge of the structure of the model, the values of the parameters, and that the random shock is i.i.d.” The pure rational expectations hypothesis is rather unrealistic, since agents are considered to possess only “bounded rationality.” Hence, in line with the treatment in the FPS, we proxy a learning mechanism in the JEM.

Even if we know the steady state, convergence will take time if we wish to avoid making the strong assumption that agents are perfectly rational. Furthermore, even if the sizes of the shocks currently hitting the economy are known, it is impossible to identify whether these are just transitory or permanent. Therefore, we assume that agents in the JEM are following a kind of learning process which takes the form of an updating rule. In this updating rule, they begin by observing the economy’s past history, simultaneously forecasting the steady state that will be achieved in the long run. As time passes, agents obtain more information about the economy and use this to confirm their past views. They therefore adjust their desired positions gradually.

Technically, this gradual adjustment or updating rule is achieved by setting the time-varying short-run equilibrium (TVSREQ) paths for several variables such as stocks. These paths are derived by filtering the actual data series with the Laxton, Rose, and Xie (LRX) filter, a modified Hodrick and Prescott (HP) filter, with the assumption that they converge over the projection horizon to their long-run steady-state values.

SREQ paths other than the TVSREQ paths set above are computed by simulating the JEM using these TVSREQ paths and the exogenous variables. This simulation ensures overall consistency across all the SREQ paths.

70. Details are shown in Drew and Hunt (1998).
71. Similar to incorporating the endogenous growth theory in the JEM, it is left for our future research to embody a rigid and formal adaptive learning mechanism, as summarized in Evans and Honkapohja (2001), to the JEM.
E. Solving the Model

Projections are obtained by solving the JEM. Although conducted simultaneously, the process of solving the model can be more easily understood by dividing it into two intuitive parts: computation of the historical innovations and adjustment of forecast errors.

When making projections with the JEM, to preserve theoretical consistency, we solve the model in an integrated fashion over both past and future. Critically, the settings of exogenous variables and TVSREQ paths for the future and forecast error adjustments affect the estimates that the model produces for the past. Similarly, changes in estimates of the past will have a simultaneous influence on forecasts of the future. Unlike the traditional Keynesian-style backward-looking model, numerous iterations are required to obtain the consistent projections across both past and future.  

1. Computing historical innovations

Since projections can be considered in terms of the impulse responses toward the steady state following innovations that actually occurred in the economy, historical innovations need to be computed. These are computed using the exogenous variables, TVSREQ paths, and forecast errors discussed below. Between them, these provide the major driving force behind the projection and determine the shape of the convergence dynamics.

2. Adjusting forecast errors

It is more realistic to assume that historical innovations do not disappear right after entering the simulation period. Therefore, historical innovations are set in some equations and are presupposed to disappear gradually according to an AR process.

F. Transforming Relative Variables into Levels

Up until now, projection has been represented in the form of relative values. We need, therefore, to transform these relative values into levels. For real variables, these are just converted into levels by multiplying them by potential GDP. Level conversion of nominal variables is a little more complicated. First, by multiplying the last observation of the price of domestically produced and consumed goods at factor cost by \((1 + \text{pdot})\), we recover the future level of the price of domestically produced and consumed goods at factor cost. Using this price level, we are then able to calculate levels for all the nominal variables.

72. When conducting simulations however, it is also possible to assume that past evaluations are not affected by future settings.

73. Setting the TVSREQ paths is also considered to be a form of forecast error adjustment. Even if agents are rational, they may predict that the current gap between the short-run equilibrium values and steady-state values will be only slowly adjusted.

74. Free forecast error adjustments by modelers are banned. Changes in forecast error adjustments need to be reported at the projection meeting.
X. Model Evaluation

The diagnostic simulations above demonstrate that the JEM displays reasonable properties when exposed to shocks. This allows us to conclude that the JEM can be used for projection and policy analysis for the Japanese economy. In this section, we look further at how the JEM’s impulses hold up against those obtained from VAR.  

A. Comparison of Impulse Responses against VAR

As proposed by Christiano, Eichenbaum, and Evans (1999), the plausibility of a DSGE model can be evaluated by comparing its impulse responses with those obtained from an identified VAR. Conventionally, since the introduction of the RBC model, much attention has been paid to the impulse responses to the technology shock. Indeed, a recent paper by Altig et al. (2003) carries out simulated method of moments (SMM), estimation to ensure similarity between the impulse responses from their DGE model and those obtained from an identified VAR.

As there are so many parameters to be estimated in the JEM, applying SMM estimation is not very straightforward. We therefore choose not to estimate parameters. Instead, we conduct an “eyeball check,” in other words, we examine whether we can identify any crucial differences between the JEM impulse responses to the productivity shock detailed above and those obtained from an identified VAR. The VAR estimated by Soejima and Sugo (2003) is employed to carry out this comparison.

Soejima and Sugo (2003) estimate a reduced-form VECM as follows:

\[ \Delta \bar{Z}_t = A(L)\Delta \bar{Z}_{t-1} + \bar{\alpha} \bar{\beta}' \bar{Z}_{t-1} + \bar{\epsilon}_t. \]

\( \bar{Z} \) denotes the vector of endogenous variables comprising real output \( \bar{X} \), real private consumption \( \bar{C} \), real money balances \( \bar{M}/\bar{P} \), potential output \( \bar{Y}^* \), the nominal short-term interest rate \( \bar{r} \), and the inflation rate \( \bar{\pi} \). All variables are in logs. \( \bar{\beta}' \bar{X}_{t-1} \) represents three cointegrated relationships, involving long-run consumption and saving, \( \bar{\pi} \) money demand, and the Phillips curve as follows:

\[ \bar{C}_{t-1} - \bar{Y}_{t-1} = -\bar{\beta}_{10}\bar{r}_{t-1} - \bar{\beta}_{11}\bar{\pi}_{t-1} - \bar{\beta}_{11}, \]

\[ \bar{M}_{t-1} - \bar{P}_{t-1} = -\bar{\beta}_{22}\bar{Y}_{t-1} - \bar{\beta}_{20}\bar{r}_{t-1} - \bar{\beta}_{21}, \]

\[ \bar{Y}_{t-1} - \bar{Y}^*_{t-1} = -\bar{\beta}_{30}\bar{\pi}_{t-1} - \bar{\beta}_{31}. \]

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75. Conventionally, a model is evaluated by moment matching exercise. However, it is not very trivial to assign a proper shock process to some equations with such a large-scale DGE model as the JEM. Hence, we conduct model evaluation by comparing impulse responses. In our related papers, Fujiwara et al. (2003) and Fujiwara, Hara, Watanabe, and Yoshimura (2004), we reversely reproduce shocks by moment matching so that we can conduct stochastic simulation in a realistic environment.

76. Amano et al. (2002) evaluate the parameter calibration in the QPM by applying a similar technique.

77. \( \bar{\beta}_a = -\bar{\beta}_5 \) is assumed.
Figure 12 compares the impulse responses to a technology shock that raises potential output by 1 percentage point in this identified VAR to the impulse responses shown in Figure 2.

The JEM’s shock responses to the technology shock, often considered the most important factor in causing business-cycle fluctuations, are quite similar to those in the VAR. This fact provides further evidence to support the application of the JEM to projection and policy analysis for the Japanese economy from this aspect.\textsuperscript{78}

\textbf{Figure 12  Impulse Responses Comparison with VAR}

Note: Dashed lines indicate two standard errors from VAR shock responses.

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\textsuperscript{78} In the future, we hope to examine whether SMM and Bayesian estimation are capable of further increasing the JEM’s ability to track the actual Japanese economy.
XI. Conclusion

In this paper, we have laid out the core structure of the JEM, describing the construction of a theoretical DGE model that has not only a well-defined steady state but also the ability to produce realistic projections through the addition of short-run dynamics. Diagnostic simulations suggest that the shock responses are reasonable, in the light of historical tendencies observed in the Japanese economic data. Further, the responses of the JEM to the most fundamental of economic shocks, namely, a technology shock, are quite similar to those obtained from a structural VAR with cointegration restrictions. We therefore have confidence in the JEM’s suitability as a fundamental model for projection as well as the monetary policy analysis relating to the Japanese economy. However, as no model is perfect for all purposes, it is advisable to pay attention to a suite of the models. Combining the insights of the JEM with those attained from a variety of DGE models oriented for different purposes, as well as from identified VAR models, would undoubtedly be the most reliable way to identify the optimal monetary policy for maximizing social welfare.

Further, innovations in macroeconomics, and especially in monetary economics and international economics, are constantly rendering even the newest macromodels obsolete. We need, therefore, to continuously update our macroeconomic knowledge, and to constantly refine the methods employed in the JEM. At the moment, the following are considered promising directions for future extensions of the model: (1) incorporating demographic dynamics, as in Faruqee (2002) and Faruqee and Muehleisen (2001), or Gertler (1998); (2) reconstructing the rather ad hoc overseas sector and giving it firmer microfoundations, following Obstfeld and Rogoff (1995) and other advocates of the NOEM; (3) estimating the parameters governing the short-run dynamics using Bayesian simulation techniques, as in Geweke (1999) and Smets and Wouters (2003); and (4) embedding learning expectations, as summarized in Evans and Honkapohja (2001).
APPENDIX 1: EQUATION LIST

A. Growth Accounting

\[ n_{\text{dot}} = n_{\text{dot}}^a. \quad (A.1) \]

\[ q_{\text{dot}} = q_{\text{dot}}^a. \quad (A.2) \]

\[ y_{\text{dot}} = (1 + n_{\text{dot}})(1 + q_{\text{dot}}) - 1. \quad (A.3) \]

\[ y_{\text{dot}}^a = (1 + n_{\text{dot}}^a)(1 + q_{\text{dot}}^a) - 1. \quad (A.4) \]

B. Expenditure Accounts

1. Output

\[ y_t = c_t + i_t + i_{ht} + g_t + i_{it} + x_t - m_t. \quad (A.5) \]

\[ py_{yt} = p c_t c_t + p i_t i_t + p i_{ht} i_{ht} + p g_t g_t + i_{it} + p x_t x_t - p m_t m_t. \quad (A.6) \]

\[ y_t^a = c_t^a + i_t^a + i_{ht}^a + g_t^a + i_{it}^a + x_t^a - m_t^a. \quad (A.7) \]

\[ py_{yt} = (1 + ti_{yt})p c_{yt}. \quad (A.8) \]

\[ py_{yt}^a = (1 + ti_{yt}^a)p c_{yt}^a. \quad (A.9) \]

\[ py_{yt}^a = pc_{yt}^a c_t^a + pi_{yt}^a i_t^a + p i_{ht}^a i_{ht}^a + pg_{yt}^a g_t^a + ii_{yt}^a + px_{yt}^a x_t^a - pm_{yt}^a m_t^a. \quad (A.10) \]

2. Consumption

\[ c_t = c r t + c f l_t. \quad (A.11) \]

\[ p c c r t = [\eta_1 t_1 + \eta_2 t_2 + \eta_3 (1 - \beta_1 - \beta_2)]y d_t. \quad (A.12) \]

\[ c f l_t = c f l_t^a + c v_t \left( \frac{yd_{t, -2} \lambda c_{t, -2}}{yd_{t, -2} \lambda c_{t, -2}^a} - 1 \right) - \left[ c v_{t_1} (r_{t, -2} - r_{t, -2}^a) + c v_{t_2} (r_{t, -2} - r_{t, -2}^a) \right] c f l_t^a \]

\[ + c v \left( \frac{n f a_{t}}{p c_t} - \frac{n f a_{t}^a}{p c_{t}} \right) - c f l a d_{t}. \quad (A.13) \]

\[ d_t = i h_t + (1 - de p r i h_t) \frac{d_{t, -1}}{1 + y d_{t}}. \quad (A.14) \]
\[ ib_t = ib^*_t + ibv_t \left( \frac{yd_{t-1}}{pih_{t-1}} - 1 \right) - \left[ ibv_{t1}(r_{t-1} - r^*_t) + ibv_{t2}(r_{t-1} - r^*_t) \right] ib^*_t \]
\[ + ibv_t \left( \frac{nfa_t}{pih_t} - \frac{nfa^*_t}{pih^*_t} \right) - ibadj_t. \]  
(A.15)

\[ c^*_t = crt^*_t + cfl^*_t. \]  
(A.16)

\[ pc_t c^*_t = \left[ \eta_1 \beta_1 + \eta_2 \beta_2 + \eta_3 (1 - \beta_1 - \beta_2) \right] yd^*_t. \]  
(A.17)

\[ pc_t c^*_t = mpcw_t twffl^*_t + \zeta (fa^*_t - fa_t). \]  
(A.18)

\[ \frac{1}{mpc_{t+1}^*} = (1 - \gamma) \delta e^r \left[ \frac{pc_{t+1}^* pc_t^*(1 + rcont^*_t)}{mpc_{t+1}^*} \right] + 1 + \theta \nu^*_t \]  
(A.19)

\[ c^*_t = pih_{pc}^*_t - (1 - \gamma) \frac{1 - \text{depri}^*_t}{1 + \text{rcont}^*_t} pih_{pc}^*_t. \]  
(A.20)

\[ twffl^*_t = hwfl^*_t + fufl^*_t + (1 + rgb^*_t) \frac{gb^*_t}{1 + ydot^*_t} \]
\[ + (1 + rnf\hat{a}^*_t) \frac{nfa^*_t}{1 + ydot^*_t} + (1 + rk^*_t) \frac{pka_t k^*_t}{1 + ydot^*_t} \]
\[ + pih^*_t (1 - \text{depri}^*_t) \frac{d^*_t}{1 + ydot^*_t}. \]  
(A.21)

\[ hwfl^*_t = hwfl_{1+}^*_t + hwfl_{2+}^*_t + hwfl_{3+}^*_t. \]  
(A.22)

\[ hwfl_{1+}^*_t = (1 - \eta_1) \beta_1 yd^*_t + \frac{(1 - \gamma)(1 + qdot^*_t)}{(1 + rcont^*_t)(1 + \alpha_t)} \text{hwfl}_{1+}^*_t. \]  
(A.23)

\[ hwfl_{2+}^*_t = (1 - \eta_1) \beta_2 yd^*_t + \frac{(1 - \gamma)(1 + qdot^*_t)}{(1 + rcont^*_t)(1 + \alpha_t)} \text{hwfl}_{2+}^*_t. \]  
(A.24)
The Japanese Economic Model (JEM)

\( h\nu fL3_\nu = (1 - \eta)(1 - \beta_1 - \beta_2)yd_\nu^\eta + \frac{(1 - \gamma)(1 + qdot_\nu^\eta)}{(1 + rcon_\nu^\eta)(1 + \alpha)}h\nu fL3_\nu^{\nu,1} \). (A.25)

\( f\nu fL3_\nu^\eta = \text{risk}_\nu^\eta + \frac{(1 - \gamma)(1 + qdot_\nu^\eta)}{1 + rcon_\nu^\eta}f\nu fL3_\nu^{\nu,1} \). (A.26)

\( ib_i_\nu^\eta = d_i_\nu^\eta - (1 - \text{depr}_i_\nu^\eta)\frac{d_i_{t-1}^\eta}{1 + ydot_\nu^\eta} \). (A.27)

\[ f\alpha + p\alpha c_i_\nu^\eta + p\text{ih}_i_\nu^\eta ib_i_\nu^\eta = yd_i_\nu^\eta + \text{risk}_i_\nu^\eta - ii_i_\nu^\eta + (1 + rcon_i_{t-1}^\eta)\frac{f\alpha_i_{t-1}}{1 + ydot_i_\nu^\eta} \]. (A.28)

\[ d_i_\nu^\eta = \left( \frac{\theta}{k_i_\nu^\eta} \right)^\nu c\nu fL_i_\nu^\eta \]. (A.29)

3. Investment

\[ k_i = (1 - \text{depr}_i)\frac{k_{t-1}}{1 + ydot_i} + i_i \]. (A.30)

\[ k_i_\nu^\eta = (1 - \text{depr}_i_\nu^\eta)\frac{k_{i_{t-1}^\eta}}{1 + ydot_i^\eta} + i_i^\eta \]. (A.31)

\[ kp_\nu^\eta = (1 - ip_1 - ip_2 - ip_3 - ip_4 - ip_5 - ip_6 - ip_7)k_\nu^\eta + ip_1\frac{k_{i_{t-1}^\eta}}{1 + ydot_i_\nu^\eta} + ip_2\frac{k_{i_{t-2}^\eta}}{(1 + ydot_i_\nu^\eta)^2} + ip_3\frac{k_{i_{t-3}^\eta}}{(1 + ydot_i_\nu^\eta)^3} + ip_4\frac{k_{i_{t-4}^\eta}}{(1 + ydot_i_\nu^\eta)^4} + ip_5\frac{k_{i_{t-5}^\eta}}{(1 + ydot_i_\nu^\eta)^5} + ip_6\frac{k_{i_{t-6}^\eta}}{(1 + ydot_i_\nu^\eta)^6} + ip_7\frac{k_{i_{t-7}^\eta}}{(1 + ydot_i_\nu^\eta)^7} \]. (A.32)
\[ k_{p_i} = (1 - \text{ip}_1 - \text{ip}_2 - \text{ip}_3 - \text{ip}_4 - \text{ip}_6 - \text{ip}_7) k, \]
\[ + \text{ip}_1 \frac{k_{i-1}}{1 + ydot} + \text{ip}_2 \frac{k_{i-2}}{(1 + ydot)^2} + \text{ip}_3 \frac{k_{i-3}}{(1 + ydot)^3} \]
\[ + \text{ip}_4 \frac{k_{i-4}}{(1 + ydot)^4} + \text{ip}_5 \frac{k_{i-5}}{(1 + ydot)^5} + \text{ip}_6 \frac{k_{i-6}}{(1 + ydot)^6} \]
\[ + \text{ip}_7 \frac{k_{i-7}}{(1 + ydot)^7}. \]  
(A.33)

\[ ii_i = ii_i^q - iiadj_. \]  
(A.34)

4. Government expenditures

\[ g_r = g_1 g_{r-1} + (1 - g_1) g_r^q + g_3 (u - u_r^q). \]  
(A.35)

\[ g_r^q = g_2 g_{r-1}^q + (1 - g_2) g_r^q + g_3 (y - y_r^q). \]  
(A.36)

\[ gtr_r = gtr_1 gtr_{r-1} + (1 - gtr_1) gtr_r^q + gtr_3 (u - u_r^q). \]  
(A.37)

\[ gtr_r^q = gtr_2 gtr_{r-1}^q + (1 - gtr_2) gtr_r^q + gtr_3 (y - y_r^q). \]  
(A.38)

5. External trade

4. Imports

\[ m_r = cm_r + im_r + gm_r + ihm_r. \]  
(A.39)

\[ m_r^q = cm_r^q + im_r^q + gm_r^q + ihm_r^q. \]  
(A.40)

\[ cm_r = cm_r c_r. \]  
(A.41)

\[ cm_r^q = cm_r c_r^q. \]  
(A.42)

\[ cm_r c_r = cm_r c_r^q = cmv \left[ (1 + ticm_r) \frac{pcm_r}{pcd_r} - (1 + ticm_r^q) \frac{pcm_r^q}{pcd_r^q} \right] \]
\[ - cm_cadj_r. \]  
(A.43)

\[ cm_r c_r^q = cm_r c_r - cmv \frac{pcm_r}{pcd_r^q}. \]  
(A.44)

\[ im_r = im_i i_r. \]  
(A.45)
\[ im_i^n = im_i^{n-1}i^{n-1}. \]  
(A.46)

\[
\begin{align*}
\imath_{i+1} = \imath_i + imv_1 \left[ (1 + tiim_i) \frac{pim_{-1}}{pid_{-1}} - (1 + tiim_i^n) \frac{pim_{-1}^n}{pid_{-1}^n} \right] - \imath_{iadj}.
\end{align*}
\]  
(A.47)

\[ \imath_i = \imath_{i-1} - \ims(1 + tiim_i^n) \frac{pim_{-1}^n}{pid_{-1}^n}. \]  
(A.48)

\[ gm_i = gm_{gg}. \]  
(A.49)

\[ gm_i^n = gm_{gg}^n. \]  
(A.50)

\[
\begin{align*}
gm_{g} = & \ gm_{gg} - gmv_1 \left[ (1 + tiigm_i) \frac{pgm_{-1}}{pgd_{-1}} - (1 + tiigm_i^n) \frac{pgm_{-1}^n}{pgd_{-1}^n} \right] - gm_{gadj}.
\end{align*}
\]  
(A.51)

\[ gm_i^n = gm_{gg} - \gms(1 + tiigm_i^n) \frac{pgm_{-1}^n}{pgd_{-1}^n}. \]  
(A.52)

\[ ihm_i = ihm_{ih}. \]  
(A.53)

\[ ihm_i^n = ihm_{ih}^{n-1}. \]  
(A.54)

\[
\begin{align*}
ihm_{ih} = & \ ihm_{ih} - \ihmv_1 \left[ (1 + tiihm_{ih}) \frac{pihm_{-1}}{pihd_{-1}} - (1 + tiihm_{ih}^n) \frac{pihm_{-1}^n}{pihd_{-1}^n} \right] \\
& - \ihm_{ihadj}.
\end{align*}
\]  
(A.55)

\[ ihm_{ih} = ihm_{ih} - \ihms(1 + tiihm_{ih}^n) \frac{pihm_{-1}^n}{pihd_{-1}^n}. \]  
(A.56)

**b. Exports**

\[ x_i^n = x_y^n + x_y^n y_t + x_p^n x_t^n. \]  
(A.57)

\[ x_i = x_i^n + xv_1 (px_{t-1} - px_{t-1}^n) x_t^n - xadj. \]  
(A.58)
c. Net exports

\[ xbal_t = px_t x_t - pm_t m_t. \] (A.59)

\[ xbal_t^q = px_t^q x_t^q - pm_t^q m_t^q. \] (A.60)

\[ netx_t = x_t - m_t. \] (A.61)

\[ netx_t^q = x_t^q - m_t^q. \] (A.62)

\[ nfa_t = (1 + r_nfa_{t-1}) \frac{nfa_{t-1}}{1 + ydot_t} + xbal_t. \] (A.63)

\[ nfa_t^q = (1 + r_nfa_{t-1}^q) \frac{nfa_{t-1}^q}{1 + ydot_t^q} + xbal_t^q. \] (A.64)

C. Income Accounts

1. Wage and labor income

\[ wa_t = wa_{t-1} \frac{1 + wdot_t}{(1 + pdot_t)(1 + qdot_t)}. \] (A.65)

\[ wa_t^q = \rho (1 - \alpha) tffp_t^{\gamma - \phi} \left( \frac{pfct_t^{\gamma}}{w_t^{\gamma}} \right)^{\phi}. \] (A.66)

\[ wp_t^q = \frac{wa_t^q}{pfct_t^{\gamma}}. \] (A.67)

\[ wp_t = \frac{wa_t}{pfct_t}. \] (A.68)

\[ wc_t^q = \frac{wa_t^q}{pc_t^{\gamma}}. \] (A.69)

\[ wc_t = \frac{wa_t}{pc_t}. \] (A.70)

\[ wehtar_t = wc_t \left[ (1 - wef_{t}) wc_t^q + wef_{t} wc_t^q \right] \]

\[ + (1 - wc_t) \left[ wel_{t} wehtar_{t-1} + wel_{t} wehtar_{t-2} + wel_{t} wehtar_{t-3} \right] \]

\[ + (1 - wel_{t}) \left[ wel_{t} - wel_{t} - wel_{t} wehtar_{t-4} \right]. \] (A.71)
\[ wdot^a = (1 + pdot^a)(1 + qdot^a) - 1. \]  
(A.72)

\[ 1 + wdot = (1 + qdot)(1 + wpe(wp.pdote) + wp.pdote) + wp.pdote + wp.pdote + wp.pdote + (1 - wp - wp - wp - wp) + wp.pdote + wp.pdote + wp.pdote + (1 - wpe)(wp.pcdote + wp.pcdote + wp.pcdote + wp.pcdote + wp.pcdote + wp.pcdote) \]

\[ + wd\left( \frac{wp^{\gamma_{i+1}}}{wp_{i+1} - 1} \right) + wd\left( u_{i+1} - u_{i-1} \right). \]  
(A.73)

\[ ylab = wa(1 - u). \]  
(A.74)

\[ ylab^a = wa^a(1 - u^a). \]  
(A.75)

2. Disposable income

\[ yd^a = (1 - td^a)(ylab^a + yd.gtr^a) + (1 - yd^a)\. \]  
(A.76)

\[ yd = (1 - td)(ylab + yd.gtr) + (1 - yd^a)\. \]  
(A.77)

3. Risk income

\[ risk^a = (rk^a - rcon^a) \frac{pka_{,k^{\gamma_{i+1}}}}{1 + ydot^a} + (rgb^a - rcon^a) \frac{gb^{\gamma_{i+1}}}{1 + ydot^a} \]

\[ + (rnfa^{\gamma_{i+1}} - rcon^{\gamma_{i+1}}) \frac{rfa^{\gamma_{i+1}}}{1 + ydot^a} \]

\[ + pkak^{\gamma_{i+1}} - pi^{\gamma_{i+1}} - (1 - depr^{\gamma_{i+1}}) \frac{pk^{\gamma_{i+1}}cu^{\gamma_{i+1}}kp^{\gamma_{i+1}}}{1 + ydot^a} \]

\[ + (1 + rk^{\gamma_{i+1}}) \frac{pka_{,k^{\gamma_{i+1}}}}{1 + ydot^a} + pk^{\gamma_{i+1}}cu^{\gamma_{i+1}}kp^{\gamma_{i+1}} - tk^{\gamma_{i+1}}depr^{\gamma_{i+1}}pka_{,k^{\gamma_{i+1}}}}{1 + ydot^a} \]

\[ + (1 - tk^{\gamma_{i+1}})(pf^{\gamma_{i+1}}y^{\gamma_{i+1}} - ylab^{\gamma_{i+1}}) - rk^{\gamma_{i+1}} + depr^{\gamma_{i+1}} \frac{pk^{\gamma_{i+1}}cu^{\gamma_{i+1}}kp^{\gamma_{i+1}}}{1 + ydot^a} \]

\[ + check^{\gamma_{i+1}}. \]  
(A.78)
\[ \text{risk}_t = \text{risk}_{t-1} + (1 - \text{risk}_{t-1}) \text{risk}_t^a. \]  
(A.79)

\[ \text{fa}_t = \text{pka}_t + \text{gb}_t + n\text{fa}_t. \]  
(A.80)

\[ \text{fa}_t^a = \text{pka}_t + \text{gb}_t^a + n\text{fa}_t^a. \]  
(A.81)

\section*{D. Stocks}

\subsection*{1. Capital}

\[
k_t = k_t^a + k_v \left( \frac{y_{t-4}}{y_{t-4}^a} - 1 \right) - [kv_{21}(r_{t-4} - r_{t-4}^a) + kv_{22}(r_{t-4} - r_{t-4}^a)]k_t^a + kv_t(x_{t-1} - x_{t-1}^a) - \text{kadj}. \tag{A.82}
\]

\[ c_{c_t}^a = \rho_\alpha \left( \text{pcf}_{t-1} \frac{1 + y\text{dot}_t^a}{c_{m_t}^a k_{v_t}^a} \right)^{-\psi} \]  
(A.83)

\[ c_{c_t}^a(1 - tk_t^a) = (1 + rk_t^a)pk_t^a - (1 - \text{depr}_t^a)pk_{t-1}^a. \]  
(A.84)

\[
dt_t^a = \frac{dt_{t-1}^a (1 - \text{depr}_t^a) + tk_t^a \text{depr}_t^a \text{pka}_t}{1 + rk_t^a}. \tag{A.85}
\]

\[
(1 - ip_1 - ip_2 - ip_3 - ip_4 - ip_5 - ip_6 - ip_7)pk_t^a + ip_1 \frac{pk_{t-1}^a}{1 + rk_t^a} + ip_2 \frac{pk_{t-2}^a}{\Pi_{j=0}^{1} (1 + rk_{t-j}^a)} + ip_3 \frac{pk_{t-3}^a}{\Pi_{j=0}^{1} (1 + rk_{t-j}^a)} + ip_4 \frac{pk_{t-4}^a}{\Pi_{j=0}^{1} (1 + rk_{t-j}^a)} + 
\]

\[
+ ip_5 \frac{pk_{t-5}^a}{\Pi_{j=0}^{1} (1 + rk_{t-j}^a)} + ip_6 \frac{pk_{t-6}^a}{\Pi_{j=0}^{1} (1 + rk_{t-j}^a)} + ip_7 \frac{pk_{t-7}^a}{\Pi_{j=0}^{1} (1 + rk_{t-j}^a)}
\]

\[ = [(1 - pk_t)pi_t^a + pk_tpi_t] + ke_t(i_t^a - i_t) - dt_t^a. \tag{A.86}
\]

\[ \text{pka}_t = (1 - pk_0)\text{pka}_{t-1} + pk_0pi_t. \tag{A.87}
\]

\subsection*{2. Government bonds and taxes}

\[ \text{gbtar}_t^a = \text{gbtar}_t y_t^a y_t^a. \]  
(A.88)

\[ \text{gbtar}_t = \text{gbtar}_t^a. \]  
(A.89)

\[ \text{gb}_t^a = \text{gb}_{t-1}^a + \text{td}_t(\text{gb}_t^a - \text{gbtar}_t) + \text{td}_t(\text{gb}_t^a - \text{gb}_{t-1}^a). \]  
(A.90)
\[ gb_t + td_t(ylab_t + yd_t gtr_t) + tiy_t pfc_t y_t + tk_t \left( pfc_t y_t - ylab_t - \frac{depr_t pka_{k, t-1}}{1 + ydott_t} \right) \]
\[ = (1 + rgb_{..}) \frac{gb_{b, t-1}}{1 + ydott_t} + pg g_t + gr_t. \quad (A.91) \]

\[ gb_t^n + td_t^n(ylab_t^n + yd_t gtr_t^n) + tiy_t^n pfc_t y_t^n \]
\[ + tk_t^n \left( pfc_t^n y_t^n - ylab_t^n - \frac{depr_t^n pka_{k, t-1}^n}{1 + ydott_t^n} \right) \]
\[ = (1 + rgb_{..}^n) \frac{gb_{b, t-1}^n}{1 + ydott_t^n} + pg g_t^n + gr_t^n. \quad (A.92) \]

\[ td_t = tdl_{t-1} + tdl_{t-2} + tdl_{t-3} + tdl_{t-4} \]
\[ + (1 - tdl_1, tdl_2 - tdl_3 - tdl_4) [td_t^n + td_3 (gb_{b, t-1} - gb_t^n) \]
\[ - td_t \left( gbtar_y_t - gbtar_y_t^n \right)]. \quad (A.93) \]

\[ pc_t c_t + pih_t i_t + pi_t i_t + pg g_t + px_t x_t - pm_t m_t \]
\[ = (1 + tiy_t^n) [pcd_t (c_t - cm_t) + pihd_t (i_t - ibm_t) + pid_t (i_t - im_t) \]
\[ + pgd_t (g_t - gm_t) + px_t x_t]. \quad (A.94) \]

\[ pc_t c_t + pih_t i_t + pi_t i_t + pg g_t + px_t x_t - pm_t m_t. \]
\[ = (1 + tiy_t) [pcd_t (c_t - cm_t) + pihd_t (i_t - ibm_t) + pid_t (i_t - im_t) \]
\[ + pgd_t (g_t - gm_t) + px_t x_t]. \quad (A.95) \]

**E. Production and the Labor Market**

\[ y_t = 0.25 \left\{ (1 - \alpha) [tfp_t (1 - u_t)]^\alpha + \alpha \left( \frac{cu_t k_{p, t-1}}{1 + ydott_t} \right) \right\}^{\frac{1}{\alpha}}. \quad (A.96) \]

\[ y_t^n = 0.25 \left\{ (1 - \alpha) [tfp_t^n (1 - u_t^n)]^\alpha + \alpha \left( \frac{cu_t^n k_{p, t-1}^n}{1 + ydott_t^n} \right) \right\}^{\frac{1}{\alpha}}. \quad (A.97) \]

\[ yp_t = 0.25 \left\{ (1 - \alpha) [tfp_t^n (1 - u_t^n)]^\alpha + \alpha \left( \frac{cu_t^n k_{p, t-1}^n}{1 + ydott_t^n} \right) \right\}^{\frac{1}{\alpha}}. \quad (A.98) \]
\[ kp_i = (1 - depr_i) \frac{kp_{i+1}}{1 + ydot_i} + ip_i. \quad (A.99) \]

\[ kp_i^q = (1 - depr_i^q) \frac{kp_{i+1}^q}{1 + ydot_i^q} + ip_i^q. \quad (A.100) \]

\[ u_i = u_i^q - uv_2 \left( \frac{y_{i-1}}{yp_{i-1}} - 1 \right) - uv_3 \left( \frac{y_{i-2}}{yp_{i-2}} - 1 \right) - uv_4 \left( \frac{wp_{i-1}}{wp_{i-1}^{eq}} - 1 \right) - uadj_i. \quad (A.101) \]

\[ cu_i = \min (cu_i^q - cuadj_i, 1). \quad (A.102) \]

**F. The Monetary Authority, Interest Rates, and Exchange Rates**

1. **Interest rates**

\[ r_{n.i} = \max \{0, \text{smooth}_i [rn_i^q + rsl_i(tpdot_{i+4} - pdottar_{i+4}) + rsl_i(tpdot_{i+5} - pdottar_{i+5}) + rsl_i(tpdot_{i+6} - pdottar_{i+6})] + (1 - \text{smooth}_i)rn_{i-1} \}. \quad (A.103) \]

\[ pdottar_i = pdottar_i^q. \quad (A.104) \]

\[ pdot_i^q = pdottar_i. \quad (A.105) \]

\[ 1 + rn_i^q = (1 + r_i^q)(1 + pdot_i^q). \quad (A.106) \]

\[ 1 + rn5_i^q = (1 + rn5_i^q) \left( \frac{1 + rt5_i^q}{1 + rt5_i^{eq}} \right) \left( \frac{1 + rn_i^q}{1 + rn_i^{eq}} \right)^{\frac{1}{20}}. \quad (A.107) \]

\[ 1 + r5_i = (1 + r5_i) \left( \frac{1 + rt5_i^q}{1 + rt5_i^{eq}} \right) \left( \frac{1 + rn_i}{1 + rn_i^{eq}} \right)^{\frac{1}{20}}. \quad (A.108) \]

\[ rnl_i^q = rnl_i^q. \quad (A.109) \]

\[ rnl_i = rl_i(1 + rn_i)(1 + rt5_i^q) + rl_z(1 + r5_i) + (1 - rl_i - rl_z)(1 + rnl_i^q) - 1. \quad (A.110) \]
\[1 + r n_i = (1 + r_i)(1 + p e d o t_{n_i}).\] (A.111)

\[1 + r S_5^{\alpha} = (1 + r S_5^{\alpha}) \left( 1 + r T_5^{\eta} \right) \left( \frac{1 + r_5^{\eta}}{1 + r T_5^{\eta}} \right)^{\frac{1}{20}}.\] (A.112)

\[1 + r S_i = (1 + r S_{n_i}) \left( 1 + r T_5^{\eta} \right) \left( \frac{1 + r_5^{\eta}}{1 + r T_5^{\eta}} \right)^{\frac{1}{20}}.\] (A.113)

\[r l_i^{\mu} = r S_i^{\mu}.\] (A.114)

\[1 + r l_i = r l_1 (1 + r_i) (1 + r T_5^{\eta}) + r l_2 (1 + r S_i) + (1 - r l_1 - r l_2) (1 + r l_i^{\eta}).\] (A.115)

\[r i_{\eta}^{\mu} = r w o_{\eta}^{\mu} + r p_{\eta}^{\mu}.\] (A.116)

\[r k_{\eta}^{\mu} = r l_{\eta}^{\mu} + r k_{r h \eta}^{\mu}.\] (A.117)

\[r g b_i = r l_i + r g b_{r l}.\] (A.118)

\[r g b_{\eta}^{\mu} = r l_{\eta}^{\mu} + r g b_{r l}^{\eta}.\] (A.119)

\[r n f a_i = r l_i + r n f a_{r l}.\] (A.120)

\[r n f a_{\eta}^{\mu} = r l_{\eta}^{\mu} + r n f a_{r l}^{\eta}.\] (A.121)

\[r c o n_{\eta}^{\mu} = r l_{\eta}^{\mu} + r c o n_{r l}^{\eta}.\] (A.122)

\[r p_i = r p_{\eta}^{\mu}.\] (A.123)

\[r g b_{r l} = r g b_{r l}^{\mu}.\] (A.124)

\[r n f a_{r l} = r n f a_{r l}^{\eta}.\] (A.125)

### 2. Exchange rates

\[z e_i = z f_i z_{e_{i+1}} + z l_i z_{e_{i+1}} + (1 - z f_i - z l_i) z_{e_{i+1}}^{\eta}.\] (A.126)

\[z_i = z_i z_{e_{i+1}} + z o z_{e_i} \frac{1 + r w o_{\eta} + r p_{i}}{1 + r_i} + (1 - z_i - z_o) z_{e_{i+1}}^{\eta}.\] (A.127)
3. Inflation expectation

\[ pdote_t = \left[ 1 - (pde_0 + pde_1 + pde_2 + pde_3 + pde_4 + pde_5 + pde_6 + pde_7 + pde_8) \right] \]

\[ \{ cpi_t [pdlt, cpidot_{4_{-1}} + pdlt, cpidot_{4_{-2}} + pdlt, cpidot_{4_{-3}}] \]

\[ + (1 - pdlt_1 - pdlt_2 - pdlt_3) cpidot_{4_{-1}} \} + (1 - cpi_t) [pdlt, pdot_{4_{-1}} \]

\[ + pdlt, pdot_{4_{-2}} + pdlt, pdot_{4_{-3}} + (1 - pdlt_1 - pdlt_2 - pdlt_3) pdot_{4_{-1}}] \}

\[ + pde, pdot_{r+1} + pde, pdot_{r+2} + pde, pdot_{r+3} + pde, pdot_{r+4} \]

\[ + pde, pdot_{r+5} + pde, pdot_{r+6} + pde, pdot_{r+7} + pde, pdot_{r+8} \]

\[ + pde, pdot_{r+9}. \] \hspace{1cm} (A.128)

\[ pcdo_{te_t} = \left[ 1 - (pde_0 + pde_1 + pde_2 + pde_3 + pde_4 + pde_5 + pde_6 + pde_7 + pde_8) \right] \]

\[ \{ pdlt, ncpidot_{r-1} + pdlt, ncpidot_{r-2} + pdlt, ncpidot_{r-3} \]

\[ + (1 - pdlt_1 - pdlt_2 - pdlt_3) ncpidot_{r-1} \} + pde, ncpidot_{r+1} \]

\[ + pde, ncpidot_{r+2} + pde, ncpidot_{r+3} + pde, ncpidot_{r+4} + pde, ncpidot_{r+5} \]

\[ + pde, ncpidot_{r+6} + pde, ncpidot_{r+7} + pde, ncpidot_{r+8} + pde, pdot_{r+9}, \]

\[ + pde_9 \left( tiy_{y_{r+1}} - tiy_{y_{r+4}} \right) \]. \hspace{1cm} (A.129)

\[ pdot_{t+1} = 0.3 \left( \frac{1}{31} \sum_{j=15}^{31} cpidot_{4_{-j}} \right) + 0.7 pdot_{t+1}. \] \hspace{1cm} (A.130)

4. Inflation

\[ pdot_t = pdf, pdote_t + (1 - pdf, )pdot_{r-1} + pdo_\phi \left( \frac{y_t}{yp_t} - 1 \right). \] \hspace{1cm} (A.131)

\[ (1 + pdot_{4_{-1}})(1 + pdot_{4_{-2}})(1 + pdot_{4_{-3}}). \] \hspace{1cm} (A.132)

\[ 1 + pcdo_{t+1} = (1 + pdot_t) \frac{pc_{r-1}}{pc_{r-1}}. \] \hspace{1cm} (A.133)
\[1 + \text{pcedot}_t = \left[ \text{pceda}_t \left( \frac{\text{pced}_t}{\text{pced}_t} - 1 \right) + 1 \right] \left[ \text{pceda}_t \left( \frac{\text{pced}_t}{\text{pced}_t} - 1 \right) + 1 \right]\]

\[
\frac{1 + \text{tic}_t}{1 + \text{tic}_{t-1}} (1 + \text{pdot}). \\
\text{(A.134)}
\]

\[1 + \text{pcmddot}_t = \left[ \text{pcmca}_t \left( \frac{\text{pcmcm}_t}{\text{pcmcm}_t} - 1 \right) + 1 \right] \left[ \text{pcmca}_t \left( \frac{\text{pcmcm}_t}{\text{pcmcm}_t} - 1 \right) + 1 \right]\]

\[
(1 + \text{pdot}) \frac{(1 + \text{ticm}_t)(1 + \text{tic}_t)}{(1 + \text{ticm}_{t-1})(1 + \text{tic}_{t-1})}. \\
\text{(A.135)}
\]

\[1 + \text{pgdot}_t = (1 + \text{pdot}) \frac{\text{pg}_t}{\text{pg}^{*}_{t-1}}. \\
\text{(A.136)}
\]

\[1 + \text{pgddot}_t = (1 + \text{pdot}) \frac{\text{pgd}_t}{\text{pgd}^{*}_{t-1}}. \\
\text{(A.137)}
\]

\[1 + \text{pgmddot}_t = (1 + \text{pdot}) \frac{\text{pgm}_t}{\text{pgm}^{*}_{t-1}}. \\
\text{(A.138)}
\]

\[1 + \text{pidot}_t = (1 + \text{pdot}) \frac{\text{pi}_t}{\text{pi}^{*}_{t-1}}. \\
\text{(A.139)}
\]

\[1 + \text{piddot}_t = (1 + \text{pdot}) \frac{\text{pid}_t}{\text{pid}^{*}_{t-1}}. \\
\text{(A.140)}
\]

\[1 + \text{pimdot}_t = (1 + \text{pdot}) \frac{\text{pim}_t}{\text{pim}^{*}_{t-1}}. \\
\text{(A.141)}
\]

\[(1 + \text{pcedt}_t)^4 = (1 + \text{pcedot})(1 + \text{pcedot}_{t-1})(1 + \text{pcedot}_{t-2})(1 + \text{pcedot}_{t-3}). \\
\text{(A.142)}
\]

\[1 + \text{npcdot}_t = (1 + \text{pdot}) \frac{\text{pc}_t/1 + \text{tic}_t}{\text{pc}^{*}_{t-1}/1 + \text{tic}_{t-1}}. \\
\text{(A.143)}
\]

The Japanese Economic Model (JEM)
\[(1 + npcdot_4)^4 = (1 + npcdot)(1 + npcdot_{t-1})(1 + npcdot_{t-2})(1 + npcdot_{t-3}). \]  
(A.144)

\[1 + npcddot = (1 + pdot) \frac{pcd}{pcd_{t-1}}. \]  
(A.145)

\[1 + npcmddot = (1 + pdot) \frac{pcm}{pcm_{t-1}}. \]  
(A.146)

\[c_{pidot} = pcde_0 \left( \frac{c_t - cm_t}{c_t} \right) npcddot + pcde_1 \left( \frac{c_{t-1} - cm_{t-1}}{c_{t-1}} \right) npcddot_{t-1} + (1 - pcde_0 - pcde_1) \left( \frac{c_{t-2} - cm_{t-2}}{c_{t-2}} \right) npcddot_{t-2} + pcme_0 \left( \frac{cm_t}{c_t} \right) npcmdot + pcme_1 \left( \frac{cm_{t-1}}{c_{t-1}} \right) npcmdot_{t-1} + pcme_2 \left( \frac{cm_{t-2}}{c_{t-2}} \right) npcmdot_{t-2} + (1 - pcme_0 - pcme_1 - pcme_2) \left( \frac{cm_{t-3}}{c_{t-3}} \right) npcmdot_{t-3}. \]  
(A.147)

\[npcidot = pcde_0 \left( \frac{c_t - cm_t}{c_t} \right) npcddot, \]  
\[+ pcde_1 \left( \frac{c_{t-1} - cm_{t-1}}{c_{t-1}} \right) npcddot_{t-1} + (1 - pcde_0 - pcde_1) \left( \frac{c_{t-2} - cm_{t-2}}{c_{t-2}} \right) npcddot_{t-2} + pcme_0 \left( \frac{cm_t}{c_t} \right) npcmdot + pcme_1 \left( \frac{cm_{t-1}}{c_{t-1}} \right) npcmdot_{t-1} + pcme_2 \left( \frac{cm_{t-2}}{c_{t-2}} \right) npcmdot_{t-2} + (1 - pcme_0 - pcme_1 - pcme_2) \left( \frac{cm_{t-3}}{c_{t-3}} \right) npcmdot_{t-3}. \]  
(A.148)
(1 + cpidot4)\(t\) = (1 + cpidot)(1 + cpidot\(t\-1\))(1 + cpidot\(t\-2\))(1 + cpidot\(t\-3\)).  
(A.149)

(1 + ncpidot4)\(t\) = (1 + ncpidot)(1 + ncpidot\(t\-1\))(1 + ncpidot\(t\-2\))(1 + ncpidot\(t\-3\)).  
(A.150)

tpdot, = pt\(t\)cpidot + (1 - pt\(t\))pdot\(t\).  
(A.151)

5. Deflators

\[
pfcteqyt = \left[ pcdeq\(c\-cmt\) + pid\(i\-im\) \right. \\
\quad + pihdeq\(iht\-ihm\) + pgd\(g\-gm\) + ii \left. \right] + px\(x\) + check2.  
\]

(A.152)

\[
= c - cmt + i - im + iht - ihm + g - gm + ii.  
\]

(A.153)

pcdeq\(c\-cmt\) + pihdeq\(iht\-ihm\)  
+ pid\(i\-im\) + pgd\(g\-gm\) + ii  
\[
= c - cmt + i - im + iht - ihm + g - gm + ii.  
\]

(A.154)

\[
= (1 + tic) [pcdeq\(c\-cmt\) + (1 + ticm)pcmcm].  
\]

(A.155)

\[
= (1 + tic) [pcdeq\(c\-cmt\) + (1 + ticm)pcmcm].  
\]

(A.156)

\[
pcm = pcm + pcmv(z - z\-1)pcrow  
+ pcmv2(pcrw - pcrw)z - pcmadj.  
\]

(A.157)

\[
= (1 - pcm)pcm + pcm(pcrwz + pcm).  
\]

(A.158)
\[ pcd_t = pcd_t^{*a} + pcdn_0 \left( \frac{y_t}{yp} - 1 \right) + pcdn_1 \left( \frac{y_{t-1}}{yp_{t-1}} - 1 \right) \\
+ pcdn_2 \left( \frac{y_{t-2}}{yp_{t-2}} - 1 \right) + pcdn_3 \left( \frac{y_{t-3}}{yp_{t-3}} - 1 \right) - pcdadj. \] (A.159)

\[ pcd_t^{*a} = pcd_t^{*a,1} + 0.75(pcd_t^{*a,1} - pcd_t^{*a,2}). \] (A.160)

\[ pih,ih_t = (1 + tiih_t)[pihd,(ih_t - ihm_t) + (1 + tiihm_t)pihm,ihm_t]. \] (A.161)

\[ pih^{*a},ih^{*a}_t = (1 + tii^{*a},h^{*a}_t)[pihd^{*a},(ih^{*a}_t - ihm^{*a}_t) + (1 + tiihm^{*a}_t)pihm^{*a}_t,ihm^{*a}_t]. \] (A.162)

\[ pihm_t = pihm_t^{*a} + pimv_1(z_{t-1} - z_{t-1}^{*a})pirowt^{*a}_t \\
+ pimv_2(pirowt^{*a} - pirowt^{*a})z_{t-1}^{*a} - pimadj. \] (A.163)

\[ pihm_t^{*a} = (1 - pihm_t)pihm_t^{*a,1} + pihm_t(pirowt^{*a}z_{t-1}^{*a} + pihm_0). \] (A.164)

\[ pihd_t = pihd_t^{*a} + pihdv_0 \left( \frac{y_t}{yp} - 1 \right) + pihdv_1 \left( \frac{y_{t-1}}{yp_{t-1}} - 1 \right) \\
+ pihdv_2 \left( \frac{y_{t-2}}{yp_{t-2}} - 1 \right) + pihdv_3 \left( \frac{y_{t-3}}{yp_{t-3}} - 1 \right) - pihdadj. \] (A.165)

\[ pihd_t^{*a} = 0.95pcd_t^{*a} + 0.05pid_t^{*a}. \] (A.166)

\[ pi,i_t = (1 + tii_t)[pid,(i_t - im_t) + (1 + tiiim_t)pim,im_t]. \] (A.167)

\[ pi^{*a},i^{*a}_t = (1 + tii^{*a},i^{*a}_t)[pid^{*a},(i^{*a}_t - im^{*a}_t) + (1 + tiiim^{*a}_t)pim^{*a},im^{*a}_t]. \] (A.168)

\[ pim_t = pim_t^{*a} + pimv_1pirowt^{*a}_t(z_{t-1} - z_{t-1}^{*a}) \\
+ pimv_2(pirowt^{*a} - pirowt^{*a})z_{t-1}^{*a} - pimadj. \] (A.169)

\[ pim_t^{*a} = (1 - pim_t)pim_t^{*a,1} + pim_t(pirowt^{*a}z_{t-1}^{*a} + pim_0). \] (A.170)
\[ pg_g = (1 + tig) [pgd_r (g_r - gm_r) + (1 + tigm_r)pgm_r gm_r] \]  \hspace{1cm} (A.171)

\[ pg_r = (1 + tig_r) [pgd_r (g_r - gm_r) + (1 + tigm_r)pgm_r gm_r] \]  \hspace{1cm} (A.172)

\[ pgm_r = pgm_r + pgm_r pgrow_r (z_{r-1} - z_r) \]
\[ + pgm_r (pgrow_r - pgrow_r) z_r - pgm_r \]  \hspace{1cm} (A.173)

\[ pgm_r = (1 - pgm_r) pgm_r + pgm_r (pgrow_r z_r + pgm_r) \]  \hspace{1cm} (A.174)

\[ pgd_r = pgd_r + pgd_r \left( \frac{y_r}{yp_r} - 1 \right) - pgd_r \]  \hspace{1cm} (A.175)

\[ pgd_r = pg_{pi pid} \]  \hspace{1cm} (A.176)

\[ px_r = px_r + px_r pxrow_r (z_r - z_r) + px_r \left( \frac{x_r}{x_{r-1}} - 1 \right) \]
\[ + px_r (pxrow_r - pxrow_r) z_r - px_r \]  \hspace{1cm} (A.177)

\[ px_r = (1 - px_r) px_r + px_r (pxrow_r z_r + px_r) \]  \hspace{1cm} (A.178)

\[ pm_r = pcm_r cm_r + pim_r im_r + pihm_r ihm_r + pgm_r gm_r \]  \hspace{1cm} (A.179)

\[ pm_r = pcm_r cm_r + pim_r im_r + pihm_r ihm_r + pgm_r gm_r \]  \hspace{1cm} (A.180)

6. Foreign prices

\[ pcrow_r = pcrow_r \]  \hspace{1cm} (A.181)

\[ pirow_r = pirow_r \]  \hspace{1cm} (A.182)

\[ pihrow_r = pihrow_r \]  \hspace{1cm} (A.183)

\[ pgrow_r = pgrow_r \]  \hspace{1cm} (A.184)

\[ pxrow_r = pxrow_r \]  \hspace{1cm} (A.185)
7. Other deflators

\[
\text{tot}_t = \frac{px_t}{pm_t}. 
\] (A.186)

\[
pc_{py}^{eq} = \frac{pc^{eq}_{py}}{py^{eq}_{py}}. 
\] (A.187)

\[
pi_{py}^{eq} = \frac{pi^{eq}_{py}}{py^{eq}_{py}}. 
\] (A.188)

\[
pg_{py}^{eq} = \frac{pg^{eq}_{py}}{py^{eq}_{py}}. 
\] (A.189)

\[
pih_{py}^{eq} = \frac{pih^{eq}_{py}}{py^{eq}_{py}}. 
\] (A.190)

\[
px_{py}^{eq} = \frac{px^{eq}_{py}}{py^{eq}_{py}}. 
\] (A.191)

\[
pm_{py}^{eq} = \frac{pm^{eq}_{py}}{py^{eq}_{py}}. 
\] (A.192)

\[
pih_{pc}^{eq} = \frac{pih^{eq}_{pc}}{pc^{eq}_{pc}}. 
\] (A.193)

Variables

\[ct\]: consumption, \(cct\): user cost of capital, \(cfl\): consumption by forward-looking consumers, \(cfladj\): polynomial adjustment cost term on consumption by forward-looking consumers, \(check1\): identity checker 1, \(check2\): identity checker 2, \(cm\): imports of consumption goods, \(cm_c\): proportion of consumption goods imported, \(cm_cadj\): polynomial adjustment cost term on proportion of consumption goods imported, \(cpidot\): inflation rate for the CPI, \(cpidot4\): annual inflation for the CPI, \(crt\): consumption by rule-of-thumb consumers, \(cu\): rate of capital utilization, \(cuadj\): polynomial adjustment cost term on rate of capital utilization, \(d\): housing stock, \(depr\): depreciation rate on capital, \(deprh\): depreciation on housing stock, \(d_t\): rate of depreciation allowance for investment, \(fa\): financial assets, \(fwf\): financial wealth, \(g\): government expenditures, \(gb\): government bonds, \(gbtar\): government debt target, \(gbtar_y\): target ratio of government bonds to output, \(gm\): imports of government goods, \(gm_g\): proportion of government goods imported, \(gm_gadj\): polynomial adjustment cost term on proportion of government goods imported, \(g_y\): target ratio.

79. Variables with superscript \(eq\) are equilibrium values. Relative prices are against domestically produced and consumed goods at factor cost. \(ydot\): is the equilibrium trend output growth rate. Variables here are detrended using this trend.
of government expenditures to output, \( gtr \): government transfers, \( gtr_y \): target ratio of government transfers to output, \( hufl \): aggregate human wealth, \( hufl1 \): human wealth 1, \( hufl2 \): human wealth 2, \( hufl3 \): human wealth 3, \( i \): corporate investment, \( ih \): housing investment, \( ihadj \): polynomial adjustment cost term on housing investment, \( ihm \): imports of housing investment goods, \( ihm_ih \): proportion of housing investment goods imported, \( ihm_ihadj \): polynomial adjustment cost term on proportion of housing investment goods imported, \( ii \): inventory investment, \( iiadj \): polynomial adjustment cost term on inventory investment, \( im \): imports of corporate investment goods, \( im_i \): proportion of corporate investment goods imported, \( im_iadj \): polynomial adjustment cost term on proportion of corporate investment goods imported, \( ip \): investment added to productive capital, \( k \): capital stock inclusive of investment not yet productive, \( kadj \): polynomial adjustment cost term on capital stock, \( kp \): production capital, \( m \): imports, \( mpcw \): marginal propensity to consume out of wealth, \( ncpidot \): inflation rate for the CPI net of indirect tax, \( ndot \): population growth rate, \( netx \): net imports, \( nfa \): net foreign assets, \( npcddot \): inflation rate for the price of domestic consumption net of indirect tax, \( npcdot \): inflation rate for the price of consumption net of indirect tax, \( npcdot4 \): annual inflation rate for the price of consumption net of indirect tax, \( npcdotdot4 \): annual inflation rate for the price of consumption net of indirect tax, \( npcdotdot44 \): annual inflation rate for the price of domestically produced and consumed goods at factor cost, \( pc \): relative price of consumption, \( pcl \): relative price of domestic consumption goods, \( pcladj \): polynomial adjustment cost term on relative price of domestic consumption goods, \( pcddot \): expected inflation rate for the price of consumption, \( pcddot4 \): annual inflation for the price of consumption, \( pcm \): relative price of imported consumption goods, \( pcmadj \): polynomial adjustment cost term on imported consumption goods, \( pcrow \): relative price of consumption goods in the rest of the world, \( pc_py \): relative price of domestically produced and consumed goods at factor cost, \( pdot \): expected inflation rate, \( pdottar \): target inflation rate, \( pdottare \): expected target inflation rate, \( pdot4 \): annual inflation rate, \( pf \): relative price of output at factor cost, \( pg \): relative price of government expenditures, \( pged \): relative price of domestic government goods, \( pgedadj \): polynomial adjustment cost term on relative price of domestic government goods, \( pgm \): relative price of imported government goods, \( pgmadj \): polynomial adjustment cost term on relative price of imported government goods, \( pgmdot \): inflation rate for the price of imported government goods, \( pg_py \): relative price of government goods relative to the price of output, \( pgrow \): relative price of government goods in the rest of the world, \( pi \): relative price of corporate investment, \( pid \): relative price of domestic corporate investment goods, \( pidadj \): polynomial adjustment cost term on relative price of domestic corporate investment goods, \( piidot \): inflation rate for the price of investment goods, \( pihd \): relative price of housing investment, \( pihdadj \): polynomial adjustment cost term on relative price of housing investment goods, \( pihm \): relative price of imported housing investment goods, \( pihmadj \): polynomial adjustment cost term on relative price of imported housing investment goods, \( pih_py \): ratio of relative price of housing investment to that of consumption, \( pih_py \): relative price of housing investment goods relative to the price of output, \( pihow \): relative price of housing investment goods in the rest of the world,
Here, we summarize the technique used in this paper when introducing the non-negativity constraint on the nominal interest rate into the large-scale macroeconomic model.

When we try to solve the large-scale nonlinear DGE model for cases where the zero nominal interest rate constraint is binding, we are sometimes unable to obtain a solution. However, if the model is linear and satisfies the condition specified in Blanchard and Kahn (1980), there exists a solution even when the zero nominal interest rate constraint is binding.

APPENDIX 2: TECHNICAL NOTES

Here, we summarize the technique used in this paper when introducing the non-negativity constraint on the nominal interest rate into the large-scale macroeconomic model.

When we try to solve the large-scale nonlinear DGE model for cases where the zero nominal interest rate constraint is binding, we are sometimes unable to obtain a solution. However, if the model is linear and satisfies the condition specified in Blanchard and Kahn (1980), there exists a solution even when the zero nominal interest rate constraint is binding.

80. Peter Hollinger is gratefully acknowledged for the analysis in this appendix, for giving us the idea and explaining how to program it.

81. If the number of eigenvalues outside the unit circle equals the number of nonpredetermined variables, there exists a unique solution.
interest rate constraint is binding. This conclusion is reached in Jung, Teranishi, and Watanabe (2005) in a dynamic application of the Kuhn-Tucker Theorem to a DSGE model.\textsuperscript{82}

The reason why the solution may not be obtained in the nonlinear model is as follows. If the model is nonlinear, and if there are equations in the model that can be expressed in the form \( x_t = a + y_t / z_t \), then inclusion of the constant means that a shock to \( z \) will change the linear relationship between \( x \) and \( y \). Therefore, if a large negative shock hits the economy within a nonlinear framework, a solution may not exist (Appendix Figure 1).

**Appendix Figure 1 Case with No Solution**

When introducing the zero nominal interest rate constraint into a nonlinear model, the most significant problem is posed by our inability to distinguish why there is no solution. In general, we cannot identify whether the model is insoluble because there exists no solution, or whether it is simply that we have failed to find the solution, even though one exists. Even assuming that the latter is the case, a further difficulty is presented in that we cannot identify the computational problem causing the insolubility. This could be any one of three possibilities: a discontinuous first derivative, stacking into the local maximum (minimum), or the wrong choice of initial value.

**Discontinuous derivatives:** We first introduce the zero nominal interest rate bound using the max function. Although introducing the zero nominal interest rate bound in this way usually provides us with a solution, there were several cases in which the solution proved unattainable. As TROLL uses the Newton-Raphson algorithm for the stacked matrix when solving the model dynamically,\textsuperscript{83} the Newton-Raphson algorithm may collapse when applied to a system of equations that includes

\textsuperscript{82} As mentioned, TE must be taken as the terminal condition.
\textsuperscript{83} For the details, see Hollinger (1996).
a max function whose Jacobian matrix is not continuous. This can be easily understood from Appendix Figure 2.

Appendix Figure 2 shows the iteration process for some arbitrary function with nonlinearity stemming from the max function. When the iteration process stacks at the kink where the derivative is discontinuous, the Newton-Raphson algorithm collapses. A possible easy countermeasure is to employ dumping, which, by altering the Newton gain, may prevent the iteration from stopping at the kink. However, our examinations to date suggest that the contribution of dumping is minimal in this context.

**Stacked at the local maximum (minimum):** Another major computational problem when solving the nonlinear model is the possibility of stacking into the local maximum. As depicted in Appendix Figure 3, with a poor choice of initial value, the solution tends to move toward the local maximum and we may end up without a solution. Again, this problem may be resolved by applying the dumping technique. Further extending the simulation period, which alters the stacked matrix, may enable a solution to be obtained. However, as above, realized gains from such attempts are extremely limited so far.

**Appendix Figure 2 Discontinuous Derivatives**

![Discontinuous Derivatives](image1)

**Appendix Figure 3 Stacking into the Local Maximum (Minimum)**

![Stacking into the Local Maximum (Minimum)](image2)
As mentioned above, to avoid the first problem (discontinuous derivatives) we introduce the functionally approximated policy rule with continuous first derivatives described in Appendix 3. However, the approximated function necessarily becomes higher order. Therefore, even if we can avoid the risk of stacking at the kink when iterating the Newton-Raphson algorithm, there exists a greater risk of stacking into the local maximum, in other words, of ending up with no solution. Hence, there is considered to be a trade-off between the above two problems.

**Choice of the wrong initial value:** When conducting steady-state simulation, it is obvious that we can obtain a solution when there are no shocks. More concretely, if we use the steady-state values as initial values for simulation without any shocks, there always exists a solution as it is input as the initial value. However, as the model is nonlinear, the large shock given to the model alters the linearly approximated dynamics as well. Therefore, as can be seen in Appendix Figure 4, even if there exists a solution, TROLL may report that no solution exists because it stacks at the local minimum if we apply the shock directly without changing the initial value.

To overcome all these problems at once, we introduce a new algorithm for solving the model with binding zero nominal interest rate bounds.  

**A. Algorithm for Sequentially Updating Initial Values and Functions**

The algorithm, “algorithm for sequentially updating initial values and functions,” where we are not only sequentially updating the initial values, but also increasing the order of the functional approximation, consists of two parts: updating the initial value, and updating the function. If we take the steady-state simulation as an example, these two parts may be outlined as follows.

1. **Updating the initial value**

   In this part, we follow the routine below.

   (1) First, we use the steady-state value as the initial value and solve the model with only 1 percent of the desired shock that is eventually to be applied to the model.

   ![Appendix Figure 4 Wrong Initial Value](image)

   84. This idea is inspired by Douglas Laxton’s presentation, “Think Globally, but Take Local Approximation,” at the TROLL seminar held in Seville, Spain in September 2002.
If we succeed in obtaining a solution, this solution is kept. Then another 1 percent shock is added to the shock applied in (1). We keep on updating the initial value as long as a solution is obtained.

If we fail to obtain a solution, we keep the initial value for this failed trial. We then decrease the shock from the level applied in the failed trial, keeping the size of the shock only slightly larger than the last successful trial. When the shock being applied in this process reaches the size of the shock given in the failed trial, we go back to (2) again.

The routine comes to an end when we reach the desired size of the shock or the number of failure attempts reaches some arbitrary number, say, 100.

2. Updating the function

If we cannot obtain a solution with the max function described in the above iteration, we use another iteration in which the function itself is updated. The process by which the order of approximation is increased is shown in Appendix Figure 5, where a policy rule with a max function has been updated to become a higher-order approximant. This is carried out using the following routine.

(1) We first replace the max function by a numerically approximated function with a continuous derivative of arbitrary order (usually the 10th order). If we can obtain a solution with the desired degree of approximation, we recognize this solution as a simulation pass.

(2) If we cannot obtain a solution, we reduce the degree of approximation until a solution is obtained using the above “updating the initial value” iteration. Each solution is used to update the initial value for a higher order of approximation until a solution is obtained for a function with the desired degree of approximation.

(3) If we cannot obtain a solution in (2), we consider that there is no solution or that the solution is unattainable.

By using these two iteration processes together, we may be able to overcome the technical difficulty of solving a large model with a non-negativity constraint on the nominal interest rate.

Our attempts to date have always succeeded in obtaining a solution using just the first part of our algorithm. We have not yet been obliged to perform the second

Appendix Figure 5 Updating the Function

![Appendix Figure 5 Updating the Function](image)
iteration process. The benefits attained from the first iteration process are huge. Even if we cannot obtain a solution when we apply the shock all at once, the solution is obtained via this initial value updating.

APPENDIX 3: FUNCTION APPROXIMATION WITH POLYNOMIAL INTERPOLATION

If one wishes to construct a highly theoretical model in which all the equations are derived from the social planner’s optimization problem (in other words, a model deriving from first principles), this typically requires dynamic programming to derive the structural equations. However, usually the researcher cannot identify the exact form of the value function that enables an analytical solution to be obtained. In these circumstances, it is often beneficial to approximate the value function numerically and then solve the system. Recently, such techniques, which are usually referred to as the numerical method, have been heavily applied in economics as in Judd (1998), Marimon and Scott (1999), Ljungqvist and Sargent (2000), and Miranda and Fackler (2002).

In this appendix, we briefly summarize one of the numerous numerical methods available, namely, “the function approximation with polynomial interpolation.” This is then applied in a simple manner to the policy rule when there is a non-negativity constraint on the nominal interest rate.

A. Second-Order Approximation of a Quadratic Equation

Here, as an example of a simple functional approximation, we attempt to approximate a quadratic equation expressed as an implicit function:

\[ F(x_1, x_2) = 0. \]  \hspace{1cm} (A.194)

According to the Weierstrass Theorem, which states that function approximations with any degree of accuracy can be obtained using a polynomial, the second-order approximant of equation (A.194), \( \hat{F} \), is shown as below:

\[
\hat{F}(x_1, x_2) = \left( \begin{array}{c}
\epsilon_{11} \\
\epsilon_{21} \\
\epsilon_{12} \\
\epsilon_{22}
\end{array} \right) \left( \begin{array}{c}
\varphi_{21}(x_1) \\
\varphi_{22}(x_2) \\
\varphi_{21}(x_1) \\
\varphi_{22}(x_2)
\end{array} \right)
\]

\[
= \epsilon_{11} \varphi_{21}(x_1) \varphi_{22}(x_2) + \epsilon_{21} \varphi_{22}(x_2) \varphi_{21}(x_1) \\
+ \epsilon_{12} \varphi_{21}(x_1) \varphi_{21}(x_2) + \epsilon_{22} \varphi_{22}(x_1) \varphi_{22}(x_2), \]

\( \epsilon \): parameters.
Polynomials are defined as Chebychev-node polynomials:\(^{85}\)

\[ \varphi_{11}(x_1) = 1, \]
\[ \varphi_{12}(x_1) = 2 \frac{x_1 - lb}{lb - ub} - 1, \]
\[ \varphi_{21}(x_2) = 1, \]
\[ \varphi_{22}(x_1) = 2 \frac{x_2 - lb}{lb - ub} - 1, \]

\(lb\): lower bound of approximation,
\(ub\): upper bound of approximation.

Equation (A.195) has four parameters. Therefore, if we pick any four points in \(x_1 - x_2\) space, parameters are just identified. How then do we select the four points? When employing the Chebychev polynomial, as here, it is generally recognized that the most appropriate point selection is given by

\[ x_i = lb + \frac{i - 1}{4 - 1} (ub - lb) \quad \forall i = 1, 2, 3, 4. \]

Constructing the polynomial and defining the points that the polynomial passes through as above, we can derive an approximated equation with any degree of accuracy.

**B. Application to the Policy Rule**

A very simple monetary policy rule\(^{86}\) is estimated by assuming that the equilibrium nominal interest rate is 1 percent annually. This estimated policy rule is expressed as follows when the zero nominal interest rate bound is imposed:

\[ \text{Call rate} = \max(0, 0.25 + 1.25 \cdot \text{CPI inflation} + 0.07 \cdot \text{output gap}). \]

The shape of this function is demonstrated in Appendix Figure 6.

The shape of the approximant of the 10th-degree polynomial interpolation, which is continuously differentiable, is presented in Appendix Figure 7.

Appendix Figure 8 shows the difference between Appendix Figures 6 and 7. The differences are seen to be minuscule. With the 10th-order approximation, we can obtain a very accurate approximation.

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85. Miranda and Fackler (2002) claim that “Chebychev-node polynomials are very nearly optimal polynomial approximants” according to Rivlin’s theorem.
86. Note that this rule differs from the one employed in the JEM.
Appendix Figure 6  Taylor Rule

Appendix Figure 7  Approximated Taylor Rule

Appendix Figure 8  Difference


