

The Bond Premium in a DSGE Model with Long-Run Real and Nominal Risks*

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January 2009, first draft August 2008

Abstract

The term premium on nominal long-term bonds in the standard dynamic stochastic general equilibrium (DSGE) model used in macroeconomics is far too small and stable relative to empirical measures obtained from the data—an example of the “bond premium puzzle.” However, in models of endowment economies, researchers have been able to generate reasonable term premiums by assuming that investors have recursive Epstein-Zin preferences and face long-run economic risks. We show that introducing Epstein-Zin preferences into a canonical DSGE model can also produce a large and variable term premium without compromising the model’s ability to fit key macroeconomic variables. Long-run real and nominal risks further improve the model’s ability to fit the data with a lower level of household risk aversion.

*We thank John Campbell, Ivan Jaccard, Hagen Kim, Sharon Koziicki, Jean-Marc Natal, Monika Piazzesi, Martin Schneider, David Vestin, Stan Zin, and seminar participants at the 2008 SCE Meetings, SED Meetings, Bank of Canada conference on Fixed Income Markets, Kansas City Fed, University of Indiana, National Bank of Belgium conference on Monetary and Financial Economics, and DSGE Workshop at the Cleveland Fed for helpful discussions, comments, and suggestions. The views expressed in this paper are those of the authors and do not necessarily reflect the views of other individuals within the Federal Reserve System.

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1 Introduction

The term premium on long-term nominal bonds compensates investors for inflation and consumption risks over the lifetime of the bond. A large finance literature finds that these risk premiums are substantial and vary significantly over time (e.g., Campbell and Shiller, 1991, Cochrane and Piazzesi, 2005); however, the economic forces that can justify such large and variable term premiums are less clear. Piazzesi and Schneider (2006) provide some economic insight into the source of a large positive mean term premium in a consumption-based asset pricing model of an endowment economy. Their analysis relies on two crucial features: first, the structural assumption that investors have Epstein-Zin recursive utility preferences,¹ and second, an estimated reduced-form process for the joint determination of consumption and inflation. With these two elements, they show that investors require a premium for holding nominal bonds because a positive inflation surprise lowers a bond’s value and is associated with lower future consumption growth. In such a situation, bondholders’ wealth decreases just as their marginal utility rises, so they require a premium to offset this risk. Using a similar structure—characterized by both Epstein-Zin preferences and reduced-form consumption and inflation empirics—Bansal and Shaliastovich (2007) also obtain significant time variation in the term premium.

An important shortcoming of such analyses is that they rely on reduced-form empirical correlations between consumption growth and inflation that have no direct structural foundation and may not be stable over time. For example, if the relative importance of technology shocks changes over time, then the reduced-form correlations may change. A more structural economic model of preferences and technology, such as the standard dynamic stochastic general equilibrium (DSGE) framework used in macroeconomics, can account for these changes and illuminate which features of the economy drive the term premium. In this paper, we undertake such a structural analysis.

Our paper also sheds light on whether the above authors’ results in an endowment economy with Epstein-Zin investors carry over to the case of a general equilibrium, production economy. There is some reason to be skeptical in this regard. Although Wachter (2006) obtained

¹ Early on, Kreps and Porteus (1978) established the theoretical framework for such recursive preferences, which were further developed by Epstein and Zin (1989) and Weil (1989).

a significant mean term premium in an endowment economy using long-memory habit preferences (à la Campbell and Cochrane, 1999), Rudebusch and Swanson (2008) showed that such long-memory habits generated only a negligible term premium in a DSGE model. In particular, because households in a production economy can endogenously trade off labor and consumption, they are much better insulated from consumption risk than households in an endowment economy, who must consume whatever endowment they receive. In a production economy, when households are hit by a negative shock, they can compensate by increasing their labor supply and working more hours, which provides partial insurance against shocks to consumption.² Households in an endowment economy do not have this opportunity, so the consumption cost of shocks is correspondingly greater, and risky assets thus carry a larger risk premium. Therefore, it is important to explore whether the endowment economy results with Epstein-Zin preferences also hold in a production economy.

We use a standard macroeconomic DSGE model to analyze the economic forces behind movements in long-term bond premiums. Although the long-term bond premium has received less attention in the literature than the equity premium, it is arguably even more important. As a practical matter, the value of long-term bonds outstanding in the U.S. (and elsewhere) is far larger than the value of equities. Central banks around the world use the yield curve to measure expectations about short-run monetary policy and long-run inflation expectations, so understanding risk premia on these securities is important for monetary policy. Modeling the premium on long-term bonds does not require us to take a stand on the controversial topics of how to model dividends and leverage; all we need is the short-term interest rate process, which is already included in the specification of standard DSGE models. The bond premium also provides an alternate metric by which to assess model performance: for example, Boldrin, Christiano, and Fisher (2001) can account for the equity premium in a two-sector DSGE model because capital immobility across the two sectors greatly increases the variance of the price of capital (and thus stock prices) and its covariance with consumption; however, this mechanism

² Jermann (1998), Lettau and Uhlig (2000), and Boldrin, Christiano, and Fisher (2001) also stress this difference between endowment and production economies in accounting for the equity premium. Our inability to generalize Wachter's (2006) results to a DSGE setting can be thought of as a failure of DSGE models with Campbell-Cochrane (1999) habits to generate a consumption process that is as volatile as we observe in the data. This is because Campbell-Cochrane households despise high-frequency variation in consumption, so endogenously generating a consumption process as volatile as the data requires enormous variation in prices, wages, or both.

cannot explain the long-term bond premium, which involves the valuation of a constant nominal coupon on a default-free government bond. Finally, the bond premium is intimately related to the behavior of inflation and nominal rigidities, which are crucial and still unresolved aspects of the current generation of DSGE models.

The underlying form of our DSGE model closely follows the standard specification of DSGE models in the literature (e.g., Woodford, 2003, Christiano, Eichenbaum, and Evans, 2005, Smets and Wouters, 2003) and, notably, contains an important role for nominal rigidities in order to endogenously describe the behavior of inflation, short-term nominal interest rates, and long-term nominal bonds. We evaluate the model based on its ability to match both basic macroeconomic moments (e.g., the standard deviations of consumption and inflation) and basic bond pricing moments (e.g., the means and volatilities of the yield curve slope and bond excess holding period returns). In order to match the bond pricing facts, we augment the standard DSGE model in two ways. First, we assume that households in the model have Epstein-Zin preferences, so risk aversion can be modeled independently from the intertemporal elasticity of substitution.³ Such a separation allows the model to match risk premiums even in the face of the intertemporal substitution possibilities associated with a variable labor supply. Second, we assume that agents in the model face long-run economic risks, as in Bansal and Yaron (2004).⁴ However, because we are pricing a nominal asset, we consider not just long-run real risk, but also long-run *nominal* risk, in the sense that the central bank’s long-run inflation objective may vary over time, as in Gürkaynak, Sack, and Swanson (2005).⁵

Together, these two key ingredients—Epstein-Zin preferences and long-run economic risk—allow our model to replicate the bond pricing facts without compromising its ability to fit the macroeconomic facts. Intuitively, our model is identical to first order to standard macroeconomic DSGE representations because the first-order approximation to Epstein-Zin preferences is the same as the first-order approximation to standard expected utility preferences. Furthermore,

³ Van Binsbergen, Fernández-Villaverde, Koijen, and Rubio-Ramírez (2008) also price bonds in a DSGE model with Epstein-Zin preferences, although their model treats inflation as an exogenous stochastic process and thus suffers from some of the same drawbacks as Piazzesi and Schneider (2006) and Bansal and Shaliastovich (2007).

⁴ Bansal and Yaron (2004) show that uncertainty about the economy’s long-run growth prospects can play an important role in generating sizable equity risk premiums.

⁵ Gürkaynak, Sack, and Swanson (2005) find that the excess sensitivity of long-term bond yields to macroeconomic announcements appears to be due to financial markets expecting some degree of pass-through from near-term inflation to the long-term inflation outlook.

the macroeconomic moments of the model are not very sensitive to the additional second- and higher-order terms introduced by Epstein-Zin preferences, while risk premiums are unaffected by first-order terms and completely determined by those second- and higher-order terms. Therefore, by varying the Epstein-Zin risk-aversion parameter while holding the other parameters of the model constant, we are able to fit the asset pricing facts without compromising the model's ability to fit the macroeconomic data.

Our analysis has implications for both the finance and macroeconomics literatures. For finance, our analysis can illuminate the earlier reduced-form results with a structural economic interpretation. For macroeconomics, our results suggest a path to transform the standard DSGE model into a complete description of the economy. As a theoretical matter, asset prices and the macroeconomy are inextricably linked; indeed, as emphasized by Cochrane (2007), asset markets are the mechanism by which capital is allocated efficiently across firms and by which consumption and investment are allocated efficiently across time and states of nature. Therefore, any correctly specified DSGE model must be capable of matching interest rates and other asset prices as well as consumption and inflation.

The remainder of the paper proceeds as follows. Section 2 generalizes the standard DSGE model to the case of Epstein-Zin preferences. Section 3 presents results for this model and shows how it is able to match the term premium without impairing the model's ability to fit macroeconomic variables. Section 4 introduces a model with enhanced long-run economic risks, which improves the model's overall fit to the data. Section 5 concludes. A brief technical appendix provides additional details of how general DSGE models can be extended to the case of Epstein-Zin preferences and solved.

2 A DSGE Model with Epstein-Zin Preferences

In this section, we generalize the simple, stylized DSGE model of Woodford (2003) to the case of Epstein-Zin preferences. We show how to price long-term nominal bonds in this model and present a variety of measures of the term premium and bond risk.

2.1 Epstein-Zin Preferences

It is standard practice in macroeconomics to assume that a representative household chooses state-contingent plans for consumption, c , and labor, l , so as to maximize expected utility:

$$\max E_0 \sum_{t=0}^{\infty} \beta^t u(c_t, l_t), \quad (1)$$

subject to an asset accumulation equation, where $\beta \in (0, 1)$ is the household's discount factor and the period utility kernel $u(c_t, l_t)$ is twice-differentiable, concave, increasing in c , and decreasing in l . The maximand in equation (1) can be expressed in first-order recursive form as:

$$V_t \equiv u(c_t, l_t) + \beta E_t V_{t+1}, \quad (2)$$

where the household's state-contingent plans at time t are chosen so as to maximize V_t .

In this paper, we follow the finance literature and generalize (2) to an Epstein-Zin specification:

$$V_t \equiv u(c_t, l_t) + \beta (E_t V_{t+1}^{1-\alpha})^{1/(1-\alpha)}, \quad (3)$$

where the parameter α can take on any real value.⁶ If $u \geq 0$ everywhere, then the proof of Theorem 3.1 in Epstein and Zin (1989) shows that there exists a solution V to (3) with $V \geq 0$. If $u \leq 0$ everywhere, then it is natural to let $V \leq 0$ and reformulate the recursion as:

$$V_t \equiv u(c_t, l_t) - \beta [E_t (-V_{t+1})^{1-\alpha}]^{1/(1-\alpha)}. \quad (4)$$

The proof in Epstein and Zin (1989) also demonstrates the existence of a solution V to (4) with $V \leq 0$ in this case.⁷ When $\alpha = 0$, both (3) and (4) reduce to the standard case of expected utility (2). When $u \geq 0$ everywhere, higher (lower) values of α correspond to greater (lesser) degrees of risk aversion. When $u \leq 0$ everywhere, the opposite is true: higher (lower) values of α correspond to lesser (greater) degrees of risk aversion.

Note that, traditionally, Epstein-Zin preferences over consumption streams have been written as:

$$\tilde{V}_t \equiv \left[c_t^\rho + \beta \left(E_t \tilde{V}_{t+1}^{\tilde{\alpha}} \right)^{\rho/\tilde{\alpha}} \right]^{1/\rho}, \quad (5)$$

⁶ The case $\alpha = 1$ corresponds to $V_t = u(c_t, l_t) + \beta \exp(E_t \log V_{t+1})$ for the case $u \geq 0$, and $V_t = u(c_t, l_t) - \beta \exp[E_t \log(-V_{t+1})]$ for $u \leq 0$.

⁷ We exclude the case where u is sometimes positive and sometimes negative, although for local approximations around a deterministic steady state with infinitesimal uncertainty, this case does not present any particular difficulties.

but by setting $V_t = \tilde{V}_t^\rho$ and $\alpha = 1 - \tilde{\alpha}/\rho$, this can be seen to correspond to (3). Moreover, the form (3) has the advantage that it allows us to consider standard DSGE utility kernels involving both labor and inelastic intertemporal substitution ($\rho < 0$), which the form (5) cannot easily handle.

The key advantage of using Epstein-Zin utility (3) is that it breaks the equivalence between the inverse of the intertemporal elasticity of substitution and the coefficient of relative risk aversion that has long been noted in the literature regarding expected utility (2)—see, e.g., Mehra and Prescott (1985) and Hall (1988). In (3), the intertemporal elasticity of substitution over deterministic consumption paths is exactly the same as in (2), but now the household’s risk aversion to uncertain lotteries over V_{t+1} can be amplified by the additional parameter α , a feature which is crucial for allowing us to fit both the asset pricing and macroeconomic facts below.⁸

We now turn to the utility kernel u . For simplicity, we adopt the usual DSGE specification (e.g., Woodford, 2003):

$$u(c_t, l_t) \equiv \frac{c_t^{1-\gamma}}{1-\gamma} - \chi_0 \frac{l_t^{1+\chi}}{1+\chi}, \quad (6)$$

which allows for tractable modeling of nominal wage as well as price rigidities—an essential ingredient of many models in this literature. If $\gamma > 1$, then (6) is nonpositive everywhere and V is defined by (4). If $\gamma \leq 1$, then there are two main approaches to ensure that the utility kernel u is everywhere positive. The first is to add a constant:

$$u(c_t, l_t) \equiv \frac{c_t^{1-\gamma}}{1-\gamma} - \chi_0 \frac{l_t^{1+\chi}}{1+\chi} + \frac{\chi_0 \bar{l}^{1+\chi}}{1+\chi}, \quad (7)$$

where \bar{l} denotes the household’s time endowment. Note, however, that additive shifts of the utility kernel, as in (7), are nonneutral and affect the household’s attitude towards risk, except for the special case of expected utility, $\alpha = 0$. (This will become apparent when we derive the household’s stochastic pricing kernel, below.) The second approach is to use (6) but impose that there is some subsistence level $\underline{c} \geq 0$ for consumption below which households cannot go. By setting \underline{c} high enough, we can ensure that u is positive over the range of admissible values for c and l . Of these two approaches, we will generally opt for the latter, which does a better

⁸ Indeed, the linearization or log-linearization of (3) is exactly the same as that of (2), which turns out to be very useful for matching the model to macroeconomic variables, since models with (2) are already known to be able to fit macroeconomic quantities reasonably well. We will return to this point in Section 3, below.

job of explaining the term premium below (although both approaches work about equally well in the larger-scale Christiano, Eichenbaum, and Evans (2005) model).

2.2 The Household's Optimization Problem

We now turn to the representative household's optimization problem under Epstein-Zin preferences. We assume that households are representative and choose state-contingent consumption and labor plans so as to maximize (3) subject to an intertemporal-flow budget constraint, specified below. We will solve the household's optimization problem as a Lagrange problem with the states of nature explicitly specified. To that end, let $s^0 \in S_0$ denote the initial state of the economy at time 0, let $s_t \in S$ denote the realizations of the shocks that hit the economy in period t , and let $s^t \equiv \{s^{t-1}, s_t\} \in S_0 \times S^t$ denote the initial state and history of all shocks up through time t . We define s_{t-1}^t to be the projection of the history s^t onto its first t components; that is, s_{t-1}^t is the history s^t as it would have been viewed at time $t - 1$, before time- t shocks have been realized.

Households have access to an asset whose price is given by $p_{t,s^t} > 0$ in each period t and state of the world s^t . In each period t , households choose the quantity of consumption c_{t,s^t} , labor l_{t,s^t} , and asset holdings a_{t,s^t} that will carry through to the next period, subject to a constraint that the household's asset holdings a_{t,s^t} are always greater than some lower bound $\underline{a} \ll 0$, which does not bind in equilibrium but rules out Ponzi schemes. Households are price takers in consumption, asset, and labor markets, and face a price per unit of consumption of P_{t,s^t} , and nominal wage rate w_{t,s^t} . Households also own an aliquot share of firms and receive a per-period lump-sum transfer from firms in the amount d_{t,s^t} . The household's flow budget constraint is thus:

$$p_{t,s^t} a_{t,s^t} + P_{t,s^t} c_{t,s^t} = w_{t,s^t} l_{t,s^t} + d_{t,s^t} + p_{t,s^t} a_{t-1,s_{t-1}^t}. \quad (8)$$

The household's optimization problem is to choose a sequence of vector-valued functions, $[c_t(s^t), l_t(s^t), a_t(s^t)]: S_0 \times S^t \rightarrow [\underline{c}, \infty) \times [0, \bar{l}] \times [\underline{a}, \infty)$ so as to maximize (3) subject to the sequence of budget constraints (8). For clarity in what follows, we assume that s^0 and s_t can take on only a finite number of possible values (i.e., S_0 and S have finite support), and we let $\pi_{s^\tau|s^t}$, $\tau \geq t \geq 0$, denote the probability of realizing state s^τ at time τ conditional on being in

state s^t at time t .

The household's optimization problem can be formulated as a Lagrangean, where the household chooses state-contingent plans for consumption, labor, and asset holdings, $(c_{t,s^t}, l_{t,s^t}, a_{t,s^t})$, that maximize V_0 subject to the infinite sequence of state-contingent constraints (3) and (8), that is, maximize:

$$\begin{aligned} \mathcal{L} \equiv & V_{0,s^0} - \sum_{t=0}^{\infty} \sum_{s^t} \mu_{t,s^t} \left\{ V_{t,s^t} - u(c_{t,s^t}, l_{t,s^t}) - \beta \left(\sum_{s^{t+1}} \pi_{s^{t+1}|s^t} V_{t+1,s^{t+1}}^{1-\alpha} \right)^{1/(1-\alpha)} \right\} - \\ & \sum_{t=0}^{\infty} \sum_{s^t} \lambda_{t,s^t} \{ p_{t,s^t} a_{t,s^t} + P_{t,s^t} c_{t,s^t} - w_{t,s^t} l_{t,s^t} - d_{t,s^t} - p_{t,s^t} a_{t-1,s_{t-1}^t} \}. \end{aligned} \quad (9)$$

The household's first-order conditions for (9) are then:

$$\begin{aligned} \frac{\partial \mathcal{L}}{\partial c_{t,s^t}} & : \quad \mu_{t,s^t} u_1|_{(c_{t,s^t}, l_{t,s^t})} = P_{t,s^t} \lambda_{t,s^t}, \\ \frac{\partial \mathcal{L}}{\partial l_{t,s^t}} & : \quad -\mu_{t,s^t} u_2|_{(c_{t,s^t}, l_{t,s^t})} = w_{t,s^t} \lambda_{t,s^t}, \\ \frac{\partial \mathcal{L}}{\partial a_{t,s^t}} & : \quad \lambda_{t,s^t} p_{t,s^t} = \sum_{s^{t+1} \supseteq s^t} \lambda_{t+1,s^{t+1}} p_{t+1,s^{t+1}}, \\ \frac{\partial \mathcal{L}}{\partial V_{t,s^t}} & : \quad \mu_{t,s^t} = \beta \pi_{s^t|s_{t-1}^t} \mu_{t-1,s_{t-1}^t} \left(\sum_{\tilde{s}^t \supseteq s_{t-1}^t} \pi_{\tilde{s}^t|s_{t-1}^t} V_{t,\tilde{s}^t}^{1-\alpha} \right)^{\alpha/(1-\alpha)} V_{t,s^t}^{-\alpha}; \quad \mu_{0,s^0} = 1. \end{aligned}$$

Letting $(1+r_{t+1,s^{t+1}}) \equiv p_{t+1,s^{t+1}}/p_{t,s^t}$, the gross rate of return on the asset, making substitutions, and defining the stationary Lagrange multipliers $\tilde{\lambda}_{t,s^t} \equiv \beta^{-t} \pi_{s^t|s^0}^{-1} \lambda_{t,s^t}$ and $\tilde{\mu}_{t,s^t} \equiv \beta^{-t} \pi_{s^t|s^0}^{-1} \mu_{t,s^t}$, these become:

$$\frac{\partial \mathcal{L}}{\partial c_{t,s^t}} : \quad \tilde{\mu}_{t,s^t} u_1|_{(c_{t,s^t}, l_{t,s^t})} = P_{t,s^t} \tilde{\lambda}_{t,s^t} \quad (10)$$

$$\frac{\partial \mathcal{L}}{\partial l_{t,s^t}} : \quad -\tilde{\mu}_{t,s^t} u_2|_{(c_{t,s^t}, l_{t,s^t})} = w_{t,s^t} \tilde{\lambda}_{t,s^t} \quad (11)$$

$$\frac{\partial \mathcal{L}}{\partial a_{t,s^t}} : \quad \tilde{\lambda}_{t,s^t} = \beta E_{t,s^t} \tilde{\lambda}_{t+1,s^{t+1}} (1+r_{t+1,s^{t+1}}) \quad (12)$$

$$\frac{\partial \mathcal{L}}{\partial V_{t,s^t}} : \quad \tilde{\mu}_{t,s^t} = \tilde{\mu}_{t-1,s_{t-1}^t} (E_{t-1,s_{t-1}^t} V_{t,\tilde{s}^t}^{1-\alpha})^{\alpha/(1-\alpha)} V_{t,s^t}^{-\alpha}; \quad \tilde{\mu}_{0,s^0} = 1. \quad (13)$$

These first-order conditions are very similar to the expected utility case except for the introduction of the additional Lagrange multipliers $\tilde{\mu}_{t,s^t}$, which translate utils at time t into utils at time 0, allowing for the "twisting" of the value function by $1-\alpha$ that takes place at each time

1, 2, \dots, t. Note that in the expected utility case, $\tilde{\mu}_{t,s^t} = 1$ for every t and s^t , and equations (10) through (13) reduce to the standard optimality conditions.

Substituting out for $\tilde{\lambda}_{t,s^t}$ and $\tilde{\mu}_{t,s^t}$ in (10) through (13), we get the household's intratemporal and intertemporal (Euler) optimality conditions:

$$\begin{aligned} \frac{-u_2|_{(c_{t,s^t}, l_{t,s^t})}}{u_1|_{(c_{t,s^t}, l_{t,s^t})}} &= \frac{w_{t,s^t}}{P_{t,s^t}} \\ u_1|_{(c_{t,s^t}, l_{t,s^t})} &= \beta E_{t,s^t} (E_{t,s^t} V_{t+1,s^{t+1}}^{1-\alpha})^{\alpha/(1-\alpha)} V_{t+1,s^{t+1}}^{-\alpha} u_1|_{(c_{t+1,s^{t+1}}, l_{t+1,s^{t+1}})} (1 + r_{t+1,s^{t+1}}) P_{t,s^t} / P_{t+1,s^{t+1}} . \end{aligned}$$

Finally, let $p_{t,s^t}^{s^\tau}$, $t \leq \tau$, denote the price at time t in state s^t of a state-contingent bond that pays one dollar at time τ in state s^τ and 0 otherwise. If we insert this state-contingent security into the household's optimization problem, we see that, for $t < \tau$:

$$p_{t,s^t}^{s^\tau} = \beta E_{t,s^t} (E_{t,s^t} V_{t+1,s^{t+1}}^{1-\alpha})^{\alpha/(1-\alpha)} V_{t+1,s^{t+1}}^{-\alpha} \frac{u_1|_{(c_{t+1,s^{t+1}}, l_{t+1,s^{t+1}})}}{u_1|_{(c_{t,s^t}, l_{t,s^t})}} \frac{P_{t,s^t}}{P_{t+1,s^{t+1}}} p_{t+1,s^{t+1}}^{s^\tau} . \quad (14)$$

That is, the household's (nominal) stochastic discount factor at time t in state s^t for stochastic payoffs at time $t + 1$ is given by:

$$m_{t,s^t,t+1,s^{t+1}} \equiv \left(\frac{V_{t+1,s^{t+1}}}{(E_{t,s^t} V_{t+1,s^{t+1}}^{1-\alpha})^{1/(1-\alpha)}} \right)^{-\alpha} \frac{\beta u_1|_{(c_{t+1,s^{t+1}}, l_{t+1,s^{t+1}})}}{u_1|_{(c_{t,s^t}, l_{t,s^t})}} \frac{P_{t,s^t}}{P_{t+1,s^{t+1}}} . \quad (15)$$

Despite the twisting of the value function by $1 - \alpha$, the price $p_{t,s^t}^{s^\tau}$ nevertheless satisfies the standard relationship,

$$\begin{aligned} p_{t,s^t}^{s^\tau} &= E_{t,s^t} m_{t,s^t,t+1,s^{t+1}} m_{t+1,s^{t+1},t+2,s^{t+2}} p_{t+2,s^{t+2}}^{s^\tau} \\ &= E_{t,s^t} m_{t,s^t,t+1,s^{t+1}} m_{t+1,s^{t+1},t+2,s^{t+2}} \cdots m_{\tau-1,s^{\tau-1},\tau,s^\tau} , \end{aligned}$$

and the asset pricing equation (14) is linear in the future state-contingent payoffs, so that we can price any compound security by summing over the prices of its individual constituent state-contingent payoffs.

2.3 The Firm's Optimization Problem

To model nominal rigidities, we assume that the economy contains a continuum of monopolistically competitive intermediate goods firms indexed by $f \in [0, 1]$ that set prices according

to Calvo contracts and hire labor from households in a competitive labor market. Firms have identical Cobb-Douglas production functions:

$$y_t(f) = A_t \bar{k}^{-(1-\eta)} l_t(f)^\eta, \quad (16)$$

where \bar{k} is a fixed, firm-specific capital stock and A_t denotes an aggregate technology shock that affects all firms.⁹ We have suppressed the explicit state-dependence of the variables in this equation and in the remainder of the paper to ease the notational burden. The technology shock A_t follows an exogenous AR(1) process:

$$\log A_t = \rho_A \log A_{t-1} + \varepsilon_t^A, \quad (17)$$

where ε_t^A denotes an independently and identically distributed (i.i.d.) aggregate technology shock with mean zero and variance σ_A^2 .

Firms set prices according to Calvo contracts that expire with probability $1 - \xi$ each period. When the Calvo contract expires, the firm is free to reset its price as it chooses, and we denote the price that the firm f sets in period t by $p_t(f)$. There is no indexation, so the price $p_t(f)$ is fixed over the life of the contract. In each period $\tau \geq t$ that the contract remains in effect, the firm must supply whatever output is demanded at the contract price $p_t(f)$, hiring labor $l_\tau(f)$ from households at the market wage w_τ .

Firms are collectively owned by households and distribute profits and losses back to households each period. When a firm's price contract expires, the firm chooses the new contract price $p_t(f)$ to maximize the value to shareholders of the firm's cash flows over the lifetime of the contract (equivalently, the firm chooses a state-contingent plan for prices that maximizes the value of the firm to shareholders). That is, the firm maximizes:

$$E_t \sum_{j=0}^{\infty} \xi^j m_{t,t+j} [p_t(f) y_{t+j}(f) - w_{t+j} l_{t+j}(f)], \quad (18)$$

where $m_{t,t+j}$ is the representative household's stochastic discount factor from period t to $t + j$.

The output of each intermediate firm f is purchased by a perfectly competitive final goods sector that aggregates the continuum of intermediate goods into a single final good using a CES

⁹ Woodford (2003), Altig, Christiano, Eichenbaum, and Lindé (2004), and others have emphasized the importance of firm-specific fixed factors for generating a level of inflation persistence that is consistent with the data. Firm-specific capital stocks also help to match the term premium as well as the persistence of inflation.

production technology:

$$Y_t = \left[\int_0^1 y_t(f)^{1/(1+\theta)} df \right]^{1+\theta}. \quad (19)$$

Each intermediate firm f thus faces a downward-sloping demand curve for its product:

$$y_t(f) = \left(\frac{p_t(f)}{P_t} \right)^{-(1+\theta)/\theta} Y_t, \quad (20)$$

where P_t is the CES aggregate price per unit of the final good:

$$P_t \equiv \left[\int_0^1 p_t(f)^{-1/\theta} df \right]^{-\theta}. \quad (21)$$

Differentiating (18) with respect to $p_t(f)$ yields the standard optimality condition for the firm's price:

$$p_t(f) = \frac{(1+\theta) E_t \sum_{j=0}^{\infty} \xi^j m_{t,t+j} mc_{t+j}(f) y_{t+j}(f)}{E_t \sum_{j=0}^{\infty} \xi^j m_{t,t+j} y_{t+j}(f)}. \quad (22)$$

where $mc_t(f)$ denotes the marginal cost for firm f at time t :

$$mc_t(f) \equiv \frac{w_t l_t(f)}{\eta y_t(f)}. \quad (23)$$

2.4 Aggregate Resource Constraints and the Government

To aggregate up from firm-level variables to aggregate quantities, it is useful to define cross-sectional price dispersion, Δ_t :

$$\Delta_t^{1/\eta} \equiv (1-\xi) \sum_{j=0}^{\infty} \xi^j p_{t-j}(f)^{-(1+\theta)/\theta\eta}, \quad (24)$$

where the occurrence of the parameter η in the exponent is due to the firm-specificity of capital.

We define L_t , the aggregate quantity of labor demanded by firms, as:

$$L_t \equiv \int_0^1 l_t(f) df. \quad (25)$$

Then L_t satisfies:

$$Y_t = \Delta_t^{-1} A_t \bar{K}^{1-\eta} L_t^\eta, \quad (26)$$

where $\bar{K} = \bar{k}$ is the capital stock. Equilibrium in the labor market requires that $L_t = l_t$, labor demand equals the aggregate labor supplied by the representative households.

In order to study the effects of fiscal shocks, we assume that there is a government sector in the model that levies lump-sum taxes G_t on households and destroys the resources it collects. Government consumption follows an exogenous AR(1) process:

$$\log G_t = \rho_G \log G_{t-1} + \varepsilon_t^G, \quad (27)$$

where ε_t^G denotes an i.i.d. government consumption shock with mean zero and variance σ_G^2 .

Although agents cannot invest in physical capital in this version of the model, we do assume that an amount $\delta\bar{K}$ of output each period is devoted to maintaining the fixed capital stock. Thus, the aggregate resource constraint implies that

$$Y_t = C_t + \delta\bar{K} + G_t, \quad (28)$$

where $C_t = c_t$, the consumption of the representative household.

Finally, there is a monetary authority in the economy which sets the one-period continuously-compounded nominal interest rate i_t according to a Taylor-type policy rule:

$$i_t = \rho_i i_{t-1} + (1 - \rho_i) \left[\log(1/\beta) + \log \bar{\pi}_t + g_y(Y_t - \bar{Y})/\bar{Y} + g_\pi(\log \bar{\pi}_t - \log \pi^*) \right] + \varepsilon_t^i, \quad (29)$$

where $\log(1/\beta)$ is the steady-state real interest rate in the model, \bar{Y} denotes the steady-state level of output, π^* denotes the steady-state rate of inflation, ε_t^i denotes an i.i.d. stochastic monetary policy shock with mean zero and variance σ_i^2 , and ρ_i , g_y , and g_π are parameters.¹⁰ The variable $\bar{\pi}_t$ denotes a geometric moving average of inflation:

$$\bar{\pi}_t = \theta_\pi \bar{\pi}_{t-1} + (1 - \theta_\pi) \pi_t, \quad (30)$$

where current-period inflation $\pi_t \equiv \log(P_t/P_{t-1})$ and we set $\theta_\pi = 0.7$ so that the geometric average in (30) has an effective duration of about four quarters, which is typical in estimates of the Taylor rule.¹¹

¹⁰ In equation (29) (and equation (29) only), we express i_t , π_t , and $1/\beta$ in annualized terms, so that the coefficients g_π and g_y correspond directly to the estimates in the empirical literature. We also follow the literature by assuming an “inertial” policy rule with i.i.d. policy shocks, although there are a variety of reasons to be dissatisfied with the assumption of AR(1) processes for all stochastic disturbances except the one associated with short-term interest rates. Indeed, Rudebusch (2002, 2006) and Carrillo, Fève, and Matheron (2007) provide strong evidence that an alternative policy specification with serially correlated shocks and little gradual adjustment is more consistent with the dynamic behavior of nominal interest rates.

¹¹ Including the usual four-quarter moving average of inflation in the policy rule adds three lags (π_{t-1} , π_{t-2} , and π_{t-3}) as state variables, while our geometric average adds only one lag ($\bar{\pi}_{t-1}$). All results are very similar for either specification.

2.5 Long-term Bonds and the Term Premium

The price of any asset in the model economy must satisfy the standard stochastic discounting relationship in which the household's stochastic discount factor is used to value the state-contingent payoffs of the asset in period $t + 1$. For example, the price of a default-free n -period zero-coupon bond that pays one dollar at maturity satisfies:

$$p_t^{(n)} = \mathbb{E}_t[m_{t+1}p_{t+1}^{(n-1)}], \quad (31)$$

where $m_{t+1} \equiv m_{t,t+1}$, $p_t^{(n)}$ denotes the price of the bond at time t , and $p_t^{(0)} \equiv 1$, i.e., the time- t price of one dollar delivered at time t is one dollar. The continuously-compounded yield to maturity on the n -period zero-coupon bond is defined to be:

$$i_t^{(n)} \equiv -\frac{1}{n} \log p_t^{(n)}. \quad (32)$$

In the U.S. data, the benchmark long-term bond is the ten-year Treasury note. Thus, we wish to model the term premium on a bond with a duration of about ten years. Computationally, it is inconvenient to work with a zero-coupon bond that has more than a few periods to maturity; instead, it is much easier to work with an infinitely-lived consol-style bond that has a time-invariant or time-symmetric structure.¹² Thus, we assume that households in the model can buy and sell a long-term default-free nominal consol which pays a geometrically declining coupon in every period in perpetuity. The nominal consol's price per one dollar of coupon in period t , which we denote by $\tilde{p}_t^{(n)}$, then satisfies:

$$\tilde{p}_t^{(n)} = 1 + \delta_c \mathbb{E}_t m_{t+1} \tilde{p}_{t+1}^{(n)}, \quad (33)$$

where δ_c is the rate of decay of the coupon on the consol. By choosing an appropriate value for δ_c , we can thus model prices of a bond of any desired Macaulay duration or maturity n , such as the ten-year maturity that serves as our zero-coupon benchmark in the data.¹³ Finally, the

¹² We have also verified that all of our results continue to hold with zero-coupon bonds as well as the consol. However, solving the model with zero-coupon bonds takes much (eight to ten times) longer than solving the model with the consol, because solving for the 40-quarter zero-coupon bond price essentially requires solving for zero-coupon bond prices of all maturities from one to 40 quarters. The consol can be solved by adding just one first-order recursive equation to the model.

¹³ As δ_c approaches 0, the consol behaves more like cash—a zero-period zero-coupon bond. As δ_c approaches 1, the consol approaches a traditional consol with a fixed (nondepreciating) nominal coupon, which, under our baseline parameter values below, has a duration of about 25 years. By setting $\delta_c > 1$, the duration of the consol can be made even longer.

continuously-compounded yield to maturity on the consol, $\tilde{i}_t^{(n)}$, is given by:

$$\tilde{i}_t^{(n)} \equiv \log \left(\frac{\delta_c \tilde{p}_t^{(n)}}{\tilde{p}_t^{(n)} - 1} \right). \quad (34)$$

Note that even though the nominal bond in our model is default-free, it is still risky in the sense that its price can covary with the household's marginal utility of consumption. For example, when inflation is expected to be higher in the future, then the price of the bond generally falls, because households discount its future nominal coupons more heavily. If times of high inflation are correlated with times of low output (as is the case for technology shocks in the model), then households regard the nominal bond as being very risky, because it loses value at exactly those times when the household values consumption the most. Alternatively, if inflation is not very correlated with output and consumption, then the bond is correspondingly less risky. In the former case, we would expect the bond to carry a substantial risk premium (its price would be lower than the risk-neutral price), while in the latter case we would expect the risk premium to be smaller.

In the literature, the risk premium or *term premium* on a long-term bond is typically expressed as the difference between the yield on the bond and the unobserved risk-neutral yield for that same bond. To define the term premium in our model, then, we first define the risk-neutral price of the consol, $\hat{p}_t^{(n)}$:

$$\hat{p}_t^{(n)} \equiv \mathbb{E}_t \sum_{j=0}^{\infty} e^{-i_{t,t+j}} \delta_c^j, \quad (35)$$

where $i_{t,t+j} \equiv \sum_{n=0}^j i_n$. Equation (35) is the expected present discounted value of the coupons of the consol, where the discounting is performed using the risk-free rate rather than the household's stochastic discount factor. Equivalently, equation (35) can be expressed in first-order recursive form as:

$$\hat{p}_t^{(n)} = 1 + \delta_c e^{-i_t} \mathbb{E}_t \hat{p}_{t+1}^{(n)}, \quad (36)$$

which directly parallels (33). The implied term premium on the consol is then given by:

$$\psi_t^{(n)} \equiv \log \left(\frac{\delta_c \tilde{p}_t^{(n)}}{\tilde{p}_t^{(n)} - 1} \right) - \log \left(\frac{\delta_c \hat{p}_t^{(n)}}{\hat{p}_t^{(n)} - 1} \right), \quad (37)$$

which is the difference between the observed yield to maturity on the consol and the risk-neutral yield to maturity.

For a given set of structural parameters of the model, we will choose δ_c so that the bond has a Macaulay duration of $n = 40$ quarters, and we will multiply equation (37) by 400 in order to report the term premium in units of annualized percentage points rather than logs.

The term premium in equation (37) can also be expressed more directly in terms of the stochastic discount factor, which can be useful for gaining intuition about how the term premium is related to the various economic shocks driving our DSGE model above. First, use (33) and (36) to write the difference between the consol price and the risk-neutral consol price as:

$$\begin{aligned}
\widehat{p}_t^{(n)} - \widehat{p}_t^{(n)} &= \delta_c (\mathbb{E}_t m_{t+1} \widehat{p}_{t+1}^{(n)} - \mathbb{E}_t m_{t+1} \mathbb{E}_t \widehat{p}_{t+1}^{(n)}), \\
&= \delta_c \left[\text{Cov}_t(m_{t+1}, \widehat{p}_{t+1}^{(n)}) + \mathbb{E}_t m_{t+1} \mathbb{E}_t (\widehat{p}_{t+1}^{(n)} - \widehat{p}_{t+1}^{(n)}) \right], \\
&= \delta_c \left[\text{Cov}_t(m_{t+1}, \widehat{p}_{t+1}^{(n)}) + e^{-i_t} \mathbb{E}_t (\widehat{p}_{t+1}^{(n)} - \widehat{p}_{t+1}^{(n)}) \right], \\
&= \mathbb{E}_t \sum_{j=0}^{\infty} e^{-i_{t,t+j}} \delta_c^{t+j+1} \text{Cov}_{t+j}(m_{t+j+1}, \widehat{p}_{t+j+1}^{(n)}), \tag{38}
\end{aligned}$$

Equation (38) makes it clear that, even though the bond price depends only on the one-period-ahead covariance between the stochastic discount factor and next period's bond price, the term premium depends on this covariance over the entire lifetime of the bond.¹⁴

Of course, the term premium is usually written as the difference between the yield on the long-term bond and the risk-neutral yield on that bond. From (37),

$$\begin{aligned}
\psi_t^{(n)} &= \log \left(1 - 1/\widehat{p}_t^{(n)} \right) - \log \left(1 - 1/\bar{p}_t^{(n)} \right), \\
&\approx \frac{-1}{\bar{p}_t^{(n)2}} (\widehat{p}_t^{(n)} - \bar{p}_t^{(n)}), \\
&= \frac{-1}{\bar{p}_t^{(n)2}} \mathbb{E}_t \sum_{j=0}^{\infty} e^{-i_{t,t+j}} \delta_c^{t+j+1} \text{Cov}_{t+j}(m_{t+j+1}, \widehat{p}_{t+j+1}^{(n)}), \tag{39}
\end{aligned}$$

where $\bar{p}_t^{(n)}$ denotes the nonstochastic steady-state bond price.¹⁵ Intuitively, the term premium is larger the more negative is the covariance between the stochastic discount factor and the price of the bond over the lifetime of the bond.

¹⁴ An exactly analogous expression holds for the case of a zero-coupon bond.

¹⁵ The first-order approximation on the second line of (39) is useful for gaining intuition and is a good approximation because the bond prices $\widehat{p}_t^{(n)}$ and $\bar{p}_t^{(n)}$ are about 40 for the parameterizations of the model we consider below. However, when we solve for the term premium in the model numerically, our solution will include the second- and third-order as well as the first-order terms.

2.6 Alternative Measures of Long-term Bond Risk

Although the term premium is the cleanest conceptual measure of the riskiness of long-term bonds, it is not directly observed in the data and must be inferred using term structure models or other methods. Accordingly, the literature has also focused on two other empirical measures that are closely related to the term premium but are more directly observed: the slope of the yield curve and the excess return to holding the long-term bond for one period relative to the one-period short rate.

The slope of the yield curve is simply the difference between the yield to maturity on the long-term bond and the one-period risk-free rate, i_t . The slope is an imperfect measure of the riskiness of the long-term bond because it can vary in response to shocks even if all investors in the model are risk-neutral. However, on average, the slope of the yield curve equals the term premium, and the volatility of the slope provides us with a noisy measure of the volatility of the term premium.

A second measure of the riskiness of long-term bonds is the excess one-period holding return—that is, the return to holding the bond for one period less the one-period risk-free rate. For the case of an n -period zero-coupon bond, this excess return is given by:

$$x_t^{(n)} \equiv \frac{p_t^{(n-1)}}{p_{t-1}^{(n)}} - e^{i_{t-1}}. \quad (40)$$

The first term on the right-hand side of (40) is the gross return to holding the bond and the second term is the gross one-period risk-free return. For the case of the consol in our model, the excess holding period return is a bit more complicated, since the consol pays a coupon in period $t - 1$ and then depreciates in value by the factor δ_c , so the excess holding period return is given by:

$$\tilde{x}_t^{(n)} \equiv \frac{\delta_c \tilde{p}_t^{(n)} + e^{i_{t-1}}}{\tilde{p}_{t-1}^{(n)}} - e^{i_{t-1}}. \quad (41)$$

Again, the first term on the right-hand side of (41) is the gross return to holding the consol and includes the one-dollar coupon in period $t - 1$ that can be invested in the one-period security. As with the yield curve slope, the excess returns in (40) and (41) are imperfect measures of the term premium because they would vary in response to shocks even if investors were risk-neutral. However, the mean and standard deviation of the excess holding period return provide popular

measures of the average term premium and the volatility of the term premium.

2.7 Model Solution Method

A technical issue in solving the model above arises from its relatively large number of state variables: A_{t-1} , G_{t-1} , i_{t-1} , Δ_{t-1} , $\bar{\pi}_{t-1}$, and the three shocks, ε_t^A , ε_t^G , and ε_t^i , make a total of eight.¹⁶ Because of this high dimensionality, discretization and projection methods are computationally infeasible, so we solve the model using the standard macroeconomic technique of approximation around the nonstochastic steady state—so-called perturbation methods. However, a first-order approximation of the model (i.e., a linearization or log-linearization) eliminates the term premium entirely, because equations (33) and (36) are identical to first order. A second-order approximation to the solution of the model produces a term premium that is nonzero but constant (a weighted sum of the variances σ_A^2 , σ_G^2 , and σ_i^2). Since our interest in this paper is not just in the level of the term premium but also in its volatility and variation over time, we compute a third-order approximate solution to the model around the nonstochastic steady state using the algorithm of Swanson, Anderson, and Levin (2006). For the baseline model above with eight state variables, a third-order accurate solution can be computed in just a few minutes on a standard laptop computer, and for the more complicated specifications we consider below with long-run risks, a third-order solution can be computed in 20 or 30 minutes. Additional details of this solution method are provided in Swanson, Anderson, and Levin (2006) and Rudebusch, Sack, and Swanson (2007).

Once we have computed an approximate solution to the model, we compare the model and the data using a standard set of macroeconomic and financial moments, such as the standard deviations of consumption, labor, and other variables, and the means and standard deviations of the term premium and the alternative measures of long-term bond risk described above. One method of computing these moments is by simulation, but this method is slow and, for a nonlinear model, the simulations can sometimes diverge to infinity. We thus compute these moments in closed form, using perturbation methods. In particular, we compute the uncon-

¹⁶ The number of state variables can be reduced a bit by noting that G_t and A_t are sufficient to incorporate all of the information from G_{t-1} , A_{t-1} , ε_t^G , and ε_t^A , but the basic point remains valid, namely, that the number of state variables in the model is large from a computational point of view.

ditional standard deviations and unconditional means of the variables of the model to second order.¹⁷ For the term premium, the unconditional standard deviation is zero to second order, so we compute the unconditional standard deviation of the term premium to third order. This method yields results that are extremely close to those that arise from simulation, while at the same time being quicker and more numerically robust.

3 Comparing the Epstein-Zin DSGE Model to the Data

We now investigate whether the model developed in the previous section, which is an otherwise standard DSGE model extended to the case of Epstein-Zin preferences, is consistent with basic features of the data. We first describe the baseline model parameters and see whether this model can match important macroeconomic and finance moments. We then investigate the best possible fit of the model to the data.

3.1 Model Parameterization

The baseline parameter values that we use for our simple New Keynesian model are reported in Table 1 and are fairly standard in the literature (see, e.g., Levin, Onatski, Williams, and Williams, 2005). We set the household’s discount factor, β , to .99 per quarter, implying a steady-state real interest rate of 4.02 percent per year. We set households’ utility curvature with respect to consumption, γ , to 2 as a baseline, implying an intertemporal elasticity of substitution (IES) in consumption of 0.5, which is consistent with estimates in the micro literature (e.g., Vissing-Jorgensen, 2002), but we will also estimate this parameter below using a “best fit” procedure, which results in an IES of 1.3, very close to the value of 1.5 used by Bansal and Yaron (2004), who argue that existing estimates in the micro literature are downward-biased due to heteroskedasticity in the consumption process.¹⁸ Households’ utility curvature with respect to labor, χ , is set to 1.5, implying a Frisch elasticity of 2/3, which is also in line with estimates

¹⁷ To compute the standard deviations of the variables to second order, we compute a fourth-order accurate solution to the unconditional covariance matrix of the variables and then take the square root along the diagonal. Note that a third-order accurate solution for X and Y is sufficient to compute the product $E[XY]$ to fourth order, when X and Y have zero mean (as in a covariance).

¹⁸ In Bansal and Yaron’s (2004) example, the assumed intertemporal elasticity of substitution is 1.5, but the micro-style regression estimate, assuming constant consumption volatility, would be only 0.6.

Table 1
Baseline Parameter Values for the Simple New Keynesian Model

β	.99	ρ_i	.73	$\bar{K}/(4\bar{Y})$	2.5
γ	2	g_π	.53	$\delta\bar{K}/\bar{Y}$.2
χ	1.5	g_y	.93	\bar{G}/\bar{Y}	.17
α	-73	ρ_A	.9		
η	.7	ρ_G	.9		
θ	.2	σ_A^2	.01 ²		
ξ	.75	σ_G^2	.004 ²		
memo:					
quasi-CRRA	75				
	χ_0	4.74			
	δ_c	.9848			

from the microeconomics literature (e.g., Pistaferri, 2003). We discuss the parameter α and its relationship to the coefficient of relative risk aversion in Section 3.2.

We set firms' output elasticity with respect to labor, η , to .7, firms' steady-state markup, θ , to .2 (implying a price-elasticity of demand of 6), and the Calvo frequency of price adjustment, ξ , to .75 (implying an average price contract duration of four quarters), all of which are standard in the literature. We set the steady-state capital-output ratio in the model to 2.5 (where output is annualized), and the capital depreciation rate to 2 percent per quarter (implying a steady-state investment-output ratio of 20 percent). Government purchases are assumed to consume 17 percent of output in the steady state. The shock persistences ρ_A and ρ_G are set to .9, as is common, and the shock variances σ_A^2 and σ_G^2 are set to .01² and .004², respectively, consistent with typical estimates in the literature. The monetary policy rule coefficients are taken from Rudebusch (2002) and are also typical of those in the literature. Finally, the parameter χ_0 is chosen to normalize the steady-state quantity of labor to unity and the parameter δ_c is chosen to set the Macaulay duration of the consol in the model to ten years, as discussed above.

3.2 The Coefficient of Relative Risk Aversion

In a model in which the household's optimization problem is homothetic (e.g., a model with fixed labor, $u(c_t, l_t) = c_t^{1-\gamma}/(1-\gamma)$), and shocks that enter multiplicatively with respect to

wealth), which is standard in the endowment economy literature using Epstein-Zin preferences, the household’s value function V_t is equal to a constant (function of parameters) times $W_t^{1-\gamma}$, where W_t denotes beginning-of-period household wealth. In that case, the expectation in (3) is over $W_{t+1}^{(1-\alpha)(1-\gamma)}$, and it is common to refer to $1 - (1 - \alpha)(1 - \gamma)$ as the household’s coefficient of relative risk aversion with respect to gambles over next-period wealth.

In contrast, the value function for the household’s optimization problem in our DSGE model is much more complicated. First, the utility kernel is not homothetic due to the presence of labor; second, the shocks in the model do not enter multiplicatively with respect to wealth; and third, the household’s true wealth includes human as well as physical capital. For all of these reasons, the household’s value function is not simply separable in wealth—in fact, the household’s value function has multiple state variables and, as discussed by Kihlstrom and Mirman (1974), it is difficult to define risk aversion when there is more than one good or more than one state variable. As a result, there is no standard or even unambiguous quantitative measure of risk aversion in our model.¹⁹

In order to compare our model and results to the endowment economy literature, we thus report the *quasi-CRRA* for our model, $1 - (1 - \alpha)(1 - \gamma)$. The interpretation of this coefficient is that, *if* labor in our model were held fixed, and *if* utility were homothetic, and *if* all the shocks in the model were multiplicative with respect to wealth, *then* the CRRA in the model would be the quasi-CRRA that we report. In the baseline parameterization of our model given in Table 1, the Epstein-Zin coefficient α is set to -73 , and γ is 2, which implies a quasi-CRRA of 75. This is a high baseline value, but it is close to the value we estimate in the “best fit” exercise below, and it will be helpful in the tables below to be able to focus on a baseline case with a similar degree of curvature to what we estimate to be the best fitting one.

We emphasize, however, that there are many reasons to think that this quasi-CRRA is not a very good measure of households’ true attitudes toward risk in our model. For example, if we consider gambles over current-period consumption, c_t , holding future consumption and current and future labor fixed, the household behaves as if its CRRA were simply γ , the same as in the

¹⁹ We do know from Epstein and Zin (1989) that, for $u(c_t, l_t) \geq 0$ everywhere, higher values of α correspond to greater risk aversion. The issue here is that we have no easy way to *quantify* the degree of risk aversion in our model in a way that one could compare to the empirical literature.

expected utility case and far less than the quasi-CRRA of 75.²⁰ For analogous gambles over next-period consumption, c_{t+1} , the household behaves as if its CRRA were $\gamma + \alpha \bar{c}^{1-\gamma}/\bar{V}$, which is about 25 percent higher than γ under our baseline parameterization, but still much less than the quasi-CRRA.²¹ Even for gambles over steady-state consumption, \bar{c} (that is, the household's level of consumption in every period, taking labor as fixed), the household behaves as if its CRRA were $\gamma + \frac{\alpha\beta}{1-\beta} \bar{c}^{1-\gamma}/\bar{V}$, which is about 55, a very high number yet still substantially less than the quasi-CRRA. Thus, the quasi-CRRA is at best only a very rough measure of households' attitudes toward risk in the model.

Even if one takes the quasi-CRRA in our DSGE model at face value, Hansen, Sargent, and Tallarini (1999) and Barillas, Hansen, and Sargent (2008) argue that low household risk aversion together with a small degree of household ambiguity aversion is isomorphic to an Epstein-Zin specification with a risk aversion parameter of 50 or 100. That is, a high quasi-CRRA in our model can be consistent with even lower levels of risk aversion than the gambles above would suggest. Malloy, Moskowitz, and Vissing-Jorgensen (2008) show, in addition, that the consumption of stockholders is much more sensitive to aggregate consumption shocks than is the consumption of nonstockholders; as a result, the required level of risk aversion in a representative agent model like ours is much higher than the level of risk aversion required in a model with heterogeneous stockholders and nonstockholders. Taken together, all of these observations suggest that our baseline value for the quasi-CRRA in the model may not be an unreasonable one, and could be reduced if one were to generalize the model along any of these dimensions.

3.3 Model Results

We report various model-implied moments in Table 2, along with the corresponding empirical moments for quarterly U.S. data from 1960 to 2007. For the empirical moments, consumption, C , is real personal consumption expenditures from the U.S. national income and product accounts, labor, L , is total hours of production workers from the Bureau of Labor Statistics

²⁰ That is, letting $c_t = c^* + \sigma\varepsilon$, the Arrow-Pratt coefficient is $-c_t(\partial^2 V_t/\partial\sigma^2)/(\partial V_t/\partial c^*) = \gamma$. Kreps and Porteus (1978) also noted that gambles over current period consumption are viewed the same by a household with generalized recursive preferences as they are by a household with expected utility preferences.

²¹ In our model, $\frac{\bar{c}^{1-\gamma}/(1-\gamma)}{\bar{V}} = (1-\beta)/\left(1 - \frac{1-\gamma}{1+\chi} \frac{\eta}{1+\theta} \frac{\bar{Y}}{\bar{C}}\right) \simeq .0073$, where bars denote steady-state values.

(BLS), and the real wage, w^r , is total wages and salaries of production workers from the BLS divided by total production worker hours and deflated by the GDP price index. Standard deviations were computed for logarithmic deviations of each series from a Hodrick-Prescott trend and reported in percentage points. Standard deviations for inflation, interest rates, and the term premium were computed for the raw series rather than for deviations from trend. Inflation, π , is the annualized rate of change in the quarterly GDP price index from the Bureau of Economic Analysis. The short-term nominal interest rate, i , is the end-of-month federal funds rate from the Federal Reserve Board, reported in annualized percentage points. The short-term real interest rate, r , is the short-term nominal interest rate less the realized quarterly inflation rate at an annual rate. The ten-year zero-coupon bond yield, $i^{(40)}$, is the end-of-month ten-year zero-coupon bond yield taken from Gurkaynak, Sack, and Wright (2007). The term premium on the ten-year zero-coupon bond, $\psi^{(40)}$, is the term premium computed by Kim and Wright (2005), in annualized percentage points.²² The yield curve slope and one-period excess holding return are calculated from the data above and are reported in annualized percentage points.

The second column of Table 2 reports results for the baseline version of our model with expected utility preferences (that is, all parameters are the same as in Table 1, except that $\alpha = 0$, which implies expected utility preferences for the household). The model does a reasonable job of matching the U.S. data for the macroeconomic variables, the short-term nominal interest rate, and the yield to maturity on the long-term bond. However, the term premium implied by the expected utility version of the model is both too small in magnitude—the model implies a term premium of one basis point—and far too stable, with an unconditional standard deviation less than one-tenth of one basis point. This basic finding of a term premium that is too small and far too stable is extremely robust with respect to wide variation of the parameters over plausible values (see Rudebusch and Swanson, 2008, for additional discussion and sensitivity analysis).

²² Kim and Wright (2005) use an arbitrage-free, three-latent-factor affine model of the term structure to compute the term premium. Alternative measures of the term premium using a wide variety of methods produce qualitatively similar results in terms of the overall magnitude and variability—see Rudebusch, Sack, and Swanson (2007) for a detailed discussion and comparison of several methods.

Table 2
Empirical and Model-Based Unconditional Moments

Variable	U.S. Data, 1961-2007	Model with Expected Utility Preferences	Model with Epstein- Zin Preferences	Model with EZ Preferences (best fit)
sd[C]	1.19	1.42	1.46	2.53
sd[L]	1.71	2.56	2.50	2.21
sd[w^r]	0.82	2.08	2.02	1.52
sd[π]	2.52	2.25	2.30	2.71
sd[i]	2.71	1.90	1.93	2.27
sd[r]	2.30	1.89	1.95	1.62
sd[$i^{(40)}$]	2.41	0.54	0.57	1.03
mean[$\psi^{(40)}$]	1.06	.010	.438	1.05
sd[$\psi^{(40)}$]	0.54	.000	.053	.184
mean[$i^{(40)} - i$]	1.43	-.047	.390	0.99
sd[$i^{(40)} - i$]	1.33	1.43	1.43	1.33
mean[$x^{(40)}$]	1.76	.015	.431	1.04
sd[$x^{(40)}$]	23.43	6.56	6.87	9.02
memo:				
quasi-CRRA		2	75	75
IES		0.5	0.5	1.3
χ		1.5	1.5	0.4
ρ_A		0.9	0.9	0.95
σ_A		.01	.01	.007

All variables are quarterly values expressed in percent. Inflation, interest rates, the term premium (ψ), and excess holding period returns (x) are expressed at an annual rate.

The third column of Table 2 reports results from the baseline parameterization of the model with Epstein-Zin preferences and a quasi-CRRA of 75 ($\alpha = -73$). Note that the model fits all of the macroeconomic variables just as well as the expected utility version of the model: that is, even for relatively high levels of risk aversion, the dynamics of the macroeconomic variables implied by the model are largely unchanged, a finding that has also been noted by Tallarini (2000) and Backus, Routledge, and Zin (2007). This is a straightforward implication of two features of the model: first, the linearization or log-linearization of Epstein-Zin preferences (3) is exactly the same as that of standard expected utility preferences (2), so to first order, these two utility specifications are the same; and second, the shocks that we consider in the model and which are standard in macroeconomics have standard deviations of only about one percent or less, so a linear approximation to the model is typically very accurate.²³

For asset prices, however, the implications of the Epstein-Zin and expected utility preferences are very different, since risk premia in the model are entirely determined by second- and higher-order terms. With Epstein-Zin preferences, the mean term premium is 43.8 basis points—almost fifty times higher than under expected utility—and the standard deviation of the term premium is 5.3 bp, compared to less than 0.1 bp for expected utility.²⁴ The fit of the model to the yield curve slope and excess holding period return show similarly marked improvements.

To illustrate the effects of increasing the quasi-CRRA in the model, the solid line in Figure 1 plots the mean term premium in the model ($\psi^{(40)}$) as a function of the quasi-CRRA, holding all the other parameters of the model fixed at their baseline values. As the quasi-CRRA increases, the mean term premium rises steadily, so that essentially any level of the term premium can be attained by making households sufficiently risk-averse. This is not the case for expected utility preferences—the dotted line in the figure—because increasing the quasi-CRRA in that

²³ As the magnitude of α increases, second-order terms in the model become relatively more important for the macroeconomic variables. Yet even for the case $\alpha = -73$, second-order terms do not have a very large effect on the macroeconomic moments in the second column of Table 2. Intuitively, this is because V is both “twisted” and “untwisted” by the factor $(1 - \alpha)$, so that much of the curvature that α introduces into the model is effectively neutralized. As a result, the parameter α only affects the macro variables in the model through its effect on uncertainty, precautionary motives, and the like, and this has only a small effect on the unconditional moments we report in Table 2.

²⁴ The mean and standard deviation of the term premium for a ten-year zero-coupon bond in the model are similar: the term premium has a mean of 40.3 bp and an unconditional standard deviation of 2.5 bp. These numbers are a few basis points less than for the ten-year-duration consol, but still far larger than we have been able to obtain with standard or habit-based expected utility specifications (see, e.g., Rudebusch and Swanson, 2008). For the “best fit” parameterization of the model (the final column of Table 2), the corresponding numbers are a mean term premium of 86.4 bp and standard deviation of 8.74 bp for the 10-year zero-coupon bond.

version of the model simultaneously decreases the intertemporal elasticity of substitution (the remaining parameters of the model are held fixed at their baseline values), and hence dampens the volatility of consumption in the model at the same time that it increases risk aversion. The net result is a maximum term premium of about 5 basis points, far less than the value in the data. Thus, separating risk aversion from the intertemporal elasticity of substitution is crucial for matching asset prices in the model.

The last column of Table 2 reports results from the “best fit” parameterization of the model with Epstein-Zin preferences, where we have searched over a wide range of values to find the parameterization that provides the closest joint fit to both the macroeconomic and financial moments in the data. The computational time required to solve the model for each set of parameter values is about 20 minutes, so it is generally infeasible to estimate the model using maximum likelihood or Bayesian estimation procedures. Instead, we perform a grid search over the five parameters listed in Table 2 that are among the most interesting and important for the term premium—namely, the quasi-CRRA, the IES, χ , ρ_A , and σ_A —and report the set of parameter values that best fits the macroeconomic and financial moments in Table 2.²⁵ We define the “best fit” to be the set of parameters that matches the equally-weighted sum of squared deviations from the moments in the first column of Table 2 as closely as possible (with one exception: we divide the standard deviation of the excess holding period return $x^{(40)}$ by 10 in order to give it roughly as much weight as the other moments in the column).²⁶ With the resulting best-fitting parameter values (reported at the bottom of Table 2), the mean term premium is about 105 basis points and the unconditional standard deviation of the term premium is 18.4 basis points, a much better fit than the baseline model. To achieve this better fit, the estimation procedure picks a high value 75 for the quasi-CRRA, and a high technology shock persistence, $\rho_A = .95$. With these extreme parameter values, holding the technology shock standard deviation fixed at its baseline value would result in macroeconomic moments that are too volatile relative to the data, so the estimation chooses a lower standard deviation,

²⁵ We conducted the grid search over the following set of parameter values: quasi-CRRA $\in \{5, 15, 25, 35, 45, 55, 65, 75, 85\}$, IES $\in \{.5, .6, .75, .9, 1.1, 1.2, 1.3, 1.4, 1.5\}$, $\chi \in \{.1, .2, .3, .4, .5, .75, 1, 1.5, 2, 3\}$, $\rho_A \in \{.9, .95\}$, and $\sigma_A \in \{.003, .004, .005, .006, .007, .008, .009, .01, .015, .02\}$. The parameter σ_A can be varied at little computational cost, and the other parameters were distributed over a four-processor computer to reduce the overall computation time.

²⁶ Minimizing the equal-weighted distance to these six moments provides us with a consistent estimator of our parameters, though it is not efficient.

$\sigma_A = .007$. The value of $\chi = 0.4$ also helps to damp down the macroeconomic volatility of the real wage and hence firms' marginal cost and inflation.

3.4 Time-varying Term Premia and Heteroskedasticity

Epstein-Zin preferences not only improve the model's ability to match the level of the term premium, they also greatly improve the model's ability to generate a term premium that varies over time. For the case of expected utility, the term premium in the model varies by less than one-tenth of one basis point, and this result is extremely robust to varying the model's parameters over wide ranges. In contrast, our baseline Epstein-Zin specification produces a term premium with an unconditional standard deviation of 5.3 basis points, and the "best fit" parameterization does even better, generating a term premium with an 18.4 basis point standard deviation.

In order for the model to generate appreciable time-variation in the term premium, however, either the stochastic discount factor or the asset return, or both, must display conditional heteroskedasticity.²⁷ In our model, the exogenous driving shocks (technology, government purchases, etc.) are all homoskedastic, but our DSGE model *endogenously* generates conditional heteroskedasticity in the stochastic discount factor and other variables. Intuitively, a second- or higher-order solution to the stochastic discount factor and other variables in the DSGE model includes terms of the form $x_{t-1}\varepsilon_t$, the product of a state variable and a shock, and the conditional variance of these terms varies with the state of the economy x .

With expected utility preferences, second-order terms and the conditional heteroskedasticity generated by the model are small. But with Epstein-Zin preferences, the size of these second- and higher-order terms is much greater and leads to substantial heteroskedasticity in the stochastic discount factor. For example, in the expected utility version of the model, the standard deviation of one-step-ahead innovations to the stochastic discount factor is 0.33 percent on average and ranges from 0.30 to 0.36 percent depending on the state of the economy.²⁸ But for the baseline

²⁷ To see this, note that one measure of the excess return to holding an asset for one period is given by $E_t(m_{t+1}p_{t+1}) - e^{-i_t}p_{t+1} = \text{Cov}_t(m_{t+1}, p_t)$, the time- t price of the asset less the risk neutral price. If the stochastic discount factor and asset price are both conditionally homoskedastic, then so is the conditional covariance and hence the risk premium.

²⁸ As discussed above, the one-step-ahead standard deviation of the stochastic discount factor depends on the state of the economy. Since we know the unconditional variances and covariances of the state variables in our

Epstein-Zin version of our model, the stochastic discount factor has a one-step-ahead standard deviation of 7.11 percent and ranges from 5.23 to 8.99 percent, a much greater variability as well as a much higher average level. This enormous increase in the heteroskedasticity of the stochastic discount factor helps to explain how the Epstein-Zin version of our model is able to generate a term premium that varies substantially over time.²⁹

From equations (6) and (15), the stochastic discount factor in the model is given by:

$$m_{t+1} \equiv \beta \left(\frac{c_{t+1}}{c_t} \right)^{-\gamma} \left(\frac{V_{t+1}}{(E_t V_{t+1}^{1-\alpha})^{1/(1-\alpha)}} \right)^{-\alpha} \frac{1}{\pi_{t+1}}. \quad (42)$$

Although consumption and inflation in the model both exhibit a slight degree of heteroskedasticity due to the presence of nonlinear terms, by far the largest source of heteroskedasticity in the model is the term in (42) involving V . Intuitively, in our model the convex disutility of work makes V more concave than in a homothetic, consumption-only model;³⁰ thus, after a negative technology shock—which causes consumption to fall, labor to rise, and V to become more negative—the one-step-ahead variance of V increases. The stochastic discount factor is even more volatile and heteroskedastic than V because of the additional coefficient $-\alpha = 73$.

3.5 The Importance of Technology Shocks for the Term Premium

Further insight into the sources of movements in bond yields can be gained from examining the model’s impulse responses to shocks, which are depicted in Figure 2 for the case of our best-fit Epstein-Zin parameterization. The first column of Figure 2 provides the response of consumption, inflation, the bond price, and the term premium to a positive one-standard-deviation shock to technology. The second and third columns provide responses for similarly-sized shocks to government spending and monetary policy, respectively. These impulse responses demonstrate that the reduced-form correlations between consumption, inflation, and the bond price depend on the underlying type of structural shock.

model, we can use these to derive the unconditional variance of the one-step-ahead standard deviation of the stochastic discount factor. The square root of that number is about .0145 percent. Multiplying by ± 2 gives a range of $\pm .029$ percent. The one-step-ahead standard deviation of the stochastic discount factor will lie within this range about 95% of the time.

²⁹ The long-term bond price is also heteroskedastic in the model, but only slightly so. The primary driver of time-varying term premia in the model is heteroskedasticity in the stochastic discount factor.

³⁰ In the homothetic case, the value function is log-linear in wealth. In our model, the value function is more concave than the logarithm of the relevant state variables.

Piazzesi and Schneider (2006) estimate that a surprise increase in inflation—which lowers the value of nominal bonds—is also typically followed by lower consumption going forward; as a result, long-term bonds lose value precisely when households desire consumption the most, resulting in a positive term premium (cf. equation (39)). Our structural model also exhibits this pattern in response to a technology shock in the first column of Figure 2: that is, inflation falls while the long-term bond price and future consumption both rise. However, for government spending and monetary policy shocks in the model, the correlation between inflation and consumption is exactly the opposite: inflation, consumption, and long-term bond prices all fall simultaneously in response to the shock. As a result, the sign of the reduced-form correlation between inflation and consumption depends on the distribution of the underlying shocks that are driving the economy. The results in Piazzesi and Schneider and the sign of the inflation-consumption correlation that they estimate suggests that technology-type shocks predominated over their sample.

Technology shocks are also the most important shock for the term premium in our DSGE model. While all three shocks in Figure 2 imply a negative covariance between the stochastic discount factor and long-term bond price, and hence a positive term premium, that covariance is both much larger and longer-lasting for the technology shock, implying a much larger term premium as a result of that particular shock (cf. equation (39)). As can be seen in Figure 2, this is primarily driven by the large and long-lasting effect that the technology shock has on inflation in the model, which in turn has a large effect on the long-term bond price. Thus, in our standard DSGE model as well as in Piazzesi and Schneider (2006), technology shocks and the negative correlation between inflation and consumption that they generate are crucial for matching the term premium.

Finally, note that all three shocks in Figure 2 imply that the term premium is countercyclical (the bottom row of the figure), consistent with a widely-held view in the macro-finance literature that risk premia should be and are higher in recessions (e.g., Campbell and Cochrane, 1999, Cochrane, 2007, Piazzesi and Swanson, 2008). Thus, not only is the term premium in our model large and variable, it is consistent with this key business-cycle correlation.

4 Long-Run Risk

The preceding section demonstrates that Epstein-Zin preferences can match both the basic macroeconomic and financial moments in a DSGE framework. This success stands in sharp contrast to habit-based specifications, which Jermann (1998), Lettau and Uhlig (2000), and Rudebusch and Swanson (2008) found failed in the DSGE setting despite their successes in endowment economy studies such as Campbell and Cochrane (1999) and Wachter (2006). However, the fit in the last two columns of Table 2 comes at the cost of a high value for the quasi-CRRA in the model. In this section, we examine to what extent a long-run risk in the model (such as long-run productivity risk or long-run inflation risk) can help the model fit the data with lower values for the quasi-CRRA.

4.1 Long-Run Productivity Risk

Since Bansal and Yaron (2004), the ability of a relatively small but highly persistent long-run consumption growth risk to account for a variety of risk premium puzzles in an endowment economy framework has been widely recognized. In our DSGE framework, it is natural to model long-run consumption risk as a long-run risk to productivity; that is, analogous to Bansal and Yaron, we now assume that the level of aggregate technology A has a small but highly persistent component A^* as well as an *i.i.d.* component:

$$\log A_t^* = \rho_{A^*} \log A_{t-1}^* + \varepsilon_t^{A^*}, \quad (43)$$

$$\log A_t = \log A_t^* + \varepsilon_t^A, \quad (44)$$

where the shocks $\varepsilon_t^{A^*}$ and ε_t^A are uncorrelated.³¹ We then replace equation (17) of our DSGE model with (43) and (44). Choosing baseline parameter values for (43) and (44) is not completely straightforward, however—Bansal and Yaron’s parameter values are for an exogenous consumption process, while consumption in our DSGE model instead is an endogenous function

³¹ See also Croce (2008). Bansal and Yaron (2004) and Croce use a difference stationary process to represent long-run risk, while we use a very persistent but stationary process; thus, our specification here may understate the importance of long-run risks relative to Bansal and Yaron. Using a difference stationary process for technology would require us to substantially alter our baseline model specification (e.g. by changing the utility kernel), which would make comparing the results to the New Keynesian DSGE literature (e.g. Woodford, 2003, Christiano et al., 2005, Smets and Wouters, 2003) difficult. We thus leave this avenue for future research.

of technology and other structural shocks. As a baseline, we set $\rho_{A^*} = .98$, similar to Bansal-Yaron's value of .979 for consumption growth. Following Bansal and Yaron, we choose values for σ_{A^*} and σ_A to match the unconditional volatility of consumption in our baseline model without long-run risk and also to set the proportion of one-step-ahead consumption growth volatility that is attributable to the long-run shock to about 5 percent, similar to Bansal and Yaron's value of 4.4 percent. This results in baseline values of $\sigma_{A^*} = .002$ and $\sigma_A = .005$.

Table 3 reports the results of incorporating this long-run productivity risk into our DSGE model above. The first column reports results for the expected utility version of the model with long-run risk and the second column reports results for our baseline Epstein-Zin parameterization of the model with long-run risk. As in Table 2, the last column of Table 3 reports results for the best-fit set of parameter values from a grid search over the quasi-CRRA, the IES, χ , σ_{A^*} , and σ_A .

In the case of expected utility (the first column), the presence of long-run productivity risk has little effect on the term premium or on other measures of bond market risk simply because households are hardly at all risk-averse. The Epstein-Zin parameterization in the middle column shows more of an effect. Relative to the baseline model without long-run risk in Table 2, the term premium is substantially more variable even though the macroeconomic variables are less variable. Finally, the best-fit column of Table 3 provides notable success with long-run productivity risk. Here, a quasi-CRRA of only 35 provides the best fit to the data, with a term premium about as large and variable as the best-fitting model without long-run risk.

Table 3
Model-Based Unconditional Moments with Long-Run Productivity Risk

Variable	Model with Expected Utility Preferences and Long-run Risk	Model with Epstein-Zin Preferences and Long-run Risk	Model with EZ Preferences and Long-run Risk (best fit)
sd[C]	.92	1.56	2.95
sd[L]	1.03	.93	1.32
sd[w^r]	1.43	1.56	1.90
sd[π]	1.12	1.64	3.14
sd[i]	1.17	1.52	2.88
sd[r]	.66	.66	1.35
sd[$i^{(40)}$]	.65	.90	1.84
mean[$\psi^{(40)}$]	.005	.084	.872
sd[$\psi^{(40)}$]	.000	.016	.183
mean[$i^{(40)} - i$]	-.018	.048	.758
sd[$i^{(40)} - i$]	.64	.72	1.15
mean[$x^{(40)}$]	.005	.083	.859
sd[$x^{(40)}$]	4.39	6.05	11.59
memo:			
quasi-CRRA	2	15	35
IES	0.5	1.5	1.5
χ	1.5	1.5	0.1
ρ_{A^*}	.98	.98	.98
σ_{A^*}	.002	.002	.004
σ_A	.005	.005	.001

All variables are quarterly values expressed in percent. Inflation and interest rates, the term premium (ψ), and excess holding period returns (x) are expressed at an annual rate.

4.2 Long-Run Inflation Risk

Since Bansal and Yaron (2004), the finance literature has stressed the importance of long-run risk in consumption growth. In contrast, there has been little attention devoted to long-run nominal risks in the economy, specifically, time-variation in the economy’s long-run inflation rate, even though such risk would be very relevant for pricing nominal bonds. Therefore, we consider the case where the monetary authority’s target rate of inflation, π_t^* , varies over time. Certainly, financial market perceptions of the long-run inflation rate in the United States appear to have varied considerably in recent decades: Kozicki and Tinsley (2001) show that survey data on long-run inflation expectations have varied substantially over the past 50 years, Rudebusch and Wu (2007, 2008) estimate a similar degree of variation in a macro-finance no-arbitrage model, and Gürkaynak, Sack, and Swanson (2005) find that the “excess sensitivity” of long-term bond yields to macroeconomic announcements is consistent with financial markets perceiving the long-run inflation rate in the economy to be less than perfectly anchored.

From the point of view of modeling the term premium, long-run inflation risk has a number of advantages over long-run productivity or consumption risk. First, estimates of the low-frequency component of productivity or consumption are extremely imprecise, so it is very difficult to test empirically the direct predictions of a Bansal-Yaron long-run productivity or consumption risk model with observable macroeconomic variables. In contrast, survey data on long-run inflation expectations are readily available and show considerable variation. Second, the idea that long-term nominal bonds are risky because of uncertainty about future monetary policy and long-run inflation is intuitively appealing. Third, estimates of the term premium in the finance literature are low in the 1960s, high in the late 1970s and early 1980s, and then low again in the 1990s and 2000s (e.g., Kim and Wright, 2005), which suggests that inflation and inflation variability are highly correlated with the term premium, at least over these longer, decadal samples. Modeling the linkage between long-run inflation risk and the term premium thus seems to be a promising avenue for understanding and modeling long-term bond yields.

Following the empirical evidence in Gürkaynak et al. (2005), we assume that π_t^* loads to some extent on the recent history of inflation:

$$\pi_t^* = \rho_{\pi^*} \pi_{t-1}^* + \vartheta_{\pi^*} (\bar{\pi}_t - \pi_t^*) + \varepsilon_t^{\pi^*}. \quad (45)$$

There are two main advantages to using specification (45) rather than a simple random walk or AR(1) specification with $\vartheta_{\pi^*} = 0$. First, (45) allows long-term inflation expectations to respond to current news about inflation and economic activity in a manner that is consistent with the bond market responses documented by Gürkaynak et al. Thus, $\vartheta_{\pi^*} > 0$ seems to be consistent with the data (Gürkaynak et al. find that a value of $\vartheta_{\pi^*} = .02$ is roughly consistent with the bond market data). Second, if $\vartheta_{\pi^*} = 0$, then even though π_t^* varies over time, it does not do so systematically with output or consumption. As a result, long-term bonds are not particularly risky, in the sense that their returns are not very correlated with the household's stochastic discount factor. Long-term bonds even have some elements of insurance in this case, because a negative shock to $\varepsilon_t^{\pi^*}$ leads the monetary authority to raise interest rates and depress output at precisely the same time that it causes long-term bond yields to fall and bond prices to rise; as a result, long-term bonds act like insurance for this type of shock and carry a negative risk premium. By contrast, if $\vartheta_{\pi^*} > 0$, then a negative technology shock today raises inflation and long-term inflation expectations and depresses bond prices at exactly the same time that it depresses output, which makes holding long-term bonds quite risky. Thus, to help the model generate a term premium that is positive on average, we will set $\vartheta_{\pi^*} > 0$.

To focus on the effects of the long-run nominal risk, we abstract away from Bansal and Yaron's long-run productivity risk in this section and consider only the effects of including equation (45) in our DSGE model. As discussed above, we set the baseline value of $\vartheta_{\pi^*} = .02$, consistent with the high-frequency bond market evidence in Gürkaynak et al. (2005). We set the baseline values for ρ_{π^*} and σ_{π^*} equal to .99 and 5 basis points, respectively, consistent with the Bayesian DSGE model estimates in Levin et al. (2005).

In Figure 1, we can see that the effects of the long-run nominal risk are indeed substantial. As the quasi-CRRA is varied along the horizontal axis, holding the other parameters of the model fixed at their baseline values, the term premium is always the highest for the version of the model with long-run inflation risk.

This observation is further reinforced in Table 4, which reports all of the basic macroeconomic and financial moments that result from introducing the long-run inflation risk into our DSGE model. The first column presents results for the model with expected utility preferences and long-run inflation risk, the second column presents results for our baseline parameterization of

the Epstein-Zin version of the model with long-run inflation risk, and the last column presents results for the best fit parameterization of the Epstein-Zin version of the model with long-run inflation risk, where we search over values for the quasi-CRRA, the IES, χ , ρ_A , σ_A , ρ_{π^*} , ϑ_{π^*} , and σ_{π^*} .

With expected utility preferences, the presence of long-run inflation risk has little effect on the term premium or other measures of bond market risk—intuitively, even though the quantity of nominal bond risk is greater, households simply aren’t risk-averse enough for that greater quantity to have a substantial effect. Introducing long-run inflation risk into the model with Epstein-Zin preferences, however, has substantial effects, particularly for the variability of the term premium and the other measures of long-term bond risk. Relative to Table 2 and even Table 3, the term premium is far more variable once long-term inflation risk is introduced into the model.³² Intuitively, technology shocks in the model are always risky for long-term nominal bonds, but those risks are particularly acute when the household is already suffering—that is, when current technology is low or current inflation is high. In those states of the world, the household’s real consumption is low and the aversion to additional risk is high. The long-run inflation risk in the model amplifies this effect by making the current state more persistent and more costly, since current inflation passes through to some extent to the longer-run inflation outlook.

³² These results hold for a ten-year zero-coupon bond in the model as well: the term premium has a mean of 45.5 bp and a standard deviation of 36.6 bp. These are a few basis points less than for the consol, but the main points in the text are all unchanged.

Table 4
Model-Based Unconditional Moments with Long-Run Inflation Risk

Variable	Model with Expected Utility Preferences	Model with Epstein-Zin Preferences	Model with EZ Preferences (best fit)
sd[C]	1.70	1.84	1.86
sd[L]	3.02	3.14	1.73
sd[w^r]	2.40	2.46	1.45
sd[π]	3.65	3.98	3.22
sd[i]	3.32	3.63	2.99
sd[r]	2.39	2.55	1.48
sd[$i^{(40)}$]	1.71	1.99	1.94
mean[$\psi^{(40)}$]	.003	.563	.748
sd[$\psi^{(40)}$]	.001	.432	.431
mean[$i^{(40)} - i$]	-.010	.464	.668
sd[$i^{(40)} - i$]	1.73	1.73	1.11
mean[$x^{(40)}$]	.003	.555	.737
sd[$x^{(40)}$]	13.07	14.78	11.83
memo:			
quasi-CRRA	2	65	65
IES	0.5	0.5	1.2
χ	1.5	1.5	0.1
ρ_A	0.9	0.9	0.95
σ_A	.01	.01	.005
ρ_{π^*}	.99	.99	.99
ϑ_{π^*}	.02	.02	.02
σ_{π^*}	5bp	5bp	1bp

All variables are quarterly values expressed in percent. Inflation and interest rates, the term premium (ψ), and excess holding period returns (x) are expressed at an annual rate.

The main drawback of long-run inflation risk in the baseline versions of our model is that the variability of the macro variables is too high relative to Table 2 and the data, due to the additional macroeconomic volatility generated by the changing π_t^* . This excessive macroeconomic volatility in the first two columns of Table 4 can be fixed once we consider varying the parameters of the model more freely. The final column of Table 4 reports results for the best-fitting set of parameter values, which involves lower values for σ_{π^*} and σ_A , both of which help to reduce the macroeconomic volatility of the model. The high estimated value for the IES and low estimated value for χ help to keep the variability of real wages, marginal cost, and inflation low, just as in the model without long-run inflation risk in Table 2. The estimates for ρ_{π^*} and ϑ_{π^*} turn out to be the same as the baseline values, but the estimate for σ_{π^*} is lower than its baseline because the “insurance effect” of exogenous shocks to π_t^* (discussed above) tends to reduce the model’s ability to fit the term premium; as a result, the best fit procedure produces an estimate of σ_{π^*} that is 0 or 1 basis point (both values fit about equally well). Note that this estimate is still consistent with substantial time-variation in π_t^* itself because of the parameter ϑ_{π^*} , which describes the pass-through of current inflation to the longer-term inflation outlook. As discussed above, this source of variability in inflation is much riskier for bondholders than are exogenous shocks to π_t^* , and our estimation procedure is picking up on this fact.

5 Conclusions

In stark contrast to our earlier work with habits (Rudebusch and Swanson, 2008), here we have found that introducing Epstein-Zin preferences into a DSGE model is a very successful strategy for matching both financial and macroeconomic moments. We are able to obtain a large and volatile term premium in a structural model of a production economy, thus generalizing the earlier endowment economy results in finance. Of course, many unresolved issues remain for exploration. For example, although we have restricted attention in this paper to a simple, stylized DSGE model along the lines of Woodford (2003), there is no reason why the methods of this paper cannot be applied to larger, more empirically relevant DSGE models such as Christiano, Eichenbaum, and Evans (2005) and Smets and Wouters (2003); indeed, preliminary research that we have conducted with these larger models indicates that all of the basic conclusions in

this paper carry over to the more empirically-oriented models. A related next step would go beyond just matching sample moments and perform full econometric estimation and inference of a DSGE model with Epstein-Zin preferences, as in van Binsbergen, et al. (2008), but extended to include intrinsic nominal rigidities and endogenous inflation. Examining to what extent a DSGE model can jointly explain the risk premiums on equity, real bonds, nominal bonds, and uncovered interest parity violations would also be very interesting. Finally, the relationship between the variability or uncertainty surrounding the central bank's inflation objective and the size and variability of the term premium warrants further study, in our view. In short, there appear to be many fruitful avenues for future research in this area.

Appendix: Equations of the Model

The following equations show exactly how we incorporate Epstein-Zin preferences into our otherwise standard DSGE model in first-order recursive form, and how bond prices and the term premium are computed in the model. The Mathematica-style syntax of these equations is consistent with the perturbation AIM algorithm of Swanson et al. (2006), which we use to solve this system to third order around the nonstochastic steady state.

(* Value function and Euler equation *)

$$V[t] == C[t]^{(1-\gamma)} / (1-\gamma) - \chi_0 * L[t]^{(1+\chi)} / (1+\chi) + \beta * V_{kp}[t],$$

$$C[t]^{-\gamma} == \beta * (\text{Exp}[\text{Int}[t]] / \pi[t+1]) * C[t+1]^{-\gamma} * (V_{kp}[t] / V[t+1])^{\alpha},$$

(* The following two equations define the E-Z-W-K-P certainty equivalent term

$V_{kp}[t] = (E_t V[t+1]^{(1-\alpha)})^{1/(1-\alpha)}$). It takes two equations to do this because perturbation AIM sets the expected value of all equations equal to zero, $E_t F(\text{variables}) = 0$. Thus, the first equation below defines $V_{\alpha\text{exp}}[t] == E_t V[t+1]^{(1-\alpha)}$. The second equation then takes the $(1-\alpha)$ th root of this expectation.

Note: the literature often refers to $1 - (1-\alpha)(1-\gamma)$ as the CRRA, but that terminology is only justifiable when the model has one state variable (wealth) and the model is homothetic. The present model does not satisfy either of these conditions. Nevertheless, α is one measure of risk aversion, as shown by Epstein and Zin.

Finally, the scaling and unscaling of $V_{\alpha\text{exp}}[t]$ by the constant VAIMSS improves the numerical behavior of the model; without it, the steady-state value of $V_{\alpha\text{exp}}$ can be minuscule (e.g., 10^{-50}), which requires Mathematica to use astronomical levels of precision in order to solve. *)

$$V_{\alpha\text{exp}}[t] == (V[t+1] / \text{VAIMSS})^{(1-\alpha)},$$

$$V_{kp}[t] == \text{VAIMSS} * V_{\alpha\text{exp}}[t]^{1/(1-\alpha)},$$

(* Price-setting equations *)

$$z_n[t] == (1+\theta) * MC[t] * Y[t] + \xi * \beta * (C[t+1] / C[t])^{-\gamma} * (V_{kp}[t] / V[t+1])^{\alpha} * \pi[t+1]^{((1+\theta)/\theta/\eta)} * z_n[t+1],$$

$$z_d[t] == Y[t] + \xi * \beta * (C[t+1] / C[t])^{-\gamma} * (V_{kp}[t] / V[t+1])^{\alpha} * \pi[t+1]^{(1/\theta)} * z_d[t+1],$$

$$p_0[t]^{(1+(1+\theta)/\theta*(1-\eta)/\eta)} == z_n[t] / z_d[t],$$

$$\pi[t]^{(-1/\theta)} == (1-\xi) * (p_0[t] * \pi[t])^{(-1/\theta)} + \xi,$$

(* Marginal cost and real wage *)

$$MC[t] == w_{\text{real}}[t] / \eta * Y[t]^{((1-\eta)/\eta)} / A[t]^{(1/\eta)} / K_{\text{Bar}}^{((1-\eta)/\eta)},$$

$$\chi_0 * L[t]^{\chi} / C[t]^{-\gamma} == w_{\text{real}}[t], (* \text{ no adj costs } *)$$

(* Output equations *)

$$Y[t] == A[t] * KBar^{(1-eta)} * L[t]^eta / Disp[t],$$

$$Disp[t]^{(1/eta)} == (1-xi) * p0[t]^{-(1+theta)/theta/eta} \\ + xi * pi[t]^{((1+theta)/theta/eta)} * Disp[t-1]^{(1/eta)},$$

$$C[t] == Y[t] - G[t] - IBar, (* aggregate resource constraint, no adj costs *)$$

(* Monetary Policy Rule *)

$$piavg[t] == rhoinflavg * piavg[t-1] + (1-rhoinflavg) * pi[t],$$

$$4*Int[t] == (1-taylrho) * (4*Log[1/beta] + 4*Log[piavg[t]] \\ + taylpi * (4*Log[piavg[t]] - pistar[t]) + tayly * (Y[t]-YBar)/YBar) \\ + taylrho * 4*Int[t-1] + eps[Int][t], (* multiply Int, infl by 4 to put at annual rate *)$$

(* Exogenous Shocks *)

$$Log[A[t]/ABar] == rhoa * Log[A[t-1]/ABar] + eps[A][t],$$

$$Log[G[t]/GBar] == rhog * Log[G[t-1]/GBar] + eps[G][t],$$

$$pistar[t] == (1-rhopistar) * piBar + rhopistar * pistar[t-1] + gssload * (4*Log[piavg[t]] - pistar[t]) \\ + eps[pistar][t],$$

(* Term premium and other auxiliary finance equations *)

$$Intr[t] == Log[Exp[Int[t-1]]/pi[t]], (* ex post real short rate *)$$

$$pricebond[t] == 1 + consoldelta * beta * (C[t+1]/C[t])^{-gamma} * (Vkp[t]/V[t+1])^alpha / pi[t+1] \\ * pricebond[t+1],$$

$$pricebondrn[t] == 1 + consoldelta * pricebondrn[t+1] / Exp[Int[t]],$$

$$ytm[t] == Log[consoldelta * pricebond[t]/(pricebond[t]-1)] * 400, (* yield in annualized pct *)$$

$$ytmrn[t] == Log[consoldelta * pricebondrn[t]/(pricebondrn[t]-1)] * 400,$$

$$termprem[t] == 100 * (ytm[t] - ytmrn[t]), (* term prem in annualized basis points *)$$

$$ehpr[t] == ((consoldelta * pricebond[t] + Exp[Int[t-1]]) / pricebond[t-1] - Exp[Int[t-1]]) * 400,$$

$$slope[t] == ytm[t] - Int[t] * 400$$

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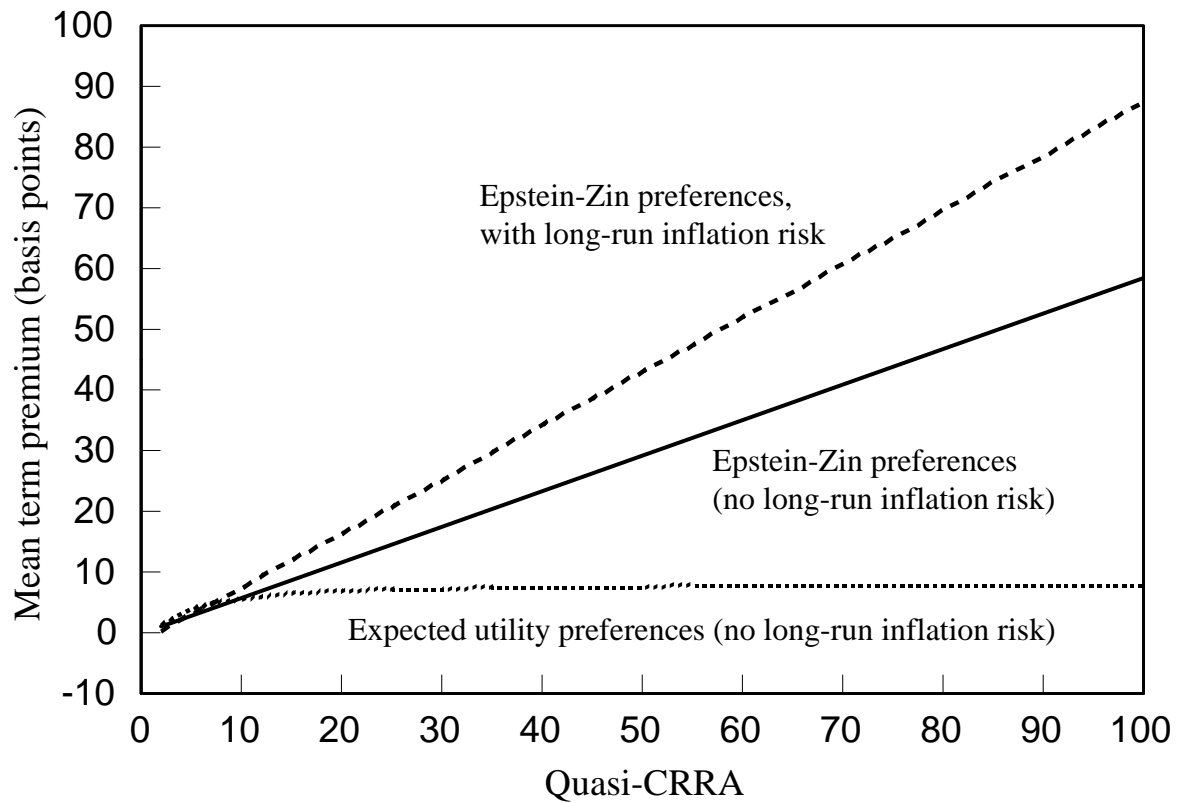


Figure 1. Mean term premium with varying amounts of risk aversion.

The solid and dashed lines show the mean 10-year term premium in a DSGE model without and with long-run inflation risk, respectively. The dotted line shows the mean term premium in the version of the model with expected utility preferences.

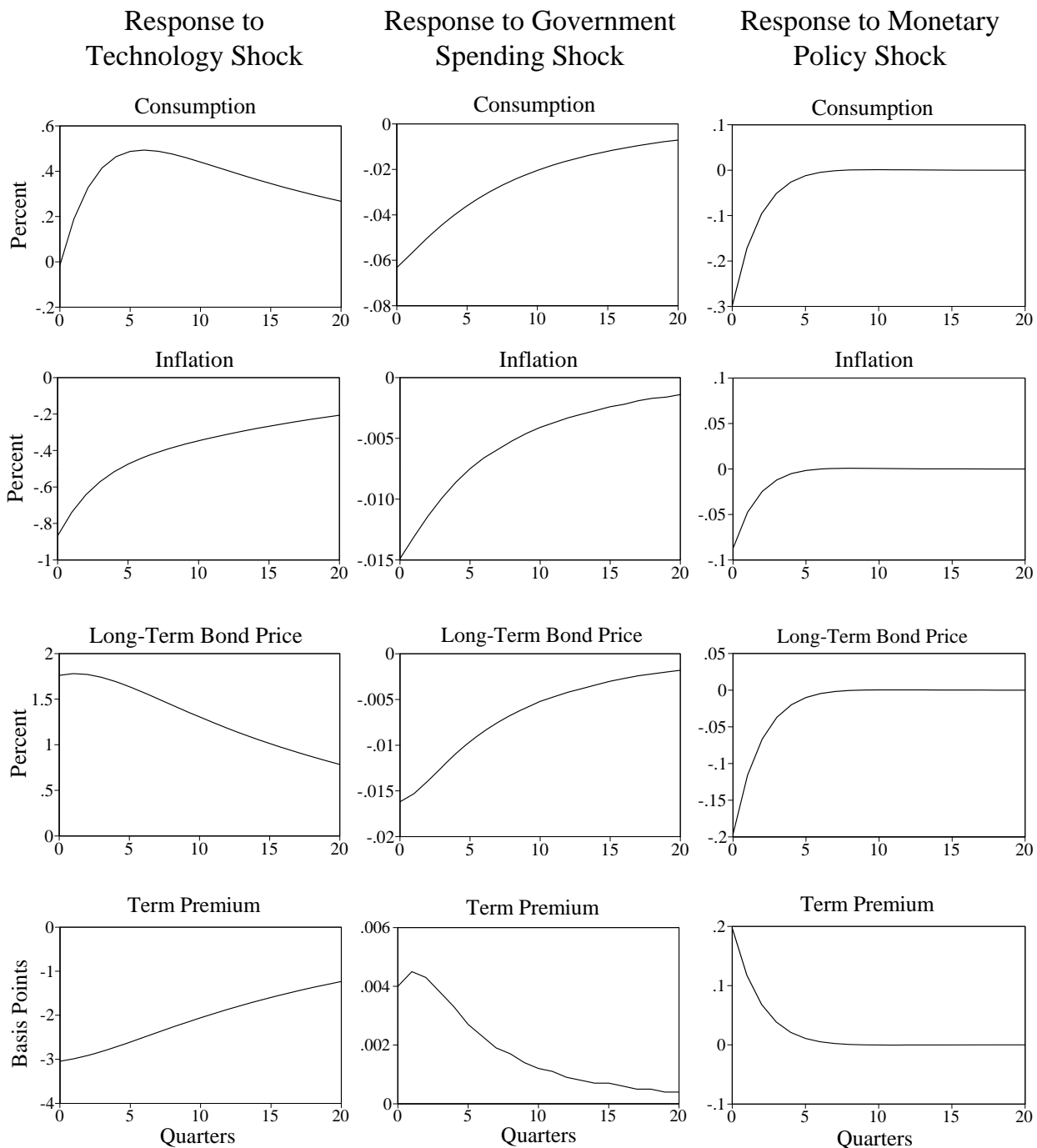


Figure 2. Impulse responses to structural shocks.

Impulse responses of consumption, inflation, long-term bond prices, and term premiums to positive one standard deviation shocks to technology, government spending, and monetary policy.