



Essays on Economic Policy (ESPE in Spanish) - Overcoming the Forecasting Limitations of Forward-Looking Theory Based Models

Download Keep in mind

In the journal Essays on Economic Policy (ESPE) - we disclose the results and policy proposals that arise from academic research carried out at the *Banco de la República*. When you read us, always keep in mind that the content of our articles, as well as the analyzes and conclusions derived from them, are the sole responsibility of their authors. The material disclosed in our ESPE magazine does not compromise or represent the opinion of *Banco de la República* or that of its Board of Directors.

AUTHOR OR EDITOR Andrés González, Lavan Mahadeva, Diego Rodríguez, Luis Rojas AUTHORS
AND/OR EDITORS Lavan Mahadeva Rojas, Luis Eduardo Publication Date: Saturday, 31 of December 2011
Theory-consistent models have to be kept small to be tractable. If they are to forecast well, they have to condition on data that are unmodelled, noisy, patchy and about the future. Agents can also use these data to form their own expectations. In this paper we illustrate a scheme for jointly conditioning the forecasts and internal expectations of linearised forward-looking DSGE models on data through a Kalman Filter fixed-interval smoother. We also trial some diagnostics of this approach, in particular decompositions that reveal when a forecast conditioned on one set of variables implies estimates of other variables which are inconsistent with economic priors.