Macroeconomic Dynamics, **6**, 2002, 713–747. Printed in the United States of America.
DOI: 10.1017.S1365100502020023

STABILIZATION POLICY AS BIFURCATION SELECTION: WOULD STABILIZATION POLICY WORK IF THE ECONOMY REALLY WERE UNSTABLE?

William A. Barnett
Washington University

Yijun He
Washington State University

Taken literally, the concept of "stabilization policy" implicitly assumes that the macroeconomy is unstable without imposition of a policy. Hence, selection of a "stabilization policy" can be viewed as selection of a policy to bifurcate the system from an unstable to a stable operating regime. The literature on dynamics of high-dimensional systems suggests that successful bifurcation selection is challenging. As an experiment to investigate this point of view, we use the continuous-time UK dynamic macroeconometric model. Under assumptions designed to be most favorable to stabilization policy, we find that policies that would produce successful bifurcation are very complicated. We also find that less complicated policies based upon reasonable economic intuition can be counterproductive, since such policies can contract the size of the stable subset of the parameter space. In fact, an economy that is dynamically stable without policy, but subject to stochastic shocks, could be bifurcated to instability with imposition of a poorly designed "stabilization" policy.

Keywords: Stability, Bifurcation, Macroeconometric Systems

1. INTRODUCTION

1.1. Motivation

The concept of "stabilization policy" is fundamental to some traditions in macroeconomics. Yet the concept rarely is rigorously defined, and has become associated with many conflicting objectives and views of the economy. In the midst of this ambiguity, one view has become common: If it were not for Lucas (1976) critique complications and the time inconsistency of many proposed "stabilization policies,"—and if the macroeconomy really were unstable—then the conduct of a

Address correspondence to: William A. Barnett, Department of Economics, Washington University, St. Louis, MO 63130, USA; e-mail: barnett@wueconc.wustl.edu.

© 2002 Cambridge University Press 1365-1005/02 $9.50

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

successful "stabilization policy" to "fine-tune" the economy would likely not be too difficult. Stabilization policy could be conducted successfully by agreeing on a final target and an instrument, and using the instrument in an active countercyclical manner to offset fluctuations in the final target of policy.

Taken literally, the very choice of the words "stabilization policy" implies that without "policy" the macroeconomy would be unstable. Stabilization policy in that literal sense therefore must be a policy that moves the economy from an unstable operating regime into a stable operating regime. In the language of mathematical dynamics, stabilization policy is a policy that bifurcates the system by moving the parameters from a point at which solutions are unstable to a point at which solutions are stable. This would require crossing a bifurcation boundary separating a stable subset from an unstable subset of the parameter space. Hence the search for a stabilization policy can be defined to be the search for a stabilizing bifurcation selection.

Attaching a policy feedback rule to the system increases the dimension of the parameter space, since the parameters of the feedback rule are added to the private sector's parameters. A result is necessary movement of the parameter space's bifurcation subsets, including the subset that supports stable solutions. This fact remains true even if the parameters of private-sector tastes and technology are unchanged. Hence, in principle, it is possible for the introduction of a policy feedback rule to produce successful bifurcation to stable solutions, even if the economy's deep parameters are unchanged. It is not the parameters that move, but rather, the bifurcation subsets.

The Lucas critique tells us that attaching a policy rule (with or without feedback) to the economy can cause structural parameters to move, even though the deep parameters have not moved. As a result, evaluation of possible policies by simulation with estimated econometric models having constant structural parameters can produce misleading results. At a later date, we plan to extend our results to an Euler equations model that holds deep parameters constant without implying that structural parameters are unaffected by policy. We anticipate that selection of a successful bifurcation policy rule in that context could be even more difficult than in the context explored in the current paper. In fact, in our initial work with the Leeper and Sims (1994) Euler equations macroeconometric model of the U.S. economy, we have located a type of bifurcation boundary not previously encountered in the existing economics literature. See He and Barnett (2001).

In the current paper we assume that the effect of policy on the structural parameters of private-sector equations is fortuitously negligible for our experiment. We do not thereby imply that we believe this to be true in general, but rather we ask a "what if" question. In particular, we investigate how difficult it would be to locate a successful policy bifurcation rule, if the Lucas critique coincidentally were not an obstacle.

In this context, an open-loop rule has very little chance of producing successful bifurcation to stability. Hence we are considering only closed-loop policy rules with

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

feedback. The use of such policy rules produces the risk of time inconsistency, especially when the rule is selected by optimal control. See Kydland and Prescott (1977). Clearly, if time inconsistency were produced by the policy, the chance of successful bifurcation to a welfare-improving stable solution would be decreased. Again, we shall assume away that serious complication. We shall assume that the economy is in reputational equilibrium, and no actions or policies adopted by the government can disturb the private sector's trust in the government. Again, we do not mean to imply that we believe the policies we consider would necessarily have that result in the real world, but again we are asking a "what if" question: If the possible complications produced by time inconsistency fortuitously did not arise, would the selection of a successful bifurcation policy be difficult? In conducting this experiment, it is not our intention to appear to be advocating the view that the economy is unstable or to appear to be advocating the UK continuous-time macroeconometric model, but rather to explore the dynamic implications of a particular tradition.

In summary, we assume that the structure of the economy and its parameters are known by the government with certainty, Lucas critique problems are negligibly small, and time inconsistency is not produced by the policies that we consider. Under these strongly simplifying assumptions, the selection of a successful bifurcation policy cannot be viewed to be robust to specification errors in the model within which the selection was made. Hence, if selection of a successful bifurcation policy is difficult under our highly simplifying assumptions, we must conclude that selection of a successful bifurcation policy in the real world would be even more difficult.

Indeed, we do find that locating successful bifurcation rules is difficult, even under our assumptions. While this conclusion may not seem surprising to mathematicians with expertise in dynamic bifurcation theory, we believe that this conclusion is at odds with widely held beliefs among those macroeconomists and applied policy analysts who believe that the economy is not stable without stabilizing policy intervention.

1.2. Earlier Research

In Barnett and He (1999), we studied bifurcation phenomena in continuous-time macroeconometric models to determine the degree to which Grandmont's (1985) findings with a simple Cobb–Douglas overlapping generations model are relevant to less restrictive models. It has often been asked whether the complex dynamics attained by Grandmont in multiple bifurcation regimes could be attained with a more general model in a manner that would be consistent with more reasonable settings of elasticities for tastes and technology. In addition, since all solutions in Grandmont's model are Pareto-optimal, the policy relevancy of complex dynamics in his model is not clear. It has sometimes been asked whether a policy-relevant model might present a more important role for complex dynamics and for the existence of multiple bifurcation regimes. See, e.g., Woodford (1989), who speculates

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

that the existence of complex dynamics may increase the potentially useful role of active policy, if imperfections exist in financial markets. Policy relevance also is implied by the recent paper by Goenka et al. (1998).

Barnett and Chen (1988) and Barnett et al. (1997), among others, have tested for chaos and for other forms of nonlinearity in univariate time series. Their findings, however, do not condition upon an economic model, and hence cannot isolate the source of instability to be within the economy. If there were chaos in the weather, the resulting chaotic shocks to the economy could be the source of chaos observed in economic time series. Similarly the many findings of nonlinearity in univariate economic time series could have been caused by nonlinear shocks from the weather or from other such sources external to the economy. Hence, further progress in this areas requires the ability to condition upon an economic model. Mathematical solution for the boundary of the chaotic subset of the parameter space currently is not possible with models having more than three parameters, and at present we are not seeking to solve for that subset by numerical methods. But we do find that numerical solution for bifurcation boundaries between the stable subset and broader classes of nonlinear dynamic behavior can be accomplished. Although nonlinearity is central to this literature, our results currently are inherently local, since our approach is based upon a local analysis of a nonlinear model.

Extending Grandmont's results to more general and empirically plausible stochastic dynamic general equilibrium models is extremely difficult, and presents problems that currently cannot be solved analytically by methods available to mathematicians. With the implied systems of nonlinear Euler equations, even numerical methods have so far not been successfully applied to locating and characterizing bifurcation boundaries for such direct extensions of Grandmont's model. Initial results by He and Barnett (2001) with the Leeper and Sims (1994) model encounter a form of bifurcation not previously considered in the economics literature and beyond the scope of the current research. However, with some older policy-relevant structural macroeconometric models, numerical methods for locating bifurcation boundaries currently are applicable. For that reason, we have chosen at present to work with a structural macroeconometric model. Although this approach does not permit us to access the deep parameters of tastes and technology, we nevertheless can produce closer connection to theory than would be possible with a more conventional discrete-time macroeconometric model, since we are using a continuous-time macroeconometric model. For that reason, we currently are applying our numerical procedures to the Bergstrom et al. (1992) UK continuous-time second-order differential-equations macroeconometric model.

Although we are in no sense advocating that model, we do believe that it is designed in a manner that is particularly favorable to the objective of producing welfare-improving stabilization policy. At a later date, we contemplate extending these procedures to apply to a system of Euler equations derived from a reasonably plausible stochastic dynamic general equilibrium model, but He and Barnett's

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

(2001) initial results suggest that such models have a more complex dynamic character and render successful bifurcation selection even more difficult.

1.3. Objectives

In our prior paper, Barnett and He (1999) demonstrated the existence of bifurcation boundaries within the economically feasible subset of the model's parameter space. Since the point estimates of the parameters are within the unstable region, it is natural to ask whether the null hypothesis of stability can be rejected. In this paper, we have two primary objectives:

(i) We explore the question of whether we can reject the hypothesis that the true values of the parameters are actually within the stable region.
(ii) We explore the ability of policy control rules to move the bifurcation boundaries in such a manner as to include within the stable region the existing unchanged point estimates of the parameters.

We also investigate the nature of the model's dynamics on bifurcation boundaries. The literature on Hopf bifurcation in economics has placed particular importance on the behavior of the system on or near those boundaries, despite the fact that those boundaries are measure zero.

The second objective is the paper's primary focus: determination of the implications of augmenting the model's equations by a policy feedback rule. According to the Lucas critique, the augmentation of Euler equations with such a feedback rule can alter structural parameters. We ask whether the use of such feedback rules is as straightforward as previously believed, even if their use does not affect structural parameters. We find the selection of stabilization policy to be more easily counterproductive than previously believed, even without Lucas critique problems affecting the selection. When we consider the use of optimal control theory to choose feedback rules, the chance of success increases, but the risk of time inconsistency increases, and the existence of specification error in the model could undermine the appearance of policy success within the model. In short, we find that under circumstances intended to be particularly favorable to stabilization policy—that is, a true Keynesian world devoid of the currently known complications—active "fine-tuning" stabilization policy is very difficult to design and can be counterproductive.

The reason for the first objective is clear, but how to do it is less than obvious. The various subsets of the parameter space bounded by bifurcation boundaries and by economic feasibility constraints are defined by nonlinear inequality constraints. Such inequality constraints truncate sampling distributions. Not only were some of the parameter estimates close to boundaries, but in fact some of the parameter estimates were on boundaries. These facts violate regularity conditions for most sampling theoretic hypothesis testing procedures. While such methods as Kuhn-Tucker tests exist to deal with inequality constraints, those tests are available only for much simpler classes of models than we are using. While in

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

principle, a Bayesian approach is possible, the application of Bayesian methods with such high-dimensional irregularly by shaped sets is prohibitively challenging at the present time. In addition, the existing parameter estimates reported for the UK model by Bergstrom et al. (1992) were provided with standard errors but not with a full covariance matrix. Hence we do not have available the covariances between those estimators. Under these adverse circumstances, we limit our statistical inference to the use of the confidence intervals about the individual parameter estimates, and we produce the region defined by the Cartesian product of those intervals. The resulting Cartesian product region is centered about the point estimate, which is in the unstable region. Determination of the true confidence ellipsoid is beyond the scope of this study. In effect, what we do in this regard is to reveal and explore the nature of the information available from the existing published standard errors. That information is made available in the Appendix of this paper.

Although we cannot provide a truly convincing test of the hypothesis of instability, we view completion of a formal test to be unnecessary to our objectives. We are asking a question about policy under the assumption of instability. Hence we are conditioning upon the hypothesis of instability. Our weak empirical results on that hypothesis are reported only to provide support for our choice of model for this experiment. That model's published point estimates indeed are in the unstable region, and we find no statistical evidence that would render conditioning upon instability to be inconsistent with the model or the data. Again, however, we are not advocating the model or its instability inference. We are conducting an experiment under assumptions intended to be particularly favorable to the introduction of "stabilization policy." In short, we are asking whether stabilization policy could reasonably be expected to be successful, if the world really were unstable, and if frictions existed in the economy so that Pareto-improving policy is possible.

1.4. Background

Much research effort has been devoted to analyzing economic dynamics. One particular area of interest is the analysis of bifurcation and chaotic phenomena in economic systems [see, e.g., Medio (1992), Barnett et al. (1996), Gandolfo (1996), and Wymer (1997)]. It has been demonstrated that economic systems exhibit many types of bifurcations such as pitchfork bifurcations in the tatonement process [see Bala (1997)], transcritical bifurcations in the Bergstrom–Nowman–Wymer continuous-time macroeconometric model [Barnett and He (1999)], Hopf bifurcations in growth models [e.g., Benhabib (1979), Boldrin and Woodford (1990), Dockner and Feichtinger (1991), and Nishimura and Takahashi (1992)], and codimension-two bifurcations in Barnett and He (1999). The theories of bifurcations and chaos in economics are described in several textbooks, such as Puu (1991), Medio (1992), and Gandolfo (1996).

Bifurcations exist in both discrete-time models [see, e.g., Boldrin and Woodford (1990) and Gandolfo (1996)] and continuous-time models [e.g., Medio (1992),

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

Gandolfo (1996), and Barnett and He (1999)]. Recently, there has been increasing interest in continuous-time macroeconometric models because such models in economics have several advantages, including higher modeling accuracy and the capability of forecasting the continuous-time path of the variables [see Bergstrom and Wymer (1976), Bergstrom et al. (1992), Bergstrom (1996), Nieuwenhuis and Schoonbeek (1997), and Wymer (1997)]. Bergstrom (1996) provides an excellent survey of research advances in continuous-time macroeconometric models. Continuous-time models have been established for several countries including the United Kingdom and the United States [see, e.g., Bergstrom (1996)]. A typical feature of those models is that their parameter estimates have been found to be in the unstable region, although close to the boundary with the stable region [see, e.g., Bergstrom et al. (1992) and Barnett and He (1999)]. In addition, these models contain adjustment frictions in many equations, and hence do not necessarily produce Pareto-optimal solution paths. For these reasons, these models are especially well suited to an initial investigation of stabilization policy.

Structural analysis of continuous-time models has been considered by Gandolfo (1992) and Nieuwenhuis and Schoonbeek (1997). Recently, Barnett and He (1999) investigated bifurcation phenomena in the Bergstrom–Nowman–Wymer continuous-time macroeconometric model of the United Kingdom. We found that both transcritical bifurcations and Hopf bifurcations exist in that model. A detailed procedure was given in that paper for determining the bifurcation boundaries. The existence of an important class of codimension-two bifurcations was also confirmed in that paper.

This paper is a continuation of Barnett and He (1999). In that paper, we investigated the properties of the UK model and found that it indeed had the properties that could render welfare-improving stabilization policy most likely to be successful. In the current paper, we ask whether stabilization policy, viewed as bifurcation selection to produce stability, can reasonably be viewed as practical and likely successful, when the economy is hypothesized to be Keynesian and devoid of such well-known complications as Lucas critique or time-inconsistency problems. We condition upon the UK continuous-time macroeconometric model not as a means to advocate or support that model but as a means of producing an experiment under circumstances most favorable to success of active stabilization policy.

In particular, to determine the potential usefulness of fiscal policy, we investigate the effect on bifurcation boundaries of augmenting the model with a fiscal policy feedback rule. We assume that the parameters of the other equations are not affected by the addition of the feedback fiscal policy rule, so that the source of the movement of the bifurcation boundaries is not the Lucas critique issue. The intent is to determine whether such rules can be expected to move the boundaries in such a manner as to include the point estimate of the parameters within the stable region. We investigate this matter both with a policy based upon heuristic economic reasoning and a policy derived from optimal control theory under the assumptions of reputational equilibrium and intertemporal time consistency of the policy.

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

2. UK CONTINUOUS-TIME MACROECONOMETRIC MODEL

Although the approach adopted in this paper is applicable to any continuous-time macroeconometric model, we will restrict our discussion to the Bergstrom–Nowman–Wymer continuous-time macroeconometric model of the United Kingdom given in Bergstrom et al. (1992). That model is the best-known and most extensively analyzed of the models in that class of models, which possess the relevant properties for this experiment in stabilization policy bifurcation selection. The model is described by the following 14 second-order differential equations:

$$D^2 \log C = \gamma_1(\lambda_1+\lambda_2-D\log C)+\gamma_2 \log\left[\frac{\beta_1 e^{-\{\beta_2(r-D\log p)+\beta_3 D\log p\}}(Q+P)}{T_1 C}\right], \tag{1}$$

$$D^2 \log L = \gamma_3(\lambda_2 - D\log L) + \gamma_4 \log\left[\frac{\beta_4 e^{-\lambda_1 t}\left\{Q^{-\beta_6}-\beta_5 K^{-\beta_6}\right\}^{-1/\beta_6}}{L}\right], \tag{2}$$

$$D^2 \log K = \gamma_5(\lambda_1 + \lambda_2 - D\log K) + \gamma_6 \log\left[\frac{\beta_5 (Q/K)^{1+\beta_6}}{r-\beta_7 D\log p+\beta_8}\right], \tag{3}$$

$$D^2 \log Q = \gamma_7(\lambda_1 + \lambda_2 - D\log Q) + \gamma_8 \log\left[\frac{\left\{1-\beta_9(qp/p_i)^{\beta_{10}}\right\}(C+G_c+DK+E_n+E_o)}{Q}\right], \tag{4}$$

$$D^2 \log p = \gamma_9(D\log(w/p)-\lambda_1) + \gamma_{10}\log\left[\frac{\beta_{11}\beta_4 T_2 w e^{-\lambda_1 t}\left\{1-\beta_5(Q/K)^{\beta_6}\right\}^{-(1+\beta_6)/\beta_6}}{p}\right], \tag{5}$$

$$D^2 \log w = \gamma_{11}(\lambda_1 - D\log(w/p)) + \gamma_{12} D\log(p_i/qp) + \gamma_{13}\log\left[\frac{\beta_4 e^{-\lambda_1 t}\left\{Q^{-\beta_6}\beta_5 K^{-\beta_6}\right\}^{-1/\beta_6}}{\beta_{12} e^{\lambda_2 t}}\right], \tag{6}$$

$$D^2 r = -\gamma_{14} Dr + \gamma_{15}\left[\beta_{13} + r_f - \beta_{14} D\log q + \beta_{15}\frac{p(Q+P)}{M} - r\right], \tag{7}$$

$$D^2 \log I = \gamma_{16}(\lambda_1+\lambda_2 - D\log(p_i I/qp)) + \gamma_{17}\log\left[\frac{\beta_9(qp/p_i)^{\beta_{10}}(C+G_c+DK+E_n+E_o)}{(p_i/qp)I}\right], \tag{8}$$

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

$$D^2 \log E_n = \gamma_{18}(\lambda_1 + \lambda_2 - D \log E_n) + \gamma_{19} \log\left[\frac{\beta_{16} Y_f^{\beta_{17}} (p_f/qp)^{\beta_{18}}}{E_n}\right], \quad \textbf{(9)}$$

$$D^2 F = -\gamma_{20} DF + \gamma_{21}[\beta_{19}(Q + P) - F], \quad \textbf{(10)}$$

$$D^2 P = -\gamma_{22} DP + \gamma_{23}\{[\beta_{20} + \beta_{21}(r_f - D \log p_f)]K_a - P\}, \quad \textbf{(11)}$$

$$D^2 K_a = -\gamma_{24} DK_a$$

$$+ \gamma_{25}\{[\beta_{22} + \beta_{23}(r_f - r) - \beta_{24} D \log q - \beta_{25} d_x](Q + P) - K_a\}, \quad \textbf{(12)}$$

$$D^2 \log M = \gamma_{26}(\lambda_3 - D \log M) + \gamma_{27} \log\left[\frac{\beta_{26} e^{\lambda_3 t}}{M}\right]$$

$$+ \gamma_{28} D \log\left[\frac{E_n + E_o + P - F}{(p_i/qp)I}\right] + \gamma_{29} \log\left[\frac{E_n + E_o + P - F - DK_a}{(p_i/qp)I}\right], \quad \textbf{(13)}$$

$$D^2 \log q = \gamma_{30} D \log(p_f/qp) + \gamma_{31} \log\left[\frac{\beta_{27} p_f}{qp}\right]$$

$$+ \gamma_{32} D \log\left[\frac{E_n + E_o + P - F}{(p_i/qp)I}\right] + \gamma_{33} \log\left[\frac{E_n + E_o + P - F - DK_a}{(p_i/qp)I}\right], \quad \textbf{(14)}$$

where t is time, D is the derivative operator, $Dx = dx/dt$, $D^2x = d^2x/dt^2$, and $C, E_n, F, I, K, K_a, L, M, P, Q, q, r$, and w are endogenous variables whose definitions are listed below:

C = real private consumption;
E_n = real non-oil exports;
F = real current transfers abroad;
I = volume of imports;
K = amount of fixed capital;
K_a = cumulative net real investment abroad (excluding changes in official reserve);
L = employment;
M = money supply;
P = real profits, interest, and dividends from abroad;
p = price level;
Q = real net output;
q = exchange rate (price of sterling in foreign currency);
r = interest rate;
w = wage rate.

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

The variables $d_x, E_o, G_c, p_f, p_i, r_f, T_1, T_2$, and Y_f are exogenous, with the following definitions:

d_x = dummy variable for exchange controls ($d_x = 1$ for 1974–1979, $d_x = 0$ for 1980 onward);
E_o = real oil exports;
G_c = real government consumption;
p_f = price level in leading foreign industrial countries;
p_i = price of imports (in foreign currency);
r_f = foreign interest rate;
T_1 = total taxation policy variable defined by Bergstrom et al. (1992, p. 317);
T_2 = indirect taxation policy variable defined by Bergstrom et al. (1992, p. 317);
Y_f = real income of leading foreign industrial countries.

The structural parameters β_i, $i = 1, 2, \ldots, 27$, γ_j, $j = 1, 2, \ldots, 33$, and λ_k, $k = 1, 2, 3$, can be estimated from historical data. A set of their estimates using quarterly data from 1974 to 1984 are given by Bergstrom et al. (1992, Table 2). The exact interpretations of these 14 equations are also available in Bergstrom et al. (1992).

The exogenous variables are assumed to satisfy the following conditions in steady state: $d_x = 0$, $E_o = 0$, $G_c = g^*(Q + P)$, $p_f = p_f^* e^{\lambda_4 t}$, $p_i = p_i^* e^{\lambda_4 t}$, $r_f = r_f^*$, $T_1 = T_1^*$, $T_2 = T_2^*$, $Y_f = Y_f^* e^{((\lambda_1+\lambda_2)/\beta_{17})t}$, where g^*, p_f^*, p_i^*, r_f^*, T_1^*, T_2^*, Y_f^*, and λ_4 are constants. Under such assumptions, it has been proven that $C(t), \ldots, q(t)$ in (1)–(14) change at constant rates in the steady state. Note that the system described by (1)–(14) is not autonomous, since time itself enters as an exogenous variable. To study the dynamics of the system around the steady state, we make a transformation by defining a set of new variables $y_1(t), y_2(t), \ldots, y_{14}(t)$:

$$
\begin{aligned}
y_1(t) &= \log\{C(t)/C^* e^{(\lambda_1+\lambda_2)t}\},\\
y_2(t) &= \log\{L(t)/L^* e^{\lambda_2 t}\},\\
y_3(t) &= \log\{K(t)/K^* e^{(\lambda_1+\lambda_2)t}\},\\
y_4(t) &= \log\{Q(t)/Q^* e^{(\lambda_1+\lambda_2)t}\},\\
y_5(t) &= \log\{p(t)/p^* e^{(\lambda_3-\lambda_1-\lambda_2)t}\},\\
y_6(t) &= \log\{w(t)/w^* e^{(\lambda_3-\lambda_2)t}\},\\
y_7(t) &= r(t) - r^*,\\
y_8(t) &= \log\{I(t)/I^* e^{(\lambda_1+\lambda_2)t}\},\\
y_9(t) &= \log\{E_n(t)/E_n^* e^{(\lambda_1+\lambda_2)t}\},\\
y_{10}(t) &= \log\{F(t)/F^* e^{(\lambda_1+\lambda_2)t}\},\\
y_{11}(t) &= \log\{P(t)/P^* e^{(\lambda_1+\lambda_2)t}\},
\end{aligned}
$$

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

$$y_{12}(t) = \log\{K_a(t)/K_a^* e^{(\lambda_1+\lambda_2)t}\},$$
$$y_{13}(t) = \log\{M(t)/M^* e^{\lambda_3 t}\},$$
$$y_{14}(t) = \log\{q(t)/q^* e^{(\lambda_1+\lambda_2+\lambda_4-\lambda_3)t}\},$$

where $C^*, L^*, K^*, Q^*, p^*, w^*, r^*, I^*, E_n^*, F^*, P^*, K_a^*, M^*, q^*$ are functions of the vector (β, γ, λ) of 63 parameters in equations (1)–(14) and the additional parameters $g^*, p_f^*, p_i^*, r_f^*, T_1^*, T_2^*, Y_f^*, \lambda_4$. The following is a set of differential equations derived from (1)–(14):

$$D^2 y_1 = -\gamma_1 D y_1 + \gamma_2\{\log(Q^* e^{y_4} + P^* e^{y_{11}}) - \log(Q^* + P^*) - \beta_2 y_7 + (\beta_2 - \beta_3) D y_5 - y_1\}, \quad \textbf{(15)}$$

$$D^2 y_2 = -\gamma_3 D y_2 + \gamma_4\left\{\frac{1}{\beta_6}\log\left[\frac{(Q^*)^{-\beta_6} - \beta_5 (K^*)^{-\beta_6}}{(Q^*)^{-\beta_6} e^{-\beta_6 y_4} - \beta_5 (K^*)^{-\beta_6} e^{-\beta_6 y_3}}\right] - y_2\right\}, \quad \textbf{(16)}$$

$$D^2 y_3 = -\gamma_5 D y_3 + \gamma_6\{(1+\beta_6)(y_4 - y_3) + \log[r^* - \beta_7(\lambda_3 - \lambda_1 - \lambda_2) + \beta_8] - \log[y_7 + r^* - \beta_7(D y_5 + \lambda_3 - \lambda_1 - \lambda_2) + \beta_8]\}, \quad \textbf{(17)}$$

$$D^2 y_4 = -\gamma_7 D y_4 + \gamma_8\left\{\log\left[\frac{1 - \beta_9 (q^* p^*/p_i^*)^{\beta_{10}} e^{\beta_{10}(y_5 + y_{14})}}{1 - \beta_9 (q^* p^*/p_i^*)^{\beta_{10}}}\right] + \log\left(C^* e^{y_1} + g^*(Q^* e^{y_4} + P^* e^{y_{11}}) + K^* e^{y_3}(D y_3 + \lambda_1 + \lambda_2) + E_n^* e^{y_9}\right) - \log(C^* + g^*(Q^* + P^*) + K^*(\lambda_1 + \lambda_2) + E_n^*) - y_4\right\}, \quad \textbf{(18)}$$

$$D^2 y_5 = \gamma_9(D y_6 - D y_5) + \gamma_{10}\left\{y_6 - y_5 - \frac{1+\beta_6}{\beta_6} \times \log\left[1 - \beta_5\left(\frac{Q^*}{K^*}\right)^{\beta_6} e^{\beta_6(y_4 - y_3)}\right] + \frac{1+\beta_6}{\beta_6}\log\left[1 - \beta_5\left(\frac{Q^*}{K^*}\right)^{\beta_6}\right]\right\}, \quad \textbf{(19)}$$

$$D^2 y_6 = \gamma_{11}(D y_5 - D y_6) - \gamma_{12}(D y_5 + D y_{14}) + \gamma_{13}\left\{\frac{1}{\beta_6}\log\left[(Q^*)^{-\beta_6} - \beta_5 (K^*)^{-\beta_6}\right] - \frac{1}{\beta_6}\log\left[(Q^*)^{-\beta_6} e^{-\beta_6 y_4} - \beta_5 (K^*)^{-\beta_6} e^{-\beta_6 y_3}\right]\right\}, \quad \textbf{(20)}$$

$$D^2 y_7 = -\gamma_{14} D y_7 + \gamma_{15}\left[\beta_{15}\frac{p^* e^{y_5}(Q^* e^{y_4} + P^* e^{y_{11}})}{M^* e^{y_{13}}} - \beta_{15}\frac{p^*(Q^* + P^*)}{M^*} - \beta_{14} D y_{14} - y_7\right], \quad \textbf{(21)}$$

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

$$D^2y_8 = \gamma_{16}(Dy_5 + Dy_{14} - Dy_8) + \gamma_{17}\Big\{(1+\beta_{10})(y_5+y_{14}) - y_8$$
$$+ \log\left[C^*e^{y_1} + g^*(Q^*e^{y_4} + P^*e^{y_{11}}) + K^*e^{y_3}(Dy_3 + \lambda_1 + \lambda_2) + E_n^*e^{y_9}\right]$$
$$- \log[C^* + g^*(Q^* + P^*) + K^*(\lambda_1+\lambda_2) + E_n^*]\Big\}, \tag{22}$$

$$D^2y_9 = -\gamma_{18}Dy_9 - \gamma_{19}\{\beta_{18}(y_5+y_{14}) + y_9\}, \tag{23}$$

$$D^2y_{10} = -\{\gamma_{20} + 2(\lambda_1+\lambda_2)\}Dy_{10} - (Dy_{10})^2$$
$$+ \gamma_{21}\beta_{19}\left\{\frac{Q^*e^{y_4} + P^*e^{y_{11}}}{F^*e^{y_{10}}} - \frac{Q^*+P^*}{F^*}\right\}, \tag{24}$$

$$D^2y_{11} = -\{\gamma_{22} + 2(\lambda_1+\lambda_2)\}Dy_{11} - (Dy_{11})^2$$
$$+ \gamma_{23}\{\beta_{20} + \beta_{21}(r_f^* - \lambda_4)\}\left[\frac{K_a^*e^{y_{12}}}{P^*e^{y_{11}}} - \frac{K_a^*}{P^*}\right], \tag{25}$$

$$D^2y_{12} = -\{\gamma_{24} + 2(\lambda_1+\lambda_2)\}Dy_{12} - (Dy_{12})^2 + \gamma_{25}\Big\{[\beta_{22} + \beta_{23}(r_f^* - r^* - y_7)$$
$$- \beta_{24}(Dy_{14} + \lambda_1 + \lambda_2 + \lambda_4 - \lambda_3)]\frac{Q^*e^{y_4} + P^*e^{y_{11}}}{K_a^*e^{y_{12}}} - [\beta_{22} + \beta_{23}(r_f^* - r^*)$$
$$- \beta_{24}(\lambda_1 + \lambda_2 + \lambda_4 - \lambda_3)]\frac{Q^*+P^*}{K_a^*}\Big\}, \tag{26}$$

$$D^2y_{13} = -\gamma_{26}Dy_{13} - \gamma_{27}y_{13} + \gamma_{28}\left\{\frac{E_n^*e^{y_9}Dy_9 + P^*e^{y_{11}}Dy_{11} - F^*e^{y_{10}}Dy_{10}}{E_n^*e^{y_9} + P^*e^{y_{11}} - F^*e^{y_{10}}}\right.$$
$$\left. + Dy_5 + Dy_{14} - Dy_8\right\} + \gamma_{29}\Big\{\log\left[E_n^*e^{y_9} + P^*e^{y_{11}} - F^*e^{y_{10}} - K_a^*e^{y_{12}}(Dy_{12}\right.$$
$$\left. + \lambda_1 + \lambda_2)\right] - \log[E_n^* + P^* - F^* - K_a^*(\lambda_1+\lambda_2)] + y_5 + y_{14} - y_8\Big\}, \tag{27}$$

$$D^2y_{14} = -\gamma_{30}(Dy_5 + Dy_{14}) - \gamma_{31}(y_5+y_{14})$$
$$+ \gamma_{32}\left\{\frac{E_n^*e^{y_9}Dy_9 + P^*e^{y_{11}}Dy_{11} - F^*e^{y_{10}}Dy_{10}}{E_n^*e^{y_9} + P^*e^{y_{11}} - F^*e^{y_{10}}} + Dy_5 + Dy_{14} - Dy_8\right\}$$
$$+ \gamma_{33}\Big\{\log\left[E_n^*e^{y_9} + P^*e^{y_{11}} - F^*e^{y_{10}} - K_a^*e^{y_{12}}(Dy_{12} + \lambda_1 + \lambda_2)\right]$$
$$- \log[E_n^* + P^* - F^* - K_a^*(\lambda_1+\lambda_2)] + y_5 + y_{14} - y_8\Big\}. \tag{28}$$

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

The steady state of the original system (1)–(14) corresponds to the steady state $y_i = 0, i = 1, 2, \ldots, 14$ of (15)–(28). The major advantage of the new system described by (15)–(28) is that it is autonomous, but still retains all the dynamic properties of the original system (1)–(14). Autonomous systems are the main subject of nonlinear systems theory. Generally speaking, it is difficult to analyze nonautonomous systems. In this paper, we will analyze the local dynamics of (15)–(28) in a neighborhood of the steady state $y_i = 0, i = 1, 2, \ldots, 14$. For simplicity, the system (15)–(28) is denoted as

$$D\boldsymbol{x} = \boldsymbol{f}(\boldsymbol{x}, \boldsymbol{\theta}), \tag{29}$$

where $\boldsymbol{x} = [y_1 \;\; Dy_1 \;\; y_2 \;\; Dy_2 \;\; \ldots \;\; y_{14} \;\; Dy_{14}]' \in R^{28}$ is the state vector, while $\boldsymbol{\theta} = [\beta_1, \ldots, \beta_{27}, \gamma_1, \ldots, \gamma_{33}, \lambda_1, \lambda_2, \lambda_3]' \in R^{63}$ is the parameter vector, and $\boldsymbol{f}(\boldsymbol{x}, \boldsymbol{\theta})$ is a vector of functions of $\boldsymbol{x}$ and $\boldsymbol{\theta}$ obtained from (15)–(28). Every component of $\boldsymbol{f}(\boldsymbol{x}, \boldsymbol{\theta})$ is smooth (infinitely differentiable) in a neighborhood of the origin. Note that (29) is a first-order system. The point $\boldsymbol{x}^* = \boldsymbol{0}$ is a steady state of (29). Since $\boldsymbol{\theta}$ represents physical quantities, its entries are bounded by theoretical and a priori feasibility constraints [see Table 2 of Bergstrom et al. (1992)]. Let Θ denote the feasible region determined by those bounds; Θ is a bounded region.

3. STABILITY OF THE STEADY STATE

In this section, we examine the local stability of the system (29) around the steady state $\boldsymbol{x}^* = \boldsymbol{0}$. For this purpose, write (29) as

$$D\boldsymbol{x} = A(\boldsymbol{\theta})\boldsymbol{x} + \boldsymbol{F}(\boldsymbol{x}, \boldsymbol{\theta}), \tag{30}$$

where

$$A(\boldsymbol{\theta}) = \left.\frac{\partial \boldsymbol{f}(\boldsymbol{x}, \boldsymbol{\theta})}{\partial \boldsymbol{x}'}\right|_{\boldsymbol{x}=\boldsymbol{x}^*}$$

is the Jacobian of $\boldsymbol{f}(\boldsymbol{x}, \boldsymbol{\theta})$ evaluated at the steady state $\boldsymbol{x}^* = \boldsymbol{0}$, $A(\boldsymbol{\theta}) \in R^{28\times 28}$, and $\boldsymbol{F}(\boldsymbol{x}, \boldsymbol{\theta}) = \boldsymbol{f}(\boldsymbol{x}, \boldsymbol{\theta}) - A(\boldsymbol{\theta})\boldsymbol{x} = \boldsymbol{o}(\boldsymbol{x})$ are the terms of higher order. In nonlinear systems theory, the local stability of (29) can be studied by examining the eigenvalues of the coefficient matrix $A(\boldsymbol{\theta})$ as follows:

(a) If all eigenvalues of $A(\boldsymbol{\theta})$ have strictly negative real parts, then (29) is locally asymptotically stable in the neighborhood of $\boldsymbol{x}^*$.
(b) If at least one of the eigenvalues of $A(\boldsymbol{\theta})$ has positive real part, then (29) is locally asymptotically unstable in the neighborhood of $\boldsymbol{x}^*$.
(c) If all eigenvalues of $A(\boldsymbol{\theta})$ have nonpositive real parts and at least one has zero real part, the stability of (29) usually cannot be determined from the matrix $A(\boldsymbol{\theta})$. One needs to analyze higher-order terms in order to determine the stability of the system [see, e.g., Khalil (1992)].

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

Since $A(\boldsymbol{\theta})$ is a function of $\boldsymbol{\theta}$, stability of (29) could be dependent on $\boldsymbol{\theta}$, as we shall verify is indeed true. For the set of estimated values of $\{\beta_i\}$, $\{\gamma_j\}$, and $\{\lambda_k\}$ given in Table 2 of Bergstrom et al. (1992), all the eigenvalues of $A(\boldsymbol{\theta})$ are stable except three of them: $s_1 = 0.0033$, $s_2 = 0.0090 + 0.0453i$, $s_3 = 0.0090 - 0.0453i$, where $i = \sqrt{-1}$ is the imaginary unit. However, the real parts of these unstable eigenvalues are so small that it is unclear whether their signs are statistically significant. We are using the model for a policy experiment of the effects of bifurcation policy on an unstable model. For that purpose, the finding that the point estimates of the parameters are in the unstable region is sufficient, regardless of whether the inference of instability is statistically significant. A formal hypothesis test of the null of stability would be very difficult with this model, but is unnecessary. Nevertheless, in the Appendix we have explored the implications for statistical significance of the information available from the existing published standard errors of the point estimates.

4. LOCATING THE STABLE-REGION BOUNDARIES

To be able to determine how the stable region is affected by policy, we must be able to locate the bifurcation boundaries that surround the stable region. This section describes the procedures we use to locate and map those boundaries. We consider two feasible parameter regions: the first is Θ that was mentioned earlier; the second, denoted as Θ_1, is the Cartesian product of confidence intervals of parameter estimates. The detailed form of Θ_1 is described in the Appendix.

We find the stable-region boundaries by first locating a parameter value $\boldsymbol{\theta}^*$ at which the system is stable and then expanding the neighborhood of $\boldsymbol{\theta}^*$ to the stable boundaries. The parameter value $\boldsymbol{\theta}^*$ is found using a gradient method described in the Appendix. On one hand, we have seen in the preceding section that $A(\boldsymbol{\theta})$ has three eigenvalues with strictly positive real parts for the set of parameter values given in Table 2 of Bergstrom et al. (1992). On the other hand, all eigenvalues of $A(\boldsymbol{\theta})$ have strictly negative real parts for $\boldsymbol{\theta} = \boldsymbol{\theta}^*$. Since eigenvalues are continuous functions of entries of $A(\boldsymbol{\theta})$, there must exist parameter values of $\boldsymbol{\theta}$ such that the (29) becomes unstable from stable (or stable from unstable) when $\boldsymbol{\theta}$ crosses such values. Those parameter values correspond to bifurcation points at which the dynamic solution properties of the system (29) change. Different types of bifurcations may arise according to the way unstable eigenvalues are created. In this section, we analyze the occurrence of transcritical bifurcations and another important class of bifurcations, the Hopf bifurcations.

An equilibrium point $\boldsymbol{x}^*$ of (29) is called *hyperbolic* if the coefficient matrix $A(\boldsymbol{\theta})$ has no eigenvalues with zero real parts. For a hyperbolic equilibrium $\boldsymbol{x}^*$, the asymptotic behavior of (29) is determined by the eigenvalues of $A(\boldsymbol{\theta})$ according to (a) and (b) in the preceding section. For small perturbations of parameters, there are no structural changes in the stability of a hyperbolic equilibrium, provided that the perturbations are sufficiently small. Therefore, bifurcations occur at nonhyperbolic equilibria only.

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

4.1. Transcritical Bifurcations

A transcritical bifurcation occurs when a system has a nonhyperbolic equilibrium with a geometrically simple zero eigenvalue at the bifurcation point, and additional transversality conditions are satisfied [given by the Sotomayor's Theorem in Sotomayor (1973)].

For a one-dimensional system, $Dx = G(x, \theta)$, the transversality conditions for a transcritical bifurcation at $(x, \theta) = (0, 0)$ are

$$G(0,0) = G_x(0,0) = 0, \qquad G_\theta(0,0) = 0, \qquad G_{xx}(0,0) \neq 0, \quad \text{and}$$
$$G_{\theta x}^2 - G_{xx}G_{\theta\theta}(0,0) > 0. \tag{31}$$

Transversality conditions for higher-order-dimension systems are given by Sotomayor (1973). The canonical form of such systems is $Dx = \theta x - x^2$. The bifurcation diagram of a transcritical bifurcation is shown in Figure 1. When $\det(A(\boldsymbol{\theta})) = 0$, $A(\boldsymbol{\theta})$ has at least one zero eigenvalue. If $A(\boldsymbol{\theta})$ has exactly one simple zero eigenvalue under the transversality conditions in (13), this $\boldsymbol{\theta}$ corresponds to a transcritical bifurcation. So, the first condition we are going to use to find the bifurcation boundary is

$$\det(A(\boldsymbol{\theta})) = 0. \tag{32}$$

Analytical forms of bifurcation boundaries can be obtained for most parameters. For example, if we are interested in bifurcations when two parameters θ_i and θ_j

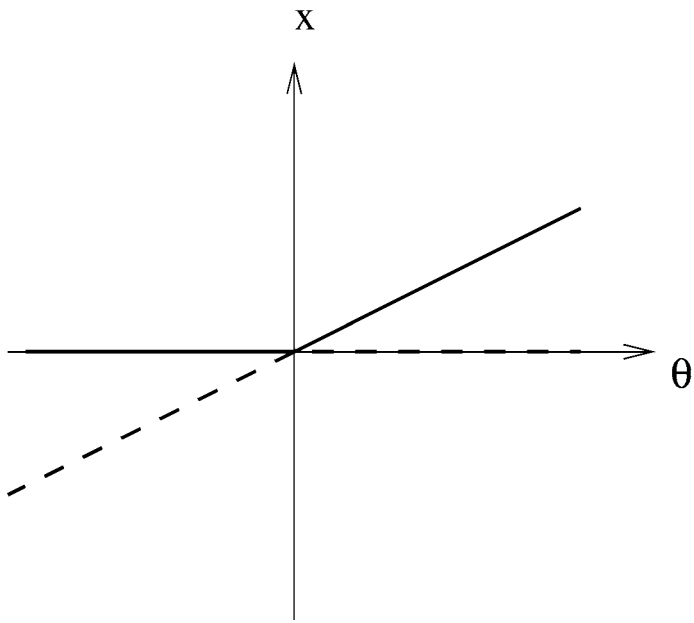


Figure 1. Transcritical bifurcation diagram.

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

change, while others are kept at $\boldsymbol{\theta}^*$, the matrix $A(\boldsymbol{\theta})$ can be rewritten as

$$A(\boldsymbol{\theta}) = A(\boldsymbol{\theta}^*) + B(\boldsymbol{\theta}^*)D(\boldsymbol{\mu})C(\boldsymbol{\theta}^*), \tag{33}$$

where $\boldsymbol{\mu} = [\theta_i, \theta_j]$, and $D(\boldsymbol{\mu})$ is a matrix of appropriate dimension. The dimension of $D(\boldsymbol{\mu})$ is usually much smaller than that of $A(\boldsymbol{\theta})$. In this case, the following proposition is helpful for simplifying the determination of transcritical bifurcation boundaries.

PROPOSITION 1. *Assume that* $A(\boldsymbol{\theta})$ *has structure* (33) *and that all eigenvalues of* $A(\boldsymbol{\theta}^*)$ *have strictly negative real parts. Then* $det(A(\boldsymbol{\theta})) = 0$ *if and only if*

$$det(I + D(\boldsymbol{\mu})C(\boldsymbol{\theta}^*)A^{-1}(\boldsymbol{\theta}^*)B(\boldsymbol{\theta}^*)) = 0. \tag{34}$$

Proof. Consider the matrix

$$\begin{bmatrix} A(\boldsymbol{\theta}^*) & -B(\boldsymbol{\theta}^*) \\ D(\boldsymbol{\mu})C(\boldsymbol{\theta}^*) & I \end{bmatrix}.$$

Then,

$$\begin{bmatrix} A(\boldsymbol{\theta}^*) & -B(\boldsymbol{\theta}^*) \\ D(\boldsymbol{\mu})C(\boldsymbol{\theta}^*) & I \end{bmatrix} \begin{bmatrix} I & A^{-1}(\boldsymbol{\theta}^*)B(\boldsymbol{\theta}^*) \\ 0 & I \end{bmatrix}$$
$$= \begin{bmatrix} A(\boldsymbol{\theta}^*) & 0 \\ D(\boldsymbol{\mu})C(\boldsymbol{\theta}^*) & I + D(\boldsymbol{\mu})C(\boldsymbol{\theta}^*)A^{-1}(\boldsymbol{\theta}^*)B(\boldsymbol{\theta}^*) \end{bmatrix}.$$

Hence,

$$\det\left(\begin{bmatrix} A(\boldsymbol{\theta}^*) & -B(\boldsymbol{\theta}^*) \\ D(\boldsymbol{\mu})C(\boldsymbol{\theta}^*) & I \end{bmatrix}\right) = \det(A(\boldsymbol{\theta}^*))\det(I + D(\boldsymbol{\mu})C(\boldsymbol{\theta}^*)A^{-1}(\boldsymbol{\theta}^*)B(\boldsymbol{\theta}^*)). \tag{35}$$

On the other hand,

$$\begin{bmatrix} I & B(\boldsymbol{\theta}^*) \\ 0 & I \end{bmatrix} \begin{bmatrix} A(\boldsymbol{\theta}^*) & -B(\boldsymbol{\theta}^*) \\ D(\boldsymbol{\mu})C(\boldsymbol{\theta}^*) & I \end{bmatrix} = \begin{bmatrix} A(\boldsymbol{\theta}^*) + B(\boldsymbol{\theta}^*)D(\boldsymbol{\mu})C(\boldsymbol{\theta}^*) & 0 \\ D(\boldsymbol{\mu})C(\boldsymbol{\theta}^*) & I \end{bmatrix},$$

which implies that

$$\det\left(\begin{bmatrix} A(\boldsymbol{\theta}^*) & -B(\boldsymbol{\theta}^*) \\ D(\boldsymbol{\mu})C(\boldsymbol{\theta}^*) & I \end{bmatrix}\right) = \det(A(\boldsymbol{\theta}^*) + B(\boldsymbol{\theta}^*)D(\boldsymbol{\mu})C(\boldsymbol{\theta}^*)) = \det(A(\boldsymbol{\theta})). \tag{36}$$

The combination of (35) and (36) results in

$$\det(A(\boldsymbol{\theta})) = \det(A(\boldsymbol{\theta}^*))\det(I + D(\boldsymbol{\mu})C(\boldsymbol{\theta}^*)A^{-1}(\boldsymbol{\theta}^*)B(\boldsymbol{\theta}^*)).$$

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

Since all eigenvalues of $A(\boldsymbol{\theta}^*)$ have strictly negative real parts, $\det(A(\boldsymbol{\theta}^*)) \neq 0$. Therefore, the preceding equation implies that $\det(A(\boldsymbol{\theta})) = 0$ if and only if (34) holds. ■

Proposition 1 is useful for simplifying the calculation of $\det(A(\boldsymbol{\theta}))$. To demonstrate the usefulness of this approach, consider finding the bifurcation boundary for $\boldsymbol{\mu} = [\theta_2, \theta_{23}] = [\beta_2, \beta_{23}]$. Only the following entries of $A(\boldsymbol{\theta})$ are functions of $\boldsymbol{\mu}$:

$$A_{2,10}(\boldsymbol{\mu}) = \gamma_2(\beta_2 - \beta_3),\ A_{2,13}(\boldsymbol{\mu}) = -\gamma_2\beta_2,$$
$$A_{24,7}(\boldsymbol{\mu}) = \gamma_{25}\delta Q^*/K_a^*,\ A_{24,13}(\boldsymbol{\mu}) = -\gamma_{25}\beta_{23}(Q^* + P^*)/K_a^*,$$
$$A_{24,21}(\boldsymbol{\mu}) = \gamma_{25}\delta P^*/K_a^*,\ A_{24,23}(\boldsymbol{\mu}) = -\gamma_{25}\delta(Q^* + P^*)/K_a^*,$$

where $\delta = \beta_{22} + \beta_{23}(r_f - r^*) - \beta_{24}(\lambda_1 + \lambda_2 + \lambda_4 - \lambda_3)$. In this case, $B(\boldsymbol{\theta}^*) \in R^{28\times 2}$ has all zero entries except for its (2, 1) entry, which is 1, and its (24, 2) entry, which is 1. Similarly, $C(\boldsymbol{\theta}^*) \in R^{5\times 28}$ has all zero entries, except for the entries at locations $(1, 7)$, $(2, 10)$, $(3, 13)$, $(4, 21)$, and $(5, 23)$, which are 1. Also, $D(\boldsymbol{\mu}) = d(\boldsymbol{\mu}) - d(\boldsymbol{\theta}^*)$, where

$$d(\boldsymbol{\mu}) = \begin{bmatrix} 0 & A_{2,10}(\boldsymbol{\mu}) & A_{2,13}(\boldsymbol{\mu}) & 0 & 0 \\ A_{24,7}(\boldsymbol{\mu}) & 0 & A_{24,13}(\boldsymbol{\mu}) & A_{24,21}(\boldsymbol{\mu}) & A_{24,23}(\boldsymbol{\mu}) \end{bmatrix}.$$

Direct calculation yields

$$C(\boldsymbol{\theta}^*)A^{-1}(\boldsymbol{\theta}^*)B(\boldsymbol{\theta}^*) = \begin{bmatrix} 13.7090 & -17.1187 \\ 0 & 0 \\ -1.7276 & 2.1573 \\ -616.4935 & 389.2039 \\ -616.4935 & 389.2039 \end{bmatrix}.$$

Using Proposition 1, we know that $\det(A) = 0$ is equivalent to

$$\det\left(\begin{bmatrix} 1 & 0 \\ 0 & 1 \end{bmatrix} + D(\boldsymbol{\mu}) \begin{bmatrix} 13.7090 & -17.1187 \\ 0 & 0 \\ -1.7276 & 2.1573 \\ -616.4935 & 389.2039 \\ -616.4935 & 389.2039 \end{bmatrix} \right) = 0,$$

or, equivalently,

$$-14.23 + 15.91\theta_2 + 0.28\theta_{23} - 0.50\theta_2\theta_{23} = 0.$$

Figure 2 depicts the bifurcation boundary when μ varies inside $\boldsymbol{\Theta}_1$.

When parameters take values on the bifurcation boundary, stability of the system (29) can be determined by examining the higher-order terms in (30). This is

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

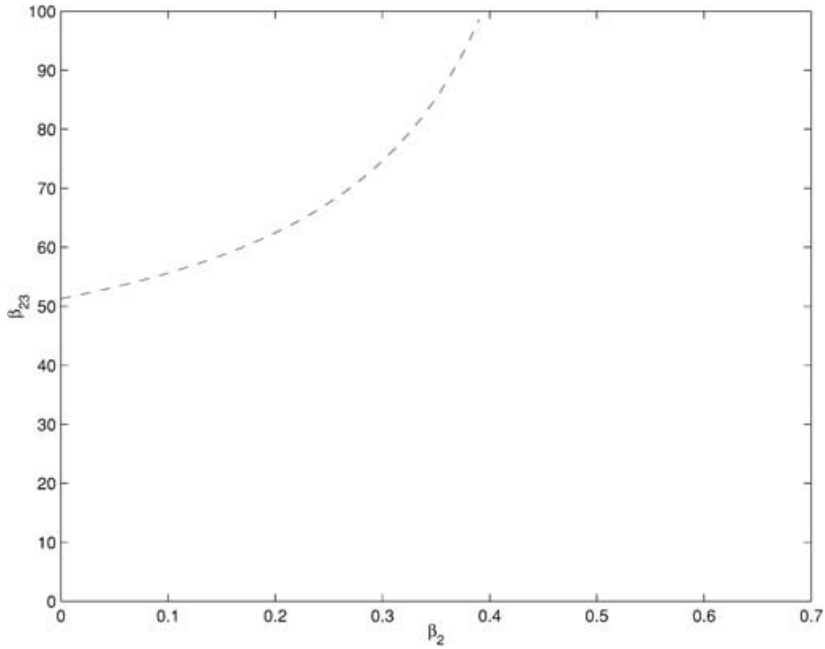


FIGURE 2. Transcritical bifurcation boundary for β_2, β_{23} within Θ_1.

usually done with the help of center manifold theory. After appropriate coordinate transformation, it is possible to write (30) as [see, e.g., Glendinning (1994) and Guckenheimer and Holmes (1983)]

$$Dx_1 = A_1(\boldsymbol{\theta})x_1 + F_1(x_1, x_2, \boldsymbol{\theta}), \tag{37}$$

$$Dx_2 = A_2(\boldsymbol{\theta})x_2 + F_2(x_1, x_2, \boldsymbol{\theta}), \tag{38}$$

where all eigenvalues of $A_1(\boldsymbol{\theta})$ have zero real parts and all eigenvalues of $A_2(\boldsymbol{\theta})$ have strictly negative real parts. Center manifold theory says that there exists a center manifold $x_2 = h(x_1)$ such that $h(0) = 0$ and $Dh(0) = 0$. Substituting $x_2 = h(x_1)$ into (37), we obtain

$$Dx_1 = A_1(\boldsymbol{\theta})x_1 + F_1(x_1, h(x_1), \boldsymbol{\theta}). \tag{39}$$

The stability of (29) is connected to that of (39) through the following theorem.

THEOREM 1 [*Carr* (1981), *Henry* (1981)]. *If the origin of* (39) *is locally asymptotically stable* (*respectively*, *unstable*), *then the origin of* (29) *is also locally asymptotically stable* (*respectively*, *unstable*).

Substituting $x_2 = h(x_1)$ into (38), we have

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

$$Dx_2 = Dh(x_1)Dx_1 = Dh(x_1)[A_1(\boldsymbol{\theta})x_1 + F_1(x_1, h(x_1), \boldsymbol{\theta})] = A_2(\boldsymbol{\theta})h(x_1) + F_2(x_1, h(x_1), \boldsymbol{\theta})$$

so that $h(x_1)$ satisfies

$$Dh(x_1)[A_1(\boldsymbol{\theta})x_1 + F_1(x_1, h(x_1), \boldsymbol{\theta})] = A_2(\boldsymbol{\theta})h(x_1) + F_2(x_1, h(x_1), \boldsymbol{\theta}), \quad (40)$$

$$h(0) = 0 \quad \text{and} \quad Dh(0) = 0. \quad (41)$$

In principle, the equations (40) and (41) can be used to solve for or approximate $h(x_1)$. In practice, solving (40) and (41) would be difficult. One usually uses a Taylor-series approximation of $h(x_1)$ with several terms to determine the local asymptotic stability (instability) of (39). For most cases, especially codimension-one bifurcations, the dimension of (39) is usually one or two. In the case of transcritical bifurcations, the dimension of (39) is one. In this case, let

$$F_1(x_1, x_2, \boldsymbol{\theta}) = a_1\frac{x_1^2}{2!} + x_1a_2x_2 + a_3\frac{x_1^3}{3!} + \cdots,$$

$$F_2(x_1, x_2, \boldsymbol{\theta}) = b_1\frac{x_1^2}{2!} + x_1b_2x_2 + b_3\frac{x_1^3}{3!} + \cdots.$$

Let $h(x_1)$ have the following Taylor expansion:

$$h(x_1) = \alpha\frac{x_1^2}{2!} + \beta\frac{x_1^3}{3!} + \cdots.$$

Then, (40) becomes

$$\left(\alpha x_1 + \beta\frac{x_1^2}{2!} + \cdots\right)\left[A_1(\boldsymbol{\theta})x_1 + a_1\frac{x_1^2}{2!} + x_1a_2\left(\alpha\frac{x_1^2}{2!} + \beta\frac{x_1^3}{3!} + \cdots\right) + a_3\frac{x_1^3}{3!} + \cdots\right] = A_2(\boldsymbol{\theta})\left(\alpha\frac{x_1^2}{2!} + \beta\frac{x_1^3}{3!} + \cdots\right) + b_1\frac{x_1^2}{2!} + x_1b_2\left(\alpha\frac{x_1^2}{2!} + \beta\frac{x_1^3}{3!} + \cdots\right) + b_3\frac{x_1^3}{3!} + \cdots.$$

By comparing coefficients of the same-order terms and also observing that $A_1(\boldsymbol{\theta}) = 0$ at a bifurcation point, we know that $\alpha = -A_2^{-1}(\boldsymbol{\theta})b_1$ and $\beta = A_2^{-1}(\boldsymbol{\theta})(\alpha a_1 - b_2\alpha)$. Therefore, (39) becomes

$$Dx_1 = A_1(\boldsymbol{\theta})x_1 + a_1\frac{x_1^2}{2!} + \left(\frac{a_2\alpha}{2!} + \frac{a_3}{3!}\right)x_1^3 + \cdots. \quad (42)$$

The stability analysis of (42) determines the stability properties of (30).

As an example, consider the stability of (30) on the transcritical bifurcation boundary for parameters β_2, β_{23}. On the bifurcation boundary shown in Figure 2, the stability of the system (29) could be determined using the previously described

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

approach. For example, consider the point $(\beta_2, \beta_{23}) = (0.1068, 55.9866)$ on the boundary. We found that (39) becomes

$$Dx_1 = 0.1308x_1^2 + o\left(x_1^2\right),$$

which is locally asymptotically unstable at $x_1 = 0$. Therefore, we know from center manifold theory that the system (29) is locally asymptotically unstable at this transcritical bifurcation point.

4.2. Hopf Bifurcations

In this section, we examine the existence of Hopf bifurcations in the system (29). Hopf bifurcations occur at points at which the system has a nonhyperbolic equilibrium with a pair of purely imaginary eigenvalues, but without zero eigenvalues. Also additional transversality conditions must be satisfied [Hopf theorem in Guckenheimer and Holmes (1983)].

The dimension of a system needs to be at least two in order for a Hopf bifurcation to occur. The transversality conditions, which are rather lengthy, are given by Glendinning (1994). The canonical form of such systems is $Dx = -y + x(\theta - (x^2 + y^2))$ and $Dy = x + y(\theta - (x^2 + y^2))$. The bifurcation diagram of a Hopf bifurcation is shown in Figure 3.

We next determine the boundaries of Hopf bifurcations. Consider the case of $\det(A(\boldsymbol{\theta})) = 0$, when $A(\boldsymbol{\theta})$ has at least one pair of pure imaginary eigenvalues (with zero real parts and nonzero imaginary parts). If $A(\boldsymbol{\theta})$ has exactly one such pair, and some additional transversality conditions hold, this point is on a Hopf bifurcation boundary.

To find Hopf bifurcation points, let $p(s) = \det(sI - A)$ be the characteristic polynomial of A and express it as $p(s) = c_0 + c_1 s + c_2 s^2 + c_3 s^3 + \cdots + c_{n-1} s^{n-1} + s^n$,

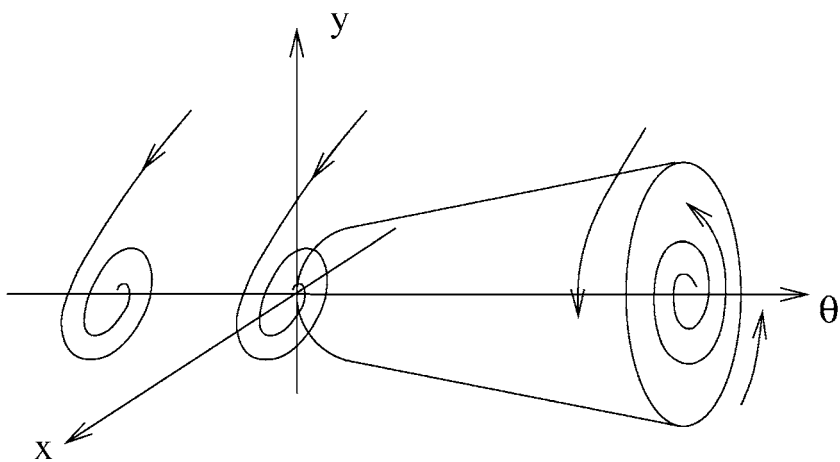


Figure 3. Hopf bifurcation diagram.

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

where $n = 28$ for the system (29). Construct the following $(n-1) \times (n-1)$ matrix:

$$S = \begin{bmatrix} c_0 & c_2 & \dots & c_{n-2} & 1 & 0 & 0 & \dots & 0 \\ 0 & c_0 & c_2 & \dots & c_{n-2} & 1 & 0 & \dots & 0 \\ & \dots & & & & & & \dots & \\ 0 & 0 & \dots & 0 & c_0 & c_2 & c_4 & \dots & 1 \\ c_1 & c_3 & \dots & c_{n-1} & 0 & 0 & & \dots & 0 \\ 0 & c_1 & c_3 & \dots & c_{n-1} & 0 & 0 & \dots & 0 \\ & \dots & & & & & & \dots & \\ 0 & 0 & & \dots & 0 & c_1 & c_3 & \dots & c_{n-1} \end{bmatrix} \begin{matrix} \\ \\ \\ \left.\begin{matrix} \\ \\ \end{matrix}\right\} \frac{n-2}{2} \text{ rows} \\ \\ \left.\begin{matrix} \\ \\ \end{matrix}\right\} \frac{n}{2} \text{ rows} \end{matrix}.$$

Let S_0 be obtained by deleting rows 1 and $n/2$ and columns 1 and 2, and let S_1 be obtained by deleting rows 1 and $n/2$ and columns 1 and 3. Then, the matrix A has exactly one pair of purely imaginary eigenvalues if [see, e.g., Guckenheimer et al. (1997)] $\det(S) = 0$ and $\det(S_0)\det(S_1) > 0$. If $\det(S) \neq 0$ or if $\det(S_0)\det(S_1) < 0$, then A has no purely imaginary eigenvalues. If $\det(S) = 0$ and $\det(S_0)\det(S_1) = 0$, then A may have more than one pair of purely imaginary eigenvalues. Therefore, the second condition for a bifurcation boundary is

$$\det(S) = 0 \quad \text{and} \quad \det(S_0)\det(S_1) \geq 0. \tag{43}$$

We use (43) to find candidates for bifurcation boundaries and then check which segments are true boundaries. Since solving (43) analytically is impossible for most problems, a numerical procedure from Barnett and He (1999) is used to find bifurcation boundaries. The stability of (29) at parameter values on the bifurcation boundary can be analyzed in the same manner as for transcritical bifurcations.

4.3. Numerical Examples

Example 1.

Figures 4A and 4B show bifurcation boundaries for $\boldsymbol{\mu} = [\theta_2, \theta_{62}]$. Figure 4A illustrates bifurcation boundaries when $\boldsymbol{\mu}$ varies within Θ_1, which is the Cartesian product of the 95% confidence intervals of the estimates; Figure 4B describes bifurcations within Θ. All other parameters are kept at $\boldsymbol{\theta}^*$. In both 4A and 4B, the dashed lines are determined by (32) and the solid lines are calculated according to (43). The shaded area is the parameter region for which the system (29) is stable. Therefore, the dashed lines along the shaded regions are the transcritical bifurcation boundaries, and the solid lines along the shaded regions represent the Hopf bifurcation boundaries.

Of special interest is the intersection point of the transcritical bifurcation boundary and the Hopf bifurcation boundary. This point corresponds to a codimension-two bifurcation. The properties of (29) near this point deserve further investigation.

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

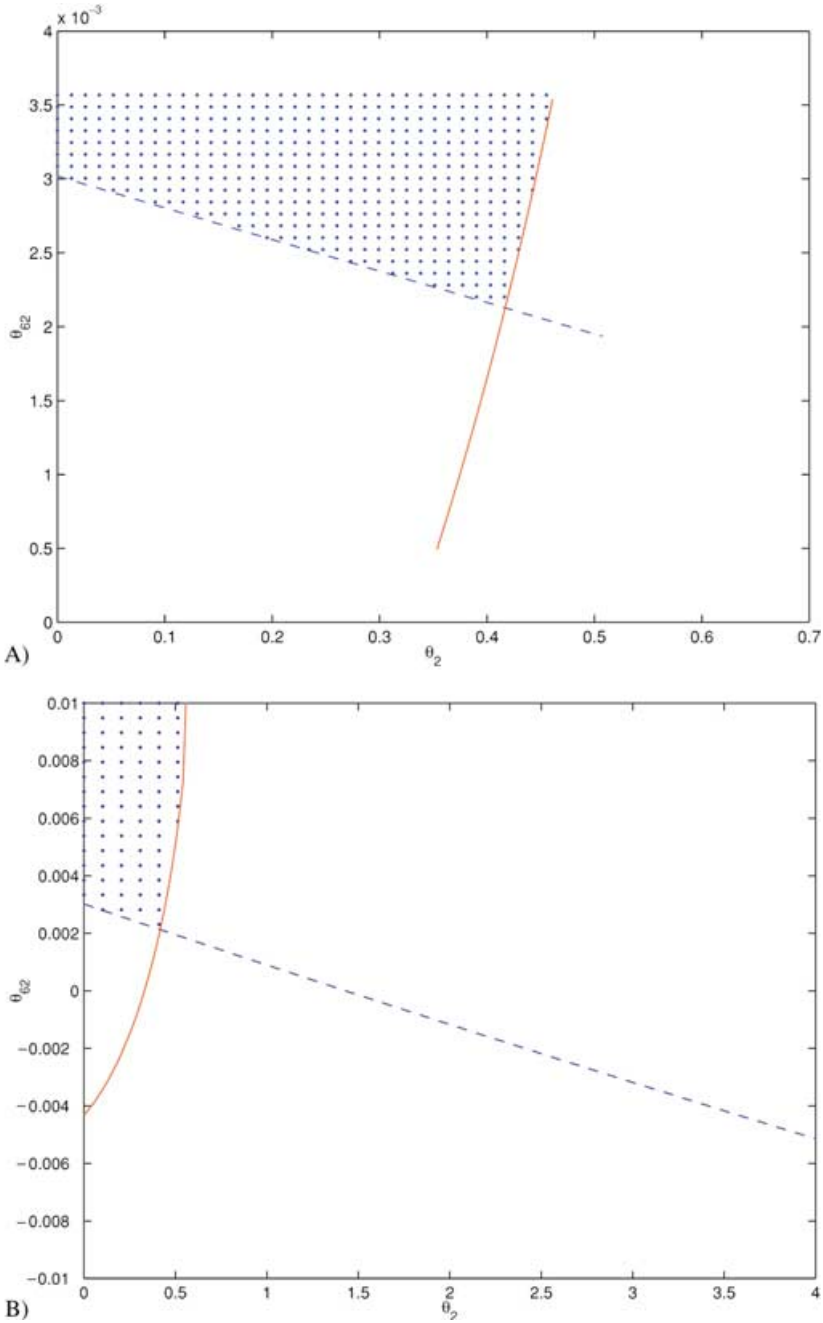


FIGURE 4. Bifurcation boundaries for θ_2, and θ_{62}. A: Bifurcation within θ_1. B: Bifurcation within θ.

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

Example 2.

If we add another parameter, θ_{23}, to our consideration, a bifurcation surface in three-dimensional space could be obtained. Figure 5 shows the bifurcation boundaries for $\boldsymbol{\mu} = [\theta_2, \theta_{23}, \theta_{62}]$. Both transcritical and Hopf bifurcation boundaries are shown.

Example 3.

Figure 6 shows bifurcation boundaries for θ_{23}, θ_{62}.

Example 4.

Figure 7 shows bifurcation boundaries for $\theta_{12}, \theta_{23}, \theta_{62}$.

5. STABILIZATION POLICY

We have seen in the preceding section that both transcritical and Hopf bifurcations exist in the continuous-time macroeconometric model. In this section, we investigate the control of bifurcations using fiscal feedback laws. We define stabilization policy to be intentional movement of bifurcation regions through policy intervention, with the intent of moving the stable region to include the parameters. If the parameters were inside the stable region without policy, then there would be no need for stabilization policy.

We first consider the effect of a heuristically plausible fiscal policy of the following form, as suggested by Bergstrom et al. (1994):

$$D \log T_1 = \gamma \left[\beta \log \left\{ \frac{Q}{Q^* e^{(\lambda_1+\lambda_2)t}} \right\} - \log \left\{ \frac{T_1}{T_1^*} \right\} \right]. \tag{44}$$

The control feedback rule (44) adjusts the fiscal policy instrument, T_1, toward a partial equilibrium level, which is an increasing function of the ratio of output to its steady-state level. In (44), β is a measure of the strength of the feedback, and γ governs the speed of adjustment. By choosing appropriate parameters β and γ, Bergstrom et al. (1994) found that the control law (44) can reduce the positive real parts of unstable eigenvalues, thereby implying that the policy might be stabilizing. Since Bergstrom is the foremost authority on the UK continuous-time model and perhaps also on continuous-time macroeconometric models in general, we would expect that if any heuristically plausible fiscal policy would be successful, it would be Bergstrom's. However, we find that the control law (44) is unlikely to stabilize the system (1)–(14).

Define

$$y_{15} = \log \left\{ \frac{T_1}{T_1^*} \right\}.$$

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

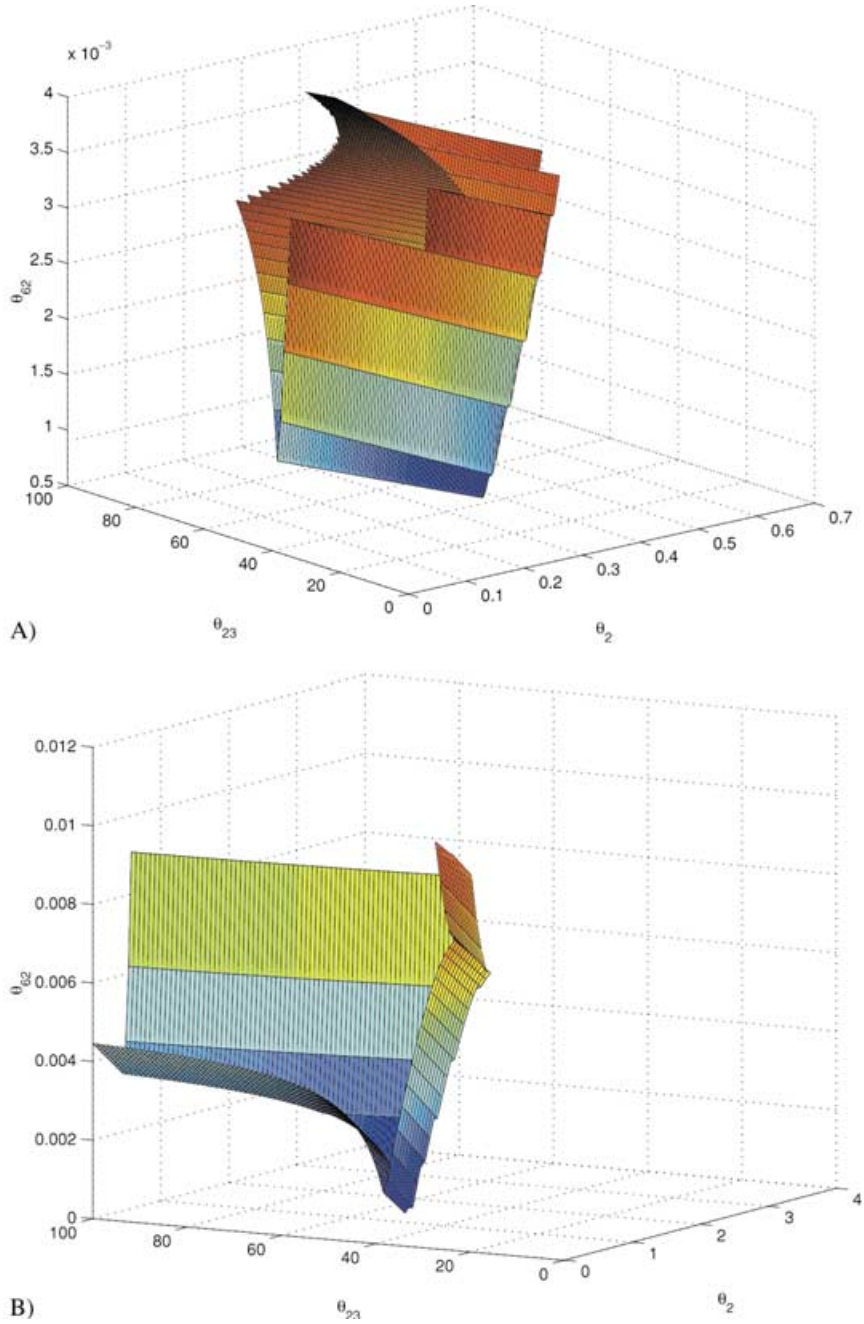


FIGURE 5. Bifurcation boundaries for θ_2, θ_{23}, and θ_{62}. A: Bifurcation within θ_1. B: Bifurcation within θ.

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

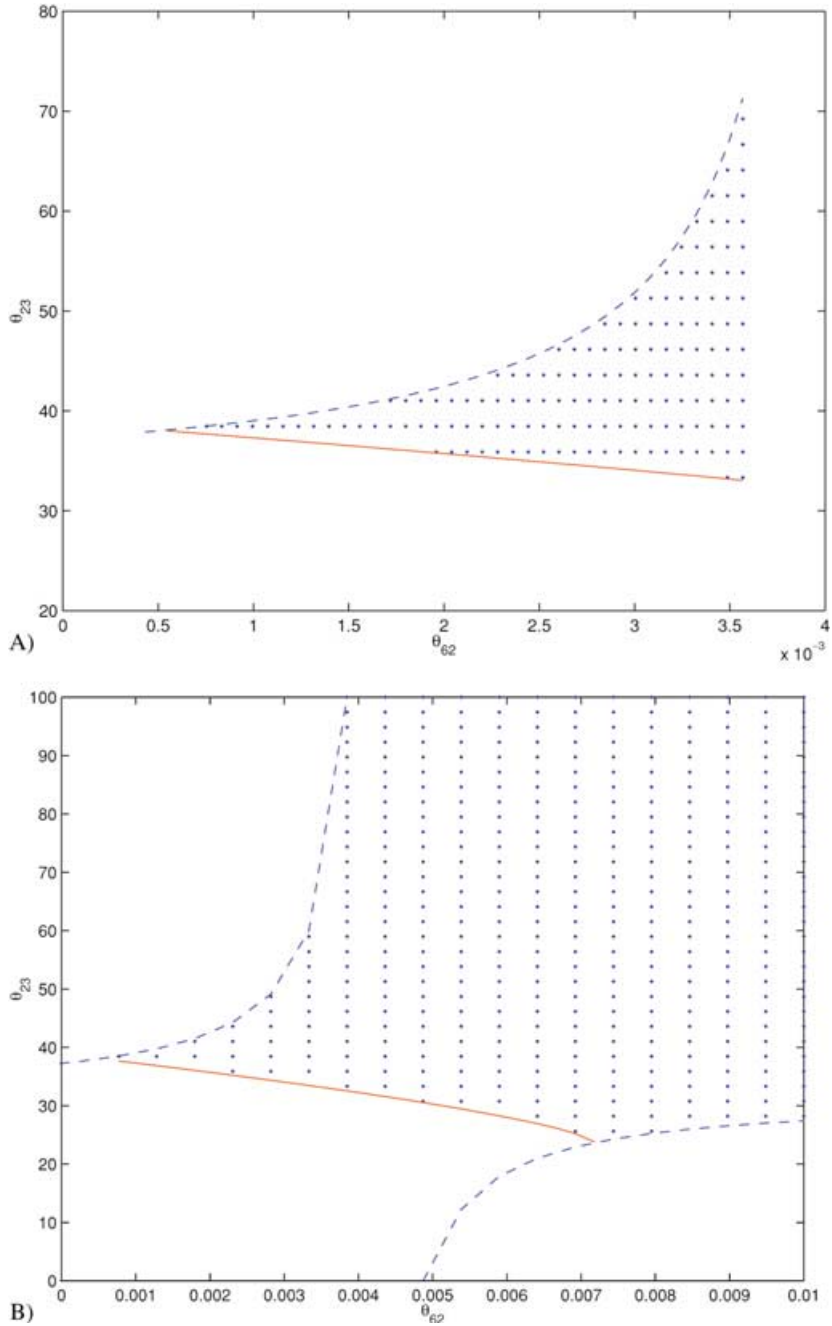


FIGURE 6. Bifurcation boundaries for θ_{23}, and θ_{62}. A: Bifurcation within θ_1. B: Bifurcation within θ.

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

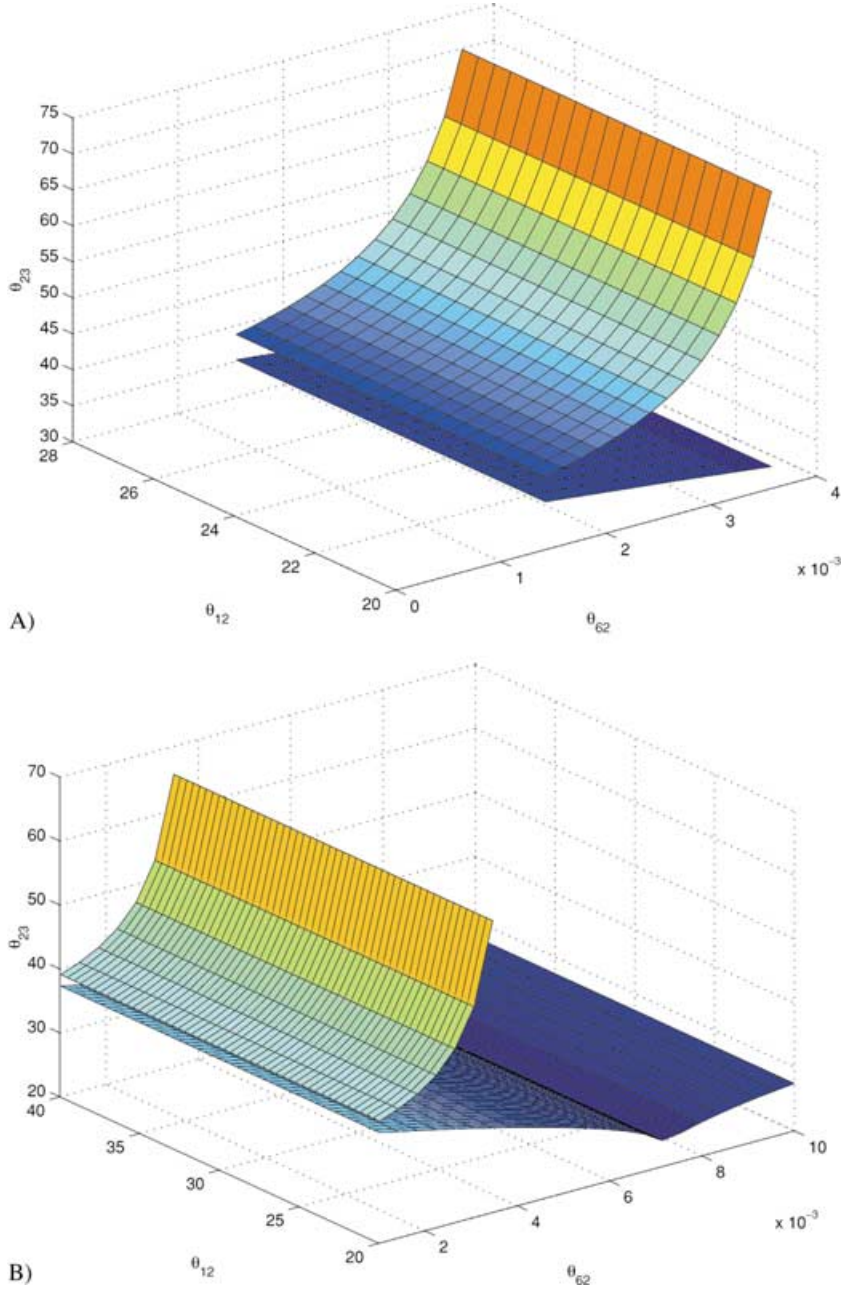


FIGURE 7. Bifurcation boundaries for θ_{12}, θ_{23}, and θ_{62}. A: Bifurcation within θ_1. B: Bifurcation within θ.

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

Then it is easy to verify that y_{15} satisfies $Dy_{15} = \gamma\beta y_4 - \gamma y_{15}$. Adding this equation to the system (29), we obtain

$$D\boldsymbol{w} = A'(\boldsymbol{\theta})\boldsymbol{w} + F'(\boldsymbol{x}, \boldsymbol{\theta}), \tag{45}$$

where

$$\boldsymbol{w} = \begin{bmatrix} \boldsymbol{x} \\ y_{15} \end{bmatrix}, \qquad F'(\boldsymbol{x}, \boldsymbol{\theta}) = \begin{bmatrix} F(\boldsymbol{x}, \boldsymbol{\theta}) \\ 0 \end{bmatrix},$$

and $A'(\boldsymbol{\theta})$ is the corresponding coefficient matrix.

Figure 8 shows the effect of the simple fiscal policy on the bifurcation boundaries for β_2 and β_{62}. Three sets of parameter values of β and γ are considered. The case $\beta = 0$ and $\gamma = 0$ corresponds to the original system (1)–(14), in which no fiscal policy control is applied. Figure 9 shows the effect of the simple fiscal policy on the bifurcation boundaries for β_2 and β_5.

Figures 8 and 9 clearly indicate that some stable regions could be destabilized and some unstable regions could be stabilized. Since the two sections, Figures 8 and 9, of the high-dimensional bifurcation regions both indicate that the feasible stable region appears to be smaller under control than without control, Bergstrom's policy is not likely to succeed.

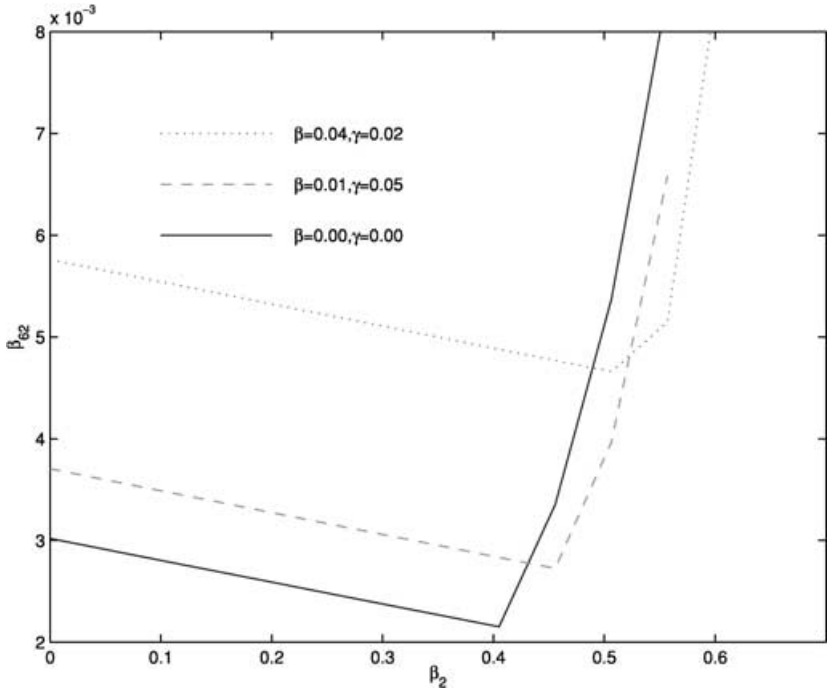


FIGURE 8. Effect of Bergstrom's simple fiscal policy for β_2 and β_{62}.

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

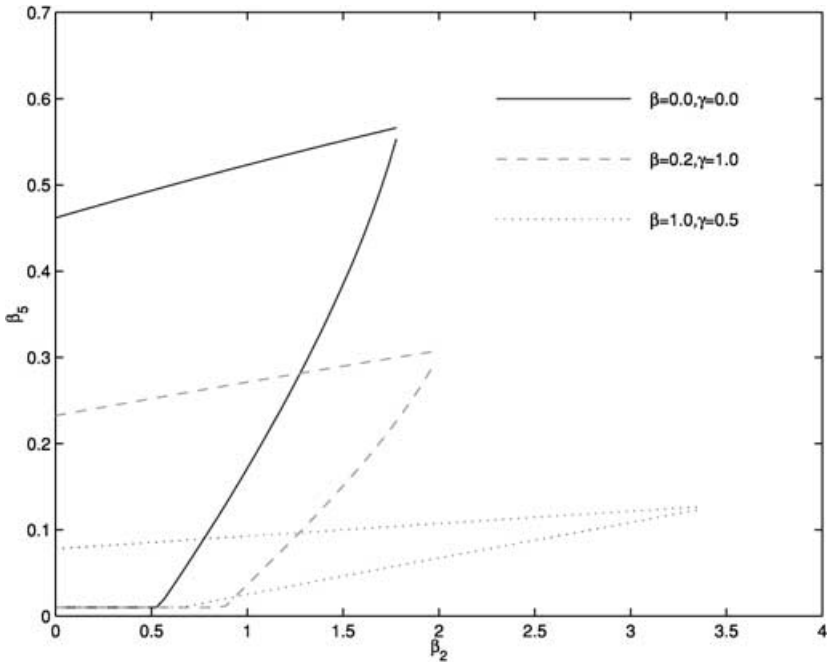


FIGURE 9. Effect of Bergstrom's simple fiscal policy for β_2 and β_5.

Next, we consider a more sophisticated fiscal feedback policy, based upon optimum control theory. Let the control be

$$u = \log\left\{\frac{T_1}{T_1^*}\right\}. \tag{46}$$

Under the control (46), the system (29) becomes

$$D\boldsymbol{x} = A(\boldsymbol{\theta})\boldsymbol{x} + B\boldsymbol{u} + \boldsymbol{F}(\boldsymbol{x}, \boldsymbol{\theta}), \tag{47}$$

where $B = [0 - \gamma_2\, 0 \ldots 0]' \in R^{28}$. Direct verification shows that the controllability matrix $[B\ AB \ldots A^{27}\ B]$ has rank 7, implying that the pair (A, B) is not controllable. Therefore, it is not possible to set the closed-loop eigenvalues of the coefficient matrix of (47) arbitrarily. However, a numerical analysis shows that there exists a linear transformation $\boldsymbol{z} = T\boldsymbol{x}$ such that

$$D\boldsymbol{z} = \begin{bmatrix} A_{11} & 0 \\ A_{21} & A_{22} \end{bmatrix} \boldsymbol{z} + \begin{bmatrix} 0 \\ B_2 \end{bmatrix} \boldsymbol{u},$$

where $A_{11} \in R^{21\times 21}$, $A_{21} \in R^{7\times 21}$, $A_{22} \in R^{7\times 7}$, $B_2 = [0 \ldots 0\, 1] \in R^7$,

$$TA(\boldsymbol{\theta})T^{-1} = \begin{bmatrix} A_{11} & 0 \\ A_{21} & A_{22} \end{bmatrix}, \qquad \text{and} \qquad TB = \begin{bmatrix} 0 \\ B_2 \end{bmatrix},$$

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

and where (A_{22}, B_2) is controllable. The exact numerical procedure for this decomposition can be found, for example, in Khalil (1992). Further, all eigenvalues of A_{11} have negative real parts, implying that $(A(\boldsymbol{\theta}), B)$ is stabilizable.

To obtain a feedback control law stabilizing (47), we consider solving the problem of minimizing

$$J = \int_0^\infty [\boldsymbol{x}' U \boldsymbol{x} + V u^2]\, dt,$$

where $U \in R^{28\times 28}$ and $V \in R^1$ are positive definite. It is known from linear system theory that the optimal feedback control law is given by $u = K\boldsymbol{x}$, where $K = -V^{-1}B'P$, and where P is positive definite and solves the algebraic Ricatti equation

$$PA + A'P - PBV^{-1}B'P + U = 0.$$

Choose $U = I$ and $V = 1$. Then, we get

$$\begin{aligned} K = [&1.5036, 0.4754, 0.0178, 0.0307, -1.1897, 18.5851, 7.2979, 1.9063,\\ &2.3147, 23.2392, 0.7488, 7.2091, 38.9965, 39.4000, 0.1841, 0.2129, 0.3061,\\ &0.0494, -0.0027, 0.0000, -0.0013, -0.0002, 0.9550, 1.8482, -0.3329,\\ &-0.5475, 0.9369, -1.0402]. \end{aligned} \tag{48}$$

Under the control $u = Kx$, the equation (47) becomes

$$D\boldsymbol{x} = [A(\boldsymbol{\theta}) + BK]\boldsymbol{x} + \boldsymbol{F}(\boldsymbol{x}, \boldsymbol{\theta}). \tag{49}$$

The choice of K ensures that all the eigenvalues of $A + BK$ have strictly negative real parts. Therefore, the state feedback law $u = K\boldsymbol{x}$ indeed stabilizes the system (49). Direct verification confirms that there exist no bifurcations under the control law (47) for (β_2, β_5).

We further check the stability of (49) under the control law (47) for all parameters $\boldsymbol{\theta} \in \Theta$. Our purpose is to see if there is a parameter vector $\tilde{\boldsymbol{\theta}} \in \Theta$ at which the system (49) is unstable. Such a parameter vector can be found by replacing (50) (in the Appendix) with maximizing over Θ the maximum real parts of the eigenvalues of the matrix $A(\boldsymbol{\theta})$. The following such $\boldsymbol{\theta} \in \Theta_1$ has been found

$$\begin{aligned} \boldsymbol{\theta} = [&0.9400, 0.5074, 2.0913, 0.2030, 0.2612, 0.1933, 0.2309, 0.0000, 0.2510,\\ &-0.3423, 1.0000, 23.5000, -0.0100, 0.2086, 0.0332, 13.5460, 0.4562,\\ &0.9322, 0.0100, 0.0034, 0.1324, -0.5006, 100.0000, 0.0000, 0.0004,\\ &71.4241, 0.8213, 4.0000, 1.0289, 0.3631, 0.1201, 0.1000, 0.0010, 3.7015,\\ &0.4860, 1.1270, 0.0042, 3.3994, 0.4802, 0.1300, 0.6851, 0.0620, 1.2134, \end{aligned}$$

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

0.3830, 4.0000, 3.2535, 3.8592, 4.0000, 4.0000, 3.5723, 0.4775, 0.0071, 0.6104, 0.0143, 0.1718, 0.1227, 2.5551, 0.1833, 0.0035, 0.0000, 0.0018, 0.0004, 0.0100].

The corresponding $R_{\max}(A(\boldsymbol{\theta}))$ equals 0.4971. Therefore, there indeed exists a parameter $\tilde{\boldsymbol{\theta}} \in \Theta_1$ at which (49) is unstable.

Because of the Lucas critique, the problems associated with using structural models for policy simulations are well known. In addition, the possibility of time inconsistency of optimal control policy conditionally upon a structural model is well known. While the use of Euler equation models having deep parameters is to be preferred for policy simulations, we are now only beginning the difficult task of investigating bifurcation with a sufficiently rich Euler equation model [see He and Barnett (2001)]. Nevertheless, it is interesting to ask, at this point in our ongoing research, whether the use of control feedback policy with a structural model would be easily implemented, if the Lucas critique and time-inconsistency issues were negligible. It seems often to be assumed that such active policy easily could be designed, if it were not for the problems produced by the Lucas critique and by the time inconsistency of optimal control.

However, our results above indicate that even without those problems, the design of a successful feedback policy can be difficult. Even when the structural parameters of the other equations remain constant, adjoining a policy feedback rule to a system causes bifurcation boundaries to shift. The policy is successful, if those shifts cause the stable region to move toward the actual values of the parameters sufficiently to include the parameters within the stable region. We find with the UK continuous-time model that the selection of a fiscal policy feedback rule produced from particularly "well-educated" heuristic economic reasoning was counterproductive. Although the use of optimal control theory is successful conditionally upon the model, the resulting policy equation is too complicated to be of practical use. Furthermore, the negative results from the heuristic non-optimal policy raise serious questions about the robustness of the optimal control conclusion to specification error. In addition, the success of the optimal control policy abstracts from the problems of possible time inconsistency of optimal control policy.

In short, the effects of policy feedback rules depend upon the complicated geometry of bifurcation boundaries and how they are moved by augmentation of the model by the feedback rule. It is not at all unlikely that such policies, when applied in the real world, could prove to be counterproductive, even if the Lucas critique and time inconsistency were not problems.

6. CONCLUSIONS

In this paper, we explore the policy relevance of bifurcation phenomena in continuous-time macroeconometric models, using the Bergstrom et al. (1992) continuous-time second-order differential-equations macroeconometric model of

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

the United Kingdom. We have obtained a new formula for determining bifurcation boundary candidates for transcritical bifurcations, and we find that the dynamics of the model are locally asymptotically unstable on those bifurcation boundaries.

The point estimates of the parameters of the model are in the unstable region, and we find little statistical evidence from the published standard errors to question the inference of instability of the model, when no policy-rule equation has been adjoined to the model. The problems associated with conducting a rigorous hypothesis test of the null hypothesis of stability in this model are prohibitively difficult, but of only distant importance to the current study. It is not our objective to determine whether or not the UK economy really is unstable, or whether or not the UK continuous-time model is an accurate representation of the actual UK economy. Our objective is to explore policy in a model that plausibly represents a continuous-time model with frictions and with point estimates in the unstable region. We believe that our empirical results are adequate to establish that the UK continuous-time model can serve that purpose. Hence we condition on that model with its parameters set at their point estimates during our policy experiment.

In contrast, the Grandmont (1985) model, which has been explored for similar reasons, has restrictive elasticities producing far less relevance to policy experiments. In addition, that model has no frictions or other forms of market failure that would permit Pareto-improving policy. In the UK model, frictions operate through adjustment lags and produce welfare loss. In principle, if policy could stabilize the model's unstable solution paths, it is possible that the economy could attain a friction-free Pareto-superior stable steady state, in which partial adjustment lags would no longer exist. For these reasons, the UK continuous-time model removes the sources of prior criticism of Grandmont's (1985) policy relevance.

We investigate the effects of fiscal policy on stabilization, and we find that conducting a successful active countercyclical policy with the UK continuous-time model may be more difficult than previously believed, as a result of the manner in which the bifurcation boundaries are affected by policy and the complex geometry of those boundaries. In particular, we find that active feedback fiscal policy rules based upon plausible economic reasoning can be counterproductive. Potentially successful stabilization rules acquired from the use of optimum control theory are too complicated to be practical and are not likely to be robust to specification error. In short, we conclude that identifying a "stabilization policy" that would be successful in an unstable economy can be far more challenging than previously thought. This conclusion is consistent with common views on the difficulties of bifurcation selection in the sophisticated area of mathematical dynamics that deals with bifurcation phenomena.

An obvious priority for further advances in this area would be application of these methods to a stochastic dynamic general equilibrium model that could be viewed as an empirically plausible and policy relevant direct extension of the model investigated by Grandmont (1985). But the use of these methods with a realistic system of Euler equations poses significant challenges that are likely to motivate our future research in this area. One possibility, as a next step in the direction,

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

would be to apply the methods in this paper to the models in Leeper and Sims (1994) and Schmitt-Grohe (1997), while progress in a related direction could be acquired by applying these methods to the model in Powell and Murphy (1997). In Our initial results with the Leeper and Sims model in He and Barnett (2001), we encounter a form of bifurcation that previously has not appeared in the economics literature, and suggest that stabilization policy with Euler equation models may be even more difficult to design successfully than with continuous time differential equation models, such as the UK continuous-time model.

In the current experiments, we investigate bifurcation to stability of a system that is unstable without policy at its parameter-point estimates. However, if the system's parameters were already in the stable region without policy and the system were subject to stochastic shocks, our results suggest that a poorly selected "stabilization policy" rather easily could destabilize the system by contracting the stable region. The parameter estimates might then no longer be within the stable region. It is not our intention to advocate the model that we have used or the view that the real-world economy is not stable without policy, but rather to explore the policy implications of a particular tradition conditionally upon a relevant model. This paper's "what if" experiments suggest the potential importance of many more such experiments with other models at other parameter settings. Our view is that such further experiments, such as those in He and Barnett (2001), rather than producing easier policy conclusions, will find that policy dynamics will become increasingly difficult as more modern models are explored. Our results so far and our views on this subject should be no surprise to experts in engineering dynamics and dynamics of natural physical systems, who have long had the same views.

REFERENCES

Bala, V. (1997) A pitchfork bifurcation in the tatonement process. *Economic Theory* 10, 521–530.

Barnett, W.A. & P. Chen (1988) The aggregation theoretic monetary aggregates are chaotic and have strange attractors: An econometric application of mathematical chaos. In W.A. Barnett, E. R. Berndt, & H. White (eds.), *Dynamic Econometric Modeling*, pp. 199–246. New York: Cambridge University Press.

Barnett, W.A. & Y. He (1999) Stability analysis of continuous time macroeconometric systems. *Studies in Nonlinear Dynamics and Econometrics* 3, 169–188.

Barnett, W.A., R. Gallant, M.J. Hinich, M. Jensen, & J. Jungeilges (1996) Comparison of the available tests for nonlinearity and chaos. In W.A. Barnett, G. Gandolfo, & C. Hillinger (eds.), *Dynamic Disequilibrium Modeling*, pp. 313–346. New York: Cambridge University Press.

Barnett, W.A., R. Gallant, M.J. Hinich, J. Jungeilges, D. Kaplan, & M. Jensen (1997) A single-blind controlled competition among tests for nonlinearity and chaos. *Journal of Econometrics* 82, 157–192.

Benhabib, J. (1979) The Hopf bifurcation and the existence and stability of closed orbits in multisector models of optimal economic growth. *Journal of Economic Theory* 21, 421–444.

Bergstrom, A.R. (1996) Survey of continuous time econometrics. In W.A. Barnett, G. Gandolfo, & C. Hillinger (eds.), *Dynamic Disequilibrium Modeling*, pp. 3–26. New York: Cambridge University Press.

Bergstrom, A.R., K.B. Nowman, & S. Wandasiewicz (1994) Monetary and fiscal policy in a second-order continuous time macroeconometric model of the United Kingdom. *Journal of Economic Dynamics and Control* 18, 731–761.

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

Bergstrom, A.R., K.B. Nowman, & C.R. Wymer (1992) Gaussian estimation of a second order continuous time macroeconometric model of the United Kingdom. *Economic Modelling* 9, 313–352.

Bergstrom, A.R. & C.R. Wymer (1976) A model of disequilibrium neoclassic growth and its application to the United Kingdom. In A.R. Bergstrom (ed.), *Statistical Inference in Continuous Time Economic Models*, pp. 267–327. Amsterdam: North-Holland.

Boldrin, M. & M. Woodford (1990) Equilibrium models displaying endogenous fluctuations and chaos: A survey. *Journal of Monetary Economics* 25, 189–222.

Carr, J. (1981) *Applications of Center Manifold Theory*. New York: Springer-Verlag.

Dockner, E.J. & G. Feichtinger (1991) On the optimality of limit cycles in dynamic economic systems. *Journal of Economics* 51, 31–50.

Gandolfo, G. (1992) Sensitivity analysis in continuous time econometric models. *Computers and Mathematics with Applications* 24, 43–55.

Gandolfo, G. (1996) *Economic Dynamics*. New York: Springer.

Glendinning, P. (1994) *Stability, Instability, and Chaos*. New York: Cambridge University Press.

Goenka, A., D. Kelly, & S. Spear (1998) Endogenous strategic business cycles. *Journal of Economic Theory* 81, 97–125.

Grandmont, J.M. (1985) On endogenous competitive business cycles. *Econometrica* 53, 995–1045.

Grandmont, J.M. (1998) Expectations formation and stability of large socioeconomic systems. *Econometrica* 66, 741–782.

Guckenheimer, J. & P. Holmes (1983) *Nonlinear Oscillations, Dynamical Systems, and Bifurcations of Vector Fields*. New York: Springer-Verlag.

Guckenheimer, J., M. Myers, & B. Sturmfels (1997) Computing Hopf bifurcations, I. *SIAM Journal on Numerical Analysis* 34, 1–21.

He, Y. & W.A. Barnett (2001) New Phenomena Identified in a Stochastic Dynamic Macroeconometric Model: A Bifurcation Perspective. Manuscript, Washington State University.

Henry, D. (1981) *Geometric Theory of Semilinear Parabolic Equations*, Springer Lecture Notes in Mathematics, Vol. 840. New York: Springer-Verlag.

Khalil, H.K. (1992) *Nonlinear Systems*. New York: Macmillan.

Kydland, F.E. & E.C. Prescott (1977) Rules rather than discretion: The inconsistency of optimal plans. *Journal of Political Economy* 85, 473–491.

Leeper, E. & C. Sims (1994) Toward a modern macro model usable for policy analysis. *NBER Macroeconomics Annual* 1994, 81–117.

Lucas, Robert E. (1976) Econometric policy evaluation: A critique. In K. Brunner & A.H. Meltzer (eds.), *The Phillips Curve and Labor Markets*, pp. 19–46. Amsterdam: North-Holland.

Medio, A. (1992) *Chaotic Dynamics: Theory and Applications to Economics*. New York: Cambridge University Press.

Nieuwenhuis, H.J. & L. Schoonbeek (1997) Stability and the structure of continuous-time economic models. *Economic Modelling* 14, 311–340.

Nishimura, K. & H. Takahashi (1992) Factor intensity and Hopf bifurcations. In G. Feichtinger (ed.), *Dynamic Economic Models and Optimal Control*, pp. 135–149. Amsterdam: North-Holland.

Powell, A. & C. Murphy (1997) *Inside a Modern Macroeconometric Model: A Guide to the Murphy Model*. Heidelberg: Springer.

Puu, T. (1991) *Nonlinear Economic Dynamics*. New York: Springer-Verlag.

Schmitt-Grohe, S. (1997) Comparing four models of aggregate fluctuations due to self-fulfilling expectations. *Journal of Economic Theory* 72, 96–147.

Sotomayor, J. (1973) Generic bifurcations of dynamic systems. In M.M. Peixoto (ed.), *Dynamical Systems*, pp. 561–582. New York: Academic Press.

Woodford, M. (1989) Imperfect financial intermediation and complex dynamics. In W.A. Barnett, J. Geweke, & K. Shell (eds.), *Economic Complexity: Chaos, Sunspots, Bubbles, and Nonlinearity*, pp. 309–334. New York: Cambridge University Press.

Wymer, C.R. (1997) Structural nonlinear continuous time models in econometrics. *Macroeconomic Dynamics* 1, 518–548.

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

APPENDIX: STATISTICAL SIGNIFICANCE OF INSTABILITY WITHOUT POLICY

For each θ_i, $i = 1, 2, \ldots, 63$, the point estimate and the corresponding standard deviation are provided in Table 2 of Bergstrom et al. (1992). For a given confidence level p, a confidence interval can be obtained for any θ_i by $[\hat{\theta}_i - \epsilon_p \sigma_i, \hat{\theta}_i + \epsilon_p \sigma_i]$, where $\hat{\theta}_i$ and σ_i are, respectively, the estimate and standard deviation of the parameter θ_i, and ϵ_p is the standard normal percentile, as is consistent with the distributional assumptions in Bergstrom et al. (1992). Both $\hat{\theta}_i$ and σ_i are available in Table 2 of Bergstrom et al. (1992). For example, the 95% confidence interval for $\theta_1 = \beta_1$ is [0.9324, 0.9476]. Let $[\underline{\theta}_i, \bar{\theta}_i]$ denote the confidence interval for the parameter θ_i, $i = 1, 2, \ldots, 63$. For several parameters, the estimates were on the boundaries of the theoretical feasible intervals. In this case, we assume $\sigma_i = 0$, so that the confidence interval becomes one point, the estimate. There are eight such parameters: $\theta_8, \theta_{11}, \theta_{13}, \theta_{28}, \theta_{33}, \theta_{48}, \theta_{60}, \theta_{63}$. Hence, our inferences condition upon their corner solution values. Define $\Theta_1 = \{\theta \in \Theta\colon \theta_i \in [\underline{\theta}_i, \bar{\theta}_i], i = 1, 2, \ldots, 63\}$. Then Θ_1, $\Theta_1 \subset \Theta$, denotes the region of θ determined by the Cartesian product of those confidence intervals. Any change in the stability of (29) over Θ_1 implies that we cannot reject the hypothesis that the parameters are on the other side of the bifurcation boundary from the side on which their point estimates lie.

Consider the following problem of minimizing the maximum real parts of the eigenvalues of the matrix $A(\boldsymbol{\theta})$:

$$\min_{\boldsymbol{\theta} \in \Theta} R_{\max}(A(\boldsymbol{\theta})), \tag{A.1}$$

where

$$R_{\max}(A(\boldsymbol{\theta})) = \max_i \{\text{real}(\lambda_i)\colon \lambda_1, \lambda_2, \ldots, \lambda_{28} \text{ are eigenvalues of } A(\boldsymbol{\theta})\}.$$

Since the dimension of $A(\boldsymbol{\theta})$ is 28×28, which is relatively high, we cannot acquire a closed-form expression for $R_{\max}(A(\boldsymbol{\theta}))$. We use the gradient method to solve the minimization problem (A.1). More precisely, let $\boldsymbol{\theta}^{(0)}$ be the estimated set of parameter values given in Table 2 of Bergstrom et al. (1992). At step n, $n \geq 0$, with $\boldsymbol{\theta}^{(n)}$, let

$$\boldsymbol{\theta}^{(n+1)} = \pi_{\Theta_1}\left[\boldsymbol{\theta}^{(n)} - a_n \frac{\partial R_{\max}(A(\boldsymbol{\theta}))}{\partial \boldsymbol{\theta}}\bigg|_{\boldsymbol{\theta}=\boldsymbol{\theta}^{(n)}}\right],$$

where $\{a_n, n = 0, 1, 2, \ldots\}$ is a sequence of positive step sizes and $\pi_{\Theta_1}[\boldsymbol{\theta}]$ is the projection onto Θ_1. The algorithm converged to the following point, $\boldsymbol{\theta}^* \in \Theta_1$:

$$\begin{aligned}\boldsymbol{\theta}^* = [&0.9400, 0.2936, 2.6871, 0.2030, 0.2562, 0.1961, 0.1345, 0.0000, 0.2440,\\ &-0.2577, 1.0000, 23.5000, -0.0100, 0.0473, 0.0288, 13.5460, 0.0100, 0.0061,\\ &0.2763, 0.2948, 0.4562, 1.0678, 44.8543, 0.1173, 0.0004, 71.4241, 0.8213, 4.0000,\\ &1.0289, 0.6698, 0.0697, 0.1311, 0.0010, 3.7078, 0.4860, 1.0537, 0.0042, 3.4562,\\ &0.4858, 0.1300, 1.0044, 0.0379, 1.3839, 0.3777, 3.9947, 3.6534, 3.9995, 4.0000,\end{aligned}$$

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press

4.0000, 3.9400, 0.4775, 0.0071, 0.6114, 0.0574, 0.1718, 0.1227, 2.2845, 0.1489,

0.0035, 0.0000, 0.0042, 0.0036, 0.0100].

The corresponding value of $R_{\max}(A(\boldsymbol{\theta}^*))$ is -0.0017, implying that all eigenvalues of $A(\boldsymbol{\theta}^*)$ have strictly negative real parts and the system (29) is locally asymptotically stable around $\boldsymbol{x}^* = \mathbf{0}$ for $\boldsymbol{\theta}^*$. Hence, we cannot reject the hypothesis of stability.

When we reduced the confidence level to 90%, resulting in smaller confidence intervals, the algorithm failed to find a value of $\boldsymbol{\theta}$ under which the system (29) is stable. With 90% confidence level, the system (29) is unstable for all parameters $\boldsymbol{\theta} \in \Theta_1$, and hence we cannot accept the hypothesis of stability at the 10% significance level.

https://doi.org/10.1017/S1365100502020023 Published online by Cambridge University Press