SHOCKS AND FRICTIONS: A FINITE PLANNING HORIZON APPROACH

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ABSTRACT. In this paper, we extend the finite planning horizon prposed by Woodford (2018) to a fully-fledge, medium-scale DSGE model. By affecting the degree of forward-lookingness of agents, finite planning horizons affect the propagation channels of all the structural shocks. Our aim is to investigate to what extent this approach to relaxing the rational expectations assumption impinges on the standard diagnosis as to the main drivers of the business cycle. The model is estimated via Bayesian techniques and is shown to outperform its rational expectation counterpart. Finite planning horizons are found to affect inference about the structural parameters and the variance and hisotrical decompositions of structural shocks.