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# **A Bayesian Approach to Counterfactual Analysis of Structural Change\***

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**ABSTRACT:** In this paper, we develop a Bayesian approach to counterfactual analysis of structural change. Contrary to previous analysis based on classical point estimates, this approach provides a straightforward measure of estimation uncertainty for the counterfactual quantity of interest. We apply the Bayesian counterfactual analysis to examine the sources of the volatility reduction in U.S. real GDP growth in the 1980s. Using Blanchard and Quah's (1989) structural VAR model of output growth and the unemployment rate, we find strong statistical support for the idea that a counterfactual change in the size of structural shocks alone, with no corresponding change in propagation, would have produced the same overall volatility reduction that actually occurred. Looking deeper, we find evidence that a counterfactual change in the size of aggregate supply shocks alone would have generated a larger volatility reduction than a counterfactual change in the size of aggregate demand shocks alone. We show that these results are consistent with a standard monetary VAR, for which counterfactual analysis also suggests the importance of shocks in generating the volatility reduction, but with the counterfactual change in monetary shocks alone generating a small reduction in volatility.

**Keywords:** Bayesian, Counterfactual, Structural Change, Volatility Reduction

**JEL Classification:** C11, C32, E32

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## 1. Introduction

A striking stylized fact of the U.S. macroeconomy is the large reduction in its volatility since the early 1980s, a feature that has been called the “Great Moderation” (Bernanke, 2004). This volatility reduction, first documented by Niemira and Klein (1994), Kim and Nelson (1999) and McConnell and Perez-Quiros (2000), has spawned a large literature attempting to isolate its source.<sup>1</sup> The literature has focused on three explanations: 1) improved macroeconomic policy, 2) changes in the private-sector’s behavior, and 3) good luck.

One approach to distinguishing between these competing explanations is through the use of counterfactual experiments. In counterfactual analysis of structural change, a macroeconomic model is estimated over two sub-samples, a pre-volatility reduction sample, denoted Period 1, and a post-volatility reduction sample, denoted Period 2. A counterfactual quantity of interest, such as the variance, is then calculated based on a model in which the parameter estimates from Periods 1 and 2 are intermingled. For example, suppose that a macroeconomic model contains parameters representing monetary policy. Counterfactual variances could be calculated in which the monetary policy parameter estimates of Period 2 are intermingled with the other parameter estimates of Period 1. If the counterfactual variance is considerably lower than the sample variance in Period 1, improved monetary policy would be a strong candidate for the source of the volatility reduction. Several papers have taken this approach to explaining the volatility reduction, including Stock and Watson (2002), Boivin and Giannoni (2003), and Ahmed, Levin, and Wilson (2004).<sup>2</sup>

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<sup>1</sup> See Simon (2000), Blanchard and Simon (2001), Chauvet and Potter (2001), Kahn, McConnell, and Perez-Quiros (2002), Stock and Watson (2002), Boivin and Giannoni (2003), Ahmed, Levin, and Wilson (2004), Kim, Nelson and Piger (2004), Sensier and van Dijk (2004), Herrera and Pesavento (2005), Choi and Jung (2006), and Gordon (2006).

<sup>2</sup> It is worth noting that counterfactual analysis is subject to the Lucas (1976) critique, in that the experiments proceed by changing sets of model parameters while holding others constant. However, a number of papers have

In this paper we also conduct counterfactual experiments to isolate sources of the volatility reduction in U.S. real GDP. However, unlike the previous literature, we develop a Bayesian approach in which posterior densities for the counterfactual variances are constructed. This Bayesian approach represents an improvement over the previous analysis based on classical point estimates because it provides a sense of statistical precision about the counterfactual quantities of interest. In particular, the hierarchical structure of the Gibbs sampler used in Bayesian estimation makes it straightforward to capture the implications of parameter uncertainty and uncertainty regarding timing of structural change on inferences about counterfactual variances. In the classical context, there is no known analytical measure of estimation uncertainty for counterfactual variances, as they are complicated nonlinear functions of the underlying model parameters. Meanwhile, a measure based on linear approximation (i.e., the “delta method”) is likely to be highly inaccurate and it is unclear how to incorporate uncertainty about the timing of structural change into such a measure. Bootstrap methods provide a potential means of measuring uncertainty about counterfactual quantities, but they are just as computationally intensive as Gibbs sampling and it is unclear whether standard bootstrap techniques are valid in the presence of a structural break of unknown timing. In any event, the classical measures of uncertainty would only be asymptotically justified, while the Bayesian approach provides an exact finite sample measure of uncertainty. Furthermore, while classical inference is difficult even with just two sources of uncertainty, it would be relatively straightforward to incorporate additional sources of uncertainty, such as that about lag length or more general model specification assumptions, in Bayesian analysis.<sup>3</sup>

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documented limited empirical relevance of the Lucas critique for small-scale vector autoregressions estimated to U.S. post-war data (e.g. Rudebusch, 2005; Sims and Zha, 2006), which is the application considered in this paper.

<sup>3</sup> Another potential benefit of the Bayesian approach is that correlation between model parameters before and after the structural break can be introduced through their joint prior distribution. Consequently, inferences about post-

We apply the Bayesian counterfactual analysis to Blanchard and Quah's (1989) structural VAR model of output growth and the unemployment rate. The model has three structural components: aggregate supply shocks, aggregate demand shocks, and a propagation mechanism for the structural shocks. The structural components are identified using a long-run restriction in which aggregate demand shocks are assumed to have no long-run effect on the level of real GDP. Estimation results suggest a large reduction in output volatility in the 1980s, with clear evidence of a reduction in the size of the structural shocks. The counterfactual analysis examines how much of the actual reduction in output volatility could have been generated by a change in shocks alone or a change in propagation alone. We find strong statistical support for the idea that a counterfactual change in the size of structural shocks alone, with no corresponding change in propagation, would have produced the same overall volatility reduction that actually occurred. By contrast, a counterfactual change in propagation alone, with no change in shocks, would have produced little or no reduction in volatility, although the inferences about this counterfactual are somewhat less precise. Meanwhile, a change in the size of aggregate supply shocks alone would have generated a larger volatility reduction than a change in the size of aggregate demand shocks alone. Thus, consistent with the previous literature, these results point towards the role of good luck rather than a change in private sector behavior or macroeconomic policy. In particular, the relatively small role of aggregate demand shocks and the lack of a role for propagation are interesting because they suggest that the volatility reduction cannot easily be related to monetary policy, either in terms of unanticipated policy shocks or the propagation of shocks due to more systematic policy.

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break parameters can depend on information in pre-break data (i.e., inference is not just equivalent to subsample analysis). For simplicity, we use noninformative priors in our application. However, we mention this issue as a general benefit of Bayesian analysis of structural change.

Because of concerns about identifying aggregate demand shocks using a long-run restriction, and to explore the role of monetary policy further, we check the robustness of our results using a standard monetary VAR similar to that considered in Stock and Watson (2002), Boivin and Giannoni (2003), and Ahmed, Levin, and Wilson (2004). We find that the results are consistent in that shocks are much more successful than propagation in generating the volatility reduction. Further, we find that a change in monetary shocks alone is only able to generate a small reduction in volatility. Thus, the primary role for shocks appears to be arising from the non-monetary shocks in the system.

Our analysis is related to, but different from Sims and Zha (2006). They employ Bayesian model comparison to test for regime changes in shock and propagation parameters for a structural VAR.<sup>4</sup> Consistent with our findings, their results support a change in shock variances only. However, their model comparison approach has a different emphasis than counterfactual analysis, which allows for changes in both shocks and propagation, but asks how much of the total change in volatility could have been generated by one or the other. This is important, as small changes in propagation might still be capable of generating large changes in the unconditional volatility of the system due to the nonlinear impact of propagation on volatility.

In the next section we discuss the principles underlying counterfactual analysis. Section 3 describes the Bayesian approach. Section 4 presents the details of our application to the volatility reduction in U.S. real GDP growth. Section 5 reports the results of the Bayesian estimation and counterfactual experiments for our application. Section 6 examines the robustness of the results

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<sup>4</sup> It should be noted that Sims and Zha (2006) also conduct some counterfactual experiments as part of their Bayesian analysis. In particular, they simulate counterfactual histories of the level of inflation under alternative policy regimes. Likewise, Dueker and Nelson (2003) use Bayesian analysis to simulate counterfactual histories of several macroeconomic variables given alternative realizations of a latent business cycle indicator. However, these experiments are somewhat different in character and implementation than the experiments about structural change in unconditional variances that are considered in this paper and in Stock and Watson (2002), Boivin and Giannoni (2003), and Ahmed, Levin, and Wilson (2004).

when we consider a standard monetary VAR along the lines of what was considered in Stock and Watson (2002), Boivin and Giannoni (2003), and Ahmed, Levin, and Wilson (2004). Section 7 concludes.

## 2. Counterfactual Analysis

The principles behind counterfactual analysis of structural change are most easily illustrated using the example of a stationary AR(1) process:

$$x_t = \phi x_{t-1} + e_t, \quad e_t \sim N(0, \sigma^2), \quad (1)$$

where  $|\phi| < 1$ . Suppose  $x_t$  undergoes a structural break corresponding to a reduction in its variance. There are two possible sources of the variance reduction: “shocks” and “propagation”. To see this, note that the variance of  $x_t$  is

$$\text{var}(x_t) \equiv \gamma_0 = \frac{\sigma^2}{1 - \phi^2}, \quad (2)$$

where  $\sigma^2$  corresponds to the variance of the shocks and  $\phi^2$  corresponds to the propagation. A reduction in either  $\sigma^2$  or  $\phi^2$  will reduce the size of  $\gamma_0$ . In practice, a variance reduction could reflect a change in both shocks and propagation.

Counterfactual analysis considers the hypothetical changes that would have occurred if either only shocks or only propagation had changed. To illustrate, let  $i, j = 1, 2$  index the structural regime for shocks and propagation, respectively:

$$\gamma_0^{(i,j)} = \frac{(\sigma^{(i)})^2}{1 - (\phi^{(j)})^2}. \quad (3)$$

Then  $i = j$  produces the actual variances for the two structural regimes, while  $i \neq j$  produces the counterfactual variances based on changes in shocks only or propagation only.

It should be noted that counterfactuals do not provide a formal decomposition of what caused the variance of  $x_t$  to change. In particular, it is easily seen from (3) that shocks and propagation interact in a nonlinear fashion to determine the variance. As a result, the changes in variance implied by the counterfactuals do not necessarily sum to the actual change in variance. Thus, some caution should be employed in interpreting counterfactuals. In essence, they represent hypothetical scenarios only.

Nevertheless, a hypothetical may be very revealing. For example, suppose the counterfactual variance corresponding to a change in shocks but not propagation ( $\gamma_0^{(2,1)}$ ) is of a similar magnitude to the variance after the structural break ( $\gamma_0^{(2,2)}$ ), while the counterfactual variance corresponding to a change in propagation but not shocks ( $\gamma_0^{(1,2)}$ ) is of a similar magnitude to the variance before the structural break ( $\gamma_0^{(1,1)}$ ). Then, the findings would be highly suggestive of a large role for shocks in producing the variance reduction. Of course, in practice, one might be concerned about the precision of these counterfactual inferences. The Bayesian approach to counterfactual analysis is designed to address this concern.

### 3. The Bayesian Approach

In Bayesian analysis, beliefs about model parameters are described using probability distributions. If data provide a lot of information about the values of parameters, posterior



densities will be relatively tight. If the data are uninformative, posterior densities will be more spread out and largely reflect the specification of prior beliefs, rather than sample information.

Given posterior distributions for model parameters, it is possible to simulate from posterior distributions for functions of those parameters, including counterfactual variances. Continuing with the simple example of a structural break in the variance of the AR(1) process in (1), we can repeatedly draw realizations of  $(\phi^{(1)}, \phi^{(2)}, \sigma^{(1)}, \sigma^{(2)})$  from their joint posterior distribution and use the unconditional variance formula in (3) to construct implied realizations and, therefore, distributions for  $\gamma_0^{(i,j)}$  for  $i, j = 1, 2$ . For  $i = j$ , we would have posterior distributions for the subsample variances of  $x_t$ . For  $i \neq j$ , we would have posterior distributions for the counterfactual variances.<sup>5</sup>

Bayesian analysis also allows us to make inferences about the relative sizes of different variances. In particular, we can calculate ratios of functions of the variances and evaluate the probabilities that they are less than a fixed value. A simple example would be the comparison of an actual and counterfactual variance:

$$\Pr \left[ \frac{\gamma_0^{(i,j)}}{\gamma_0^{(i,i)}} < k \right].$$

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<sup>5</sup> Note that the counterfactual variances will reflect the weaker dependence between shock and propagation parameters across subsamples than within subsamples. For example, suppose that shock and propagation parameters are negatively related within subsamples such that the posteriors for the actual unconditional variances are much tighter than would be implied by independent draws from the marginal distributions for the parameters. Then, given weak dependence or independence (as would be the case under a noninformative prior) between parameters across subsamples, the posteriors for the counterfactual variances will be much less precise than for the actual variances. However, if the dependence between shock and propagation parameters reflects the relative size of the shock variance, then it is possible to use this dependence when constructing counterfactual variances in order to get more precise inferences. To capture this dependence, we consider sorting the realized propagation parameters by the realized shock variances and assigning them a rank, which can be matched to the quantile of the realized shock variance in the other subsample. In practice, we find that sorting makes counterfactual posteriors only slightly more precise. Thus, for simplicity of presentation, we report the basic results without sorting.

That is, we can evaluate the probability that the counterfactual variance when  $i \neq j$  is less than some percentage, denoted by the fraction  $k$ , of the actual variance in sample period  $i$ . The important benchmark is a probability of 0.5, which, given  $k = 1$ , suggests “even odds” that the one variance is bigger than the other. Meanwhile, as we vary  $k$  from one towards zero, probabilities much higher or lower than 50% provide strong statistical support for one variance being significantly (in an economic sense) larger than the other.

A particularly attractive feature of the Bayesian framework is that it allows us to account for uncertainty about the exact timing of structural change in a relatively straightforward manner. In particular, estimation of a breakdate can be added to estimation of the parameters and the actual and counterfactual variances. Accounting for uncertainty about the timing of structural change represents an improvement over the existing literature, which has conducted counterfactual analysis conditional on a given breakdate.

#### **4. Application**

In this section we describe an application of Bayesian counterfactual analysis to examine the possible sources of the recent volatility reduction in U.S. real GDP growth. For our application, we consider Blanchard and Quah’s (1989) long-run structural VAR model of output growth and the unemployment rate. Beyond the basic distinction between shocks and propagation, the model allows us to consider aggregate supply and aggregate demand shocks as separate possible sources of the volatility reduction. In terms of propagation, the model also allows us to identify contemporaneous structural propagation of shocks across series, in addition to the dynamic propagation considered in counterfactual experiments based on reduced-form VARs (e.g., Stock and Watson, 2002).

#### 4.1 A Long-Run Structural VAR Model of Output and Unemployment

We start with a reduced-form VAR model for output growth and the unemployment rate:

$$\Phi(L)Y_t = c + e_t, \quad e_t \sim N(0, \Omega), \quad (4)$$

where  $Y_t \equiv (\Delta y_t, u_t)'$ ,  $\Phi(L) \equiv I - \sum_{k=1}^p \Phi_k L^k$ ,  $c \equiv (c_1, c_2)'$ ,  $e_t \equiv (e_{1t}, e_{2t})'$ , and  $\Omega = \begin{bmatrix} \sigma_1^2 & \sigma_{12} \\ \sigma_{12} & \sigma_2^2 \end{bmatrix}$ . We

assume that the lag order,  $p$ , is finite and that  $Y_t$  is stationary, meaning that we can invert  $\Phi(L)$

to solve for the vector Wold form:

$$Y_t = \mu + \Psi(L)e_t, \quad (5)$$

where  $\mu = \Phi(1)^{-1}c$ , and  $\Psi(L) = \Phi(L)^{-1}$ .

The key structural assumption is that the reduced-form representation in (5) corresponds to the following linear structural model:

$$Y_t = \mu + \beta(L)\varepsilon_t, \quad \varepsilon_t \sim N(0, D), \quad (6)$$

where  $\varepsilon_t \equiv (\varepsilon_t^{AS}, \varepsilon_t^{AD})'$ ,  $D \equiv \begin{bmatrix} \sigma_{AS}^2 & 0 \\ 0 & \sigma_{AD}^2 \end{bmatrix}$ ,  $\beta(L) \equiv \sum_{k=0}^{\infty} \beta_k L^k$ , and  $\beta_0 = \begin{bmatrix} 1 & 1 \\ \beta_{0,21} & \beta_{0,22} \end{bmatrix}$ . That is,

output growth and the unemployment rate depend on current and lagged values of aggregate supply shocks ( $\varepsilon_t^{AS}$ ) and aggregate demand shocks ( $\varepsilon_t^{AD}$ ). For the purpose of separating out changes in the size of shocks from changes in the contemporaneous propagation of shocks across series, we normalize the size of both structural shocks in terms of their initial impact on output

growth.<sup>6</sup> In terms of this model,  $D$  reflects the size of shocks and  $\beta(L)$  reflects the propagation of the shocks. The matrix  $\beta_0$  captures the proportional impact of the shocks on each series, rather than the size of shocks. In particular, regardless of the size of shocks or how the shocks are normalized,  $\beta_0$  only changes given a change in the contemporaneous propagation of shocks across series.

We identify aggregate demand shocks, aggregate supply shocks, and the propagation of the shocks using a long-run restriction, as in Blanchard and Quah (1989). Briefly, long-run identification proceeds by assuming no long-run effect of the aggregate demand shock on the level of output ( $y_t$ ), that is,  $\beta(1)$  is a lower triangular matrix. This restriction is then used to solve for  $\beta(L)$  and  $D$ . The details of this solution are provided in the appendix.

#### 4.2 Counterfactual Experiments

Given the structural model in (6), the variance of  $Y_t$  is a function of the shock variances  $D$  and the propagation  $\beta(L)$ :

$$\Gamma_0 = \sum_{k=0}^{\infty} \beta_k D \beta_k' . \quad (7)$$

As with the simple AR(1) example, we can consider a structural break in the variance of  $Y_t$  and perform counterfactual analysis based on the structural break. Letting  $i, j = 1, 2$  index the structural regime for propagation and shocks, respectively:

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<sup>6</sup> Given the normalization, there is an implicit assumption that both structural shocks have a non-zero initial impact on output growth.

$$\Gamma_0^{(i,j)} = \sum_{k=0}^{\infty} \beta_k^{(j)} D^{(i)} \beta_k^{(j)}. \quad (8)$$

Then,  $i = j$  produces the actual variance estimates for the two structural regimes and  $i \neq j$  produces counterfactual variances.

### 4.3 Bayesian Estimation

The reduced-form VAR in (4) is equivalently written as:

$$Y_t = \Pi' X_t + e_t, \quad (9)$$

where  $\Pi = [c \quad \Phi_1 \quad \dots \quad \Phi_p]'$  and  $X_t = [1 \quad Y_{t-1}' \quad \dots \quad Y_{t-p}']'$ . We allow for a one-time structural break in the parameters of (9) at the breakdate  $\tau$ . That is, we have:

$$Y_t = \begin{cases} \Pi^{(1)'} X_t + e_t, & e_t \sim N(0, \Omega^{(1)}), \quad t < \tau \\ \Pi^{(2)'} X_t + e_t, & e_t \sim N(0, \Omega^{(2)}), \quad t \geq \tau \end{cases}. \quad (10)$$

The breakdate  $\tau$  is assumed to be unknown, and is thus a parameter to be estimated.

We estimate the parameters of the model in (10) using Bayesian methods. We assume a Normal prior for the intercept/slope parameters,  $\text{vec}(\Pi^{(i)}) \sim N(\underline{\Pi}, \underline{\Sigma})$ ,  $i = 1, 2$ , an Inverted Wishart distribution for variance-covariance parameters,  $\Omega^{(i)-1} \sim W(\underline{\nu}, \underline{S})$ , and a Uniform prior for the breakdate,  $\tau \sim U(\kappa T, (1 - \kappa)T)$ , where  $\kappa$  determines the fraction of the sample period over which a structural break is allowed to occur. While the joint posterior density of  $(\Pi^{(1)}, \Pi^{(2)}, \Omega^{(1)}, \Omega^{(2)}, \tau)$  is not available analytically, it can be simulated via the Gibbs Sampler (Gelfand and Smith, 1990). In particular, we obtain 10,000 draws from the Gibbs Sampler for each parameter,

after discarding an initial 5,000 draws to ensure convergence. The details of the Gibbs Sampling procedure are provided in the appendix.

Given draws from the joint posterior density for the reduced-form parameters, we can solve for the structural propagation parameters and the structural variance parameters using the long-run identification procedure. Then, we can form the actual and counterfactual variances  $\Gamma_0^{(i,j)}$  by mixing the variance parameters from structural regime  $i$  with the propagation parameters in structural regime  $j$ , where  $i, j = 1, 2$ . Doing this for each draw from the Gibbs sampler provides us with posterior densities for the counterfactual variances that are neither conditional on model parameters nor conditional on the timing of the unknown breakdate, but take uncertainty about these parameters and the breakdate into account.

## 5. Empirical Results

In this section we present the empirical results for our investigation of the sources of the volatility reduction in U.S. real GDP growth based on the long-run structural VAR model presented in the previous section. First, we describe the details of the data, model specification, and priors used for estimation. Second, we report the estimation results for the structural break and model parameters. Third, we report the findings for the counterfactual experiments based on the Bayesian inferences about the model parameters.

### 5.1 Data, Model Specification, and Priors

The data series are 100 times the log first differences of U.S. real GDP and the level of the U.S. civilian unemployment rate. We sample seasonally-adjusted measures at a quarterly

frequency for the period of 1960:Q1 to 2005:Q4. The raw data were obtained from the St. Louis Fed website (<http://www.stls.frb.org/fred/>).

Beyond which variables to include in the VAR model, the main specification issue is how many lags to include in estimation. We report results for a model with four lags of quarterly data, although we note that the results are qualitatively very similar for models with two lags and eight lags.

We consider noninformative priors for simplicity, although the results are robust to more informative priors based on training sample information. The priors are “noninformative” in the sense that the priors for the VAR parameters would have resulted in posterior means and standard deviations that are the same as OLS estimates and standard errors if the breakdate were known, although because we also assume a noninformative (i.e., Uniform) prior for the breakdate, the results are not identical to OLS. For the intercept/slope parameters, the hyperparameters for the Normal prior are  $\underline{\Pi} = 0$  and  $\underline{\Sigma} = (1.0 \times 10^6) \times I$ , with rejection sampling based on the largest modulus of the eigenvalues for the companion form representation of the VAR to ensure stationarity. For the variance-covariance parameters, the hyperparameters for the Wishart prior are  $\underline{\nu} = 0$  and  $\underline{S} = (1.0 \times 10^6) \times I$ , which is a flat, but improper prior (i.e., it does not integrate to one) for the precision matrix  $\Omega^{(i)-1}$ . For the unknown breakdate, the hyperparameter for the Uniform prior is  $\kappa = 0.15$ , which corresponds equal weights for a breakdate sometime between 1966:Q3 and 1998:Q4.

## 5.2 Bayesian Estimation Results

We first look at the timing of the structural break. Figure 1 displays the posterior density and cumulative distribution for the breakdate parameter  $\tau$ . It is clear from the sharpness of the

posterior density and the steepness of the corresponding cumulative distribution that the data are highly informative about the presence of a structural break in the VAR parameters sometime between 1982-1988. In particular, if there were no structural break, the posterior would be relatively flat, like the Uniform prior. Also, it is clear from the precision of the posterior density that it would be robust to a wide range of truncations of possible breakdates implied by the hyperparameter  $\kappa$  for the Uniform prior.<sup>7</sup> The posterior includes 1984, which is often cited as the most likely date of a volatility reduction in output growth. Meanwhile, it should be noted that the dates for the possible timing of the structural break reflect that the model allows for a change in mean and variance parameters for both output growth and the unemployment rate, rather than simply a change in output growth volatility.

Given the results for the structural break, we next look at the estimates for structural shocks and propagation before and after the break. First, in terms of structural shocks, Table 1 presents quartiles for the posterior distributions of the aggregate supply (AS) and aggregate demand (AD) shock standard deviations,  $\sigma_{AS}$  and  $\sigma_{AD}$ . The results suggest that the structural break corresponds to a reduction in the size of structural shocks, at least in terms of their impact on output growth. The quartile values for the posterior distributions of  $\sigma_{AS}$  and  $\sigma_{AD}$  both fall by half, although the reduction in aggregate demand shocks is smaller in absolute magnitude. Second, in terms of propagation, Figure 2 displays the median and quartiles of the posterior distribution of the impulse response functions,  $\frac{\partial y_{t+q}}{\partial \varepsilon_t^{AS}}, \frac{\partial y_{t+q}}{\partial \varepsilon_t^{AD}}$ , for  $q = 1$  to 40.<sup>8</sup> The impulse

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<sup>7</sup> However, as with classical estimation of unknown breakdates, it is important to have a sufficient number of observations on either side of a breakdate to avoid irregularities in the likelihood function when a small number of observations can be overfit by a heavily parameterized model.

<sup>8</sup> To conserve space and because our primary focus is on output growth volatility, we do not report the impulse response functions for the unemployment rate.



response functions have the same general shape as reported in Blanchard and Quah (1989).

Aggregate supply shocks generate persistent long-run effects, while aggregate demand shocks generate a hump-shaped response that decays to zero over a business cycle horizon. Notably, the impulse response functions look reasonably similar before and after the structural break.

However, the relatively wide quartile bands imply a fair degree of uncertainty about whether there was a change in propagation.

### *5.3 Results for Counterfactual Experiments*

Given the estimation results for the structural VAR, it is useful to consider counterfactual experiments to determine whether the change in the size of structural shocks could have generated the entire reduction in output growth volatility or, alternatively, whether even small changes in propagation could have generated large changes in output growth volatility due to the nonlinear impact of propagation on variance. Meanwhile, given uncertainty about the extent of a change in propagation, it is particularly important to consider the Bayesian approach to counterfactual analysis because it captures the extent to which an imprecisely estimated change in propagation could have generated a large volatility reduction even if posterior means suggest little reduction.

As discussed above, the counterfactual experiments involve mixing shock variance and propagation parameters from before and after the structural break and solving for the resulting unconditional variances. For ease of interpretation of units, we report our inferences in terms of the standard deviations rather than variances. Also, while the structural VAR model includes the unemployment rate, we focus on the results for output growth. Specifically, we consider  $\sigma_{\Delta y}^{(i,j)}$ , which is the square root of the (1,1) element of  $\Gamma_0^{(i,j)}$  in (8), where  $i, j = 1, 2$ , with Periods 1 and 2

denoting the pre-break and post-break periods, respectively. Table 2 presents quartiles for the posterior distributions of the actual and counterfactual standard deviations of output growth.

The first and second rows of Table 2 report results for the actual standard deviations,  $\sigma_{\Delta y}^{(1,1)}$  and  $\sigma_{\Delta y}^{(2,2)}$ , in the pre-break and post-break periods, respectively. The results confirm the large reduction in output growth volatility after the structural break. Specifically, the median estimate fell by roughly 50%, while the upper quartile for  $\sigma_{\Delta y}^{(2,2)}$  is well below the lower quartile for  $\sigma_{\Delta y}^{(1,1)}$ . These results are evident in Figure 3, which displays the posterior densities for the actual and counterfactual standard deviations of output growth. Almost all of the posterior density for the post-break standard deviation lies below the density for the pre-break standard deviation.

The third and fourth rows of Table 2 report results for the counterfactual standard deviations,  $\sigma_{\Delta y}^{(1,2)}$  and  $\sigma_{\Delta y}^{(2,1)}$ , corresponding to a change in propagation alone and a change in shocks alone, respectively. A change in propagation alone is entirely unsuccessful at generating the actual reduction in variance. Indeed, the median of  $\sigma_{\Delta y}^{(1,2)}$  is actually above that of the actual standard deviation,  $\sigma_{\Delta y}^{(1,1)}$ , in the pre-break period. A change in shocks alone is able to generate a volatility reduction, with the median value is close to that of the actual standard deviation,  $\sigma_{\Delta y}^{(2,2)}$ , in the post-break period. Again, these results are evident in Figure 3, which shows that the counterfactual standard deviation given a change in shocks alone is almost as precisely estimated as the actual post-break standard deviation, but the counterfactual standard deviation given a change in propagation alone is less precisely estimated than the pre-break standard deviation.

While the results in Table 2 and Figure 3 clearly suggest that it is a change in shocks, not propagation, that could have generated the entire reduction in output growth volatility, the

Bayesian approach also allows for more precise inferences along these lines. In particular, as discussed in Section 3, we can calculate ratios of functions of the actual and counterfactual variances and evaluate the probabilities that these ratios are less than a fixed value. Based on this idea, Figure 4 displays probabilities that counterfactual reductions in the standard deviation of output growth are larger than fixed percentages of the actual reduction in the standard deviation of output growth. At one extreme, consider 0% of the actual change (i.e., no change). The probability that a change in shocks alone would have reduced volatility is high at about 0.9, while the probability that a change in propagation alone would have reduced volatility is low at about 0.3. At the other extreme, consider 100% of the actual change. The probability that a change in shocks alone would have reduced volatility by more than the actual change is just below 0.5, which would correspond to “even odds” that one reduction is larger than the other. The probability that a change in propagation alone would have reduced volatility by more than the actual change is 0. In between the extremes, these probabilities are useful for illustrating the economic significance of a change in volatility. In particular, there is a reasonably high probability (above 0.8) that the counterfactual change in volatility given a change in shocks alone would have lowered volatility by more than 75% of the actual reduction. Conversely, there is only a small probability (less than 0.05) that the counterfactual change in volatility given a change in propagation alone would have lowered volatility by even 25% of the actual reduction.

Given the primary role played by shocks in the overall volatility reduction, we examine the relative importance of AS and AD shocks separately. The fifth and sixth rows of Table 2 report results for the counterfactual standard deviations,  $\sigma_{\Delta y}^{(1,AS1/AD2)}$  and  $\sigma_{\Delta y}^{(1,AD1/AS2)}$ , corresponding to a change in AS shocks alone and a change in AD shocks alone, respectively. The results suggest that AS shocks are more successful than AD shocks at generating a large reduction in

volatility. The median for  $\sigma_{\Delta y}^{(1,AS1/AD2)}$ , which corresponds to a change in AD shocks alone, is only a bit lower than that of the actual standard deviation,  $\sigma_{\Delta y}^{(1,1)}$ , in the pre-break period. By contrast, the median for  $\sigma_{\Delta y}^{(1,AD1/AS2)}$ , which corresponds to a change in AS shocks alone, is closer to that of the actual standard deviation,  $\sigma_{\Delta y}^{(2,2)}$ , in the post-break period, although the lower quartile for  $\sigma_{\Delta y}^{(1,AD1/AS2)}$  is still above the upper quartiles for  $\sigma_{\Delta y}^{(2,2)}$  and  $\sigma_{\Delta y}^{(2,1)}$ , suggesting that AS shocks could not have generated the entire volatility reduction on their own. These results are evident in Figure 5, which displays the posterior densities for the actual and individual shock counterfactual standard deviations of output growth. Much of the posterior density for the counterfactual standard deviation given a change in AS shocks alone lies below the density for the counterfactual standard deviation given a change in AD shocks alone, although these counterfactuals are clearly less precisely estimated than the actual standard deviations.

Figure 6 displays the probabilities that the counterfactual reductions in volatility implied by changes in one type of shock alone are larger than fixed percentages of the actual reduction in the standard deviation of output growth. For both AS and AD shocks, there is a high probability that the corresponding counterfactual change would have reduced volatility, with the probability above 0.9 for AS shocks and above 0.8 for AD shocks. At the same time, there is a low probability that either AS shocks alone or AD shocks alone would have generated the entire reduction, with the probability about 0.1 for AS shocks and about 0.05 for AD shocks. There is a higher probability of a large volatility reduction for AS shocks alone than for AD shocks alone, with “even odds” that a change given AS shocks alone is about 60% of the actual reduction and a change given AD shocks alone is about 25% of the actual reduction.

## 6. Robustness

There are some issues with Blanchard and Quah's (1989) structural VAR based on a long-run restriction that potentially argue for consideration of a short-run structural VAR instead. First, the long-run identification presented above is predicated on the assumption that there is only one type of AS shock and one type of AD shock, where "type" is defined in terms of the impact of the shock on the dynamic relationship between output and unemployment. If there are multiple types of AS and AD shocks, then it would be important to include additional variables and allow for additional shocks in the structural VAR. However, it is, arguably, much more practical to include a larger number of variables in a short-run structural VAR and still identify key structural shocks. Second, from an econometric perspective, identification based on the spectral density at frequency zero, as is done with long-run restrictions, is much weaker than identification based on the short-run variance-covariance matrix of forecast errors (see Faust and Leeper, 1997, on this point). In particular, estimates of the spectral density at frequency zero can be highly sensitive to the number of lags included in estimation, while estimates of the short-run variance-covariance matrix are somewhat more stable.

With these concerns in mind, we conduct a robustness check on our main model by also considering a short-run monetary VAR along the lines of what was considered in Boivin and Giannoni (2003) and Ahmed, Levin, and Wilson (2004). The short-run monetary VAR model includes output growth, consumer-price inflation, commodity-price inflation, and the monetary policy instrument and identifies monetary shocks on the basis of the short-run restriction of delayed responses for output and prices to monetary shocks. Specifically, in terms of the notation in Section 4, the impact matrix  $\beta_0$  for the structural model is assumed to be lower triangular, with the policy instrument variable being the last element of  $Y_t$ . Identification is based on the

Choleski factorization of the variance-covariance matrix  $\Omega$ , with normalization of the size of shocks being in terms of their initial impact on their associated variable (e.g., the monetary shock in terms of the monetary policy variable).

The data series for output growth is the same as before. The series for the inflation variables are 100 times the log first differences of the U.S. CPI and the Commodity Research Bureau Spot Price Index for all Commodities, respectively. The series for the monetary policy instrument is the level of the federal funds rate. As before, we sample seasonally-adjusted (when applicable) measures at a quarterly frequency for the period of 1960:Q1 to 2005:Q4 and the raw data were obtained from the St. Louis Fed website (<http://www.stls.frb.org/fred/>). The number of lags and the priors are the same as before, with only a change in the number of variables in the VAR model.

Table 3 presents quartiles for the posterior distributions of the actual and counterfactual standard deviations of output growth given estimation based on the short-run monetary VAR. The results are qualitatively very similar to those in Table 2. A change in propagation alone generates a standard deviation that is close to the standard deviation in the pre-break period, while a change in shocks alone generates a standard deviation that is close to the standard deviation in the post-break period. Also, consistent with the findings for AD shocks, monetary shocks appear to generate only a small reduction in volatility. Meanwhile, these results are qualitatively very similar to the findings in Stock and Watson (2002), Boivin and Giannoni (2003), and Ahmed, Levin, and Wilson (2004), but our results provide statistical credibility for the idea that shocks, not propagation, could have generated the volatility reduction in U.S. output growth.

## 6. Conclusions

We develop a Bayesian approach to making inferences about counterfactual quantities. Importantly, the Bayesian approach provides posterior densities that give a sense of statistical precision about counterfactual quantities and allow us to evaluate the probability of economically significant changes in those quantities.

We apply this approach to study the sources of the “Great Moderation” of U.S. output growth volatility in the 1980s. The results support the notion that this reduction in volatility was largely driven by good luck in the form of smaller shocks hitting the economy rather than changes in the propagation of those shocks. Furthermore, we find that a change in the size of aggregate demand shocks and monetary shocks would not have generated much of a volatility reduction on their own.

## Appendix

### *A.1 Identification of Structural VAR via Long-Run Restrictions*

The structural VAR in (6) is identified using a long-run restriction, as in Blanchard and Quah (1989). Long-run identification proceeds by assuming that there is no long-run effect of the aggregate demand shock on the level of output ( $y_t$ ). Technically, the spectral density of the aggregate demand component of output growth is equal to zero at frequency zero. Given (5) and (6), the spectral density for  $X_t$  at frequency zero is proportional to the long-run variance-covariance matrix, denoted  $\Lambda$ ,

$$\Lambda = \Psi(1)\Omega\Psi(1)' = \beta(1)D\beta(1)'. \quad (\text{A1})$$

In order for the aggregate demand component of output growth to have a spectral density of zero at frequency zero,  $\beta(1)$  must be lower triangular. That is, the aggregate demand shock does not contribute to the permanent movements in output. In practice, identification proceeds by constructing  $\Lambda$  using  $\Psi(1)$  and  $\Omega$  from the reduced-form model. Then, the Choleski factorization of  $\Lambda$  provides a unique lower triangular matrix that is equivalent to  $\beta(1)D^{1/2}$ .

Given  $\beta(1)D^{1/2}$ , full identification of the structural model follows from the relationship between the reduced-form forecast errors and the structural shocks implied by the assumption that forecast errors and structural shocks are both uncorrelated across time:

$$e_t = \beta_0 \varepsilon_t. \quad (\text{A2})$$



Then, substituting (A2) into (6) implies:

$$\Psi(L)\beta_0 = \beta(L). \quad (\text{A3})$$

The condition (A3) is general and holds for the following case:

$$\Psi(1)\beta_0 = \beta(1). \quad (\text{A4})$$

Rearranging and multiplying both sides by  $D^{1/2}$ , we can determine the un-normalized impact matrix  $\theta_0 = \beta_0 D^{1/2}$ :

$$\theta_0 = \Psi(1)^{-1} \beta(1) D^{1/2}. \quad (\text{A5})$$

Then, given (A5) and the normalization of shocks in terms of their initial impact on output growth, we can solve for  $\beta_0$  and  $D$  as follows:

$$\beta_0 = \begin{bmatrix} 1 & 1 \\ \theta_{0,21}/\theta_{0,11} & \theta_{0,22}/\theta_{0,12} \end{bmatrix}, \quad D = \begin{bmatrix} \theta_{0,11}^2 & 0 \\ 0 & \theta_{0,12}^2 \end{bmatrix}. \quad (\text{A6})$$

## A.2 Bayesian Estimation of the Reduced Form VAR via the Gibbs Sampler

We begin by writing the reduced-form VAR model in (9) in matrix notation. Define the vectors  $\Delta \tilde{y} = (\Delta y_1, \dots, \Delta y_T)'$ ,  $\tilde{u} = (u_1, \dots, u_T)'$ , and  $\tilde{e}_i = (e_{i1}, \dots, e_{iT})'$  and form the matrices

$Y = [\Delta \tilde{y} \quad \tilde{u}]$ ,  $X = [\tilde{1} \quad Y_{-1} \quad \dots \quad Y_{-p}]$ , and  $e = [\tilde{e}_1 \quad \tilde{e}_2]$ , where  $Y_{-k}$  holds the  $k^{th}$  lag of  $\Delta \tilde{y}$  and  $\tilde{u}$ . The model in (9) is then equivalently written as:

$$Y = X\Pi + e. \quad (A7)$$

Again, we are interested in the case where the parameters of the reduced-from VAR undergo a one-time structural break at the breakdate  $\tau$ . Thus, the model in (A7) can be partitioned into the two subsamples:

$$\begin{aligned} Y^{(1)} &= X^{(1)}\Pi^{(1)} + e^{(1)} \\ Y^{(2)} &= X^{(2)}\Pi^{(2)} + e^{(2)}, \end{aligned} \quad (A8)$$

where  $Y^{(1)}$ ,  $X^{(1)}$ ,  $\Pi^{(1)}$  and  $e^{(1)}$  hold the first  $\tau - 1$  rows of  $Y$ ,  $X$ ,  $\Pi$  and  $e$  respectively, while  $Y^{(2)}$ ,  $X^{(2)}$ ,  $\Pi^{(2)}$  and  $e^{(2)}$  hold last the  $T - (\tau - 1)$  rows of  $Y$ ,  $X$ ,  $\Pi$  and  $e$  respectively.

The model in (A8) can be estimated in a Bayesian framework using the Gibbs Sampler.

In particular, starting with arbitrary initial values for  $\Omega^{(1)}$ ,  $\Omega^{(2)}$  and  $\tau$ , the Gibbs sampler proceeds by iterating the following three steps:

1. Generate  $vec(\Pi^{(1)})$  and  $vec(\Pi^{(2)})$  from their conditional posterior density given

previous values for  $\Omega^{(1)}$ ,  $\Omega^{(2)}$  and  $\tau$ . This density is given by:

$$vec(\Pi^{(i)}) | \Omega^{(i)}, \tau, Y^{(i)}, X^{(i)} \sim N(\bar{\Pi}^{(i)}, \bar{\Sigma}^{(i)}),$$

$$\text{where } \bar{\Sigma}^{(i)} = \left( \underline{\Sigma}^{-1} + \Omega^{(i)-1} \otimes X^{(i)'} X^{(i)} \right)^{-1}, \quad \bar{\Pi}^{(i)} = \bar{\Sigma}^{(i)} \times (\underline{\Sigma}^{-1} \underline{\Pi} + (\Omega^{(i)-1} \otimes X^{(i)'}) vec(Y^{(i)})).$$

A generated value for  $\Pi^{(i)}$  is then formed from the generated value of  $vec(\Pi^{(i)})$ .

2. Generate  $\Omega^{(1)}$  and  $\Omega^{(2)}$  from their conditional posterior distribution given previous values for  $\Pi^{(1)}$ ,  $\Pi^{(2)}$  and  $\tau$ . This density is given by:

$$\Omega^{(i)-1} \mid \Pi^{(i)}, \tau, Y^{(i)}, X^{(i)} \sim W(\bar{\nu}^{(i)}, \bar{S}^{(i)}),$$

where  $\bar{\nu}^{(1)} = \underline{\nu} + \tau - 1$ ,  $\bar{\nu}^{(2)} = \underline{\nu} + T - (\tau - 1)$  and  $\bar{S} = (\underline{S}^{-1} + e'e)$ .

3. Generate  $\tau$  from its conditional posterior distribution given previous values of  $\Pi^{(1)}$ ,  $\Pi^{(2)}$ ,  $\Omega^{(1)}$ , and  $\Omega^{(2)}$ . This density is given by:

$$p(\tau \mid \Pi^{(1)}, \Pi^{(2)}, \Omega^{(1)}, \Omega^{(2)}, Y, X) \propto L(\tau \mid \Pi^{(1)}, \Pi^{(2)}, \Omega^{(1)}, \Omega^{(2)}, Y, X),$$

where the likelihood is evaluated for all possible breakdates between  $\kappa T$  and  $(1 - \kappa)T$ , with

$L(\tau \mid \Pi^{(1)}, \Pi^{(2)}, \Omega^{(1)}, \Omega^{(2)}, Y, X)$  equal to the joint Normal density of the data  $Y$  given

$\Pi^{(1)}, \Pi^{(2)}, \Omega^{(1)}, \Omega^{(2)}$  and  $\tau$ .

After a sufficient number of initial draws, the subsequent draws from the Gibbs sampler will no longer reflect the arbitrary starting values, but will behave like draws from the joint posterior density,  $p(\Pi^{(1)}, \Pi^{(2)}, \Omega^{(1)}, \Omega^{(2)}, \tau \mid Y, X)$ .

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**Table 1**

Quartiles of Posterior Distributions for Standard Deviations of Aggregate Supply and Aggregate Demand Shocks

	<i>Period</i>	<i>25<sup>th</sup> Percentile</i>	<i>Median</i>	<i>75<sup>th</sup> Percentile</i>
<i>Aggregate Supply</i>	1	2.79	3.38	3.77
	2	1.47	1.68	1.84
<i>Aggregate Demand</i>	1	1.08	1.92	2.71
	2	0.37	0.71	1.08

Notes: The structural shocks are normalized in terms of their initial impact on output growth. The standard deviations are expressed in terms of quarterly percentage points. Period 1 refers to the pre-break period and Period 2 refers to the post-break period.

**Table 2**  
Quartiles of Posterior Distributions for Standard Deviations of Real GDP Growth

	<i>Propagation</i>	<i>Shocks</i>	<i>25<sup>th</sup> Percentile</i>	<i>Median</i>	<i>75<sup>th</sup> Percentile</i>
<i>Actual</i>	1	1	4.37	4.66	5.00
	2	2	2.08	2.25	2.46
<i>Counterfactuals</i>	2	1	4.57	5.02	5.86
	1	2	2.11	2.32	2.68
<i>Individual Shock Counterfactuals</i>	1	AS 1 AD 2	3.46	4.02	4.60
	1	AD 1 AS 2	2.69	3.20	3.87

Notes: The standard deviations are expressed in terms of quarterly percentage points. Period 1 refers to the pre-break period and Period 2 refers to the post-break period. AS refers to aggregate supply. AD refers to aggregate demand.

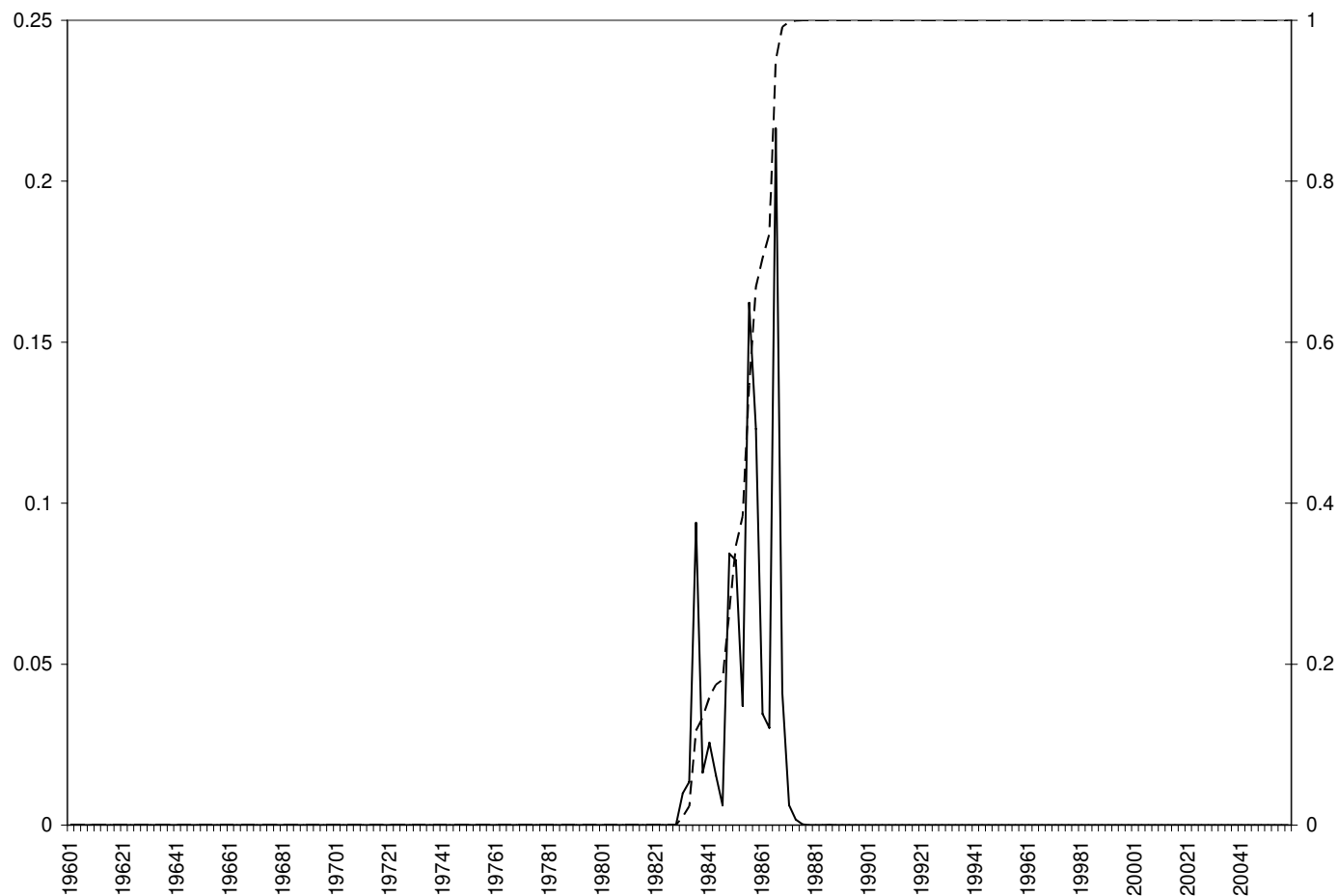
**Table 3**

Quartiles of Posterior Distributions for Standard Deviations of Real GDP Growth Based on a Short-Run Monetary VAR

	<i>Propagation</i>	<i>Shocks</i>	<i>25<sup>th</sup> Percentile</i>	<i>Median</i>	<i>75<sup>th</sup> Percentile</i>
<i>Actual</i>	1	1	4.72	5.06	5.52
	2	2	2.26	2.46	2.71
<i>Counterfactuals</i>	2	1	4.60	5.00	5.52
	1	2	2.46	2.67	2.94
<i>Individual Shock Counterfactuals</i>	1	Monetary 1 Other Shocks 2	3.05	3.33	3.73
	1	Other Shocks 1 Monetary 2	4.34	4.65	5.05

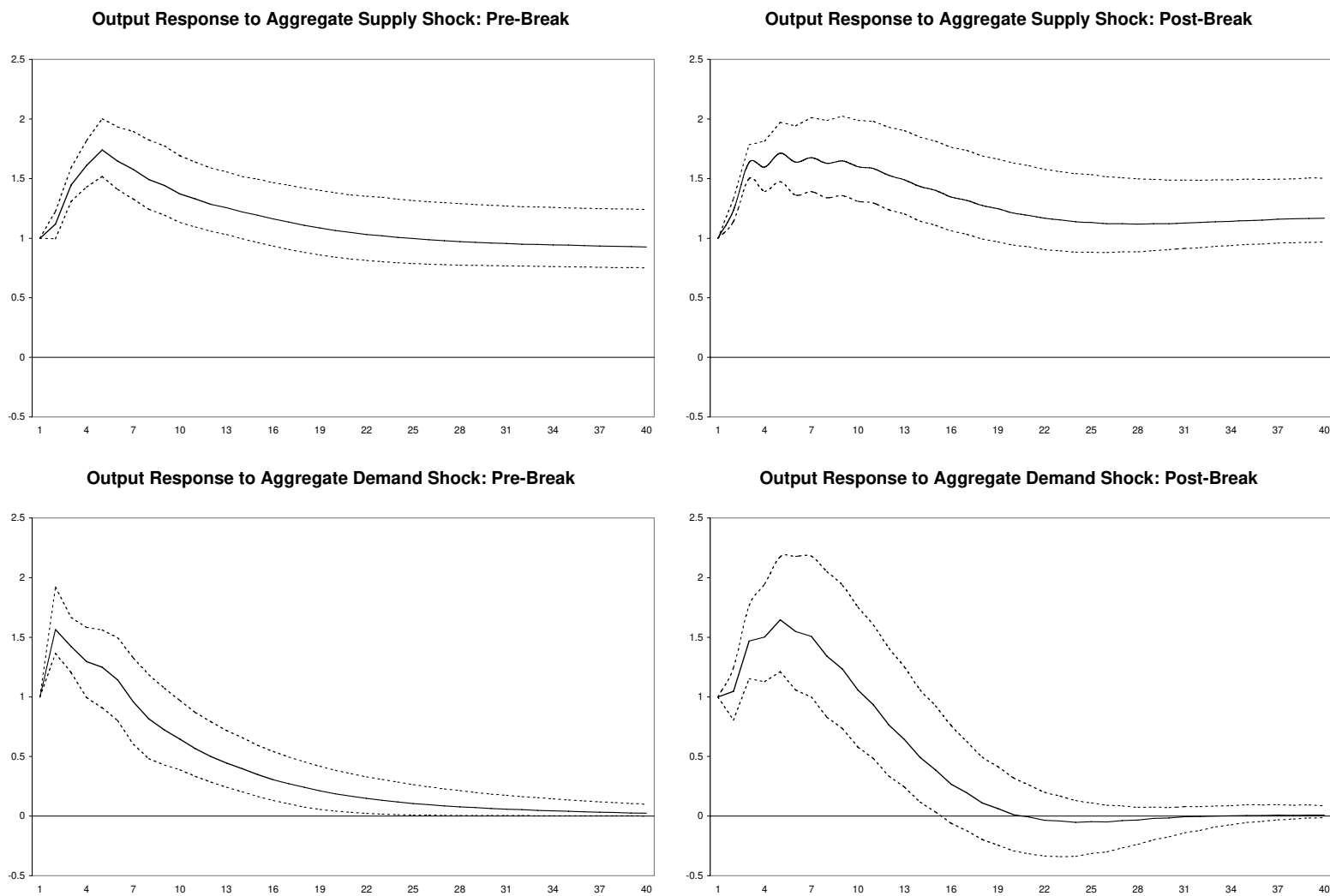
Notes: The standard deviations are expressed in terms of quarterly percentage points. Period 1 refers to the pre-break period and Period 2 refers to the post-break period. The results for this table are based on a short-run monetary VAR model of output growth, consumer price inflation, commodity price inflation, and the federal funds rate, with four lags and monetary shocks identified from the restriction that they impact output growth, consumer price inflation, and commodity price inflation only with a lag.





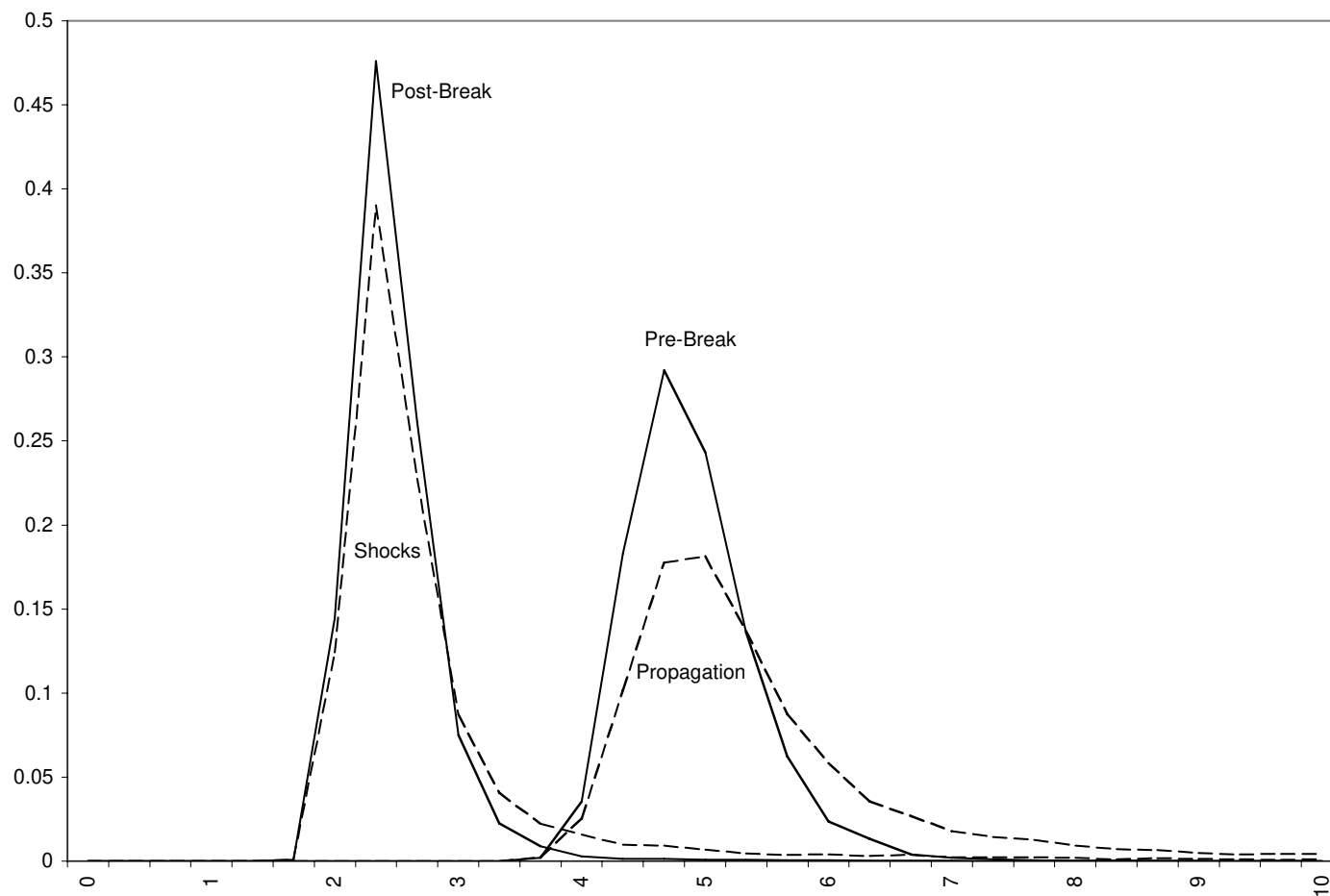
**Fig. 1 – Posterior Density for the Timing of the Structural Break**

Notes: The  $x$ -axis units are quarters in the sample period. The  $y$ -axis units refer to frequency as a fraction of the total number of simulations. The solid line is the simulated posterior density for the unknown breakdate. The dashed line is the corresponding cumulative distribution (right axis).



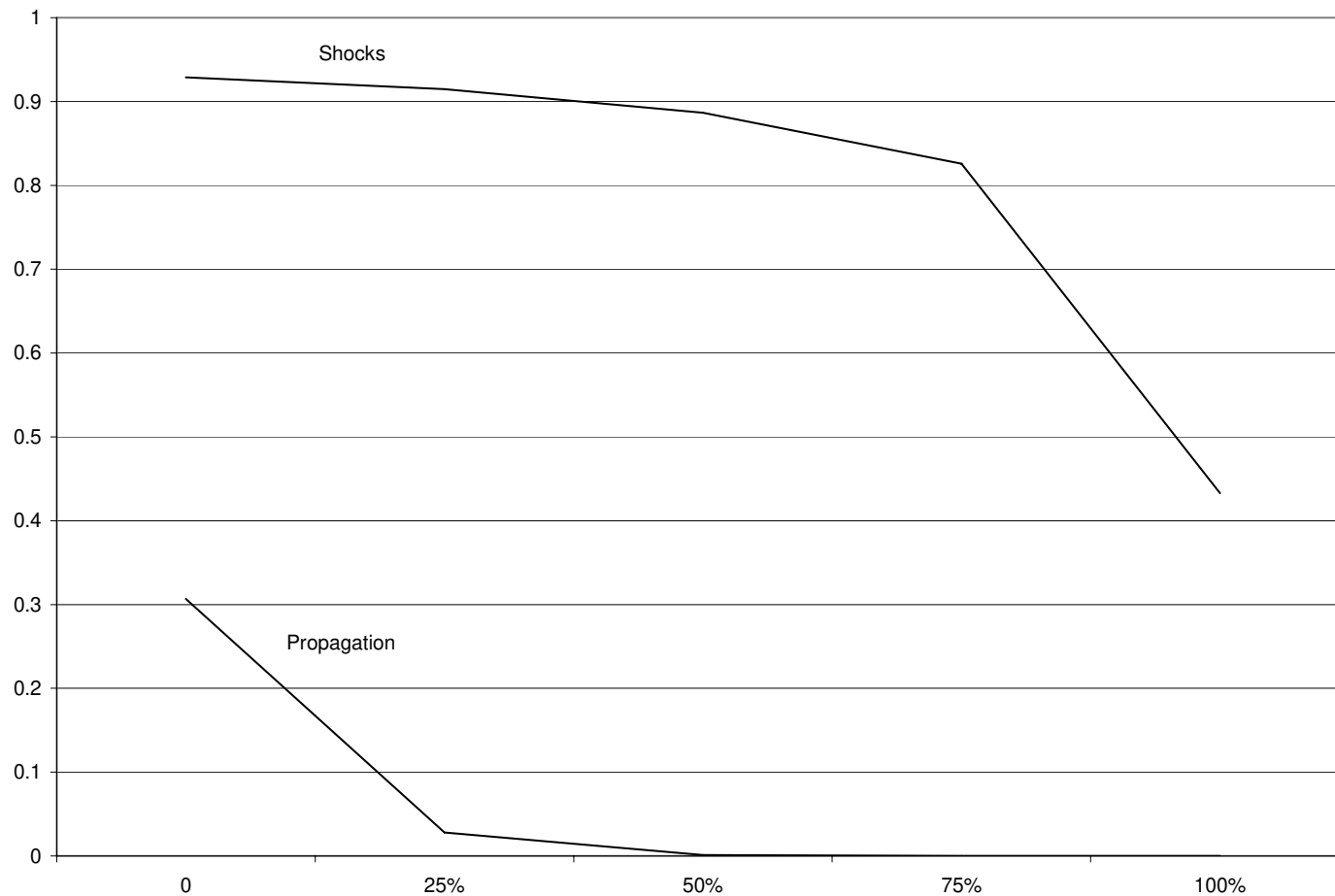
**Fig. 2 – Impulse Response Functions**

Note: The  $x$ -axis units are quarters after a shock. The  $y$ -axis units refer to impact of the shock on output. The results are based on simulated posterior distributions. The solid lines represent median responses. The dashed lines represent upper and lower quartile responses.



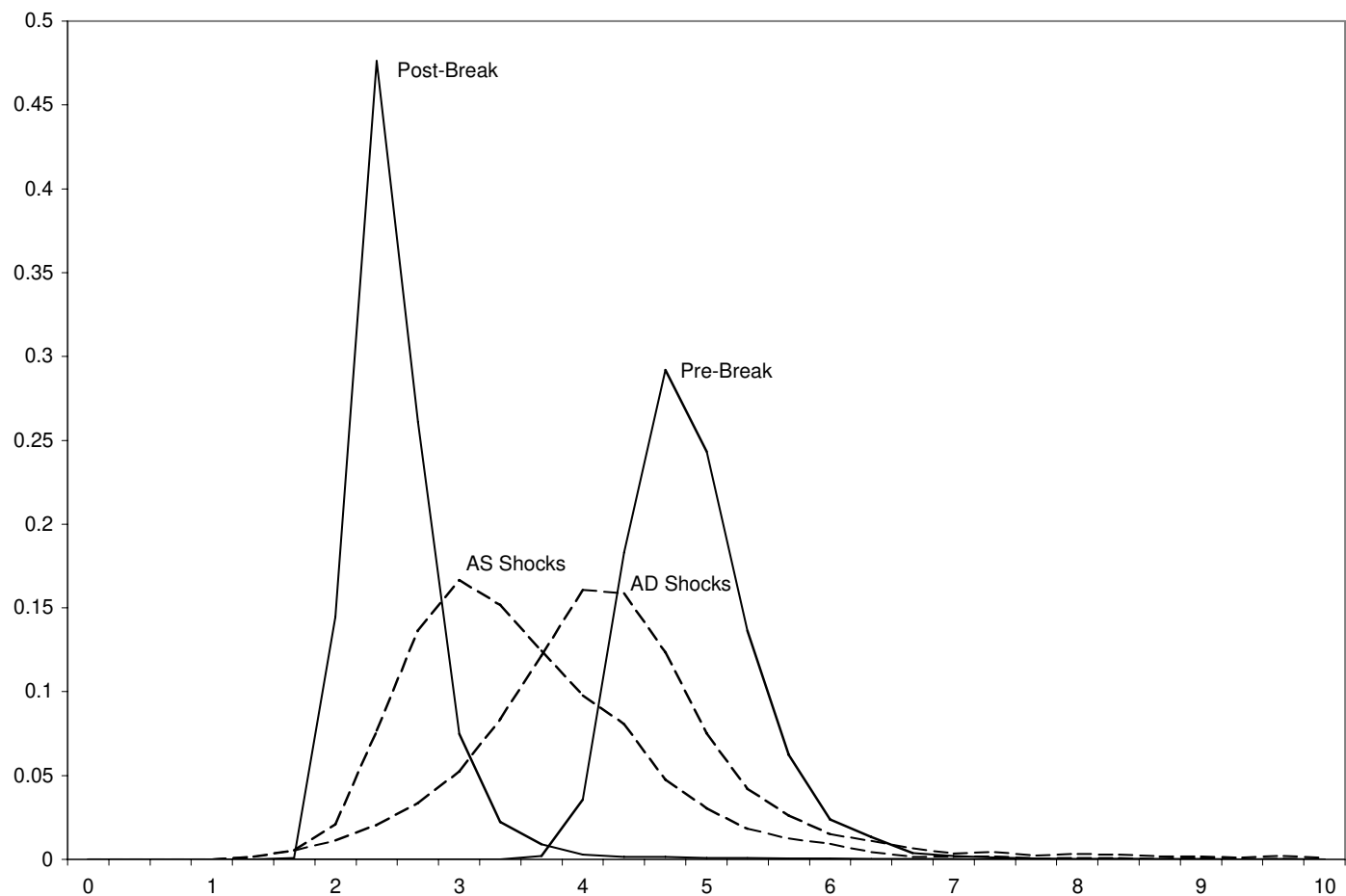
**Fig. 3 – Posterior Densities for Actual and Counterfactual Standard Deviations of Output Growth**

Notes: The  $x$ -axis units are values for the standard deviations expressed in terms of quarterly percentage points. The  $y$ -axis units refer to frequency as a fraction of the total number of simulations. The solid lines denote the simulated posterior densities for the pre-break and post-break periods. The dashed lines denote the simulated posterior densities for the counterfactuals, where “Shocks” refers to post-break shocks and pre-break propagation and “Propagation” refers to post-break propagation and pre-break shocks.



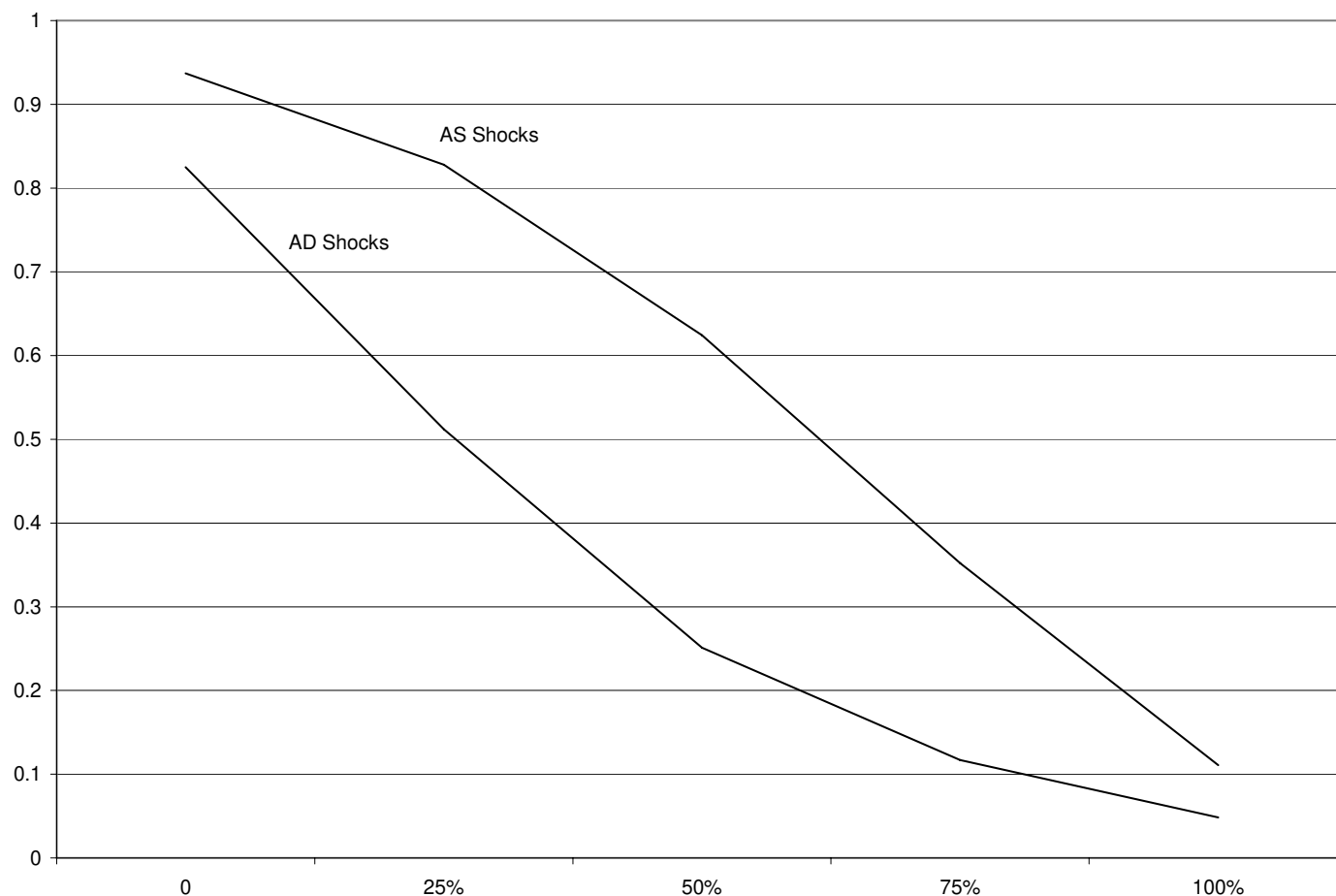
**Fig. 4 – Probabilities of Counterfactual Changes in Volatility**

Notes: The x-axis units are percentages of the actual change in the standard deviation of output growth. The y-axis units are probabilities. The solid lines denote the probabilities that the counterfactual reductions in volatility are larger than fixed percentages of the actual reduction in volatility, where “Shocks” refers to post-break shocks and pre-break propagation and “Propagation” refers to post-break propagation and pre-break shocks.



**Fig. 5 – Posterior Densities for Actual and Individual Shock Counterfactual Standard Deviations of Output Growth**

Notes: The  $x$ -axis units are values for the standard deviations expressed in terms of quarterly percentage points. The  $y$ -axis units refer to frequency as a fraction of the total number of simulations. The solid lines denote the simulated posterior densities for the pre-break and post-break periods. The dashed lines denote the simulated posterior densities for the counterfactuals, where “AS Shocks” refers to post-break aggregate supply shocks and pre-break aggregate demand shocks and propagation and “AD Shocks” refers to post-break aggregate demand shocks and pre-break aggregate supply shocks and propagation.



**Fig. 6 – Probabilities of Individual Shock Counterfactual Changes in Volatility**

Notes: The  $x$ -axis units are percentages of the actual change in the standard deviation of output growth. The  $y$ -axis units are probabilities. The solid lines denote the probabilities that the counterfactual reductions in volatility are larger than fixed percentages of the actual reduction in volatility, where “AS Shocks” refers to post-break aggregate supply shocks and pre-break aggregate demand shocks and propagation and “AD Shocks” refers to post-break aggregate demand shocks and pre-break aggregate supply shocks and propagation.