

## Theoretical Models: Key

1. Theoretical models often involve a tradeoff between realism and tractability. How to balance these two goals often depends on the context. For the Federal Reserve, their models play an important role in making forecasts that are then used to manage expectations and set policy. This places increased emphasis on realism.

For undergraduate macro classes, understanding the economic mechanisms behind the model is much more important than forecasting. This places greater weight on tractability which requires smaller models. In sum, the Fed should not start using 5 equation models and we should not start using 1800 equation models.

2. Like #1, this probably depends on the context. If the goal is to make forecasts, then I am tempted to say that empirical fit is more important. But if the goal is economic intuition, then I would argue that appealing assumptions are more important.

3. True, at least for the interesting ones. Most macroeconomic variables depend on innumerate factors. It would be impossible to include them all. Every model is thus underspecified. Even trying to include most of them will likely result in a convoluted model that is incomprehensible. Models exist to simplify a complicated world. The goal is to explain some important things, not everything.