

# Application of Dsge Models for the Analysis of Latvian Economic Processes

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## ABSTRACT

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Nowadays DSGE models are the mainstream of macroeconomic theory. DSGE stands for dynamic, stochastic, general equilibrium and the main purpose of these models is to perform the analysis of business cycle fluctuations and economic policy. The main advantage of DSGE models is related to their theoretical foundations – the dynamics of economic processes is described as interaction of rational optimizing agents, which react to “exogenous stochastic disturbances” (shocks). These advantage of DSGE models helps to analyse both economic processes on the aggregated level and individual markets under the circumstances of uncertainty. Historically, DSGE models have gone through several stages of development. The origins of DSGE models are related to Lucas critique – a series of papers, which presented a new approach of macroeconomic processes analysis. This approach was rather controversial with Keynesian theory. In the terms of R. Lucas, macroeconomic models must be based on microfoundations and consider expected variables, because the consideration of expectations in macroeconomic models best describes “the real economic situation” and makes these models suitable for economic policy development and analysis. The first DSGE models were basically RBC (Real Business Cycle) models, but their main drawback was assumption of neutrality of money, which made them not suitable for monetary policy analysis. Later DSGE models correct this drawback – contemporary DSGE models are used for various purposes, for instance, fiscal and monetary policy analysis.

**Keywords:** macroeconomic modelling, DSGE, Latvian economy