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Abstracts

What Ends Recessions?

CHRISTINA D. ROMER AND DAVID H. ROMER

We analyze the contributions of monetary and fiscal policy to postwar economic recoveries. We find that the Federal Reserve typically responds to downturns with prompt and large reductions in interest rates. Discretionary fiscal policy, in contrast, rarely reacts before the trough in economic activity, and even then the responses are usually small. Simulations using multipliers from both simple regressions and a large macroeconomic model show that the interest rate falls account for nearly all of the above average growth that occurs early in recoveries. Our estimates also indicate that on several occasions expansionary policies have contributed substantially to above normal growth outside of recoveries. Finally, the results suggest that the persistence of aggregate output movements is largely the result of the extreme persistence of the contribution of policy changes.

Toward a Modern Macroeconomic Model Usable for Policy Analysis

ERIC M. LEEPER AND CHRISTOPHER A. SIMS

A macroeconomic model is presented that is both a completely specified dynamic general equilibrium model and a probabilistic model for time series data. We view the model as a potential competitor to the existing IS/LM-based model that continues to be used for actual policy analysis. Our approach is also an alternative to recent efforts to calibrate real business cycle models. In contrast to these existing models, the one we present embodies all the following important characteristics: (1) It generates a complete multivariate stochastic process model for the data it aims to explain, and the full specification is used in the maximum likelihood estimation of the model; (2) it integrates modeling of nominal variables—money stock, price level, wage level, and nominal interest rate—with modeling real variables; (3) it contains a Keynesian investment function, breaking the tight relationship of the return on investment with the capital–output ratio; (4) it treats both monetary and fiscal policy explicitly; and (v) it is based on dynamic optimizing behavior of the private agents in the model. Flexible-price and sticky-price versions of the model are estimated, and their fits are evaluated relative to a naive model of no change in the variables and to an unrestricted vector autoregression (VAR). The model's implications for the dynamic responses to structural shocks are displayed, including policy shocks, and evaluates the relative importance of various shocks for determining economic fluctuations.

The U.S. Fiscal Problem: Where We Are, How We Got Here, and Where We're Going

ALAN J. AUERBACH

Several issues are dealt with regarding the causes and implications of recent and projected U.S. federal budget deficits. The author considers why deficits have remained so large in spite of deficit reduction efforts, evaluates the impact of the recent policies of the Clinton administration, and offers long-range deficit projections. Among his findings are the following:

1. Until the past year, deficit projections over the past decade have been consistently too optimistic; had initial projections for the current fiscal year proved accurate, the deficit-reducing policies of the early 1990s already would have driven the federal budget well into surplus; there is no single explanation for these large and systematic forecasting errors.
2. The budget rules that legislators have developed to control deficits, including those now in effect, are ill-designed for their apparent purpose. They fail to compensate for forecasting errors and encourage shifts in the timing of revenues and expenditures. The paper presents evidence that such shifting has followed the incentives of the different schemes.
3. The projected decline in the deficit as a share of gross domestic product (GDP) over the next few years reflects not only the policies already enacted but also the continuation of significant real reductions in discretionary spending—representing a drop of 2.2% of GDP between 1994 and 2004.
4. Eve if such optimistic forecasts prove to be correct, longer-run projections suggest that current fiscal policy is unsustainable. Without any growth in the relative price of health care, the demographic transition still is projected to lead to sharp increases in Social Security and Medicare benefits as a share of GDP, and primary deficits of nearly 4% of GDP.

Reconsidering the Costs of Business Cycles with Incomplete Markets

ANDREW ATKESON AND CHRISTOPHER PHELAN

We measure the potential welfare gains from countercyclical policy in an economy with incomplete markets. In the course of conducting this measure-

ment, we focus on two questions as central to the determination of those potential gains: (1) What is the likely effect of countercyclical policy on the nature of the income risk faced by individuals in the economy, (2) What are the likely general equilibrium effects brought about as asset prices change due to the implementation of countercyclical policies? In taking up the first question, we see it as critical to distinguish whether the main effect of countercyclical policy is to reduce directly the income risk faced by each individual or is simply to reduce the correlation across individuals in the income risk that they face. We present a model of the wage and employment risk faced by individuals over the cycle in which the levels of those risks are chosen endogenously. On the basis of that model, we argue that the main effect of countercyclical policy aimed at reducing aggregate fluctuations may be simply to remove the correlation across individuals in the unemployment risk that they face. We then use asset price data to argue that in an incomplete markets framework, the potential welfare gains from countercyclical policy are close to zero.

The East Asian Miracle: Four Lessons for Development Policy

JOHN PAGE

Four public policy lessons of the East Asian miracle are examined. The argument is made that eight East Asian economies can be distinguished from other developing countries on the basis of three common characteristics—rapid, persistent, and shared growth. A growth accounting exercise based on cross-country data indicates that while accumulation was the primary source of growth, total factor productivity (TFP) change was also significant. Macroeconomic stability and broad-based education are found to have contributed significantly to both accumulation and TFP change. The conclusion is made that manufactured export orientation rather than industrial policy played the dominant role in increasing economywide TFP growth rates.

On the Speed of Transition in Central Europe

PHILIPPE AGHION AND OLIVIER JEAN BLANCHARD

Transition in Central Europe is four years old. State firms that dominated the economy are struggling with market forces. A new private sector quickly emerged and has taken hold. Unemployment, which did not exist, is high and still increasing. Will this process of transition accelerate or slow down? Will unemployment keep increasing? Can things go wrong and how? We make a first pass at answering those questions. The basic structure of the model we develop is standard, that of the transition from a low to a high productivity sector. But we pay attention to two aspects that strike us as important. The first are the interactions between unemployment and the decisions of both state and private firms. The second are the idiosyncracies that come from the central planning legacy, from the structure of control within state firms to the lack of many market institutions, which limits private sector growth. We start with a description of transition in Poland so far. We then develop a model and use it to think about the determinants of the speed of transition and the level of unemployment. Finally, we return to the role of policy and the future in Poland, as well as the causes of cross-Central European country variations.