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Editorial

Mark Gertler and Kenneth Rogoff

This year's twentieth edition of the NBER *Macroeconomics Annual* once again hosts a range of debates at the cutting edge of the field. Many of the issues covered here, including the sources of European unemployment and churn in U.S. labor markets, the causes of the twenty-year trend decline in volatility of U.S. output, and the appropriate targets for monetary policy, are already central to the policy debate. Here, thanks not only to the lucid analyses of the authors, but also the often contrasting views of the two discussants for each paper, the reader gets an extraordinary opportunity to understand key issues driving the debates.

Few other issues have been as vexing for global policymakers as the failure of Europe to generate the same economic dynamism as the United States. A core question is why European employment levels (averaging 60–65 percent of the adult workforce) are so much lower than employment levels in the United States (averaging over 75 percent of the adult workforce). Recently, 2004 Nobel Laureate Edward Prescott has touched off a sharp debate by arguing that most of the differences can be explained by higher tax rates in Europe and their effects on discouraging labor force participation. In their paper, "Work and Leisure in the United States and Europe: Why So Different?" Alberto Alesina, Edward Glaeser, and Bruce Sacerdote follow Olivier Blanchard and others in taking issue with Prescott's analysis, arguing that microeconomic evidence argues strongly against the high labor supply elasticities Prescott requires to support his quantitative estimates. They also show that neither the cross-country evidence within Europe nor the time series evidence is particularly supportive of the tax differential view. They argue instead that low employment ratios in Europe reflect a combination of historic choices made by Europe's still powerful labor unions, as well as Europeans' preference for being

able to coordinate leisure time. As friends and relatives take more leisure, individual Europeans in turn find themselves desiring to do more of the same. It will be interesting to see if similar explanations can explain differentials between the East and West Coasts of the United States.

Also, what is the key driver of increases in unemployment during recessions? Over the past twenty-five years, and especially since the seminal work of Clark and Summers, and Davis and Haltiwanger, macroeconomists have increasingly come to appreciate the importance of churn in labor markets: the gross rates of quits and layoffs swamps the net rate as a remarkably high percentage of the labor force changes jobs each year, particularly in the United States with its highly flexible labor market. As Federal Reserve Chair Alan Greenspan has often emphasized, an average of 1 million Americans change jobs each week (out of a labor force of approximately 100 million), and roughly the same number find jobs each week as well. Are recessions characterized by a balanced rise in lost jobs and fall in new jobs, or does something very different go on? In his provocative paper "Job Loss, Job Finding, and Unemployment in the U.S. Economy over the Past Fifty Years," Robert E. Hall argues that variation in the unemployment rate in the United States derives almost entirely from fluctuations in the hiring rate of new workers, as opposed to job separations, which he argues are relatively constant over the cycle. He argues that these new results, also emphasized in work by Robert Shimer, are a challenge to standard theories that emphasize fluctuations in layoffs as the primary source of unemployment fluctuations. His discussants provide interesting alternative points of view.

One of the striking features of most Organisation for Economic Co-operation and Development (OECD) economies over the past twenty years, but particularly the United States, is the trend decline in macroeconomic volatility that has taken place since 1985. Is it due to better policy, particularly monetary policy? Or is the main cause better financial markets or something else entirely? In their paper "The Rise in Firm-Level Volatility: Causes and Consequences," Diego Comin and Thomas Philippon point out the interesting fact that whereas aggregate volatility may have been falling, firm-level volatility has actually been *rising*. They explore a number of alternative explanations of this striking contrast, including the possibility that the change is due to shifts in technology and to deepening of financial markets. They find an

especially interesting correlation between volatility and spending on research and development.

Over the past ten years, many central banks have increasingly come to focus on targeting inflation rates in setting interest rate policy. Should they be focusing on targeting wage inflation instead? Andrew T. Levin, Alexei Onatski, John C. Williams, and Noah Williams, in their paper "Monetary Policy Under Uncertainty in Micro-Founded Macroeconometric Models," develop a second-generation microeconomic-based model of macroeconomic fluctuations, with Bayesian parameter estimates that allow the data to influence initial parameter estimates based on the authors' prior beliefs. They then use the estimated model to compare optimal policy (in terms of the welfare of the representative household) with a range of simple implementable rules. Remarkably, they find that a simple wage-inflation rule for monetary policy is considerably better than the best inflation-targeting rule, and only slightly worse quantitatively than the optimal rule. The paper is notable in embodying a broad consensus in macroeconomics on how to model monetary policy and business-cycle dynamics. An important issue raised by Carl E. Walsh, one of the two discussants for the paper, is the potential sensitivity of the results compared to the 1980s Volcker disinflation, a difficult problem in general for any time-series approach limited to the United States and the postwar period.

Bayesian estimation of micro-based macroeconomic models is also featured in Thomas Lubik's and Frank Schorfheide's paper, "A Bayesian Look at New Open Economy Macroeconomics." Their paper offers a useful roadmap for researchers aiming to estimate both small-country and simple two-country macroeconomic models using Bayesian methods, with a particular emphasis on how to deal with potential misspecification and identification problems. Their paper not only offers useful potential insights into a number of empirical puzzles, it helps illustrate how Bayesian approaches might be useful in communicating the results of large macroeconomic models to a wider public.

Stephanie Schmitt-Grohé and Martín Uribe explore "Optimal Fiscal and Monetary Policy in a Medium-Scale Macroeconomic Model." As do the other dynamic stochastic general equilibrium models presented in this volume, their paper allows for a number of realistic real-world rigidities and frictions. A core result is that optimal policy calls for a relatively stable inflation rate even in situations where a number of factors (such as the presence of nominal non-state-contingent debt,

no lump-sum taxes, and sticky wages) would seem to create strong incentives for highly variable inflation. Their paper suggests that central banks' incentives to maintain relatively stable inflation rates over the coming decades may be more stable than is sometimes believed.

The authors would like to take this opportunity to thank Martin Feldstein and the National Bureau of Economic Research for their continued support of the NBER *Macroeconomics Annual* and its associated conference; the NBER's conference staff, especially Rob Shannon, for excellent logistical support; and the National Science Foundation for financial assistance. Stacia Joy Sowerby did an excellent job as conference rapporteur and editorial assistant for this volume. Finally, we are deeply grateful to Jane Trahan for her tireless efforts in assisting with editing the manuscript and helping to manage the production process.

This volume is Mark Gertler's last as co-editor. He wishes to thank Martin Feldstein for the honor of following in the footsteps of the many outstanding co-editors of the *Macroeconomics Annual* and also Kenneth Rogoff for being a great partner in this undertaking.

Abstracts

1 Work and Leisure in the United States and Europe: Why So Different?

Alberto Alesina, Edward Glaeser, and Bruce Sacerdote

Americans average 25.1 working hours per person of working age per week, but the Germans average 18.6 hours. The average American works 46.2 weeks per year, while the French average 40 weeks per year. Why do western Europeans work so much less than Americans? Recent work argues that these differences result from higher European tax rates, but the vast empirical labor-supply literature suggests that tax rates can explain only a small amount of the differences in hours between the United States and Europe. Another popular view is that these differences are explained by long-standing European culture, but Europeans worked more than Americans as late as the 1960s. In this paper, we argue that European labor-market regulations, advocated by unions in declining European industries who argued “work less—work all,” explain the bulk of the difference between the United States and Europe. These policies do not seem to have increased employment, but they may have had a more society-wide influence on leisure patterns because of a social multiplier where the returns to leisure increase as more people are taking longer vacations.

2 Job Loss, Job Finding, and Unemployment in the U.S. Economy over the Past Fifty Years

Robert E. Hall

New data compel a new view of events in the labor market during a recession. Unemployment rises almost entirely because jobs become harder to find. Recessions involve little increase in the flow of workers

out of jobs. Another important finding from new data is that a large fraction of workers departing jobs move to new jobs without intervening unemployment. I develop estimates of separation rates and job-finding rates for the past fifty years, using historical data informed by detailed recent data. The separation rate is nearly constant, while the job-finding rate shows high volatility at business-cycle and lower frequencies. I review modern theories of fluctuations in the job-finding rate. The challenge to these theories is to identify mechanisms in the labor market that amplify small changes in driving forces into fluctuations in the job-finding rate of the high magnitude actually observed. In the standard theory developed over the past two decades, the wage moves to offset driving forces, and the predicted magnitude of changes in the job-finding rate is tiny. New models overcome this property by invoking a new form of sticky wages or by introducing information and other frictions into the employment relationship.

3 The Rise in Firm-Level Volatility: Causes and Consequences

Diego Comin and Thomas Philippon

We document that the recent decline in aggregate volatility has been accompanied by a large increase in firm-level risk. The negative relationship between firm-level and aggregate risk seems to be present across industries in the United States and across OECD countries. Firm-level volatility increases after deregulation, and it is linked to research and development (R&D) spending, as well as access to external financing. Further, R&D intensity is also associated with lower correlation of sectoral growth with the rest of the economy.

4 Monetary Policy Under Uncertainty in Micro-Founded Macroeconometric Models

Andrew T. Levin, Alexei Onatski, John C. Williams, and Noah Williams

We use a micro-founded macroeconometric modeling framework to investigate the design of monetary policy when the central bank faces uncertainty about the true structure of the economy. We apply Bayesian methods to estimate the parameters of the baseline specification using postwar U.S. data and then determine the policy under commitment that maximizes household welfare. We find that the performance of the optimal policy is closely matched by a simple operational rule

that focuses solely on stabilizing nominal wage inflation. Furthermore, this simple wage stabilization rule is robust to uncertainty about the model parameters and to various assumptions regarding the nature and incidence of the innovations. However, the characteristics of optimal policy are very sensitive to the specification of the wage-contracting mechanism, thereby highlighting the importance of additional research regarding the structure of labor markets and wage determination.

5 A Bayesian Look at New Open Economy Macroeconomics

Thomas Lubik and Frank Schorfheide

This paper develops a small-scale two-country model following the new open economy macroeconomics paradigm. Under autarky, the model specializes to the familiar three-equation New Keynesian dynamic stochastic general equilibrium (DSGE) model. We discuss two challenges to successful estimation of DSGE models: potential model misspecification and identification problems. We argue that prior distributions and Bayesian estimation techniques are useful to cope with these challenges. We apply these techniques to the two-country model and fit it to data from the United States and the Euro area. We compare parameter estimates from closed and open economy specifications, study the sensitivity of parameter estimates to the choice of prior distribution, examine the propagation of monetary policy shocks, and assess the model's ability to explain exchange-rate movements.

6 Optimal Fiscal and Monetary Policy in a Medium-Scale Macroeconomic Model

Stephanie Schmitt-Grohé and Martín Uribe

In this paper, we study Ramsey-optimal fiscal and monetary policy in a medium-scale model of the U.S. business cycle. The model features a rich array of real and nominal rigidities that have been identified in the recent empirical literature as salient in explaining observed aggregate fluctuations. The main result of the paper is that price stability appears to be a central goal of optimal monetary policy. The optimal rate of inflation under an income-tax regime is $\frac{1}{2}$ percent per year, with a volatility of 1.1 percent. This result is surprising given that the model features a number of frictions—particularly nonstate-contingent nominal

public debt, no lump-sum taxes, and sticky wages—that, in isolation, would call for a volatile rate of inflation. Under an income-tax regime, the optimal income-tax rate is quite stable, with a mean of 30 percent and a standard deviation of 1.1 percent. Simple monetary and fiscal rules are shown to implement a competitive equilibrium that mimics well the one induced by the Ramsey policy. When the fiscal authority is allowed to tax capital and labor income at different rates, optimal fiscal policy is characterized by a large and volatile subsidy on capital.