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# Abstracts

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## *"Rules vs. Discretion" after Twenty-five Years*

NANCY L. STOKEY

Two models of government policy are presented. In the first the choice of an instrument for conducting monetary policy is analyzed. The ease of observing policy under an exchange-rate regime is shown to confer an advantage on it compared with a regime that targets the money growth rate. In the second a discretionary fiscal regime is compared with one that mandates a simple policy rule restricting capital taxation. The discretionary regime is preferred under a Ramsey government, but the rule confers an advantage if the type of government is uncertain and the probability of a myopic administration is high enough.

## *Current Accounts in the Long and the Short Run*

AART KRAAY AND JAUME VENTURA

Faced with income fluctuations, countries smooth their consumption by raising (lowering) savings when income is high (low). How much of these savings do countries invest at home and abroad? In other words, what are the effects of fluctuations in savings on domestic investment and the current account? In the long run, we find that countries invest the marginal unit of savings in domestic and foreign assets in the same proportions as in their initial portfolio, so that the latter is remarkably stable. In the short run, we find that countries invest the marginal unit of savings mostly in foreign assets, and only gradually do they rebalance their portfolio back to its original composition. This means that countries try to smooth not only consumption, but also domestic investment. To achieve this, they use foreign assets as a buffer stock.

## *Productivity Growth in the 2000s*

J. BRADFORD DELONG

A near-consensus sees the cause of the productivity speedup of the 1990s in the information technology (IT) sector. The pace of invention and innovation in that sector generated real price declines of between ten and twenty percent per year for

decades. Increased productivity in the IT capital-goods-producing sector, coupled with real capital deepening as the quantity of investment bought by a dollar of nominal savings grows, has driven the productivity speedup. Will this higher level of productivity growth persist? The answer appears to be “probably.” The most standard of applicable growth models predicts that the social return to IT investment would have to suddenly drop to near zero for the upward jump in productivity growth to reverse itself. More complicated models that focus in more detail on the determinants of investment spending or on the sources of increased total factor productivity strengthen, not weaken, forecasts of productivity growth over the next decade.

### *Has the Business Cycle Changed and Why?*

JAMES H. STOCK AND MARK W. WATSON

From 1960 to 1983, the standard deviation of annual growth rates in real GDP in the United States was 2.7%. From 1984 to 2001, the corresponding standard deviation was 1.6%. This paper investigates this large drop in the cyclical volatility of real economic activity. The paper has two objectives. The first is to provide a comprehensive characterization of the decline in volatility using a large number of U.S. economic time series and a variety of methods designed to describe time-varying time-series processes. In so doing, the paper reviews the literature on the moderation and attempts to resolve some of its disagreements and discrepancies. The second objective is to provide new evidence on the quantitative importance of various explanations for this “great moderation.” Taken together, we estimate that the moderation in volatility is attributable to a combination of improved policy (20–30%), identifiable good luck in the form of productivity and commodity price shocks (20–30%), and other unknown forms of good luck that manifest themselves as smaller reduced-form forecast errors (40–60%).

### *Expenditure Switching and Exchange-Rate Policy*

CHARLES ENGEL

Changes in nominal exchange rates can lead to *expenditure switching* when they change relative international prices. A traditional argument for flexible nominal exchange rates posits that when prices are sticky in producers’ currencies, nominal-exchange-rate movements can change relative prices between home and foreign goods. But if prices are fixed *ex ante* in consumers’ currencies, nominal exchange-rate flexibility cannot achieve any relative price adjustment. In that case nominal-exchange-rate fluctuations have the undesirable feature that they lead to deviations from the law of one price. The case for floating exchange rates is weakened if prices are sticky in this way. The empirical literature appears to support the notion that prices are sticky in consumers’ currencies. Here, additional support for this conclusion is provided. We then review some new approaches in the theoretical literature that imply an important expenditure-switching role even when

consumer prices are sticky in consumers' currencies. Further empirical research is needed to resolve the quantitative importance of the expenditure-switching role for nominal exchange rates.

### *Optimal Currency Areas*

ALBERTO ALESINA, ROBERT J. BARRO, AND SILVANA TENREYRO

As the number of independent countries increases and their economies become more integrated, we would expect to observe more multicountry currency unions. This paper explores the pros and cons for different countries to adopt as an anchor the dollar, the euro, or the yen. Although there appear to be reasonably well-defined euro and dollar areas, there does not seem to be a yen area. We also address the question of how trade and comovements of outputs and prices would respond to the formation of a currency union. This response is important because the decision of a country to join a union would depend on how the union affects trade and comovements.

