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Abstracts

1. Dormant Shocks and Fiscal Virtue

Francesco Bianchi and Leonardo Melosi

We develop a theoretical framework to account for the observed instability of the link between inflation and fiscal imbalances across time and countries. Current policymakers' behavior influences agents' beliefs about the way debt will be stabilized. The standard policy mix consists of a virtuous fiscal authority that moves taxes in response to debt and a central bank that has full control over inflation. When policymakers deviate from this virtuous regime, agents conduct Bayesian learning to infer the likely duration of the deviation. As agents observe more and more deviations, they become increasingly pessimistic about a prompt return to the virtuous regime and inflation starts drifting in response to a fiscal imbalance. Shocks that were dormant under the virtuous regime now start manifesting themselves. These changes are initially imperceptible, can unfold over decades, and accelerate as agents' beliefs deteriorate. Dormant shocks explain the run-up of US inflation and uncertainty in the 1970s. The currently low long-term interest rates and inflation expectations might hide the true risk of inflation faced by the US economy.

2. Understanding Noninflationary Demand-Driven Business Cycles

Paul Beaudry and Franck Portier

During the last thirty years, US business cycles have been characterized by countercyclical technology shocks and almost constant inflation.

While the first fact runs counter to an RBC view of fluctuation and calls for demand shocks as a source of fluctuations, the second fact is difficult to reconcile with a New Keynesian model in which demand shocks, when accommodated, should be inflationary. In this paper we show that noninflationary demand-driven business cycles can be very easily explained if one moves away from the representative agent framework on which both the New Keynesian model and the RBC model are based. In particular, we first show how changes in demand induced by changes in perceptions about the future can cause business cycle type fluctuations in a Walrasian setting when agents' skills are specialized in different sectors. Such a model is able to generate demand-driven positive comovements of consumption, investment, and hours together with procyclical real wages and relative price of investment. To illustrate how the real mechanism we put forward works in the presence of sticky prices, we present a modified New Keynesian model with specialized agents where noninflationary demand-driven fluctuations arise as the outcome. We also document the relevance of the assumptions underlying our framework using PSID data over the period 1968 to 2007.

3. Reference Dependence and Labor Market Fluctuations

Kfir Eliaz and Ran Spiegler

We incorporate reference-dependent worker behavior into a search-matching model of the labor market, in which firms have all the bargaining power and productivity follows a log-linear AR(1) process. Motivated by Akerlof (1982) and Bewley (1999), we assume that existing workers' output falls stochastically from its normal level when their wage falls below a "reference point," which (following Köszegi and Rabin 2006) is equal to their lagged-expected wage. We formulate the model game-theoretically and show that it has a unique subgame perfect equilibrium that exhibits the following properties: existing workers experience downward wage rigidity, as well as destruction of output following negative shocks due to layoffs or loss of morale; newly hired workers earn relatively flexible wages, but not as much as in the benchmark without reference dependence; market tightness is more volatile than under this benchmark. We relate these findings to the debate over the "Shimer puzzle" (Shimer 2005).

4. Pledgability and Liquidity: A New Monetarist Model of Financial and Macroeconomic Activity

Venky Venkateswaran and Randall Wright

When limited commitment hinders credit, assets help by serving as collateral. We study models where assets differ in pledgability, and hence liquidity. Previous analyses focus on producers; we emphasize consumers. Household debt limits are determined by having assets seized after default. The framework, which nests standard growth and asset-pricing theory, is calibrated to analyze monetary policy and financial innovation. Inflation can raise output, employment, and investment, plus improve housing and stock markets. For the baseline calibration, optimal inflation is positive. Increases in pledgability can generate booms and busts in economic activity, but may still be good for welfare.

5. Shocks and Crashes

Martin Lettau and Sydney C. Ludvigson

Three shocks, distinguished by whether their effects are permanent or transitory, are identified to characterize the postwar dynamics of aggregate consumer spending, labor earnings, and household wealth. The first shock accounts for virtually all of the variation in consumption; we argue that it can be plausibly interpreted as a permanent total factor productivity shock. The second shock, which underlies the vast bulk of quarterly fluctuations in labor income growth, permanently reallocates rewards between shareholders and workers but leaves consumption unaffected. Over the last twenty-five years, the cumulative effect of this shock has persistently boosted stock market wealth and persistently lowered labor earnings. We call this a factor share shock. The third shock is a persistent but transitory innovation that accounts for the vast majority of quarterly fluctuations in asset values but has a negligible impact on consumption and labor earnings at all horizons. We call this an exogenous risk aversion shock. We show that the 2000 to 2002 asset market crash and recession surrounding it was characterized by a negative transitory wealth (positive risk aversion) shock, predominantly affecting stock market wealth. By contrast, the 2007 to 2009 crash and recession was characterized by a string of large negative productivity shocks, as well as positive risk aversion shocks.