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Abstracts

Fiscal Policy in Latin America

MICHAEL GAVIN AND ROBERTO PEROTTI

Fiscal policy in Latin America has been understudied, in part because of inadequate data. This paper utilizes a new, comprehensive database on fiscal outcomes in 13 major Latin American economies which covers central government, local government, and nonfinancial public enterprises at a reasonably detailed level of aggregation. Armed with this database, we lay out some basic facts about fiscal policy in Latin America. We find stark differences between fiscal outcomes in Latin America and in industrial countries. Fiscal outcomes have been far more volatile in Latin America. In sharp contrast to the industrial economies, fiscal policy in Latin America has also been procyclical, casting doubt on the applicability of the Barro (1979) tax-smoothing hypothesis to Latin America. We discuss alternative explanations of fiscal policy procyclicality. We also consider the relationship of fiscal policy to the exchange-rate regime. Contrary to much conventional wisdom, we find no evidence that fixed exchange rates impose greater discipline on fiscal policy. We also find that fiscal expansions in Latin America have been significantly associated with exchange-rate collapses.

The Neoclassical Revival in Growth Economics: Has it Gone Too Far?

PETER J. KLENOW AND ANDRÉS RODRÍGUEZ-CLARE

In our view there has been a “Neoclassical Revival” in growth economics spurred by the empirical findings of Mankiw, Romer, and Weil (1992), Barro and Sala-i-Martin (1995), and Young (1994 and 1995). By this we mean a revival of the neoclassical growth model—which features a common level of productivity but different levels of human and physical capital across countries—as a viable candidate for explaining the major part of country differences in levels and growth rates of output per worker. Marshaling existing evidence from the labor literature on the returns to schooling and experience, we construct new measures of human capital across countries. We find that productivity differences are the

dominant source of the large international dispersion in levels and growth rates of output per worker. We conclude that, although models that focus on physical and human capital are clearly important, research needs to be re-focused on explaining the causes of productivity differences across countries.

The Economics of Prefunding Social Security and Medicare Benefits

MARTIN FELDSTEIN AND ANDREW SAMWICK

This paper presents a detailed analysis of the economics of prefunding benefits for the aged, focusing on social security but indicating some of the analogous magnitudes for prefunding Medicare benefits. We use detailed census and social security information to model the transition to a fully funded system based on mandatory contributions to individual accounts. The funded system that we examine would permanently maintain the level of benefits now specified in current law and would require no new government borrowing (other than eventually selling the bonds that are officially in the social security trust fund). During the transition, the combined rate of payroll tax and mandatory saving rises initially by 2 percentage points (to a total of 14.4%) and then declines so that, in less than 20 years, it is less than the current 12.4% payroll tax. We estimate the influence of such prefunding on the growth of the capital stock and the level of national income and show that the combination of higher pretax wages and lower payroll taxes could raise wages net of income and payroll taxes by more than 35% in the long run. We also discuss distributional issues and the way that the poor can be at least as well off as under social security. A stochastic simulation shows that a small increase in the mandatory saving rate would reduce the risk of receiving less than the scheduled level to less than 1%. Separate calculations are presented of the value of the "forward-looking recognition bonds" and "backward-looking recognition bonds" which the government might issue if it decides not to pay future social security benefits explicitly.

Unemployment Expectations, Jumping (S,s) Triggers, and Household Balance Sheets

CHRISTOPHER D. CARROLL AND WENDY E. DUNN

This paper examines the relationship between household balance sheets, consumer purchases, and expectations. We find few robust empirical relationships between balance sheet measures and spending, but we do find that unemployment expectations are robustly correlated with spending. We then construct a formal model of durables and nondurables consumption with an explicit role for unemployment and for household debt. We find that the model is capable of explaining several empirical regularities which are, at best, unexplained by standard models. Finally, we show that a loosening of liquidity constraints can produce a runup in debt similar to that experienced recently in the United States, and

that after such a liberalization consumer purchases show heightened sensitivity to labor income uncertainty, providing a potential rigorous interpretation of the widespread view that the buildup of debt in the 1980s may have played an important role in the weakness of consumption during and after the 1990 recession.

The New Neoclassical Synthesis and the Role of Monetary Policy

MARVIN GOODFRIEND AND ROBERT G. KING

Macroeconomics is moving toward a New Neoclassical Synthesis, which like the synthesis of the 1960s melds classical with Keynesian ideas. This paper describes the key features of the new synthesis and its implications for the role of monetary policy. We find that the New Neoclassical Synthesis rationalizes an activist monetary policy, which is a simple system of inflation targets. Under this "neutral" monetary policy, real quantities evolve as suggested in the literature on real business cycles. Going beyond broad principles, we use the new synthesis to address several operational aspects of inflation targeting. These include its practicality, the response to oil shocks, the choice of price index, the design of a mandate, and the tactics of interest rate policy.

An Optimization-Based Econometric Framework for the Evaluation of Monetary Policy

JULIO J. ROTEMBERG AND MICHAEL WOODFORD

This paper considers a simple quantitative model of output, interest rate and inflation determination in the United States, and uses it to evaluate alternative rules by which the Fed may set interest rates. The model is derived from optimizing behavior under rational expectations, both on the part of the purchasers of goods (who choose quantities to purchase given the expected path of real interest rates), and upon that of the sellers of goods (who set prices on the basis of the expected evolution of demand). Numerical parameter values are obtained in part by seeking to match the actual responses of the economy to a monetary shock to the responses predicted by the model. The resulting model matches the empirical responses quite well and, once due account is taken of its structural disturbances, can account for our data nearly as well as an unrestricted VAR. The monetary policy rule that most reduces inflation variability (and is best on this account) requires very variable interest rates, which in turn is possible only in the case of a high average inflation rate. But even in the case of a constrained-optimal policy, that takes into account some of the costs of average inflation and constrains the variability of interest rates so as to keep average inflation low, inflation would be stabilized considerably more and output stabilized considerably less than under our estimates of current policy. Moreover, this constrained-optimal policy also allows average inflation to be much smaller.

