Volume Title: NBER Macroeconomics Annual 1987, Volume 2

Volume Author/Editor: Stanley Fischer, editor

Volume Publisher: The MIT Press

Volume ISBN: 0-262-56040-0

Volume URL: http://www.nber.org/books/fisc87-1

Publication Date: 1987

Chapter Title: Editorial in "NBER Macroeconomics Annual 1987, Volume 2"

Chapter Author: Stanley Fischer

Chapter URL: http://www.nber.org/chapters/c11096

Chapter pages in book: (p. 1 - 6)

Editorial

The major economic issues of the day—unemployment, exchange-rate fluctuations, productivity and long-term growth, developing country growth, and the economic significance of the budget deficit—are covered by articles in this second issue of the *NBER Macroeconomics Annual.* And in keeping with the aim of covering both topics of current policy interest and recent theoretical developments, one article presents and evaluates recent work attempting to lay new analytical foundations for the view that price stickiness in the economy can both be rationally explained and provide a basis for active countercyclical policies.

Kevin Murphy and Robert Topel of the University of Chicago analyze changes in the unemployment rate since the late sixties. The underlying puzzle is why the "natural" or full-employment rate of unemployment has risen, from what was believed to be about 4.5 percent in the late sixties to current estimates of 6.0 to 6.5 percent. A frequent explanation for part of the change is that the demographic composition of the labor force has changed to include a higher proportion of groups with higher natural rates of unemployment. Murphy and Topel standardize for this factor by examining unemployment rates for males aged 18–64, a group whose labor force attachment is strong.

Murphy and Topel characterize the behavior of unemployment for this group since 1968 using the March *Current Population Survey.* Their data cover 540,000 different individuals who were surveyed at different times during the period. Their concise presentation of an extraordinary volume of data analysis emphasizes four conclusions: that the rise in unemployment is very broadly based, not concentrated by industry, age, or schooling, though it is to some extent affected by geographic location; that most of the increase in total unemployment is accounted for by an increase in the frequency of very long spells of unemployment; that unemployment is more broadly based than it used to be, with the employed facing a greater probability of encountering unemployment than they used to; and that intersectoral labor mobility has declined as the unemployment rate has risen. They also find that relative wages have not changed much, and that real wages have been falling over much of the period since 1973.

In attempting to account for these facts, Murphy and Topel consider the implications of the "intersectoral shift" theory of unemployment, which attributes much of the rise in unemployment to an increase in the size and frequency of shifts of the demand for labor between sectors, rather than a reduction in the overall demand for labor. Primarily because the extent of intersectoral mobility falls when unemployment rises, they reject this theory. David Lilien, the main proponent of that view, discusses the Murphy-Topel findings and explains why he believes that the theory still contributes to understanding the increase in unemployment. Murphy and Topel are drawn instead to the view that shifts in macroeconomic factors, such as aggregate demand, must have played a significant role in changing unemployment. One of the many strengths of this article is its careful presentation of the detailed facts about unemployment that will have to be dealt with by any future accounts of the causes of changing U.S. unemployment rates.

Julio Rotemberg of MIT presents a comprehensive survey, development and evaluation of recent work attempting to lay the microeconomic foundations of Keynesian-type macroeconomic theory. Most of the conclusions of Keynesian economics, including a role for monetary and fiscal policy, follow once it is shown that changes in aggregate demand—the quantity of goods demanded at the current price level—change the level of output. Such a conclusion is likely to follow if prices and/or wages are slow to adjust to shifts in demand. If prices and wages adjust freely, a shift in demand will simply change the aggregate price level, rather than cause a boom or a recession.

Early Keynesian theory simply postulated that wages or prices were sticky, and proceeded to discuss the implications of that postulate. That was a very useful procedure that generated predictions about the effects of changes in the money stock or fiscal policy that appeared broadly consistent with the facts. However, simply postulating a key assumption—wage or price stickiness—rather than explaining it as sensible or rational behavior by firms and/or workers and consumers is not entirely satisfactory.

In the last few years there has been an explosion of work on the new Keynesian microfoundations. Much of this work builds on the assumption that prices are costly to change. This in itself is not a deep explanation of price stickiness, and in particular invites the question of how such costs can possibly be large enough to produce recessions, which cost the economy billions and perhaps hundreds of billions of dollars in wasted output. The key result here, characterized by Rotemberg as the PAYM insight, and explained in the article, is that small costs of changing prices for firms may be able to generate quite large business cycles.

Rotemberg's evaluation of the new Keynesian microfoundations is one of judicious enthusiasm. He views the theories as an advance, but also points to some weaknesses, particularly in the step of aggregating from the behavior of individual prices to the general price level. This is an account of work in progress, different attitudes on which may be gathered from the comments and report of the floor discussion.

Jeffrey Frankel and Richard Meese of the University of California at Berkeley ask whether exchange rates fluctuate excessively. Both the longer-term and day-to-day movements in the exchange rate since 1973 appear to be larger than was then anticipated. Nonetheless, those fluctuations might be fully justified as rational responses to changes in the fundamental economic forces that should move the exchange rate.

Frankel and Meese emphasize the virtually total inability of economic models to explain exchange rate movements, not only in advance, but even after the event. There are, they assert, no very successful empirical models of exchange rate determination. Theoretical models of exchange rate determination that suggest that interest rates and the relative levels of income in the trading countries should affect exchange rates leave large unexplained errors, particularly on a monthly or short-term basis.

One reaction would be that such failures imply that exchange rates are excessively volatile, being moved by forces other than the fundamentals. Frankel and Meese take a more cautious approach, saying that in the absence of successful models of exchange rate fundamentals it is not possible to show conclusively that rates fluctuate excessively. They describe a variety of sophisticated tests of excess volatility but downplay their significance in light of the absence of a successful fundamentals model. They then go on to models in which variations in the risk premia on foreign currencies cause movements in both forward and spot exchange rates, again finding little systematic in the results of those tests. In the final section they use survey data on the expectations of market participants to uncover the process by which expectations are formed, and to decide whether independent movements in expectations may account for exchange rate movements. They conclude with a presumption in favor of the view that rates have fluctuated excessively, but caution that even so, intervention by central banks will not necessarily succeed in stabilizing rates.

Paul Romer of the University of Rochester examines the recent productivity slowdown in the United States in the context of the long-run growth of the economy. Much of the article is devoted to an interesting and in many ways radical reexamination of the process of economic growth in the United States and the rest of the world. Romer's main empirical finding is that capital formation appears to play the key role in determining growth over long periods, even though standard theories suggest its role should be quite small.

In seeking to explain why capital and investment might play such a role, Romer develops theories in which there are increasing returns to scale for the economy as a whole, even if not necessarily for individual firms in the economy. The economy's stock of knowledge increases as individual firms invest and innovate—this is surely a lesson that any reading of accounts of growth will support. Romer also explores the role of increasing returns to scale when firms are not perfectly competitive. Increasing returns have the strong implication—contrary to the so-called convergence hypothesis—that the developing countries will likely never catch up to the richer countries.

Romer's explanation for the recent productivity slowdown in the United States is quite simple. The empirical section of his article shows that virtually all of growth is accounted for by the growth of the capital stock, and very little by increased labor inputs. Thus an increase in employment contributes very little to faster growth, implying that average output per worker declines. The explanation receives a careful evaluation from the discussants and in comments from the floor.

Kemal Dervis of the World Bank and Peter Petri of Brandeis University analyze growth in the developing countries. Even as the developed economies have suffered slowdowns of growth in this decade, several developing countries have continued to grow at extraordinary rates. Dervis and Petri start by isolating twenty middle-income countries and dividing them into three groups, the top third or A group, the middle, and the bottom third.

The behavior of the groups is then examined along several dimensions. The fast growers for instance invest more of their GNP, started with smaller governments, and expanded exports very rapidly. They did not have especially small government budget deficits, nor did they enjoy any unusual improvement in the terms of trade. The results of a set of regressions reinforce the positive association between investment and growth.

Dervis and Petri then turn to more detailed accounts of two of the success stories of development, Korea and Turkey. Korea has enjoyed extraordinary rates of growth for two decades, with time out mainly at the beginning of the eighties. Turkey did reasonably well until the midseventies, then went into a deep crisis, and with the aid of foreign capital inflows, turned the situation around rapidly in the early eighties. Turkey is widely cited as an example of the success of development based on the opening up of the economy to foreign trade, and is regarded as a showcase example for the Baker strategy of recovery of the debtor nations through the combination of foreign capital inflows and domestic liberalization.

Dervis and Petri argue that both countries opened up significantly to trade, liberalizing imports and encouraging exports, but that the governments (particularly in Korea) did not take a laissez faire approach. They note also that capital markets were not seriously liberalized in either country. The story they present is one of outward orientation, with an emphasis on the provision of appropriate price signals. Although concentrating on the success stories may produce misleading conclusions (were there countries, such as Chile, that appeared to follow similar strategies but did not succeed?) this careful detailed look at particular countries is a very useful way of trying to draw lessons for development strategies.

The final article, by Douglas Bernheim of Stanford, is on Ricardian equivalence. Less opaquely, the question is whether government budget deficits make any difference, to national saving, to the interest rate, and to the balance of payments. The standard macroeconomic models and newspaper accounts suggest that a reduction in taxes that increases the deficit leads to an increase in private-sector consumption as individuals get to keep more of their pretax income, and as a consequence to an increase in the interest rate as the rate of saving falls, to an appreciation of the currency (at least initially) and to a current account deficit.

The Ricardian equivalence hypothesis points out that an increased current deficit implies that taxes will have to be higher sometime in the future than they would otherwise be, in order to pay off the debt. If people anticipate these taxes, they will increase their saving now in order to pay the future taxes. In its strongest form, the hypothesis is that private saving will increase by exactly the same amount as the budget deficit, interest rates will therefore be unaffected, and the current account will likewise not change.

Bernheim's article examines the theoretical and empirical basis for the view that Ricardian equivalence rather than being a theoretical curiosum is a good approximation to the way the world works. In the theoretical section he provides a comprehensive review of the extensive literature on this topic, arguing that theoretical considerations alone suggest that nonequivalence rather than equivalence should be taken as the starting presumption in considering the issue. The empirical section shows how difficult it has been to decisively accept or reject Ricardian equivalence. Bernheim concludes that the evidence supports the conclusion he draws from the theoretical section, that deficits do matter. But as the discussants' comments indicate, this conclusion is not shared by all.

It may seem surprising that the Ricardian equivalence view can survive the high real interest rates and massive current account deficits of the period since 1982. This is prima facie evidence against Ricardian equivalence. However, proponents of the view argue that the timing of the increase in interest rates, which began before the deficit increased, suggests that the deficits are not the cause of the rise in rates.

In all cases the formal discussants and floor discussion provide additional insights and evaluations of the articles, and should be read.

Readers of this volume are likely to be struck both by the sophistication and care shown in the articles, and by the hesitancy of some authors to draw conclusions that appear entirely obvious to common sense. That hesitancy to draw too strong conclusions in an article is not a license to conclude that anything and everything goes when policy decisions have to be made. Rather at that point it becomes necessary to weigh the uncertainties and the consequences of mistakes—for instance in the case of Ricardian equivalence, to consider the consequences of mistakenly assuming a deficit will have no impact when it does—in making rational policy decisions.

Takeo Hoshi of the MIT Department of Economics served as both rapporteur and editorial adviser for this volume. His assistance was invaluable.

Stanley Fischer