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Recent Developments in Macroeconomics

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Preface

The papers in this special issue of the *Journal of Money, Credit, and Banking* were presented and discussed at a conference on "Recent Developments in Macroeconomics" held at the Federal Reserve Bank of Cleveland on October 30–31, 1987. The purpose of the conference was to discuss the practical aspects of recent developments in macroeconomic research and the relevance of these developments for economic policy. Contributors summarized the intersection of the new and the practical in their research.

In many ways, we have crossed a new threshold in macroeconomic research and policy analysis. Just as there was a major integration of microeconomics and finance theory in the 1960s and 1970s, there is a rapid infusion of microeconomic theory into the analysis of traditional macroeconomic issues. The growing divergence between what is taught in graduate schools and what is practiced in policy circles has created dilemmas for newly trained economists hired by government and for their employers as well.

A common theme that appears in contemporary macroeconomic research is that people, operating through markets, will try to protect themselves from the undesirable effects of government policy. Consequently, many newly trained economists often regard discretionary macroeconomic policy actions as necessarily leading to suboptimal macroeconomic performance, a conclusion that puzzles many who have been trained in conventional macroeconomic theory. Of course, there is still a great deal of debate within the economics profession about the practical significance of these theoretical developments. It is important, however, that the knowledge gained by more than a decade of macroeconomic research be understood by economic policymakers. It was in pursuit of this goal that the Federal Reserve Bank of Cleveland sponsored this conference.

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WILLIAM T. GAVIN
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Introduction

THE PURPOSE OF THIS CONFERENCE was to review and debate the practical aspects of recent developments in macroeconomics. Macroeconomic analysis has changed in many ways since the 1960s. These changes have been largely due to attempts by economists to build models of aggregate outcomes that are consistent with microeconomic theory. While there is no clear consensus about a specific macroeconomic model, there is greater agreement that the “economic way of thinking” that underlies the field of microeconomics should be integrated into the analysis of macroeconomic issues. In the six papers of this conference, each author presents his view about how this integration has proceeded and his evaluation of the practical results of this research.

In the first paper Gregory Mankiw summarizes current research in macroeconomics. He argues that many economists have become disillusioned with the theoretical foundations of traditional macroeconomic theory and are dissatisfied with its practical applications. Mankiw goes on to describe the three main strands of research that he believes hold the most promise for future progress in macroeconomics.

The first research area lies in developing techniques for modeling expectations more carefully. The introduction of rational expectations makes conventional macroeconomic models much more complex and has led economists to consider whether conventional macroeconomic models are consistent with optimizing

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behavior by individuals. Much of the recent work in economics is an attempt to construct macroeconomic models consistent with agents that optimize when forming expectations as well as when maximizing utility or profits.

The second research area involves the use of market clearing (Mankiw uses the term “equilibrium”) models in macroeconomics. Market clearing models represent an attempt to build a simple foundation for macroeconomics comparable to the competitive market model in microeconomics. Researchers are currently trying to see to what extent the business cycle can be explained by this simple model.

The third research area includes the use of disequilibrium models. The economists who work in disequilibrium models often take some aspect of the Keynesian tradition as a premise and try to build a model of microbehavior consistent with that premise.

Overall, Mankiw is somewhat pessimistic about the practical aspects of recent developments in macroeconomics. The one practical result that he stressed was the insight provided by the work in the rational expectations literature on the time inconsistency of discretionary policy schemes. He suggested that while we now often disagree about what form policy rules should take, most economists agree that there is a deadweight loss to society by not having policy rules.

In the second paper, Bennett McCallum discusses the evolution of the Phillips curve as a foundation for formulating and evaluating monetary policy. He reviews the development of the wage-price sectors in Keynesian models and the challenge posed by rational expectations. He describes in some detail the dissatisfaction with the theoretical foundations alluded to in the Mankiw paper.

McCallum agrees with Mankiw’s conclusion that we have not yet developed a satisfactory dynamic microfoundation model to replace the static models of the past. He also agrees that we have learned that there is a value to precommitment. The paper concludes with a brief review of his recommendation that the Federal Reserve commit to a rule for nominal GNP growth. This would be a feedback rule in which the Federal Reserve would attempt to stabilize the growth rate of nominal GNP along a path equal to the potential growth rate for real output. The rule would include a feedback mechanism for offsetting past deviations of velocity from some predetermined trend.

In the third paper, Larry Katz discusses recent developments in labor economics and their application to macroeconomic models. He describes three areas of research: the sectoral-shifts hypothesis, the efficiency-wage hypothesis, and the insider-outsider models of hysteresis in the labor market. The insider-outsider models explain why employment and unemployment levels can become dependent on the past history of shocks to the labor market, and why there may be no underlying natural rate of unemployment that the market will tend to over time.

The sectoral-shifts hypothesis states that the business cycle can be explained by the slow reallocation of labor across sectors in response to idiosyncratic shocks that affect the relative demand for labor in different sectors. Katz describes work in this area, concluding that the models are elegant, but that the empirical evi-

dence does not seem to give much weight to these ideas as a primary explanation of business fluctuations.

The efficiency-wage hypothesis states that a worker's productivity depends on wages in some positive fashion. Firms will then find it profitable to pay wages above the market clearing rate, causing involuntary employment. Katz describes alternative rationales for this result and suggests various policy recommendations designed to reduce involuntary unemployment.

The insider-outsider hypothesis assumes that it is costly to replace current employees with unemployed workers and that current employees can influence the wage-setting process without taking the interests of outside workers into account. These models have gained attention because they may explain why European unemployment has remained so high for so long and why real wages can be rising in spite of such persistently high unemployment.

In the fourth paper, Larry Kotlikoff presents a practical application of many new ideas in macroeconomics. Kotlikoff uses simulations of a rational-expectations, 55-generation, overlapping-generations model to show the effects of various fiscal policies. This framework allows one to trace the macro outcomes back to the micro behavior of households and firms.

Kotlikoff presents specific examples including analyses of changing the tax base, investment incentives, and tax rates. The use of this approach leads to different measures of budget deficits and questions whether definitions that were constructed to help the government finance its day-to-day operations are adequate for analyzing the economic consequences of fiscal policies. The importance of this argument is illustrated in an analysis of the stance of fiscal policy in the first term of the Reagan administration.

Kotlikoff's paper was unique in offering a new framework for giving quantitative answers to policy questions. Most of the policy recommendations coming out of recent research tend to be a description of rules that operate at a high level of generality about the structure of the economy as, for example, in the discussion of the specific policy rule by McCallum. This paper offers a framework for analyzing many fine details of fiscal policy changes. The cost of presenting more detail about some aspects of the economy, however, is that one must present less detail about others. Kotlikoff's model does not include money and, therefore, cannot address issues in which inflation plays an important role. The model also does not include unemployment or cyclical fluctuations and, therefore, cannot be used to address most issues of stabilization policy.

In the fifth paper, Alan Stockman summarizes recent developments in the theory of international finance as they apply to a variety of policy issues. One of the most important developments is the use of general-equilibrium asset-pricing models to analyze problems in international finance. Using this approach allows one to address new issues and generally gives different answers to old questions than do the static partial-equilibrium models that are still widely used in policy circles.

Stockman goes on to describe many of the conclusions that have been drawn from analysis of these models. For example, analysis of these models has shown the conditions under which the nominal exchange regime is irrelevant for real outcomes. Other analysis has shown that explicitly incorporating risk into the model alters the way both policy and nonpolicy shocks affect the economy. More generally, experience with these models indicates that the correlations one expects between exchange rates and other variables, like the terms of trade, depend on the sources of the shocks and the characteristics of the economy. Stockman shows how some conditions can lead to a positive correlation between the real exchange rate and the current account, and how other conditions can lead to a negative correlation.

Stockman also discusses the globalization of financial markets. Recent work indicates that the gains from trade on financial markets are just as important as gains from trade in goods and services. When people are allowed to trade in global financial markets, the effects of policy and other shocks can be mitigated or even reversed. In general, the new literature finds that the need for policy action is limited as financial markets become integrated because private agents can use these markets to protect themselves from adverse shocks.

In the final paper, Mark Gertler summarizes historical and recent research in modeling financial services. He argues that the past emphasis on monetary services has been associated with a neglect in the study of other financial services. In the first part of his paper, he describes the traditional literature and explains why economists concentrated so exclusively on money.

In recent years there has been a revival of interest in macroeconomic research on financial services. Gertler attributes the renewed interest in financial intermediation to two factors. First, he notes that as an economy becomes more sophisticated less of the credit intermediation is directly tied to bank deposits and, therefore, it is relevant (and easier) to identify separate money and credit shocks, and their separate effects. Second, a reappraisal of the evidence indicates that non-monetary financial activity may have been an important determinant of the economy in past U.S. business cycles.

In the second part of his paper, Gertler surveys the new literature on financial markets. He discusses the developments in modeling the effects of asymmetric information. Introducing asymmetric information leads to the endogenous evolution of markets for intermediation services with real world characteristics. Another part of the recent literature deals with the special nature of bank loans. Gertler also explains how work is proceeding on the attempt to build real business cycle models with markets for real financial services and how these markets can generate or amplify propagating shocks.

A major reason for the revival of this financial market literature is the attempt to build models of the business cycle that do not rely on some form of money illusion. In the traditional literature, there was an assumption that some form of money illusion was at the root of the business cycle. Therefore, understanding the money supply process was important for understanding and stabilizing business

cycles. The use of reserve requirements on bank deposits meant that the money supply process was commingled with the credit supply process.

In recent years, the renewed interest in real business cycle theories has led to more interest in understanding the microfoundations of money and to more careful modeling of the markets for intermediation and transaction services. Gertler reviews the literature that focuses on the market for intermediation services.

As Mankiw suggested in the opening paper, recent theoretical developments do not appear to have had much effect on applied macroeconomics. This is partly so because there is always a lag between the time new discoveries are made and the time they are put to practical use. It takes time for new ideas to be tested and accepted by economists at commercial and government enterprises. The progress of the Keynesian revolution in economics is a good case in point.

It may also be that appearances are deceiving. There have been many changes in emphasis, in research programs underway, and in ways of discussing issues in macroeconomics today. While the large Keynesian models still dominate the forecasting field, in many respects, they have become more useful for their organization of accounting, rather than economic, relationships. As work in the spirit of Kotlikoff's simulation model proceeds, we can expect to see new methods of organizing data and more practical applications of recent developments in macroeconomics.