Thoughts on DeLong, Jeanne and Bordo, volatility, and policy.

Olivier Blanchard

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I shall feel free to roam quite widely. Five main points:

1 The long, broad, view. Looking at the major macroeconomic failures of the 20th century.

Due to what? Big (new?) shocks and failures of macroeconomic policy. (extension of DeLong footnote 1)

- Lack of relevant theory. The Great Depression.

- Loss of policy control. Large deficits and hyperinflations (From Europe in the 20s to Latin America in the 80s).

- Keeping the right policies for too long (From Churchill and the Gold Standard, to Cavallo and the Currency Board.)

- Excess confidence in policy. (The 60s, the long run trade off, the 70s and the moving natural rate)

The last three risks are definitely still present. The last one in particular. Too much confidence in inflation targeting plus automatic stabilizers.

2 The dramatic decline in volatility since WWII in rich countries

(Building on a Brookings Paper with John Simon).

- Decline in volatility (measured either as rolling $\sigma(\Delta \log Y_t)$, or $\sigma(Y - \bar{Y}_t)$, with various constructions of the trend $\bar{Y}_t$.

  Figure for the US. But true for all rich countries, except (and not a small except) Japan in the 1990s.

- Smooth trend, interrupted? Or dramatic decline in the mid 1980s?

- Shocks or policies?

  A hint. If policies, should see less persistence of process for output. No evidence. All the action in the standard deviation of innovations.

- Bottom line. Be (very much) aware of Japan. But, elsewhere, so far so good.

Figure 1. Rolling standard deviation of output growth
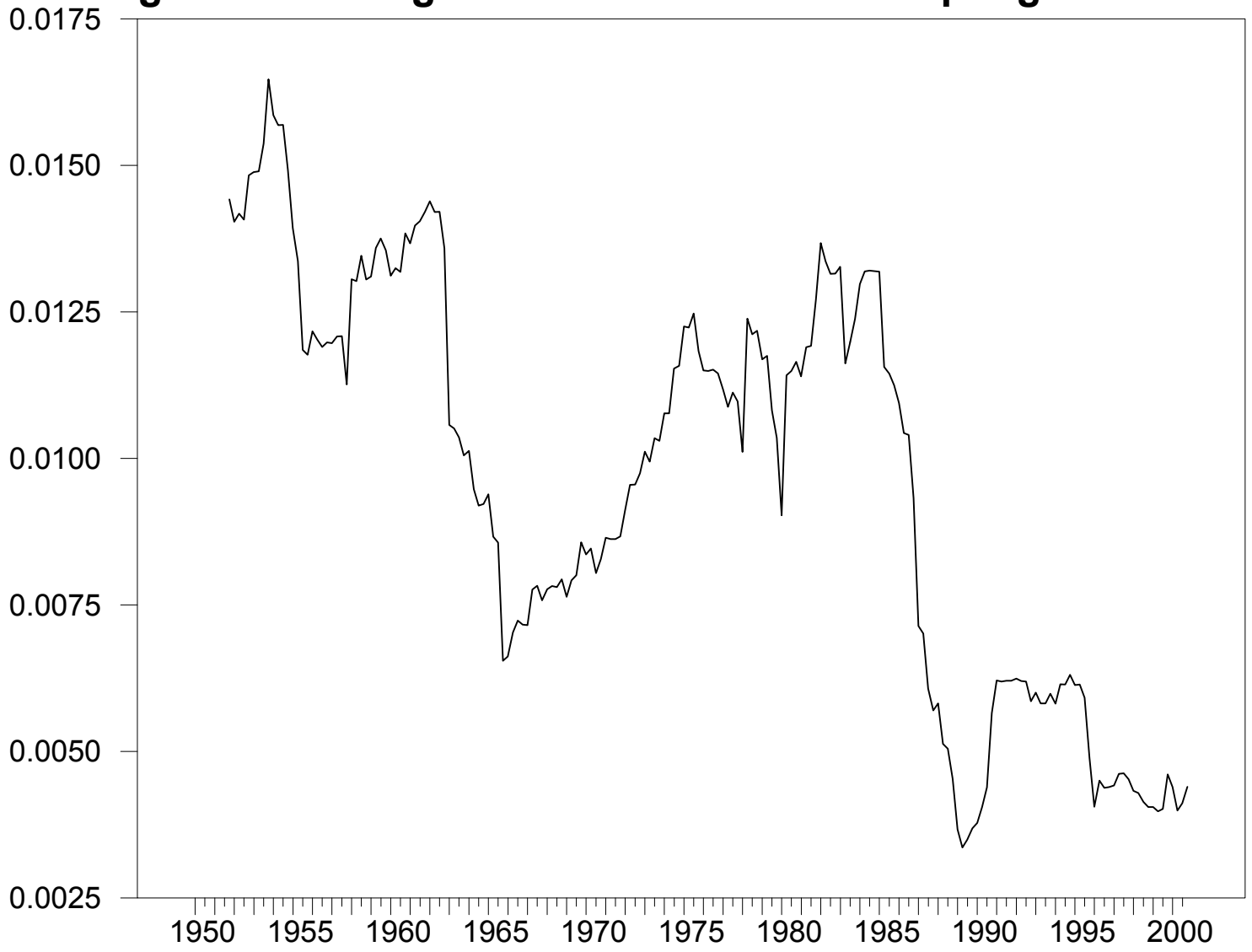
3   Structural changes and volatility

DeLong focuses mostly on implications of IT. (More uncertainty? More potential for bubbles?)

More at work: capital market integration, deregulation, and so on. Some potential trails:

- Better credit markets. Stabilizing or destabilizing?

  Smooths consumption of services and non durables. But allows for easier stock adjustment for durables.

  Put another way:

  Multiplier is weaker, but the accelerator effect is stronger. (I have not checked whether this actually holds).

  Logic true a fortiori of investment.

  Empirically, decline in the standard deviation of all components of C, and I.

- IT and inventories. Stabilizing or destabilizing?

  Production reacts to sales faster. Stronger multiplier. Destabilizing.

  Lower desired inventory ot sales ratio. Weaker accelerator. Stabilizing.

  Empirically: appears to have been stabilizing (not sure). But we need to understand exactly why.

- Technological progress, depreciation, and investment. Stabilizing, or destabilizing?

  Large increase in the rate of depreciation for equipment. Should lead to a smaller accelerator effect. Stabilizing.

  But, economic rather than physical obsolescence. So, now two margins of decision. Likely to increase the response of investment. Destabilizing.

- The service economy (Greenspan's obsession about the weight of GDP) Stabilizing? Empirically. Composition matters, but not much.

4 Fiscal policy

- In the 90s, a lot of discussion of perverse effects.

- Evidence is that, in normal environments, it works. (Although Perotti: Works less well in Europe than in the United States)

- Crazy to rely on history–given automatic stabilizers. I strongly agree with Seidman and Lewis. Make tax rates contingent on deviation of growth from normal.

- The danger: What is the normal growth rate? What is the natural unemployment rate?

  The mistakes of the 1970s and 1980s in Europe, and the build up of debt. Make contingent tax adjustments stop after a year or two. Then shift to discretionary responses if appropriate.

5   Monetary policy

Inflation targeting represents enormous progress, relative to earlier behavior.

Divine coincidence: Stable inflation requires output to be equal to the natural level of output. So even those who care very much about output can go along.

But only a first approximation. As the literature has and will continue to make clear.

- In the presence of nominal wage rigidity and supply shocks, unexpected inflation may be the way to return output to its natural level.

- The natural level of output depends on capital accumulation, which depends on investment.

  Central bank should care about composition consumption/investment, not only the deviation of output from normal.

  Not a case of gaps and triangles (to quote Okun). Here all the distortions are potentially gaps.

- Similar point with respect to the current account deficit. If output equal to the natural level, and large current account deficit, may (need not) be optimal to deviate.

- Similar point with respect to asset price movements. Even absent non linearities.

- Non linearities, if present, also may require deviations from inflation targeting. The discussion in Bordo Jeanne is an extremely useful example.

  How relevant are non linearities? One fascinating feature of Figure 1. Look at boom-busts in property prices in Figure 1. Take averages over all 9 episodes:

  Average length of a boom: 3.9 years

  Average length of a bust: 4.2 years

  (Goes against my priors. An important result.)

- One last, big, worry. The liquidity trap. Think about a double dip recession in the United States. Why not a 4 or 5% inflation rate?