Ec 102
Seminar in Advanced Macroeconomics
Week 12: Explaining Recessions

Professor S. O'Connell Fall 2012

The recession that accompanied the global financial crisis of 2008-09 was the worst in the industrial countries since the Great Depression of the 1930s. The unemployment rate in the USA is still above 8 percent, and in some countries in the "south" of the Euro zone (e.g., Spain), unemployment is around 25%, comparable to what it was in the USA in the depths of the Great Depression. It is roughly fair to say that the macroeconomics profession as a whole had no inkling that the Great Moderation would come to such a spectacular and costly end. What have we learned? Can the lessons from the Great Recession be incorporated via marginal changes in existing macroeconomic models, or is a more fundamental re-thinking required?

Readings:

Blanchard, O. J., G. Dell'Ariccia, and P. Mauro (2010) "Rethinking Macroeconomic Policy" *Journal of Money, Credit and Banking* 42 (Supplement s1): 119-215

Brunnermeier, K. (2009) "Deciphering the Liquidity and Credit Crunch 2007-2008" *Journal of Economic Perspectives* 23(1), Winter: 77-100

Geanakopolous, J. (2010) "Solving the Present Crisis and Managing the Leverage Cycle" *Federal Reserve Bank of New York Economic Policy Review*, August: 101-131

Romer, D. (2011) "What Have We Learned About Fiscal Policy From the Crisis?" IMF Conference on Macro and Growth Policies in the Wake of the Crisis, March.

Woodford, M. (2009) "Heeding Daedalus: Optimal Inflation and the Zero Lower Bound. Comment and Discussion" *Brookings Papers on Economic Activity* 2009: 38-49

DISCUSSION QUESTIONS

1. Among our authors for this week, Olivier Blanchard, David Romer, and Michael Woodford all represent what might be called an MIT tradition in Keynesian macroeconomics. This tradition began in the 1950s and 1960s with Samuelson, Solow, and Modigliani, who opposed Friedman and monetarism. Second-generation monetarists like Dornbusch and Fischer then came to MIT in the 1970s and joined forces with the incumbents and their students to push forward versions of the Keynesian AS/AD apparatus that incorporated Friedman's natural rate hypothesis. The MIT school then spent much of the period between the mid-1970s and the end of the millennium responding to theoretical challenges from the Chicago/Minnesota New Classical school, first in the form of the rational-expectations revolution and Lucas supply curve (implying the policy ineffectiveness proposition) and then in the form of real business cycle theory. The New Keynesian research program sought to construct models that would satisfy the theoretical critiques of Lucas and associates while generating responses to nominal demand shocks (e.g., from monetary policy) that matched the persistent output effects obtained from unconstrained VARs. Michael Woodford's 2003 book *Interest and Prices* was a watershed in this effort – it unified disparate strands of the New Keynesian literature and effectively replaced the AS/AD model with the New Keynesian AS/IS/MP model we have studied this semester.
   1.1. Blanchard was among the many economists to celebrate the New Keynesian synthesis as at least a tentative point of closure, as late as the eve of the global financial crisis (his student Jordi Gali, whom we read in week 1, was another). The central policy implication of the

New Keynesian model is arguably two-fold: (1) a Taylor rule has very desirable properties for stabilizing the macroeconomy; and (2) if a Taylor rule is in place, there is no particular need for an activist fiscal policy. Where do Blanchard *et al.* (2011) see these two propositions going as a result of the Great Recession?

1.2. There is virtually nothing in David Romer's *Advanced Macroeconomics* textbook on the role of fiscal policy in macroeconomic stabilization, although there is a full chapter on fiscal deficits. Reading Romer (2011), do you see this changing in the next edition? If so, how; and will new models be required?

1.3. Michael Woodford's *Interest and Prices* lays out the New Keynesian model. He provides an explicit welfare rationale for targeting zero inflation, by showing that when firms follow Calvo-style pricing, nonzero inflation reduces welfare by inducing inefficient price differentials on similar goods. He shows that monetary policy rules that combine a strong countervailing response to inflation (the Taylor principle) with a countercyclical response to the output gap have favorable properties in anchoring expectations about inflation and reducing the volatility of output – even when the divine coincidence fails so that policymakers face tradeoffs between their two objectives. Woodford's paper for this week responds to a paper by Williams that uses a New Keynesian model to document the cost of ignoring the zero bound on the nominal interest rate. We touched briefly on the Williams (2009) paper in week 7. What do you learn from Woodford's comment, about why the zero bound was not regarded as an urgent problem before 2008-09? Should economists in the New Keynesian tradition have advocated a target inflation rate well above zero?

2. Brunnermeier (2009) and Geanakopolous (2010) take up a theme stressed by Krugman in last week's reading. They argue that although financial markets work well during normal times by supporting risk sharing and the efficient intermediation of funds, they are prone to liquidity crises during which the collective behavior of market participants imposes losses that are far out of proportion to the underlying shocks.

2.1. Brunnermeier (2009) argues that the 'originate and distribute' model gradually increased systemic risks in the US financial system to inefficient levels. How did this happen, and was this a failure of regulation?

2.2. Brunnermeier discusses four mechanisms that amplified the effects of the housing market downturn in the USA. These mechanisms operated through *borrower balance sheets*, the *lending channel*, runs on *financial institutions*, and *network effects*. How do these mechanisms work?

2.3. Geanakopolous (2010) wants to convince you that modern financial systems are subject to socially inefficient *leverage cycles*, and that the current crisis is a case in point. Can you explain the leverage cycle? The policies appropriate for managing a crisis are likely to be very different from those appropriate for reducing the vulnerability of the system to a crisis. What does Geanakopolous propose under these two headings?

References

Williams, John (2009) "Heeding Daedalus: Optimal Inflation and the Zero Lower Bound" *Brookings Papers on Economic Activity*