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Editorial, NBER Macroeconomics Annual 2003

This year's *Macroeconomics Annual* provides a mix of cutting-edge research and policy analysis on various topics.

Arminio Fraga, Ilan Goldfajn, and André Minella give an overview of how to think about "Inflation Targeting in Emerging Market Economies." Until recently, all three authors have been affiliated with the Central Bank of Brazil. Arminio Fraga took over as governor of the bank in the wake of the country's 1999 financial crisis. He is widely credited with having overseen a period of monetary stability unprecedented in the modern history of a country that has experienced one full-fledged hyperinflation and one borderline hyperinflation over the past two decades. The idea that inflation targeting could work in any form in a country with such supposedly weak institutions, and where fiscal dominance had been the norm, surprised many observers, as did the country's success in making a transition to a managed floating exchange rate regime. In their paper, the authors look not only at Brazil's experience but also at those of inflation targeters around the world. They try to draw lessons going forward. This paper is important precisely because in 1999 Brazil did not seem to many observers to have the prerequisites for a successful transition to inflation targeting. There are some (the editors of this volume included) who are skeptical of the claims of some of the more zealous inflation-targeting proponents, especially considering that almost every country in the world has experienced a significant drop in inflation over the past 15 years, including those that would seem to flout the basic principles of inflation targeting. This broad-ranging paper, combined with the balanced discussion that accompanies it, provides a major contribution to the debate. Fraga, Goldfajn, and Minella make a credible case that Brazil has adopted a thoughtful and meaningful version of inflation targeting rather than "inflation targeting lite," as some have maintained.

Pierpaolo Benigno and Michael Woodford take a complementary theoretical approach to analyzing macroeconomic policy. Their paper offers an analytical method for studying optimal monetary and fiscal policy in a modern new Keynesian monetary model. In economics, as in many other disciplines, the growing power of computers has led to a wholesale shift away from analytical methods toward computation-based approaches. This adaptation to technological progress is a welcome and natural one, but as one can see from the Benigno and Woodford paper, much is still to be gained from analytical approaches in terms of intuition and insight. Using their general framework, they tackle several classic policy issues—including optimal tax-smoothing, time consistency with government debt, and coordination of fiscal and monetary policy rules—with startling simplicity and clarity. As one can see from the subsequent discussion, methodological debates in economics can be quite intense, but the *Macroeconomics Annual* has long prided itself on providing a forum for such debates, and the present one is illuminating.

Perhaps one of the most exciting areas of intellectual growth in economics over the past ten years has been in the area of behavioral economics, as recognized by the recent Nobel prize awarded in this area. The field of finance has been perhaps the most eager consumer of this new approach. Yet there is considerable skepticism within the economics profession as a whole about what can be gained by abandoning long-established basic principles. Many argue that, whereas experimental evidence of irrationality may be convincing in the small, it is not at all convincing when it comes to explaining the behavior of important markets that aggregate across many individuals. Perhaps for this reason, many broad areas of research have not yet been significantly affected by behavioral economics. Annette Vissing-Jorgensen's paper takes a critical yet balanced look at some of the field's strongest claims of success. She argues that direct observations of investor expectations and actions are essential to sort out competing claims. Using a novel dataset, courtesy of Union Bank of Switzerland (UBS)/Paine Webber/Gallup, she finds that irrational behavior seems to diminish significantly as wealth rises, strongly suggesting that transaction costs might be a much simpler explanation for many supposed anomalies (such as limited investor diversification). Once wealth is taken into account, it would appear that surprisingly modest transaction costs can explain limited investor participation in stock markets.

N. Gregory Mankiw, Ricardo Reis, and Justin Wolfers use survey data to highlight the heterogeneity in investor expectations about inflation, a property that few modern macroeconomic models include. They argue that their empirical evidence provides additional strong support for the Mankiw and Reis model of sticky expectations as an explanation for

observed business-cycle dynamics and for aggregate responses to monetary policy. (Mankiw, of course, is presently on leave from his professorship at Harvard University to serve as Chair of the President's Council on Economic Advisers. His decision to write a paper for the *Macroeconomics Annual* should be seen as a reflection of his infectious enthusiasm for this exciting recent line of work.) Although the paper certainly stirred widespread discussion, there was broad agreement that it raises two fundamental questions: (1) Why is there such a dispersion of expectations about a basic macro variable, and (2) should macroeconomists be working harder to explain it?

Conventional wisdom is that the United States has enjoyed much higher productivity growth than Europe has, in no small part because of more flexible labor and product markets. But as Susanto Basu, John G. Fernald, Nicholas Oulton, and Sylaja Srinivasan note in their paper, "The Case of the Missing Productivity Growth, or Does Information Technology Explain Why Productivity Accelerated in the United States but Not in the United Kingdom?" this popular explanation does not explain why productivity growth in the United Kingdom—with its relatively flexible markets—has also lagged. The paper gives a clear and cogent overview of the various competing theories of U.S. and U.K. productivity growth, employing new evidence and new data for the latter country. The conclusion of the paper is that, because investment in technology yields high returns only with substantial lag, the fact that the United Kingdom began investing heavily in information technology (IT) well after the United States may explain disparities in productivity to date. The cautious prediction of the paper is that the United Kingdom is likely to see a sharp rise in productivity growth, echoing the boom in the United States, sometime over the next several years.

Finally, Dirk Krueger and Fabrizio Perri ask how the much-vaunted increase in cross-sectional earnings variability in the United States has affected individual welfare. In their paper entitled "On the Welfare Consequences of the Increase in Inequality in the United States," they begin with the premise that welfare ought to be based on consumption variability as opposed to income variability. Then they present some startling evidence to suggest that the rise in cross-sectional consumption variability has been much less dramatic than the rise in income variability. Using this information to help delineate the key parameters, they proceed to use a simple quantitative variant of the standard lifetime-utility framework to calculate the welfare losses associated with the modest rise in consumption variability. They find that these losses, overall, have not been large, and they cite increased access to credit markets as a potential reason that consumption variability has remained relatively immune to

the rise in income variability. As the conference discussion indicates, the authors' results are striking and clearly warrant additional investigation into the measure and nature of idiosyncratic consumption volatility.

The authors would like to take this opportunity to thank Martin Feldstein and the National Bureau of Economic Research for their continued support of the *NBER Macroeconomics Annual* and its associated conference; the NBER's conference staff, especially Rob Shannon, for excellent logistical support; and the National Science Foundation for financial assistance. Doireann Fitzgerald did an excellent job again as conference rapporteur and editorial assistant for this volume. This volume marks her last *Macroeconomics Annual* in this capacity, although we expect to see her name appear as an author sometime in the future.

Mark Gertler and Kenneth Rogoff