

Brookings Papers

ON ECONOMIC ACTIVITY

SPRING 2012

DAVID H. ROMER

JUSTIN WOLFERS

Editors

BROOKINGS INSTITUTION PRESS
Washington, D.C.

Copyright © 2012 by

THE BROOKINGS INSTITUTION

1775 Massachusetts Avenue, N.W., Washington, D.C. 20036

ISSN 0007-2303

ISBN-13: 978-0-8157-2432-2

Authorization to photocopy items for internal or personal use or the internal or personal use of specific clients is granted by the Brookings Institution for libraries and other users registered with the Copyright Clearance Center Transactional Reporting Service, provided that the basic fee is paid to the Copyright Clearance Center, 222 Rosewood Drive, Danvers, MA 01923. For more information, please contact CCC at (508) 750-8400. This authorization does not extend to other kinds of copying, such as copying for general distribution, for creating new collective works, or for sale. Specific written permission for such copying must be obtained from the Permissions Department, Brookings Institution Press, 1775 Massachusetts Avenue, N.W., Washington, DC 20036; FAX (202) 536-3623; E-mail permissions@brookings.edu.

Brookings Papers

ON ECONOMIC ACTIVITY

SPRING 2012

| | |
|------------------------------------------------------------------------------------------------------------------------------------------------------------|-----|
| <i>Editors' Introduction</i> | vii |
| JEFFREY R. CAMPBELL, CHARLES L. EVANS, JONAS D. M. FISHER, and ALEJANDRO JUSTINIANO <i>Macroeconomic Effects of Federal Reserve Forward Guidance</i> | 1 |
| Comments by Charles W. Calomiris and Michael Woodford 55 General Discussion 74 | |
| JAMES H. STOCK and MARK W. WATSON <i>Disentangling the Channels of the 2007–09 Recession</i> | 81 |
| Comments by Alan S. Blinder and Christopher A. Sims 136 General Discussion 148 | |
| JAY C. SHAMBAUGH <i>The Euro's Three Crises</i> | 157 |
| Comments by Ricardo Reis and Hélène Rey 212 General Discussion 227 | |
| J. BRADFORD DELONG and LAWRENCE H. SUMMERS <i>Fiscal Policy in a Depressed Economy</i> | 233 |
| Comments by Martin Feldstein and Valerie A. Ramey 275 General Discussion 290 | |
| KAREN DYNAN <i>Is a Household Debt Overhang Holding Back Consumption?</i> | 299 |
| Comments by Atif Mian and Karen M. Pence 345 General Discussion 358 | |
| ERIC CHANEY <i>Democratic Change in the Arab World, Past and Present</i> | 363 |
| Comments by George A. Akerlof and Lisa Blaydes 401 General Discussion 410 | |

PURPOSE

The *Brookings Papers on Economic Activity* publishes research in macroeconomics, broadly defined, with an emphasis on analysis that is empirical, focuses on real-world events and institutions, and is relevant to economic policy. Papers are presented and discussed at conferences twice each year, and the papers and discussant remarks are published in the journal several months later. The intended audience includes analysts from universities, research institutions, governments, and business. The subject matter encompasses all fields of economic inquiry relevant to macroeconomics, including business cycles; development and long-term growth; the distribution of income, wealth, and opportunities; financial markets; international capital and foreign exchange markets; fiscal and monetary policy; international trade; labor markets; the public sector and the welfare state; energy; the environment; political economy; regulation and industrial organization; education; health; and demography.

The conference and the journal are based upon the work partially supported by the National Science Foundation under Grant No. 0752779 and the Alfred P. Sloan Foundation. The papers and discussant remarks reflect the views of the authors and not necessarily the views of the funding organizations or the staff members, officers, or trustees of the Brookings Institution.

CALL FOR PAPERS

Although most papers that appear in the *Brookings Papers* are solicited by the editors, the editors welcome submitted proposals. Editorial decisions are generally made about nine months in advance of each conference. Therefore, proposals should be received by December 1 for the following fall conference and by June 1 for the following spring conference. Proposals should be no more than five double-spaced pages and should be sent to brookingspapers@brookings.edu.

ACCESSING THE JOURNAL

The full texts of the papers in this issue and all previous issues of the *Brookings Papers on Economic Activity* are now available online at the *Brookings Papers* website, www.brookings.edu/about/projects/bpea, under "Past Editions." Also visit the *Brookings Papers* website for information about participants in this conference and agendas for upcoming conferences. To purchase print subscriptions or single copies, visit www.brookings.edu/about/press/journals, or contact the Brookings Institution Press at 866-698-0010 or P.O. Box 465, Hanover, PA 17331-0465. All Brookings periodicals are available online through both OCLC (www.oclc.org) and Project Muse (<http://muse.jhu.edu>). Archived issues of Brookings journals are also available through JSTOR (www.jstor.org).

**EDITORS,
PANEL
ADVISERS,
AND STAFF
FOR THE
NINETY-THIRD
CONFERENCE**

George A. Akerlof *University of California, Berkeley*
Olivier J. Blanchard *Massachusetts Institute of Technology*
Lisa Blaydes *Stanford University*
Alan S. Blinder *Princeton University*
William C. Brainard *Yale University*
Charles W. Calomiris *Columbia University*
Jeffrey R. Campbell *Federal Reserve Bank of Chicago*
Eric Chaney *Harvard University*
Steven J. Davis *University of Chicago*
J. Bradford DeLong *University of California, Berkeley*
Karen Dynan *Brookings Institution*
Charles L. Evans *Federal Reserve Bank of Chicago*
Martin Feldstein *Harvard University*
Jonas D. M. Fisher *Federal Reserve Bank of Chicago*
Ted Gayer *Brookings Institution*
Robert E. Hall *Stanford University*
Caroline M. Hoxby *Stanford University*
Erik Hurst *University of Chicago*
Alejandro Justiniano *Federal Reserve Bank of Chicago*
Atif Mian *University of California, Berkeley*
N. Gregory Mankiw *Harvard University*
Karen M. Pence *Board of Governors of the Federal Reserve System*
George L. Perry *Brookings Institution*
Valerie A. Ramey *University of California, San Diego*
Ricardo Reis *Columbia University*
Hélène Rey *London Business School*
David H. Romer *University of California, Berkeley*
Jay C. Shambaugh *Georgetown University*
Christopher A. Sims *Princeton University*
Lawrence H. Summers *Harvard University*
Betsey Stevenson *Princeton University*
James H. Stock *Harvard University*
Mark W. Watson *Princeton University*
Justin Wolfers *Princeton University*
Michael Woodford *Columbia University*

Willem Daniel *Brookings Institution*
Heather R. Kirsch *Brookings Institution*
Natasha Plotkin *Brookings Institution*
Michael Treadway *Brookings Institution*

**GUESTS WHOSE
WRITINGS OR
COMMENTS
APPEAR IN
THIS ISSUE**

Martin Neil Baily *Brookings Institution*
Laurence M. Ball *Johns Hopkins University*
Christopher D. Carroll *Johns Hopkins University*
Karl E. Case *Wellesley College*
Gerald S. Cohen *Ziff Brothers Investments*
John C. Driscoll *Board of Governors of the Federal Reserve System*
Janice C. Eberly *U.S. Department of the Treasury*
Wendy Edelberg *Congressional Budget Office*
Douglas J. Elliott *Brookings Institution*
Benjamin M. Friedman *Harvard University*
Refet S. Gürkaynak *Massachusetts Institute of Technology*
Jan Hatzius *Goldman Sachs*
Michael T. Kiley *Board of Governors of the Federal Reserve System*
Donald L. Kohn *Brookings Institution*
Arvind Krishnamurthy *Northwestern University*
Andrew Levin *Board of Governors of the Federal Reserve System*
Laurence H. Meyer *Macroeconomic Advisers*
Frederic S. Mishkin *Columbia University*
Eric T. Swanson *Federal Reserve Bank of San Francisco*
Linda L. Tesar *University of Michigan*

Editors' Introduction

THE BROOKINGS PANEL ON ECONOMIC ACTIVITY held its ninety-third conference in Washington, D.C., on March 22 and 23, 2012. The conference was held against a backdrop of a U.S. economy continuing to struggle to recover from the Great Recession, European economies facing renewed crisis and recession, and an unprecedented period of ferment and possibilities for democratic change in the Middle East.

The six papers in this issue address various aspects of these extraordinary developments. The first paper, by Jeffrey Campbell, Charles Evans, Jonas Fisher, and Alejandro Justiniano, examines how the Federal Reserve, having brought its policy interest rate down to its lower bound, can use forward guidance—public statements about its future interest rate actions—to influence the economy. In the second paper, James Stock and Mark Watson compare the dynamics of a wide range of macroeconomic variables in the Great Recession with their behavior in previous recessions and attempt to identify the sources of the recession and the slow recovery. The third paper, by Jay Shambaugh, turns to Europe, arguing that policymakers cannot resolve the continent's troubles unless they recognize that the euro is facing three inter-related crises: a fiscal crisis, a banking crisis, and a growth crisis. In the fourth paper, Bradford DeLong and Lawrence Summers analyze the role of fiscal policy when the economy faces a long period of high unemployment and monetary policy is constrained; they conclude that fiscal expansion in those circumstances easily passes a cost-benefit test, and indeed, that it likely more than pays for itself in budgetary terms. The fifth paper, by Karen Dynan, presents new evidence from micro data about the role of the overhang of household debt in restraining consumption and slowing the recovery, and assesses households' progress over the past few years in reducing their high leverage. In the last paper, Eric Chaney addresses the remarkable events of the "Arab Spring," examining the historical roots of the low levels of democracy in the Arab world and the sources of the recent uprisings.

