Comments on
Financial Innovations and Macroeconomic Volatility

by Urban Jermann and Vincenzo Quadrini

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November 17, 2006
Standard deviation of US GDP growth
Standard deviation of US GDP (HP filter)
This paper...

- Financial structure of firms has become more volatile after 1984

- Model in which financial factors are key to generate fluctuations

- Two financial frictions:
  - Endogenous borrowing limit (limited commitment)
  - Exogenous cost of paying out dividends
Main result

- Model calibrated to US data pre and post-1984

- Explain the Great Moderation as a consequence of firms’ greater financial flexibility
Outline of my Comments

1. Will tell you why this is a very nice paper

2. Comments on the empirical motivation

3. Comments on the theoretical framework
Why I think this is the right direction

- A look at the Great Moderation from a different perspective
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- A look at the Great Moderation from a different perspective

- Justiniano and Primiceri (2005):
  Large scale DSGE model with time varying volatility of structural shocks
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- A look at the Great Moderation from a different perspective

- Justiniano and Primiceri (2005):
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- Reduction in volatility of GDP explained by a reduction in volatility of a shock to the real return on capital
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- This shock is a “wedge” in the Euler Equation pricing the capital stock

- Might proxy for un-modeled financial frictions (CKM, 2006)
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- This shock is a “wedge” in the Euler Equation pricing the capital stock
- Might proxy for un-modeled financial frictions (CKM, 2006)
- Interpretation: Great Moderation comes from a reduction in financial frictions
- Bingo!
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2. Comments on the empirical motivation
A closer look at the empirical motivation of JQ

- Decline in volatility of GDP in early 1980s is very sharp
Volatility of US GDP
A closer look at the empirical motivation of JQ

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- This is the real puzzle
- This is why the Monetary Policy hypothesis has received so much attention
A closer look at the empirical motivation of JQ

- Decline in volatility of GDP in early 1980s is very sharp
- This is the real puzzle
- This is why the Monetary Policy hypothesis has received so much attention
- Let’s have a look at the financial variables examined in JQ
Time varying SD of Debt Repurchase
Time varying SD of Equity Payout
Reduction in vol. of components of GDP

- Which component of GDP has experienced the sharpest and most dramatic reduction in volatility?
Reduction in vol. of components of GDP

GDP

Consumption

Investment

Non-durables

and services

Durables
Reduction in vol. of components of GDP

GDP

Consumption
- Non-durables
- Durables
- and services

Investment
- Non-residential
- Residential
Time varying SD of Non-Residential investment
Time varying SD of Equipment & Software
Time varying SD of Residential investment
Reduction in vol. of components of GDP

GDP

Consumption

Non-durables and services

Durables

Investment

Non-residential

Residential
Share of residential assets owned by HH
What do we learn?

- **Household** sector owns most of *residential* assets (85%)
- **Business** sector owns most of *non-residential* assets
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- Household sector owns most of residential assets (85%)

- Business sector owns most of non-residential assets

- Smooth change in volatility of firms’ financial structure is consistent with smooth change in volatility of non-residential investment!
What do we learn?

- Household sector owns most of residential assets (85%)
- Business sector owns most of non-residential assets
- Smooth change in volatility of firms’ financial structure is consistent with smooth change in volatility of non-residential investment!
- Shouldn’t we pay more attention to the household sector to explain the Great Moderation?
  - Campbell and Hercowitz (2006)
  - Mertens (2006)
  - Guerron (2006)
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2. Comments on the empirical motivation
   ■ Change in volatility of financial structure is too smooth
   ■ Household sector seems to be key
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3. Comments on the theoretical framework
Theoretical issues: a closer look at the model

Key elements

- Limited commitment
- Quadratic cost of paying out dividends
Theoretical issues: a closer look at the model

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**Limited commitment**
- Strong micro-foundation
- No role in the Great Moderation

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- Natural questions:
  - Why do we need it?
  - Can’t we write a simpler model?

**Quadratic cost of paying out dividends**
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**Quadratic cost of paying out dividends**
- Crucial for the quantitative result!
- Non-standard
- Ad-hoc
Theoretical issues: a closer look at the model

- Ad-hoc quadratic costs of paying out dividends
- Shouldn’t we think of structural interpretations?
  - Signaling problem
  - Progressive taxation
  - Risk adverse entrepreneurs
- Either non-symmetric cost or more appropriate interpretation for private equity
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2. Comments on the empirical motivation
   - Increase in volatility of financial structure is too smooth
   - Household sector seems to be important!

3. Comments on the theoretical framework
   - What is the role of limited commitment?
   - Quadratic adjustment costs of paying out dividends???