Comments on
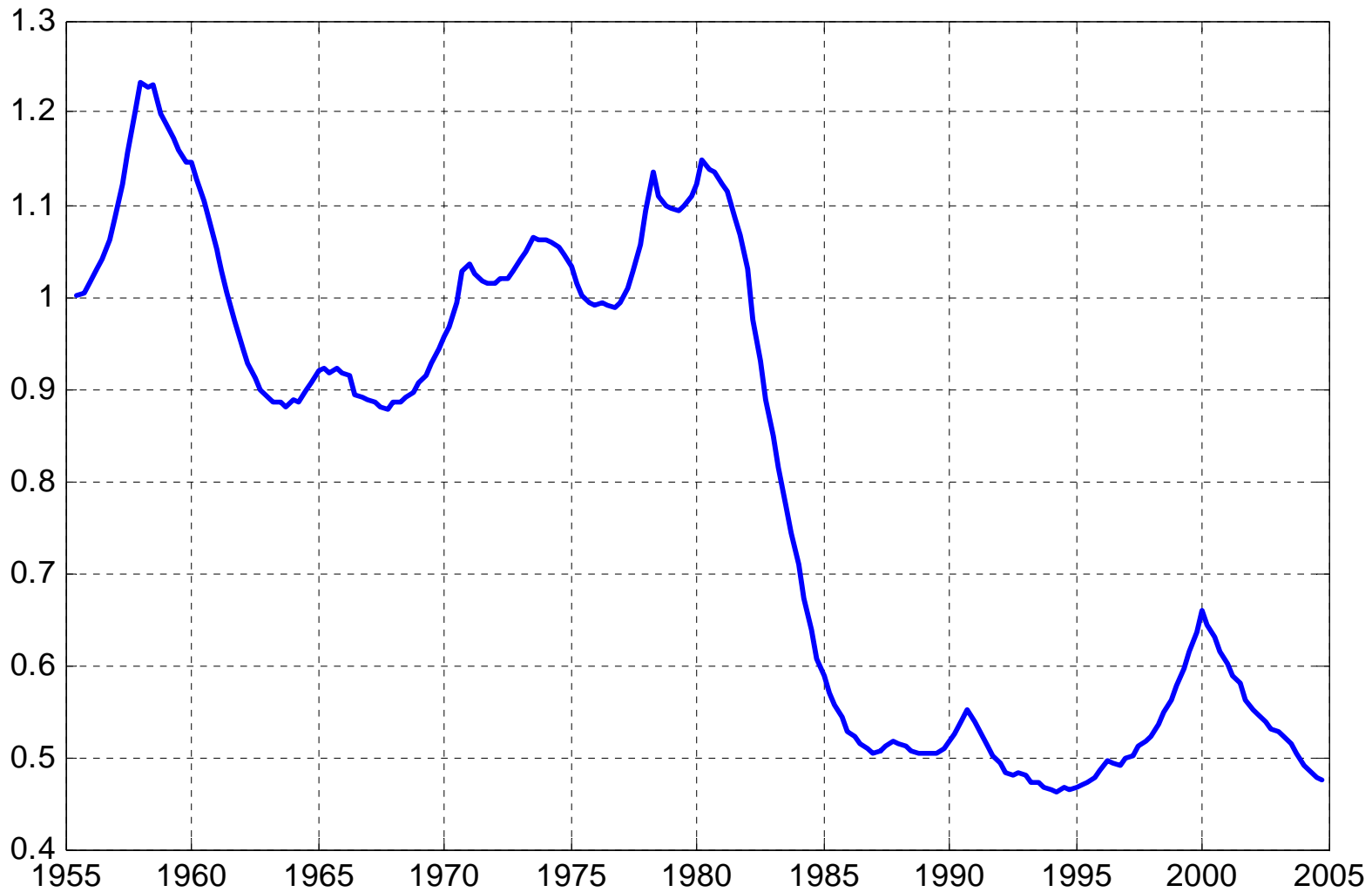
Financial Innovations and Macroeconomic Volatility
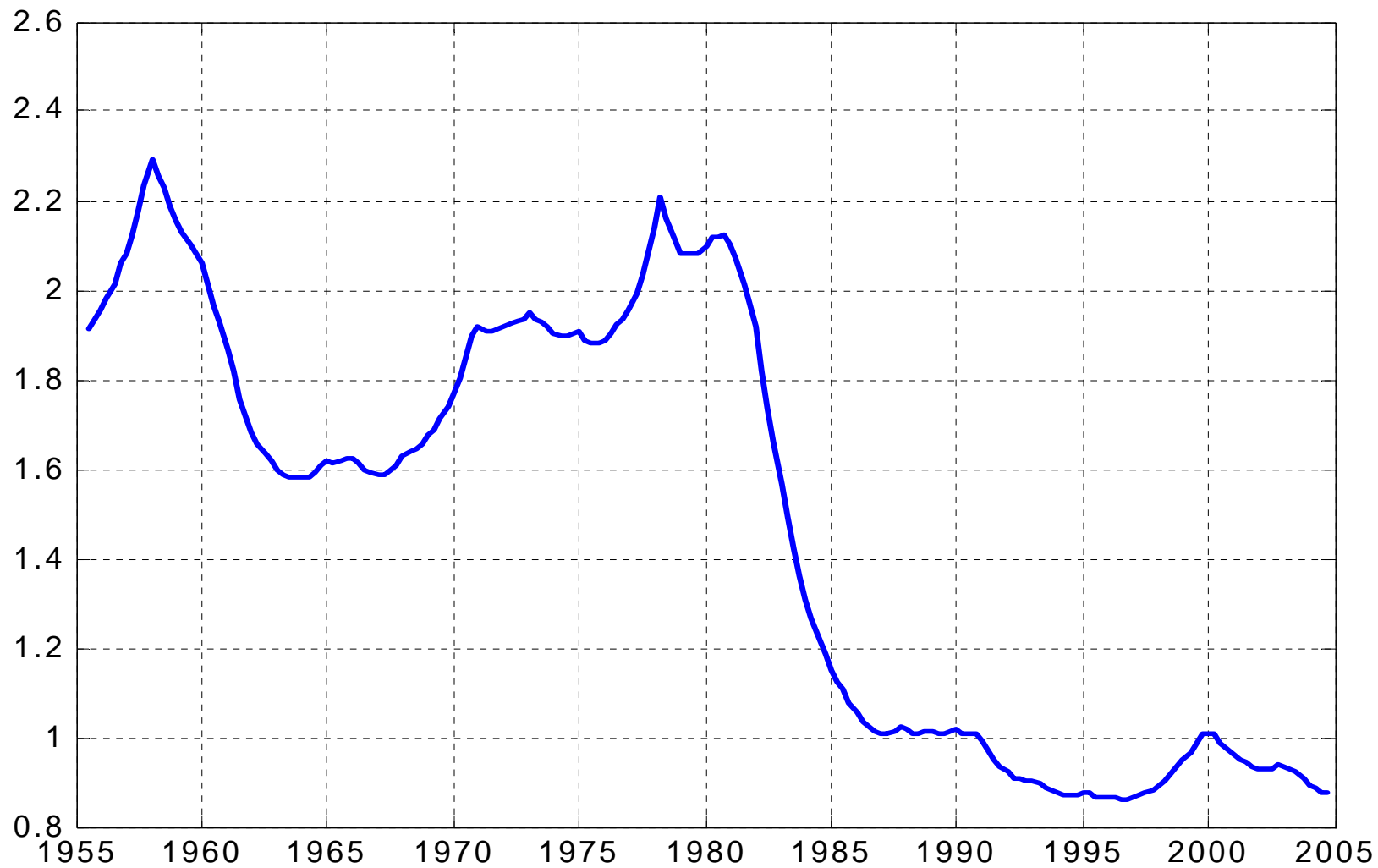
by **Urban Jermann and Vincenzo Quadrini**

Giorgio Primiceri
Northwestern University

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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- Justiniano and Primiceri (2005):
  Large scale DSGE model with time varying volatility of structural shocks

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- Justiniano and Primiceri (2005):
  Large scale DSGE model with time varying volatility of structural shocks

- Reduction in volatility of GDP explained by a reduction in volatility of a shock to the real return on capital

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- 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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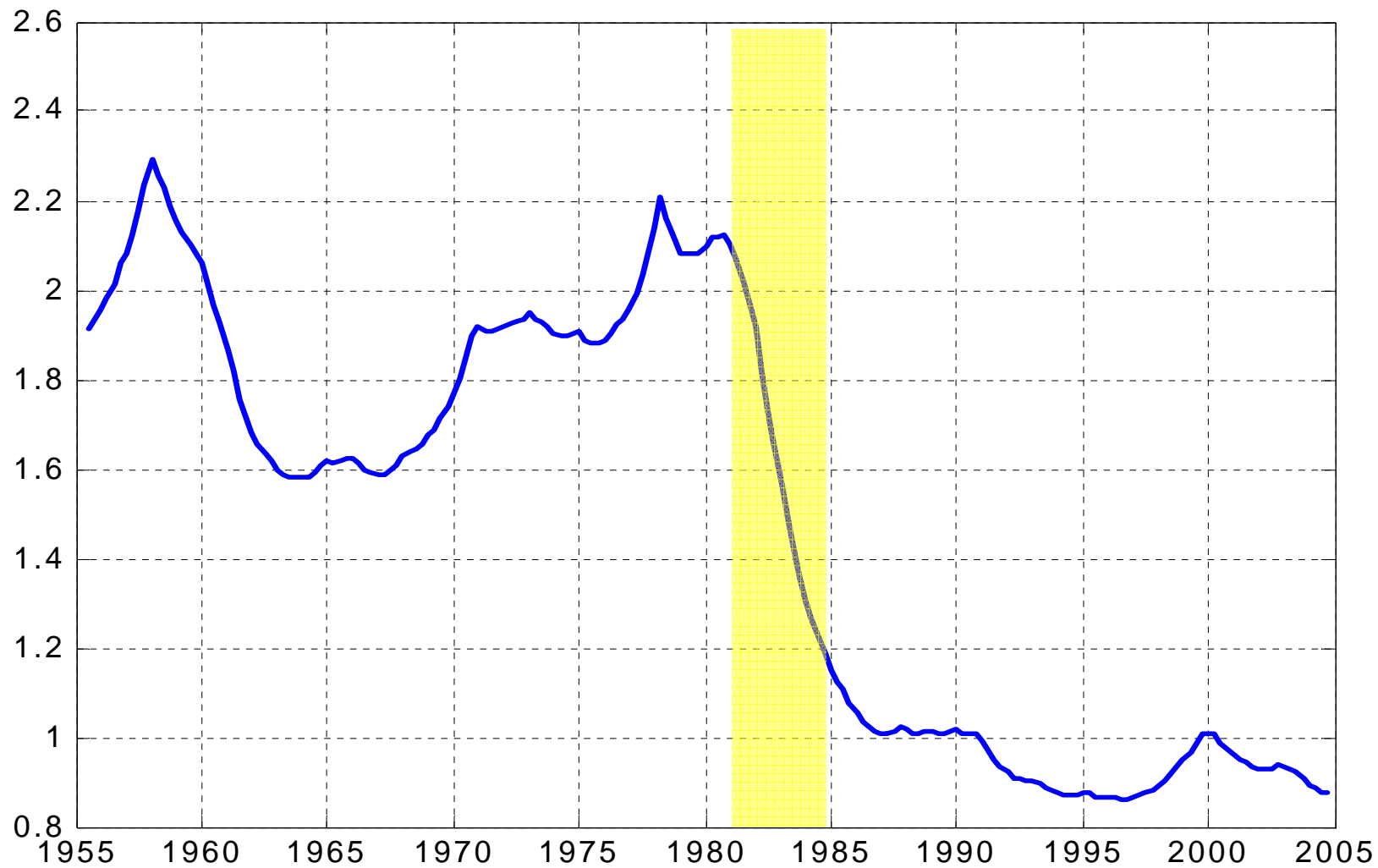
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A closer look at the empirical motivation of JQ

- Decline in volatility of GDP in early 1980s **is very sharp**

Volatility of US GDP

A closer look at the empirical motivation of JQ

- 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
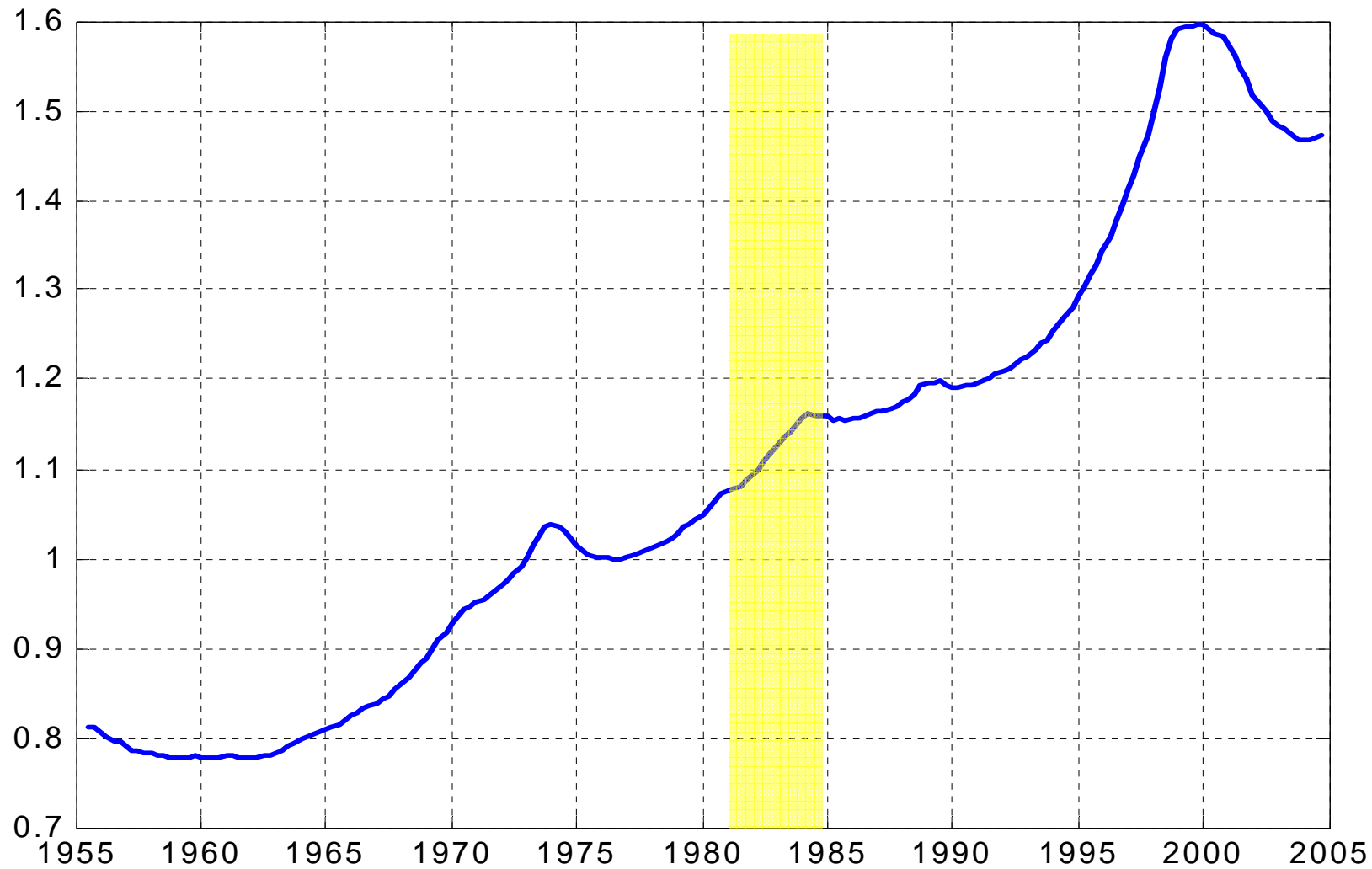
A closer look at the empirical motivation of JQ

- 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
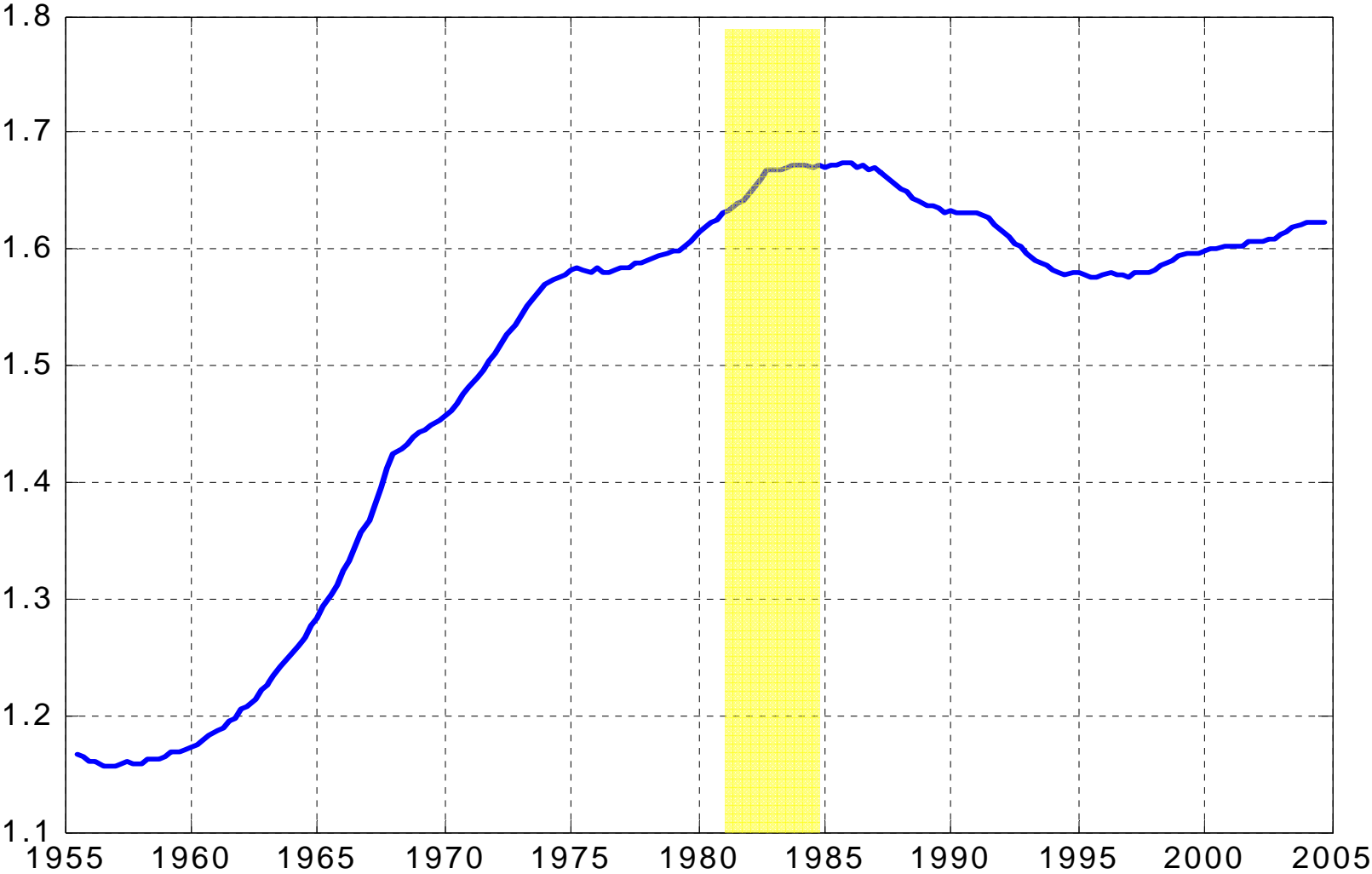
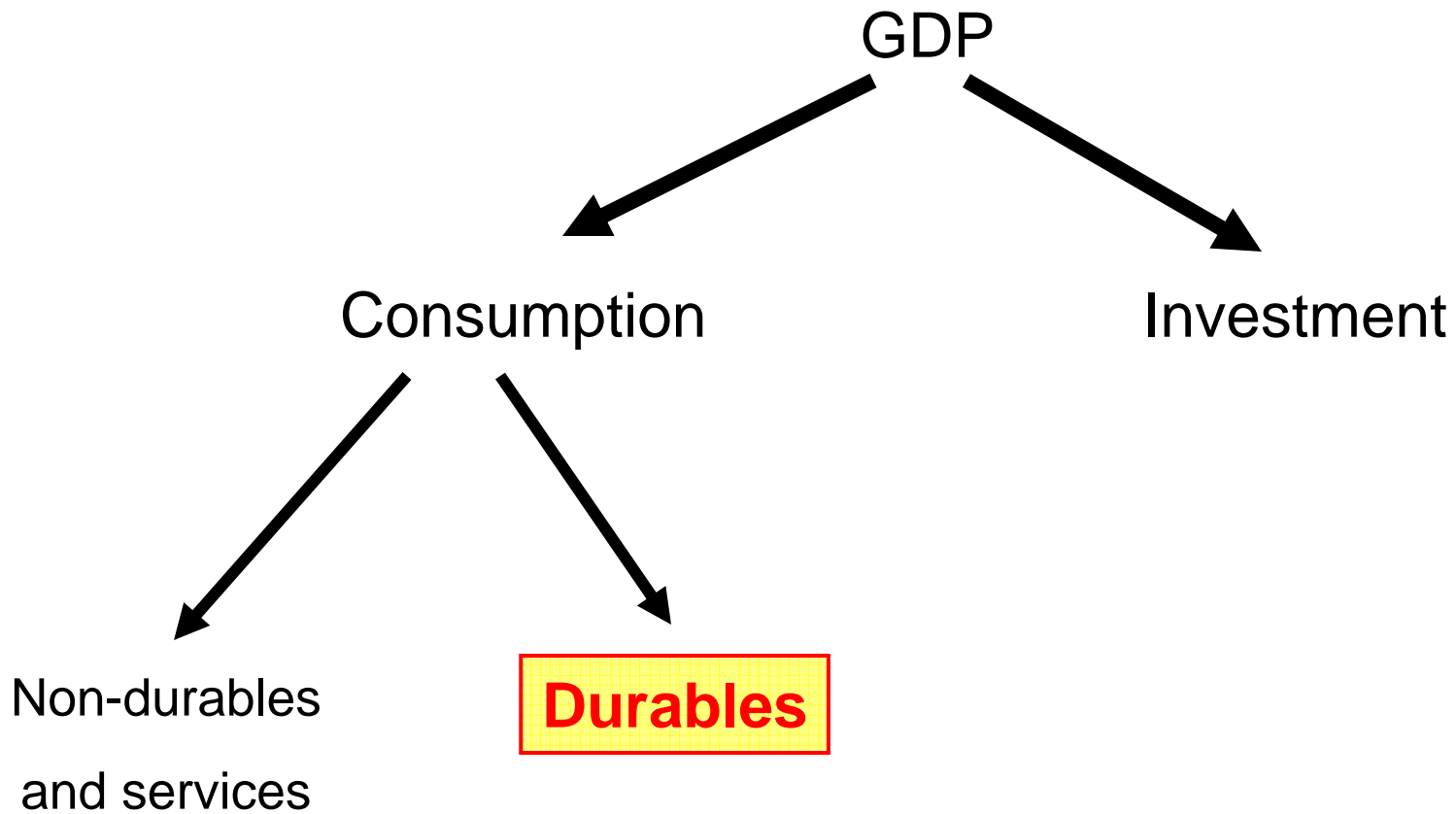# Time varying SD of Equity Payout

Reduction in vol. of components of GDP

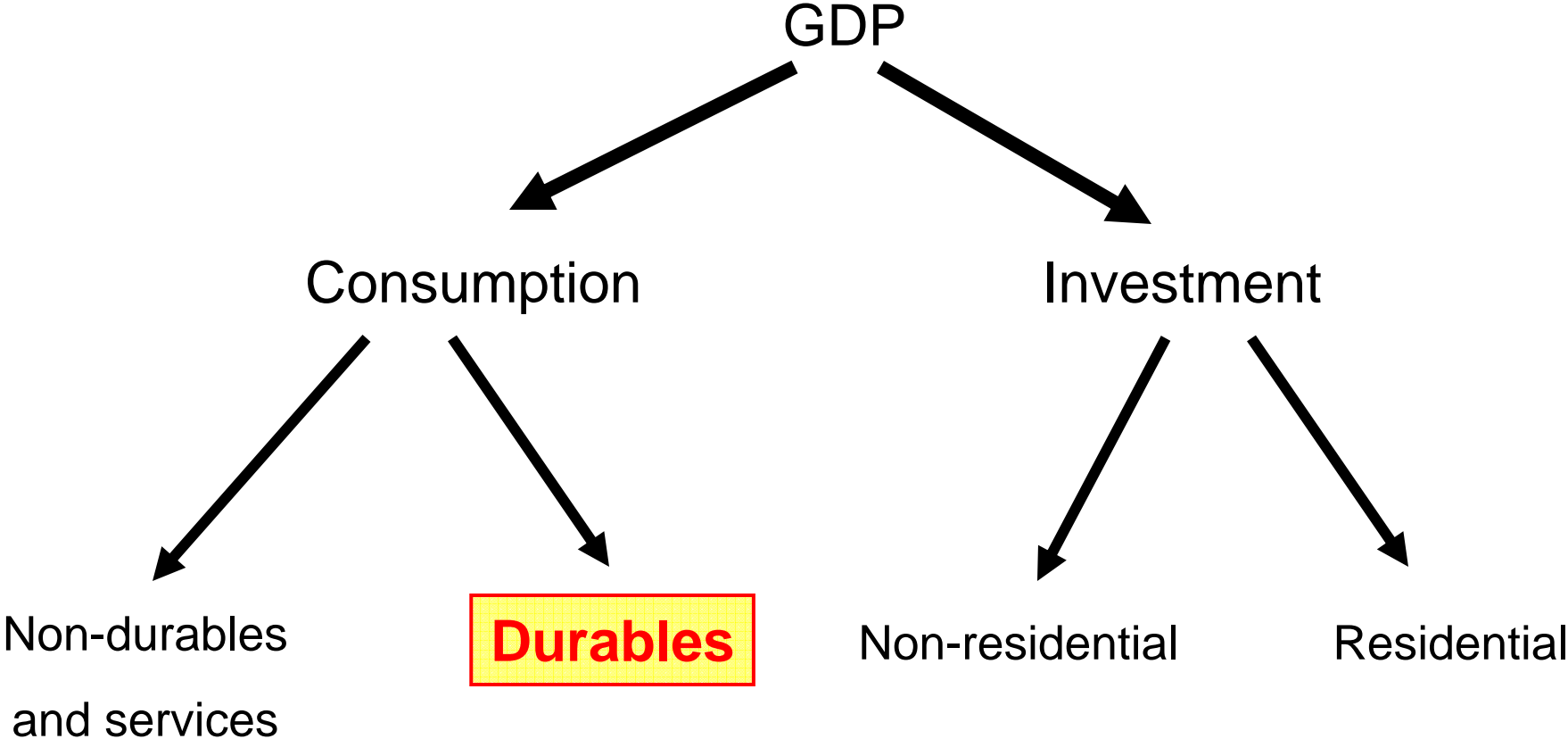- Which component of GDP has experienced the sharpest and most dramatic reduction in volatility?

Reduction in vol. of components of GDP

GDP

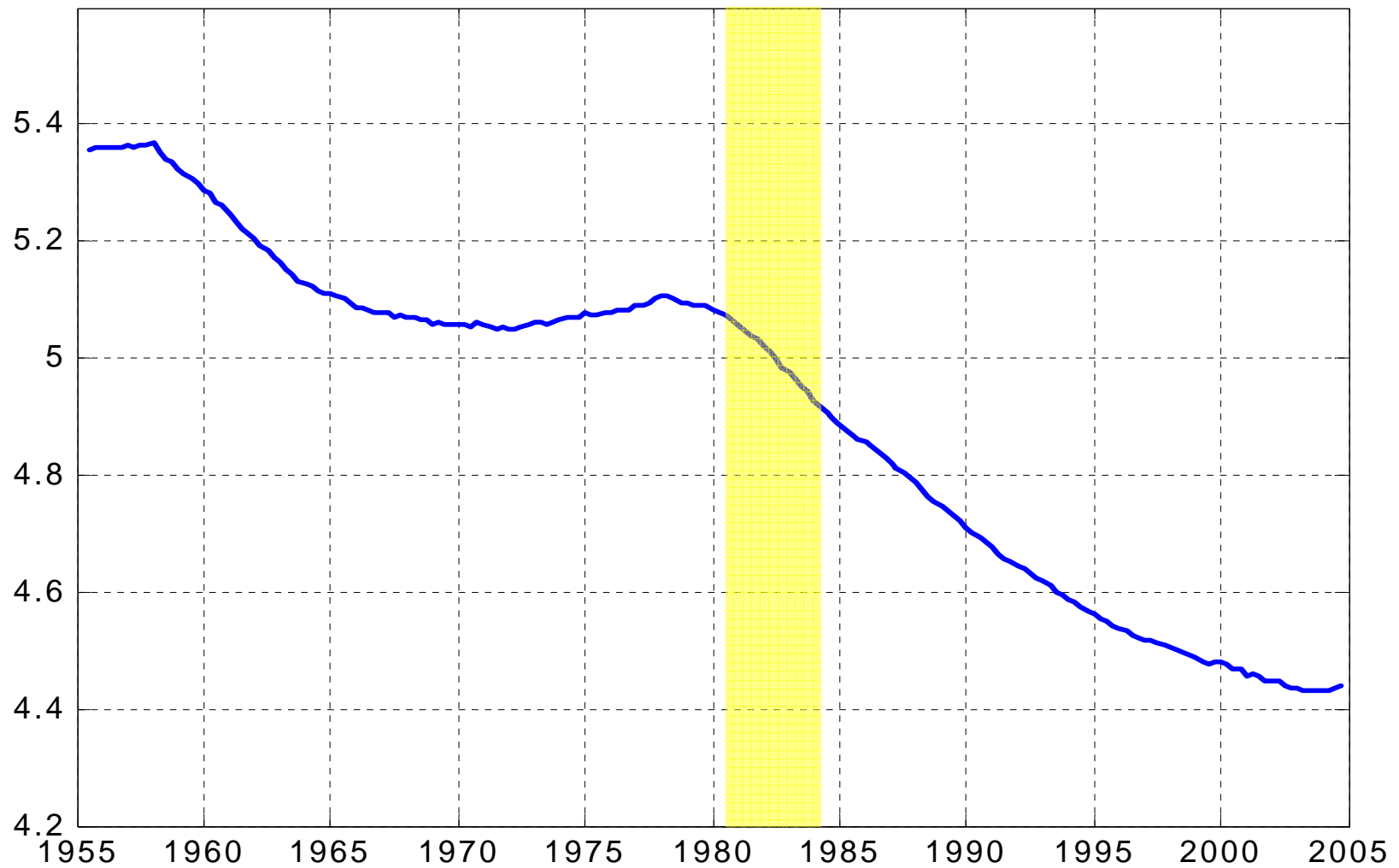Consumption

Investment

Non-durables

and services

Durables

Reduction in vol. of components of GDP

GDP

Consumption

Investment

Non-durables
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Durables

Non-residential

Residential
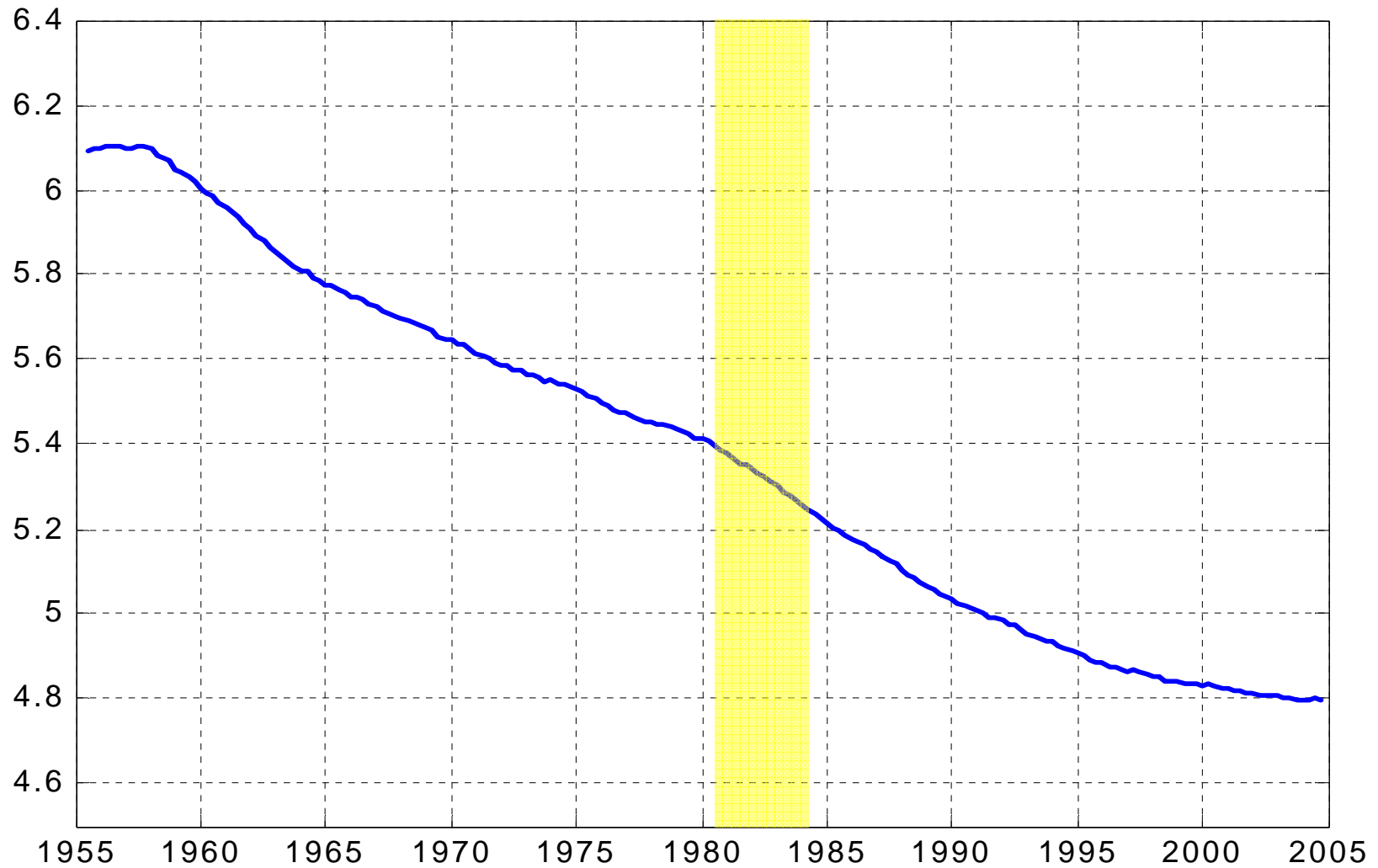
Time varying SD of Non-Residential investment
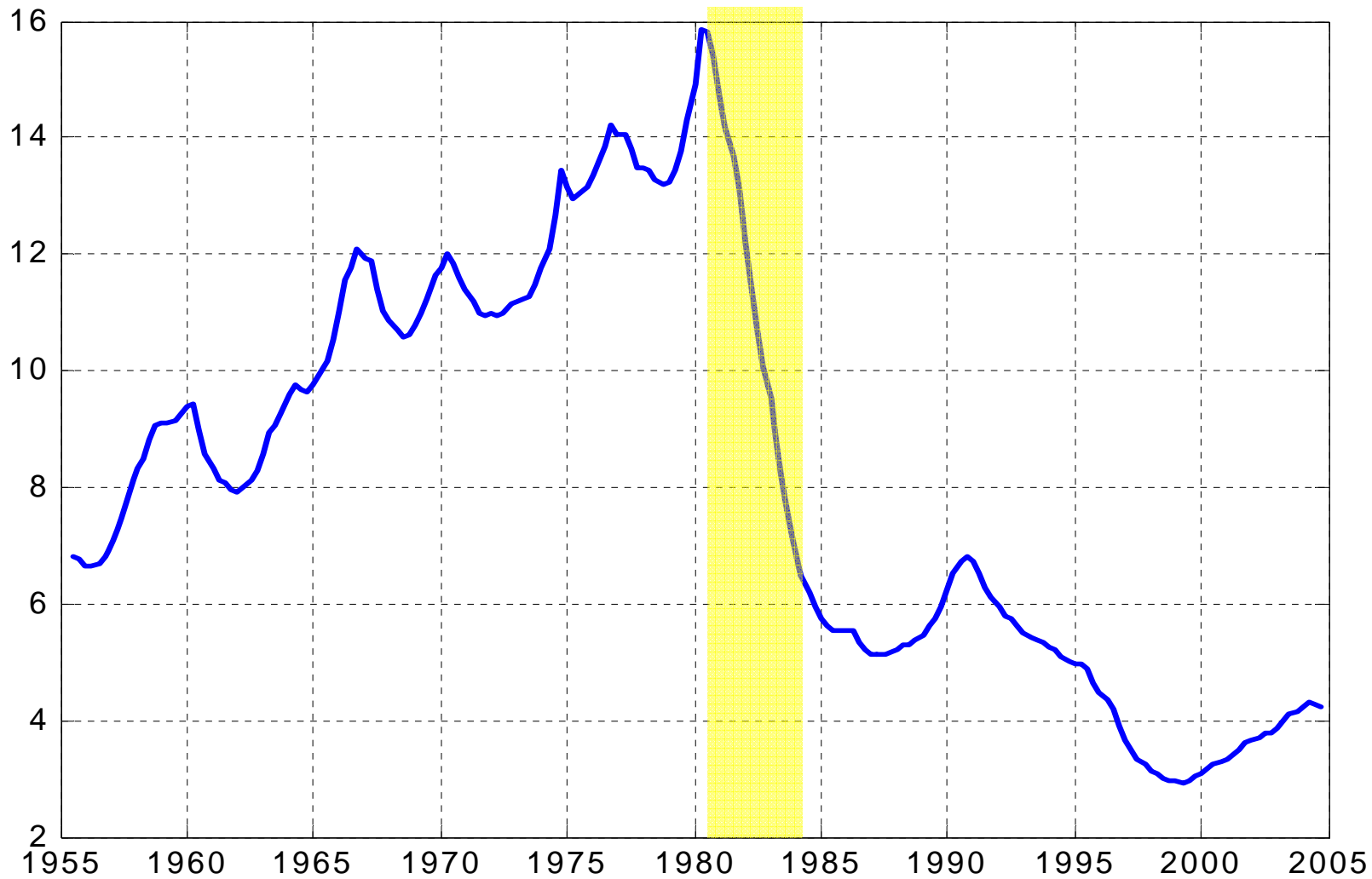
Time varying SD of Equipment & Software

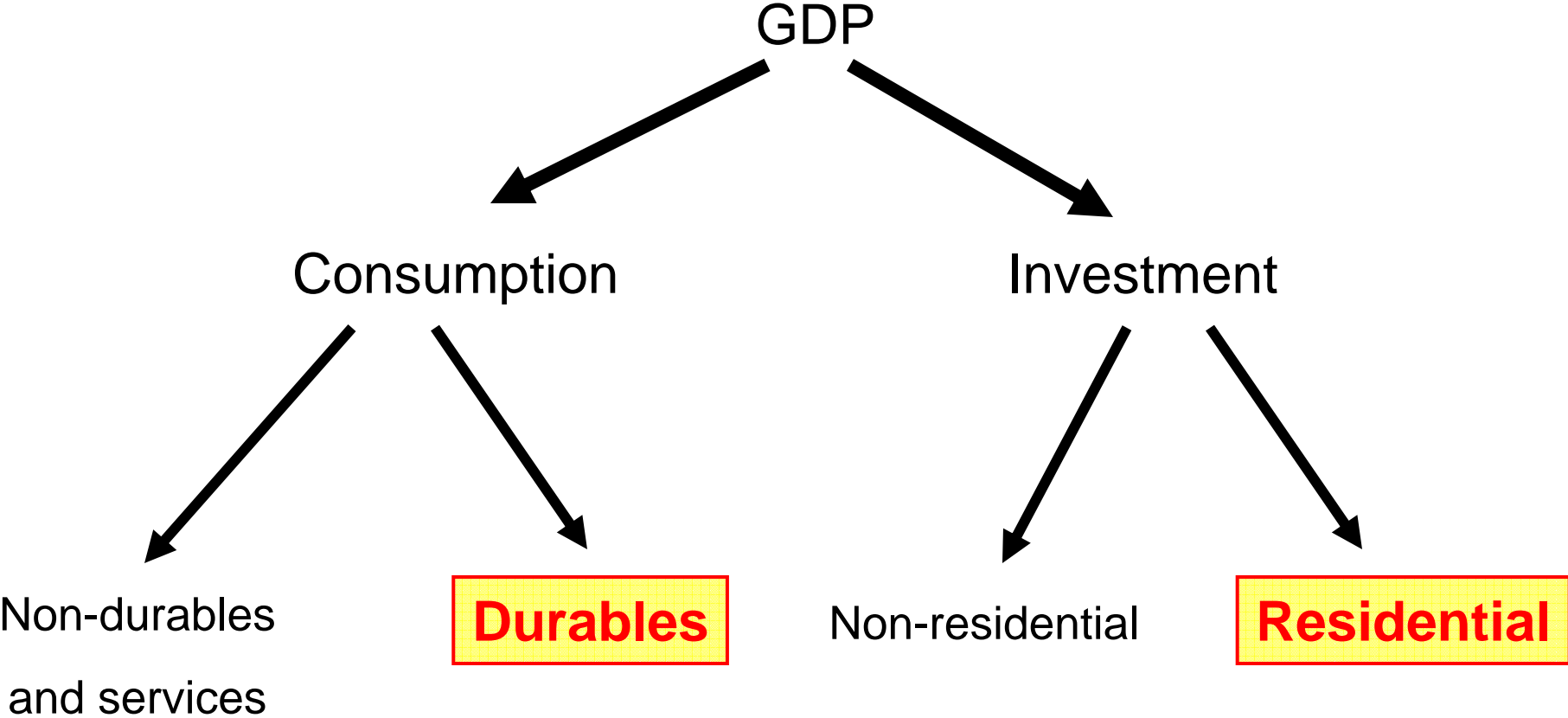# Time varying SD of Residential investment

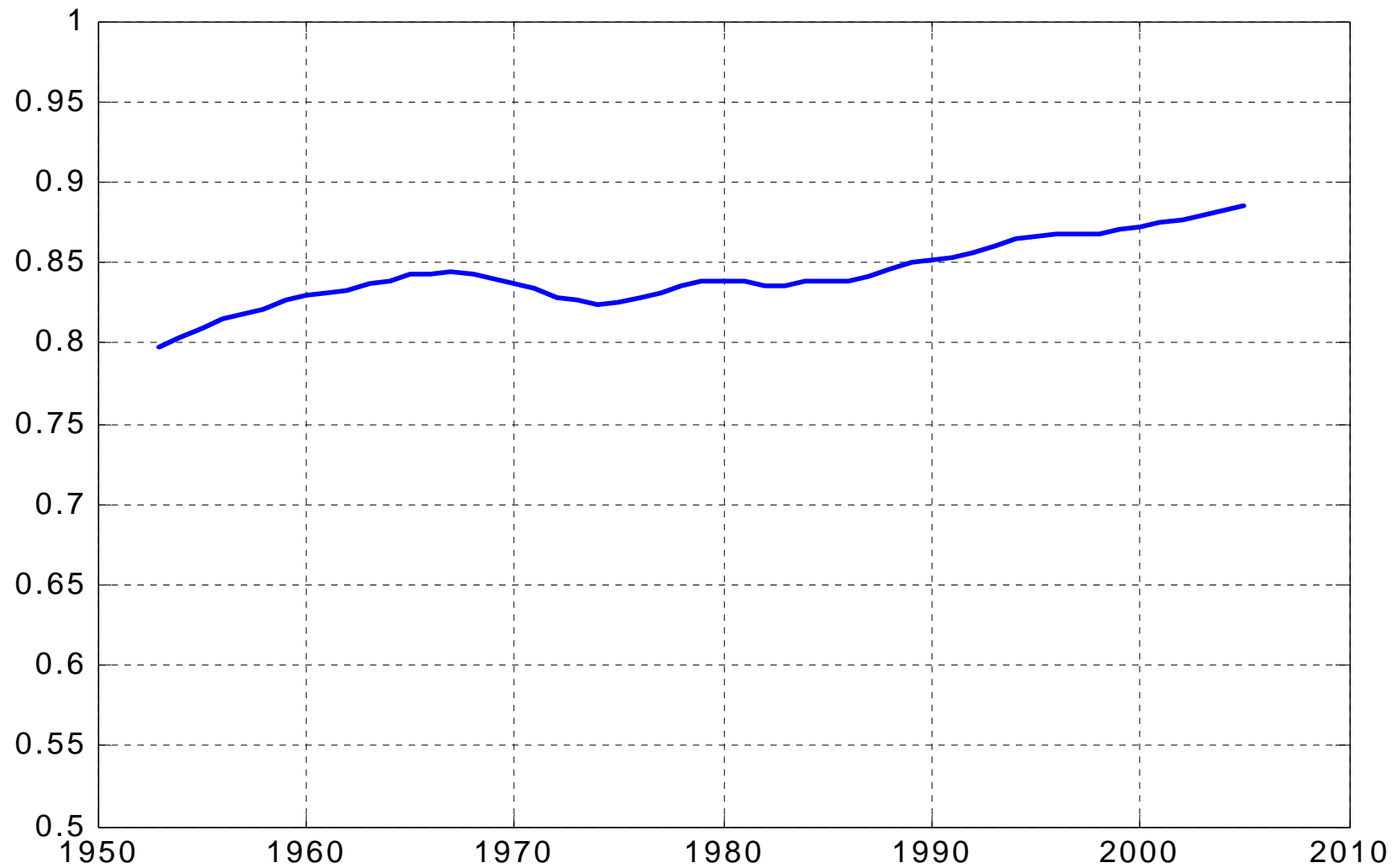# Reduction in vol. of components of GDP

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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- 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
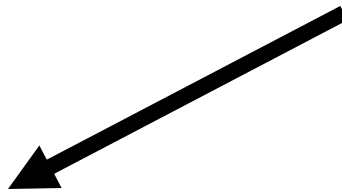
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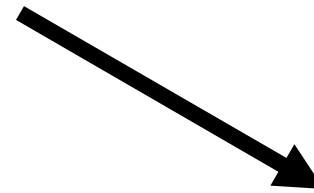3. Comments on the theoretical framework

Theoretical issues: a closer look at the model

Key elements

Limited commitment

Quadratic cost of paying out dividends

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- Strong micro-foundation

- No role in the Great Moderation

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  Why do we need it?
  Can't we write a simpler model?

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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

Outline of my Comments

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

    - Larger scale models indicates this as a promising direction

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???