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Editorial, NBER Macroeconomics Annual 1999

This volume of the *NBER Macroeconomics Annual* focuses primarily on explanations of current notable macroeconomic phenomena. Some of the papers also discuss policy responses. In particular, the paper by Jonathan Parker tries to understand the increase in the consumption-to-GDP ratio in the United States, the paper by John Heaton and Deborah Lucas tries to explain the rise in U.S. asset prices, the paper by Fernando Alvarez and Marcelo Veracierto seeks to rationalize unemployment in European countries, and the paper by Takeo Hoshi and Anil Kashyap explores the causes and implications of the Japanese banking crisis. The other papers in the volume deal with international financial and economic crises: Roberto Chang and Andrés Velasco propose a theory of liquidity crises in emerging markets and derive its policy implications, while Michael Mussa and Miguel Savastano discuss the IMF approach to dealing with stabilization and balance-of-payments crises.

The recent increases in both consumption and asset prices in the United States are related, because the latter is often used to rationalize the former. There is little doubt that a stock-market crash would dampen consumer spending. However, there is also an undeniable tension between explanations of the two phenomena. For example, one potential explanation for the rise in consumption is that people have become more impatient. On the other hand, an increase in impatience would normally require that asset prices fall, so that people would be willing to hold on to their assets. Thus, a potential explanation for the increase in asset prices is that people have become *more* patient. One common feature of the papers by Parker and by Heaton and Lucas is that they both dismiss monocausal explanations of the rises in consumption and asset prices, respectively, attributing these phenomena instead to a combination of factors.

Parker is able to cast doubt on a number of the single-cause explana-

tions that have been offered for the rise in the ratio of consumption to income. These include the changes in the age composition of the population, changes in government tax, transfer and spending policies, changes in access to credit, and, mostly notably, the aforementioned increase in asset prices. Parker in fact offers both timing and cross-section regression evidence that the increase in asset prices has relatively little to do with the consumption boom. By contrast, the possibility that increased impatience accounts for the increase in consumption cannot be ruled out, particularly as we have recently seen increases in real interest rates on fixed-income securities that exceed even the increase in the rate of growth of consumption.

Heaton and Lucas take aim at the claim that the stock-market boom in the United States can be explained by increases in stock-market participation. They point out that, even though many more individuals hold some stocks, the bulk of shares in publicly traded companies are still held by a very small fraction of the population. They also cast doubt on other single-cause explanations of asset price increases, including the suggestions that they reflect expected higher earnings growth or increased patience. However, by combining the various explanations, and in particular by giving a large role to increases in average diversification brought about by the explosive growth in mutual funds (which they model in a novel way), the authors can account quantitatively for the increase in U.S. stock prices. In his discussion, John Campbell argues that for the story to work diversification would need to have increased for the richest wealthholders as well, and he wonders whether this occurred in practice. This is now left as an important question for future research.

The volume includes two papers on crises in financial markets. The first, by Hoshi and Kashyap, is a study of the origins and likely future evolution of the problems of the Japanese banking system. Hoshi and Kashyap argue that, as in the case of many other banking crises, the origins of this problem can be traced to financial deregulation. In the Japanese case, this led the banks' best customers to borrow elsewhere. The authors show that much of the cross-sectional distribution of bank returns in Japan can be explained by the degree to which banks relied on large corporate customers who defected to the capital markets when deregulation permitted. A key question at this point is whether Japanese banks' fortunes can be expected to improve over time without much in the way of government help. This would be possible, for instance, if future bank profits could be expected to cover some of the losses that have yet to be recognized formally.

Hoshi and Kashyap argue forcefully against the optimistic view, on

the basis of two pieces of evidence. First, a rereading of the accounting evidence suggests to them that the magnitude of Japanese bank losses is very large. Second, they expect the Japanese banking system to shrink over time, rather than grow. The main basis for this conclusion is that they expect financial-market deregulation to lead Japanese borrowers to become as dependent on banks as U.S. borrowers are. Since many firms in Japan still rely on bank financing to a larger extent than similarly placed U.S. firms, the implication is that bank lending in Japan will begin to shrink substantially. Thus there is little chance that the bad-loan problem of Japanese banks will cure itself without substantial outside help. As the discussants emphasized, the future of Japanese banks would be much brighter if they could expect to increase their fee income to the extent that U.S. banks have done. Hoshi and Kashyap suggest that this is one respect where, unfortunately, the institutions in the two countries do not appear to be converging, as Japanese banks still derive very little of their income from fees.

The second paper on financial-market crises is by Chang and Velasco, who focus on recent financial problems in emerging markets. The aim of their paper is to discuss the properties of these crises as well as the policy implications derived by considering a very specific interpretation of these crises. In particular, motivated by the observation that many of these crises occurred in situations where countries' reserves were low relative to their short-term loans from abroad, Chang and Velasco consider a theoretical setting in which the crises are essentially the results of bank runs. Foreigners lend funds to banks in emerging markets, which in turn use the funds to finance illiquid investments. If domestic residents run on the banks, then the investments must be liquidated, the returns are low, and foreigners cannot all be repaid.

Chang and Velasco use a model that has much in common with the celebrated Diamond–Dybvig model of bank runs. However, their setting differs in that, unlike a central bank in a closed economy, the government of a small open economy cannot act as a lender of last resort if the exchange rate is fixed, or if all transactions are carried out in foreign currency. It is for this reason that regulatory interventions can be much more appealing in the open-economy context. For example, an emerging-market government may wish to encourage domestic banks to borrow long-term even though individual banks prefer to borrow short-term. The reason is a type of externality, arising because individual banks ignore the effects of their increased short-term borrowing on the likelihood of a run on the entire banking system. Similarly, Chang and Velasco show that financial-market liberalization may make emerging economies more vulnerable to runs. The exchange-rate

regime also has implications for the financial fragility studied in this paper: In particular, the existence of flexible exchange rates, together with the requirement that domestic residents make their deposits in domestic currency, makes it possible for emerging-market governments to act as lenders of last resort after all. Under these conditions the government can respond to an impending run by printing the requisite domestic currency, then allowing the currency to depreciate. In the Chang–Velasco model this strategy avoids runs altogether.

Several commentators noted that these issues of financial fragility were not central in Mussa and Savastano's discussion of the IMF approach to economic stabilization. Rather, their paper suggests that the IMF views the countries that seek its support as requiring changes in "fundamentals," so that their current-account financing problems do not recur. The required changes in fundamentals involve fiscal and monetary contractions as well as reforms of institutions. The liberalization that lies at the heart of many of the proposed institutional reforms is seen as necessary to increase sustainable growth. The paper spends relatively little time defending these specific institutional reforms against their critics, however. Rather, the paper deals explicitly with several other criticisms of IMF programs. It argues, for example, that IMF programs are not all identical; for example, the magnitudes of fiscal and monetary adjustments that are proposed differ by country. The paper emphasizes that, in addition, IMF programs react flexibly to evolving circumstances. Initial IMF targets are not rigidly maintained over time but rather are allowed to change as new information accumulates. Mexico's successful adjustment to the 1994 crisis, for example, involved the violation of several interim program targets.

The authors see the need for fiscal contraction as relatively noncontroversial, because it improves the current account by reducing imports. That these contractions can also reduce the feasible repayment to foreign creditors by reducing asset values is recognized indirectly, by acknowledging that the required fiscal adjustments are sometimes modest. Still, the extent to which the IMF takes this problem into account is quite controversial. The lack of a precise formula by which fiscal adjustments are set, while probably a strength given the myriad considerations that make each country a special case, naturally complicates the judgment of whether the IMF staff is giving these considerations their proper weight.

Mussa and Savastano recognize that the domestic credit creation targets are more controversial. One reason for this is that one cannot forecast future credit creation (or money growth) without a model for money demand, and estimated money demand curves have large residuals. They thus take pains to argue that these targets are not rigidly adhered

to as circumstances change. Since there has been a shift (in both academic discourse and central bank practice) back towards thinking of monetary policy in terms of interest rates, the IMF might be able to silence this criticism at low cost by describing its suggestions for monetary policy in these terms. It might then be easier to communicate that the IMF cannot accept blame simultaneously for raising interest rates and for allowing currencies to devalue, given that it sees interest-rate increases as the only short-term method for preventing depreciation.

Alvarez and Veracierto return to a topic that has long occupied the *Macro Annual*, namely the increase in European unemployment. The authors try to deduce the importance of European labor-market policies by studying these within a simple calibrated model of search, in which unemployed individuals are indifferent between searching and staying out of the labor force altogether. They focus, in particular, on minimum wages, increases in wages brought about by unions, firing taxes, and unemployment insurance. Even setting the minimum wage so that it covers 90% of the average wage has very little effect on unemployment in the model. Minimum wages might well have larger effects if the model were extended so that workers would not all earn the same wage in the absence of the search frictions. While unions also raise wages, they raise wages for everyone, and the result is that they have much larger effects on unemployment. One attractive feature of the authors' model with unions is that it can easily match both the size of the union wage premium and the fraction of the U.S. workforce that is employed by unions.

As in many previous studies, firing taxes are found to have relatively modest effects on unemployment, because they discourage both hiring and firing. By contrast, unemployment insurance acts as a firing subsidy in this model. It thus leads to a substantial increase in the number of temporary withdrawals from work that are rewarded by the government. While this means that UI has a large effect on unemployment, Alvarez and Veracierto show that the effects implied by their model are similar in magnitude to those estimated by Nickell (1997) using a cross section of countries. The fact that such strong policy conclusions follow from such a stripped-down model led many commentators to worry about the robustness of the results. It was generally agreed, however, that the advantage of the broad modeling framework of the paper is that it can be modified to study many aspects of the labor market while providing a range of testable implications.

We close with some acknowledgments. We owe a tremendous debt of thanks to the NBER's conference department, who as usual did a superb job with the logistics. Refet Gurkaynak did a fine job as assistant editor

of this volume. We also wish to thank Martin Feldstein, the National Bureau of Economic Research, and the National Science Foundation for their continued support of the *Macro Annual* conference, now in its fourteenth year.

This is the last volume for which Julio Rotemberg will serve as coeditor. Julio would like to express his thanks to the authors, discussants, and conference participants who over the years have made his job so interesting.

Ben S. Bernanke and Julio J. Rotemberg