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# *Abstracts*

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## *Macroeconomics and Politics*

ALBERTO ALESINA

The recent game-theoretic macroeconomic literature provides a useful tool for analyzing the relationship between political institutions and the macroeconomy. In particular, this paper examines two related issues: the effects of electoral competition on macroeconomic policy and on the economic cycle, and the role of different degrees of independence of the Central Bank as a determinant of monetary policy. The game-theoretic literature in this area has generated several results that are consistent with the empirical evidence. This claim is supported by reviewing the available empirical results and by performing several new tests. In particular, this paper emphasizes the different empirical implications of rational and optimizing politico-economic models in respect to non-rational approaches. Several open issues and new directions of research are also explored in the conclusions.

## *What are the Costs of Excessive Deficits?*

DAVID ROMER

This paper addresses the question of whether or not a period of large government budget deficits, such as that experienced by the United States in the 1980s, is likely to be highly costly to the economy. It finds that if present and future taxpayers are less than perfectly linked, and if the capital stock is too low, then redistributions of wealth from future to present generations—which would result from a policy of temporarily low taxes and high deficits—directly reduce social welfare. The welfare costs of deficits created in this way are likely to be large even if the links between present and future generations are nearly perfect. By contrast, other commonly emphasized costs of deficits, in particular costs through the crowding out of capital (because of either imperfect links between generations or liquidity constraints) or through an irregular pattern of taxes, appear to be of moderate size for plausible parameter values.

### *Sources of Business Cycle Fluctuations*

MATTHEW SHAPIRO AND MARK WATSON

What shocks account for the business cycle frequency and long-run movements of output and prices? This paper addresses this question using the identifying assumption that only supply shocks, such as shocks to technology, oil prices, and labor supply affect output in the long-run.

Real and monetary aggregate demand shocks can affect output, but only in the short-run. This assumption sufficiently restricts the reduced form of key macroeconomic variables to allow estimation of the shocks and their effect on output and price at all frequencies. Aggregate demand shocks account for about 20 percent to 30 percent of output fluctuations at business cycle frequencies. Technological shocks account for about 1/4 of cyclical fluctuations, and about 1/3 of output's variance at low frequencies. Shocks to oil prices are important in explaining episodes in the 1970s and 1980s. Shocks that permanently affect labor input account for the balance of fluctuations in output, namely, about half of its variance at all frequencies.

### *Equilibrium Interpretations of Employment and Real Wage Fluctuations*

JOHN KENNAN

This paper uses an equilibrium approach to analyze monthly data on employment, hours worked, and real wages in manufacturing industries for six countries (Austria, Canada, Denmark, Japan, the United Kingdom, and the United States). If the data represent equilibrium responses to labor demand shocks (such as technology shocks), then the real wage should be strongly procyclical. However, the paper shows that, under certain structural interpretations of the data, the real wage is not strongly procyclical, even though the model is driven almost entirely by labor demand shocks.

### *Perspectives on the Japanese Current Account Surplus\**

KAZUO UEDA

This paper uses a number of perspectives to analyze the causes of the strong correlation between fiscal policy variables and the Japanese current account surplus in the 1980s. The paper finds that the price elasticities of trade flows and the interest rate elasticities of investment are fairly low. Accordingly, the paper argues that the popular Mundell-Flemming approach somewhat overemphasizes the causality from fiscal policy to the current account. Conversely, the importance of U.S. fiscal policy and the decrease in oil prices may have been understated in previous explanations of the increase in the Japanese current account surplus. The decline in the budget deficits through the traditional income-expenditure mechanism were also important. From a longer-term perspective, the sharp slowdown in private investment in the 1970s and its relative stability in the 1980s, despite large

fluctuations in oil prices, is an important cause of both the surplus and the strong correlation between fiscal policy and the current account. Such a perspective helps to understand the developments in the 1985–87 period as well.

### *An Equilibrium Model of the Crash*

FISCHER BLACK

Fischer Black theorizes that investors' tastes had been changing, in that they were tolerating higher levels of risk at various levels of income than before. He also assumes that investors' estimates of mean reversion, that is, the change in the market's expected return following a change in the level of the market, were growing more slowly than actual mean reversion before the crash. When investors realized their error, he believes, they reduced their estimates of expected return and cut their holdings of stocks.

### *Crash-Testing the Efficient Market Hypothesis*

KENNETH FRENCH

Kenneth French believes that neither investor panic nor a breakdown of market mechanisms on October 19 drove prices to an irrationally low level. Rather, the crash may have been the response of an efficient market to news about expected future cash flows or returns. French theorizes that prices were irrationally high before the crash, that investors were unaware of this, and that events on or about October 19 brought prices back to rational levels. His conclusion is that no new regulation of the stock market is necessary.

### *Portfolio Insurance and Other Investor Fashions as Factors in the 1987 Stock Market Crash*

ROBERT SHILLER

Robert Shiller asserts that investors already had a "crash mentality" before October 19, associated with views about borrowing, government debt, and the perception that portfolio insurance was affecting markets. The proximate cause of the crash, he believes, was a response to price declines: the assumption by investors that the crash had arrived. In Shiller's opinion, the crash was as much a sociological or psychological phenomenon as an economic one.

