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Abstracts

Wage Inequality and Unemployment: United States vs. Europe

GIUSEPPE BERTOLA AND ANDREA ICHINO

Throughout the 1970s and 1980s, wage differentials widened in the U.S. but not in Europe, where marginal labor-force groups experienced increasing and persistent unemployment instead. Both phenomena may be explained, for different labor-market institutions, by more pronounced volatility of labor-demand forcing processes in a simple model of labor allocation under idiosyncratic uncertainty. If workers bear the costs of labor reallocation, then a higher option value of work in currently depressed regions, occupations, or sectors is consistent with wider wage differentials in equilibrium. Under centralized wage setting and job-security legislation, conversely, higher likelihood of negative shocks in the near future decreases labor demand by hiring firms. These and other implications of our model are consistent with the phenomena motivating our work and with other pieces of evidence.

Capital Utilization and Returns to Scale

CRAIG BURNSIDE, MARTIN EICHENBAUM, AND SERGIO REBELO

This paper studies the implications of procyclical capital utilization rates for inference regarding cyclical movements in labor productivity and the degree of returns to scale. We organize our investigation around five questions that we study using a measure of capital services based on electricity consumption: (1) Is the phenomenon of near or actual short-run increasing returns to labor an artifact of the failure to accurately measure capital utilization rates? (2) Can we find a significant role for capital services in aggregate and industry-level production technologies? (3) Is there evidence against the hypothesis of constant returns to scale? (4) Can we reject the notion that the residuals in our estimated production functions represent technology shocks? (5) How does correcting for cyclical variations in capital services affect the statistical properties of estimated aggregate technology shocks? The answer to the first two questions is yes. The answer to the third and fourth questions is no. The answer to the fifth question is "a lot."

Real Effects of Exchange-Rate-Based Stabilization: An Analysis of Competing Theories

SERGIO REBELO AND CARLOS A. VÉGH

This paper uses a unified analytical framework to assess, both qualitatively and quantitatively, the relevance of the different hypotheses that have been proposed to explain the real effects of exchange-rate-based stabilizations. The four major hypotheses analyzed are: (1) the supply-side effects associated with an inflation decline; (2) the perception that the exchange-rate peg is temporary; (3) the fiscal adjustments that tend to accompany the peg; and (4) the existence of nominal rigidities in wages or prices.

Inflation Indicators and Inflation Policy

STEPHEN G. CECCHETTI

In recent years, policymakers throughout the world have advocated that monetary policy shift toward inflation targeting. Recent actions in the United States serve to highlight the desire of the Federal Reserve to keep inflation both low and stable, while downplaying the likely output and employment consequences. But control of inflation requires both that one be able to forecast its future path, and that one have estimates of what impact policy changes have on that path. Unfortunately, inflation is very difficult to forecast even at very near horizons. This is true because the relationship of candidate inflation indicators to inflation is neither very strong nor very stable. Beyond this, the relationship between monetary policy instruments, such as the federal funds rate, and inflation also varies substantially over time and cannot be estimated precisely. Construction of policy rules must take these difficulties into account. Several rules are examined, and they have the following interesting properties. First, since prices take time to respond to all types of impulses, the federal funds rate should be raised immediately following a shock. One should not wait for prices to rise before acting. Finally, comparison of the results of price-level targeting with nominal-income targeting suggest that the difficulties inherent in forecasting and controlling the former provide an argument for focusing on the latter.

Recent Central-Bank Reforms and the Role of Price Stability as the Sole Objective of Monetary Policy

CARL E. WALSH

Recent and prospective central banking reforms represent attempts to develop institutional solutions for the inflation bias that can arise under discretionary monetary policy. An alternative to mandated objectives or targeting requirements is offered by proposals to develop incentive contracts that base the central bank's rewards (or penalties) solely on the realized rate of inflation. Deriving optimal incentive schemes provides a normative benchmark against which central bank institutions can be compared. New Zealand's policy structure most resembles a performance contract; it has well-defined procedures for setting short-run targets and a system to ensure accountability. As yet, however, this system has not really been tested. In Europe, the emphasis has been on political independence. Less attention has been given to ensuring that the correct incentives for making short-run policy tradeoffs are established, nor has sufficient attention been placed on ensuring accountability.

Declarations Are Not Enough: Financial Sector Sources of Central Bank Independence

ADAM S. POSEN

This paper seeks to explain the pattern of central bank independence prior to the recent fashion for its adoption. The sources of central bank independence matter for economic outcomes because it is by no means clear that such independence is self-enforcing. Since central bankers know that exercise of their independence can be curtailed, they will only pursue counterinflationary policies consistently when there exists an interest group that can protect them politically from the costs of doing so. This paper argues that the financial sector is the most prominent such group, and that central bank independence—and inflation—varied across countries from 1950 to 1989 according to national differences in effective financial opposition to inflation. The results of this analysis have two major policy implications: (1) moves to central bank independence in countries where appropriate political support does not exist may not reduce inflation over the long term; (2) financial deregulation will affect inflation levels in previously unrecognized ways.

The Unending Search for Monetary Salvation

STANLEY FISCHER

This paper discusses some recently popular strategies for improving the performance of monetary policy, including increasing the independence of the central bank, setting explicit inflation targets, and fixing the exchange rate. With respect to central bank independence, the most important conclusion is that a central bank should have instrument independence (the freedom to set its instruments as it chooses) but not goal independence (the freedom to set its ultimate objectives); this arrangement makes the central bank accountable, which is necessary both for the central banker to have proper incentives and for democratic oversight. The need for accountability is also a reason to set explicit inflation targets; inflation targeting does not necessarily imply greater output variability, if the target inflation rate is adjusted for supply shocks. Fixing the exchange rate—even temporarily—may help reduce inflation and inflationary expectations, particularly in an economy starting from a situation of low central bank credibility.

Banks and Derivatives

GARY GORTON AND RICHARD ROSEN

In the last ten to fifteen years financial derivative securities have become an important, and controversial, product for commercial banks. The controversy concerns whether the size, complexity, and risks associated with these securities; the difficulties with accurately reporting timely information concerning the value of firms' derivative positions; and the concentration of activity in a small number of firms has substantially increased the risk of collapse of the world banking system. Despite the widespread attention to derivatives, there has been little systematic analysis. We estimate market values and interest-rate sensitivities of interest-rate swap positions of U.S. commercial banks to empirically address the question of whether swap contracts have increased or decreased systemic risk in the U.S. banking system. We find that the banking system as a whole faces little net interest-rate risk from swap portfolios.