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Chapter Author: Ben S. Bernanke, Julio J. Rotemberg

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Abstracts

Liquidity Crises in Emerging Markets: Theory and Policy

ROBERTO CHANG AND ANDRÉS VELASCO

International illiquidity—defined as a situation in which a country's consolidated financial system has potential short-term obligations in foreign currency that exceed the amount of foreign currency to which it has access on short notice—was a common element in recent financial and exchange-rate crises in Mexico, East Asia, Russia, Eduador, and Brazil. Illiquidity can render economies vulnerable to self-fulfilling panics. If creditors lose confidence and stop rolling over existing loans—whether to the private sector as in Asia or to the government as in Mexico or Brazil—the collapse of the currency or the financial system or both is the likely outcome. We build a model of crashes driven by illiquidity and show how and in what circumstances self-fulfilling collapses can occur. Vulnerability depends on a host of factors, such as the maturity and currency denomination of debts, the health of the banking sector, the fiscal stance, and the exchange-rate regime. We also use the model to analyze options for crisis prevention and crisis management. Certain kinds of capital controls, stringent bank regulation, and flexible exchange rates are among the policies that can reduce illiquidity and limit financial fragility.

The IMF Approach to Economic Stabilization

MICHAEL MUSSA AND MIGUEL SAVASTANO

This paper explains the IMF approach to economic stabilization, with emphasis on its quantitative aspects. It argues that a Fund-supported program is a process, comprising six broadly defined phases, that evolves along a multiplicity of potential pathways delimited by the Fund's policies governing assistance to members and by the member's resolve to implement the measures needed to restore external payments viability. The paper discusses the three-pronged approach to stabilization that is at the core of all IMF programs, stresses the iterative character of the Fund's "financial programming" framework, and explains the rationale for setting quantitative performance criteria for fiscal and monetary policy in all Fund arrangements. A main theme of the paper is that IMF programs contain a great deal of flexibility to respond both to differences in circumstances and to changes in conditions in individual cases.

The Japanese Banking Crisis: Where Did It Come From and How Will It End?

TAKEO HOSHI AND ANIL KASHYAP

We argue that the deregulation leading up to the Big Bang has played a major role in the current banking problems. This deregulation allowed large corporations to switch quickly from depending on banks to relying on capital-market financing. We present evidence showing that large Japanese borrowers, particularly manufacturing firms, have already become almost as independent of banks as comparable U.S. firms. The deregulation was much less favorable for savers, and consequently they mostly continued turning their money over to the banks. However, banks were also constrained. They were not given authorization to move out of traditional activities into new lines of business. These developments together meant that the banks retained assets and had to search for new borrowers. Their new lending primarily flowed to small businesses and became much more tied to property than in the past. These loans have not fared well during the 1990s. We discuss the size of the current bad-loan problem and conclude that it is quite large (on the order of 7% of GDP). Looking ahead, we argue that the Big Bang will correct the aforementioned regulatory imbalances. This will mean that banks will have to fight to retain deposits. More importantly, we expect even more firms to migrate to capital-market financing. Using the U.S. borrowing patterns as a guide, we present estimates showing that this impending shift implies a *massive* contraction in the size of the Japanese banking sector.

Stock Prices and Fundamentals

JOHN HEATON AND DEBORAH LUCAS

We consider a variety of fundamentals-based explanations for the recent stock price run-up, including changes in preferences, dividend growth rates, and the extent of risk sharing. In a calibrated OLG model we focus on two aspects of risk sharing—the market participation rate and the degree of diversification. We conclude that the relatively small changes in participation that have occurred over this decade are unlikely to be a major part of the explanation. Increased portfolio diversification, however, is likely to have had a larger effect. There is empirical evidence that households have significantly diversified their portfolios, selling individual stocks and buying mutual funds. An important difference between poorly diversified portfolios and investment in a market index is the reduced likelihood of catastrophic outcomes. When this is reflected in model parameters, the expected equity premium falls by more than 4%. More generally, we construct scenarios that are loosely consistent with the data in which the

required return on stocks falls by 2%. Using a calibrated Gordon growth model, we find that this change in expected returns goes at least halfway towards justifying the current high level of the price–dividend ratio in the U.S. stock market.

Labor-Market Policies in an Equilibrium Search Model

FERNANDO ALVAREZ AND MARCELO VERACIERTO

We explore to what extent differences in employment and unemployment across economies can be generated by differences in labor-market policies. We use a version of the Lucas–Prescott equilibrium search model with undirected search and endogenous labor-force participation. Minimum wages, degree of unionization, firing taxes, and unemployment benefits are introduced and their effects analyzed. When the model is calibrated to U.S. observations, it reproduces several of the elasticities of employment and unemployment with respect to changes in policies reported in the empirical literature. We find that: (1) minimum wages have small effects; (2) firing taxes have similar effects to those found in frictionless general equilibrium models; (3) unions have large and negative effects on employment, unemployment, and welfare; and (4) unemployment benefits substantially increase unemployment and reduce welfare.

Spendthrift in America? On Two Decades of Decline in the U.S. Saving Rate

JONATHAN A. PARKER

During the past two decades, the personal saving rate in the United States has fallen from 8% to below zero, and the share of GDP that households consume rose by 6 percentage points. This increase in the share of consumption was concurrent with a reduction in the growth rate of real consumption spending per person, high real rates of return, and an increasing ratio of aggregate wealth to income. Despite this last fact, wealth changes can explain little of the boom in consumption spending: The largest increases in national wealth postdate the consumption boom, and households with differing wealth levels nevertheless had similar increases in consumption. The changing age distribution of the U.S. population does not explain the consumption boom, either: While it may be that younger, wealthier cohorts are driving this boom, the preponderance of evidence suggests rather that the rising consumption-to-income ratio is due to a common time effect. The main findings of the paper are consistent with either an increase in discount rates or a general belief in better economic times in the future. Alternatively, the low rates of saving could be due to a combination of factors, such as the increase in intergenerational transfers from the Social Security system, which has raised the consumption of the elderly, and increased access to credit and an expanded menu of financial instruments raising the consumption of the young.