CENTRE FOR APPLIED MACROECONOMIC ANALYSIS

ANU COLLEGE OF BUSINESS & ECONOMICS

CAMA Newsletter

Issue 8, September 2009

Welcome

Welcome to the September edition of the CAMA Newsletter. It's been another busy quarter for CAMA with a number of exciting conferences and events taking place. We have also had the pleasure of several visitors to CAMA over recent months including CAMA Advisory Board member **Professor Dale Henderson** and member of CAMA's Finance and Macroeconomy program **Professor Sherrill Shaffer**. They were generous colleagues from whom staff and students benefited significantly and were a lively addition to CAMA's intellectual community.

We are also pleased to announce that **Dr Pedro Gomis-Porqueras** and **Professor Bruce Preston** have taken over the directorship of the of the Macroeconomic Theory Program. We look forward to the directions that they plan to take the program and would like to recognise the work of Timothy Kam who has led this program since its foundation officially handing over the reigns in July this year. Tim is still a member of the Macroeconomic Theory program and we thank him for his important contribution.

We are delighted to see the number of working papers that came in over the last three months. Details of recent working papers are listed below and all are available online. We hope to have the CAMA working paper series up on SSRN in the near future as well. We would like to thank all our members for the continuing contribution to CAMA and wish you all the best for the final few months of 2009.

Contents

Events

Conference in Honour of Professor Adrian Pagan

On 13-14 July, a conference was held at Coogee Beach in Sydney to celebrate the contribution of Professor Adrian Pagan to econometrics and applied time series. The conference was hosted jointly by various institutions, with many others happy to provide support. Professor Pagan has made a substantial contribution to his field, and is recognised both nationally and internationally. Adrian is best known for his early work in developing the Breusch-Pagan test for heteroskedasticity, and for his work on non-parametric econometrics, structural VAR models, business cycles, financial econometrics and generator regressors. The conference brought together more than 90 people from Australia and overseas to celebrate his life. M. Hashem Pesaram from the University of Cambridge, and Pravin K. Trivedi from Indiana University provided the keynote addresses. In recognition of the influence that he has had in Australia in his career to date, over 12 institutions provided sponsorship for the event.

The common theme emerging from the conference was that apart from his intellectual contributions, Adrian has been instrumental in encouraging and mentoring young researchers. Professor Pagan is one of CAMAs foundation research associates, and many staff and students involved in CAMA have been fortunate to be beneficiaries of this generosity. Our thanks go out to Professor Pagan for his contribution to economics particularly in Australia and also to his mentoring role for CAMA staff and students. More details, and papers from the conference can be found at http://cama.anu.edu.au/Pagan2009.asp

The Financial Crisis: What Happened and Why?

Professor Dale Henderson of Georgetown University and member of the CAMA Advisory Board visited CAMA on the prestigious travel grant program to support international academics to contribute to the intellectual environment of ANU and beyond. Professor Henderson served in the International Finance Division at the Federal Reserve Board from 1971 to1984 and from 1989 to 2009 departing as a senior adviser. He has also taught at Yale University and the Universities of Pennsylvania and Virginia.

On July 21, Professor Henderson presented a public lecture entitled "The Financial Crisis: What Happened and Why?" at the Hedley Bull Centre at the ANU. The lecture provided a description and an analysis of the current financial crisis. Professor Henderson views the crisis as a 'financial perfect storm'' resulting from a combination of developments in global markets for goods and financial assets. Special attention was devoted to the incentives in place in financial markets in the US and the UK. A comparison of the experiences of these two countries was used in assessing the relative importance of the various changes in incentives. Professor Henderson's Lecture is available through the ANU podcast website: http://www.anu.edu.au/discoveranu/content/podcasts/

Behavioural Macroeconomics Conference

CAMA, with the generous support from numerous sponsors, hosted a conference on behavioural macroeconomics ("Behavioural Macroeconomics: Theory and Policy Implications") in Sydney on 22-23 June 2009.

The event, attended by leading scholars from the USA, Europe and Australasia, showcased recent research in this new and burgeoning field of economics, which has received heightened attention in the wake of the global financial crisis. Topics covered were wide and varied, from firms' pricing policies when customers experience regret and consumer behaviour in credit markets to animal spirits as drivers of business cycles and the importance of religious beliefs in understanding the U.S. housing market. The overall quality of the papers and discussions was high, some sessions generating vigorous debate, while the variety of topics broadened many a participant's horizon.

The lessons to be drawn from this conference were summarised in the closing remarks by the centre's director, Prof. Warwick McKibbin. He pointed out that it is not yet clear which of the many interesting insights delivered by behavioural economists are the truly salient ones and that, while deficient on some dimensions, much of existing economic theory remains powerful and relevant. Clearly, plenty more work remains to be done. Further details about the conference, including the program and the papers, may be obtained from the conference website: http://cama.anu.edu.au/Behavioural_Macroeconomics.asp

Inflation in an Era of Relative Price Schocks

On the 17 & 18 August the Reserve Bank of Australia and the Centre for Applied Macroeconomic Analysis, Australian National University, jointly hosted a conference on Inflation in an Era of Relative Price Shocks. The conference considered the substantial swings in global commodity prices, particularly of food and energy, over recent years. Specifically, it examined the causes and nature of these price shocks, their effect on economies around the world, and how policy makers should respond to relative price movements.

The papers from the conference can be found at http://www.rba.gov.au/PublicationsAndResearch/Conferences/2009/index.html.

A volume containing the conference papers and discussions will be published at the end of 2009.

This was the second of two conferences hosted by CAMA and the RBA (together with the Viessmann Institute) on this theme. The first was held earlier in the year in Münster, Germany. Papers from this earlier conference are available at http://www.wlu.ca/viessmann/rba09.htm

CAMA In the Media

Links to CAMA members' media appearances can be found at http://cama.anu.edu.au/media.asp

Publication News

J Alonso-Carrera, MJ Freire-Seren and B Manzano, "Macroeconomic Effects from the Regional Allocation of Public Capital Formation", *Regional Science and Urban Economics*, 39 (5), 2009, 563-574. **[CAMA Working Paper 9/2008]**

A Cooray, "The Financial Sector and Economic Growth", *Economic Record: Special Issue*, 85, 2009, 10-21.

A Cooray, "Government Expenditure, Governance and Economic Growth", *Comparative Economic Studies*, 51, 2009, 401- 418.

P Alessandri, **P Gai**, S Kapadia, N Mora, and C Puhr "Towards a Framework for Quantifying Systemic Stability", *International Journal of Central Banking*, forthcoming.

P Gai, S Kapadia, S Millard, and A Perez, "Financial Innovation, Macroeconomic Stability and Systemic Crises" *Economic Journal*, issue 118, 2008, 401-426.

G Cameron, **P Gai** and **KY Tan**, "Sovereign Risk in the Classical Gold Standard Era", *Economic Record*, forthcoming. **[CAMA Working Paper 11/2006]**

P Gomis-Porqueras, A Peralta-Alva, "Optimal Monetary and Fiscal Policies in a Search Theoretic Model of Monetary Exchange", *European Economic Review*, forthcoming.

V Hall and J McDermott, "The New Zealand Business Cycle", *Econometric Theory*, 25(4), August 2009, 1050-1069.
[CAMA Working Paper 21/2006]

A Leigh, How Much Did the 2009 Fiscal Stimulus Boost Spending? Evidence from a Household Survey, August 2009.
http://econrsss.anu.edu.au/~aleigh/pdf/FiscalStimulus.pdf

W McKibbin, The 2007 Shann Memorial Lecture – "A New Climate Strategy Beyond 2012: Lessons from Monetary History"
http://www.lowyinstitute.org/Publication.asp?pid=1097

W McKibbin, A Morris and **P Wilcoxen**, "A Copenhagen Collar: Achieving Comparable Effort Through Carbon Price Agreements"
http://www.brookings.edu/reports/2009/08_carbon_morris.aspx

W McKibbin and **KY Tan**, "Learning and International Transmission of Shocks", *Economic Modelling*, Vol. 26(5), September 2009, 1033–1052. **[CAMA Working Paper 1/2007]**

Fabio Mendez and **F Sepulveda** , "What Do we Talk about When We Talk About Corruption?", *Journal of Law, Economics, and Organization*, forthcoming.

F Sepulveda ,"Training and Productivity: Evidence for US Manufacturing Industries", *Oxford Economic Papers*, forthcoming.

S Shaffer and Jason Shogren, "Repeated Contests: A General Parameterization", *Economics Letters*, in press. **[CAMA Working Paper 27/2008]**

P Smith, S Sorensen and MR Wickens, "The Equity Premium and the Business Cycle: The Role of Demand and Supply Shocks", *International Journal of Finance and Economics*, forthcoming, 2009. **[CAMA Working Paper 5/2006]**

New Research Associates

We are delighted to welcome our newest Research Associate to the following CAMA program:

Finance and the Macroeconomy Program

Professor Pierre Siklos, Professor of Economics and Director of the Viessmann European Research Centre, Wilfrid Laurier University.

Upcoming Visitors to CAMA @ ANU

CAMA Staff at ANU are looking forward to welcoming the upcoming visits by:

Professor David Vines,
Oxford University
27 September - 23 December 2009

David is Co-Director along with Professor Alan Woodland of CAMA's Globalisation and Trade program

Professor Adrian Pagan,
Queensland University of Technology/University of New South Wales
1 November 2009 - 28 February 2010

Adrian is well known to the CAMA community and is a member of CAMA's Macro-economic Models and Methods program.

New Working Papers

Click on the title to download a paper.

25/2009
Modelling the Global Financial Crisis
By WJ McKibbin and A Stoeckel

This paper models the global financial crisis as a combination of shocks to global housing markets and sharp increases in risk premia of firms, households and international investors in an intertemporal (or DSGE) global model. The model has six sectors of production and trade in 15 major economies and regions. The paper shows that a 'switching' of expectations about risk premia shocks in financial markets can easily generate the severe economic contraction in global trade and production currently being experienced in 2009 and subsequent events. The results show that the future of the global economy depends critically on whether the shocks to risk are expected to be permanent or temporary. The best representation of the crisis may be one where initial long lasting pessimism about risk is unexpectedly revised to a more moderate scenario. This suggests a rapid recovery in countries not experiencing a balance sheet adjustment problem.

24/2009
Modelling International Linkages for Large Open Economies: US and Euro Area
By M Dungey and D Osborn

Empirical modelling of the international linkages between the Euro Area and the US requires an open economy specification. This paper proposes and implements a structural VECM framework which imposes long run and short run cross-economy restrictions based on theoretically motivated restrictions and empirically supported dominance assumptions. The SVECM distinguishes between permanent and temporary shocks in a system where one cross-economy cointegrating relationship links output levels. In addition, the short run dynamics incorporate both contemporaneous interactions and feedbacks between the two economies. Importantly, greater empirical coherence is obtained by allowing for more direct inflationary effects between the two economies than considered in other recent analyses. Estimated using data from 1983Q1 to 2007Q4, the results demonstrate the cross-country impact of shocks. Although US shocks generally produce stronger effects, nevertheless some shocks originating in the Euro Area have significant effects on the US, particularly for inflation and interest rates.

23/2009
Detecting Contagion with Correlation: Volatility and Timing Matter
By M Dungey and A Yalama

We examine whether contagion tests are affected by controls for volatility clustering and the collection of synchronized data sets. Without controlling for volatility clustering synchronization does not apparently matter. Once volatility clustering is accounted for synchronized data dramatically changes results.

22/2009
How Much Did the 2009 Fiscal Stimulus Boost Spending? Evidence from a Household Survey
By A Leigh

Using survey evidence, I estimate the impact of a $12 billion package of household payments delivered in Australia between March and May 2009. Forty percent of households who said that they received the payment reported having spent it. This is approximately twice the spending rate that has been recorded in surveys assessing the 2001 and 2008 tax rebates in the United States. Using an approach for converting spending rates into an aggregate marginal propensity to consume (MPC), this is consistent with an aggregate MPC of 0.41−0.42. Since this estimate is based only on first-quarter spending, it may be an underestimate of the longer-run impact of the package on consumer expenditure.

21/2009
A Note on the Anchoring Effect of Explicit Inflation Targets
By J Libich

Empirical literature provided convincing evidence that explicit (ie legislated) inflation targets anchor expectations. We propose a novel game theoretic framework with generalized timing that allows us to formally capture this beneficial anchoring effect. Using the framework we identify several factors that influence whether and how strongly expectations are anchored, namely: (i) the public's cost of decision making, (ii) the public's inflation aversion, (iii) the slope of the Phillips curve, (iv) the magnitude of supply shocks, (v) the degree of central bank conservatism, and under many (but not all) circumstances, (vi) the explicitness of the inflation target.

20/2009
Does Democracy Explain Gender Differentials in Education?
By A Cooray

This study shows that despite a strong empirical association between gender differentials in enrolment ratios and democracy, that democracy alone does not explain gender differentials in education in Africa and Asia. The results indicate that income, employment in agriculture, religious heterogeneity and colonialism also help explain the under-representation of girls in education in these regions. Countries in which the duration of suffrage has been longer, tend to perform better on average in terms of gender equality in education.

19/2009
Carbon Offsets, Reversal Risk and US Climate Policy
By BK Mignone, MD Hurteau, Y Chen and B Sohngen

One controversial issue in the larger cap-and-trade debate is the proper use and certification of carbon offsets related to changes in land management. Advocates of an expanded offset supply claim that inclusion of such activities would expand the scope of the program and lower overall compliance costs, while opponents claim that it would weaken the environmental integrity of the program by crediting activities that yield either nonexistent or merely temporary carbon sequestration benefits. Our study starts from the premise that offsets are neither perfect mitigation instruments nor useless "hot air."

18/2009
Consequences of Alternative U.S. Cap-and-Trade Policies: Controlling Both Emissions and Costs
By WJ McKibbin, M Morris, PJ Wilcoxen and YY Cai

The U.S. Congress continues to debate a potential cap-and-trade program for the control of greenhouse gas emissions. The economic effects of such a bill remain in dispute, with some arguing that a cap-and-trade program would create jobs and improve economic growth and others arguing that the program would shift jobs overseas and hit households with large energy price increases. This report applies a state-of-the art global economic model to the question and offers insights to policymakers about how to the design the program to achieve long run environmental goals at minimum cost and with low risk to the economy.

17/2009
Do Rising Top Incomes Lift All Boats?
By D Andrews, C Jencks and A Leigh

Pooling data for 1905 to 2000, we find no systematic relationship between top income shares and economic growth in a panel of 12 developed nations observed for between 22 and 85 years. After 1960, however, a one percentage point rise in the top decile's income share is associated with a statistically significant 0.12 point rise in GDP growth during the following year. This relationship is not driven by changes in either educational attainment or top tax rates. If the increase in inequality is permanent, the increase in growth appears to be permanent, but it takes 13 years for the cumulative positive effect of faster growth on the mean income of the bottom nine deciles to offset the negative effect of reducing their share of total income.

16/2009
Statistical Opacity in the U.S. Banking Sector
By G Li, L Sanning and S Shaffer

Motivated by the observation that very few banks fail in normal years, we explore the impact of that pattern on the precision of a standard statistical failure model, and discuss implications for regulation and risk management. Out-of-sample forecasting is found to be worse for a model fitted to recent data with few failures than for a model fitted to much older data with more failures. This property may mask observable drift in risk linkages until aggregate risk levels have risen high enough to trigger new failures, thus suggesting an informational basis for the puzzling recurrence of bank crises.

15/2009
Recovery Before Redemption: A Theory of Delays in Sovereign Debt Renegotiations
By D Benjamin and MLJ Wright

Negotiations to restructure sovereign debts are protracted, taking on average almost 8 years to complete. In this paper we construct a new database (the most extensive of its kind covering ninety recent sovereign defaults) and use it to document that these negotiations are also ineffective in both repaying creditors and reducing the debt burden countries face. Specifically, we find that creditor losses average roughly 40 per-cent, and that the average debtor exits default more highly indebted than when they entered default. To explain this apparent large inefficiency in negotiations, we present a theory of sovereign debt renegotiation in which delay arises from the same commitment problems that lead to default in the first place. A debt restructuring generates surplus for the parties at both the time of settlement and in the future. However, a creditor's ability to share in the future surplus is limited by the risk that the debtor will default on the settlement agreement. Hence, the debtor and creditor find it privately optimal to delay restructuring until future default risk is low, even though delay means some gains from trade remain unexploited. We show that a quantitative version of our theory can account for a number of stylized facts about sovereign default, as well as the new facts about debt restructurings that we document in this paper. Finally, we argue that our findings shed light on the existence of delays in bargaining in a wider range of contexts.

14/2009
Financial Instability Prevention
By AH Hallett, J Libich and P Stehlik

The paper attempts to assess to what extent the central bank or the government should respond to developments that cause financial instability, such as housing or asset bubbles, overextended fiscal policies, or excessive public or household debt. To analyze this question we set up a simple reduced-form model in which monetary and fiscal policy interact, and consider several scenarios with both benevolent and idiosyncratic policymakers. The analysis shows that the answer depends on certain characteristics of the economy, as well as on the degree of ambition and conservatism of the two policymakers. Specifically, we identify circumstances under which financial instability prevention is best carried out by: (i) both monetary and fiscal policy ('sharing'), (ii) only one of the policies ('specialization'), and (iii) neither policy ('indifference'). In the former two cases there are circumstances under which either policy should be more pro-active than the other, and also circum-stances under which fiscal policy should be ultra-active: ie care about nothing but the prevention of financial instability. These results are important in the context of the current crisis. We also show that neither the government nor the central bank should be allowed to freely select the degree of their activism in regard to financial instability threats. This is because of a moral hazard problem: both policymakers have an incentive to be insufficiently pro-active, and shift the responsibility to the other policy. Such behaviour has strong implications for the optimal design of the delegation process.

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Paper Submission

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