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Black Youths Aided by Tight Labor Markets

Young men typically experience higher unemployment than adults do, and young black men are more likely to be unemployed than young whites are. But when local economies are booming and labor markets are tight, these differences narrow considerably. Even young black men, who usually fare worst in U.S. labor markets, do much better when conditions are good, according to NBER Research Associate **Richard Freeman.**

In **Employment and Earnings of Disadvantaged Young Men in a Labor Shortage Economy** (*NBER Working Paper No. 3444*), Freeman calculates that in areas with overall unemployment rates below 4 percent in 1987, the unemployment rate for all youths was 5.8 percent and for black youths was 7.2 percent. But in areas where the overall unemployment rate was above 7 percent, 9.7 percent of all youths and 24.6 percent of black youths were unemployed.

Freeman also observes that tight labor markets lower the fraction of youth that is out of school but neither working nor looking for work. In areas with unemployment above 7 percent, 52 percent of black youths are not working, looking for work, or in school. In areas with less than 4 percent unemployment, on the other hand, only 27 percent of black youngsters are in that category. Among white youths, the comparable figures are 32 percent and 21 percent, respectively.

Finally, Freeman finds that low overall unemployment rates lead to higher wages for young men. He estimates that a 1 percent fall in the overall unemployment rate raises the average wage of black youth by 4 to 7 percent, and of all youth by 3 to 4 percent.

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Freeman uses data on 45 large metropolitan areas that encompass more than half of the U.S. labor force. His focus is youths aged 14 to 21. He calculates the unemployment rate as the ratio of the number of people looking for work to the sum of those looking for work, those working, and those with a job who are not working (for example, those on temporary layoff).

New Wave of S and L Woes Is Possible

The crisis that plagued the savings and loan (S and L) industry during the 1980s began in the late 1970s when interest rates skyrocketed. S and Ls, or thrifts, had to pay the new higher rates to finance their activities, while most of their assets were long-term mortgages at lower fixed rates. This gap between the high rates paid to depositors and the low rates received from mortgages squeezed the thrifts and eventually led to the industry's current problems.

In a recent study for the NBER, **Patric Hendershott** and **James Shilling** warn that there could be another S and L debacle if interest rates rise sharply. "Thrifts [were] even more vulnerable in 1989 than they were in 1977," they write in **The Continued Interest Rate Vulnerability of Thrifts** (*NBER Working Paper No. 3415*). The dollar volume of fixed-rate mortgages funded by short-term deposits was slightly higher in 1989 than it was in 1977, and thrifts had over $325 billion in adjustable-rate loans with rate caps on their books.

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A sharp and sustained rise in interest rates would cause significant losses on both types of loans, the authors caution. If a repetition of the 1977–86 interest rate cycle occurred today, before thrifts were fully recapitalized and profitable, the cumulative loss for the thrift industry over a 10-year period would be $90–140 billion, depending on how repayments of fixed-rate mortgages are reinvested. The cumulative capital loss, or present-value potential cost to the taxpayer, would be $45–65 billion.

If rates rise only half that much, the cumulative cashflow loss would be $40–65 billion, and the taxpayer cost would be less than $10 billion.

To reach these estimates, the authors use March 1989 data on individual institutions and construct an aggregate balance sheet for the thrift industry.

Political Cycles in OECD Countries

The different cyclical economic policies of governments of the left and the right have no sustained effect on growth and incomes but do result in different average levels of inflation, according to a new NBER study by **Alberto Alesina** and **Nouriel Roubini.** When left-of-center parties take office, they typically "pump up" the economy and temporarily increase the rate of growth. After about two years, though, inflation rises, and the economy returns to its long-run or natural rate of growth. In contrast, when right-of-center governments win elections, they typically fight inflation, causing a recession or a slowdown in growth. After inflation has been reduced, economic growth eventually returns to its natural rate, and price increases remain low.

In **Political Cycles in OECD Economies** (*NBER Working Paper No. 3478*), Alesina and Roubini analyze the relationship between shifts in government and inflation, unemployment, and income growth in 18 OECD countries from 1960–87. They find that temporary declines in employment and output growth follow the election of the right, including Republicans in the United States and Conservatives in the United Kingdom. Temporary increases in employment and output growth follow victories for the left, including Democrats in the United States and Labor in the United Kingdom. But even long after the election, inflation tends to be higher under the left than the right. In many of the 18 countries, however, inflation tends to increase immediately after an election, perhaps because the government pursues short-run expansionary monetary and fiscal policies in order to get elected.

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Alesina and Roubini further find that governments do not deliberately try to time recessions and recoveries to give themselves an advantage at the polls—or at least they do not succeed in such attempts. Rather, the authors conclude, governments pursue policies they believe will be popular with their own political constituents. Typically, supporters of the left are more concerned about unemployment and supporters of the right about inflation. A pattern of partisan differences in short-term unemployment growth and inflation develops, particularly in countries with two-party systems, or where there are clearly identifiable shifts from left to right, but less in countries with large coalition governments. Nor does this pattern apply to countries such as Japan, which were governed by the same political party during all of 1960–87.

The Alesina–Roubini study is based on quarterly

data for Australia, Austria, Belgium, Canada, Denmark, Finland, France, West Germany, Japan, Ireland, Italy, the Netherlands, New Zealand, Norway, Sweden, Switzerland, the United Kingdom, and the United States.

Federal Funds Rate Best Reflects Monetary Policy

The federal funds rate—that is, the interest rate that one bank charges another to borrow reserves required by the Federal Reserve System—is a better predictor of real economic activity than any other monetary indicator, according to a recent study by NBER Research Associates **Ben Bernanke** and **Alan Blinder.** In **The Federal Funds Rate and the Channels of Monetary Transmission** (*NBER Working Paper No. 3487*), Bernanke and Blinder find that, for forecasting the economy, the federal funds rate is "markedly superior" to both M1 (which includes all checking account deposits) and M2 (M1 plus money market account balances, money market mutual funds, and some other deposits), the three-month Treasury bill rate, and the ten-year Treasury bond rate.

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Bernanke and Blinder study nine measures of real economic activity: industrial production; capacity utilization; total employment; the unemployment rate; housing starts; personal income; retail sales; consumption; and durable goods orders. Over 1959–89, the federal funds rate predicts *each* of these nine variables better than either of the monetary aggregates. Further, the federal funds rate predicts at least six of the nine variables better than either of the other interest rates. It does not predict housing starts as well as the other rates, and the results for retail sales and consumption are mixed.

Bernanke and Blinder find that the federal funds rate was a better predictor for 1959–79 than for 1980–9, perhaps because the Fed supposedly reduced its reliance on the federal funds rate as an intermediate monetary target in October 1979.

Finally, Bernanke and Blinder argue that the federal funds rate primarily reflects Federal Reserve policy and does not simply respond to changes in the economy. In other words, they find that movements in the federal funds rate are caused primarily by changes in the *supply* of bank reserves, not by changes in the *demand* for those reserves resulting, for example, from unexpected cash withdrawals from bank accounts in response to other economic forces. Their evidence on this point is particularly strong for the period before 1979.

Japan's Financial Structure Makes High Debt Safer Than in the United States

As the debt loads of American companies soared in the 1980s, some enthusiasts pointed to the even greater indebtedness of Japanese companies. Japan's experience indicated that high debt-equity ratios could be safe, they said. Now, a new NBER study by **Takeo Hoshi, Anil Kashyap,** and **David Scharfstein** suggests that the comparison is misleading.

What enables Japanese companies to manage high leverage, they write, is an institutional environment absent in America. Supportive Japanese institutions include: 1) the *keiretsu,* several broad "groups" of industrial firms, each including several affiliated financial institutions; and 2) the "main bank" system, under which even a non-*keiretsu* firm gets about 23 percent of its total loans from its top bank. When firms linked to these institutions run into financial trouble, they sustain sales and investment far better than Japanese firms without such links.

In **The Role of Banks in Reducing the Costs of Financial Distress in Japan** (*NBER Working Paper No. 3435*), the authors examine 125 firms that ran into financial trouble. All of the companies were profitable at the beginning of the study period, 1978 to 1985. Then their operating incomes fell too low to cover interest payments for two consecutive years. Of these companies, 45 belonged to a *keiretsu* and 80 did not.

"The safety net did prevent temporary unprofitability from undermining the companies' fundamental soundness."

When the financial distress occurred, those belonging to the *keiretsu,* or having a dominant lender, were buffered. The main bank organized creditors to refinance debt. The financial relief sometimes included temporary interest rate concessions, or

even a write-down of the debt. At the same time, the *keiretsu* network encouraged suppliers to continue providing trade credits while it discouraged corporate customers from fleeing en masse to competitors. When necessary, it helped the firm move into more profitable lines of business.

The results were striking. In the three years following the onset of financial distress, *keiretsu* firms enjoyed 58 percent higher sales than non-*keiretsu* companies. They invested 46 percent more. Non-*keiretsu* firms couldn't even invest enough to keep pace with depreciation, whereas *keiretsu* firms increased their capital stock by 11 percent, thus positioning themselves better for improving sales.

Even non-*keiretsu* companies gained these benefits as long as they had a main bank with a big stake in their success. If a firm obtained 33 percent of its funds from its top bank, instead of the 23 percent average, then its sales over the three years would be 22 percent higher and its investment 20 percent higher than the average troubled firm.

Of course, this safety net couldn't remove the effects of financial distress entirely. Even the "aided" firms suffered low sales and investment compared to financially healthy companies. But the safety net did prevent temporary unprofitability from undermining the companies' fundamental soundness. This gave the aided firms a far better chance of recovering.

The authors suggest several reasons why a structure with just a few well-informed creditors is better for helping financially strapped firms. For instance, with only a few creditors, it is inherently easier to organize financial relief. There are far fewer holdouts than with a large number of banks and bondholders, where each lender has only a small stake in the company's recovery and has less incentive to risk additional funds in a bailout that may not work.

Additionally, the *keiretsu* and/or main bank can obtain critical information more easily from the firm. Sometimes they even assign their own executives to join the management of the troubled company. Hence, they can better judge whether the firm is merely suffering temporary financial distress or whether it has a terminal disease. A diffuse group of bondholders, less able to make that judgment, is likely to put safety first.

In short, the authors conclude, it makes sense for some Japanese firms to take on more risky debt; they have the institutional structure to cope. In contrast, U.S. firms are usually wise to avoid overleveraging, since they generally rely on a large and diffuse pool of banks and bondholders. RK

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