Macro Markets: Creating Institutions for Managing Society's Largest Economic Risks.

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banking lie in the reductions in costs for bank clients—including lower costs of underwriting, lower costs of working out financial distress, and lower costs of corporate governance. Much of the literature on the advantages of multi-faceted banking relationships has emphasized those cost reductions, particularly in Japan and Germany. The authors mention that literature, but do not dwell on it or extend it.

An emphasis on the relationship benefits of universal banking also raises interesting issues for regulatory reform. For example, it may be that a repeal of restrictions on equity holdings by banks (which might reduce costs of corporate governance and financial distress for bank clients) would have greater benefits for the economy than allowing banks to sell insurance (which receives comparatively greater attention by the authors). Furthermore, repealing underwriting restrictions may imply greater relationship-cost savings if banks were also allowed to sell the issues they underwrite to their own customers (contrary to current regulations) and thus retain control over stock voting rights of client firms (as German banks do).

Notwithstanding these criticisms, this is a commendable book full of useful information, which provides a wealth of careful and accessible analysis for public policy makers, scholars, and graduate students interested in bank regulatory reform. It is required reading for anyone interested in exploring the benefits and costs of expanding American banks' powers.

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Macro markets: Creating institutions for managing society's largest economic risks. By ROBERT J. SHILLER. Clarendon Lectures in Economics. Oxford and New York: Oxford University Press, Clarendon Press, 1993. Pp. xi, 254. $29.95. ISBN 0–19–828782–8.

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In this terrific book, Bob Shiller proposes financial securities that will allow people to hedge against changes in lifetime income that are beyond their control. Such securities will tend to yield a positive return when there is bad news about one or another component of lifetime income. The exposition of the basic notion in Chapters 1–5 and 9 will be accessible to non- economists who are familiar with basic concepts of finance and statistics. I will focus my review on summarizing those chapters.

The proposed securities are tied to lifetime income because people care about lifetime rather than instantaneous income (p. 31). Given moral hazard, the payoffs on securities should be tied to measures of income that are beyond any given individual's control (p. 7). There are a number of useful possibilities, including securities that hedge against risks in the price of housing, in inflation, and in income for unincorporated businesses and agriculture (pp. 78–115). But because labor income accounts for the lion's share of most people's income, one wants above all a security whose returns reflect movements in the present value of labor income (p. 53).

Ultimately one might want markets in wages or incomes for specific occupational categories. But insofar as changes in (say) the median wage in a broad occupational category reflect a change in the mix of jobs included in the category, and insofar as people can easily change jobs, such markets might yield relatively limited benefits. A better flow would seem to be aggregate labor income or aggregate income (pp. 53, 59–61).

The idea is to create a market for the claim on the present value of GDP of each of a number of countries. In the simplest case, people would short the security tied to their own country and go long in a security tied to foreign GDP. The security would be structured in such a way that shorts and longs balance one another, so that the net value of all positions is zero. When the present value of a given country's GDP does unexpectedly well, the value of the corresponding security will tend to go up. Having shorted the corresponding security, citizens of that country will have a margin call, and will write a check to their broker. Citizens of countries whose GDP does unexpectedly poorly correspondingly will tend to receive a check. Wealth will thereby tend to be transferred from citizens of countries whose GDP does unexpectedly well to those of countries whose GDP does unexpectedly poorly (pp. 6, 39, 53–55).

Such a market could be well traded and thus have low transactions costs. An initial, and admittedly rough, estimate of the world market return, suggests that much national income risk can be diversified away (pp. 3, 67).

One might be skeptical about such calculations on the grounds that if such markets were needed, the private sector would already have invented them. Papers that attempt to formally test for full insurance, both within and across countries, do, however, typically find that the data are inconsistent with full risk-sharing. In addition, private sector initiative is inhibited by the public good aspect in setting up such markets. The initiator experiments with institutional details and educates the public. Competitors free-ride on what results. In the end, many markets are inventions whose dates of introduction are to a great extent "accidents of history" (pp. 9–16, 68–72, 207–08).

There is in any case the problem that people do not seem to take advantage of existing opportunities to diversify risk. Particularly relevant are the well-known failure of the CPI futures market in the 1980s and similar although the less well-known difficulties in marketing securities or insurance that will hedge real estate price declines (pp. 14–16, 83). Unfortunately, we do not understand particularly well how people make decisions about risk and insurance. It does, however, seem unlikely that intellectual arguments alone will get people to use the proposed hedging instruments. Instead, broad-based success of the proposed markets will likely require a national drive underwritten with the consensus support of opinion leaders (commentators, lawmakers, financial planners). Clearly, any such success may be decades away. But the markets may develop first with a relatively small number of sophisticated traders such as investment fund managers. Because of the public good aspect of the market, public subsidy of establishment of the market may be fitting (pp. 18, 23, 201, 208, 214).

So goes the basic idea. The book also considers many technical aspects of the proposed securities. From the preceding discussion, it may not be obvious how one creates a security tied to the present value of future GDP. But the ingenious details are spelled out in the book (subject to the caveat that prices reflect fundamentals—Shiller continues to believe that there will be excess volatility, but feels speculation will not affect long-term hedgers (pp. 25–27, 46–48, 205)). And the book also analyzes technical aspects of construction of indices necessary to price the claims, considering potential complications from data revisions, measurement error, and so on. Unlike the rest of the book, this analysis, in Chapters 6–8, requires a knowledge of econometrics and linear algebra that most non-economists probably do not have.

Evidently, this ambitious book goes beyond topics usually treated by economists. As Shiller emphasizes, answers to many important questions, such as how people decide what securities to buy, are not obvious, and may not be easily obtained with conventional economic analysis. My own view is that Shiller writes with good sense, and that both formal evidence and casual introspection suggests that it is important to continue to think about risk sharing arrangements. Comparative advantage dictates that I use my remaining space to note a fact suggested by conventional economic analysis.

What Shiller finds in his quantitative calculation is essentially that the proposed securities will lower volatility of GDP. Whether this translates into utility gains for many individuals depends, of course, on many things. One of the central determinants is the magnitude of the correlation between lifetime family income and the present value of GDP. For a given family, shorting the security will provide more insurance if the correlation is high than if it is near zero.

It is well known that individual incomes contain a large idiosyncratic component. Pischke (1992, pp. 26, 28), for example, indicates that for a representative family in the Survey on Income and Program Participation, the standard deviation of innovations in the present value of family income per family member is about 25 times that of the innovation in aggregate per capita income. (This present value is computed using the textbook permanent income model, from estimates of a time series process for income.) Pischke

does not report correlations between family and aggregate income. But it would seem likely that much uncertainty about family income comes from factors not well correlated with aggregate factors. Perhaps such idiosyncratic uncertainty is already hedged in one way or another. But whether or not this is the case, it remains to be shown that securities tied to aggregate income would provide substantial benefit for many families. If not, maybe a finer set of securities, perhaps tied to regions or to occupations, would yield considerably greater welfare benefits.

But what am I saying but that the book succeeded in its aim, of making me think about which risks society lets us hedge, and which it leaves us to face ourselves? The book is fresh, provocative, well written, and well argued. I recommend it not only to financial and macro-economists, but to the larger economic community interested in the character and costs of business cycles.

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H Public Economics

Partisan politics, divided government, and the economy. By ALBERTO ALESINA AND HOWARD ROSENTHAL. Cambridge, New York, and Melbourne: Cambridge University Press, 1994. Pp. 304. $65.00. ISBN 0–521–43029–1.

Co-written by a political scientist and an economist, this book ably investigates the joint determination of economic and political events. The authors explore how political institutions evolve in response to the preferences and incentives of individual voters and their political representatives as well as how those institutions, in turn, affect the performance of political and economic systems. The book is the outgrowth of a collaboration initiated in 1987 when the two authors became intrigued by two empirical regularities—the midterm electoral cycle and the partisan business cycle. The first of these regularities, that the president's party loses vote share in midterm congressional elections, pertains to the influence of voter and politician preferences and incentives on political outcomes. The latter regularity, that the economy expands after a Democratic victory in the presidential elections and contracts following a Republican win, pertains to the influence of political institutions on macroeconomic performance.

The book is divided into two parts. The first (Chs. 2 through 6) models the influence of voter and legislator preferences and incentives on policy outcomes. Alesina and Rosenthal posit that political parties, as well as voters, care about being truthful to their ideological preferences, in addition to winning per se. According to this assumption, party platforms are nonconvergent because political parties represent the interests and values of different constituencies. Alesina and Rosenthal review the empirical evidence from American politics which strongly supports the assumption of policy divergence and which indicates that politics is low-dimensional; that is, a single liberal-conservative ideological line summarizes, to a significant extent, voters' and politicians' preferences. In such a setting, voters can take advantage of the institutional provision of checks and balances in American government (such as between the executive and legislative branches), to attain the middle-of-the-road policies that they prefer over the more extreme ideological positions adopted by the two major parties. An explanation is thereby provided for divided government. Voters, that is, can put one party in charge of the executive branch and the other party in control of the legislative branch and count on the division of political power to produce the middle-of-the-road policies that voters prefer.

Provided that voters are uncertain of electoral results, the critical assumption made by Alesina and Rosenthal about the divergence of partisan platforms also provides an explanation for the midterm electoral cycle. That is, because voters cannot predict the outcome of on-year elections (elections where the presidency is being decided), they can moderate any unanticipated swings in such elections through their congressional voting in