



Market Volatility.

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Market Volatility. By ROBERT J. SHILLER. MIT Press, Cambridge, Mass. 1989. xiv + 464 pp. £31.50.

About two-thirds of the 26 chapters in this book are reprints of much of Shiller's pioneering work on volatility in stock, bond and real estate markets, 1977-89, edited only to correct typos and add cross-references within the book. Most of the remaining (new) material consists of an up-to-date discussion of the basic issues analysed in the previously published work.

The book has six parts: Basic Issues and Alternative Models; The Stock Market; The Bond Market; The Real Estate Market; The Aggregate Economy; Popular Models and Investor Behavior. Much of Part I and a chapter overviewing each of the remaining sections is non-technical and likely to be accessible to practitioners. There is also a non-technical concluding chapter and, to the relief of those of us who regularly get requests for Shiller's data, a chapter that lists the long-term data that Shiller, and subsequently many others, have used.

Most of the book relates to volatility in the stock market, and because of space constraints this is the only part of the book that I shall discuss. Shiller's first study of such volatility was his seminal 1981 *American Economic Review* paper (Chapter 5). This compared the variance of actual versus 'perfect-foresight' stock prices (among other tests). Under the simple efficient markets null of a constant expected return, Shiller showed that the volatility of the actual must be less than that of the perfect-foresight price. His now famous graph of actual versus perfect-foresight prices showed that this implication is grossly counterfactual.

Or did it? Much research suggests that dividends and prices follow non-stationary unit root processes; Shiller's work instead assumed them stationary around a trend line. Allen Kleidon (*Journal of Political Economy*, 1986), among many others, argued that in the presence of unit roots Shiller's procedure will likely find excess volatility even if there is none. In subsequent research (mostly done jointly with John Campbell), Shiller acknowledged that this point might be right in principle, but he argued that in practice it does not explain the volatility that is empirically present (Chapters 7-11, 16).

Is, then, the finding of excess volatility generally accepted? It may come as a surprise to those who have not been following the debate of late, but the answer, I believe, is yes. Both Eugene Fama ('Efficient Capital Markets: II', unpublished, 1990) and Kleidon ('Comment', *Journal of Finance*, 1988), for example, agree that volatility tests suggest that something is wrong with the simple efficient markets model. Both, however, interpret such tests merely as part of a growing body of evidence that expected returns vary over time—a possibility ruled out in the simple model that was the focus of Shiller's original work—and argue that this variation is plausibly rational.

In his initial 1981 paper, Shiller did note that his results could be interpreted as evidence of the importance of such variation. But when, in subsequent research, he examined some standard models for expected returns in detail, he concluded that these do not adequately explain the excess volatility (Chapters 8, 11 and 22). He also finds a rational bubble explanation unattractive, because it is too narrow (Chapter 4).

Instead, while acknowledging the undoubted importance of 'smart' investors, who behave according to the usual tenets of economic theory, he argues for the simultaneous importance of 'naive' investors, whose investment decisions are governed as much by psychological and social as by traditional economic factors (Chapters 1, 2, 22, 25). His surveys of market participants (Chapters 22-5) suggest a big role for non-traditional factors.

Even Shiller himself, however, describes his formal models for the decisions of such investors (Chapters 1, 22) as 'illustrative', merely intended to 'awaken us to possibilities' (pp. 432, 375). Compared with the efficient markets models that Shiller and others have rejected, the 'fads' models that have been developed to date are not as tightly linked to a scientific theory (whether economic or otherwise), and do not have equally sharp testable predictions.

But maybe that's good news for the rest of us. Shiller has already beaten the rest of us to the punch in the development of volatility tests, thereby raising as yet unresolved

questions about what makes asset prices move. Any who do not want to be left behind in the race to answer such questions would be well advised to study this book.

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Real Exchange Rates, Devaluation and Adjustment: Exchange Rate Policy in Developing Countries. By S. EDWARDS. MIT Press, Cambridge, Mass. and London. 1989. xi + 371 pp. £29.25.

This book deals with the theory of equilibrium and disequilibrium real exchange rates (RERs) for developing countries. Two theoretical chapters open the book. They are followed by empirical chapters on cross-country evidence about real exchange rate behaviour, real exchange rate realignments through nominal devaluations and the effects of nominal devaluations on output, wages and income distribution.

The theoretical analysis is itself divided into two parts. In Chapter 2 a two-period dependent-economy framework is set up to study how changes in real variables or 'fundamentals' affect the equilibrium real exchange rate. Bringing in intertemporal effects has the advantage that one can analyse the effects of, say, anticipated changes in protection on the path of the RER. The problem is that many qualitative results depend heavily on the degree of intertemporal substitutability in consumption, a parameter about which we have little intuition. Extension of the dependent-economy model to a dynamic framework that has become so popular in the last decade is certainly most welcome. It would have been nice, however, if some of the 'structuralist' features so often emphasized in the older trade and development literature, like the role of largely non-competitive intermediate and capital goods, had also been brought into the analysis.

In the second theoretical chapter, a perfect-foresight model of a simple monetary economy is developed to show that monetary disturbances such as those engendered from money financing of excessive fiscal deficits will generate exchange rate misalignment. One can, of course, question the perfect-foresight assumption, but the framework handles nicely dual exchange rates, a definite stylized representation of many foreign exchange markets in developing countries.

For many, the empirical chapters (about three-quarters of the book) will be the most interesting. One finds a wealth of information on devaluation episodes, including the changes in exchange controls and trade restrictions surrounding the devaluation, along with a judicious mix of country-level analysis (statistical properties of black market premia, simple illustrations of changes in fundamentals and RER paths) and pooled time-series cross-section analyses of RER determinants, current account determinants and so forth. The empirical work is well focused, with econometric results used to construct series on equilibrium RERs and to determine what makes for successful/unsuccessful devaluations. The constant concern with policy issues throughout the empirical work is an example for others to follow.

A number of the conclusions reached in the study confirm earlier ones reached by Krueger (*Foreign Trade Regimes and Economic Development*, Ballinger, 1978). Fiscal imbalances are often the culprit behind RER misalignments, and the relaxation of foreign exchange controls that tends to accompany liberalization episodes is often short-lived. But there are new ones too, in particular on the costs of not adjusting. Here, the cross-country approach is particularly useful in showing how the disequilibrium situations that usually precede devaluations have had severe negative effects on growth. Unfortunately, none of the structural parameters that were shown to have a determinant influence on the qualitative results derived in the theoretical part of the book are estimated. Also, there is some tension between the empirical work on the RER (where the index is defined as the ratio of a trade-weighted basket of partners' price indices to the domestic wholesale or consumer price index) and the theoretical work, where the RER is defined as the relative price of non-tradables.

Finally, it would have been nice to see some attempts at classifications by country groups that reflect different structures and sizes of the external sector. The policy