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Produced in the Research Department. Edited by Preston J. Miller, Kathleen S. Rolfe, and Martha L. Starr and typeset by Joseph R. Piepgras. Graphic design by Barbara Birr, Public Affairs Department.

Address comments and questions to the Research Department, Federal Reserve Bank, Minneapolis, Minnesota 55480 (telephone 612-340-2341).

In This Issue

Boots

The U.S. economic outlook over the next two years is not terrific, according to David E. Runkle in "Bad News From a Forecasting Model of the U.S. Economy" (p. 2). Real growth is predicted to be significantly below average, while inflation is predicted to be slightly above average.

But how confident should we be of this forecast? As Runkle points out, the same statistical model that generated this forecast booted it a year ago. The model was too optimistic about inflation and real growth in 1990, making especially large errors on consumption and housing. Yet, the model's forecast errors do not seem unusual judging from either the model's historical record or the records of other forecasters. And the errors do not seem to indicate a flaw in the model's structure, such as omitted explanatory variables. So, while last year's errors were large, they seem typical for national forecasts. The answer, then, is, We should be no less, or more, confident of this forecast than we are of any other.

Suspenders

By their nature, banks are illiquid. Their assets, such as loans, have a longer maturity than their liabilities, such as deposits. If enough depositors decide to withdraw their money, a bank has to sell its assets, often at a big discount, and may find it has too few resources to pay off all depositors. This is a bank run.

As Neil Wallace describes in "A Banking Model in Which Partial Suspension Is Best" (p. 11), U.S. banks in the late 1800s and early 1900s dealt with runs by suspending withdrawals; that is, they stopped converting deposits into cash. The public disliked suspensions, however, and this dislike helped lay the foundation for much of our current banking structure, including the Federal Reserve System and federal deposit insurance.

Wallace argues that the goal of avoiding suspensions may be inappropriate. In a coherent model of banking, he shows that partial suspension is the best possible banking arrangement; that is, there are situations when it is best to pay out less to depositors who show up late to withdraw than to those who show up early. While the model is special, Wallace argues that many of its features resemble those of actual economies and that its key implication that partial suspensions are best would hold up under more general specifications.

Preston J. Miller
Editor