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The Labor Market in Real Business Cycle Theory (p. 2)

Gary D. Hansen
Randall Wright

Resolving the National Bank Note Paradox (p. 13)

Bruce Champ
Neil Wallace
Warren E. Weber

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In This Issue

Relieving Labor Pains

Explaining activity in the labor market has been a pain for models based on real business cycle (RBC) theory. The standard RBC model assumes that agents optimize and markets clear, and it attributes fluctuations in general economic activity only to unexpected changes in the production process, or technology shocks. The standard model's predictions match many U.S. business cycle facts surprisingly well. However, they don't match two facts about the U.S. labor market: that the number of hours worked varies much more than productivity and that the correlation between those two time series is close to zero.

In "The Labor Market in Real Business Cycle Theory" (p. 2), Gary D. Hansen and Randall Wright examine, within a unified setting, four adjustments to the standard RBC model that have been proposed to help the model with the labor market. None of the adjustments involves changing the assumptions that agents optimize and markets clear. Each of the adjustments, Hansen and Wright conclude, does indeed relieve some of the model's labor market pains without upsetting its predictions for the rest of the economy.

Relaxing Tight Fists

The period of the National Banking System seems ideal to test alternative theories about how the economy operates under different monetary arrangements. Under this system, banks were allowed to issue notes, backed by government bonds, that the public accepted as cash. All theories which assume profit maximization imply that under such a system banks would continue to buy up bonds and issue notes until the additional return—the nominal interest rate—was just equal to the additional cost—the cost of intermediating between bonds and money. Yet previous researchers have found that bankers in this period were too tight-fisted. Nominal interest rates were too high to be explained by intermediation costs, or equivalently, bankers did not put out enough notes to take advantage of their profit opportunities. The usefulness of this period as a testing ground thus appeared suspect.

In "Resolving the National Bank Note Paradox" (p. 13), Bruce Champ, Neil Wallace, and Warren E. Weber find that previous researchers failed to account for two significant costs of issuing notes. When these costs are included, bankers' fists turn out to be relaxed after all: bankers did indeed issue enough notes to exhaust their profit opportunities. The usefulness of this period as a testing ground is thereby restored.

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