

ABSTRACTS OF THE ARTICLES

Ageing population, the median voter and the size of the welfare state

András Simonovits

This paper discusses three models in which a redistributive overlapping generations (OLG) block is regulated by the median voter to explain the size of the welfare state. The first part deals with a puzzle reported in *Razin et al. (2002)*: other things being equal, there is a negative correlation between the dependency share (i.e. an ageing population) and the size of the welfare state. To explain the puzzle, they assumed (i) that workers receive the same benefits as the elderly and (ii) that workers have exogenous expectations of future tax rates and old-age benefits. The paper exposes a serious error in the empirical part of the study: ageing and increasing dependency have been confused. If the counterfactual assumptions are replaced by more general, realistic ones, the revised model behaves better; the paradox survives, but poorer workers must apply for huge credits, which contradicts reality. The second part of the paper generalizes from *Casamatta et al. (2000)*, who analysed the connection between earnings-related benefits and optimal contribution rate, taking into account the existence of credit constraints. Following up the idea of *Razin et al.*, moderate workers' benefits are introduced. For reasonably low inter-temporal elasticity of substitution, the paradox disappears. The third part of the paper outlines the approach of *Tabellini (2000)*. In this model, parents care about their children's consumption, while the children care about their parents' consumption. Notwithstanding the exogenous expectations, the paradox disappears. The conclusions raise questions about the appropriateness of the model family.

Coherent risk measurement and capital allocation

Péter Csóka

However much a bank (or company or insurance provider) concentrates only on business, it cannot avoid financial (credit, market, operational or other) risks that need to be measured and covered. Total cover is either very expensive or not even possible, so that every business unit has to hold some risk-free liquid capital to avoid insolvency. What it needs is *coherent risk measurement*: the capital allocated has to match the risks, but even if the risks are measured well, distribution problems can still arise. Thanks to diversification effects, the total risk of a portfolio is less than the sum of the risks of its sub-portfolios. *Coherent capital allocation* entails addressing the question of how much capital to divide among the sub-portfolios, or how to distribute 'correctly' the advantages of diversification. This yields the contribution of the assets to the risk. The study employs game theory and examples of compound options to demonstrate coherent measurement and distribution of risks. Attention is drawn to the dangers of inconsistencies. The authors examine how far

the methods of risk measurement applied in practice (notably VaR—value at risk) meet the requirements set in theory.

The new Basel regulations and an approach based on internal rating

Ágnes Szabó-Morvai

The study deals with the methodological background to the latest proposals of the Basel Bank Supervisory Committee. First of all, it presents the basis of the regulations: the CreditMetrics model or a simplified version of it. From this system, it derives the central equation of the IRB model, on which the internal rating is based, and shows what assumption the Committee made when devising the regulations. Finally, it touches briefly on how the model handles the relations between portfolio elements and how the analysis changes in the case of small firms.

Perspectives on the US current account deficit and sustainability

Catherina L. Mann

The U.S. current account balance has been deeply in deficit in the last two decades. This process may mean that the country is ‘living beyond its means,’ but it may also mean that America is an ‘oasis of prosperity’. This essay considers the underpinnings of the large US current account deficit. It then tackles the question of whether the US current account deficit is sustainable. The paper considers three perspectives: 1) a domestic perspective based on national income and product accounts, 2) an international perspective based on trade flows in goods and services, and 3) an international perspective based on flows and holdings of financial assets. All three perspectives underline the specifics of the US situation. Unlike other countries that run huge current account deficits, the US need not be very worried by the situation, because a) American bonds and stocks represent such a huge share of the international bonds and stocks, and b) their values are denominated in US dollars, which constrains sudden withdrawals.