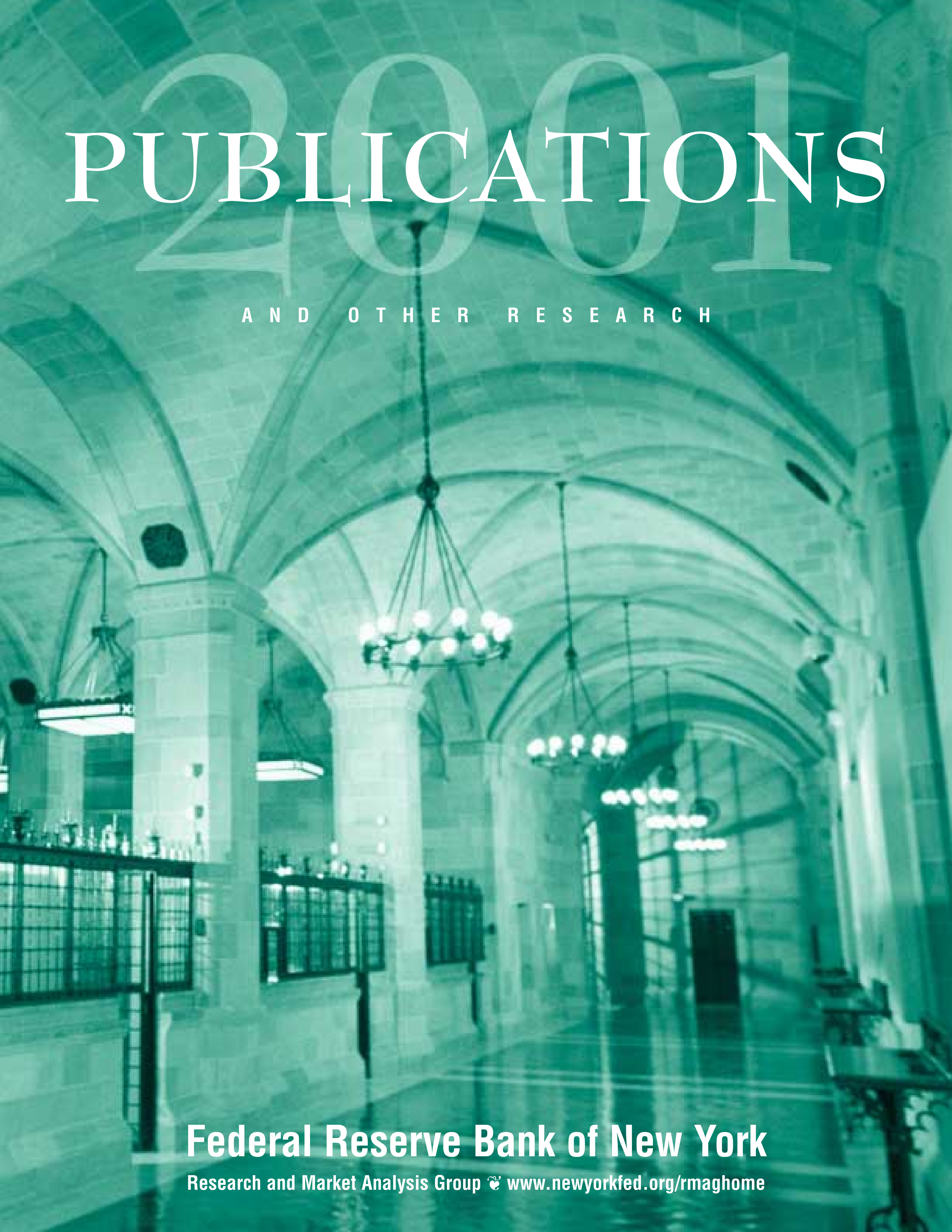

2001 PUBLICATIONS

AND OTHER RESEARCH

Federal Reserve Bank of New York

Research and Market Analysis Group ❦ www.newyorkfed.org/rmaghome

Contents

Federal Reserve Bank of New York
Research and Market Analysis Group
www.newyorkfed.org/rmaghome

January 2002

Introduction

The Federal Reserve Bank of New York's Research and Market Analysis Group produces a wide variety of publications and discussion papers of interest to business and banking professionals, policymakers, academics, and the general public.

This catalogue lists recent issues in each of our research series:

- the *Economic Policy Review*
  our policy-oriented flagship publication
- *Current Issues in Economics and Finance*
  a newsletter-style publication focusing on economic and financial topics
- *Second District Highlights*
  a regional supplement to *Current Issues* covering financial and economic developments in the Federal Reserve System's Second District
- *Staff Reports*
  technical papers presenting research findings.

In addition, the Research and Market Analysis Group produces *Research Update*, a quarterly newsletter complementing this catalogue. *Research Update* offers summaries of selected studies and listings of recent publications in our research series. It also provides other news and information about the Research Group.

Members of the Group also publish papers in many economic and finance journals, conference volumes, and scholarly books. A list of these publications begins on page 15.

We invite you to order, at no charge, copies from our research series or to join our subscriber lists. Or you can visit our web site for publications and papers.

Economic Policy Review

The *Economic Policy Review* is a policy-oriented research journal that focuses on macroeconomic, banking, and financial market topics.

EPR articles are available at www.newyorkfed.org/rmaghome/econ_pol/index.html.

Volume 7

Number 1

The Challenges of Risk Management in Diversified Financial Companies
Christine M. Cumming and Beverly J. Hirtle

In recent years, financial institutions and their supervisors have placed increased emphasis on the importance of measuring and managing risk on a firmwide basis—a coordinated process referred to as consolidated risk management. Although the benefits of this type of risk management are widely acknowledged, few if any financial firms have fully developed systems in place today, suggesting that significant obstacles have led them to manage risk in a more segmented fashion. In this article, the authors examine the economic rationale behind consolidated risk management. Their goal is to detail some of the key issues that supervisors and practitioners have confronted in assessing and developing consolidated risk management systems. In doing so, the authors clarify why implementing consolidated risk management involves significant conceptual and practical difficulties. They also suggest areas in which additional research could help resolve some of these difficulties.

Using Credit Risk Models for Regulatory Capital: Issues and Options
Beverly J. Hirtle, Mark Levonian, Marc Saidenberg, Stefan Walter, and David Wright

The authors describe the issues and options that would be associated with the development of regulatory minimum capital standards for credit risk based on banks' internal risk measurement models. Their goal is to provide a sense of the features that an internal-models (IM) approach to regulatory capital would likely incorporate, and to stimulate discussion among financial institutions, supervisors, and other interested parties about the many practical and conceptual issues involved in structuring a workable IM regulatory capital regime for credit risk. The authors focus on three main areas: prudential standards defining the risk estimate to be used in the capital requirements, model standards describing the essential components of a comprehensive credit risk model, and validation techniques that could be used by supervisors and banks to assess model accuracy. The discussion highlights a range of alternatives for each of these areas.

What Drives Productivity Growth?
Kevin J. Stiroh

Economists have long debated the best way to explain the sources of productivity growth. Neoclassical theory and "new growth" theory both regard investment—broadly defined to include purchases of tangible assets, human capital expenditures, and research and development efforts—as a critical source of productivity growth, but they differ in fundamental ways. Most notably, the neoclassical framework focuses on diminishing and internal returns to aggregate capital, while new growth models emphasize constant returns to capital that may yield external benefits. This article finds that despite their differences, both theories help explain productivity growth. The methodological tools of the neoclassical economists allow one to measure the rate of technical change, and the models of the new growth theorists provide an internal explanation for technical progress.

Actual Federal Reserve Policy Behavior and Interest Rate Rules
Ray C. Fair

A popular way to approximate Federal Reserve policy is through the use of estimated interest rate equations, or policy "rules." In these rules, the dependent variable is the interest rate that the Federal Reserve is assumed to control and the explanatory variables are those factors assumed to affect Federal Reserve behavior. This article presents estimates of such a rule, using data from 1954:1-1999:3 but omitting the 1979:4-1982:3 period, when monetary targets were emphasized. Although the estimated coefficient on inflation is found to be larger in the post-1982 period, the difference is not statistically significant, and statistical tests fail to reject the hypothesis that the interest rate rule is stable across these two periods.

Leading Economic Indexes for New York State and New Jersey
James Orr, Robert Rich, and Rae Rosen

The authors develop indexes of leading economic indicators for New York State and New Jersey over the 1972-99 period. They find that the leading indexes convey useful information about the future course of economic activity in both states. The authors then construct separate indexes to forecast recessions and expansions in each state. The movements of the recession and expansion indexes are found to display a close relationship with the behavior of the leading indexes. Accordingly, the recession and expansion indexes allow the authors to extend the informational content of the leading indexes by estimating the probability of an upcoming cyclical change in state economic activity within the next nine months.

Number 2

In November 2000, the Federal Reserve Bank of New York sponsored the conference "Welfare Reform Four Years Later: Progress and Prospects." This special issue is dedicated to the conference proceedings.

Papers include:

Opening Remarks
Jamie B. Stewart, Jr.

How Are Families Who Left Welfare Doing over Time? A Comparison of Two Cohorts of Welfare Leavers
Pamela Loprest

Declining Caseloads/Increased Work: What Can We Conclude about the Effects of Welfare Reform?
Rebecca M. Blank

Changing Caseloads: Macro Influences and Micro Composition
Robert A. Moffitt and David W. Stevens

Changing the Culture of the Welfare Office: The Role of Intermediaries in Linking TANF Recipients with Jobs
LaDonna Pavetti, Michelle K. Derr, Jacquelyn Anderson, Carole Trippe, and Sidnee Paschal

Welfare Reform and New York City's Low-Income Population
Howard Chernick and Cordelia Reimers

Using Financial Incentives to Encourage Welfare Recipients to Become Economically Self-Sufficient
Philip K. Robins and Charles Michalopoulos

Number 3

Infrastructure and Social Welfare in Metropolitan America

Andrew F. Haughwout

Public infrastructure investment may indirectly affect firm productivity and household welfare through its impact on the location of economic activity. Existing infrastructure policies encourage firms and households to move from dense urban environments to the surrounding suburbs. Nevertheless, several recent studies have suggested that the concentration of producers and consumers within cities results in "agglomeration economies" that are socially beneficial. In light of these findings, the author recommends the creation of infrastructure investment authorities that would have the power to select and finance projects that promote the overall well-being of a given region. Such authorities would most likely direct a larger share of infrastructure investment to the central cities.

The Effect of Employee Stock Options on the Evolution of Compensation in the 1990s

Hamid Mehran and Joseph Tracy

Between 1995 and 1998, actual growth in compensation per hour (CPH) accelerated from approximately 2 percent to 5 percent. Yet as the labor market continued to tighten in 1999, CPH growth unexpectedly slowed. This article explores whether this aggregate "wage puzzle" can be explained by changes in the pay structure—specifically, by the increased use of employee stock options in the 1990s. The CPH measure captures these options on their exercise date, rather than on the date they are granted. By recalculating compensation per hour to reflect the options' value on the grant date, the authors find that the adjusted CPH measure accelerated in each year from 1995 to 1999.

Personal On-Line Payments

Kenneth N. Kuttner and James J. McAndrews

The swift growth of e-commerce and the Internet has led to the development of a new form of electronic funds transfer—the personal on-line payment—that uses web and e-mail technologies to initiate and confirm payments. This article describes this payment instrument and the trends that have given rise to it. The authors explain that personal on-line payment systems are already providing a convenient alternative to checks, money orders, and cash, and may replace credit cards for some small-scale retail e-commerce. However, issues such as the interoperability of diverse systems and the systems' inherent risks will continue to be central. The authors also suggest that although personal on-line payment systems are not likely to have a great impact on monetary policy, they do raise regulatory issues associated with consumer rights and protection.

The Effect of Interest Rate Options Hedging on Term-Structure Dynamics

John Kambhu and Patricia C. Mosser

Market participants and policymakers closely monitor movements in the yield curve for information about future economic fundamentals. In several recent episodes, however, disruptions to market liquidity have affected the short-term dynamics of the curve independently of fundamentals. This article provides evidence that the short-run dynamics in the intermediate maturities of the yield curve changed around 1990, with the appearance of positive feedback in weekly interest rate changes. The feedback is consistent with the effects of options dealers' hedging activity and it is found only in the 1990s, after the interest rate options market grew to significant size. The authors also show that the market liquidity/positive-feedback effects are concentrated in the weeks after the largest interest rate changes. Their results suggest that the times when market participants and policymakers are most interested in extracting from the yield curve a signal about economic fundamentals are precisely the times when changes in the curve may be distorted by liquidity effects.

Current Issues in Economics and Finance

Current Issues in Economics and Finance is a newsletter-style publication offering concise and timely analyses of economic and financial topics.

Second District Highlights—a regional supplement to *Current Issues*—covers important financial and economic developments in the Federal Reserve System's Second District.

Both series are available in html and pdf formats at www.newyorkfed.org/rmaghome/curr_iss/index.html.

Volume 7

No. 1
Declining Manufacturing Employment in the New York–New Jersey Region: 1969-99
Jason Bram and Michael Anderson

Between 1969 and 1999, the New York–New Jersey region experienced a steeper drop in manufacturing employment than any other area of the United States. Much of the unusually sharp job decline can be attributed to the geographic dispersion of manufacturing—that is, the gradual movement of manufacturing activity from the more urbanized and industry-intensive states of the Northeast to the less industrially developed states of the South and West.
Second District Highlights series

No. 2
The Effects of a Booming Economy on the U.S. Trade Deficit
Stefan Papaioannou and Kei-Mu Yi

The robust growth of the U.S. economy between 1996 and 1999 spurred U.S. demand for foreign goods and contributed to a surge in the U.S. trade deficit. An analysis of the effects of the expansion on the trade balance suggests that the economic boom can account for roughly a third of the sharp rise in the merchandise trade deficit during this period.

No. 3
New York–New Jersey Job Expansion to Moderate in 2001
James Orr and Rae D. Rosen

New York City will set the pace for job growth in the New York–New Jersey region in 2001, with employment advancing 1.9 percent over the year. For the region as a whole, the rate of job growth will drop to 1.5 percent, from 2.2 percent in 2000.
Second District Highlights series

No. 4
Stocks in the Household Portfolio: A Look Back at the 1990s
Joseph Tracy and Henry Schneider

The growing prominence of stocks as a household asset in the 1990s encouraged the view that the United States had become a nation of zealous investors alert to every market development and eager to acquire new stocks. Yet an analysis of the factors behind the rise in the household equity share suggests that exceptionally high returns on stocks—rather than aggressive investment behavior—accounted for much of the increased importance of stocks.

No. 5
Curbing Unemployment in Europe: Are There Lessons from Ireland and the Netherlands?
Cédric Tille and Kei-Mu Yi

Since the mid-1980s, unemployment rates in Ireland and the Netherlands have plummeted, while the average rate for the European Union has maintained its longtime high level. Ambitious labor market reforms—including wage moderation and the tightening of unemployment benefits—have helped to bring the Irish and Dutch rates down. Other European countries would benefit from adopting similar reforms, but they are unlikely to see the same dramatic improvement in their unemployment numbers.

No. 6

Investing in Information Technology: Productivity Payoffs for U.S. Industries

Kevin J. Stiroh

Although firms have invested billions of dollars in information technology to boost their productivity, many analysts continue to question whether these investments do in fact lead to productivity gains. An industry-level analysis of productivity performance provides robust evidence of a link, showing that the industries experiencing the largest productivity acceleration in the late 1990s were the producers and most intensive users of information technology.

No. 7

Fiscal Policy in New York and New Jersey: 1977-97

Andrew F. Haughwout

Between 1977 and 1997, real government spending in New York and New Jersey rose more than 40 percent, led by sharply higher outlays for public welfare and education. Increased tax revenues offset the spending hikes, allowing the states to run large cash surpluses in most years, but both states saw their long-term debt grow markedly. As a result, net financial wealth rose only marginally in New Jersey and declined slightly in New York over the twenty-year period.

Second District Highlights series

No. 8

To What Extent Does Productivity Drive the Dollar?

Cédric Tille, Nicolas Stoffels, and Olga Gorbachev

The continuing strength of the dollar has fueled interest in the relationship between productivity and exchange rates. An analysis of the link between the dollar's movements and productivity developments in the United States, Japan, and the euro area suggests that productivity can account for much of the change in the external value of the dollar over the past three decades.

No. 9

Equipment Expenditures since 1995: The Boom and the Bust

Jonathan McCarthy

Business investment in equipment surged in the 1990s, then fell back sharply after mid-2000. A popular explanation of these trends holds that the soaring stock market and declining computer prices of the last decade encouraged excess investment, setting the stage for the retrenchment that followed. Yet an analysis of the factors underlying investment suggests that capital spending patterns in the late 1990s would have been quite similar had stock values and equipment prices remained near their recent historical averages.

No. 10

An International Survey of Stress Tests

Ingo Fender, Michael S. Gibson, and Patricia C. Mosser

In the summer of 2000, central banks from the Group of Ten countries surveyed large international banks about their use of stress tests—a risk management tool that measures a firm's exposure to extreme movements in asset prices. The survey findings highlight the risks that most concern financial institutions and clarify how these institutions use stress tests in their overall risk management programs.

No. 11

The Effect of Tax Changes on Consumer Spending

Charles Steindel

Many supporters of the tax cut enacted this summer viewed it as an important stimulus to consumer spending. But an analysis of the effects of earlier income tax cuts suggests that the consumer response to such initiatives is, in fact, quite variable. Two conclusions stand out: First, consumers will be more likely to boost spending if the change in tax liabilities is permanent. Second, consumers will wait to increase spending until a tax change affects their take-home pay.

Research Update

Research Update is a quarterly newsletter designed to keep you informed about the Research Group's current work. The newsletter—which complements this catalogue—offers summaries of selected studies and listings of recent articles and papers in our research series.

Research Update also reports on other news within the Group, including:

- staff publication in outside journals,
- upcoming conferences at the Federal Reserve Bank of New York,
- calls for papers, and
- new publications and services.

You can subscribe to *Research Update* by using the enclosed order form. The publication is also available in html and pdf formats at www.newyorkfed.org/rmaghome/update/index.html.

Staff Reports

The *Staff Reports* series features technical research papers designed to stimulate discussion and elicit comments. These papers are intended for eventual publication in leading economic and finance journals.

The series is available only at www.newyorkfed.org/rmaghome/staff_rp/index.html.

Macroeconomics and Growth

No. 115
Information Technology and the U.S. Productivity Revival: What Do the Industry Data Say?
Kevin J. Stiroh

This study examines the link between information technology (IT) and the U.S. productivity revival of the late 1990s. Industry-level data show a broad productivity resurgence that reflects the production and use of IT. The most IT-intensive industries experienced significantly larger productivity gains than other industries, and a wide variety of econometric tests show a strong correlation between IT capital accumulation and labor productivity. To quantify the aggregate impact of IT use and IT production, the author presents a novel decomposition of aggregate labor productivity. He shows that virtually all of the aggregate productivity acceleration can be traced to the industries that either produce or use information technology most intensively, with essentially no contribution from the industries that are less involved in the IT revolution.

No. 117
Structural Change in U.S. Wage Determination
Robert W. Rich and Donald Rissmiller

This paper provides an empirical investigation into the determinants and stability of the aggregate wage inflation process in the United States over the 1967-2000 period. Using compensation per hour as the measure of wages, the authors specify a Phillips curve model that links wage growth to its past values as well as to the unemployment rate, price inflation, labor productivity growth, and an additional set of labor market variables. Their results do not reject the hypothesis that real wages and labor productivity move proportionally in the long run. More important, endogenous structural break tests provide little evidence of model instability. The authors conclude that aggregate wage determination has remained stable over the past thirty years and that any recent shift in the inflation-unemployment relationship reflects developments outside the labor market.

No. 122
Productivity: What Is It, and Why Do We Care about It?
Charles Steindel and Kevin J. Stiroh

U.S. productivity growth has been the focus of considerable attention in recent years. This paper presents a broad overview of productivity—both labor and total factor—and discusses its importance. The authors describe the official U.S. productivity statistics prepared by the Bureau of Labor Statistics and discuss several stylized facts. They show how productivity relates to critically important variables like long-run growth, living standards, and inflation, and describe the proximate factors that determine labor productivity using a standard growth accounting framework. Finally, the authors outline a series of unresolved productivity issues that have direct implications for the future of the U.S. economy.

No. 126

Recent Changes in the U.S. Business Cycle

Marcelle Chauvet and Simon Potter

The U.S. business cycle expansion, which started in March 1991, is the longest on record. This study examines whether the expansion is a onetime, unique event or whether its length results from a change in U.S. economic stability. Bayesian methods are used to estimate a common factor model that allows for structural breaks in the dynamics of a wide range of macroeconomic variables. The study finds strong evidence that a reduction in volatility is common to the series examined. Furthermore, the reduction implies that future expansions will be considerably longer than the historical average.

No. 131

A Primer on the Economics and Time Series Econometrics of Wealth Effects: A Comment

Martin Lettau, Sydney Ludvigson, and Nathan Barczi

In a recent paper, Davis and Palumbo (2001) investigate the empirical relationship between aggregate consumption, asset wealth, and labor income. Although cointegration implies that an equilibrium relationship ties these variables together in the long run, Davis and Palumbo focus on a short-run structural question: how quickly does consumption adjust to changes in income and wealth—within a quarter, or over many quarters? They claim to answer this question, and imply that spending adjusts only gradually after gains or losses in income or wealth have been realized. This comment argues that a statistical methodology different from that of Davis and Palumbo is required to address this question, and once the methodology has been employed, the evidence weighs heavily against their interpretation.

No. 136

New Evidence on the Lending Channel

Adam B. Ashcraft

This study examines whether banks play a special role in the monetary policy transmission mechanism. The author uses the presence of internal capital markets in bank holding companies to isolate plausibly exogenous variation in the financial constraints faced by banks. In particular, he demonstrates that affiliated bank loan growth is less sensitive to changes in the federal funds rate than that of unaffiliated banks, and that these relatively unconstrained banks are better able to smooth insured deposit outflows by issuing uninsured debt. State loan growth also becomes less sensitive to changes in the federal funds rate as the loan market share of affiliated banks increases, but state output growth is largely unaffected.

No. 139

Is Equipment Price Deflation a Statistical Artifact?

Bart Hobijn

The author argues that equipment price deflation might be overstated because the methods used to measure it rely on the erroneous assumption of perfectly competitive markets. The main intuition behind this argument is that what these price indices might actually capture is not a price decrease but the erosion of the market power of existing vintages of machines. To illustrate this, the author introduces an endogenous growth model in which heterogeneous final goods producers can choose their technology, which is provided by monopolistically competing machine suppliers. This market structure implies that the best machines are marketed to the best workers and sold at the highest markup. In the model's economy, the endogenously determined markups are such that standard methods will tend to find equipment price deflation, even though the model exhibits no such deflation.

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International

No. 116

Exchange Rates and Wages

Linda Goldberg and Joseph Tracy

The authors offer an explanation for the paradoxical finding that industry wages are significantly more responsive to exchange rate changes than industry employment is. Using 1976-98 Current Population Survey data, they find that the main mechanism for exchange rate effects on wages occurs through job turnover, and this phenomenon strongly affects the wages of workers undergoing such transitions. By contrast, workers who remain with the same employer are found to experience little, if any, wage impacts from exchange rate shocks. In addition, the least-educated workers—who also change jobs most often—are found to shoulder the largest adjustments to exchange rates.

No. 119

When Is U.S. Bank Lending to Emerging Markets Volatile?

Linda S. Goldberg

This study characterizes the size and portfolio diversification patterns of U.S. banks engaging in foreign lending and explores the determinants of fluctuations in U.S. bank claims on a broad set of countries. Claims on Latin American and Asian emerging markets, and on industrialized countries, are found to be sensitive to U.S. macroeconomic conditions. When the United States grows rapidly, there is substitution between claims on industrialized countries and claims on the United States. The response pattern of claims on emerging markets to U.S. conditions is found to differ across banks of different sizes and across emerging markets. The study also finds that, unlike U.S. bank claims on industrialized countries, claims on emerging markets are not highly sensitive to local-country GDP and interest rates.

No. 121

Gender Differences in the Labor Market Effects of the Dollar

Linda Goldberg and Joseph Tracy

Although the dollar has been shown to influence workers' expected wages, the analysis to date has focused on the male workforce. This paper shows that exchange rate fluctuations also have important implications for women's wages, particularly at job transition. Changes in the dollar's value can cause the wage gap between women who change jobs and women who do not to expand or contract sharply, with the most pronounced effects occurring among the least-educated women and women in highly competitive manufacturing industries. In addition, women who remain in their jobs apparently show greater wage sensitivity to currency movements than do their male counterparts.

No. 124

International Dimensions of Optimal Monetary Policy

Giancarlo Corsetti and Paolo Pesenti

The authors argue that strict adherence to inward-looking policy objectives such as domestic output stabilization cannot be optimal when firms' markups are exposed to currency fluctuations. Such policies induce excessive volatility in exchange rates and foreign sales revenue, leading exporters to raise prices in response to higher risk. In general, optimal rules trade off a larger domestic output gap against lower import prices. Monetary rules in a world Nash equilibrium lead to less exchange rate volatility than inward-looking rules and discretionary policies, even when the latter do not suffer from inflationary (or deflationary) bias. Gains from international monetary cooperation are related in a nonmonotonic way to the degree of exchange rate pass-through.

No. 127

Border Effects and the Availability of Domestic Products Abroad

Carolyn L. Evans

Borders have a sizable negative impact on trade flows. This "border effect" could have two explanations: less international than domestic trade in the goods actually exchanged between countries ("flow"), or differences between the sets of goods traded internationally and domestically ("availability"). This paper provides a theoretical and empirical examination of the distinction between these explanations. The results suggest that a portion of the border effect is indeed due to differences between the set of goods available domestically and internationally. On average across industries, about half of the effect is due to flows, while the remainder may be attributed to availability.

No. 128

Home Bias in Trade: Location or Foreign-ness?

Carolyn L. Evans

This paper probes the causes of home bias, in which consumers generally elect to purchase domestic goods over imports. It questions whether this phenomenon arises from pure locational factors, such as tariffs or access to a local distribution network, or an inherent preference for domestic goods. The apparent tendency toward home bias is found to arise almost entirely from locational factors. Moreover, if a firm establishes and sells from a foreign subsidiary, its local sales are found to be nearly on a par with those of domestic firms in that market. "Foreign-ness" per se does not appear to impact purchases of imported goods.

No. 137

Does Foreign Ownership Contribute to Sounder Banks in Emerging Markets? The Latin American Experience

Jennifer S. Crystal, B. Gerard Dages, and Linda S. Goldberg

Foreign banks entering emerging markets are usually thought to improve the condition and performance of acquired institutions, and more generally to enhance local financial stability. The authors use bank-specific data for several Latin American countries since the mid-1990s to investigate this theory. Across the seven largest countries, they find that the financial strength ratings of local banks acquired by foreign entities generally show a slight improvement relative to their domestic counterparts. The authors' more in-depth studies of Chile, Colombia, and Argentina do not indicate striking differences in health between foreign and domestic banks. However, foreign banks often have higher average loan growth, average provisioning expense, and loss-absorption capacity. These results suggest that foreign ownership can provide important positive influences on the stability and development of emerging market banking systems.

No. 140

Specialization and the Volume of Trade: Do the Data Obey the Laws?

James Harrigan

The core subjects of trade theory are the pattern and volume of trade: which goods are traded by which countries, and how much of those goods is traded. The first part of this paper discusses evidence on comparative advantage, with an emphasis on connecting theoretical models with data analyses. The second part considers the theoretical foundations of the gravity model and reviews the few studies that have tried to test, rather than simply use, the implications of gravity. Both parts yield the same conclusion: we are still in the very early stages of empirically understanding specialization and the volume of trade, but the work to date is a starting point for further research.

No. 142

One Reason Countries Pay Their Debts: Renegotiation and International Trade

Andrew K. Rose

This paper estimates the effect of sovereign debt renegotiation on international trade. Sovereign default may be associated with a subsequent decline in such trade either because creditors want to deter default by debtors, or because trade finance dries up after default. To estimate the effect, the author uses an empirical gravity model of bilateral trade and a large panel data set covering fifty years and more than 200 trading partners. The model controls for various factors that influence bilateral trade flows, including the incidence of International Monetary Fund programs. Using the dates of sovereign debt renegotiations conducted through the Paris Club as a proxy measure for sovereign default, the author finds that renegotiation is associated with an economically and statistically significant decline in bilateral trade between a debtor and its creditors. The decline is roughly 8 percent a year and persists for about fifteen years.

Microeconomics

No. 118

What's Driving the New Economy? The Benefits of Workplace Innovation

Sandra E. Black and Lisa M. Lynch

Using a representative sample of U.S. firms surveyed in 1993 and 1996, the authors examine the relationship between workplace innovations and productivity and wages. They find that firms that reengineer their workplaces and incorporate more high-performance practices experience higher productivity. In an examination of wage determinants within these firms, the authors find that reengineering a workplace to incorporate more high-performance practices leads to higher wages. However, increased use of profit sharing is found to result in lower regular pay for employees, especially technical workers and clerical/sales workers.

Banking and Finance

No. 120

Financial Market Implications of the Federal Debt Paydown

Michael J. Fleming

The author describes how the U.S. Treasury securities market is reacting to the paydown of the federal debt. He explains that because many of the features that make Treasuries an attractive benchmark are likely to be adversely affected, market participants are moving toward agency debt securities, corporate debt securities, and interest rate swaps as reference and hedging benchmarks. He also explains that the Federal Reserve is taking steps to adjust its portfolio in response to the paydown, and suggests that the steps will have little effect on monetary policy.

No. 123

How Do Stock Repurchases Affect Bank Holding Company Performance?

Beverly Hirtle

The author examines the relationship between stock repurchases and financial performance for a large sample of bank holding companies from 1987 to 1998. Higher levels of repurchases in one year are found to be associated with higher profitability and a lower share of problem loans in the subsequent year. This result appears to be driven primarily by banks with publicly traded stock, especially stock traded on major exchanges. The study also suggests that the repurchase-performance link is driven by different factors for different types of banks. In particular, the evidence is consistent with one hypothesis for banks traded on major exchanges: bank managers may opt to return excess funds to shareholders when they have limited outside investment opportunities.

No. 125

Currency Orders and Exchange Rate Dynamics: Explaining the Success of Technical Analysis

Carol L. Osler

This paper provides a microstructural explanation for two key predictions of technical analysis: trends tend to be reversed at predictable support and resistance levels, and trends gain momentum once these levels are crossed. The explanation is based on an analysis of stop-loss and take-profit orders at a large foreign exchange dealing bank—the first foreign exchange data of their kind available to academic research. The orders' requested execution rates are found to be strongly clustered at round numbers, which are often used as support and resistance levels. The marked differences between the clustering patterns of stop-loss and take-profit orders, and between the patterns of stop-loss buy and stop-loss sell orders, explain the success of the two predictions.

No. 129

Bank Integration and Business Volatility

Donald Morgan, Bertrand Rime, and Philip Strahan

The authors investigate how bank migration across state lines over the past quarter-century has affected the size and covariance of business fluctuations within states. They conclude that the theoretical effect of integration on business cycle size is ambiguous because some shocks are dampened by integration while others are amplified. Empirically, integration is found to diminish employment growth fluctuations within states and to decrease deviations in growth across them. In other words, business cycles within states become smaller with integration, but more alike. The results for the United States bear on the financial convergence under way in Europe, where banks remain highly fragmented across nations.

No. 130

Idiosyncratic Risk and Volatility Bounds, or Can Models with Idiosyncratic Risk Solve the Equity Premium Puzzle?

Martin Lettau

This paper uses Hansen and Jagannathan's (1991) volatility bounds to evaluate models with idiosyncratic consumption risk. It shows that idiosyncratic risk does not change the volatility bounds when consumers have CRRA preferences and the idiosyncratic shock distribution is independent of the aggregate state. Following Mankiw (1986), the author shows that idiosyncratic risk can help to enter the bounds when idiosyncratic uncertainty depends on the aggregate state of the economy. He computes an upper bound of the volatility bounds using individual income data and assumes that agents must consume their endowment. The model does not pass the Hansen-Jagannathan test, even for very volatile idiosyncratic income data.

No. 133

Measuring Treasury Market Liquidity

Michael J. Fleming

The author examines a comprehensive set of liquidity measures for the U.S. Treasury market. He finds highly significant price impact coefficients, which are strongly correlated with bid-ask spreads and episodes of reported poor liquidity such as the fall 1998 financial market turmoil. Quote and trade sizes are found to correlate modestly with these episodes and with the other liquidity measures, as are yield spreads between on-the-run and off-the-run securities. In contrast, trading volume and trading frequency are only weakly correlated with these other measures, suggesting that they are poor liquidity proxies. The various measures, almost without exception, are positively correlated across securities, especially Treasury notes.

No. 135

The Overnight Interbank Market: Evidence from the G-7 and the Euro Zone

Alessandro Prati, Leonardo Bartolini, and Giuseppe Bertola

This analysis of the major industrial countries' interbank markets for overnight loans links the behavior of very short-term interest rates to the operating procedures of the countries' central banks. Previous studies on this topic have focused on key features of the U.S. federal funds rate's behavior. Yet this study finds that many of these features are not robust to changes in institutional details and changes in the style of central bank intervention, along both cross-sectional and time series dimensions of data. The study suggests that the empirical features of the day-to-day behavior of short-term interest rates are more strongly influenced by institutional arrangements than by extensively researched market frictions.

No. 138

Are Bank Shareholders Enemies of Regulators or a Potential Source of Market Discipline?

Sangkyun Park and Stavros Peristiani

In moral hazard models, bank shareholders have incentives to transfer wealth from the deposit insurer—that is, maximize put option value—by pursuing riskier strategies. For safe banks with large charter value, however, the risk-taking incentive is outweighed by the possibility of losing charter value. By focusing on the relationship between book value, market value, and a risk measure, this study develops a semiparametric model for estimating the critical level of bank risk at which put option value starts to dominate charter value. From these estimates, the authors infer the extent to which the risk-taking incentive prevailed during 1986-92, a period of serious banking and financial turmoil. They find that despite the environment, shareholders' risk-taking incentive was confined primarily to a small fraction of highly risky banks.

No. 141

Common Determinants of Bond and Stock Market Liquidity: The Impact of Financial Crises, Monetary Policy, and Mutual Fund Flows

Tarun Chordia, Asani Sarkar, and Avanidhar Subrahmanyam

The authors study common determinants of daily bid-ask spreads and trading volume for the bond and stock markets over the 1991-98 period. They find that spread changes in one market are affected by lagged spread and volume changes in both markets. Further, spread and volume changes are predictable to a considerable degree using lagged market returns, lagged interest rates, lagged spreads, and lagged volume. During financial crises, stock and bond spreads and volume are more volatile and become more highly correlated; moreover, money supply positively affects financial market liquidity, albeit with a two-week lag. During normal times, increases in mutual fund flows enhance stock market liquidity and trading volume, but during financial crises, U.S. government bond funds see higher inflows, resulting in increased bond market liquidity.

Quantitative Methods

No. 132

Markov Switching in Disaggregate Unemployment Rates

Marcelle Chauvet, Chinhui Juhn, and Simon Potter

The authors develop a dynamic factor model with Markov switching to examine secular and business cycle fluctuations in U.S. unemployment rates. In the model, they extract the common dynamics among unemployment rates disaggregated for seven age groups. This framework allows the authors to analyze the contribution of demographic factors to secular changes in unemployment rates as well as the separate contribution of changes due to asymmetric business cycle fluctuations. The study finds strong evidence in favor of the common factor and the switching between high and low unemployment rate regimes. In addition, demographic adjustments are found to account for much of the secular change in the unemployment rate, particularly the abrupt increase in the 1970s and 1980s and the subsequent decrease.

No. 134

Forecasting Recessions Using the Yield Curve

Marcelle Chauvet and Simon Potter

The authors compare forecasts of recessions using four specifications of the probit model: a time-invariant conditionally independent version, a business cycle specific conditionally independent model, a time-invariant probit with autocorrelated errors, and a business cycle specific probit with autocorrelated errors. The more sophisticated versions of the model take into account some of the potential underlying causes of the documented predictive instability of the yield curve. The authors find strong evidence in favor of the more sophisticated specification, which allows for multiple breakpoints across business cycles and autocorrelations. They also develop a new approach to the construction of real-time forecasts of recession probabilities.

Outside Journals

Members of the Research and Market Analysis Group publish in a wide range of economic and finance journals, conference volumes, and scholarly books.

Published in 2001

Leonardo Bartolini

"Banks' Reserve Management, Transaction Costs, and the Timing of Federal Reserve Intervention," with Giuseppe Bertola and Alessandro Prati. *Journal of Banking and Finance* 25, no. 7 (July): 1287-317.

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