PUBLICATIONS AND OTHER RESEARCH

2005

Federal Reserve Bank of New York
Research and Statistics Group ■ www.newyorkfed.org/research

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www.newyorkfed.org/research

January 2006

Introduction

The Federal Reserve Bank of New York's Research and Statistics 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 our research series:

- *the Economic Policy Review*
  a policy-oriented journal focusing on economic and financial market issues
- *Current Issues in Economics and Finance*
  concise studies of topical economic and financial issues
- *Second District Highlights*
  a regional supplement to *Current Issues*
- *Staff Reports*
  technical papers intended for publication in leading economic and finance journals.

The Research Group also offers two other publications of interest to readers:

- *EPR Executive Summaries*
  online versions of selected *Economic Policy Review* articles, in abridged form
- *Research Update*
  a quarterly newsletter providing summaries of studies and listings of recent publications in our research series.

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 20.

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/research/epr**.

Volume 11

Number 1, August 2005

"Labor Market Developments in the United States and Canada since 2000," proceedings of a conference cosponsored by the Canadian Consulate General in New York, the Centre for the Study of Living Standards, the Federal Reserve Bank of New York, and the New York Association for Business Economics, December 2, 2004.

Conference Overview and Summary of Papers

Erica L. Groshen, Zahir Lalani, and David Murchison

The Weak Jobs Recovery: Whatever Happened to "the Great American Jobs Machine"?

Richard B. Freeman and William M. Rodgers III

Commentary

Lars Osberg

Are Good Jobs Disappearing in Canada?

René Morissette and Anick Johnson

Commentary

Erica L. Groshen

The Recession of 2001 and Unemployment Insurance Financing

Wayne Vroman

Commentary

Timothy C. Sargent

Number 2, December 2005

"Urban Dynamics in New York City," proceedings of a conference sponsored by the Federal Reserve Bank of New York, April 22, 2005.

Conference Overview and Summary of Papers

Erica L. Groshen and Giorgio Topa

Urban Colossus: Why Is New York America's Largest City?

Edward L. Glaeser

Commentary

J. Vernon Henderson

The Geography of Entrepreneurship in the New York Metropolitan Area

Stuart S. Rosenthal and William C. Strange

Commentary

Robert Inman

Exogenous Shocks and the Dynamics of City Growth: Evidence from New York

Andrew F. Haughwout and Bess Rabin

EPR Executive Summary available

Commentary

Stephen L. Ross

The Promised City: Openness and Immigration in the Making of a World Metropolis

Kenneth T. Jackson

Immigration Trends in the New York Metropolitan Area

George J. Borjas

Commentary

Stephen J. Trejo

Trajectories for the Immigrant Second Generation in New York City

John Mollenkopf

Commentary

Douglas S. Massey

Immigration, Health, and New York City: Early Results Based on the U.S. New Immigrant Cohort of 2003

Guillermina Jasso, Douglas S. Massey, Mark R. Rosenzweig, and James P. Smith

Commentary

Adriana Lleras-Muney

Public Education in the Dynamic City: Lessons from New York City

Amy Ellen Schwartz and Leanna Stiefel

Commentary

Dalton Conley

Forthcoming

Trading Risk, Market Liquidity, and Convergence Trading in the Interest Rate Swap Spread

John Kambhu

While trading activity is generally thought to play a central role in the self-stabilizing behavior of markets, the risks in trading on occasion can affect market liquidity and heighten asset price volatility. This article examines empirical evidence on the limits of arbitrage in the interest rate swap market. Specifically, it analyzes how the risk associated with convergence trading—in which speculators trade on the expectation that asset prices will converge to normal, or fundamental, levels—can affect market liquidity and amplify shocks in asset prices. These effects are considered in terms of the behavior of the interest rate swap spread and the volume of repo contracts. The author finds both stabilizing and destabilizing forces attributable to leveraged trading activity. Although the swap spread tends to converge to its fundamental level, it does so more slowly when traders are weakened by losses; moreover, higher trading risk can cause the spread to diverge from its fundamental level. In addition, repo volume falls when convergence trading risk is higher, and reflects shocks that destabilize the swap spread. The behavior of repo volume in particular points to how trading risk affects market liquidity and asset price volatility.

EPR Executive Summary available

Local or State? Evidence on Bank Market Size Using Branch Prices

Paul Edelstein and Donald P. Morgan

With the elimination of state laws against branching, banks can now compete across states. They are no longer limited to competing in local markets, defined by the Federal Reserve as metropolitan statistical areas or small groups of rural counties. Accordingly, a "local or state?" debate over market size is taking place among researchers, with some arguing that banking markets are statewide and others contending that they remain local. This article contributes to the debate with a novel, arguably better, indicator of market size: bank branch prices, as opposed to bank deposit rates. The pattern of branch price data suggests that banking markets are not necessarily local. The authors find that branch prices in ten northeastern states over the 1990s are more closely correlated with bank concentration at the state level than at the local level, consistent with the "state-market" argument. However, they caution that the relationship is not completely robust; it depends partly on how the data are parsed. Further study using a larger set of branch price data will help settle the debate more definitively.

EPR Executive Summary available

The Evolution of Repo Contracting Conventions in the 1980s

Kenneth D. Garbade

Contracting conventions for repurchase agreements, or repos, changed significantly in the 1980s. The growth of the repo market, new uses for repos, and the emergence of new and previously unappreciated risks prompted market participants to revise their contracting conventions. This article describes the evolution of the conventions during that period, focusing on three key developments: the recognition of accrued interest on repo securities, a change in the application of federal bankruptcy law to repos, and the accelerated growth of a new form of repo—tri-party repo. The author argues that the emergence of tri-party repo owed to the efforts of individual market participants acting in their own economic self-interest. By comparison, recognition of accrued interest and the change in bankruptcy law were effected by participants taking collective action and seeking legislative relief, respectively, because uncoordinated, individual solutions would have been more costly. These developments offer important insights into how markets operate: contracting conventions that are efficient in one market environment may have to be revised when the environment changes, and institutional arrangements can change in any number of ways.

EPR Executive Summary available

EPR Executive Summaries

Visit our website for concise summaries of *Economic Policy Review* articles.

Our online publication *EPR Executive Summaries* condenses many of the articles published in the *Review*. Readers of the summaries will find timely, policy-oriented discussions that are easy to absorb.

The summaries make the technical research of New York Fed economists more accessible to policymakers, educators, business and financial leaders, and others. The series is designed to foster a fuller understanding of our research among those who are in a position to put our ideas and findings to work.

Summaries, in html format, are available for many articles published since 2002.

www.newyorkfed.org/research/epr/executive_summary.html

Current Issues in Economics and Finance

Current Issues in Economics and Finance offers concise studies of topical economic and financial issues.

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/research/current_issues**.

Volume 11

No. 1, January 2005

The Predictive Abilities of the New York Fed's *Empire State Manufacturing Survey*

Richard Deitz and Charles Steindel

Business surveys often give early signals of the direction and magnitude of economic activity. One release, the relatively new *Empire State Manufacturing Survey*, is demonstrating an ability to provide information ahead of U.S. production and employment trends. In fact, the predictive power of this survey appears to be at least equal to that of two established manufacturing surveys.
Second District Highlights

No. 2, February 2005

The Treasury Auction Process: Objectives, Structure, and Recent Adaptations

Kenneth D. Garbade and Jeffrey F. Ingber

Treasury auctions are designed to minimize the cost of financing the national debt by promoting broad, competitive bidding and liquid secondary market trading. A review of the auction process—from the announcement of a new issue to the delivery of securities—reveals how these objectives have been met. Also highlighted are changes in the auction process that stem from recent advances in information-processing technologies and risk management techniques.

No. 3, March 2005

What Financing Data Reveal about Dealer Leverage

Tobias Adrian and Michael J. Fleming

The Federal Reserve collects data on the financing activities of the primary government securities dealers. Some market analysts argue that the data show a considerable rise in dealer leverage in recent years. However, a close reading of the data suggests that dealer borrowing involving fixed-income securities has grown only modestly. Moreover, the increase that has occurred is not clearly associated with greater risk taking.

No. 4, April 2005

Are We Underestimating the Gains from Globalization for the United States?

Christian Broda and David Weinstein

Over the last three decades, trade has more than tripled the variety of international goods available to U.S. consumers. Although an increased choice of goods clearly enhances consumer well-being, standard national measures of welfare and prices do not assign a value to variety growth. This analysis—the first effort to measure such gains—finds that the value to consumers of global variety growth in the 1972-2001 period was roughly $260 billion.

No. 5, May 2005

Improving Business Payments by Asking What Corporations *Really* Want

Sandy Krieger and Michele Braun

A recent study led by the New York Fed sheds light on the changes in the payment process that large corporations would most like to see. The study's results, summarized in this article, suggest that corporate treasurers and cash managers would particularly value enhancements that decrease unauthorized and insufficiently funded payments, streamline data formats, improve bank services and information posting, and reduce cross-border payment uncertainties.

No. 6, June 2005

New York City Immigrants: The 1990s Wave

Rae Rosen, Susan Wieler, and Joseph Pereira

Fueled by a steady influx of immigrants, New York City's population turnover in the 1990s was almost double the average for the nation's 100 largest cities. A close look at the city's new foreign-born residents suggests that they are a very diverse group, showing marked differences in education level, English language fluency, and other characteristics that help determine labor market skills and performance.

Second District Highlights

No. 7, July 2005

Trends in Federal Funds Rate Volatility

Spence Hilton

The behavior of the fed funds rate—a key monetary policy target and a benchmark for short-term interest rates—is closely watched by many market participants. After a decade marked by periodic bouts of high volatility in the funds rate, volatility has declined sharply since 2001. An analysis of the major factors influencing the rate's behavior shows that some of the forces behind the current fall in volatility first emerged in response to the earlier increases.

No. 8, August 2005

U.S. Jobs Gained and Lost through Trade: A Net Measure

Erica L. Groshen, Bart Hobijn, and Margaret M. McConnell

Recent concerns about the transfer of U.S. services jobs to overseas workers have deepened long-standing fears about the effects of trade on the domestic labor market. But a balanced view of the impact of trade requires that we consider jobs created through the production of U.S. exports as well as jobs lost to imports. A new measure of the jobs gained and lost in international trade flows suggests that the net number of U.S. jobs lost is relatively small—2.4 percent of total U.S. employment as of 2003.

No. 9, September 2005

Explaining Settlement Fails

Michael J. Fleming and Kenneth D. Garbade

The Federal Reserve now makes available current and historical data on trades in U.S. Treasury and other securities that fail to settle as scheduled. An analysis of the data reveals substantial variation in the frequency of fails over the 1990-2004 period. It also suggests that surges in fails sometimes result from operational disruptions, but often reflect market participants' insufficient incentive to avoid failing.

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No. 10, October 2005

The Evolution of Commuting Patterns in the New York City Metro Area

Jason Bram and Alisdair McKay

Has the migration of jobs to the suburbs changed the commuting patterns in the New York City metro area? An analysis of current commuting trends suggests that Manhattan remains the region's undisputed employment center and that workers are actually traveling farther to their jobs. Two factors appear to account for the longer commutes: the dispersion of people and jobs and a greater tolerance for long-distance travel among employers and employees.

Second District Highlights

No. 11, November 2005

Intraday Trading in the Overnight Federal Funds Market

Leonardo Bartolini, Svenja Gudell, Spence Hilton, and Krista Schwarz

Transaction-level data for the federal funds market provide a rare look at the intraday behavior of trade volume and prices. An analysis of the data reveals that trade volume exhibits large swings over the course of the day while prices remain fairly stable, with rate volatility rising sharply only in the late afternoon. The analysis underscores the important role played by institutional deadlines—most notably, the close of trading—in driving movements in this market.

No. 12, December 2005

The Income Implications of Rising U.S. International Liabilities

Matthew Higgins, Thomas Klitgaard, and Cédric Tille

Although the United States has seen its net liabilities surge in recent years, its investment income balance has remained positive—largely because U.S. firms operating abroad earn a higher rate of return than do foreign firms operating here. The continuing buildup in liabilities, however, should soon push the U.S. income balance below zero. In that event, net income flows will begin to boost the nation's current account deficit instead of reducing it.

Research Update

Research Update is a quarterly newsletter designed to keep you informed about the Research and Statistics 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,
- presentations by economists at academic conferences and industry gatherings,
- 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/research/research_update**.

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/research/staff_reports**.

Macroeconomics and Growth

No. 198, January 2005

Comparing Forecast-Based and Backward-Looking Taylor Rules: A "Global" Analysis

Stefano Eusepi

This paper examines the performance of forecast-based nonlinear Taylor rules in a class of simple microfunded models. It shows that even if the policy rule leads to a locally determinate (and stable) inflation target, there exist other learnable "global" equilibria such as cycles and sunspots. Moreover, under learning dynamics, the economy can fall into a liquidity trap. By contrast, more backward-looking and "active" Taylor rules guarantee that the unique learnable equilibrium is the inflation target. This result is robust to different specifications of the role of money, price stickiness, and the trading environment.

No. 199, January 2005

Central Bank Transparency under Model Uncertainty

Stefano Eusepi

Eusepi explores the effects of central bank transparency on the performance of optimal inflation targeting rules. He assumes that both the central bank and the private sector face uncertainty about the "correct" model of the economy and have to learn. A transparent central bank can reduce one source of uncertainty for private agents by communicating its policy rule to the public. The paper shows that central bank transparency plays a crucial role in stabilizing the agents' learning process and expectations. By contrast, lack of transparency can lead to expectations-driven fluctuations that have destabilizing effects on the economy, even when the central bank has adopted optimal policies.

No. 203, March 2005

A Search for a Structural Phillips Curve

Timothy Cogley and Argia M. Sbordone

The New Keynesian Phillips curve (NKPC), a model of price setting with nominal rigidities, implies that the dynamics of inflation are well explained by the evolution of real marginal costs. This paper analyzes whether this relationship is structurally invariant. The authors estimate an unrestricted time-series model for inflation, unit labor costs, and other variables, and present evidence that their joint dynamics are well represented by a vector autoregression (VAR) with drifting coefficients and volatilities. They then apply a two-step minimum distance estimator to estimate deep parameters of the NKPC. Given estimates of the unrestricted VAR, Cogley and Sbordone estimate parameters of the NKPC by minimizing a quadratic function of the restrictions that this theoretical model imposes on the reduced form. Their results suggest that one can reconcile a constant-parameter NKPC with the drifting-parameter VAR—evidence that the price-setting model is structurally invariant.

No. 204, March 2005

Do Expected Future Marginal Costs Drive Inflation Dynamics?

Argia M. Sbordone

This paper discusses a more general interpretation of the two-step minimum distance estimation procedure proposed in earlier work by Sbordone. The estimator is again applied to a version of the New Keynesian Phillips curve, in which inflation dynamics are driven by the expected evolution of marginal costs. The paper clarifies econometric issues, addresses concerns about uncertainty and model misspecification raised in recent studies, and assesses the robustness of previous results. While confirming the importance of forward-looking terms in accounting for inflation dynamics, Sbordone suggests how the methodology can be applied to extend the analysis of inflation to a multivariate setting.

No. 205, March 2005

The Politics of Central Bank Independence: A Theory of Pandering and Learning in Government

Gauti Eggertsson and Eric Le Borgne

The authors propose a theory to explain why, and under what circumstances, a politician endogenously gives up rent and delegates policy tasks to an independent agency. Applied to monetary policy, this theory 1) formalizes the rationale for delegation and 2) does not rely on the inflation bias that underlies most existing theories of central bank independence. Delegation trades off the cost of having a possibly incompetent technocrat with a long-term job contract against the benefit of having a technocrat who 1) invests more effort into the specialized policy task and 2) has less incentive than a politician to pander to public opinion. Eggertsson and Le Borgne's key theoretical predictions are broadly consistent with the data.

No. 206, April 2005

Shock Identification of Macroeconomic Forecasts Based on Daily Panels

Marlene Amstad and Andreas M. Fischer

This paper proposes a new procedure for shock identification of macroeconomic forecasts based on factor analysis. The authors' identification scheme for information shocks relies on data reduction techniques for daily panels and the recognition that macroeconomic releases exhibit a high level of clustering. This information clustering facilitates the interpretation of forecast innovations as real or nominal information shocks. An empirical application is provided for Swiss inflation. Amstad and Fischer show that the monetary policy shocks generate an asymmetric response to inflation, that the pass-through for consumer price index inflation is weak, and that the information shocks to inflation are not synchronized.

No. 208, May 2005

Who Is Afraid of the Friedman Rule?

Joydeep Bhattacharya, Joseph Haslag, Antoine Martin, and Rajesh Singh

The authors explore the connection between optimal monetary policy and heterogeneity among agents. They utilize a standard monetary economy with two types of agents that differ in the marginal utility they derive from real money balances—a framework that produces a nondegenerate stationary distribution of money holdings. Without type-specific fiscal policy, the authors show that the zero-nominal-interest-rate policy (the Friedman rule) does not maximize type-specific welfare; further, it may not maximize aggregate ex ante social welfare. Indeed, one or, more surprisingly, *both* types of agents may benefit if the central bank deviates from the Friedman rule.

No. 214, July 2005

The Cost of Business Cycles for Unskilled Workers

Toshihiko Mukoyama and Ayşegül Şahin

This paper reconsiders the cost of business cycles under incomplete markets. It focuses on the heterogeneity in the cost of business cycles among agents with different skill levels. Unskilled workers are subject to a much larger risk of unemployment during recessions than are skilled workers. Moreover, unskilled workers earn less income, which limits their ability to self-insure. The authors examine how this heterogeneity in unemployment risk and income translates into heterogeneity in the cost of business cycles. They find that the welfare cost of business cycles for unskilled workers is much higher than that for skilled workers.

No. 217, August 2005

Reconciling Bagehot with the Fed's Response to September 11

Antoine Martin

The nineteenth-century economist Walter Bagehot maintained that in order to prevent bank panics, a central bank should provide liquidity to the market at a very high interest rate. This recommendation seems to be in sharp contrast with the policy adopted by the Federal Reserve after September 11 when, for a few days, the federal funds rate was very close to zero. This paper shows that Bagehot's recommendation can be reconciled with the Fed's policy if one recognizes that Bagehot had in mind a commodity money regime in which the amount of reserves available is limited. A high price for this liquidity allows banks that need it most to self-select. In contrast, the Fed has the virtually unlimited ability to expand the money supply temporarily.

No. 218, September 2005

Assessing High House Prices: Bubbles, Fundamentals, and Misperceptions

Charles Himmelberg, Christopher Mayer, and Todd Sinai

Conventional metrics used to judge the level of housing prices can be misleading because they fail to account for both the time-series pattern of real long-term interest rates and predictable differences in the long-run growth rates of house prices across local markets. The authors construct measures of the annual cost of single-family housing for forty-six metropolitan areas in the United States over the past twenty-five years and compare them with local rents and incomes. Their measures show that during the 1980s, houses looked most overvalued in cities that subsequently experienced the largest house price declines. From the trough of 1995 to 2004, the cost of owning rose somewhat relative to the cost of renting, but not, in most cities, to levels that made houses look overvalued.

No. 224, October 2005

The Tobin Effect and the Friedman Rule

Joydeep Bhattacharya, Joseph Haslag, and Antoine Martin

This study addresses whether the Friedman rule can be optimal in an economy in which the Tobin effect is operative. The authors present an overlapping generations economy with capital in which limited communication and stochastic relocation create an endogenous transaction role for fiat money. With logarithmic utility, the "anti-Tobin" effect is operative, and the Friedman rule is optimal (that is, stationary-welfare-maximizing) regardless of whether or not there is long-run growth. Under the constant relative risk aversion form of preferences, the authors show that an operative "anti-Tobin" effect is a sufficient condition for the Friedman rule to be optimal. Also, contrary to models with linear storage technologies, the authors' model shows that zero inflation is not optimal.

No. 225, October 2005

Optimality of the Friedman Rule in an Overlapping Generations Model with Spatial Separation

Joseph Haslag and Antoine Martin

Haslag and Martin examine models with spatial separation and limited communication that have shown some promise toward resolving the disparity between theory and practice concerning optimal monetary policy; these models suggest that the Friedman rule may not be optimal. The authors show that intergenerational transfers play a key role in this result, that the Friedman rule is a necessary condition for an efficient allocation in equilibrium, and that the rule is chosen whenever agents can implement mutually beneficial arrangements. The study concludes that in order for these models to resolve the aforementioned disparity, they must answer the following question: Where do the frictions that prevent agents from implementing mutually beneficial arrangements come from?

No. 228, November 2005

Time-Varying Pass-Through from Import Prices to Consumer Prices: Evidence from an Event Study with Real-Time Data

Marlene Amstad and Andreas M. Fischer

This paper analyzes the pass-through from import prices to CPI inflation in real time. The authors' strategy follows an event-study approach that compares inflation forecasts before and after import price releases. Inflation forecasts are modeled using a dynamic factor procedure that relies on daily panels of Swiss data. Amstad and Fischer find strong evidence that monthly import price releases provide important information for CPI inflation forecasts, and that the behavior of updated forecasts is consistent with a time-varying pass-through. The robustness of this latter result is supported by an alternative CPI measure that excludes price components subject to administered pricing as well as by panels capturing difference levels of information breadth. Finally, the authors' empirical findings cast doubt on a prominent role for sticky prices in the low pass-through findings.

No. 229, November 2005

Can U.S. Monetary Policy Fall (Again) into an Expectation Trap?

Roc Armenter and Martin Bodenstein

The authors provide a tractable model to study monetary policy under discretion. They restrict their analysis to Markov equilibria. The study finds that for all parametrizations with an equilibrium inflation rate of about 2 percent, there is a second equilibrium with an inflation rate just above 10 percent. Thus, the model can simultaneously account for the low and high inflation episodes in the United States. The authors carefully characterize the set of Markov equilibria along the parameter space and find their results to be robust, suggesting that expectation traps are more than just a theoretical curiosity.

No. 234, December 2005

Great Expectations and the End of the Depression

Gauti B. Eggertsson

This study argues that the U.S. economy's recovery from the Great Depression was driven by a shift in expectations brought about by the policy actions of President Franklin Delano Roosevelt. On the monetary policy side, Roosevelt abolished the gold standard and—even more important—announced the policy objective of inflating the price level to pre-depression levels. On the fiscal policy side, Roosevelt expanded real and deficit spending. Together, these actions made his policy objective credible; they violated prevailing policy dogmas and introduced a policy regime change such as that described in work by Sargent and by Temin and Wigmore. The economic consequences of Roosevelt's policies are evaluated in a dynamic stochastic general equilibrium model with sticky prices and rational expectations.

No. 235, December 2005

Optimal Monetary and Fiscal Policy under Discretion in the New Keynesian Model: A Technical Appendix to "Great Expectations and the End of the Depression"

Gauti B. Eggertsson

This paper details the microfoundations of the model presented in Staff Report no. 234, "Great Expectations and the End of the Depression." It defines the Markov perfect equilibrium formally in the nonlinear model, discusses in some detail the approximation method used and the order of accuracy of this approximation, and gives proofs of two propositions not proved in that study. In addition, this paper states a proposition that shows the equivalence between the linear quadratic approximation in the aforementioned Staff Report and a first-order approximation to the exact nonlinear conditions of the government in the Markov perfect equilibrium defined here.

No. 236, December 2005

A Review of Core Inflation and an Evaluation of Its Measures

Robert Rich and Charles Steindel

Viewing stabilization of either consumer price index (CPI) inflation or personal consumption expenditure (PCE) inflation as a central goal of U.S. monetary policy, the authors evaluate a variety of candidate core inflation measures. Almost all candidate measures demonstrate the ability to track the mean rate of aggregate inflation and movements in its underlying trend. In the within-sample analysis, core measures derived through exponential smoothing, in combination with simple measures of economic slack, have substantial explanatory content for changes in aggregate inflation several years in advance. In the out-of-sample analysis, however, no measure performs consistently well in forecasting inflation. Taken together, the findings show that there is no individual measure of core inflation that can be considered superior to other measures.

International

No. 200, January 2005

Vehicle Currency Use in International Trade

Linda S. Goldberg and Cédric Tille

The forces motivating the *choice* of currency in international trade transactions have long been debated. The authors introduce a model designed to contrast the contribution of macroeconomic variability with that of industry-specific features in the selection of an invoice currency. They show that producers in industries with high demand elasticities are more likely than producers in other industries to display herding in their choice of currency. This industry-related force is more influential than local macroeconomic performance in determining producers' choices. Drawing on data for twenty-four countries, the authors document that the dollar is widely used for most transactions involving the United States as well as for international trade flows not directly involving the United States.

No. 201, February 2005

Productivity Spillovers, Terms of Trade, and the "Home Market Effect"

Giancarlo Corsetti, Philippe Martin, and Paolo Pesenti

The authors analyze the welfare implications of international spillovers related to productivity gains, changes in market size, or government spending. They introduce trade costs and endogenous varieties in a two-country general equilibrium model with monopolistic competition, drawing a distinction between productivity gains from manufacturing efficiency and those related to firms' lower cost of entry or product differentiation. Their model suggests that countries with lower manufacturing costs have higher GDP but supply a smaller number of goods at a lower international price. Countries with lower entry and differentiation costs also have higher GDP, but supply a larger array of goods at improved terms of trade. Higher domestic demand has macroeconomic implications that are similar to those of a reduction in firms' entry costs.

No. 209, May 2005

The Simple Geometry of Transmission and Stabilization in Closed and Open Economies

Giancarlo Corsetti and Paolo Pesenti

This paper provides an introduction to the recent literature on macroeconomic stabilization in closed and open economies. Corsetti and Pesenti present a stylized theoretical framework, illustrating its main properties with the help of an intuitive graphical apparatus. Among the issues discussed are optimal monetary policy and the welfare gains from macroeconomic stabilization, the international transmission of real and monetary shocks and the role of exchange rate pass-through, and the design of optimal exchange rate regimes and monetary coordination among interdependent economies.

No. 219, September 2005

Exchange Rate Pass-Through to Import Prices in the Euro Area

José Manuel Campa, Linda S. Goldberg, and José M. González-Mínguez

This study presents an empirical analysis of transmission rates from exchange rate movements to import prices across countries and product categories in the euro area over the past fifteen years. The results show that exchange rate pass-through to import prices in the short run is high, although incomplete, and that it differs across industries and countries; in the long run, exchange rate pass-through is higher and close to 1. The authors do not find compelling evidence that the euro's introduction caused a structural change in exchange rate pass-through. Although some estimated point elasticities have declined, structural breaks in exchange rate pass-through into import prices are evident only in a limited sample of manufacturing industries.

No. 222, October 2005

Trade Invoicing in the Accession Countries: Are They Suited to the Euro?

Linda S. Goldberg

Countries aspiring to join the euro area—the so-called accession countries—are increasingly binding their economic activity, external and internal, to the euro-area countries. This phenomenon is observed in the currency invoicing of international trade transactions, where accession countries have reduced their use of the U.S. dollar in invoicing such transactions. The optimal invoicing choice for an accession country depends on its composition of trade and on correlations between fluctuations in home and trade-partner macroeconomic variables. Goldberg finds that the exporters in some accession countries may be pricing too much of their trade in euros rather than in U.S. dollars, even in their trade transactions with the euro-area and other European Union countries, and may be taking on excessive risk in international markets.

No. 226, October 2005

Financial Integration and the Wealth Effect of Exchange Rate Fluctuations

Cédric Tille

Tille first presents a detailed decomposition of the U.S. balance sheet, which exhibits substantial leverage in terms of currencies and across asset categories. He then incorporates these features of international financial integration in a simple general equilibrium model and analyzes how they affect the international transmission of monetary shocks. The author finds that financial integration is a central component of the model, with the valuation gains from an exchange rate depreciation leading to a welfare effect that is at least as large as that stemming from nominal rigidities alone but possibly much larger. He characterizes how interdependence is affected by the composition of the portfolio across asset categories and how structural features of the model interact with financial integration.

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No. 230, November 2005

Does the Time Inconsistency Problem Make Flexible Exchange Rates Look Worse Than You Think?

Roc Armenter and Martin Bodenstein

Lack of commitment in monetary policy leads to the well-known Barro-Gordon inflation bias. In this paper, Armenter and Bodenstein argue that two phenomena associated with the time inconsistency problem have been overlooked in the exchange rate debate. The authors show that, absent commitment, independent monetary policy can also induce expectation traps—that is, welfare-ranked multiple equilibria—and perverse policy responses to real shocks—that is, an equilibrium policy response that is welfare inferior to policy inaction. Both possibilities imply higher macroeconomic volatility under flexible exchange rates than under fixed exchange rates.

No. 231, November 2005

Establishing Credibility: Evolving Perceptions of the European Central Bank

Linda S. Goldberg and Michael W. Klein

Goldberg and Klein present a novel empirical framework that uses high-frequency data to test for persistent variation in market perceptions of central bank inflation aversion. Tests of the effect of news announcements on the slope of yield curves in the euro area and on the euro-dollar exchange rate suggest that the market's perception of the policy stance of the European Central Bank during its first six years of operation evolved significantly, with a belief in the Bank's inflation aversion increasing in the wake of its monetary tightening. In contrast, tests based on the response of the slope of the U.S. yield curve to news offer no comparable evidence of any change in market perceptions of the inflation aversion of the Federal Reserve.

Microeconomics

No. 212, June 2005

Propensity Score Matching, a Distance-Based Measure of Migration, and the Wage Growth of Young Men

John C. Ham, Xianghong Li, and Patricia B. Reagan

This paper estimates the effect of U.S. internal migration on real wage growth between the movers' first and second jobs. Ham, Li, and Reagan develop an economic model to 1) assess the appropriateness of matching as an econometric method for studying migration and 2) choose the conditioning variables used in the matching procedure. The authors find a significant effect of migration on the wage growth of college graduates of 10 percent and a marginally significant effect for high-school dropouts of -12 percent. If the authors use a measure of migration based on moving across either county lines or state lines, the significant effects of migration for college graduates and dropouts disappear.

No. 213, June 2005

Selection Bias, Demographic Effects, and Ability Effects in Common Value Auction Experiments

Marco Casari, John C. Ham, and John H. Kagel

The authors find clear demographic and ability effects on bidding in common value auctions: inexperienced women are much more susceptible to the winner's curse than are men, but they catch up quickly; economics and business majors substantially overbid relative to other majors; and those with superior SAT/ACT scores are much less susceptible to the winner's curse. There are strong selection effects in bid estimates for both inexperienced and experienced subjects that are not identified using standard econometric techniques, but rather through the authors' experimental design effects. Ignoring these selection effects is most misleading for inexperienced bidders, because the unbiased estimates of the bid function indicate much faster learning and adjustment to the winner's curse for individual bidders than do the biased estimates.

No. 221, September 2005

Barriers to Network-Specific Innovation

Antoine Martin and Michael J. Orlando

The authors examine incentives for network-specific investment and the implications for network governance. They model an environment in which participants that make payments over a network can invest in a technology that reduces the marginal cost of using the network. A network effect results in multiple equilibria; either all agents invest and network usage is high or no agents invest and network usage is low. When commitment is feasible, the high-use equilibrium can be implemented; however, when commitment is infeasible, fixed costs associated with use of the network-specific technology result in a holdup problem that implements the low-investment equilibrium. Thus, governance structures necessary to achieve commitment will be preferred to those necessary merely to achieve coordination.

Banking and Finance

No. 207, April 2005

The Joint Dynamics of Liquidity, Returns, and Volatility across Small and Large Firms

Tarun Chordia, Asani Sarkar, and Avanidhar Subrahmanyam

This paper explores liquidity spillovers in market-capitalization-based portfolios of NYSE stocks. Return, volatility, and liquidity dynamics across the small- and large-cap sectors are modeled by way of a vector autoregression model, using data that span more than 3,000 trading days. The authors find that volatility and liquidity innovations in one sector are informative in predicting liquidity shifts in the other. Impulse responses indicate the existence of persistent liquidity, return, and volatility spillovers across the small- and large-cap sectors. Lead and lag patterns across small- and large-cap stocks are stronger when spreads in the large-cap sector are wider. Consistent with the notion that private informational trading in large-cap stocks is transmitted to other stocks with a lag, order flows in the large-cap decile predict both transaction-price-based and mid-quote returns of small-cap deciles when large-cap spreads are high.

No. 210, June 2005

Banks, Markets, and Efficiency

Falko Fecht and Antoine Martin

This study addresses the question whether the increased financial market access of households improves welfare in a financial system where there is intense bank competition for private households' funds. The authors use a model in which the degree of liquidity insurance offered to households through banks' deposit contracts is restrained by household financial market access; however, they also assume spatial monopolistic competition among banks. Fecht and Martin's results suggest that in Germany's bank-dominated financial system, characterized by intense competition for households' deposits, improved financial market access might reduce welfare because it only reduces risk sharing. In contrast, in the U.S. banking system, where there is less competition for households' deposits, a high level of household financial market participation might be beneficial.

No. 211, June 2005

The Impact of Network Size on Bank Branch Performance

Beverly J. Hirtle

Despite recent innovations that might have reduced banks' reliance on brick-and-mortar branches for distributing retail financial services, the number of U.S. bank branches has continued to increase steadily over time. Furthermore, an increasing percentage of these branches are held by banks with large branch networks. This paper assesses the implications of these developments by examining a series of simple branch performance measures and asking how these measures vary, on average, across institutions with different branch network sizes. Based on bank-average deposits per branch, small business loans per branch, and net deposit funding costs, mid-sized branch networks may be at a competitive disadvantage relative to both larger and smaller branch networks.

No. 215, August 2005

How and Why Do Small Firms Manage Interest Rate Risk? Evidence from Commercial Loans

James Vickery

This paper studies fixed-rate and adjustable-rate loans to see how small firms manage their exposure to interest rate risk. Its main findings are that credit-constrained firms consistently favor fixed-rate loans, which minimize their exposure to rising interest rates; that firms adjust their exposure depending on how interest rate shocks covary with industry output; and that the time-series share of fixed-rate bank loans moves with interest rates in a manner consistent with recent evidence on debt market timing. The author concludes that the "fixed versus adjustable" dimension of financial contracting helps small U.S. firms ameliorate interest rate risk, and discusses implications for risk management theories and the credit channel of monetary policy.

No. 216, August 2005

Arbitrage Pricing Theory

Gur Huberman and Zhenyu Wang

Focusing on capital asset returns governed by a factor structure, the Arbitrage Pricing Theory (APT) is a one-period model, in which preclusion of arbitrage over static portfolios of these assets leads to a linear relation between the expected return and its covariance with the factors. The APT, however, does not preclude arbitrage over dynamic portfolios. Consequently, applying the model to evaluate managed portfolios is contradictory to the no-arbitrage spirit of the model. An empirical test of the APT entails a procedure to identify features of the underlying factor structure rather than merely a collection of mean-variance efficient factor portfolios that satisfies the linear relation.

No. 220, September 2005

Too Big to Fail after All These Years

Donald P. Morgan and Kevin J. Stiroh

The naming of eleven banks as "too big to fail" (TBTF) in 1984 led bond raters to raise their ratings on new bond issues of TBTF banks about a notch relative to those of other, unnamed banks. The relationship between bond spreads and ratings for the TBTF banks tended to flatten after that event, suggesting that investors were even more optimistic than raters about the probability of support for those banks. The spread-rating relationship in the 1990s remained flatter for TBTF banks (or their descendants) even after the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991, suggesting that investors still see those banks as TBTF. Until investors are disabused of such beliefs, investor discipline of big banks will be less than complete.

No. 223, October 2005

Why Is the U.S. Treasury Contemplating Becoming a Lender of Last Resort for Treasury Securities?

Kenneth D. Garbade and John E. Kambhu

The U.S. Treasury announced in August 2005 that it is exploring whether to provide a backstop securities lending facility for U.S. Treasury securities. This paper examines the conceptual basis for such a facility by analogizing the market for borrowing and lending Treasury securities with the market for borrowing and lending money prior to the founding of the Federal Reserve System in 1914. An inelastic supply of Treasury securities has led to several recent episodes of chronic settlement fails. A backstop lending facility would mitigate the fails problem by allowing the Treasury to act as a lender of last resort of Treasury securities during periods of unusual market stress.

No. 227, October 2005

Money Market Integration

Leonardo Bartolini, Spence Hilton, and Alessandro Prati

Bartolini, Hilton, and Prati use transaction-level data and detailed modeling of the high-frequency behavior of federal funds–Eurodollar yield spreads to provide evidence of strong integration between the federal funds and Eurodollar markets, the two core components of the dollar money market. Their results contrast with previous research indicating that these two markets are segmented, showing them to be well integrated even at high (intraday) frequency. The authors document several patterns in the behavior of federal funds–Eurodollar spreads, including liquidity effects from trading volume on the volatility of yield spreads. Their analysis supports the view that targeting federal funds rates alone is sufficient to stabilize rates in the (much larger) dollar money market as a whole.

No. 233, December 2005

The Return to Retail and the Performance of U.S. Banks

Beverly J. Hirtle and Kevin J. Stiroh

The U.S. banking industry is experiencing a renewed focus on retail banking, a trend often attributed to the stability and profitability of retail activities. This paper examines the impact of banks' retail intensity on performance from 1997 to 2004 by developing three complementary definitions of retail intensity (retail loan share, retail deposit share, and branches per dollar of assets) and comparing these measures with both equity market and accounting measures of performance. The authors find that an increased focus on retail banking across U.S. banks is linked to significantly lower equity market and accounting returns for all banks but lower volatility for only the largest banking companies. They conclude that retail banking may be a relatively stable activity, but it is also a low-return one.

Quantitative Methods

No. 202, March 2005

Reexamining the Consumption-Wealth Relationship: The Role of Model Uncertainty

Gary Koop, Simon M. Potter, and Rodney W. Strachan

Lettau and Ludvigson's influential work on the consumption-wealth relationship finds that while consumption responds to permanent changes in wealth in the expected manner, most changes are transitory with no effect on consumption. This paper investigates the robustness of these results to model uncertainty using Bayesian model averaging and finds that uncertainty exists. Whether this uncertainty has important implications depends on the weight the researcher places on economic theory. If Koop, Potter, and Strachan work with Lettau and Ludvigson's exact model, their findings are very similar. However, working with a broader set of models, they find that the exact magnitude of the role of permanent shocks is difficult to estimate precisely.

No. 232, November 2005

One-Sided Test for an Unknown Breakpoint: Theory, Computation, and Application to Monetary Theory

Arturo Estrella and Anthony P. Rodrigues

The econometrics literature contains a variety of two-sided tests for unknown breakpoints in time-series models with one or more parameters. This paper derives an analogous one-sided test that takes into account the direction of the change for a single parameter. In particular, the authors propose a sup t statistic, which is distributed as a normalized Brownian bridge. The method is illustrated by testing whether the reaction of monetary policy to inflation has increased since 1959.

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