Introduction

The Federal Reserve Bank of New York’s Research and Market Analysis Group produces a wide range of publications and discussion papers of interest to business and banking professionals, policymakers, academics, and the general public. This brochure lists recent issues in each of our principal research series:

- **The Economic Policy Review**
  our policy-oriented flagship publication

- **Current Issues in Economics and Finance**
  a newsletter-style publication focusing on economic, financial, and regional topics

- **Staff Reports**
  technical papers presenting research findings

- **Research Papers**
  discussion papers reporting preliminary research findings.

Members of the Research Group also publish papers in many economic and finance journals, conference volumes, and scholarly books. A list of these publications begins on page 18.

We invite you to order, at no charge, copies from any series or to join our subscriber lists. We also encourage you to visit our web site (www.ny.frb.org/rmaghome), where these publications and papers are available. At the site, you can also learn about receiving free e-mail notifications when our publications are released.
This special issue is dedicated to the proceedings of a conference—held at the Federal Reserve Bank of New York on November 13 and 14, 1996—on the New York metropolitan region’s economy in the national and world arenas. It contains five papers presented by academic and Federal Reserve Bank participants, commentaries on two of the papers, presentations by four industry specialists, and summaries of the day’s discussions.

Opening Remarks
William J. McDonough

National and Regional Factors in the New York Metropolitan Economy
Jonathan M. McCarthy and Charles Steindel

Sources of New York Employment Fluctuations
Kenneth N. Kuttner and Argia M. Sbordone

Commentary
Henry J. Raimondo

Commentary
Todd E. Clark

The Performance of Metropolitan Area Industries
Matthew P. Drennan

Industrial Restructuring in the New York Metropolitan Area
James Orr

Potential Employment Effects of the Restructuring of Retail Banking
Lawrence J. Radecki

Business Services and the Economic Performance of the New York Metropolitan Region
Thierry Noyelle

The Securities Industry and the New York-New Jersey Region
Richard Cantor

Technological Trends Affecting the Manufacturing Sector of New York City
Mitchell L. Moss

The Outlook for the Metropolitan Area
Dick Netzer

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.ny.frb.org/maghome/econ_pol.
Creating an Integrated Payment System: The Evolution of Fedwire
Adam M. Gilbert, Dara Hunt, and Kenneth C. Winch
Adapted from remarks given before the Seminar on Payment Systems in the European Union in Frankfurt, Germany, on February 27, 1997.

The Round-the-Clock Market for U.S. Treasury Securities
Michael J. Fleming
U.S. Treasury securities are traded in London and Tokyo as well as in New York, creating a virtual round-the-clock market. The author describes that market by examining trading volume, price volatility, and bid-ask spreads over the global trading day. He finds that trading volume and price volatility are highly concentrated in New York trading hours. Bid-ask spreads are found to be wider overseas than in New York and wider in Tokyo than in London. Despite the lower liquidity of the overseas locations, the author finds that overseas price changes in U.S. Treasury securities are unbiased predictors of overnight New York price changes.

Market Returns and Mutual Fund Flows
Eli M. Remolona, Paul Kleiman, and Debbie Gruenstein
With the increased popularity of mutual funds come increased concerns. Namely, could a sharp drop in stock and bond prices set off a cascade of redemptions by mutual fund investors and could the redemptions exert further downward pressure on asset markets? The authors analyze this relationship by using instrumental variables—a measuring technique previously unapplied to market returns and mutual fund flows—to determine the effect of returns on flows. Despite market observers' fears of a downward spiral in asset prices, the authors conclude that the short-term effect of market returns on mutual fund flows typically has been too weak to sustain such a spiral.

The Evolving External Orientation of Manufacturing: A Profile of Four Countries
José Campa and Linda S. Goldberg
Using more than two decades of industry data, the authors profile the external orientation of manufacturing industries in the United States, Canada, the United Kingdom, and Japan. They use the term “external orientation” to describe the potential exposure of an industry's revenues and costs to world events through exports, imports, and imported inputs. For each major manufacturing industry, the authors provide histories of the share of total revenues earned in foreign markets, the role of imports in domestic consumption, and the costs of imported inputs in total production. In addition, they construct a measure of net external orientation, which is intended to capture how much an industry's use of imported inputs (a cost factor) can potentially offset exposure to the international economy through exports (a revenue factor).

Credit, Equity, and Mortgage Refinancings
Stavros Peristiani, Paul Bennett, Gordon Monsen, Richard Peach, and Jonathan Raiff
Using a unique loan level data set that links individual household credit ratings with property and loan characteristics, the authors test the extent to which homeowners' credit ratings and equity affect the likelihood that mortgage loans will be refinanced as interest rates fall. Their logit model estimates strongly support the importance of both the credit and equity variables. Furthermore, the authors' results suggest that a change in the overall lending environment over the past decade has increased the probability that a homeowner will refinance.
A Framework for the Pursuit of Price Stability
William J. McDonough
Based on remarks delivered before the Annual Financial Services Forum of the New York State Bankers Association on March 21, 1996, and the Economic Club of New York on October 2, 1996.

Inflation Targeting: Lessons from Four Countries
Frederic S. Mishkin and Adam S. Posen
In recent years, a number of central banks have chosen to orient their monetary policy toward the achievement of numerical inflation targets. This study examines the experience of the first three countries to adopt an inflation-targeting strategy—New Zealand, Canada, and the United Kingdom. It also considers the German experience with a monetary targeting scheme that incorporated many elements of inflation targeting even earlier. The authors find that the countries adopting a numerical inflation target have successfully maintained low inflation rates. Other benefits of inflation targeting include increased central bank accountability, heightened public understanding of monetary policy, and an improved climate for economic growth.

Bank Capital Requirements for Market Risk: The Internal Models Approach
Darryll Hendricks and Beverly Hirtle
The increased prominence of trading activities at many large banking companies has highlighted bank exposure to market risk—the risk of loss from adverse movements in financial market rates and prices. In response, bank supervisors in the United States and abroad have developed a new set of capital requirements to ensure that banks have adequate capital resources to address market risk. This paper offers an overview of the new requirements, giving particular attention to their most innovative feature: a capital charge calculated for each bank using the output of that bank’s internal risk measurement model. The authors contend that the use of internal models should lead to regulatory capital charges that conform more closely to banks’ true risk exposures. In addition, the information generated by the models should allow supervisors and market participants to compare risk exposures over time and across institutions.

The Benefits of Branching Deregulation
Jith Jayaratne and Philip E. Strahan
When the Riegle-Neal Interstate Banking and Branching Efficiency Act went into effect in June 1997, it marked the final stage of a quarter-century-long effort to relax geographic restrictions on banks. This article examines an earlier stage of the deregulatory process—the actions taken by the states between 1978 and 1992 to remove the barriers to intrastate branching and interstate banking—to determine how the lifting of geographic restrictions affects the efficiency of the banking industry. The analysis reveals that banks’ loan losses and operating costs fell sharply following the state initiatives, and that the cost declines were largely passed along to bank borrowers in the form of lower loan rates. The authors argue that these efficiency gains arose because better performing banks were able to expand their market share once geographic restraints were eased.
What Moves the Bond Market?

Michael J. Fleming and Eli M. Remolona

In an examination of the U.S. Treasury securities market, the authors attempt to explain the sharpest price changes and most active trading episodes. They find that each of the twenty-five largest price shocks and twenty-five greatest trading surges can be attributed to just-released macroeconomic announcements. They also measure the market’s average reactions to these announcements and analyze the extent to which the reactions depend on the degree of announcement surprise and on prevailing market conditions. The market’s price and trading reactions are found to reflect differences of informational content in and among the varying announcements under changing market conditions.

Is There an Inflation Puzzle?

Cara S. Lown and Robert W. Rich

Why has U.S. inflation failed to accelerate despite six years of continuing economic expansion? The authors investigate whether compensation growth has played a role, either as a temporary restraint on inflation or as the underlying source of a new inflation regime. They offer two pieces of evidence suggesting that compensation growth has in fact acted as a temporary curb on rising prices. First, they show that the forecasting performance of a traditional Phillips curve model begins to break down in late 1993. When a measure of compensation growth is incorporated, however, the stability of the model is restored. Second, they show that the slowdown in compensation growth appears to be temporary and was unusually severe from late 1992 to early 1995, a period that roughly coincides with the breakdown in their traditional model.
1997 Job Outlook: The New York–New Jersey Region
James Orr and Rae D. Rosen

Major industrial and governmental restructurings have dominated employment reports in the New York–New Jersey region, leading to widespread pessimism about the region’s job prospects. Nevertheless, for the past several years, the two states have managed to achieve modest job gains. In 1997, employment growth in New York and New Jersey should accelerate slightly as the pace of restructurings slows.

Volume 3, Number 1 (January)

The Effects of Price Limits on Trading Volume: A Study of the Cotton Futures Market
Joan Evans and James M. Mahoney

Will trading volume shift from a market with price limits to a closely related market without them? An examination of the U.S. cotton market reveals that trading volume does in fact move from a class of security that is subject to trading limits (cotton futures) to another that is not (options on cotton futures). The results add to the debate on trading limits by calling into question the limits’ overall effectiveness.

Volume 3, Number 2 (January)

Debt, Delinquencies, and Consumer Spending
Jonathan M. McCarthy

The sharp rise in household debt and delinquency rates over the last year has led to speculation that consumers will soon revert to more cautious spending behavior. Yet an analysis of the past relationship between household liabilities and expenditures provides little support for this view.

Volume 3, Number 3 (February)

Bad Debt Rising
Donald P. Morgan and Ian Toll

Charge-offs on credit card loans are rising sharply. While many analysts blame this trend on an expanding supply of credit cards, a closer look reveals the importance of two demand factors—wealth and the share of the population at peak borrowing age—in explaining the increase in bad debt.

Volume 3, Number 4 (March)
Falling Reserve Balances and the Federal Funds Rate
Paul Bennett and Spence Hilton
The growth of “sweeps”— a banking practice in which depository institutions shift funds out of customer accounts subject to reserve requirements— has reduced the required balances held by banks in their accounts at the Federal Reserve. This development could lead to greater volatility in the federal funds rate as banks try to manage their accounts with very low balances. An analysis of the evidence suggests that the volatility of the funds rate is rising slightly, but not enough to disrupt the federal funds market or affect the implementation of monetary policy.
Volume 3, Number 5 (April)

Are There Good Alternatives to the CPI?
Charles Steindel
Critics of the consumer price index—the most widely watched inflation measure— contend that it overstates inflation by as much as 1 percentage point a year. Some have argued that alternative indexes eliminate the CPI’s upward bias and offer a more accurate reading of inflation levels. A closer look at these alternatives, however, reveals that they have substantive problems of their own, suggesting that the CPI, though flawed, is still our most reliable indicator of changes in inflation.
Volume 3, Number 6 (April)

The Growing U.S. Trade Imbalance with China
Thomas Klitgaard and Karen Schiele
Over the past decade, the United States has gone from enjoying a small trade surplus with China to grappling with an enormous deficit. Just to keep the gap from expanding in 1997, U.S. exports to China would need to grow at an extraordinary rate—four times as fast as Chinese exports to the United States. Despite recent U.S. gains and China’s efforts at trade liberalization, growth on that order appears unlikely, and the trade imbalance can be expected to widen in the near term.
Volume 3, Number 7 (May)

The Samurai Bond Market
Frank Packer and Elizabeth Reynolds
Issuance in the samurai bond market has more than tripled over the past several years. Some observers have attributed this growth to a systematic underestimation of credit risk in the market. A detailed review of credit quality, ratings differences, and initial issue pricing in the samurai bond market, however, turns up little evidence to support this concern.
Volume 3, Number 8 (June)

Designing Effective Auctions for Treasury Securities
Leonardo Bartolini and Carlo Cottarelli
Most discussions of treasury auction design focus on the choice between two methods for issuing securities—uniform-price or discriminatory auctions. Although auction theory and much recent research appear to favor the uniform-price method, most countries conduct their treasury auctions using the discriminatory format. What are the main issues underlying the debate over effective auction design?
Volume 3, Number 9 (July)

The Market to the Rescue? The Promise—and the Price—of the New Social Security Investment Proposals
Susan Miller
Three new plans for reforming Social Security financing recommend investing a portion of future payroll deductions in the financial markets. The plans aim to shore up Social Security’s trust fund, improve individual returns, and enhance national saving. This analysis concludes, however, that the effectiveness of the plans would depend largely on individual saving and investment decisions, government fiscal policy, and developments in the financial markets. In addition, the proposed reforms could expose the program to unprecedented market risk.
Volume 3, Number 10 (August)
Do Rising Labor Costs Trigger Higher Inflation?

David A. Brauer

The evidence that developments in compensation growth lead overall CPI inflation has thus far been inconclusive. This study, however, sheds new light on the relationship between labor costs and price inflation. By breaking down compensation and prices into their various components, the author finds that compensation growth in the service-producing segment of the private sector can help predict prices for a specific group of services.

Volume 3, Number 11 (September)

The New York–New Jersey Job Recovery

Second District Highlights

James Orr and Rae D. Rosen

Modest employment growth is expected to continue through 1997, with the New York City metropolitan area creating the bulk of new jobs.

Volume 3, Number 12 (October)

Human Resource Needs in the Evolving Financial Sector

Rebecca S. Demsetz

As banks, securities houses, and insurance companies offer increasingly similar services, how have their human resource needs changed? An analysis of survey data reveals that all three industries have come to rely more heavily on high-skilled labor; however, the educational and occupational profiles of their workforces have not become substantially more alike.

Volume 3, Number 13 (November)

New York City’s Unemployment Picture

Second District Highlights

Jason Bram, David Brauer, and Elizabeth Miranda

Why has New York City unemployment climbed unexpectedly in recent years? Sharp growth in the city’s labor force participation rate—not job losses—can explain the rise.

Volume 3, Number 14 (December)

Inflation Goals: Guidance from the Labor Market?

Erica L. Groshen and Mark E. Schweitzer

As inflation rates in the United States decline, analysts are asking if there are economic reasons to hold the rates at levels above zero. A study of inflation’s effects on the labor market suggests that low rates of inflation do help the economy to adjust to changes in labor supply and demand. When inflation’s disruptive effects are balanced against this benefit, however, the labor market justification for pursuing a positive long-term inflation goal effectively disappears.

Volume 3, Number 15 (December)
Research Update is a quarterly newsletter designed to keep you informed about the Research Group’s current work. The newsletter—which complements this brochure—offers summaries of selected studies and a listing of recent articles and papers in our four main 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, and new publications and services. You can subscribe to Research Update by using the enclosed order form, or you can obtain the publication at www.ny.frb.org/rmaghome/update.
A Three-Factor Econometric Model of the U.S. Term Structure
Frank F. Gong and Eli M. Remolona
The authors estimate a three-factor model to fit both the time-series dynamics and cross-sectional shapes of the U.S. term structure. To exploit the conditional density of yields, the authors estimate the model with a Kalman filter, a procedure that also allows them to use data for six maturities without making special assumptions about measurement errors. The estimated model reproduces the basic shapes of the average term structure, including the hump in the yield curve and the flat slope of the volatility curve. A likelihood ratio test favors the model over a nested two-factor model. Another likelihood ratio test, however, rejects the no-arbitrage restrictions the model imposes on the estimates. An analysis of the measurement errors suggests that the three factors still fail to capture enough of the comovement and persistence of yields.
Number 19 (January)

Technological Diffusion through Trade and Imitation
Michelle P. Connolly
An endogenous growth model is developed demonstrating both static and dynamic gains from trade for developing nations due to the beneficial effects of trade on imitation and technological diffusion. The concept of learning-to-learn in both imitative and innovative processes is incorporated into a quality-ladder model with North-South trade. Domestic technological progress occurs via innovation or imitation, while growth is driven by technological advances in the quality of domestically available inputs. In the absence of trade, Southern imitation of Northern technology leads to asymptotic conditional convergence between the two countries, demonstrating the positive effect of imitation on Southern growth. Free trade generally results in a positive feedback effect between Southern imitation and Northern innovation, yielding a higher common steady-state growth rate. Immediate conditional convergence occurs. Thus, trade in this model confers dynamic as well as static benefits on the South, even when specializing in imitative processes.
Number 20 (February)
Rational Bias in Macroeconomic Forecasts
David Laster, Paul Bennett, and In Sun Geoum
The authors develop a model of macroeconomic forecasting in which the wages firms pay their forecasters are a function of the forecasters' accuracy as well as the publicity they generate for their employers by being correct. In the resulting equilibrium, forecasters with identical models, information, and incentives nevertheless produce a variety of predictions. In the case of heterogeneous incentives, the forecasters whose wages are most closely tied to publicity, as opposed to accuracy, produce the forecasts that deviate most from the consensus. The authors find empirical support for their model using a twenty-year panel of real GNP/GDP forecast data from the survey Blue Chip Economic Indicators. Although the consensus outperforms virtually every forecaster, many forecasters choose to deviate from it substantially and regularly. Moreover, the extent of this deviation varies by industry in a manner consistent with the authors' model.
Number 21 (March)

Entry Restrictions, Industry Evolution, and Dynamic Efficiency: Evidence from Commercial Banking
Jith Jayaratne and Philip E. Strahan
The authors show that bank performance improves significantly after restrictions on bank expansion are lifted. They find that operating costs and loan losses decrease sharply after states permit statewide branching and, to a lesser extent, after states allow interstate banking. The improvements following branching deregulation appear to occur because better banks grow at the expense of their less efficient rivals. By retarding the "natural" evolution of the industry, branching restrictions reduce the performance of the average banking asset. The authors also find that most of the reduction in banks' costs is passed along to bank borrowers in the form of lower loan rates.
Number 22 (March)

Foreign Investment Fluctuations and Emerging Market Stock Returns: The Case of Mexico
John Clark and Elizabeth Berko
The authors investigate the economically and statistically significant positive correlation between monthly foreign purchases of Mexican stocks and Mexican stock returns. They find that a surprise foreign inflow equal to 1 percent of market capitalization is associated with a 13 percent increase in Mexican stock prices. The authors explore whether this correlation might be explained by permanent reductions in conditional expected returns resulting from expansion of the investor base along the lines modeled by Merton (1987), or correlations with other factors causing returns, price pressures, or positive feedback strategies by foreign investors, and conclude that the available evidence is consistent with the base-broadening hypothesis.
Number 24 (May)
Can Competition between Brokers Mitigate Agency Conflicts with Their Customers?
Sugato Chakravarty and Asani Sarkar

The authors study competitive but strategic brokers executing trades for an informed trader in a multiperiod setting. The brokers can choose to (a) execute the order as agents first and trade for themselves as dealers afterward or (b) trade for themselves first and execute the order later. The authors show that the equilibrium outcome depends on the number of brokers. When brokers exceed a critical number (greater than one), the informed trader distributes its order (equally) among the available brokers. The brokers, in turn, execute the trader’s order first and trade personal quantities as dealers afterward. Thus, regulators can mitigate trading abuses arising from a conflict of interest between the brokers’ agency and principal functions (such as front running) by encouraging competition between brokers as an alternative to banning such practices.

Language, Learning, and Location
Andrew John and Kei-Mu Yi

Language is a fundamental tool for communication of ideas between people, and so is an essential input in production and trade. Neighboring societies and communities have a strong incentive to utilize a common language, and indeed there are countless examples of language assimilation, especially in the last 100 years. Hence, it is puzzling that history has also recorded numerous examples of communities that coexist with distinct languages and limited economic interaction. The authors present a stylized model to reconcile both assimilation and nonassimilation. The model has two languages, locations, and time periods. Agents are initially endowed with one or both languages and a location. Agents choose whether to learn the other language, and subsequently choose whether to move to the other region. An agent can produce output only with others who share the same location and language. Agents who are learning cannot produce. The model delivers multiple equilibria. Full assimilation is possible, but it is also possible for location and language differences to lead to nonassimilation.

Price Formation and Liquidity in the U.S. Treasury Market: Evidence from Intraday Patterns around Announcements
Michael J. Fleming and Eli M. Remolona

The authors identify striking adjustment patterns for price volatility, trading volume, and bid-ask spreads in the U.S. Treasury market when public information arrives. Using newly available high-frequency data, they find a notable lack of trading volume upon a major announcement when prices are most volatile. The bid-ask spread widens dramatically with price volatility and narrows just as dramatically with trading volume. Trading volume surges only after an appreciable lag following the announcement. High levels of price volatility and trading volume then persist, with volume persisting somewhat longer.

Traders’ Broker Choice, Market Liquidity, and Market Structure
Sugato Chakravarty and Asani Sarkar

Hedgers and a risk-neutral informed trader choose between a broker that takes a position in the asset (a capital broker) and a broker that does not (a discount broker). The capital broker exploits order flow information to mimic informed trades and offset hedgers’ trades, reducing informed profits and hedgers’ utility. But the capital broker has a larger capacity to execute hedgers’ orders, increasing market depth. In equilibrium, hedgers choose the broker with the lowest price per unit of utility while the informed trader chooses the broker with the lowest price per unit of the informed order flow. However, the chosen broker may not be the one with whom market depth and net order flow are higher.

Number 26 (June)

Number 27 (July)

Number 28 (August)
Agency Problems and Risk Taking at Banks
Rebecca S. Demsetz, Marc R. Saidenberg, and Philip E. Strahan
The moral hazard problem associated with deposit insurance generates the potential for excessive risk taking on the part of bank owners. The banking literature identifies franchise value as one force mitigating that risk taking. The authors argue that in the presence of owner/manager agency problems, managerial risk aversion may also offset the excessive risk taking that stems from moral hazard. Empirical models of bank risk tend to focus either on the disciplinary role of franchise value or on owner/manager agency problems. The authors estimate a unified model and find that both franchise value and ownership structure affect risk at banks. More important, they identify an interesting interaction effect: The relationship between ownership structure and risk is significant only at low-franchise-value banks—those where moral hazard problems are most severe and where conflicts between owner and manager risk preferences are therefore strongest.
Number 29 (September)

Growth Uncertainty and Risk Sharing
Stefano Athanasoulis and Eric van Wincoop
The authors propose a new methodology to evaluate the gains from global risk sharing. They obtain estimates of growth uncertainty at various horizons from regressions of country-specific deviations from world growth on a wide range of variables in the information set. Since this residual risk can be entirely hedged, the authors use it to obtain a measure of the welfare gain that can be achieved by a representative country. They find that nations can reap very large benefits by engaging in risk-sharing arrangements. Using postwar data, the authors find that the gain for a 35-year horizon, corresponding to an equivalent permanent increase in consumption, is 6.6 percent when based on a set of forty-nine countries and 1.5 percent when based on twenty-one OECD countries. In addition, using data from 1870 to 1990, they find that the potential gain from a 120-year horizon ranges from 4.9 percent for a small set of rich countries to 16.5 percent for a broad set of twenty-four countries.
Number 30 (October)

Identifying Inflation’s Grease and Sand Effects in the Labor Market
Erica L. Groshen and Mark E. Schweitzer
Inflation has been accused of causing distortionary price and wage fluctuations (sand) and has been lauded for facilitating adjustments to shocks in periods of downward wage rigidity (grease). The authors investigate whether these two effects can be distinguished from each other in a labor market by the following identification strategy: inflation-induced deviations among employers’ mean wage changes are seen to represent unintended intramarket distortions (sand), while inflation-induced interoccupational wage changes are seen to reflect intended alignments with intermarket forces (grease). Using a unique forty-year panel of wage changes made by large midwestern employers, the authors find a wide variety of evidence to support the identification strategy. They also find some indications that occupational wages in large firms gained flexibility in the past four years. These results strongly support other findings that grease and sand effects exist, but they also suggest that these effects offset each other in a welfare sense and in unemployment effects. Thus, at inflation levels of up to 5 percent, the net impact of inflation is beneficial but statistically indistinguishable from zero; it turns detrimental afterward.
Number 31 (October)
Option-Implied Probability Distributions and Currency Excess Returns
Allan M. Malz

The author describes a method of extracting the risk-neutral probability distribution of future exchange rates from option prices. In foreign exchange markets, interbank option-pricing conventions make possible reliable inferences about risk-neutral probability distributions with relatively little data. Moments drawn from risk-neutral exchange rate distributions are used to explore several issues related to the puzzle of excess returns in currency markets. Tests of the international capital-asset-pricing model using risk-neutral moments as explanatory variables indicate that option-based moments have considerably greater explanatory power for excess returns in currency markets than has been found in earlier work. Tests of several hypotheses generated by the peso problem approach indicate that jump risk measured by the risk-neutral coefficient of skewness can explain only a small part of the forward bias. These tests take into account not only the second but the third and fourth moments of the exchange rate implied by option prices.

Number 32 (November)

Regulatory Evaluation of Value-at-Risk Models
Jose A. Lopez

Beginning in 1998, U.S. commercial banks may determine their regulatory capital requirements for market risk exposure by using value-at-risk (VAR) models—that is, models of the time-varying distributions of portfolio returns. Currently, regulators can use three statistical methods to evaluate the accuracy of VAR models: the binomial method, the interval forecast method, and the distribution forecast method. These methods use hypothesis tests to examine whether the VAR forecasts in question exhibit properties characteristic of accurate VAR forecasts. However, given the low power often exhibited by these tests, these methods may often misclassify inaccurate forecasts as accurate. The author proposes a new evaluation method, based on proper scoring rules for probability forecasts. Simulation results indicate that this new method can differentiate between forecasts of accurate and inaccurate alternative VAR models.

Number 33 (November)
Demography, National Savings, and International Capital Flows
Matthew Higgins
The author addresses the relationship between age distributions, national savings, and the current account balance. The results point to substantial demographic effects, with increases in both the youth and old-age discrepancy ratios associated with lower saving rates. They also point to differential effects on savings and investment, and thus to a role for demography in determining the current account balance. The estimated demographic effect on the current account balance exceeds 6 percent of GDP over the last three decades for a number of countries and, given expected demographic trends, is likely to be substantially larger over the coming decades.
Number 34 (December)

The Home Market, Trade, and Industrial Structure
Donald R. Davis
Does national market size matter for industrial structure? This has been suggested by theoretical work on “home market” effects, as in Krugman (1980, 1995). In this study, the author shows that what previously was regarded as an assumption of convenience—transport costs only for the differentiated goods—matters a great deal. In a focal case in which differentiated and homogeneous goods have identical transport costs, the home market effect disappears. The author discusses available evidence on the relative trade costs for differentiated and homogeneous goods. No compelling argument is found that market size will matter for industrial structure.
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