FEDERAL RESERVE BANK OF NEW YORK
RESEARCH AND MARKET ANALYSIS GROUP

# PUBLICATIONS

## & Other Research 1998

# 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 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.

# 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.ny.frb.org/rmaghome/econ_pol**.

Volume 4, Number 1 (March)

This special issue is dedicated to the proceedings of the conference "Excellence in Education: Views on Improving American Education," held at the Federal Reserve Bank of New York in November 1997. Papers include:

Volume 4, Number 2 (June)

**Policy Rules and Targets: Framing the Central Banker's Problem**

*Stephen G. Cecchetti*

The author presents an analytical framework for the formulation of a central bank policy rule and examines some conceptual issues relating to the current debate over the effectiveness of such rules. In discussing the move by many central banks to adopt a price-level or inflation rate target—the basis for one type of rule—he suggests that central banks are implicitly changing the relative importance they attach to the goals of price and output stability. Using 1984-95 data, he shows that an effort to decrease inflation variability modestly could cause output to deviate significantly from its optimal path. The article also addresses the influence of various types of uncertainty on policymaking, the possible justifications for interest rate smoothing, and the consequences of the fact that nominal interest rates cannot fall below zero.

**The Expanding Geographic Reach of Retail Banking Markets**

*Lawrence J. Radecki*

In the view of most policymakers and economists, competition in retail banking takes place in local markets the size of a single county or metropolitan area. This article suggests that banking competition has in recent years shifted to larger geographic arenas. The author's review of 1997 survey data reveals that many banks set uniform rates for both retail loans and deposits across an entire state or broad regions of a large state. Regression analysis of the relationship between retail deposit rates and measures of market concentration provides further evidence of an expansion in market size: the clear relationship that earlier studies detected between individual banks' deposit rates and measures of concentration at the local level is no longer present, while a relationship does emerge at the state level.

**Dealers' Hedging of Interest Rate Options in the U.S. Dollar Fixed-Income Market**

*John E. Kambhu*

Despite investors' willingness to hold a variety of financial assets and risks, a significant share of interest rate options exposures remains in the hands of dealers. This concentration of risk makes the interest rate options market an ideal place to explore the effects of dealers' dynamic hedging on underlying markets. Using data from a global survey of derivatives dealers and other sources, this article estimates the potential impact of dynamic hedging by interest rate options dealers on the fixed-income market. The author finds that for short-term maturities, turnover volume in the most liquid hedging instruments is more than large enough to absorb dealers' dynamic hedges. For medium-term maturities, however, an unusually large interest rate shock could lead to hedging difficulties.

**Does Consumer Confidence Forecast Household Expenditure? A Sentiment Index Horse Race**

*Jason Bram and Sydney Ludvigson*

This article is the first formal investigation of consumer attitudes that compares the forecasting power of the University of Michigan's Index of Consumer Sentiment and the Conference Board's Consumer Confidence Index. The authors find that measures available from the Conference Board have both economically and statistically significant explanatory power for several categories of consumer spending. By contrast, measures available from the University of Michigan generally exhibit weaker forecasting power for most categories of spending. As part of their analysis, the authors examine the ways in which the surveys underlying these measures differ and test whether certain types of survey questions are particularly important for predicting consumer spending.

Volume 4, Number 2 (*continued*)

**Vertical Specialization and the Changing Nature of World Trade**
*David Hummels, Dana Rapoport, and Kei-Mu Yi*

A major feature of globalization has been the enormous increase in international flows of goods and services: countries are now trading much more with each other. In this article, the authors demonstrate the greater role vertical specialization is playing in these increased flows. Vertical specialization occurs when a country uses imported intermediate parts to create a good it later exports—that is, the country links sequentially with other countries to produce a final good. Deriving evidence from four case studies as well as OECD input-output tables, the authors reveal that vertical specialization has accounted for a large and increasing share of international trade over the last several decades. They also note that because the trends encouraging vertical specialization—lower trade barriers and improvements in transportation and communications technologies—are likely to continue, this type of international trade should become even more prevalent in the next century.

Volume 4, Number 3 (October)

In February 1998, the Federal Reserve Bank of New York hosted the conference "Financial Services at the Crossroads: Capital Regulation in the Twenty-First Century." This special issue is dedicated to the conference proceedings. Papers include:

**Conference Overview: Major Themes and Directions for the Future**
*William J. McDonough*

**Opening Remarks**
*Chester B. Feldberg*

**The Impact of Capital Requirements on U.K. Bank Behaviour**
*Tolga Ediz, Ian Michael, and William Perraudin*

**Assessing the Impact of Prompt Corrective Action on Bank Capital and Risk**
*Raj Aggarwal and Kevin T. Jacques*

**Fair Value Accounting and Regulatory Capital Requirements**
*Tatsuya Yonetani and Yuko Katsuo*

**Measuring the Relative Marginal Cost of Debt and Capital for Banks**
*Thuan Le and Kevin P. Sheehan*

**Industry Practices in Credit Risk Modeling and Internal Capital Allocations: Implications for a Models-Based Regulatory Capital Standard**
*David Jones and John Mingo*

**Credit Risk in the Australian Banking Sector**
*Brian Gray*

**Portfolio Credit Risk**
*Thomas C. Wilson*

**Capital Allocation and Bank Management Based on the Quantification of Credit Risk**
*Kenji Nishiguchi, Hiroshi Kawai, and Takanori Sazaki*

**Supervisory Capital Standards: Modernise or Redesign?**
*Edgar Meister*

**The Value of Value at Risk: Statistical, Financial, and Regulatory Considerations**
*Jon Danielsson, Casper G. de Vries, and Bjørn N. Jørgensen*

**Horizon Problems and Extreme Events in Financial Risk Management**
*Peter F. Christoffersen, Francis X. Diebold, and Til Schuermann*

**Methods for Evaluating Value-at-Risk Estimates**
*Jose A. Lopez*

**Pilot Exercise—Precommitment Approach to Market Risk**
*Jill Considine*

**Value at Risk and Precommitment: Approaches to Market Risk Regulation**
*Arupratan Daripa and Simone Varotto*

**Designing Incentive-Compatible Regulation in Banking: The Role of Penalty in the Precommitment Approach**
*Shuji Kobayakawa*

# CURRENT ISSUES IN ECONOMICS AND FINANCE

*Current Issues in Economics and Finance* is a newsletter-style publication offering concise and timely analyses of economic, financial, and other topics. *Current Issues* articles are available at **www.ny.frb.org/rmaghome/curr_iss**.

*Second District Highlights*—a regional supplement to *Current Issues*—covers important financial and economic developments in the Federal Reserve System's Second District. *Second District Highlights* articles are available at **www.ny.frb.org/rmaghome/curr_iss/sec_dis**.

Electronic Trading on Futures Exchanges
*Asani Sarkar and Michelle Tozzi*

Although the open outcry method is still the best way to trade highly active contracts on futures exchanges, electronic systems can improve the efficiency and cost effectiveness of trading some types of futures and options. In recent years, the volume of electronic trades on futures exchanges has more than doubled, and it should continue to grow rapidly.
Volume 4, Number 1 (January)

Evaluating the Price Competitiveness of U.S. Exports
*Thomas Klitgaard and James Orr*

An index developed by the authors is used to track the U.S. dollar's performance against a number of foreign currencies. The authors' comparison of the index with the relative export growth rates of Japan and Germany suggests that in the 1990s the dollar stayed near levels that put the United States and its main export rivals on an equal footing. Nevertheless, the dollar's rise in 1997, if sustained, will make it more difficult for U.S. firms to keep pace with their competitors.
Volume 4, Number 2 (February)

New York–New Jersey Job Recovery Expected to Continue in 1998
*James Orr, Rae D. Rosen, and Mike De Mott*

The pattern of employment recovery in the New York–New Jersey region is expected to remain unbroken in 1998, despite a slight slowing of job growth.
Volume 4, Number 3 (March)
*Second District Highlights*

### ATM Surcharges
*James J. McAndrews*

The recent spread of ATM surcharges has sparked significant debate among consumers, policymakers, and ATM owners. Much of this debate has focused on the direct costs that surcharges impose on consumers. The use of ATM surcharges, however, also raises broader questions about ATM deployment, customer convenience, and the nature of banking competition.

Volume 4, Number 4 (April)

### Foreign Ownership of U.S. Treasury Securities: What the Data Show and Do Not Show
*Dorothy Meadow Sobol*

The Treasury Department makes available to the public considerable information about foreign holdings of its securities. Nevertheless, it is not possible to determine from the published data exactly which foreigners own U.S. Treasury debt and how much of this debt is in foreign hands.

Volume 4, Number 5 (May)

### How Effective Is Lifeline Banking in Assisting the "Unbanked"?
*Joseph J. Doyle, Jose A. Lopez, and Marc R. Saidenberg*

Many consumers who lack checking accounts are paying relatively high costs to access the nation's payments system. Legislation aimed at opening the system to these unbanked individuals has centered on requiring commercial banks to offer low-cost "lifeline" accounts. But will cost savings alone motivate these consumers to access the payments system through banks?

Volume 4, Number 6 (June)

### Earnings Inequality: New York–New Jersey Region
*David Brauer, Beethika Khan, and Elizabeth Miranda*

Over the past two decades, inequality trends in the New York–New Jersey region have largely followed the nation's: among year-round, full-time workers, the earnings gap has widened about 50 percent.

Volume 4, Number 7 (July)
*Second District Highlights*

### Free versus Fair Trade: The Dumping Issue
*Thomas Klitgaard and Karen Schiele*

Trade liberalization has had little effect on the use of antidumping tariffs—tariffs imposed on imports judged by a government to be unfairly priced. As more countries resort to such tariffs, questions arise about the merits of this form of trade protection, particularly when other remedies are available to industries hurt by import competition.

Volume 4, Number 8 (August)

### Bank Holding Company Capital Ratios and Shareholder Payouts
*Beverly Hirtle*

Last year's sharp drop in the capital ratios of bank holding companies could cast doubt on the companies' future capital strength, especially if credit quality eroded significantly or if profitability weakened. However, an analysis linking the drop in ratios to bank efforts to increase shareholder payouts in a period of strong profitability suggests that these concerns are premature.

Volume 4, Number 9 (September)

### New York City's New-Media Boom: Real or Virtual?

*Jason Bram and Mike De Mott*

The new-media industry has been a fairly strong contributor to New York City's economic growth. However, it may be premature to describe the city as a new-media hub.

Volume 4, Number 10 (October)

*Second District Highlights*

### Rethinking the Value of Initial Claims as a Forecasting Tool

*Margaret M. McConnell*

The weekly numbers on initial claims for unemployment insurance convey key information about the labor market. But how reliable are claims in predicting changes in the much anticipated monthly employment report? According to a simple forecasting model, claims consistently send an accurate signal about employment during recessions but not during expansions.

Volume 4, Number 11 (November)

### The Dollar and U.S. Manufacturing

*Linda S. Goldberg and Keith Crockett*

U.S. manufacturing industries are becoming increasingly sensitive to changes in the international value of the dollar. A look at recent studies of exchange rate effects on industry performance suggests that the 1997-98 rise in the dollar may significantly reduce U.S. producers' profits and compel firms to scale back their investment in new plants and equipment.

Volume 4, Number 12 (November)

### Viewing the Current Account Deficit as a Capital Inflow

*Matthew Higgins and Thomas Klitgaard*

With the 1998 current account deficit approaching $225 billion, attention is again focusing on the deficit's impact on U.S. jobs. Although a high deficit does adversely affect employment in export- and import-competing industries, it also means that considerable foreign capital is flowing into the United States, supporting domestic investment spending that stimulates growth and creates jobs.

Volume 4, Number 13 (December)

### New York–New Jersey Region's Job Growth to Continue in 1999, but Risks Have Risen

*James Orr and Rae D. Rosen*

Employment growth in the New York–New Jersey region in 1998 is likely to match the previous year's pace of 1.7 percent, or 200,000 new jobs. Growth will continue in 1999, but it will slow modestly, to about 1.2 percent, or 145,000 new jobs.

Volume 4, Number 14 (December)

*Second District Highlights*

# 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 brochure—offers summaries of selected studies and a listing of recent articles and papers in our 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**.

# 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 at **www.ny.frb.org/rmaghome/staff_rp**.

## Estimation of Cross-Country Differences in Industry Production Functions

*James Harrigan*

International trade economists typically assume that there are no cross-country differences in industry total factor productivity (TFP). This paper, however, finds large and persistent TFP differences across a group of industrialized countries in the 1980s. The author calculates TFP indexes and statistically examines the sources of the observed large TFP differences across countries. Two hypotheses are examined to account for TFP differences: constant returns to scale production with country-specific technological differences and industry-level scale economies with identical technology in each country. The data support the constant returns/different technology hypothesis over the increasing returns/same technology hypothesis.

Number 36 (January)

## How Big Are Potential Welfare Gains from International Risksharing?

*Eric van Wincoop*

Extensive evidence exists suggesting that the degree of risksharing accomplished by international financial markets is low. Some researchers argue that this is the result of small potential benefits from risksharing. The gains from riskpooling that have been reported in the literature range from negligible to enormous. This paper documents the extent to which the results are sensitive to the parameterization of preferences and to assumptions about the stochastic process and measurement of the endowment. The paper finds that for realistic assumptions about the underlying factors, the potential gains from risksharing are quite sizable. For member countries of the Organization for Economic Cooperation and Development, the gains are equivalent to increases in tradables consumption in the range of 1.1 to 3.5 percent for a 50-year horizon and 2.5 to 7.4 percent for a 100-year horizon.

Number 37 (February)

## How Workers Use 401(k) Plans: The Participation, Contribution, and Withdrawal Decisions

*William F. Bassett, Michael J. Fleming, and Anthony P. Rodrigues*

To investigate how workers use 401(k) plans to save for retirement, this paper examines workers' participation, contribution, and withdrawal decisions. The authors find that 65 percent of eligible workers participate in 401(k) plans. Employee participation rises with income, age, job tenure, and education. Although participation also rises if the employer matches contributions, 401(k) participation does not grow with the rate of matching. When pension plan assets are withdrawn in lump-sum distributions before retirement, just 28 percent of distribution recipients (representing 56 percent of distribution assets) roll over the withdrawn funds into tax-qualified savings plans. Overall, the authors' findings suggest that many workers, particularly those with low incomes, do not use 401(k) plans to save for retirement.

Number 38 (March)

## Consistent Covariance Matrix Estimation in Probit Models with Autocorrelated Errors

*Arturo Estrella and Anthony P. Rodrigues*

Some recent time-series applications use probit models to measure the forecasting power of a set of variables. Correct inferences about the significance of the variables require a consistent estimator of the covariance matrix of the estimated model coefficients. A potential source of inconsistency in maximum likelihood standard errors is serial correlation in the underlying disturbances, which may arise, for example, from overlapping forecasts. The authors discuss several practical methods for constructing probit autocorrelation-consistent standard errors, drawing on the generalized method of moments techniques of Hansen (1982), Newey-West (1987), and others, and provide simulation evidence that these methods can work well.

Number 39 (April)

## Economic Geography and Regional Production Structure: An Empirical Investigation

*Donald R. Davis and David E. Weinstein*

Researchers advance two principal theories to explain why countries or regions trade: comparative advantage and increasing returns to scale. Yet virtually no empirical work assesses the relative importance of these two theories in accounting for production structure and trade. The authors use a framework that nests an increasing returns model of economic geography featuring "home market effects" with that of Heckscher-Ohlin to account for the structure of regional production in Japan. They find statistical evidence that economic geography effects exist in eight of nineteen manufacturing sectors. This result contrasts sharply with the findings of Davis and Weinstein (1996), who conclude that economic geography has scant economic significance for the structure of international production. Thus, although economic geography may explain little about the international structure of production, it is very important for understanding the regional structure of production.

Number 40 (May)

## Output Fluctuations in the United States: What Has Changed since the Early 1980s?

*Margaret M. McConnell and Gabriel Perez Quiros*

The authors document a structural break in the volatility of U.S. GDP growth in the first quarter of 1984 and provide evidence that this break emanates from a reduction in the volatility of durable goods production. They find no evidence of increased stability in the nondurables, services, or structures sectors of the economy. In addition, no other Group of Seven country experienced a contemporaneous reduction in output volatility. Finally, the authors show that the reduction in durables volatility corresponds to a decline in the share of durable goods accounted for by inventories.

Number 41 (June)

### Identifying Noise Traders: The Head-and-Shoulders Pattern in U.S. Equities

*Carol Osler*

This paper identifies a specific set of agents as noise traders in U.S. equity markets and examines the agents' effects on returns. These individuals, who speculate using the "head-and-shoulders" chart pattern, are shown to qualify as noise traders because (1) trading volume is exceptionally high when they are active, and (2) their trading is unprofitable. The author finds that although head-and-shoulders sales (purchases) lower (raise) prices, these effects disappear within two weeks.

Number 42 (July)

### Soft Exchange Rate Bands and Speculative Attacks: Theory and Evidence from the ERM since August 1993

*Leonardo Bartolini and Alessandro Prati*

The authors present a model of a "soft" exchange rate target zone and interpret it as a stylized description of the post-August 1993 exchange rate mechanism (ERM). Their central bank targets a moving average of the current and past exchange rates rather than the exchange rate's current level, thus allowing the rate to move within wide margins in the short run but within narrow margins in the long run. For realistic parameters, soft target zones are significantly less vulnerable to speculative attacks than "hard" target zones. These predictions are consistent with the ERM's experience and the abatement of speculative pressure in European markets since the bands' widening in 1993.

Number 43 (August)

### The Dual Nature of Trade: Measuring Its Impact on Imitation and Growth

*Michelle P. Connolly*

Imports of goods that embody foreign technology can raise a country's output directly as inputs into production and indirectly through reverse-engineering of these goods. This paper first quantifies spillovers from high-technology imports to domestic imitation and innovation in both developed and developing countries. It then considers the contribution of foreign and domestic innovation to real per capita GDP growth using international patent data for forty countries from 1970 to 1985.

Number 44 (August)

### Structural Change in the Mortgage Market and the Propensity to Refinance

*Paul Bennett, Richard Peach, and Stavros Peristiani*

The authors hypothesize that the intrinsic benefit required to trigger a refinancing has become smaller because of a combination of technological, regulatory, and structural changes that have made mortgage origination more competitive and more efficient. To test this hypothesis, they estimate an empirical hazard model of loan survival using a database that controls for homeowners' credit ratings, equity, loan size, and measurable transaction costs. The results show that credit ratings and home equity have significant effects on the probability that homeowners will refinance. In addition, homeowners appear to postpone refinancing in the face of increased interest rate volatility. Finally, the results clearly support the hypothesis that structural change in the mortgage market has increased homeowners' propensity to refinance.

Number 45 (September)

### International Trade and American Wages in General Equilibrium, 1967-1995

*James Harrigan*

In the last quarter century, wage inequality has increased dramatically in the United States. At the same time, other trends have developed: the United States has become more integrated with the world economy, the relative prices of final goods have changed, the capital stock has more than doubled, and the labor force has become steadily more educated. This paper estimates a flexible, empirical, general equilibrium model of wage determination in an attempt to sort out the connections between

these trends. Aggregate data on prices and quantities of imports, outputs, and factor supplies are constructed from disaggregate sources. The econometric analysis shows that wage inequality has been partly driven by changes in relative factor supplies and relative final goods prices. In contrast, imports have played a negligible direct role in exacerbating wage inequality.
Number 46 (September)

### Skilled Labor–Augmenting Technical Progress in U.S. Manufacturing

*James A. Kahn and Jong-Soo Lim*

This paper examines the role of skilled labor in the growth of total factor productivity. The authors use panel data from manufacturing industries to assess the extent to which productivity growth in yearly cross section is tied to industry shares of skilled labor inputs. They find robust evidence that productivity growth was increasingly concentrated in high-skill industries during a unique ten-year period beginning in the early 1970s. They do not find any positive association between productivity growth and new capital investment.
Number 47 (October)

### The Performance of Investment Newsletters

*Jeffery F. Jaffe and James M. Mahoney*

This paper analyzes the recommendations of common stocks made by the investment newsletters followed by the *Hulbert Financial Digest*. The authors conclude that, taken as a whole, the securities recommended by newsletters do not outperform appropriate benchmarks. In addition, the analysis suggests that the future performance of a newsletter is related to its past performance when performance is measured by raw returns. Evidence of persistence, however, vanishes when performance is measured by abnormal returns. The paper uncovers little, if any, evidence of herding—that is, cross-sectional dependence of recommendations across newsletters. Newsletters tend to recommend securities that have performed well recently. Finally, newsletters with poor performance are more likely to go out of business.
Number 48 (October)

### Implied Mortgage Refinancing Thresholds

*Paul Bennett, Richard Peach, and Stavros Peristiani*

The optimal prepayment model asserts that rational homeowners refinance when they can reduce the current value of their liabilities by an amount greater than the refinancing threshold, defined as the cost of carrying the transaction plus the time value of the embedded call option. To compute the notional value of the refinancing threshold, researchers have traditionally relied on a discrete option-pricing model. Using a unique loan-level data set that links homeowner attributes with property and loan characteristics, this study proposes an alternative approach of estimating the implied value of the refinancing threshold. This empirical method enables the authors to measure the minimum interest rate differential needed to justify refinancing conditional on the borrower's creditworthiness, remaining maturity, and other observable characteristics.
Number 49 (October)

### Piggy Banks: Financial Intermediaries as a Commitment to Save

*Donald P. Morgan and Katherine A. Samolyk*

Savers with uncertain life spans cannot stick to long-term investment plans when they invest directly in liquid assets. Before horizons are known, all savers will plan to roll over their short-term assets if returns turn out to be high. Once returns are realized, however, the short-term investors tend to consume their liquid assets rather than reinvest them. Delegating investment decisions to an intermediary reduces this commitment problem and leads to more efficient portfolios. The higher return to savings should also lead to increased savings rates.
Number 50 (November)

### Why Did Thrift Goodwill Matter in 1989?

*Sangkyun Park*

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 limits thrift goodwill that can be counted as regulatory capital. This paper examines if and why the goodwill clause adversely affected the market value of thrifts. The main findings are that goodwill had a large negative effect on the stock returns of low-capital thrifts in 1989 and that the negative effect persisted in the following two years. These findings suggest that a reduced put option value accounted for a large portion of the stock price decline. Finally, the role of asymmetric information appears to have been small.

Number 51 (November)

### Institutional Affiliation and the Role of Venture Capital: Evidence from Initial Public Offerings in Japan

*Yasushi Hamao, Frank Packer, and Jay R. Ritter*

In U.S. firms going public, the presence of venture capital in the firm's ownership structure has been linked with both improved long-term performance and lower underpricing at the time of the initial public offerings (IPOs). In Japan, however, the long-run performance of venture capital-backed IPOs appears to be no better than that of other IPOs. Many of the major venture capital firms in Japan are subsidiaries of securities firms—which may face a conflict of interest when underwriting the venture capital-backed issue. The authors find that firms with venture backing from a securities company subsidiary perform significantly worse over a three-year time horizon than other IPOs. In addition, IPOs in which the lead venture capitalist is also the lead underwriter have higher initial returns than other venture capital-backed IPOs and sell at higher price/earnings ratios than comparable stocks. These results suggest that conflicts of interest influence the pricing and long-run performance of IPOs in Japan.

Number 52 (November)

### Trade Inventories

*Jonathan McCarthy and Egon Zakrajšek*

The authors examine the behavior of trade inventories under two competing hypotheses: convex delivery costs and fixed costs of ordering. In the presence of fixed costs, (S,s) inventory policies are optimal, and steady-state reduced-form predictions regarding the dynamics of inventories and sales can be used to test the model. The alternative of convex delivery costs is provided by the structural estimation of a linear-quadratic (L-Q) model. At the industry level, the results are consistent with the reduced-form predictions of the (S,s) model, and structural parameter estimates obtained from the Euler equation estimation indicate that the L-Q model does not fit the data. At the firm level, however, estimates of the structural cost parameters generate dynamics of inventories and deliveries that are observationally equivalent to those predicted by the steady-state reduced-form probability relationships of the (S,s) model.

Number 53 (December)

### Microeconomic Inventory Adjustment and Aggregate Dynamics

*Jonathan McCarthy and Egon Zakrajšek*

Using high-frequency firm-level data, the authors construct an empirically tractable model in which the aggregate dynamics are derived explicitly from the underlying microeconomic data. The results show that the microeconomic adjustment function in both the manufacturing and trade sectors is nonlinear and asymmetric—results that are consistent with firms using (S,s)-type inventory policies. There are differences in the estimated adjustment functions between the two sectors and between the durable and nondurable goods firms within each sector. The estimated adjustment function is highly stable across subperiods, indicating little change in the inventory adjustment process over time. As predicted, higher moments of the cross-sectional distribution of inventory deviations affect aggregate inventory dynamics.

Number 54 (December)

### The Consolidation of the Financial Services Industry: Causes, Consequences, and Implications for the Future

*Allen N. Berger, Rebecca S. Demsetz, and Philip E. Strahan*

This paper designs a framework for evaluating the causes, consequences, and future implications of financial services industry consolidation and reviews the extant research literature within the context of this framework (including more than 250 references). The evidence is consistent with several conclusions. First, some types of consolidation appear to have led to increases in market power. Second, although consolidation has led to improvements in profit efficiency and diversification of risks, there has been little or no cost efficiency improvement on average. Third, consolidation has had relatively little effect on the availability of services to small customers, but it has generated potential improvements in payments system efficiency. Finally, increases in systemic risk or expansion of the financial safety net may impose costs on the financial system.

Number 55 (December)

### Employment versus Wage Adjustment and the U.S. Dollar

*José Manuel Campa and Linda S. Goldberg*

Using two decades of annual data, the authors explore the links between real exchange rates and employment, wages, and overtime activity in specific U.S. manufacturing industries. Across two-digit industry levels of aggregation, exchange rate movements do not have large effects on the number of jobs created or on the number of hours worked. More substantial effects are picked up in industry wages—especially for industries characterized by low price-over-cost markup ratios—and in overtime wages and overtime employment. The industry-by-industry pattern of wage responsiveness is not strongly related to industry export orientation or to changes in overall external orientation. Industries with low price-over-cost markups and industries with a less skilled workforce exhibit relatively larger employment elasticities but lower wage elasticities.

Number 56 (December)

### What Was the Market's View of U.K. Monetary Policy? Estimating Inflation Risk and Expected Inflation with Indexed Bonds

*Eli M. Remolona, Michael R. Wickens, and Frank F. Gong*

The inflation risk premium in nominal yields is one measure of the credibility of monetary policy. This measure is time varying and can be estimated by combining the information in the nominal term structure with that in the real term structure. The authors estimate this risk premium using a generalized CIR affine-yield model with one factor driving the real term structure of monthly observations on two-year, five-year, and ten-year U.K. index-linked debt and two factors driving the term structure of the corresponding nominal yields. The estimates show that the inflation risk premium contributes on average about 100 basis points to nominal yields. Since the United Kingdom's exit from the Exchange Rate Mechanism, this figure has fallen to 70 basis points, suggesting that policy credibility has increased. The inflation risk premium provides a correction to the break-even method of forecasting inflation and yields an unbiased forecast.

Number 57 (December)

# RESEARCH PAPERS

The *Research Papers* series features discussion papers reporting preliminary research findings.

These papers are available at **www.ny.frb.org/rmaghome/rsch_pap**.

Asset Market Hangovers and Economic Growth: U.S. Housing Markets
*Matthew Higgins and Carol Osler (No. 9801)*

Methods for Evaluating Value-at-Risk Estimates
*Jose A. Lopez (No. 9802)*

Interbank Interest Rates as Term Structure Indicators
*Allan M. Malz (No. 9803)*

Modelling the Instability of Mortgage-Backed Prepayments
*Stavros Peristiani (No. 9804)*

Judging the Risk of Banks: What Makes Banks Opaque?
*Donald P. Morgan (No. 9805)*

Rethinking the Role of NAIRU in Monetary Policy: Implications of Model Formulation and Uncertainty
*Arturo Estrella and Frederic S. Mishkin (No. 9806)*

Institutional Affiliation and the Role of Venture Capital: Evidence from Initial Public Offerings in Japan
*Yasushi Hamao, Frank Packer, and Jay R. Ritter (No. 9807)*

Risksharing within the United States: What Have Financial Markets and Fiscal Federalism Accomplished?
*Stefano Athanasoulis and Eric van Wincoop (No. 9808)*

Stock Market Crises in Developed and Emerging Markets
*Sandeep Patel and Asani Sarkar (No. 9809)*

Import Demand under a Foreign Exchange Constraint
*Angelos A. Antzoulatos and Simone Peart (No. 9810)*

The Changing U.S. Income Distribution: Facts, Explanations, and Unresolved Issues
*David Brauer (No. 9811)*

Can VARs Describe Monetary Policy?
*Charles L. Evans and Kenneth N. Kuttner (No. 9812)*

An Analysis of Brokers' Trading, with Applications to Order Flow Internalization and Off-Exchange Block Sales
*Sugato Chakravarty and Asani Sarkar (No. 9813)*

Estimating the Adverse Selection and Fixed Costs of Trading in Markets with Multiple Informed Traders
*Sugato Chakravarty, Asani Sarkar, and Lifan Wu (No. 9814)*

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Paul Bennett

"Rational Bias in Macroeconomic Forecasts," with David Laster and In Sun Geoum. *Quarterly Journal of Economics*, forthcoming.

Sandra E. Black

"Beyond the Incidence of Employer-Provided Training," with Lisa Lynch. *Industrial and Labor Relations Review*, October.

"Do Better Schools Matter? Parental Valuation of Elementary Education." *Quarterly Journal of Economics*, forthcoming.

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