The bid-ask spread—the difference between bid and offer prices—is a good tool for assessing and tracking the liquidity of U.S. Treasury securities, according to a new article in the Economic Policy Review (vol. 9, no. 3).

In “Measuring Treasury Market Liquidity,” Michael J. Fleming estimates and evaluates a comprehensive set of liquidity measures for the U.S. Treasury market. Recently available high-frequency data, he observes, now enable researchers to assess and track liquidity more effectively using such measures as the bid-ask spread, quote size, and trade size.

Because of their vast liquidity, Treasuries are important for a range of market-related trading and analytical activities. Market participants, for example, use Treasuries to hedge positions in other fixed-income securities and speculate on interest rates because they can buy and sell Treasuries quickly and with low transaction costs. The high volume of trading and narrow bid-ask spreads also make Treasury rates reliable reference rates for pricing and analyzing other securities.

Fleming finds that the commonly used bid-ask spread serves as a sound measure of liquidity. The spread is easy to understand, can be calculated quickly using real-time data, and correlates with a more sophisticated price impact measure and with episodes of reported poor market liquidity.

Conversely, quote size and trade size are only modestly useful tools for measuring liquidity: they correlate less strongly with episodes of poor liquidity and with the bid-ask spread and price impact measure. Trading volume and trading frequency—two other measures—emerge as weak proxies for liquidity, as both high and low levels of trading activity are associated with periods of poor liquidity.
Structural Change Helps Explain Stalled Growth in Jobs

While output has grown steadily during the U.S. expansion that began in November 2001, employment has shown no signs of recovery. In a new study ("Has Structural Change Contributed to a Jobless Recovery?" Current Issues in Economics and Finance, vol. 9, no. 8), Erica Groshen and Simon Potter argue that the failure of employment to rebound may reflect an unusually high concentration of structural changes—permanent shifts in the distribution of workers throughout the economy.

Noting that all recessions combine structural and cyclical adjustments, the authors present evidence that structural changes predominated in the 2001 recession while cyclical changes—"reversible responses to lulls in demand"—lost importance. First, the authors’ review of layoff trends during the last six recessions reveals that temporary layoffs helped drive the rise and fall of unemployment before 1990 but played only a small role during the 2001 recession. Permanent job losses accounted for most of the movement in the unemployment rate in 2001.

Second, a look at job flows in major U.S. industries during and after recessions suggests that before 1990, job losses (and gains) were quickly reversed once the economy began to recover. In 2001-02, by contrast, most industries that lost jobs during the recession continued to shed them during the recovery, and those industries that added jobs made further gains. The pattern that emerges, the authors note, is “one in which jobs are relocated from some industries to others, not reclaimed by the same industries that had lost them earlier.”

According to Groshen and Potter, this shift toward new positions in different industries helps explain why the payroll numbers have been so slow to rise: Firms require more time to establish and fill new jobs than to recall workers to their old positions. The authors note, moreover, that in the current environment of financial market weakness and economic uncertainty, “firms may hesitate to create new jobs because of the risks involved in expanding their businesses or undertaking new ventures.”

Publications and Papers

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Macroeconomics and Growth

No. 171, August 2003
An Investigation of the Gains from Commitment in Monetary Policy
Ernst Schaumburg and Andrea Tambalotti
This study proposes a simple framework for analyzing a continuum of monetary policy rules characterized by differing degrees of credibility, in which commitment and discretion become special cases of what the authors call quasi commitment. The monetary policy authority is assumed to formulate optimal commitment plans, to be tempted to renege on them, and to succumb to this temptation with a constant exogenous probability known to the private sector. By interpreting this probability as a continuous measure of the (lack of) credibility of the monetary policy authority, the authors investigate the welfare effect of a marginal increase in credibility. Their main finding is that in a simple model of the monetary transmission mechanism, most of the gains from commitment accrue at relatively low levels of credibility.

International

No. 172, September 2003
Tariffs and the Great Depression Revisited
Mario J. Crucini and James Kahn
Drawing on recent business cycle research on the Great Depression, the authors return to an argument they advanced in a 1996 Journal of Monetary Economics article: Features of the Hawley-Smoot tariffs could have done more to decrease economic activity than is customarily believed, although not enough to account for the severe decline of the early 1930s. In this study, the authors reformulate their argument in a business cycle accounting framework that apportions fluctuations between three types of “wedges”: (productive) inefficiency, the consumption-leisure margin, and intertemporal inefficiency. Tariff increases in their model correspond primarily to productive inefficiency in a prototype one-sector model. Moreover, the wedge implied by tariffs during the Depression correlates well with the overall measure of productive inefficiency. By failing to produce a labor wedge of any consequence, their model offers persuasive evidence that factors other than tariffs also contributed significantly to the severity of the Depression.

Banking and Finance

No. 170, July 2003
Stock Market Reaction to Financial Statement Certification by Bank Holding Company CEOs
Beverly J. Hirtle
In 2002, the SEC mandated that CEOs of large, publicly traded firms certify the accuracy of their financial statements. This paper investigates whether certification has had a measurable effect on the stock market valuation of the forty-two BHCs subject to the order. It finds that the firms had a positive average abnormal return of 30 to 60 basis points on certification day—a result driven primarily by BHCs that certified in advance of the SEC’s deadline. Characteristics associated with greater opacity are systematically associated with these certification-day abnormal returns. In addition, average abnormal returns for not-yet-certifying BHCs were positive, though not statistically significant, on the day the first two BHCs certified, lending weak support to the idea that early certification may have signaled to investors that other BHCs were likely to certify. These results suggest that the certification requirement provided relevant information to investors and was thus an effective public policy tool, at least in the banking sector.
Papers Presented by Economists in the Research and Market Analysis Group


“How Important Are Technology Shocks for Business Cycles?” James Kahn. Economics Department seminar, Johns Hopkins University, Baltimore, Maryland, September 9.


Other New Publications

● “Residential Foreclosures in the City of Buffalo, 1990-2000.” This comprehensive study by the New York Fed’s Buffalo Branch examines the rise in foreclosures, the characteristics of the neighborhoods in which foreclosures occurred, and the nature of foreclosed loans in Buffalo and in a number of the city’s communities.

● The Regional Economy of Upstate New York. This quarterly newsletter, produced by the New York Fed’s Buffalo Branch, focuses on issues of importance to upstate New York. The summer 2003 issue examines the composition of the upstate New York economy under the new North American Industry Classification System. The system categorizes industries according to how their products are made, rather than what goods they produce.

Find both publications at www.newyorkfed.org/aboutthefed/buffalo_branch.html.
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No. 3, September 2003

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Linda Goldberg and Deborah Leonard

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