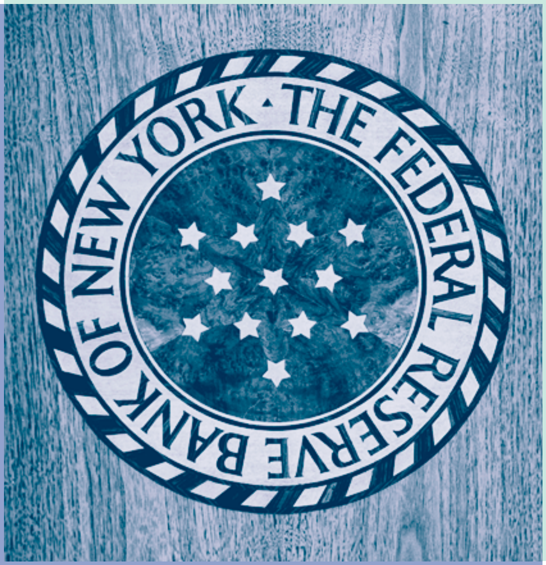

Publications
and Other Research
2002

Federal Reserve Bank of New York

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

Contents

Federal Reserve Bank of New York
Research and Market Analysis Group
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January 2003

Introduction

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

This catalogue lists recent issues in our research series:

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

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

- *EPR Executive Summaries*
  on-line 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 15.

Economic Policy Review

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

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

Volume 8

Number 1

In April 2001, the Federal Reserve Bank of New York sponsored the conference "Financial Innovation and Monetary Transmission." This special issue is dedicated to the conference proceedings. Contents include:

Number 2

A special issue on the economic effects of September 11.

Introduction

The Economic Policy Review *Editorial Board*

Measuring the Effects of the September 11 Attack on New York City

Jason Bram, James Orr, and Carol Rapaport

The attack on the World Trade Center had an enormous financial, as well as emotional, impact on New York City. This article measures the short-term economic effects on the city's labor force and capital stock through June 2002, the end of the recovery process at the World Trade Center site. Using a lifetime-earnings loss concept, the authors estimate that the nearly 3,000 workers killed in the attack lost $7.8 billion in prospective income. Moreover, the employment impact in the key affected sectors—such as finance, air transportation, hotels, and restaurants—translated into an estimated earnings shortfall of $3.6 billion to $6.4 billion, while the cost of repairing and replacing the damaged physical capital stock and infrastructure totaled an estimated $21.6 billion. Accordingly, the authors determine that the total attack-related cost to New York City through June 2002 was between $33 billion and $36 billion. The article also examines the attack's effects on the city's most economically vulnerable residents and analyzes survey findings on the incidence of post-traumatic stress disorder and alcohol and drug use after September 11.
EPR Executive Summary available

What Will Homeland Security Cost?

Bart Hobijn

The increased spending on security by the public and private sectors in response to September 11 could have important effects on the U.S. economy. Sizable government expenditures, for example, could trigger a rise in the cost of capital and wages and a reduction in investment and employment in the private sector, while large-scale spending by businesses could hamper firm productivity. This article attempts to quantify the likely effects of homeland security expenditures on the economy. It suggests that the total amount of public- and private-sector spending will be relatively small: the annual direct costs of the homeland security efforts are estimated to be $72 billion, or 0.66 percent of GDP in 2003. In the private sector, homeland security expenses are estimated to lower labor productivity levels by at most 1.12 percent. Therefore, the reallocation of resources associated with homeland security is unlikely to have any large and long-lasting effects on the U.S. economy.

EPR Executive Summaries

You can now visit our web site for useful summaries of *Economic Policy Review* articles.

Our new on-line publication—*EPR Executive Summaries*—condenses many of the articles published in the *Review*. Readers of the summaries will find timely, policy-oriented studies that are easy to absorb, with links to key charts, related articles, and other resources.

The summaries make the technical research of New York Fed economists more accessible to policymakers, educators, business and financial leaders, and others. This 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 twelve articles published in 2002.

www.newyorkfed.org/rmaghome/econ_pol/eprsumm/summlist.html

Number 2 (continued)

When the Back Office Moved to the Front Burner: Settlement Fails in the Treasury Market after 9/11

Michael J. Fleming and Kenneth D. Garbade

Settlement fails, which occur when securities are not delivered and paid for on the date scheduled by the buyer and seller, can expose market participants to the risk of loss due to counterparty insolvency. This article examines the institutional and economic setting of the fails problem that affected the Treasury market following September 11 and describes how the Federal Reserve and the U.S. Treasury responded. The authors explain that fails rose initially because of the physical destruction of trade records and communication facilities. Fails remained high because a relatively low federal funds rate and investor reluctance to lend securities kept the cost of borrowing securities to avert or remedy a fail comparable to the cost of continuing to fail. The fails problem was ultimately resolved when the Treasury increased the outstanding supply of the on-the-run ten-year note through an unprecedented "snap" reopening. The article also suggests other ways to alleviate chronic fails, such as the introduction of a securities lending facility run by the Treasury and the institution of a penalty fee for fails.

EPR Executive Summary available

Liquidity Effects of the Events of September 11, 2001

James J. McAndrews and Simon M. Potter

Banks rely heavily on incoming payments from other banks to fund their own payments. The terrorist attacks of September 11, 2001, destroyed facilities in Lower Manhattan, leaving some banks unable to send payments through the Federal Reserve's Fedwire payments system. As a result, many banks received fewer payments than expected, causing unexpected shortfalls in banks' liquidity. These disruptions also made it harder for banks to redistribute balances across the banking system in a timely manner. In this article, the authors measure the payments responses of banks to the receipt of payments from other banks, both under normal circumstances and during the days following the attacks. Their analysis suggests that the significant injections of liquidity by the Federal Reserve, first through the discount window and later through open market operations, were important in allowing banks to reestablish their normal patterns of payments coordination.

EPR Executive Summary available

Has September 11 Affected New York City's Growth Potential?

Jason Bram, Andrew Haughwout, and James Orr

In addition to exacting a tremendous human toll, the September 11 attack on the World Trade Center caused billions of dollars in property damage and a temporary contraction in New York City's economy. This article explores the effect of these events on the longer run economic prospects for the city. For many years, growth in New York has taken the form of rising property prices, reflecting a steady transition from low- to high-paying jobs. During the 1990s, the city's expansion was built on several

factors, including improving fiscal conditions, better public services, and shifting industrial and population structures that favored job and income growth. The study suggests that the effects of September 11 will not eliminate these advantages in the medium term; in fact, preliminary indications are that the city remains an attractive location for businesses as well as households. Nevertheless, New York City will face many challenges as it attempts to return to its pre-attack growth path.
EPR Executive Summary available

Terrorism and the Resilience of Cities
James Harrigan and Philippe Martin

The September 11 attacks in New York and Washington have forced Americans to confront the fact that to live or work in a large city is to be at greater risk of large-scale terrorism. What do these risks, and the public perception of them, imply for cities in general and the future of New York City in particular? In this article, the authors begin their exploration of this issue by examining why cities exist in the first place. To conduct their analysis, they simulate two key theoretical models of economic geography, using data that approximate the characteristics of a major U.S. city as well as estimates of the costs of the September 11 attacks. The authors conclude that the very forces that lead to city formation also lead cities to be highly resilient in the face of catastrophes such as terrorist attacks. They argue that New York City in particular is likely to continue to thrive despite any ongoing terrorist threat.
EPR Executive Summary available

Forthcoming

The following articles and papers are currently available only at our web site.

What Market Risk Capital Reporting Tells Us about Bank Risk
Beverly J. Hirtle

In recent years, financial market supervisors and the financial services industry have increasingly emphasized the role of public disclosure in ensuring the efficient and prudent operation of financial institutions. This article examines the market risk capital figures reported to bank regulators by U.S. bank holding companies with large trading operations to assess the extent to which such disclosure provides market participants with meaningful information about risk. It argues that, when one looks across banks, market risk capital figures provide little additional information about the extent of an institution's market risk exposure beyond what is conveyed by simply knowing the relative size of its trading account. In contrast, when one examines individual banks over time, these figures appear to provide information not available from other data in regulatory reports. These findings suggest that market risk capital figures are most useful for tracking changes in individual banks' market risk exposures over time.

Forthcoming (continued)

A special issue on corporate governance. Contents include:

Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature

Benjamin E. Hermalin and Michael S. Weisbach

The authors identify the primary findings of the empirical literature on boards of directors. Typically, these studies have sought to answer one of the following questions: How are the characteristics of the board related to profitability? How do these characteristics affect boards' observable actions? What factors affect board makeup and evolution? Across these studies, a number of regularities have emerged—notably, the fact that board composition does not seem to predict corporate performance, while board size has a negative relationship to performance. The authors note, however, that because there has been little theory to accompany these studies, it is difficult to interpret the empirical results, particularly with respect to possible policy prescriptions.

Executive Equity Compensation and Incentives: A Survey

John E. Core, Wayne R. Guay, and David F. Larcker

Stock and option compensation and the level of managerial equity incentives are aspects of corporate governance that are especially controversial to shareholders, institutional activists, and government regulators. Similar to much of the corporate finance and corporate governance literature, research on stock-based compensation and incentives has not only generated useful insights, but also produced many contradictory findings. Not surprisingly, many fundamental questions remain unanswered. In this study, the authors synthesize the broad literature on equity-based compensation and executive incentives and highlight topics that seem especially appropriate for future research.

A Survey of Blockholders and Corporate Control

Clifford G. Holderness

The author surveys the empirical literature on large-percentage shareholders in public corporations, focusing on four key issues: the prevalence of blockholders; the motivation for block ownership; the effect of blockholders on major corporate decisions, specifically executive compensation, leverage, and the incidence of takeovers; and the effect of blockholders on firm value. A central finding of this study is that there is little reason for policymakers or small investors to fear large-percentage shareholders in general, especially when the blockholders are active in firm management.

Transparency, Financial Accounting Information, and Corporate Governance

Robert M. Bushman and Abbie J. Smith

Audited financial statements along with supporting disclosures form the foundation of the firm-specific information set available to investors and regulators. In this paper, the authors discuss economics-based research focused on the properties of accounting systems and the surrounding institutional environment important to effective governance of firms. They provide a framework for understanding the operation of accounting information in an economy, discuss a broad range of important research findings, present a conceptual framework for characterizing and measuring corporate transparency at the country level, and isolate a number of future research possibilities.

The Corporate Governance of Banks

Jonathan R. Macey and Maureen O'Hara

The study argues that commercial banks pose unique corporate governance problems for managers and regulators as well as for claimants on the banks' cash flows, such as investors and depositors. The authors support the general principle that fiduciary duties should be owed exclusively to shareholders. However, in the special case of banks, they contend that the scope of the fiduciary duties and obligations of officers and directors should be broadened to include creditors. In particular, the authors call on bank directors to take solvency risk explicitly and systematically into account when making decisions or else face personal liability for failure to do so.

Incentive Features in CEO Compensation in the Banking Industry
Kose John and Yiming Qian

This paper examines the incentive features of top-management compensation in the banking industry. Economic theory suggests that the compensation structures for bank management should have low pay-performance sensitivity because of the high leverage of banks and the fact that banks are regulated institutions. In accordance with this school of thought, the authors find that the pay-performance sensitivity for bank CEOs is lower than it is for CEOs of manufacturing firms. This difference is attributable largely to the difference in debt ratios. The authors also find that banks' pay-performance sensitivity declines with bank size.

A special issue on affordable housing. Contents include:

State of New York City's Housing and Neighborhoods: An Overview of Recent Trends
Michael H. Schill and Glynis Daniels

The Impact of Building Restrictions on Housing Affordability
Edward L. Glaeser and Joseph Gyourko

Government Regulation and Changes in the Affordable Housing Stock
C. Tsuriel Somerville and Christopher J. Mayer

Housing Production Subsidies and Neighborhood Revitalization: New York City's Ten-Year Capital Plan for Housing
Ingrid Gould Ellen, Michael H. Schill, Amy Ellen Schwartz, and Ioan Voicu

Effects of Homeownership on Children: The Role of Neighborhood Characteristics and Family Income
Joseph M. Harkness and Sandra J. Newman

The Impacts of New Neighborhoods on Poor Families: Evaluating the Policy Implications of the Moving to Opportunity Demonstration
John Goering

The Twenty-Fifth Anniversary of the Community Reinvestment Act: Past Accomplishments and Future Regulatory Challenges
William C. Apgar and Mark Duda

Current Issues in Economics and Finance

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

Current Issues articles are available in html and pdf formats at **www.newyorkfed.org/rmaghome/curr_iss/**.

Volume 8

No. 1
Has Foreign Bank Entry Led to Sounder Banks in Latin America?
Jennifer S. Crystal, B. Gerard Dages, and Linda S. Goldberg

Policymakers continue to debate the merits of opening emerging market financial sectors to foreign ownership. A comparison of the 1995-2000 performance of foreign and domestic banks in select Latin American countries reveals that while foreign banks differed little from their domestic counterparts in overall financial condition, they showed more robust loan growth, a more aggressive response to asset quality deterioration, and a greater ability to absorb losses—characteristics that could help to strengthen the financial systems of their host countries.

No. 2
Live Long and Prosper: Challenges Ahead for an Aging Population
Erica L. Groshen and Thomas Klitgaard

Over the next thirty years, the percentage of people who are sixty-five and over will grow rapidly while the percentage of people in their working years will decline. This shift in the age distribution of the population will put enormous pressure on social security systems in the United States, Germany, and Japan as the number of workers whose payroll taxes fund each retiree drops sharply.

No. 3
Should U.S. Investors Hold Foreign Stocks?
Asani Sarkar and Kai Li

U.S. investors have traditionally been reluctant to acquire foreign securities—in part, perhaps, because they fear that restrictions on trading in foreign markets will sharply limit any gains they might realize from diversifying their portfolios. An analysis of the effects of one type of restriction, short-sale constraints, on stock returns between 1976 and 1999 suggests that investing in emerging market stocks offers substantial benefits even when a ban on short sales is in place.

No. 4
Securities Trading and Settlement in Europe: Issues and Outlook
Linda S. Goldberg, John Kambhu, James M. Mahoney, Lawrence Radecki, and Asani Sarkar

The institutional arrangements for trading and settling securities in Europe remain fragmented along national lines, making cross-border trading costly. Consolidation efforts are under way, however, and major market centers have now emerged in France, Germany, and the United Kingdom. Although the restructuring of trading and settlement systems should bring the European Community closer to its goal of a single capital market, changes in corporate governance and the competitive environment may raise significant regulatory issues.

No. 5

Has Inventory Volatility Returned? A Look at the Current Cycle

James A. Kahn and Margaret M. McConnell

The massive liquidation of inventories during the 2001 recession contrasts sharply with the more moderate inventory movements observed in recent decades. While the rundown might be seen as evidence that firms are not managing their inventories as effectively as some economists have claimed, a careful analysis of inventory behavior in 2001 suggests that during much of the recession, firms were successfully regulating their inventories to avoid a large buildup of excess stock.

No. 6

The Consolidation of European Stock Exchanges

James McAndrews and Chris Stefanadis

With the growing appeal of cross-border trading in Europe, efforts are under way to establish consolidated exchanges that offer trading in stocks from many European countries. An analysis of these evolving pan-European exchanges suggests that consolidation could reduce the costs and complications of cross-border trading through such enhancements as a standardization of trading platforms. Yet regulatory, legal, and economic barriers to the creation of these exchanges may delay any benefits of consolidation.

No. 7

Why Hasn't Electronic Bill Presentment and Payment Taken Off?

Chris Stefanadis

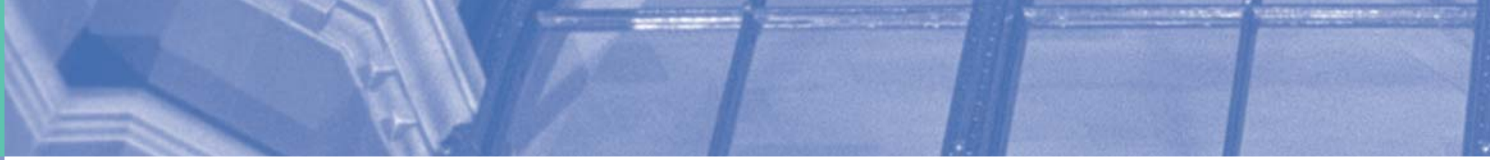
The delivery and payment of bills over the Internet could offer many advantages—low processing costs and enhanced marketing opportunities for billers, savings in time and postage for customers. Nevertheless, electronic billing has not found favor with potential users. A lack of coordination among billers and customers, combined with the high fixed costs of the new technology, may help account for the cool reception.

No. 8

Issues in Corporate Governance

William J. McDonough

On September 29, 2002, William J. McDonough, President of the Federal Reserve Bank of New York, delivered the William Taylor Memorial Lecture in Washington, D.C., at an event cosponsored by the William Taylor Memorial Fund and the Group of Thirty, a private, international consultative group on economic and monetary affairs. In his lecture, Mr. McDonough describes the actions already taken by private- and public-sector groups to strengthen corporate governance and accounting standards and identifies areas where reforms are still needed.



Research Update

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

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

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

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

Staff Reports

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

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

Macroeconomics and Growth

No. 144
Has Monetary Policy Become Less Powerful?
Jean Boivin and Marc Giannoni

This study investigates why monetary policy shocks may have had a reduced effect on the economy since the early 1980s. The authors estimate a vector autoregression over the pre- and post-1980 periods and corroborate the existing results that suggest a stronger systematic policy response to the economy in the later period. They also estimate a fully specified model that replicates the dynamic response of output, inflation, and the federal funds rate to policy shocks in both periods. After quantifying the importance of changes in monetary policy and the private sector in explaining the reduced effect of shocks, the authors find that changes in the systematic elements of policy are consistent with a more stabilizing policy post-1980 and largely account for the reduced effect of unexpected exogenous interest rate shocks. Consequently, there is little evidence that monetary policy has become less powerful.

No. 153
Borrowers' Financial Constraints and the Transmission of Monetary Policy: Evidence from Financial Conglomerates
Adam B. Ashcraft and Murillo Campello

Building on recent evidence on the functioning of internal capital markets in financial conglomerates, the authors conduct a novel test of the balance-sheet channel of monetary policy. Specifically, they investigate how the lending response to monetary policy differs across small banks that are affiliated with the same bank holding company but operate in different geographical areas. These banks face similar constraints accessing internal and external sources of funds, but have different pools of borrowers. Because the banks typically concentrate their lending with small local businesses, the authors can exploit cross-sectional differences in local economic indicators at the time of a policy shock to study whether the strength of borrowers' balance sheets affects the response of bank lending. They find evidence that the negative response of bank loan growth to a monetary contraction is significantly stronger when borrowers have weaker balance sheets.

No. 156
Inventory Dynamics and Business Cycles: What Has Changed?
Jonathan McCarthy and Egon Zakrajšek

By historical standards, the U.S. economy has experienced remarkable stability since the mid-1980s. One explanation attributes the diminished variability of economic activity to inventory management improvements led by information technology. This study, however, finds that changes in inventory dynamics have played a reinforcing—rather than a leading—role in the reduced volatility. A decomposition of the reduction in the volatility of manufacturing output shows that the reduction almost entirely reflects a decline in the variance of the growth contribution of shipments. And although the volatility of total inventory investment has fallen, the decline occurred well before the mid-1980s and was driven by the reduced variability of materials and supplies. The analysis also shows that since the mid-1980s, inventory dynamics have helped to stabilize manufacturing production, but this effect appears to be a consequence of changes in how industry-level sales and aggregate economic activity respond to shocks, rather than a cause of changes in macroeconomic behavior.

International

No. 146

On the Distributional Effects of Exchange Rate Fluctuations

Cédric Tille

This paper examines the differential impact of exchange rate fluctuations on households in a country. The author extends earlier research by relaxing the assumption of complete international sectoral specialization. His setup allows for the presence of several different sectors in a given country, each producing a different type of good. In combination with incomplete asset markets, the sectoral dimension is found to lead to a heterogenous impact of exchange rate fluctuations within each country. In particular, although a depreciation of a country's currency has an adverse, "beggar-thyself" effect for the country as a whole, a minority of households do benefit.

No. 147

How Valuable Is Exchange Rate Flexibility? Optimal Monetary Policy under Sectoral Shocks

Cédric Tille

The author explores the optimal monetary policy reaction to productivity shocks in an open economy. Whereas earlier studies have assumed that countries specialize in producing particular goods, the author enriches the analysis by allowing for incomplete specialization. He confirms the finding of Obstfeld and Rogoff (2000)—who build on Friedman (1953)—that a flexible exchange rate is highly valuable in delivering the optimal response to country-specific shocks. Its value, however, is found to be much smaller when shocks are sector-specific, because exchange rate fluctuations then lead to misallocations between different firms within a sector. Moreover, the limitation on the value of flexibility is sizable even when specialization is high.

No. 148

Terms of Trade and Exchange Rate Regimes in Developing Countries

Christian Broda

Since Friedman (1953), an advantage often attributed to flexible exchange rate regimes over fixed regimes is the ability to insulate the economy more effectively against real shocks. Using a post–Bretton Woods sample (1973-96) of seventy-five developing countries, the author assesses whether the responses of real GDP, real exchange rates, and prices to terms-of-trade shocks differ systematically across regimes. He finds that responses are significantly different across regimes in a way that supports Friedman's hypothesis. In response to a negative terms-of-trade shock, countries with fixed regimes experience large and significant declines in real GDP, and the real exchange rate depreciates slowly and by means of a fall in prices. Countries with more flexible regimes, by contrast, tend to have small real GDP losses and immediate, large real depreciations.

No. 149

Exchange Rate Pass-Through into Import Prices: A Macro or Micro Phenomenon?

José Manuel Campa and Linda S. Goldberg

Exchange rate regime optimality, as well as monetary policy effectiveness, depends on the tightness of the link between exchange rate movements and import prices. Recent debates hinge on whether producer currency pricing (PCP) or local currency pricing (LCP) of imports is more prevalent, and on whether exchange rate pass-through rates are endogenous to a country's macroeconomic conditions. The authors provide cross-country and time-series evidence on both issues for the imports of twenty-five OECD countries. Across the OECD and especially within manufacturing industries, there is compelling evidence of partial pass-through in the short run that rejects PCP and LCP. Over the long run, PCP is more prevalent for many types of imported goods. Higher inflation and exchange rate volatility are weakly associated with higher pass-through. However, for OECD countries, the most important determinants of changes in pass-through over time are microeconomic and relate to the industry composition of a country's import bundle.

No. 150

Stop-Loss Orders and Price Cascades in Currency Markets

C. L. Osler

This analysis of high-frequency exchange rates offers three main findings to support the hypothesis that stop-loss orders contribute to rapid, self-reinforcing price movements, or "price cascades." Namely, it finds that: exchange rate trends are unusually fast when rates reach levels at which stop-loss orders cluster; the response to stop-loss orders is larger than the response to take-profit orders, which generate negative-feedback trading and are unlikely to contribute to price cascades; and the response to stop-loss orders lasts longer than the response to take-profit orders. These results indicate that stop-loss orders propagate trends and are sometimes triggered in waves, contributing to price cascades. Stop-loss-propagated price cascades may help explain the well-known "fat tails" of the distribution of exchange rate returns and the high frequency of large exchange rate moves.

No. 151

Uncertainty, Exchange Rate Regimes, and National Price Levels

Christian Broda

Large differences in national price levels exist across countries. This paper develops a general equilibrium model predicting that these differences should be related to countries' exchange rate regimes. The empirical findings confirm that countries with fixed exchange rate regimes have higher national price levels than countries with flexible regimes. At the disaggregate level, the relationship between exchange rate regimes and national price levels is stronger for nontraded goods than for traded goods. The study also finds that measuring the misalignment in national price levels around times of regime shifts without considering a break in its equilibrium value results in an overestimation of the true misalignment.

No. 152

Self-Validating Optimum Currency Areas

Giancarlo Corsetti and Paolo Pesenti

A currency area can be a self-validating optimal policy regime, even when monetary unification does not foster real economic integration and intra-industry trade. In the authors' model, firms choose the optimal degree of exchange rate pass-through to export prices while accounting for expected monetary policies, and monetary authorities choose optimal policy rules while taking firms' pass-through as given. The authors show that two equilibria exist, each of which defines a self-validating currency regime. In the first, firms preset prices in a domestic currency and let prices in the foreign currency be determined by the law of one price. Optimal policy rules then target the domestic output gap, and floating exchange rates support the flex-price allocation. In the second, firms preset prices in a consumer currency, and a monetary union is the optimal policy choice for all countries. Although a common currency helps synchronize business cycles across countries, flexible exchange rates deliver a superior welfare outcome.

No. 155

The Trade Comovement Problem in International Macroeconomics

M. Ayhan Kose and Kei-Mu Yi

Recent empirical research has found that pairs of countries with stronger trade linkages tend to have more highly correlated business cycles. This study assesses whether the standard international business cycle framework can replicate this intuitive result. Employing a three-country model with transportation costs, the authors simulate the effects of increased goods-market integration under two asset market structures: complete markets and international financial autarky. They find that under international financial autarky, the model generates stronger correlations for pairs of countries that trade more, but the increased correlation explains only about 6 percent of the empirical findings. This result is broadly robust to many combinations of shock specifications, import shares, and elasticities of substitution. Because the difference between business cycle theory and the empirical results cannot be resolved by changes in parameter values and the structure of the standard models, the authors term this discrepancy the "trade comovement problem."

Banking and Finance

No. 143
The Role of Bank Advisors in Mergers and Acquisitions
Linda Allen, Julapa Jagtiani, Stavros Peristiani, and Anthony Saunders

In their dual role as lenders and advisors to firms that are the target or the acquirer in a merger, banks can be viewed as serving a certification function. Such banks, however, face a potential conflict of interest that may mitigate or offset any certification effect. An analysis of this phenomenon finds evidence of this effect for banks as advisors to target firms. In contrast, conflicts of interest appear to dominate the effect when banks advise acquirers. Moreover, because the market prices conflicts of interest, the authors find significantly negative abnormal returns for bank advisors that advise their own loan customers in acquiring other firms.

No. 145
Are Larger Treasury Issues More Liquid? Evidence from Bill Reopenings
Michael J. Fleming

This paper makes use of a natural experiment of the U.S. Treasury Department to examine the relationship between Treasury security issue size and liquidity. T-bills first issued with fifty-two weeks to maturity and reopened at twenty-six weeks are shown to be more liquid than comparable-maturity bills first issued with twenty-six weeks to maturity. The relationship is less pronounced when bills are on-the-run (the most recently auctioned bills of a given maturity), as opposed to off-the-run, and persists when controlling for other factors that affect liquidity. The reopened bills are found to have higher yields (lower prices) than comparable-maturity bills, indicating that the indirect liquidity benefits of reopenings are more than offset by the direct supply costs.

No. 154
Diversification in Banking: Is Noninterest Income the Answer?
Kevin J. Stiroh

The U.S. banking industry is steadily increasing its reliance on nontraditional business activities that generate fee income, trading revenue, and other types of noninterest income. This paper assesses potential diversification benefits from this shift. At the aggregate level, declining volatility of net operating revenue reflects reduced volatility of net interest income, rather than diversification benefits from noninterest income, which is quite volatile and has become more correlated with net interest income. At the bank level, growth rates of net interest income and noninterest income have also become more correlated in recent years. Finally, greater reliance on noninterest income, particularly trading revenue, is associated with higher risk and lower risk-adjusted profits. These results suggest little obvious diversification benefit from the ongoing shift toward noninterest income.

Quantitative Methods

No. 157
On Both Sides of the Quality Bias in Price Indexes
Bart Hobijn

It is often argued that price indexes do not fully capture the quality improvements of new goods in the market. Because of this shortcoming, the indexes are perceived to overestimate the actual price increases that occur. This paper argues that the quality bias in price indexes is just as likely to be upward as it is to be downward. The author shows how both the sign and magnitude of the quality bias in the most commonly applied price index methods are determined by the cross-sectional variation of prices per quality unit across the product models sold in the market. He does so by simulating a model of a market that includes monopolistically competing suppliers of the various product models and a representative consumer with CES (constant elasticity of substitution) preferences. The bias in the commonly applied price index methods is illustrated by comparing the methods' estimates of inflation with the theoretical inflation rate implied by the data-generating process.

Outside Journals

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

Published in 2002

Macroeconomics and Growth

Arturo Estrella

"Dynamic Inconsistencies: Counterfactual Implications of a Class of Rational Expectations Models," with Jeffrey Fuhrer. *American Economic Review* 92, no. 4 (September): 1013-28.

Margaret McConnell

"Policymakers' Revealed Preferences and the Output-Inflation Variability Trade-off: Implications for the European System of Central Banks," with Stephen G. Cecchetti. *Manchester School of Economic and Social Studies* 70, no. 4: 596-618.

Simon Potter

"Predicting a Recession: Evidence from the Yield Curve in the Presence of Structural Breaks," with Marcelle Chauvet. *Economics Letters* 77, no. 2 (October): 245-53.

Kevin Stiroh

"Are ICT Spillovers Driving the New Economy?" *Review of Income and Wealth* 48, no. 1 (March): 33-57.

"Computers and Productivity: Are Aggregation Effects Important?" with Robert H. McGuckin. *Economic Inquiry* 40, no. 1 (January): 42-59.

"The Economic Impact of Information Technology." In Hossein Bidgoli, ed., *The Encyclopedia of Information Systems*, 1-15. Amsterdam: Academic Press.

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