

Abstracts of Articles Accepted in Journals, Books, and Conference Volumes*

Premiums and Penalties for Surplus and Deficit Education: Evidence from the United States and Germany

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Published in *Economics of Education
Review* 19(2) (2000) pp. 169–178.

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An intriguing finding in the literature on the role of education in the labor market concerns workers who have acquired either more or less education than they say their jobs require. Contrary to predictions from a rigid, structural view of jobs, several authors have found that the labor market rewards workers for having completed more schooling than their jobs require and penalizes workers who have “too little” schooling. We investigate whether the structural changes in the labor market in the United States over the 1970s and 1980s (see Levy, F., and Murnane, R. 1992. “U.S. Earnings Levels and Earnings Inequality: A Review of Recent Trends and Proposed Explanations.” *Journal of Economic Literature* 30, pp. 1,333–1,381) affected the rewards and penalties associated with having too much or too little schooling for a job. We then examine whether the same rewards and penalties for surplus and deficit education observed in the United States apply in Germany, a country with a much more structured educational system and labor market. We test explicitly for differences over time in the United States and at a point in time between the United States and Germany. We find, consistent with a universalistic view of labor markets, more similarities across countries than over time.

The Supplemental Security Income Program

Mary C. Daly, with
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Cornell University

Forthcoming in *Means-Tested Transfer
Programs in the U.S.*,
ed. Robert Moffitt. Chicago:
University of Chicago Press.

This chapter provides an overview of the Supplemental Security Income (SSI) program, a means-tested program providing cash payments to the aged, blind, and disabled. Begun in 1974, SSI is now one of the largest federal government means-tested programs, with over 6.6 million recipients in 1998. While it once served primarily an aged population, the majority of SSI recipients are now working age adults and children with disabilities. To better understand why SSI grew, why the composition of SSI recipients changed, and how SSI is likely to evolve, we examine SSI program rules and the behavioral responses they induce, placing each in the context of the broader social welfare system.

We first describe the program, including its eligibility criteria and benefit structure. We show that, despite attempts to impose uniform federal standards, there continues to be substantial variation by state in both allowances and benefits. We then review trends in SSI growth and examine how changes in ineligibility criteria, outreach efforts by the Social Security Administration and state governments, local economic conditions, and the generosity of SSI benefits relative to other programs have affected these trends. Next we examine the effects of SSI program incentives on the behavior of eligible individuals and on states providing social welfare services. Since program incentives differ across the SSI population served—the aged, working age adults with disabilities, and children with disabilities—we focus separately on each group. Finally, we consider the role SSI

*The abstracts are arranged alphabetically by FRB San Francisco authors, whose names are in boldface.

How Working Age People with Disabilities Fared over the 1990s Business Cycle

Mary C. Daly, with
Richard V. Burkhauser,
Cornell University
Andrew J. Houtenville,
Cornell University

Forthcoming in *Ensuring Health and Income Security for an Aging Workforce*, eds. Peter Budetti, et al.
Kalamazoo, MI:
Upjohn Institute for Employment.

The Effects of Pensions, Health, and Health Insurance on Retirement: A Comparative Analysis of California and the Nation

Mary C. Daly
Robert G. Valletta

Forthcoming in *Employment and Health Policies for Californians over 50*, eds. Dorothy Rice and Edward Yelin.
San Francisco: UCSF and the California Wellness Foundation.

Inflation Expectations and the Stability Properties of Nominal GDP Targeting

Richard Dennis

Forthcoming in *The Economic Journal*.

plays in protecting the economic well-being of low-income populations, discuss how recent changes in welfare policy are likely to affect SSI case-loads, summarize our findings, and discuss areas for future research.

Using data from the March Current Population Survey (CPS) we show that while the longest peacetime economic expansion in the United States' history has increased the economic well-being of most Americans, the majority of working age men and women with disabilities have been left behind. Robust economic growth since the recession of the early 1990s has lifted nearly all percentiles of the income distribution of working age men and women without disabilities beyond their previous business cycle peak levels of 1989. In contrast, the majority of working age men and women with disabilities did not share in economic growth over this period. Not only did their employment and labor earnings fall during the recession of the early 1990s, but their employment and earnings continued to fall during the economic expansion that followed.

Among the factors that affect individual retirement decisions, previous research has identified the timing of social security payments, private pension eligibility, health status, and health insurance coverage as key determinants. In this chapter, we first review existing research on the links between retirement outcomes and these key determinants. We then examine the impact of the first three factors (excluding health insurance) relying primarily on data from the 1998 California Work and Health Survey. We also compare results from the California survey with results based on nationally representative samples from the Current Population Survey and the Health and Retirement Survey. The empirical results indicate substantial effects of social security, private pensions, and poor health on retirement decisions in California and in the nation as a whole.

Ball (1999) uses a small closed economy model to show that nominal GDP targeting can lead to instability. This paper extends Ball's model to uncover the role inflation expectations play in generating this instability. Allowing inflation expectations to be formed by the more general mixed expectations process, which encompasses Ball's model, we show that nominal GDP targeting is unlikely to lead to instability. We further show in Ball's model that, where exact targeting causes instability, moving to inexact targeting restores stability.

Fixed or Floating: Is It Still Possible to Manage in the Middle?

Reuven Glick

Forthcoming in *Financial Markets
and Policies in East Asia*,
ed. Gordon de Brouwer (2001). Boston:
Kluwer Academic Publishers.

This paper reviews the theoretical and empirical basis for the view that intermediate (“soft”) exchange rate regimes have become increasingly less feasible. It shows that the proportion of countries with hard currency pegs or flexible exchange rates has increased over time, and that the countries remaining in the “shrinking middle” typically must restrict capital movements. The paper also assesses the feasibility of alternative exchange rate arrangements for the developing countries of East Asia.

This paper was presented to the conference on “Financial Markets and Policies in East Asia” at the Australian National University, Canberra, September 4–5, 2000.

Foreign Reserve and Money Dynamics with Asset Portfolio Adjustment: International Evidence

Reuven Glick, with
Michael M. Hutchison,
University of California, Santa Cruz

Published in *Journal of International
Financial Markets, Institutions, and
Money* 10(3–4) (December)
pp. 229–247.

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In this paper we argue that more complete modeling of foreign exchange intervention and sterilization dynamics is necessary when there are adjustment costs to changing private portfolios and/or the central bank attempts to balance longer-run monetary control against short-term exchange rate objectives. We show that measured correlations between domestic credit and foreign asset changes, often interpreted as “sterilization coefficients,” may be misleading because they vary with the pattern of disturbances as well as with private agent and central bank behavior. We assess the empirical significance of this issue by estimating vector error correction models of the domestic and foreign asset components of the monetary base for Japan and Germany. In both countries, we find that the impact of foreign exchange intervention on domestic credit falls markedly after several months, implying that the degree of sterilization decreases over time. However, the monetary base remains largely insulated as foreign asset positions are subsequently “unwound.”

Expectations, Credibility, and Disinflation in a Small Macroeconomic Model

Chan G. Huh
Kevin J. Lansing

Published in *Journal of Economics
and Business* 2000(51) pp. 51–86.

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We used a version of the Fuhrer-Moore model to study the effects of expectations and central bank credibility on the economy’s dynamic transition path during a disinflation. Simulations were compared under four different specifications of the model which vary according to the way that expectations are formed (rational versus adaptive) and the degree of central bank credibility (full versus partial). The various specifications exhibited qualitatively similar behavior and were able to reasonably approximate the trend movements in U.S. macro variables during the Volcker disinflation of the early 1980s. However, the specification with adaptive expectations/partial credibility was the only one to capture the temporary rise in long-term nominal interest rates observed in U.S. data at the start of the disinflation. We also found that incremental reductions in the output sacrifice ratio were largest at the low end of the credibility range, suggesting that a central bank may face diminishing returns in its efforts to enhance credibility.

Forecasting the Forecasts of Others in the Frequency Domain

Kenneth Kasa

Published in *Review of Economic
Dynamics* 3(4) (October) pp. 726–756.

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This paper studies a class of models developed by R.M. Townsend (1983, *J. Polit. Econ.* 91, 546–588) and T.J. Sargent (1991, *J. Econom. Dynam. Control* 15, 245–273). These models feature dynamic signal extraction problems and an infinite regress in expectations. This paper uses frequency domain methods to compute an analytical solution to the fixed point problem posed by the infinite regress in expectations. The advantage of a frequency domain approach vis-à-vis a time domain approach derives from the fact that these models produce equilibria with nonfundamental moving average representations, in which market observations do not reveal the underlying shocks to agents' information sets. As a result, decision rules contain moving average components that are more easily handled in the frequency domain than in the time domain.

A Theory of Liquidity in Residential Real Estate Markets

John Krainer

Forthcoming in
Journal of Urban Economics.

A “hot” real estate market is one where prices are rising, average selling times are short, and the volume of transactions is higher than the norm. “Cold” markets have the opposite characteristics: prices are falling, liquidity is poor, and volume is low. This paper provides a theory to match these observed correlations. I show that liquidity can be good while prices are high because the opportunity cost of failing to complete a transaction is high for both buyers and sellers. I also show how state-varying liquidity depends on the absence of smoothly functioning rental markets.

Equilibrium Valuation of Illiquid Assets

John Krainer, with
Stephen F. LeRoy, *University of
California, Santa Barbara*

Forthcoming in *Economic Theory*.

We develop an equilibrium model of illiquid asset valuation based on search and matching. We propose several measures of illiquidity and show how these measures behave. We also show that the equilibrium amount of search may be less than, equal to, or greater than the amount of search that is socially optimal. Finally, we show that excess returns on illiquid assets are fair games if returns are defined to include the appropriate shadow prices.

Do Savings Associations Have a Special Commitment to Housing?

Elizabeth Laderman, with
Wayne Passmore, *Board of Governors
of the Federal Reserve System*

Published in *Journal of Financial
Services Research* 17(1) (February)
pp. 41–68.

In this paper, we investigate whether elimination of the savings association charter might reduce lending to nontraditional mortgage borrowers. We present a theoretical model of lender portfolio choice in which non-traditional lenders have some market power and traditional lenders are price takers in the mortgage market. The comparative statics indicate differences between nontraditional and traditional lenders in terms of their asset allocation responses to changes in borrower income and house prices. Empirical tests indicate the absence of such differences between savings associations and commercial banks, suggesting that elimination of the savings association charter would not impair lending to nontraditional mortgage borrowers.

Evaluating the Predictive Accuracy of Volatility Models

Jose A. Lopez

Forthcoming in *Journal of Forecasting*.

Statistical loss functions that generally lack economic content are commonly used for evaluating financial volatility forecasts. In this paper, an evaluation framework based on loss functions tailored to a user's economic interests is proposed. According to these interests, the user specifies the economic events to be forecast, the criterion with which to evaluate these forecasts, and the subsets of the forecasts of particular interest. The volatility forecasts from a model are then transformed into probability forecasts of the relevant events and evaluated using the specified criteria (i.e., a probability scoring rule and calibration tests). An empirical example using exchange rate data illustrates the framework and confirms that the choice of loss function directly affects the forecast evaluation results.

Geometric Relationships in a Currency Trio

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Published in *Derivatives Quarterly* 6
(Spring) pp. 14–21.

This article is published by
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This article provides an example of how geometric concepts can help visualize and interpret the sometimes complex relations between financial variables. We illustrate the power and the elegance of the geometric approach to statistical concepts in finance by analyzing the volatilities and correlations in a currency trio, i.e., a set of three currencies. We expand previous work in this area by providing further insight into the relationship between volatilities and correlations in a currency trio and by analyzing differences in the correlation structure across currency trios and over time. We also present a graphical method for comparing the predictive ability of correlation forecasts from several competing models. The geometric approach towards analyzing correlation structures and correlation forecasts may be particularly helpful for financial institutions. As these institutions survive on their ability to react to the massive amount of data generated by financial markets and management information systems, they can take advantage of the human capability to instantaneously understand pictures by transforming such data into graphics.

Is Implied Correlation Worth Calculating? Evidence from Option Prices and Historical Data

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Credit Suisse Group, Zurich

Published in *Journal of Derivatives* 7(3)
(January) pp. 65–82.

This abstract is from *The Journal of Derivatives*, published by Institutional Investor, Inc. For a copy of the article, please call (212) 224-3800.

Implied volatilities, as derived from option prices, have been shown to be useful in forecasting the subsequently observed volatility of the underlying financial variables. In this paper, we address the question of whether implied correlations, derived from options on the exchange rates in a currency trio, are useful in forecasting the observed correlations. We compare the forecast performance of the implied correlations from two currency trios with markedly different characteristics against correlation forecasts based on historical time-series data. For the correlations in the USD/DEM/JPY currency trio, we find that implied correlations are useful in forecasting observed correlations, but they do not fully incorporate all the information in the historical data. For the correlations in the USD/DEM/CHF currency trio, implied correlations are much less useful. In general, since the performance of implied correlations varies across currency trios, implied correlations may not be worth calculating in all instances.

Bank Credit versus Nonbank Credit and the Provision of Liquidity by the Central Bank

Milton Marquis

Forthcoming in *Challenges for Modern
Central Banking*,
eds. Anthony Santomero, Staffan Viotti,
and Anders Vredin. Boston:
Kluwer Academic Publishers.

When banks tighten their terms and conditions on business lending, bank loan rates rise and the economy slows as firms shift their borrowing away from the banks and toward nonbank sources of credit. When tighter lending standards coincide with economic downturns, the contraction of output and the decline in employment are exacerbated. The central bank can offset this decline in bank loans by injecting liquidity into the banking system. However, this action raises inflationary expectations, and nominal interest rates in the credit markets increase such that the consequent decline in nonbank credit can more than offset the increase in bank credit and the economy experiences an even sharper decline.

Bank Intermediation over the Business Cycle

Milton Marquis, with
Tor Einarsson, *University of Iceland*

Forthcoming in *Journal of Money,
Credit, and Banking*.

A model is developed in which banks engage in valued asset transformation by converting illiquid assets (working capital loans) into highly liquid demand deposit accounts that households use for transactions purposes. Consumption-smoothing behavior induces countercyclicality in the degree to which firms rely on bank borrowings to finance their working capital expenses, which is consistent with U.S. data. The importance of financial markets that provide alternative sources of short-term funds to firms also is illustrated. Absent these markets, nominal interest rates become nearly perfectly positively correlated with output, which is counterfactual, and monetary shocks induce (perhaps artificially) large aggregate employment responses.

Housing Price Cycles and Prepayment Rates of U.S. Mortgage Pools

Joe Matthey, with
Nancy Wallace, *University
of California, Berkeley*

Forthcoming in *Journal of Real Estate
Finance and Economics* 23(2).

Empirical mortgage prepayment models generally have trouble explaining differences in mortgage prepayment speeds among pools with similar interest rates on the underlying mortgages. In this paper, we model some of the sources of termination heterogeneity across mortgage pools, particularly the role of regional variations in housing prices in generating atypical prepayment speeds. Using a sample of Freddie Mac mortgage pools from 1991–1998, we compare two classes of empirical models: a rational option pricing model using a backward-solving pricing algorithm and an empirical hazard model. In both empirical estimation strategies, we find evidence that differences in house price dynamics across regions are an important source of between-pool heterogeneity. This finding is then shown to be robust to alternative ways of parameterizing pool heterogeneity in mortgage termination models.

Pegging and Macroeconomic Performance in East Asia

Ramon Moreno

Forthcoming in
ASEAN Economic Bulletin.

This paper assesses the case for pegging in East Asia by briefly surveying the recent literature on the choice of exchange rate regime. Using a new method for classifying exchange rate regimes based on exchange rate volatility, East Asia's experience with pegged exchange rates is examined. In contrast to other areas, inflation in East Asia under pegging is similar to that under floating, as are monetary and fiscal conditions. Growth tends to be higher under pegging, but the channels are not clear since pegging was not associated with greater competitiveness nor with lower exchange rate

volatility, and openness was not higher under pegging. Before 1997 pegging was associated with higher cumulative inflation and similar cumulative growth around currency crisis episodes. Thus, differences in economic performance across pegged and floating regimes in East Asia are relatively modest. However, the 1997 crises—which were preceded by pegged regimes—were followed by unprecedented contractions in output that suggest that the costs of pegging may have risen.

Is the Fed Too Timid? Monetary Policy in an Uncertain World

Glenn D. Rudebusch

Forthcoming in
Review of Economics and Statistics.

Estimates of the Taylor rule using historical data from the past decade or two suggest that monetary policy in the U.S. can be characterized as having reacted in a moderate fashion to output and inflation gaps. In contrast, the parameters of optimal Taylor rules derived using empirical models of the economy often recommend much more vigorous policy responses. This paper attempts to match the historical policy rule with an optimal policy rule by incorporating uncertainty into the derivation of the optimal rule and by examining plausible variations in the policymaker's model and preferences.

Opportunistic and Deliberate Disinflation under Imperfect Credibility

Glenn D. Rudebusch, with
Antulio Bomfim, *Board of Governors
of the Federal Reserve System*

Published in *Journal of Money, Credit,
and Banking* 32(4, part 1) (November)
pp. 707–721.

One strategy for disinflation prescribes a deliberate path towards low inflation. A contrasting opportunistic approach eschews deliberate action and instead waits for unforeseen shocks to reduce inflation. This paper compares the ability of these two approaches to achieve disinflation—and at what cost. We analyze these issues using the Federal Reserve's FRB/US model, which allows alternative assumptions to be made about expectations held by agents in the economy; hence, the credibility of the central bank can be considered in assessing the cost of deliberate and opportunistic disinflations.

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Eurosystem Monetary Targeting: Lessons from U.S. Data

Glenn D. Rudebusch, with
Lars E.O. Svensson,
Stockholm University

Forthcoming in
European Economic Review.

Using a small empirical model of inflation, output, and money estimated on U.S. data, we compare the relative performance of monetary targeting and inflation targeting. The results show monetary targeting to be quite inefficient, yielding both higher inflation and output variability. This is true even with a nonstochastic money demand formulation. Our results are also robust to using a P^* model of inflation. Therefore, in these popular frameworks, there is no support for the prominent role given to money growth in the Eurosystem's monetary policy strategy.

Bank Charter Value and the Viability of the Japanese Convoy System

Mark M. Spiegel

Published in *Journal of the Japanese and International Economies* 14(3) (September) pp. 149–168.

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This paper compares the performance of a convoy banking system, similar to that which prevailed in Japan, to a fixed-premium deposit insurance regime. While neither regime is generally preferable over the other, the performance of the convoy system is shown to be more sensitive to changes in bank charter values and the overall health of the banking system under fairly general conditions. The recent breakdown of the convoy system may therefore be partly attributable to adverse movements in these characteristics in Japan.

The Role of Financial Development in Growth and Investment

Mark M. Spiegel, with
Jess Benhabib, *New York University*

Published in *Journal of Economic Growth* 5(4) (December) pp. 341–360.

This paper decomposes the well-documented relationship between financial development and growth. We examine whether financial development affects growth solely through its contribution to growth in “primitives,” or factor accumulation rates, or whether it also has a positive impact on total factor productivity growth. Our results suggest that indicators of financial development are correlated with both total factor productivity growth and investment. However, the indicators that are correlated with total factor productivity growth differ from those that encourage investment. In addition, many of the results are sensitive to the inclusion of country fixed effects, which may indicate that the financial development indicators are proxying for broader country characteristics.