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Research UPDATE

from the Federal Reserve Bank of New York

RESEARCH AND MARKET ANALYSIS GROUP

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Also in This Issue…

New Research: October–December 2000

Two Theories Provide Contrasting Explanations for Productivity Growth

Economists have long debated the best way to explain the sources of productivity growth. In "What Drives Productivity Growth?" (***Economic Policy Review***, forthcoming), author Kevin Stiroh gives an overview of the link between investment and productivity in two alternate frameworks—the neoclassical and new growth theories. Stiroh also discusses how both views make valuable contributions to a fuller explanation of productivity growth.

The key distinction between these theories, according to Stiroh, concerns the aggregate returns to capital and the implications for long-run productivity growth. In the neoclassical view, capital suffers from diminishing returns, and productivity growth is ultimately determined by exogenous technical progress. In contrast, the new growth view provides an endogenous mechanism for long-run growth, either by avoiding diminishing returns to capital or by explaining technological progress internally.

Despite the models' differences, Stiroh explains how both the neoclassical and new growth approaches make important contributions to our general understanding of the economic growth process. More specifically, he shows how these two views help to explain U.S. productivity growth. "The methodological tools developed by neoclassical economists provide a means to measure the rate of technical progress, while the models of the new growth economists can provide an internal explanation for technical progress," he concludes.

This article is currently available only at **www.ny.frb.org/rmaghome/econ_pol**.

Publications and Papers

The Research and Market Analysis Group produces a wide range of publications:

- ***The Economic Policy Review***—a policy-oriented research journal focusing on macroeconomic, banking, and financial market topics.
- ***Current Issues in Economics and Finance***—a newsletter-style publication offering concise and timely analyses of 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 intended for publication in leading economic and finance journals. This series is available only in electronic form.
- ***Publications & Other Research***—an annual catalogue of the Group's research output.

All publications are available at **www.ny.frb.org/rmaghome/publications.html**. You can also subscribe to most publications or order certain back issues from our web site. (***Staff Report***s are available only on-line.)

Fed's Efforts to Provide Liquidity around the Century Date Change Likely Had a Stabilizing Effect on the Financing Markets

The Federal Reserve sought to assure the markets that it was fully prepared to provide liquidity if normal trading activities were disrupted.

The century date change prompted widespread fears that Y2K-related computer problems among market participants could lead to disturbances in the nation's financing markets. A recent study, however, suggests that a Federal Reserve initiative to maintain orderly conditions in the country's capital markets around the year-end had a stabilizing effect ("The Federal Reserve's Contingency Financing Plan for the Century Date Change," ***Current Issues in Economics and Finance***, vol. 6, no. 15).

Authors Evangeline Sophia Drossos and Spence Hilton explain that the Federal Reserve was especially concerned about disruptions in trading and market-making activities in the short-term federal funds and repurchase agreement (RP) financing markets—markets critical to the central bank's effective implementation of monetary policy. This concern owed in large part to market participants who, seeking to avert risk, suggested that they would curtail normal trading activities and apply credit limits narrowly in the weeks surrounding the date change. Such steps threatened to create conditions in which banks and primary dealers could not obtain needed funding at a reasonable cost.

To help maintain orderly conditions in these two markets, the Federal Reserve established a special facility to enable primary dealers to obtain emergency funding by purchasing temporary options on RPs. "Through this action and a related initiative to create a special lending facility for banks, the Federal Reserve sought to assure the markets that it was fully prepared to provide liquidity if normal trading activities were disrupted," observe Drossos and Hilton.

Although it is difficult to pinpoint the exact effect of the Federal Reserve's actions, market participants noted that the options likely exerted a calming influence ahead of the year-end by easing anxieties about prospective market conditions. In addition, Drossos and Hilton explain that year-end funding premiums declined substantially at key times during the options program, suggesting that the availability of the options helped allay market participants' worst fears about high borrowing costs around the date change.

Electricity Deregulation Should Bring Cost Savings over Time

States engaged in deregulating the electricity industry have recently experienced dramatic surges in the price of power. While such incidents may be inevitable as the industry adjusts to structural change, the reforms should ultimately drive electricity rates below the levels that would prevail under a system of state-supervised utilities.

In "Lowering Electricity Prices through Deregulation" (***Current Issues in Economics and Finance***, vol. 6, no. 14), Thomas Klitgaard and Rekha Reddy examine the economic basis of deregulation and explain why, over time, restructuring should lead to cost savings for households and businesses. The authors note that reforms at the federal level have created a wholesale market in which independent energy producers compete against one another and against the utilities. Since profits flow to those producers that operate most efficiently, energy firms have strong incentives to reduce production costs by streamlining operating procedures and pursuing new technologies. Cost cuts achieved by the firms should, in turn, translate into lower rates for consumers.

Also contributing to greater efficiency, according to Klitgaard and Reddy, are state initiatives to create a competitive retail market for electricity. By giving consumers the option to buy electricity from suppliers other than the local utility, these initiatives can ensure that cost savings realized at the wholesale level are passed on to consumers.

Although Klitgaard and Reddy stress the benefits of deregulation, they acknowledge that reform poses significant operational challenges. The most difficult task is coordinating the output of multiple providers to match the supply of electricity to demand. A second challenge is ensuring that a deregulated system possesses sufficient capacity to meet needs during peak-load periods.

Call for Papers on Corporate Governance

On October 4 and 5, 2001, the Federal Reserve Bank of New York and the *Journal of Financial Intermediation* will cosponsor the conference "Corporate Governance in the Banking and Financial Services Industries." The conference will be held at the New York Fed.

The goal of the conference is to provide a better understanding of corporate governance practices as they relate to financial institutions. For more information, please visit: **www.ny.frb.org/rmaghome/callforpapers5.html**.

New Titles in the *Staff Reports* Series

International

The following ***Staff Report*** is available only at **www.ny.frb.org/rmaghome/staff_rp/2000.htm**.

No. 114

Is the Integration of World Asset Markets Necessarily Beneficial in the Presence of Monetary Shocks?
Cédric Tille

The author evaluates the consequences of the integration of international asset markets when goods markets are characterized by price rigidities. Using an open-economy general equilibrium model with volatility in the money markets, he shows that such integration is not universally beneficial. The country with the more volatile shocks will benefit, whereas the country with moderate volatility will suffer. The welfare effects reflect changes in the terms of trade that occur because forward-looking price setters adjust to the changes in exchange rate volatility brought about by the integration of global asset markets.

New York Fed Conference Examines the Consequences of Welfare Reform

Despite the fanfare surrounding welfare reform, the actual success of the measures has not been fully evaluated yet. This was the consensus of the academic researchers, government officials, and advocates for the poor who met at the New York Fed to discuss the consequences of the 1996 legislative changes to public assistance.

The November 17 conference, "Welfare Reform Four Years Later: Progress and Prospects," featured a wide range of papers focusing on different aspects of welfare reform:

- "How Are Families Who Left Welfare Doing over Time? A Comparison of Two Cohorts of Welfare Leavers," by Pamela Loprest, uncovers little support for the conventional view that women who exit the welfare rolls first—the most work-ready recipients—should do especially well. She finds that women who left the program in the mid- and late 1990s all had similar post-welfare employment rates, job characteristics, wages, and other measures of success.
- In "Declining Caseloads/Increased Work: What Can We Conclude about the Effects of Welfare Reform?" Rebecca Blank reveals that macroeconomic factors such as the fall in unemployment explain between 25 and 50 percent of the observed decline in the welfare caseload in the early and mid-1990s.
- Robert Moffitt and David Stevens, in "Changing Caseloads: Macro Influences and Micro Composition," conclude that welfare recipients work more in an expan-

sionary economy. Movements in the wage rates of recipients are countercyclical, the authors observe, because women with the greatest earnings potential typically leave the welfare rolls during upturns.

- In "Changing the Culture of the Welfare Office: The Role of Intermediaries in Linking TANF Recipients with Jobs," LaDonna Pavetti and her coauthors determine that to match welfare recipients with jobs, there must be clear information channels between the welfare office and those organizations that intermediate between the welfare system and employers.

- A study by Howard Chernick and Cordelia Reimers, "Welfare Reform and New York City's Low-Income Population," finds that despite a robust economy and administrative efforts to reduce the number of public assistance recipients, many of the city's households who lost welfare benefits after reform still retained Medicaid benefits.

- Philip Robins and Charles Michalopoulos, in "Using Financial Incentives to Encourage Welfare Recipients to Become Economically Self-Sufficient," examine a Canadian program that offers an earnings supplement, rather than standard benefits, to public assistance recipients working full-time. They conclude that a similar program in the United States would raise full-time employment at little cost to the government.

These papers will be published in a special volume of the Bank's ***Economic Policy Review***. Preliminary drafts are now available by visiting **www.ny.frb.org/rmaghome/callpapers.html**.

Recently Published

Margaret McConnell. 2000. "Output Fluctuations in the United States: What Has Changed since the Early 1980s?" with Gabriel Perez Quiros. ***American Economic Review*** 90, no. 5 (December): 1464-76.

Donald P. Morgan and Kevin J. Stiroh. 2000. "Bond Market Discipline of Banks." In ***The Changing Financial Industry Structure and Regulation: Bridging States, Countries, and Industries***, 494-526. Proceedings of the Federal Reserve Bank of Chicago's 36th Annual Conference on Bank Structure and Competition.

Simon Potter. 2000. "Nonlinear Impulse Response Functions." ***Journal of Economic Dynamics and Control*** 24, no. 10 (August): 1425-46.

Lawrence Radecki. 2000. "Competition in Shifting Product and Geographic Markets." ***Antitrust Bulletin*** 45, no. 3: 571-613.

Kevin J. Stiroh. 2000. "How Did Bank Holding Companies Prosper in the 1990s?" ***Journal of Banking and Finance*** 24, no. 11 (November): 1703-47.

Eric van Wincoop. 2000. "Intranational versus International Saving-Investment Co-Movements." In Greg Hess and Eric van Wincoop, eds., ***Intranational Macroeconomics***, 11-36. Cambridge: Cambridge University Press.

Papers Presented by Economists in the Research and Market Analysis Group

"Division of Spoils: Rent-Sharing and Discrimination in a Regulated Industry," *Sandra Black and Philip Strahan*. Michigan State University, Department of Economics Seminar, East Lansing, Michigan, October 25.

The authors examine the effects of banking deregulation on the labor market and find evidence of rent-sharing—occurring disproportionately among male workers—in an environment of restricted competition.

"National Border Effects and Heterogeneous Fixed Costs of International Trade," *Carolyn Evans*. Empirical Investigations in International Trade Conference, University of Colorado, Boulder, Colorado, November 5.

The paper shows that previous estimates of the effects of national borders on trade may overstate the magnitude and impact of ad valorem trade barriers, due to the omission of the effects of fixed costs of trade that vary across firms.

"Does Model Uncertainty Justify Caution? Robust Optimal Monetary Policy in a Forward-Looking Model," *Marc Giannoni*. Latin American and Caribbean Economic Association Conference on New Developments in Monetary Policy Design, Rio de Janeiro, Brazil, October 14.

The author proposes a method to derive robust monetary policy rules amid uncertainty about the true parameters of a model.

"Exchange Rates and Wages," *Linda Goldberg and Joseph Tracy*. Columbia University Department of Economics Seminar, New York City, November 15.

Exchange rate movements are found to influence the expected wages of workers, to have a stronger influence on the wages of workers undergoing job transitions, and to have the strongest influence on the wages of the least educated workers.

"The Impact of Employee Stock Options on the U.S. Labor Market," *Hamid Mehran and Joseph Tracy*. The Olin Foundation, Georgetown University, Washington, D.C., November 3.

The authors conclude that although stock option realizations remain a small percentage of overall compensation, these realizations have had an important impact on compensation per hour.

"Market Discipline of Banks," *Don Morgan and Kevin Stiroh*. Federal Deposit Insurance Corporation and *Journal of Financial Services Research* Conference on Incorporating Market Information into Financial Supervision, Washington, D.C., November 9.

The authors find that investors look beyond ratings and bank performance measures to the underlying assets held by banks, and show that bond market discipline of banks is stonger than has been suggested by other researchers.

RESEARCH AND MARKET ANALYSIS GROUP PUBLICATIONS AND PAPERS: October-December 2000

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Economic Policy Review Forthcoming

Actual Federal Reserve Policy Behavior
and Interest Rate Rules
Ray C. Fair

What Drives Productivity Growth?
Kevin J. Stiroh

Current Issues in Economics and Finance, Vol. 6

No. 11
Changing Technology and the Payment System
Jamie B. Stewart, Jr.

No. 12
The Emergence of Electronic Communications
Networks in the U.S. Equity Markets
James McAndrews and Chris Stefanadis

No. 13
Financial Crises in the Emerging Markets:
The Roles of the Public and Private Sectors
Terrence J. Checki and Ernest Stern

No. 14
Lowering Electricity Prices through Deregulation
Thomas Klitgaard and Rekha Reddy

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