

Research Update

Research and Statistics Group

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Research Group Welcomes Two Resident Scholars

The Research Group is pleased to announce that Nobuhiro Kiyotaki and Suresh M. Sundaresan will serve as its resident scholars for 2005-06. They succeed MIT's Jiang Wang, who served as the first resident scholar.

Professor Kiyotaki, the Cassel Professor of Economics at the London School of Economics, is renowned for his research on monetary theory and business cycles. He is the recipient of the Yrjo Jahnsson Award in Economics and the JEA-Nakahara Prize. He has published in the *American Economic Review*, the *Journal of Political Economy*, the *Quarterly Journal of Economics*, the *Review of Economic Studies*, and many other journals. Professor Kiyotaki is a fellow of the British Academy; a council member of the Econometric Society, the European Economic Association, and the Royal Economic Society; and an associate editor of *Economic Letters*.

Professor Sundaresan is the Chase Manhattan Bank Foundation Professor of Financial Institutions at Columbia Business School. He has written on such

topics as Treasury auctions, asset pricing, and risk management, and his work has appeared in numerous journals, including the *Journal of Business*, the *Journal of Finance*, the *Journal of Political Economy*, and the *Review of Financial Studies*.

Professor Sundaresan is an associate editor of the *Journal of Finance* and the *Review of Derivatives Research*. His current research focuses on default risk and its effect on asset pricing and sovereign debt securities.

The Research Group established its Program for Resident Scholars in 2004 to attract to the New York Fed, for a stay of at least one year, outstanding researchers with an international reputation. The scholars are selected from the top academic and policy institutions in areas related to the Bank's broad policy interests. Resident scholars pursue their own research while participating fully in the Group's activities. They work closely with the director of research, contribute to policymaking discussions, and provide intellectual leadership by advising and collaborating with the Group's economists. ■

Economic Policy Review Features Papers on the Disparity in U.S.-Canadian Job Growth

While observers of North American economies have focused on the lack of job growth in the current U.S. recovery, another phenomenon—the disparity in job growth between the United States and Canada—has gone largely unnoticed. At the same time that the United States has been struggling to create jobs over the past five years, Canada has been producing them at a fast clip.

To shed light on this disparity, the New York Fed recently cosponsored the conference “Labor Market Developments in the United States and Canada since 2000.” The proceedings are published in the new issue of the Bank’s *Economic Policy Review*.

The sessions engaged key Canadian and U.S. economists to explore the reasons for the lack of job growth in the United States, to contrast the U.S. experience with that of Canada, and to offer potential lessons from these experiences.

The Canadian Consulate General in New York, the Centre for the Study of Living Standards, and the New York Association for Business Economics were the conference cosponsors.

The papers presented considered many explanations for the divergent performance of the two sister economies in creating jobs. The common theme that emerged is the key role played by labor market policy and by institutions—through unemployment insurance (UI), constraints on wage flexibility, and social support for the jobless—in channeling into different outcomes the common shocks faced by the U.S. and Canadian economies.

In “*The Weak Jobs Recovery: Whatever Happened to ‘the Great American Jobs Machine’?*” Richard B. Freeman and William M. Rodgers III examine the operation of the U.S. labor market in the current recovery. They find that in terms of job creation, the recovery has been the worst in recent history. Moreover, the

Publications and Papers

The Research and Statistics Group produces a wide range of publications:

- ***The Economic Policy Review***—a policy-oriented journal focusing on economic and financial market issues.
- ***EPR Executive Summaries***—online versions of selected *Economic Policy Review* articles, in abridged form.
- ***Current Issues in Economics and Finance***—concise studies of topical economic and financial issues.
- ***Second District Highlights***—a regional supplement to *Current Issues*.
- ***Staff Reports***—technical papers intended for publication in leading economics and finance journals, available only online.
- ***Publications and Other Research***—an annual catalogue of our research output.

slow employment growth is not attributable to one sector's poor performance, nor is it concentrated in certain geographic areas. The weak recovery, conclude the authors, represents a major shift in the link between the labor market and the economy over the business cycle, rather than an idiosyncratic break in historic patterns.

René Morissette and Anick Johnson answer the question, “*Are Good Jobs Disappearing in Canada?*” by analyzing changes in the share of jobs falling in certain real wage categories over 1997-2004. Their findings suggest that well-paid jobs (\$25 or more an hour) are not disappearing in Canada. The authors also find little evidence that the relative importance of well-paid jobs has declined or that the relative importance of low-paid jobs (less than \$10 per hour) has risen over the past two decades.

The economic downturn of 2001, according to Wayne Vroman, was one of the mildest in fifty years. Yet between 2002 and 2004, several large states had difficulties financing their UI programs. In “*The Recession of 2001 and Unemployment Insurance Financing,*” Vroman examines the recession's effects on states experiencing UI funding problems and the borrowing options available when state trust fund reserves are inadequate. The author concludes that all of the states that had to borrow had low trust fund balances at the end of December 2000—right before the recession began—and that funding problems have been concentrated among the large states.

The papers, and the comments on them, are available at www.newyorkfed.org/research/epr/2005n1.html.

Website News

The Research and Statistics Group's publications website is a useful source of information on our economists and our publications.

Recently, we have added two features to the site:

- A “Papers Presented” page, which identifies the many presentations given by our economists at academic conferences, university seminars, and business and policy meetings.
- An archive of articles from the *Monthly Review*, a journal covering economic and financial market issues. The predecessor to the *Quarterly Review*, the *Monthly Review* was published from 1963 to 1976.

Visitors to the site can also access our research publications; view a detailed list of our economists and their areas of expertise; link to pages focusing on the regional, national, and global economies; and search for other Federal Reserve System research.

www.newyorkfed.org/research/publication_annuals/index.html

New Study Measures the Net Effects of Trade on U.S. Employment

In “U.S. Jobs Gained and Lost through Trade: A Net Measure” (*Current Issues in Economics and Finance*, vol. 11, no. 8), authors Erica Groshen, Bart Hobijn, and Margaret McConnell investigate the effects of recent trade patterns on the domestic labor market by measuring not only the jobs lost to imports but also the jobs created through the production of U.S. exports.

The authors begin their inquiry by noting the rising concern over the transfer of U.S. service sector jobs to overseas workers. Many observers have suggested that “offshoring” has caused a surge in the displacement of U.S. workers and was largely to blame for the sluggish recovery of the labor market in the years following the 2001 recession.

Groshen, Hobijn, and McConnell assess the scale of job losses by considering how recent trade flows to and from the United States have affected employment. They first calculate how many U.S. workers, at current wages, prices, and productivity levels, would be needed to

produce the goods and services imported by the United States. They subtract from this figure the number of workers needed to produce the goods and services exported by the United States. This calculation yields an estimate of the number of jobs needed to produce U.S. net imports domestically—a measure that the authors term “U.S. jobs embodied in net imports.”

The authors determine that in 2003, 2.6 million jobs were embodied in net imports for the entire private economy. Relative to overall U.S. payrolls, this number is small—2.4 percent of the total.

The authors find no evidence to support claims that a surge in offshoring played a large role in the so-called jobless recovery. Instead, their study reveals that the growth of jobs lost to net trade flows actually slowed during the post-recession period of weak job gains. More broadly, Groshen, Hobijn, and McConnell show that a pickup in jobs lost to trade can coincide with a strong labor market. ■

Other New Publications

- *The Regional Economy of Upstate New York*. This newsletter, produced by the New York Fed’s Buffalo Branch, focuses on issues of importance to upstate New York. In “How New York’s Agriculture Industry Is Staying Competitive,” authors Richard Deitz and Margaret Cowell examine the challenges facing the state’s agriculture industry and outline some innovative responses by local agricultural producers.

www.newyorkfed.org/research/regional_economy/upstatenews.html

Conference Focuses on the Use of Quantitative Models to Evaluate Alternative Policies

In September, economists from central banks, policy institutions, and academia met to discuss recent developments in the use of quantitative structural models to simulate and evaluate alternative monetary and fiscal policies.

The presentations were part of the conference “Quantitative Evaluation of Stabilization Policies,” cosponsored by the New York Fed, the Program for Economic Research of Columbia University, and the Dynare Project of CEPREMAP (Centre pour la recherche économique et ses applications). The sessions were held at Columbia’s Italian Academy for Advanced Studies in America.

“The papers addressed methods of econometric estimation and tests of the empirical fit of dynamic stochastic general equilibrium models,” observed the New York Fed’s Paolo Pesenti, who organized the conference with Michael Woodford of Columbia and Michel Juillard of CEPREMAP. “The studies also focused on ways of taking into account parameter and model uncertainty in policy evaluation exercises, the welfare consequences of stabilization policies, and the degree to which simple rules can approximate a fully optimal policy.”

The agenda included:

- “Fiscal Determination of Hyperinflation,” by Thomas Sargent, Noah Williams, and Tao Zha
- “Monetary Policy Analysis with Potentially Misspecified Models,” by Marco Del Negro and Frank Schorfheide
- “An Estimated DSGE Model of the U.S. Economy,” by Rochelle M. Edge, Michael T. Kiley, and Jean-Philippe Laforte
- “Empirical Properties of Closed and Open Economy DSGE Models of the Euro Area,” by Malin Adolfson, Stefan Laséen, Jesper Lindé, and Mattias Villani
- “Welfare Effects of Tax Policy in Open Economies: Stabilization and Cooperation,” by Jinill Kim and Sunghyun Henry Kim
- “Monetary Policy Rules in Economies with Traded and Non-Traded Goods,” by Brian M. Doyle, Christopher J. Erceg, and Andrew T. Levin
- “Linear-Quadratic Approximation to Optimal Policy: An Algorithm and Two Applications,” by Filippo Altissimo, Vasco Cúrdia, and Diego Rodriguez Palenzuela

Links to the papers can be found at www.newyorkfed.org/research/conference/2005/quantitative.html.

New Titles in the *Staff Reports* Series

The following new *Staff Reports* are available at www.newyorkfed.org/research/staff_reports.

MACROECONOMICS AND GROWTH

No. 214, July 2005

The Cost of Business Cycles for Unskilled Workers

Toshihiko Mukoyama and Ayşegül Şahin

This paper reconsiders the cost of business cycles under incomplete markets. Mukoyama and Şahin focus on the heterogeneity in the cost of business cycles among agents with different skill levels. Unskilled workers are subject to a much larger risk of unemployment during recessions than are skilled workers. Moreover, unskilled workers earn less income, which limits their ability to self-insure. The authors examine how this heterogeneity in unemployment risk and income translates into heterogeneity in the cost of business cycles. They find that the welfare cost of business cycles for unskilled workers is much higher than that for skilled workers.

No. 217, August 2005

Reconciling Bagehot with the Fed's Response to September 11

Antoine Martin

The nineteenth-century economist Walter Bagehot maintained that in order to prevent bank panics, a central bank should provide liquidity to the market at a very high interest rate. This recommendation seems to be in sharp contrast with the policy adopted by the Federal Reserve after September 11 when, for a few days, the federal funds rate was very close to zero. This paper shows that Bagehot's recommendation can be reconciled with the Fed's policy if one recognizes that Bagehot had in mind a commodity money regime in which the amount of reserves available is limited. A high price for this liquidity

allows banks that need it most to self-select. In contrast, the Fed has the virtually unlimited ability to expand the money supply temporarily.

No. 218, September 2005

Assessing High House Prices: Bubbles, Fundamentals, and Misperceptions

Charles Himmelberg, Christopher Mayer, and Todd Sinai

Conventional metrics used to judge the level of housing prices can be misleading because they fail to account for both the time-series pattern of real long-term interest rates and predictable differences in the long-run growth rates of house prices across local markets. The authors construct measures of the annual cost of single-family housing for forty-six metropolitan areas in the United States over the past twenty-five years and compare them with local rents and incomes. Their measures show that during the 1980s, houses looked most overvalued in cities that subsequently experienced the largest house price declines. From the trough of 1995 to 2004, the cost of owning rose somewhat relative to the cost of renting, but not, in most cities, to levels that made houses look overvalued.

INTERNATIONAL

No. 219, September 2005

Exchange Rate Pass-Through to Import Prices in the Euro Area

José Manuel Campa, Linda S. Goldberg, and José M. González-Mínguez

This paper presents an empirical analysis of transmission rates from exchange rate movements to import prices across countries and product categories in the euro area over the past fifteen years. The results show that exchange rate pass-through to import prices in the short run is high, although incomplete, and that it differs across industries and countries; in the long run, exchange rate pass-through is higher and close to 1. The authors do not find compelling evidence that the euro's introduction caused a structural change in

exchange rate pass-through. Although some estimated point elasticities have declined, structural breaks in exchange rate pass-through into import prices are evident only in a limited sample of manufacturing industries.

MICROECONOMICS

No. 221, September 2005

Barriers to Network-Specific Innovation

Antoine Martin and Michael J. Orlando

The authors examine incentives for network-specific investment and the implications for network governance. They model an environment in which participants that make payments over a network can invest in a technology that reduces the marginal cost of using the network. A network effect results in multiple equilibria; either all agents invest and network usage is high or no agents invest and network usage is low. When commitment is feasible, the high-use equilibrium can be implemented; however, when commitment is infeasible, fixed costs associated with use of the network-specific technology result in a holdup problem that implements the low-investment equilibrium. Thus, governance structures necessary to achieve commitment will be preferred to those necessary only to achieve coordination.

BANKING AND FINANCE

No. 215, August 2005

How and Why Do Small Firms Manage Interest Rate Risk? Evidence from Commercial Loans

James Vickery

This paper studies fixed-rate and adjustable-rate loans to see how small firms manage their exposure to interest rate risk. Its main findings are that credit-constrained firms consistently favor fixed-rate loans, which minimize their exposure to rising interest rates; that firms adjust their exposure depending on how interest rate shocks covary with industry output; and that the time-series share of fixed-rate bank loans

moves with interest rates in a manner consistent with recent evidence on debt market timing. The author concludes that the “fixed versus adjustable” dimension of financial contracting helps small U.S. firms ameliorate interest rate risk, and discusses implications for risk management theories and the credit channel of monetary policy.

No. 216, August 2005

Arbitrage Pricing Theory

Gur Huberman and Zhenyu Wang

Focusing on capital asset returns governed by a factor structure, the Arbitrage Pricing Theory (APT) is a one-period model in which preclusion of arbitrage over static portfolios of these assets leads to a linear relation between the expected return and its covariance with the factors. The APT, however, does not preclude arbitrage over dynamic portfolios. Consequently, applying the model to evaluate managed portfolios is contradictory to the no-arbitrage spirit of the model. An empirical test of the APT entails a procedure to identify features of the underlying factor structure rather than merely a collection of mean-variance efficient factor portfolios that satisfies the linear relation.

No. 220, September 2005

Too Big to Fail after All These Years

Donald P. Morgan and Kevin J. Stiroh

The naming of eleven banks as “too big to fail” (TBTF) in 1984 led bond raters to raise their ratings on new bond issues of TBTF banks about a notch relative to those of other, unnamed banks. The relationship between bond spreads and ratings for the TBTF banks tended to flatten after that event, suggesting that investors were even more optimistic than raters about the probability of support for those banks. The spread-rating relationship in the 1990s remained flatter for TBTF banks (or their descendants) even after the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991, suggesting that investors still see those banks as TBTF. Until investors are disabused of such beliefs, investor discipline of big banks will be less than complete. ■

Recently Published

Morten Bech. 2005. **“Gridlock Resolution and Bank Failures in Interbank Payment Systems,”** with Kimmo Soramaki. In Harry Leinonen, ed., *Liquidity, Risks, and Speed in Payment and Settlement Systems—A Simulation Approach*, 151-77. Helsinki: Bank of Finland.

Morten Bech. 2005. **“Systemic Risk in a Netting System Revisited,”** with Kimmo Soramaki. In Harry Leinonen, ed., *Liquidity, Risks, and Speed in Payment and Settlement Systems—A Simulation Approach*, 277-98. Helsinki: Bank of Finland.

Arturo Estrella. 2005. **“Productivity, Monetary Policy, and Financial Indicators.”** In *Investigating the Relationship between the Financial and Real Economy*, 166-76. BIS Papers, no. 22, April.

Arturo Estrella. 2005. **“Why Does the Yield Curve Predict Output and Inflation?”** *Economic Journal* 115, no. 505 (July): 722-44.

Arturo Estrella. 2005. **“The Yield Curve and Recessions.”** *International Economy*, summer: 8-9, 38.

James Harrigan. 2005. **“Distance, Time, and Specialization: Lean Retailing in General Equilibrium,”** with Carolyn L. Evans. *American Economic Review* 95, no. 1 (March): 292-313.

James Harrigan. 2005. **“Tight Clothing: How the MFA Affects Asian Apparel Exports,”** with Carolyn L. Evans. In Takatoshi Ito and Andrew K. Rose, eds., *International Trade in East Asia*, 367-90. NBER conference volume. Chicago: University of Chicago Press.

Antoine Martin. 2005. **“Heterogeneity, Redistribution, and the Friedman Rule,”** with Joydeep Bhattacharya and Joseph H. Haslag. *International Economic Review* 46, no. 2 (May): 437-54.

James McAndrews. 2005. **“Money Is Privacy,”** with Charles M. Kahn and William Roberds. *International Economic Review* 46, no. 2 (May): 377-99.

Ayşegül Şahin. 2005. **“Repeated Moral Hazard with Persistence,”** with Toshihiko Mukoyama. *Economic Theory* 25, no. 4 (June): 831-54.

Til Schuermann. 2005. **“Deposit Insurance and Risk Management of the U.S. Banking System: What Is the Loss Distribution Faced by the FDIC?”** with Andrew Kuritzkes and Scott M. Weiner. *Journal of Financial Services Research* 27, no. 3 (September): 217-43.

Til Schuermann. 2005. **“What Do We Know about Loss Given Default?”** In Edward I. Altman, Andrea Resti, and Andrea Sironi, eds., *Recovery Risk: The Next Challenge in Credit Risk Management*, 3-24. London: Risk Publications.

Kevin Stiroh. 2005. **“Growth of U.S. Industries and Investments in Information Technology and Higher Education,”** with Dale W. Jorgenson and Mun S. Ho. In Carol Corrado, John Haltiwanger, and Daniel Sichel, eds., *Measuring Capital in the New Economy*, 403-72. NBER conference volume. Chicago: University of Chicago Press.

Kevin Stiroh. 2005. **Information Technology and the American Growth Resurgence,** with Dale W. Jorgenson and Mun S. Ho. Vol. 3 of *Productivity*. Cambridge, Mass.: MIT Press.

George Zanjani. 2005. **“Insurance, Self-Protection, and the Economics of Terrorism,”** with Darius Lakdawalla. *Journal of Public Economics* 89, no. 9-10 (September): 1891-1905. ■

Papers Presented by Economists in the Research and Statistics Group

“Stock Returns and Volatility: Pricing the Permanent and Transitory Components of Market Risk,” Tobias Adrian. China International Conference, cosponsored by the China Center for Financial Research, Tsinghua University, and MIT’s Sloan School of Management, Kunming, China, July 6. With Joshua Rosenberg. Also presented at the Econometric Society World Congress, London, England, August 24, and the European Finance Association annual meeting, Moscow, Russia, August 26.

“Time-Consistent Fiscal Policy and Heterogeneous Agents,” Roc Armenter. Society for Economic Dynamics annual meeting, Central European University, Budapest, Hungary, June 25.

“Borrowers’ Financial Constraints and the Transmission of Monetary Policy: Evidence from Financial Conglomerates,” Adam Ashcraft. NBER Summer Institute 2005 Monetary Economics Workshop, Cambridge, Massachusetts, July 12. With Murillo Campello.

“Illiquidity in the Interbank Payment System following Widescale Disruptions,” Morten Bech. Der Nederlandsche Bank research seminar, Amsterdam, the Netherlands, April 14. With Rod Garratt. Also presented at a Bank of England seminar, London, England, April 24.

“Monetary Policy Tick-by-Tick,” Michael Fleming. Vrije Universiteit Amsterdam seminar, Amsterdam, the Netherlands, September 20. With Monika Piazzesi. Also presented at the conference on Open Market Operations and the Financial Markets, cosponsored by the Société Universitaire Européenne de Recherches Financières (SUERF) and the Bank of Finland, Helsinki, Finland, September 23.

“A Decomposition of the Sources of Incomplete Cross-Border Transmission: The Case of Beer,” Rebecca Hellerstein. UCLA Department of Economics seminar, Los Angeles, California, April 6. Also presented at a USC Department of Economics seminar, Los Angeles, California, April 7, a Cornell University Department of Economics seminar, Ithaca, New York, April 20, a Northwestern University–European University Institute conference on Inflation, Interest Rates, and Relative Prices, Florence, Italy, June 14, and the Society for Economic Dynamics annual meeting, Central European University, Budapest, Hungary, June 24.

“Banks, Markets, and Efficiency,” Antoine Martin. University of Connecticut Department of Economics seminar, Storrs, Connecticut, September 9. With Falko Fecht.

“Board Committee Structures, Incentives, and Firm Performance,” Hamid Mehran. European Financial Management Association annual meeting, Milan, Italy, July 1. With Rachel Hayes and Scott Schaefer.

“Intra-Day Trade Clustering and Two-Sided Markets,” Asani Sarkar. Conference on the Microstructure of Equity and Currency Markets, Norges Bank, Oslo, Norway, September 9. With Robert Schwartz and Avner Wolf. Also presented at Binghamton University, Binghamton, New York, September 23.

“A Limited Information Approach to the Simultaneous Estimation of Wage and Price Dynamics,” Argia Sbordonc. Society for Computational Economics, Eleventh International Conference on Computing in Economics and Finance, George Washington University, Washington, D.C., June 24.

“A Search for a Structural Phillips Curve,” Argia Sbordone. Banque de France Workshop on Monetary Models and Aggregate Dynamics, Paris, France, June 20. With Timothy Cogley. Also presented at the Symposium on Economics and Institutions, cosponsored by the Centre for Studies in Economics and Finance (CSEF) and the Innocenzo Gasparini Institute for Economic Research (IGIER), Capri, Italy, June 29.

“Volatility Accounting: A Production View of Increased Economic Stability,” Kevin Stiroh. NBER 2005 Summer Institute Conference on Research in Income and Wealth, Cambridge, Massachusetts, July 25.

“Menu Costs at Work: Restaurant Prices and the Introduction of the Euro,” Andrea Tambalotti. Università di Pavia Department of Economics seminar, Pavia, Italy, March 14. With Bart Hobijn and

Federico Ravenna. Also presented at the Society for Economic Dynamics annual meeting, Central European University, Budapest, Hungary, June 23, and the Econometric Society World Congress, London, England, August 22.

“Financial Integration and the Wealth Effect of Exchange Rate Fluctuations,” Cédric Tille. Twentieth Annual Congress of the European Economic Association, University of Amsterdam, Amsterdam, the Netherlands, August 27.

“The Empirical Content of Models with Multiple Equilibria,” Giorgio Topa. Society for the Advancement of Economic Theory Conference on Current Trends in Economics, Vigo, Spain, June 30. With Andrea Moro and Alberto Bisin. ■

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Research and Statistics Group Publications and Papers: July-September 2005

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ECONOMIC POLICY REVIEW

Vol. 11, no. 1, August 2005

Papers from the conference “Labor Market Developments in the United States and Canada since 2000”

Conference Overview and Summary of Papers

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The Weak Jobs Recovery: Whatever Happened to “the Great American Jobs Machine”?

Richard B. Freeman and William M. Rodgers III

Are Good Jobs Disappearing in Canada?

René Morissette and Anick Johnson

The Recession of 2001 and Unemployment Insurance Financing

Wayne Vroman

Forthcoming

Local or State? Evidence on Bank Market Size Using Branch Prices

Paul Edelstein and Donald P. Morgan

Trading Risk, Market Liquidity, and Convergence Trading in the Interest Rate Swap Spread

John Kambhu

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Trends in Federal Funds Rate Volatility

Spence Hilton

No. 8, August 2005

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Explaining Settlement Fails

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