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ROUNDUP

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Banking Trends and Financial Regulation

The Banking Industry. The U.S. economy may be limping along, but commercial banks are thriving. Helped by elaborate risk-shifting techniques, cheap funds, a surge in mortgage refinancing and a change in accounting standards, the industry saw its 2002 return on assets reach a 30-year high, according to the Fed's annual banking survey.

All this stands in sharp contrast to the early 1990s, when the economy also experienced a fairly brief recession followed by tepid recovery, but hundreds of depository institutions failed and credit rationing exacerbated the economic malaise. Today, says Milton H. Marquis in a San Francisco Fed *Economic Letter*, "there is little evidence that the overall availability of credit to businesses has been unduly tight."

Still, business borrowing has continued to decline throughout the current recovery, falling by over seven percent in 2002, the largest drop in more than a decade. In the face of lingering excess capacity, business borrowers have continued to cut back on investment and inventories while lean payrolls have freed up funds internally. Big companies have also taken advantage of low interest rates and investor interest to issue bonds instead of relying on bank credit. Meanwhile, [bank lending has become hugely concentrated in home mortgages \(which are now the dominant means of financing for small business\)](#).

Low interest rates have continued to boost banks' profitability on several fronts. As attractive investment alternatives diminished, households decided to keep more of their savings in the form of bank deposits, providing lenders a cheap-funds windfall. At the same time, the yield curve got steeper, benefiting intermediaries that pay short-term rates on deposits while earning long-term interest on loans. And loan charge-offs plateaued, as households and businesses refi-

nanced their debt at lower rates and longer maturities. The question hanging over the industry – especially banks overexposed in the home mortgage market – is what happens when interest rates start to climb? (Mark Carlson and Roberto Perli, “[Profits and Balance Sheet Developments at U.S. Commercial Banks in 2002](#),” Board of Governors *Federal Reserve Bulletin*, June 2003; Milton H. Marquis, “[Bank Lending to Businesses in a Jobless Recovery](#),” FRB San Francisco *Economic Letter*, July 25, 2003)

Money and Inflation

Liquidity Trap. The term “liquidity trap” refers to situations where nominal interest rates fall so close to zero that the monetary authority can no longer cut rates to stimulate the economy. For the past year, the Federal Reserve has more or less publicly acknowledged its concern about facing such a dilemma and initiated a broad internal review of policy mechanisms designed to avoid or escape the trap. After signaling an historic shift in its views about the relative dangers of inflation and deflation, the Fed’s Open Market Committee in June reduced its target federal funds rate to one percent, the lowest level in four decades.

During this policy turnabout, the central bank has engaged in a delicate dance with market participants, seeking to alert them to the potential hazard of deflation without talking down the economy or sowing panic. In the process, the Fed has come under critical fire for failing to communicate clearly its economic assessment and policy intentions. Exploring the market side of this dynamic, Board of Governors economist Antulio N. Bomfim recently looked at data from interest rate swap markets (where participants gamble on the future level of borrowing rates) to estimate the likelihood that the U.S. economy might slip into a liquidity trap.

Usually, the odds that rates will approach zero are so small as to be negligible. But Bomfim finds that in January 2003, derivatives traders estimated the probability of short-term rates grazing the lower bound at roughly four percent over two years. While higher than at any time in recent history, these odds are still quite long – and the author concludes that market participants saw extremely low rates as “a

temporary phenomenon” due to “revert to more normal levels in due course.” In hindsight, Bomfim’s findings seem to suggest that the markets: a) had a more sanguine view than the Fed; b) assumed the central bank could navigate around the trap; or c) simply couldn’t decipher the Fed’s cautionary messages. (Antulio N. Bomfim, “[‘Interest Rates as Options:’ Assessing the Markets’ View of the Liquidity Trap](#),” Board of Governors FEDS Working Paper, July 7, 2003.)

Saving and Investment

Pension Liabilities and Stock Prices. As stock prices escalated during the late 1990s, companies watched their pension plans accumulate vast surpluses and increasingly booked the “overfunding” as operating income – to the point where an analyst told the *Wall Street Journal* that corporate retirement plans had become “more a profit center than an employee benefit.”¹ Now that the bubble has burst, pension underfunding has taken on epidemic proportions (General Motors recently issued \$13 billion in new debt to shore up its troubled retirement plan), the federal Pension Benefit Guaranty Corporation is on the brink of financial crisis and the Board of Governors has released a working paper that indicts both the nation’s pension accounting system and the investor laxity it facilitates.

In the paper, authors Julia Lynn Coronado and Steven A. Sharpe show that investors have not bothered to differentiate between a company’s core business earnings and its reported returns on pension assets, even though the latter provides neither a good indicator of the firm’s pension exposure nor its future profitability. In theory, diligent investors should ignore pension earnings and focus on the marked-to-market net asset value of corporate retirement plans, which is disclosed in a required footnote to annual reports. The footnote allows investors to directly assess the net value of pension investments and obligations, instead of estimating their value indirectly from pension earnings. Ignoring tax considerations, an extra dollar in pension assets should add an extra dollar to a company’s market value while an extra dollar in the present value of future pension liabilities should have the opposite effect.

¹ The Federal Reserve also has a history of diverting “excess” pension returns to prop up earnings. For details, see “[Uncivil Service: Pension Rebellion Stirs the Fed](#),” *FOMC Alert*, August 2000.

Rather than paying attention to this revealing footnote, however, investors have wishfully fixated on pension returns, which the Financial Accounting Standards Board allows firms to report as misleading five-year averages. Since the stock market began its nosedive three years ago, lagged pension earnings and current asset values have diverged sharply. Coronado and Sharpe find that stock prices reflect these artificially inflated pension earnings rather than the dismal state of pension fund balance sheets. In short, even though the overall equity market continued to droop, loose pension accounting rules and investor naïveté helped sustain a residuum of stock-price inflation. In 2001, the authors estimate, companies with defined benefit plans were overvalued by five to ten percent.

Coronado and Sharpe do a good job of ruling out other explanations for their findings besides investor carelessness. For example, they point out that investors value pension returns as much as core business earnings whether or not the company has a high price-earnings ratio. Since private- and public-sector pension funds themselves account for a fifth of all holdings in U.S. equity markets, it would be fascinating to ascertain how much of the lingering overvaluation they are responsible for. (Julia Lynn Coronado and Steven A. Sharpe, [“Did Pension Plan Accounting Contribute to a Stock Market Bubble?”](#) Board of Governors FEDS Working Papers 2003-38, July 2003.)

Other Macroeconomic Topics

Jobless Recovery. After considerable hemming and hawing, the National Bureau of Economic Research announced in July that the most recent recession had ended back in November 2001. Many Americans, however, were in no mood to celebrate. For long after the economy started to expand in late 2001, employment continued to drop while the poverty rate rose and the number of Americans without health insurance spiked dramatically. In short, the recovery of 2002-2003 has appeared disappointingly similar to the jobless-growth period that followed the recession of 1990-1991.

The New York Fed’s Erica L. Groshen and Simon Potter theorize that structural change – the decline of some industries and growth of others – may explain what has become a recurring lag between the resump-

tion of GDP and employment growth. Groshen and Potter observe that creating new jobs in new industries takes longer than rehiring workers to their old jobs. And they note that fewer employers now rely on temporary layoffs to weather downturns, as the auto industry and other manufacturers did for many years.

Groshen and Potter calculate that in 2001, almost 80 percent of U.S. employees worked in industries affected mainly by structural shifts (in which firms continue to gain or lose jobs at a similar pace through downturn and expansion alike) rather than cyclical shifts (the more familiar pattern of job loss or gain reversing quickly once recession gives way to recovery). By contrast, structural-shift industries accounted for just half of all employment in the recessions and recoveries of the mid ‘70s, early ‘80s and early ‘90s.

The labor-market trends examined by Groshen and Potter could also reflect employment practices that have inhibited hiring in *all* industries. The Kansas City Fed’s Stacey Schreft and Aarti Singh, for example, suggest that firms are increasingly using what they call “just-in-time” employment techniques, relying on temporary and part-time workers and overtime. Because temps and part-timers are counted in employment statistics, these techniques do not cause jobless recoveries directly. But Schreft and Singh say they contribute indirectly by boosting productivity growth, enabling employers to delay full-scale hiring and weakening job markets and household spending.

Still, Schreft and Singh suggest that flexible employment practices are “largely positive” because they allow the economy to react more quickly – and less violently – to shocks. Groshen and Potter agree that jobless recoveries may be the flip side of dampened business cycles, noting that the unemployment rate, while still stuck above six percent, remains moderate by historical standards. They also note that teenagers account for a large share of the recent decline in employment – a development they see as “arguably beneficial” if it results in more teens staying in school and using summer vacation to hit the books. Unfortunately, neither pair of authors offers solutions to the deep dislocations these changes mete out to the adult population. (Erica L. Groshen and Simon Potter, [“Has Structural Change Contributed to a Jobless Recovery?”](#) FRB New York *Current Issues in Economics and Finance*, August 2003; Stacey L. Schreft and Aarti

Singh, “A Closer Look at Jobless Recoveries,” FRB Kansas City *Economic Review*, Second Quarter 2003)

International Trade and Finance

Euro Zone Inflation Rates. When the 11 member countries of the European Monetary Union adopted a joint currency in January 1999, many observers expected their inflation rates to continue to converge, as they had in the years leading up to the euro. In 1999, most of the countries had inflation rates below the two percent limit set by the Maastricht Treaty as one of the criteria for EMU membership.

Three years later, all the countries in the euro zone exceeded the two percent limit except France and Germany – in many cases by substantial margins. As Margarida Duarte reports in the Richmond Fed’s *Economic Quarterly*, inflation rates in euro land have diverged instead of converging since the adoption of the common currency, with smaller and poorer countries like Ireland and Portugal tending towards higher inflation than larger and wealthier countries like France and Germany.

One explanation is simply that poorer countries are catching up to richer ones – by growing faster and thereby courting higher inflation. To the extent that the euro accelerated the process of European integration, increased trade and rising labor and capital mobility would tend to cause the prices of goods to converge, which would in turn boost inflation in countries that had lower prices to begin with. In other words, inflation *divergence* could result from the process of economic *convergence*.

Whatever its causes, this divergence highlights the main problem with monetary unions: when the European Central Bank attempts to keep a lid on inflation in rapid-growth countries, it also suppresses growth in sluggish economies like France and Germany. (In response, France and Germany have flouted Maastricht’s “Stability and Growth Pact” restrictions on the use of expansionary fiscal policy.) Issues of policy sovereignty played a substantial role in Sweden’s recent rejection of the euro, and in the Richmond Fed article and an earlier Board of Governors study, Duarte hints that she understands exactly why the Swedes demurred. (Margarida Duarte, “The Euro and Inflation Divergence in Europe,” FRB Richmond *Economic Quarterly*, Summer 2003;

Margarida Duarte and Alexander L. Wolman, “Regional Inflation in a Currency Union: Fiscal Policy vs. Fundamentals,” Board of Governors *International Finance Discussion Papers*, July 2002.)

Work and Wages

Immigration. In the scholarly literature on “segmented assimilation” one issue that remains largely unresolved is the degree of workplace discrimination experienced by black immigrants to the U.S. Social scientists attempting to tackle this question face three analytical conundrums. First, all immigrants, regardless of race, encounter job-related hurdles. Second, black and white immigrants tend to come from different countries. And third, immigrants often return home, which would bias research results if those who go back were those who faced the worst discrimination.

Atlanta Fed labor economist Madeline Zavodny attempts to address these problems by comparing the earnings of white and nonwhite Cuban immigrants. Her data offer several advantages besides a single country of origin. For one thing, Cuban immigrants to the U.S. seldom go back to Cuba due to the bad blood between the two nations’ governments. For another, recent Cuban immigrants have attended roughly similar public schools, which ameliorates the analytical problem of controlling for quality of schooling.

Zavodny finds that nonwhite Cuban immigrants (those who identify themselves as “black” or “other” in surveys) earn 15 percent less than white Cuban immigrants. The difference shrinks to four percent after adjusting for education, age at migration, and years in the United States – though the author stresses that time does not heal the racial earning gap. Still, Zavodny’s estimate deserves to be regarded cautiously, since, for technical reasons, her study does not control for other differences between the two ethnic groups, including state of residence (most white Cubans live in low-wage Florida while many nonwhite Cubans live in high-wage New York).

A similar omission crops up in a separate Atlanta Fed paper by Zavodny on the H-1B visa program – an initiative that allows technology companies to hire foreign workers if they attest that they have not been able to recruit U.S. residents for the same positions. Surprisingly, her research indicates that in states with large volumes of H-1B applications relative to the

number of technology-industry jobs, tech workers have higher and faster-growing wages and are less likely to be unemployed. In other words, the influx of visa-holders reportedly enhances rather than undermines labor-market leverage for the domestic workforce.

Zavodny attributes this counterintuitive result to the fact that foreign tech workers have skills that complement, rather than substitute for, the skills of their U.S. counterparts. But flaws in her methodology raise red flags about the conclusion. Though Zavodny tries to correct for the problem of reverse causality – the fact that employers in high-wage states have more incentive to seek out employees from India and other countries – she does so using a technique² that presumes the geographic distribution of Indian immigrants (who account for roughly half of H-1B recipients) is unrelated to labor market conditions in different states. Since the majority of Indian immigrants moved to the U.S. after 1990, it seems wrongheaded to assume that their choice of a new home had nothing to do with local job markets. (Madeline Zavodny, “[Race, Wages and Assimilation among Cuban Immigrants](#),” FRB Atlanta Working Paper 2003-10, July 2003; Madeline Zavodny, “[The H-1B Program and Its Effects on Information Technology Workers](#),” FRB Atlanta *Economic Review*, Third Quarter 2003.)

Mandatory Vacation Laws. Before World War II, Europeans and Americans typically enjoyed the same amount of paid vacation, the only difference being that Europe’s laws mandated the break while U.S. employers offered it voluntarily or as the result of collective bargaining. In the postwar years, however, labor-backed governments in Europe extended mandatory vacation by roughly one week per decade while U.S. employers remained free of any legal obligation to provide paid leave. Statistical research by Joseph G. Altonji and Jennifer Oldham confirms that European vacation laws were binding – that is, the dramatic decrease in hours worked by Europeans in the postwar years wasn’t simply a function of cultural preferences.

While Altonji and Oldham declare themselves “skeptical that social regulation of vacation weeks does more good than harm,” they cite some circumstances under which mandatory vacations might be

socially beneficial – if, for instance, workers are afraid of negotiating longer vacations because they fear being labeled as slackers. But the case for vacation laws is presented in perfunctory fashion. For example, Altonji and Oldham acknowledge that longer vacations might improve workers’ physical or mental health, thereby driving down the cost of a country’s healthcare system. However, they fail to point out that society might also have an interest in enabling people to spend more time with their families, especially children and the elderly.

The authors also neglect the implications of a societal learning curve with respect to vacations. If Americans suddenly were granted five weeks’ vacation, the U.S. economy would be severely disrupted. But European economies function quite smoothly with generous vacation laws, in part because workers in many European countries take time off simultaneously, thereby reducing coordination problems. Altonji and Oldham conclude by acknowledging that whether vacation laws “needlessly restrict choice or solve a failure of the market to provide an efficient level of vacation is an open question.” (Joseph G. Altonji and Jennifer Oldham, “[Vacation Laws and Annual Work Hours](#),” FRB Chicago *Economic Perspectives*, Third Quarter 2003.)

Regional and Sectoral Trends

Lease Now, Pay Later. Conventional wisdom insists that leasing a car is convenient but expensive for consumers. Since new vehicles lose over a quarter of their value when they’re driven off the lot, people who replace their cars every couple of years pay a steep price – one that’s sometimes compounded by the terms of a lease.

As it turns out, leasing has been a costly proposition for Detroit too. When automakers promoted the practice in the 1990s in order to expand sales, they failed to realize how much it would affect the residual value of vehicles. As previously leased but relatively new autos began to flood the market, the resale value of two-year-old cars tanked, indirectly pinching the industry’s bottom line.

Using data from the Fed’s Survey of Consumer Finances, a Board of Governors working paper examines the financial profiles of leasers and sheds

² The technique requires that the “instrumental variable” – in this case, the number of Indian immigrants in each state – be correlated with the demand for visas but not correlated with labor market conditions.

some light on automakers' self-inflicted wound. According to Ana Aizcorbe, Martha Starr and James Hickman, the vast majority of people who lease vehicles have high incomes and good credit. Such consumers are likely less intent on avoiding a big down payment than combating the specter of delayed gratification. For less cash up front, leasing allows them to drive a much fancier vehicle than they could buy – the catch being that they typically have little to show for it when their lease expires. (Ana Aizcorbe, Martha Starr and James T. Hickman, [“The Replacement Demand for Motor Vehicles: Evidence from the Survey of Consumer Finances,”](#) Board of Governors FEDS Working Paper 2003-44, July 2003.)

Tourism. In the Kansas City Fed's *Economic Review*, Chad Wilkerson argues that travel and tourism is the Rodney Dangerfield of U.S. industries. While the sector constitutes a bigger chunk of the economy (four to six percent) than residential construction or motor vehicle manufacturing, it receives far less attention from economists and policymakers. Like these industries, tourism is cyclical – it tends to languish in downturns and rebound during expansions. During 1990-91, however, tourism helped cushion the U.S. recession, because it grew slowly while the economy shrank. More recently, tourism hit its postwar nadir after the September 11 attacks and has yet to recover, exerting a persistent drag on the rest of the U.S. economy.

According to Wilkerson, tourism's share of overall output more than doubled during the second half of the 20th century – a finding that may be influenced by his definition of the sector as the sum of the hotel and lodging, air transportation, and amusement and recreation industries. Wilkerson acknowledges that the statistical basis for his historical comparison is fuzzy (in the 1950s, tourists were more likely to travel by train while their 1990s counterparts are more likely to visit amusement parks). But he does not explain why, according to his measures, tourism currently accounts for only 3.6 percent of U.S. employment, which is less than its share of GDP. The implication that tourism offers a source of high productivity jobs seems hard to square with the industry's labor-intensive, low-wage traditions. (Chad Wilkerson, [“Travel and Tourism: An Overlooked Industry in the U.S. and Tenth District,”](#) FRB Kansas City *Economic Review*, Third Quarter 2003.)

Public Sector and Miscellaneous

Affordable Housing. The idea that government can provide solutions to urban poverty has taken a beating along all points of the political spectrum. But a recent New York Fed conference on affordable housing made clear that bureaucracies can and do learn from past mistakes. And most of the conference proceedings – collected in the Bank's *Economic Policy Review* – express subdued optimism about the prospects for effective public-sector intervention in inner-city housing markets.

Seeking to avoid the problems associated with high-rise projects of the mid-twentieth century, housing policy in recent decades has tended to favor market-oriented mechanisms like vouchers that encourage mixed-income neighborhoods. Under the “Section 8” amendment to the 1974 Housing Act, low-income tenants receive subsidies for private sector housing, allowing them to limit the amount they pay in rent to one-third of their incomes. But even though Section 8 and other demand-side programs account for over half the federal funds going to active housing programs, Uncle Sam and local governments continue to finance some additions to the supply of affordable housing through tax credits and grants for construction and rehabilitation. Thus, experts continue to debate what constitutes an appropriate mix of demand- and supply-side interventions.

In their contribution to the FRB New York collection, Ingrid Gould Ellen, Michael H. Schill, Amy Ellen Schwartz, and Ioan Voicu emphasize the need to expand the stock of affordable housing. Noting that over \$5 billion in public funds has been invested in building and rehabbing low-income housing in the South Bronx and other hard-hit New York City neighborhoods since 1986, Ellen et al. suggest the capital infusion has succeeded, even though it was designed to make high-poverty neighborhoods more livable rather than to disperse poor families throughout the metro area. The authors attribute this success in part to New York's tight housing market, which renders voucher programs ineffective. They also claim that well-designed mixed-income developments can create positive neighborhood spillovers, unlike smaller-scale or diffuse government initiatives.

Skeptics counter that production programs cost more than demand-side mechanisms. However, unlike

vouchers, efforts such as Hope VI (which provides grants to revitalize severely distressed public housing) tend to reduce rents for the entire population of low-income tenants by increasing the supply of affordable housing. In contrast, Section 8 subsidies ratchet up the demand for rental units and thereby exert upward pressure on the rents paid by poor and working-class families who don't receive vouchers. (Oddly, neither Ellen et al. nor other contributors point out this advantage of boosting affordable housing stocks.) Moreover, an article by Denise DiPasquale, Dennis Fricke, and Daniel Garcia-Diaz finds that the cost gap between voucher and production programs is actually smaller than previous studies have suggested.

Meanwhile, Michael H. Schill and Glynis Daniels explain that public investment in housing has combined with rent control and other government programs to make New York more affordable for poor families than many other large metropolitan areas. Despite their budget-buster reputation, New York City rents actually grew slower than the national average in the late 1990s. Indeed, by 1999, New York ranked next-to-last among seven large U.S. cities in the share of families paying more than half their incomes on rent (Chicago, Los Angeles, Boston, San Francisco and Philadelphia had larger portions of families with severe rent burdens; only Houston had a smaller share).

Perhaps because of this favorable feature of its housing market – and the durability of strong renters' rights – New York still lags the nation in homeownership rates, clocking in at less than half the U.S. average. Thus it seems fair to assume that New Yorkers disproportionately miss out on the perceived benefits associated with home owning, such as higher rates of personal saving. However, much of the research on these benefits is fraught with methodological difficulties. For example, it can be extremely tricky to distinguish the direct advantages of homeownership from the indirect advantages of living in a neighborhood of homeowners.

In a study designed to separate the direct impact of homeownership from neighborhood effects, Joseph M. Harkness and Sandra J. Newman examine how home owning affects children. Their research confirms earlier findings that children of homeowners perform better in school, are less likely to end up on welfare and enjoy other positive developmental outcomes. Harkness and Newman also find that the direct conse-

quences of homeownership outweigh neighborhood effects in part because measures of community stability are surprisingly similar between homeowner and renter neighborhoods.

The advantages of homeownership notwithstanding, it remains eminently possible to improve the lives of poor families who rent their homes. The provisional findings of the "Moving to Opportunity" (MTO) experiment indicate that children whose families received MTO assistance in order to move from housing projects to rental properties in low-poverty neighborhoods do better in school, have fewer behavior problems (including arrests for violent crime), and are less likely to be injured or have asthma attacks. According to John Goering, who summarizes the existing research, it is not always clear to what extent these improvements are attributable to families moving out of the projects (into any neighborhood) and to what extent they are due to their relocating in low-poverty neighborhoods – a question that will be addressed more thoroughly in ongoing research on the MTO program. (Ingrid Gould Ellen, Michael H. Schill, Amy Ellen Schwartz, and Ioan Voicu, "Housing Production Subsidies and Neighborhood Revitalization: New York City's Ten-Year Capital Plan for Housing;" Denise DiPasquale, Dennis Fricke, and Daniel Garcia-Diaz, "Comparing the Costs of Federal Housing Assistance Programs;" Michael H. Schill and Glynis Daniels, "State of New York City's Housing and Neighborhoods: An Overview of Recent Trends;" Joseph M. Harkness and Sandra J. Newman, "Effects of Homeownership on Children: The Role of Neighborhood Characteristics and Family Income;" John Goering, "The Impacts of New Neighborhoods on Poor Families: Evaluating the Policy Implications of the Moving to Opportunity Demonstration;" in FRB New York *Economic Policy Review*, June 2003.)

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