

POLICY ISSUES

FEDERAL RESERVE BANK OF CHICAGO

A DIGEST OF THIRD-QUARTER POLICY RESEARCH

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WELCOME TO ANOTHER EDITION OF *POLICY ISSUES*, a periodic digest summarizing research, analyses and policy positions produced by the Federal Reserve of Chicago. This issue contains summaries of research and analyses produced during the third quarter of 2000, including research appearing in Chicago Fed publications, as well as research by Bank staff printed in external publications.

EMERGING PAYMENTS CONFERENCE

On October 10-11, 2000, the Bank hosted a conference, "Promoting the Use of Electronic Payments: Considering Future Requirements." The conference addressed the future development and broader use of electronic payments. It focused on such issues as: what we have learned from other countries' experience with electronic banking, what are the business cases for alternative payment innovations, and how technology, security and legal policies are evolving. Proceedings will be available soon.

RISK MANAGEMENT IN THE GLOBAL ECONOMY

On September 21 - 23, 2000, the Bank and the *Journal of Banking and Finance* sponsored a symposium, "Risk Management in the Global Economy: Measurement, Management, and Macroeconomic Implications," as part of a series on "The Financial System in the Third Millennium: Perspectives and Problems." Recent events in global capital markets have highlighted the importance of sound risk management techniques to efficient and effective financial markets. Individual firms, governments and international financial agencies have all had to deal with a plethora of complex instruments and positions. In some cases an inadequate understanding of risk management instruments and positions contributed to the failure of some firms and governmental organizations. Many policy-makers viewed a number of these situations as severe enough to be a threat to the stability of the global financial system. Proceedings will be available soon.

FOSTERING MAINSTREAM FINANCIAL ACCESS FOR THE UNBANKED

This new page on the Federal Reserve Bank of Chicago's Web site has been designed as an Internet-based, one-stop information source for those interested in improving the delivery of affordable and convenient mainstream financial services to underserved consumers. The page encourages and supports research and innovation in the improved delivery of affordable, convenient financial products and services to the nation's underserved consumers. The site has been designed to appeal to the widest audience possible, including academics, government officials, nonprofit organizations and banks and other financial services providers. Materials include academic research, current events, current and pending legislation and regulation, conferences and workshops, demonstration projects, financial literacy programs, and innovative product offerings by the financial services industry. The site also includes a search engine to assist users in locating materials pertinent to their needs, as well as an interactive component, which allows users to submit information of interest to others interested in financially underserved consumer issues.

RESEARCH SOURCE DESCRIPTIONS

Full-text Chicago Fed research, analyses and policy positions are contained in the Bank's published works described below.

CHICAGO FED LETTER

A monthly newsletter, intended for a general audience, featuring an essay on an economic or financial issue of regional or national interest. Includes a regional economic index.

ECONOMIC PERSPECTIVES

A quarterly journal of in-depth articles reporting on the Bank's economic research.

WORKING PAPERS

A series of research studies aimed at academic audiences and intended to generate comments and suggestions regarding research in the study. Working papers cover various macroeconomic and microeconomic topics such as monetary policy, the Midwest economy, the financial sector and labor markets.

PUBLIC-POLICY STUDIES

Occasional studies on various policy issues that are generally less technical and more appropriate for a wider audience than working papers.

COMMENT LETTERS

Letters written by the Federal Reserve Bank of Chicago in response to requests for public comments on proposed regulatory changes related to banking or other areas. The letters communicate the Bank's policy-related research, as well as analyses and positions in areas such as financial markets and risk management.

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The views expressed in the research and analyses summarized in *Policy Issues* are the authors' and do not necessarily reflect the views of the Federal Reserve Bank of Chicago or the Federal Reserve System.

BANKING AND FINANCIAL ISSUES

Banking and Currency Crises and Systemic Risk: Lessons from Recent Events

by George G. Kaufman

Economic Perspectives, Third Quarter 2000, Vol. XXIV, Issue 3

Banking and currency crises have done severe economic damage in many countries in recent years. This article examines the causes and characteristics of these crises and the public policies intended to prevent them or mitigate their adverse consequences.


<http://www.frbchi.org>
Collateral Damage Detected:

by Jon Frye

Supervision and Regulation Emerging Issues Series

In a period of high default, it is intuitive that debt recovery would run low. This intuition is confirmed by data on U.S. corporate bonds. Using the bond data to estimate an appropriate credit model, we extrapolate that in a severe economic downturn recoveries might decline 20-25 percentage points from the normal-year average. Loan recoveries may decline by a similar amount, but from a higher level. This could cause loss given default to increase by nearly 100% and to have a proportionate effect on economic capital. But correlated recovery risk is absent from first-generation credit models. Therefore, these models may significantly understate the capital required at banking institutions.


<http://www.frbchi.org>
Predicting Inadequate Capitalization: Early Warning system for Bank Supervision

by Julapa A. Jagtiani, James W. Kolari, Catharine M. Lemieux, and G. Hwan Shin

Supervision and Regulation Emerging Issues Series September 2000 (S&R-2000-10R)

This paper seeks to examine the efficacy of early warning system (EWSs) with respect to predicting incipient financial distress of banking institutions. A sample of banks with total assets between \$300 million and \$1 billion is gathered, financial and economic data for individual banks are collected, and EWSs that have been applied in banking studies are tested. Rather than attempting to predict bank failure as in previous banking literature, we classify banks as capital adequate or capital inadequate and seek to predict inadequately capitalized banks one year prior to the initial decline of the capital ratio. The EWS models developed in this paper could identify capital inadequate banks with a reasonable degree of accuracy. Thus, our models could be potentially useful as effective EWSs for purposes of supervisory action.


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Do Markets React to Bank Examination Ratings? Evidence of Indirect Disclosure of Management Quality through BHCs' Applications to Convert to FHCs

by Linda Allen, Julapa Jagtiani, James Moser

Supervision and Regulation Emerging Issues Series October 2000 (S&R-2000-9R)

Certain nonrecurring circumstances associated with the passage of the Financial Services Modernization Act of 1999 have created a unique opportunity for the market to obtain bank examination ratings of management quality. We utilize this natural experiment in order to determine how the market views this heretofore private information. We find that the stock market utilized bank examination ratings in order to reveal regulatory intent, rather than simply as information about management quality. Revelation of unsatisfactory M ratings (denoted "bad news") causes BHC stock returns and market risk betas to increase, whereas revelation of acceptable M ratings ("good news") causes BHC stock returns and market risk betas to decrease. The market thrives on "bad news" because unsatisfactory M ratings indicate that regulatory intervention is likely to occur, possibly benefiting both shareholders and creditors. On the other hand, revelation of acceptable M ratings ("good news") indicates that bank regulators are unprepared to intervene in the near future. Moreover, we find lower bond spreads for the subsample of FHCs with satisfactory M ratings revealed upon conversion.



<http://www.frbchi.org>

Interest-rate Derivatives and Bank Lending

by James T. Moser, Elijah Brewer III, and Bernadette Minton

Journal of Banking and Finance, Vol. 24, March 2000, pp. 353-379.

We study the relationship between bank participation in derivatives contracting and bank lending for the period 30 June 1985 through the end of 1992. Since 1985 commercial banks have become active participants in the interest-rate derivative products markets as end-users, or intermediaries, or both. Over much of this period significant changes were made in the composition of bank portfolios. We find that banks using interest-rate derivatives experience greater growth in their commercial and industrial (C&I) loan portfolios than banks that do not use these financial instruments. This result is consistent with the model of Diamond (1984) which predicts that intermediaries' use of derivatives enables increased reliance on their comparative advantage as delegated monitors.



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Algorithms for Solving Dynamic Models with Occasionally Binding Constraints

by, Jonas D. Fisher and Larry Christiano

Journal of Economic Dynamics and Control, July 2000.

We describe and compare several algorithms for approximating the solution to a model in which inequality constraints occasionally bind. Their performance is evaluated and compared using various parameterizations of the one sector growth model with irreversible investment. We develop parameterized expectation algorithms which, on the basis of speed, accuracy and convenience of implementation, appear to dominate the other algorithms.


<http://www.elsevier.com/inca/publications/store/5/0/5/5/4/7/>
Understanding Intraday Credit in Large-Value Payment Systems

By Ruilin Zhou

Economic Perspectives, Third Quarter 2000, Vol. XXIV, Issue 3

This article explains how large-value payment systems work, using either gross or net settlement. The author discusses risk control in a real-time gross settlement system and analyzes the pricing of credit to provide intraday liquidity. She argues for distinguishing between consumption/investment debt and payment debt. A theoretical model suggests that, under the assumption that there are no opportunities for intraday optimization of consumption and production, the risk-free rate on intraday payment credit should be zero. This is because the cost of intraday liquidity is a transaction cost of the underlying goods/assets trade and, thus, should be minimized.


<http://www.frbchi.org/pubsspeech/publications/periodicals/ep/2000/3qep3.pdf>
Changing Financial Industry Structure and Regulation

By Elijah Brewer III and Douglas D. Evanoff

Chicago Fed Letter, September 2000, No. 157a

On May 3-5, 2000, the Federal Reserve Bank of Chicago held its 36th annual Conference on Bank Structure and Competition, focusing on the changing financial industry structure and regulation. This Chicago Fed Letter summarizes key issues discussed at the conference, including new opportunities for financial service providers, antitrust work in the changing financial environment and new financial delivery systems. Planning for the 2001 Bank Structure Conference, scheduled for May 9-11, 2001, is currently underway.


http://www.frbchi.org/pubs-speech/publications/periodicals/chilet/cflsep2000_157a.pdf

A Modest Proposal: Securitizing Multinational LDC Debt

by James T. Moser

Chicago Fed Letter, September 2000, No. 157

The developments of the last five years suggest that political support for the IMF's debt workout arrangements for less developed countries (LDCs) is declining. This Chicago Fed Letter outlines one potential alternative to the present framework. Innovations in financial architecture have led to the successful development of securitization trusts as a cost-effective means of managing credit risk. Securitization trusts offer the potential to decrease the dependence of debtor nations on the well-developed countries. Greater LDC autonomy over economic policy can go a long way toward lessening frictions between have and have-not nations, while simultaneously maintaining a supply of readily available credit to meet crisis situations.



http://www.frbchi.org/pubsspeech/publications/periodicals/chilet/cflsep2000_157.pdf

For How Long Are Newly Chartered Banks Financially Fragile?

by Robert DeYoung

Working Paper WP-2000-9

This paper examines the financial performance of 1,664 commercial banks chartered between 1980 and 1985, a period of intense chartering activity preceding the banking recession of the late 1980s. The author estimates the probability distribution of failure for these new banks, and compares the findings to a benchmark sample of small established banks. The findings show that the fragility of a new bank varies over time in a fairly regular "life-cycle" pattern. On average, new banks are initially less likely to fail than established banks; after about four years, they become more likely to fail than established banks; and as time passes and new banks mature, they fail at rates similar to those of established banks. But these failure patterns varied across banks depending on economic, regulatory, and financial conditions. Banks chartered just prior to the banking recession failed at the highest rates. State laws restricting the acquisition of new banks are associated with higher rates of new bank failure, but easy-entry chartering policies are not. The new banks were more sensitive to capital levels than the established banks, evidence that justifies recent increases in minimum capital requirements for new banks. Finally, the results suggest that early warning signals may be easier to identify for new banks than for established banks, perhaps because banks in the early stages of their life cycles are less heterogeneous and, hence, simpler to model than mature banks.



http://research.frbchi.org/WorkingPapers/wp2000_09.pdf



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Subordinated Debt and Bank Capital Reform

by Douglas D. Evanoff and Larry D. Wall

Working Paper WP-2000-7

In recent years there has been a growing realization that there are significant problems with the current bank risk-based capital guidelines. As financial firms have become more sophisticated and complex they have effectively arbitrated the existing capital requirements. They have become so good at avoiding the intent of capital regulation that the regulations have essentially ceased being a safety and soundness issue for supervisors and have become more a compliance issue.

The goal of this article is to provide a comprehensive review and evaluation of the purpose and potential of subordinated debt proposals and to present a regulatory reform proposal that incorporates what the authors believe are the most desirable characteristics of subordinated debt. The article is intended as a reference piece from which readers new to the topic may find a thorough review of the issues, and others can draw on specific aspects of the debate. Coverage includes: (1) a discussion of the characteristics of sub-debt that make it attractive for imposing market and supervisory discipline on banks; (2) an explanation of how current regulatory arrangements do not allow these features to be fully utilized; (3) a discussion of the role of debt markets, equity markets, and supervision in disciplining firm behavior, and how the use of sub-debt avoids many of the problems associated with alternative regulatory proposals; (4) a review of the evidence on the extent of market pricing and disciplining of risk imposed by holders of bank liabilities; (5) a review of some of the existing sub-debt proposals, emphasizing their differences and the reasoning behind those differences; (6) a new regulatory reform proposal that increases the role of sub-debt and (7) a discussion of some of the standard questions raised about sub-debt proposals and, when appropriate, an explanation of how the authors' proposal addresses these concerns.



http://research.frbchi.org/WorkingPapers/wp2000_07.pdf

Hedging the Risk

by Michael Atz

Supervision & Regulation Emerging Issues-2000-7 (Policy Study), July 2000

This paper discusses the opportunities banks have when dealing with hedge funds. It identifies the various hedge-fund investing strategies and their investment returns for the first four months of 2000, as well as outlines the many ways in which banks interact with hedge funds. Loans and lines of credit are the most basic services that banks provide to hedge funds. The question then becomes one of leverage. Banks also interact with hedge funds in several other ways. Banks with extensive trading operations can often find themselves investing in some of the same instruments as the hedge funds that borrow from them. Finally, this paper briefly identifies each of the risks banks must recognize and manage as they deal with hedge funds. They include credit, reputation, market pricing, counter-party, legal and liquidity risks.



<http://www.frbchi.org/regulation/WorkingPapers/sr20007.pdf>

Home Mortgage Lending by Applicant Race/Ethnicity: Do HMDA Figures Provide a Distorted Picture?

by Paul Huck

Consumer Issues Research Series-2000-3 (Policy Study), July 2000

The Home Mortgage Disclosure Act of 1975 (HMDA) was designed to further the goal of fair access to mortgage credit and requires lenders to report information including the location, loan amount, income, and the race/ethnicity and sex of the applicant(s) for each application taken by the lender. However, the race/ethnicity of applications taken by mail or phone is not provided in a significant proportion of applications. Given the widespread use of HMDA data by lenders, community groups, researchers and regulators and the importance of mortgage lending as a public-policy issue, the strengths and shortcomings of the data must be clearly understood.

The main findings are that reported approval rates by race/ethnicity are significantly overstated for refinance and home-improvement loans, whereas home-purchase loans are little affected by this reporting problem. A review of trends in how race/ethnicity is reported and in the technology of mortgage lending leads to the reasonable conjecture that missing race/ethnicity will become a bigger problem in the near future.


<http://www.frbchi.org>
Comment Letter to the Committee for Systemically Important Payment Systems, Bank for International Settlements, Re: Core Principles for Systemically Important Payment Systems

A Response by the Federal Reserve Bank of Chicago

September 8, 2000

This letter is a follow-up to comments submitted in March 2000 about Part 1 of the Report of the Task Force on Payment System Principles and Practices entitled Core Principles for Systemically Important Payment Systems. The letter outlines several recommendations to help support the Committee's goal of assuring that systemically important payment systems are designed, operated and overseen in a manner that is consistent with the public interest. The Bank advocates a standard of little or no credit risk and little or no liquidity risk for systemically important payment systems. This letter draws on analyses from Bill Bergman, Richard Lamm, James Moser and Robert Steigerwald.



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Comment Letter to the Commodity Futures Trading Commission, Re: Regulatory Reinvention, Proposed Rules Concerning Intermediaries, Clearing Organization Reinvention and Exemption for Bilateral Transactions, 65 Federal Register 38986-39039 (June 22, 2000)

A Response by the Federal Reserve Bank of Chicago

August 7, 2000

In this letter, the Bank supports the Commission's change in its regulatory approach from one of specific mandates to the consistent application of broad, flexible core principles. The Bank also notes that the proposed regulations are consistent with the unified and streamlined regulatory approach that the Bank suggested in its March 1999 letter to the Senate Committee on Agriculture, Nutrition and Forestry regarding reauthorization. This letter draws on analyses from Richard Lamm, John McPartland, James Moser and Robert Steigerwald.



Comment Letter to the Federal Reserve Board of Governors, Re: Modifying Federal Reserve ACH Deposit Deadlines and Pricing Practices Relative to Private-Sector ACH Operators, Docket No. R-1037

A Response by the Federal Reserve Bank of Chicago

July 25, 2000

This letter reiterates that competition by the Reserve Banks in the market for ACH services has been fair and in the public interest. Rather than view the current proposal as a remedy for presumed competitive inequity, the Bank regards it as a policy improvement that will increase coordination among ACH services providers and, consequently, enhance the value of the ACH to its users. In addition, the letter outlines potential adverse implications of the ACH operator definition for competitive equity among commercial ACH intermediaries. This letter draws on analyses from Eve Boboch, Edward Green and James Moser.



Comment Letter to the Federal System Board of Governors, Re: Truth in Lending, Docket No. R-1075

A Response by the Federal Reserve Bank of Chicago

September 1, 2000

This letter comments on proposed revisions to Regulation Z, Truth in Lending, with specific reference to Section 32, Home Owners and Equity Protection Act of 1994, to address the reported increase in predatory lending practices in the home-equity lending market. It notes that the Chicago Fed shares the public's concern regarding predatory lending practices in the mortgage markets but also recognizes that distinctions need to be made between legitimate, risk-based subprime lending and loans produced by abusive practices. The letter draws on analyses from Ken Davidson, William Lloyd, Lauren Pilot-Mitchell and Lorrie Woos.



ECONOMIC ISSUES

Reexamining the Filibuster and Proposal Powers in the Senate

by Leslie M. McGranahan and Alison Alter

Legislative Studies Quarterly, May 2000, pp. 259-284.

Conventional wisdom views the Senate filibuster as a protection of minority rights. In this paper we challenge this intuition by showing that this common belief always holds true only for specific assumptions about Senate procedures. We show that under an open rule, while the filibuster option may advantage the minority, it is also true that the filibuster option may benefit the proposer at the expense of the minority. Whether the filibuster under an open rule advantages or disadvantages the minority, the majority, or the proposer, is a function of the proposer's preferred policy, the status quo, and the costs faced by potential filibusterers.

The Benefit Principle as a Preferred Approach to Taxing Business

by William A. Testa, William H. Oakland

Economic Development Quarterly, May, 2000.

State-local tax policies to encourage growth and development have been roundly criticized as detrimental to social welfare. In response, recent proposals have included delimiting the ability of states and localities to fashion tax policies. Not only are such proposals unworkable, but they fail to harness the creative energy and ideas of development practitioners because they act competitively to foster growth and development. The authors propose an alternative basis on which to fashion state-local taxation of business—that is, the so-called benefit principle—which aligns business taxes with costs of government services received by business entities.

(S,s) Inventory policies in general equilibrium

by Jonas D. Fisher and Andreas Hornstein,

Review of Economic Studies, January, Vol. 67(1), No. 230, pp. 117-146.

We study the aggregate implications of (S, s) inventory policies in a dynamic general equilibrium model with aggregate uncertainty. Firms in the model's retail sector face idiosyncratic demand risk, and (S, s) inventory policies are optimal because of fixed order costs. The distribution of inventory holdings affects the aggregate outcome in two ways: variation in the decision to order and variation in the rate of sale through the pricing decisions of retailers. We find that both mechanisms must operate to reconcile observations that orders are more volatile than, and inventory investment is positively correlated with, sales, while remaining consistent with other salient business cycle characteristics. The model exhibits strong amplification for some shocks and persistence to a limited extent.


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INTERNATIONAL ISSUES

Disruptions in Global Financial Markets: The Role of Public Policy

by Michael Moskow

Economic Perspectives, Third Quarter 2000, Vol. XXIV, Issue 3

How should public policy evolve in light of the recent series of financial crises worldwide? In this article, the author argues that market discipline must play an essential role in any future policy reforms.



<http://www.frbchi.org/pubs-speech/publications/periodicals/ep/2000/3qep1.pdf>

Understanding the Korean and Thai Currency Crises

By Craig Burnside, Martin Eichenbaum and Sergio Rebelo

Economic Perspectives, Third Quarter 2000, Vol. XXIV, Issue 3

This article reviews and interprets the recent currency crises in Korea and Thailand. The authors argue that a prime cause of the crises were large, unfunded government guarantees to failing financial sectors.



<http://www.frbchi.org/pubs-speech/publications/periodicals/ep/2000/3qep3.pdf>

LABOR AND HOUSEHOLD ISSUES

A Note on the Benefits of Homeownership

by Daniel R. Aaronson

Journal of Urban Economics, May 2000.

This brief note adds to recent work that attempts to identify externalities associated with homeownership. The results suggest that some of the homeownership effect found by Green and White is driven by family characteristics associated with homeownership, especially residential stability. However, as much as homeownership increases residential stability, it appears to be correlated with higher school attainment. Attempts to control for endogeneity cannot eliminate this finding.



<http://www.apnet.com/www/journal/ue.htm>

Part-Time Work and Hourly Wages

by Daniel Aaronson and Eric French

Chicago Fed Letter, August 2000, No. 156

Many studies find a correlation between how much a worker is paid (per hour) and how many hours he or she works. The usual casual interpretation of this correlation is that those with lower wages choose to work fewer hours. However, it's also possible that those who work fewer hours are offered lower wages. The authors find evidence that the latter interpretation may be relevant as well, at least for older workers. That means that researchers are potentially overestimating the response to work incentives of high wages. This is important because tax cuts are viewed as similar to wage increases. Therefore, unless labor-supply analyses account for part-time workers earning less than full-time workers, the work disincentives of taxes may be overestimated. This Chicago Fed Letter summarizes the nature of this problem, offers an empirical solution, and discusses public-policy issues related to it.



http://www.frbchi.org/pubs-speech/publications/periodicals/chilet/cflaug2000_156.pdf

Understanding the (Relative) Fall and Rise of Construction Wages

by David B. Oppedahl

Chicago Fed Letter, July 2000, No. 155

The labor market for the construction industry has been especially tight after the construction boom of the 1990s. This has resulted in wage increases beyond those found in other industries, departing from the long-term trend of downward relative wages for construction workers. However, the long-term trend suggests continued de-skilling in the construction sector, which will lead to further downward pressure on wages. In view of this, the relative wage gains for construction workers may not be sustainable.



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The Labor Supply Response to (Mismeasured but) Predictable Wage Changes

by Eric French

Working Paper WP-2000-8

Problems with measurement error have led many researchers to criticize panel data studies of intertemporal labor supply. In this study, the author addresses the measurement error problems explicitly. The author estimates the properties of measurement error in the Panel Study of Income Dynamics Validation Study. He then uses this information about measurement error to purge measurement error from the Panel Study of Income Dynamics, showing there exists a large transitory component to wages, even after accounting for measurement error. While wage changes may not be predictable, transitory wage changes predictably disappear. When estimating the labor supply response to these predictable wage changes, the author accounts for serially correlated measurement error and for measurement error that is correlated with true hours and wages. The author finds almost no correlation between hours worked and predictable wage changes. Therefore, failure to control for measurement error cannot explain the low estimated labor supply elasticities in other papers.



http://research.frbchi.org/WorkingPapers/wp2000_08.pdf

REGIONAL ISSUES

Emerging Urban Markets in the Midwest

by Loula S. Merkel and William A. Testa

Chicago Fed Letter, July 2000, No. 155a

Midwest cities began to turn around their fortunes in the 1990s, not through outside assistance but by building on their inherent advantages and by virtue of favorable trends. In the first quarter of 2000, the Federal Reserve Bank of Chicago held a series of conferences on the potential of emerging inner-city markets. Conference participants represented a wide range of stakeholders, including private business organizations, public and nonprofit agencies, and academics. The essay summarizes the discussions and highlights the issues presented at the conferences.



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