

Research UPDATE

from the Federal Reserve Bank of New York

RESEARCH AND MARKET ANALYSIS GROUP

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RMAG Plans to Expand Electronic Distribution of Publications

The Research and Market Analysis Group is taking steps to expand the electronic distribution of its publications and to increase reader awareness of the on-line services it offers. We have long made available at our web site (www.ny.frb.org/rmaghome) the latest releases in our research series as well as a large collection of articles and papers dating back to 1995. Now, in a new move, we are posting publications on the web site *before* the print copies are available. This means that our on-line readers can enjoy early access to articles that will appear in upcoming issues of the *Economic Policy Review* and *Current Issues in Economics and Finance*.

To receive word of the advance posting of our publications, readers can sign up for our free Electronic Alert service at the RMAG web site. Subscribers receive timely e-mails alerting them to the availability of new research publications at the site. Links built into the e-mails connect to the publications for swift access.

In another new initiative to attract on-line readers, we are upgrading our web site to enable

users to search our publication listings by field of interest. This new feature will be phased in later this year. We are also promoting our work in the electronic journals published by the Social Science Research Network. Abstracts of papers in our *Staff Reports* series appear in the journals; SSRN subscribers can link to the papers to read and download them in their entirety.

We also offer other on-line services to speed access to our publications and direct readers to related research:

- Our site doubles as the gateway to the huge array of publications produced by the Federal Reserve Board and the other banks in the Federal Reserve System. Visitors can

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search these materials by publication topic, keyword, author, or JEL code. They can then link directly to the materials or order print copies electronically.

- At our economists' home pages, readers can find comprehensive information on the economists' Bank and non-Bank publications. The connecting links take readers directly to many of these publications.

- Our regional economy page offers important information to visitors interested in the Federal Reserve's Second District. For instance, they can review the New York Fed's projections for job growth in the region or link to graphs profiling New York–New Jersey economic trends.

U.S. Budget Surpluses, and Their Challenges, Are the Focus of a Fed Conference

The past several years of strong real growth and low inflation have transformed the U.S. economy from one burdened by large budget deficits to one enjoying two straight years of surpluses, with projections for a continuation. However, with this solid fiscal performance have come unique challenges to the financial markets, which must adjust to the shrinking supply of new Treasury debt resulting from the surpluses.

To offer insight into these developments, last December the Federal Reserve Bank of New York organized the conference “Fiscal Policy in an Era of Surpluses: Economic and Financial Implications.” The conference proceedings were published in the latest issue of the Bank's *Economic Policy Review* (vol. 6, no. 1).

More than 100 market participants, policymakers, and academics attended the conference. They began by examining the economic forces

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.

The nation's recent fiscal improvement has raised concerns about the declining supply of Treasury securities.

and policy developments that have led to the nation's recent fiscal improvement. Some contended that much of the improvement could be traced to the rapid growth of individual tax receipts resulting from the shift in income distribution and sizable capital-gains realizations. Others cautioned that the growth in entitlement spending, an outlay that claims a large share of the federal budget, could potentially spawn deficits in the long run.

In a discussion of the federal budget's effect on the economy, a key point to emerge was that automatic stabilizers, such as the progressive income tax and transfer payments, continue to moderate economic fluctuations. Some of the participants also noted that the new decade should see a continued reduction in the ratio of Treasury debt to GDP.

From the market perspective, a main concern was how to enhance liquidity amid declining volumes of new Treasury issues. Among the solutions put forth was the proposal that the Treasury issue 104-week bills and allow market participants to create new stripped instruments by exchanging with the Treasury coupon securities or principal payments of similar maturities.

The final session considered the current and future benchmark status of the Treasury mar-

Forthcoming in the *Economic Policy Review*

The following article, slated for spring publication, is available at our web site:

- "The Timing and Funding of Fedwire Funds Transfers" by James McAndrews and Samira Rajan.

McAndrews and Rajan attribute the late-afternoon peak in Fedwire funds transfers to attempts by banks to coordinate payment timing more closely. To enable banks to realize even higher levels of coordination and the reduction in financing costs that could result, the authors propose the creation of synchronization periods. During these periods, banks could expect to receive incoming payments entered by paying banks.

ket. Discussants observed that the attributes that make the market a good benchmark—high market liquidity, efficiency, and trading activity—were weakened by the financial market crisis of 1998 and have yet to recover fully. Moreover, other markets—namely, those for agency debt, corporate debt, and interest rate swaps—have features that make them attractive alternative benchmarks. Nevertheless, some conference attendees argued that many of these alternatives themselves lack the attributes desirable in a benchmark.

E-Commerce Prompts Banks to Alter Business Strategies

How are banks responding to the rapid growth of on-line commerce? In "The Emerging Role of Banks in E-Commerce" (*Current Issues in Economics and Finance*, vol. 6, no. 3),

John Wenninger sees some signs that banks are changing their business strategies to become actively involved in the electronic marketplace.

According to Wenninger, banks have already begun to use the Internet as a supplementary channel for delivering traditional credit and deposit services. In addition, some banks are taking the further step of developing new products designed specifically for e-commerce. These products include electronic billing and collection services, the issuance of electronic money and checks, and the verification of identities for e-commerce participants. A few of the largest commercial banks have undertaken to help firms automate their transactions with suppliers, distributors, and retailers.

If these on-line products prove successful, Wenninger observes, “banks may increasingly act as e-commerce facilitators while their long-standing business lines decline in importance.”

Wenninger’s study also examines the new forms of competition facing banks in the electronic marketplace. One potential rival—banks that operate exclusively on the Internet—may be able to offer more attractive deposit and

loan rates than many traditional banks because they do not need to support a costly branch network. Other competitive pressures will arise as electronic “information aggregators” search out the most favorable rates on deposits and mortgages and release their findings on-line. Once consumers are able to comparison-shop for the best rates across institutions and across geographic areas, banks may see a weakening of their market power in local regions.

With the shift toward electronics, banks will also encounter new strategic risks. In particular, Wenninger notes the danger that banks will misjudge the degree to which electronic banking will substitute for traditional forms of banking. Currently, it is unclear whether on-line banking will supplement the existing “brick and mortar” branch networks or substantially replace them. Banks that choose to scale back the size of their branch networks too sharply run the risk of alienating segments of their customer base that are not ready to rely fully on electronic banking.

Call for Papers on Financial E-Commerce

On February 23-24, 2001, the Federal Reserve Bank of New York and the *Journal of Financial Services Research* will cosponsor a conference on financial e-commerce. Interested individuals may now submit papers for review by a selection committee.

Selected papers will be published in a special issue of the *Journal of Financial Services Research*, to be edited by Franklin Allen of the University of Pennsylvania and James McAndrews and Philip Strahan of the Federal Reserve Bank of New York’s Research and Market Analysis Group.

For complete information on the submission procedures, please go to www.ny.frb.org/rmaghome. You can also contact jamie.mcandrews@ny.frb.org.

Fed Conference to Examine How Technological Change and Regulatory Reform Will Affect the Financial System

On June 9, the Federal Reserve Bank of New York will sponsor the conference “Specialization, Diversification, and the Structure of the Financial System: The Impact of Technological Change and Regulatory Reform.”

The conference will examine the implications of divergent corporate strategies: a commitment to specialize in core business lines, on the one hand, and a move to diversify across a wide range of products and services, on the other. Participants will discuss the forces shaping the choices made by banks, insurers, and securities firms; the risks and

rewards of various corporate strategies; and the issues raised for supervisors and risk managers.

Professionals in the fields of banking, insurance, securities, economics, risk management, and bank supervision will attend the conference, which is being organized by the Bank’s Banking Studies area. The conference proceedings will be published in a future issue of the Bank’s *Economic Policy Review*.

To learn more about the conference, please go to www.ny.frb.org/rmaghome.

Recently Published

Don Morgan. 2000. “Capital Market Frictions and Deposit Constraints at Banks,” with Jith Jayaratne. *Journal of Money, Credit, and Banking* 32, no. 1 (February): 74-92.

Carol Osler. 2000. “Rational Speculators and Exchange Rate Volatility,” with John A. Carlson. *European Economic Review* 44 (January): 231-53.

Paolo Pesenti. 1999. “Stability, Asymmetry, and Discontinuity: The Launch of European Monetary Union,” with Giancarlo Corsetti. *Brookings Papers on Economic Activity*, no. 2 (December): 295-372.

Eric van Wincoop. 2000. “Do Borders Matter? Evidence from Japanese Regional Net Capital Flows,” with Yasushi Iwamoto. *International Economic Review* 41, no. 1: 241-69.

Eric van Wincoop. 2000. “A Method for Solving Multi-Region Models.” *Economics Letters* 66, no. 3 (March): 333-6.

Eric van Wincoop. 2000. “Trade in Nominal Assets and Net International Capital Flows,” with Philippe Bacchetta. *Journal of International Money and Finance* 19, no. 1 (February): 55-72.

New Titles in the *Staff Reports* Series

The following new *Staff Reports* are available at www.ny.frb.org/rmaghome.

Macroeconomics and Growth

No. 101

Microeconomic Inventory Adjustment: Evidence from U.S. Firm-Level Data

Jonathan McCarthy and Egon Zakrajšek

The authors examine inventory adjustment in the U.S. manufacturing sector using quarterly firm-level data over the 1978-97 period. Their evidence indicates that the inventory investment process is nonlinear and asymmetric, results consistent with a nonconvex adjustment cost structure.

International

No. 96

Can Vertical Specialization Explain the Growth of World Trade?

Kei-Mu Yi

Yi demonstrates that the enormous growth in the trade share of output can be reconciled with the relatively small declines in tariffs worldwide once vertical specialization is included in international trade models. Vertical specialization magnifies the trade growth effects of trade barrier reduction. The author simulates a dynamic model of trade with vertical specialization and finds that it can explain about 70 percent of the growth of trade.

No. 100

Towards New Open Economy Macroeconometrics

Fabio Ghironi

Ghironi develops a model that lends itself more directly to empirical investigation than other recent open economy models. He proposes a plausible strategy for parameter estimation using data from Canada and the United States. The author then proceeds to illustrate a practical application of the model, showing how a shock to the U.S. economy is transmitted to Canada under an inflation-targeting monetary regime.

Microeconomics

No. 97

What Do We Really Know about Trends in Outpatient Medical Expenditures for Children, 1977 to 1987?

Carol Rapaport and Christopher A. Trenholm

Rapaport and Trenholm examine patterns in medical expenditures for children in the 1977-87 period. They find that expenditures declined for Hispanic children and children in poor families relative to other children but remained stable for black children and children on Medicaid. These results suggest that the recent Medicaid expansions may not help all children attain good health.

Banking and Finance

No. 98

Compositional Dynamics and the Performance of the U.S. Banking Industry

Kevin J. Stiroh

The author presents a decomposition framework for commercial banks and shows that both firm-level changes and dynamic reallocation effects have made substantial contributions to the changes in the profitability and capitalization of the U.S. banking industry from 1976 to 1998. His results provide a new perspective for understanding the impact of changes in competition on the performance of the U.S. banking industry.

No. 99

Monetary Policy Surprises and Interest Rates: Evidence from the Fed Funds Futures Markets

Kenneth N. Kuttner

Kuttner estimates the impact of monetary policy actions on bill, note, and bond yields, using data from the futures market for federal funds to separate changes in the target funds rate into anticipated and unanticipated components. The response of bond rates to anticipated changes is found to be essentially zero, while the response to unanticipated movements is large and highly significant.

Papers Presented by Economists in the Research and Market Analysis Group

“The Economic Significance of National Border Effects,” *Carolyn Evans*. University of Chicago Graduate School of Business Seminar, Chicago, Illinois, October 20, 1999.

Evans examines the economic significance of the downward effect of national borders on trade flows. She finds that national border effects may present distortionary barriers to trade and welfare costs, thereby creating policy challenges.

“Foreign and Domestic Bank Participation in Emerging Markets: Lessons from Mexico and Argentina,” *Linda Goldberg*. *International Financial Contagion: How It Spreads and How It Can Be Stopped*, a conference cosponsored by the Asian Development Bank, the International Monetary Fund, and the World Bank, Washington, D.C., February 3-4. With Gerard Dages and Daniel Kinney.

The paper’s findings suggest that the health of privately owned banks, and not foreign versus domestic ownership per se, is a critical element in the growth, volatility, and cyclicity of bank lending. Diversity in ownership appears to contribute to greater stability of credit in times of domestic crises and low domestic demand.

“Resurrecting the (C)CAPM: A Cross-Sectional Test When Risk Premia Are Time-Varying,” *Martin Lettau and Sydney Ludvigson*. National Bureau of Economic Research Asset Pricing Meeting, Chicago, Illinois, November 5, 1999.

Unlike many empirical tests of the (C)CAPM, this analysis specifies the pricing kernel as a conditional linear factor model, as would be expected if risk premia varied over time. It demonstrates that such conditional factor models can explain a substantial fraction of the cross-sectional variation in returns on portfolios sorted by size and book-market value.

“The (Past and) Future of European Currencies,” *Paolo Pesenti*. *The Future of National Currencies*, a conference sponsored by Pontificia Universidad Católica, Santiago, Chile, January 18-19. With Giancarlo Corsetti.

The paper analyzes recent monetary developments in Europe and discusses future prospects for European Economic and Monetary Union.

“Assessing the Impact of Short-Sale Constraints on the Gains from International Diversification,” *Asani Sarkar*. American Finance Association Meetings, Boston, Massachusetts, January 7-10.

The author finds that the benefit to U.S. investors from diversifying internationally, especially over emerging markets, remains substantial after short-sale constraints are imposed.

“Raising the Speed Limit: U.S. Economic Growth in the Information Age,” *Kevin Stiroh*. Brookings Institution Spring Conference, Washington, D.C., March 30-31. With Dale Jorgenson.

The paper examines the underpinnings of the successful performance of the U.S. economy in the late 1990s and finds information technology to be an important part of the growth resurgence.

“Beggars-Thy-Neighbor or Beggar-Thyself: The Income Effect of Exchange Rate Fluctuations,” *Cédric Tille*. National Bureau of Economic Research International Finance and Macroeconomics Program Meeting, Cambridge, Massachusetts, March 24.

The author analyzes the welfare effects of exchange rate fluctuations. He highlights the key role of import retailers who purchase goods from foreign firms to sell in the domestic market, a factor that has not been considered in the existing literature.

RESEARCH AND MARKET ANALYSIS GROUP PUBLICATIONS AND PAPERS: January–March 2000

Economic Policy Review, Vol. 6, No. 1

“Fiscal Policy in an Era of Surpluses: Economic and Financial Implications”
*Proceedings of a Conference Sponsored
by the Federal Reserve Bank of New York*

Papers include:

Formation of Fiscal Policy: The Experience
of the Past Twenty-Five Years
Alan J. Auerbach

The Automatic Fiscal Stabilizers: Quietly Doing
Their Thing
Darrel Cohen and Glenn Follette

The Near-Term Outlook for Fiscal Policy
Rudolph G. Penner

Fiscal Policy in an Era of Surpluses
Gary Gensler

Enhancing the Liquidity of U.S. Treasury
Securities in an Era of Surpluses
*Paul Bennett, Kenneth Garbade,
and John Kambhu*

The Benchmark U.S. Treasury Market: Recent
Performance and Possible Alternatives
Michael J. Fleming

Forthcoming Vol. 6, No. 2

The Timing and Funding of Fedwire Funds
Transfers
James McAndrews and Samira Rajan

Current Issues in Economics and Finance, Vol. 6

No. 1
Are High-Quality Firms Also High-Quality
Investments?
Peter Antunovich, David Laster, and Scott Mitnick

No. 2
Health Insurance Trends Point to an Increase in
Uninsured Children in New York and New Jersey
Carol Rapaport and Reagan Murray
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The views expressed in the publications and papers summarized in Research Update are those of the authors and do not necessarily reflect the position of the Federal Reserve Bank of New York or the Federal Reserve System.