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The Stock Market: Fundamentally Sound or on the Bubble?

Adam M. Zaretsky

Reserve requirements are enshrined in introductory economics textbooks as one of the "tools," albeit a crude one, of monetary policy. Such regulations are understood to affect the banking system, and, ultimately, the economy by influencing the proportion of total assets that depositories hold as cash assets (either vault cash or balances with the Federal Reserve).

The cause of the seemingly unending rise in recent stock prices is of keen interest to economists. Although several explanations have been proffered, the underlying controversy splits economists into two groups: those who believe the rise is justified by market fundamentals and those who do not. Clearly separating the two groups, though, is easier said than done.

Calculating asset values from market fundamentals is a method that's well-grounded in economic theory. It is based on expectations about firm profits and relies on two assumptions: 1) that individual agents act rationally; and 2) that markets operate efficiently. Agents acting rationally implies that stockholders will adjust their expectations in response to new information; markets operating efficiently implies that they will immediately incorporate new information into market prices.

The concept of efficient markets also implies that arbitrage opportunities do not exist. They occur, for example, when two assets that are perfect substitutes have different prices. In such a case, an arbitrageur will buy the lower-priced one and sell the higher-priced one (pocketing the profit) until the prices are the same. However, as recently stated in *The Economist*,"The deepest insight of financial economics is that markets are fairly 'efficient' meaning that you can earn high returns only by taking big risks. There really is no free lunch."

Still, many economists believe that asset prices do move away from fundamentals sometimes. When this occurs, asset prices are believed to be driven by speculation, which is thought to cause speculative bubbles. Two of the most famous examples of these bubbles are the stock market crashes of 1929 and 1987. Even today, some economists maintain that the strong performance of the U.S. stock market in recent years is being caused by a bubble, rather than changing fundamentals.

Attempting to explain the existence of bubbles, some economists have proposed that they may, in fact, be rational. Suppose, for instance, investors realize that fundamentals are not driving stock prices and that a bubble exists. They know it will burst, but don't know when it will burst, only that it could burst today. Consequently, investors, by assuming a higher-than-normal risk, demand a higher return—a rational response. That said, there is no compelling evidence in the literature that rational bubbles exist.

More often than not, though, bubbles seem to form because a group psychology overcomes investors, who start making decisions based on a perceived frenzy. The housing market offers a good analogy. In a survey of California respondents in the late 1980s, 75 percent agreed with the statement: "Housing prices are booming. Unless I buy now, I won't be able to afford a home later." (Housing prices increased roughly 20 percent between 1987 and 1988 in many California cities.) Only 28 percent of Milwaukee survey respondents agreed with the same statement. (Housing prices were unchanged there.) What seems to matter, then, is whether investors *think* "hot" markets are fads, which contradicts economists' assumption of rational agents. In such cases, prices are high today only because investors believe that prices will be high tomorrow, not because the fundamentals support these levels.

The issue is not easily resolved. Perhaps what is most important, though, is that investors can recognize when fundamentals are no longer driving asset prices. Anecdotal evidence appears to suggest that currently they are not—at least in some market sectors. For researchers, though, anecdotes aren't enough. To those economists persuaded of their presence, bubbles challenge the foundations of economic theory because they contradict the underlying assumption of rational agents, upon which economic models are based. To those not persuaded of their presence, market phenomena like the Great Depression, the stock market crash of October 1987, and other apparent bubbles, demand and await persuasive explanations.

For more information, see his article in the April 1999 issue of the St. Louis Fed's *Regional Economist.*

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Electronic Payments Continue to Rise, Fed Study Reveals

The Federal Reserve has commissioned a two-phased national study this year to gather information on retail payment volumes, attitudes and trends. In the first phase, the Fed hired Payment Technologies Inc. (PTI) to conduct a search of all existing studies and literature and prepare a report summarizing the findings. The full results of the first phase will be released later this summer, but preliminary results, released in May, show that all payment types are growing and that electronic payments of all forms are on the upswing.

PTI examined nearly all types of retail payments and found a number of trends. Following are summaries of some of the payment methods studied:

- **Cash**: Cash continues to be the dominant instrument for small-dollar purchases.
- **Checks**: Despite increases in electronic payment methods, checks continue to grow at an annual clip of about 2 percent.
- **Credit Cards**: Credit cards are expected to continue growing, but at a slower pace. They are one of the most costly forms of payment acceptance among retailers.
- **Debit Cards**: Both online and offline use of debit cards is growing, though offline debit (which entails linking to the Visa and MasterCard networks, rather than the user's checking or savings account) is cannibalizing the existing account base.
- **Internet Payments**: These types of payments are growing dramatically, and that growth is expected to continue. Of the 51.3 million consumers who routinely access the Internet, 21.5 million (42 percent) are comfortable providing their credit card information for online purchases.

The second phase of the study, a quantitative survey of consumers, businesses and financial institutions, will take place this fall. That phase will be designed to fill in the knowledge gaps and answer questions still pending about retail payments. The entire study was commissioned in the wake of the Fed's 1997 review, led by Vice Chair Alice Rivlin, of its role in the payments system.

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Feditorial: Providing a Bridge to the Community

William Poole

I knew little of the Federal Reserve's community affairs responsibilities when I became president of the St. Louis Fed in March 1998, but the more I have learned, the greater my pride in the work of our Community Affairs Department. We reach a wide array of audiences through this department—from financial institutions to community development organizations, from small businesses to government agencies.

The involvement of the Federal Reserve System in this area is nothing new. Since 1981, Community Affairs staff members around the System have supported the Fed's economic growth objectives by promoting community development and fair and impartial access to credit. The St. Louis Fed works to help financial institutions and their communities understand and address community development problems and their related financial service needs. We offer resources free of charge to financial institutions, as well as to the general public. These resources include: the quarterly newsletter *Bridges*; community profiles that describe the demographics and lending, service and investment opportunities in Eighth District regions; conferences, training sessions and forums; presentations; and pamphlets, videos and software. At the same time, our Community Affairs staff collaborates on projects with other Reserve Banks.

The Federal Reserve's Community Affairs goals, I believe, are admirable:

- helping to foster active participation of financial institutions in providing credit and banking services to traditionally under-served markets;
- encouraging cooperation among all parties in the lending process;
- developing greater public awareness about the benefits and risks of financial services products; and
- promoting a better understanding about the processes and resources that support successful community development programs.

In many ways, these efforts provide the Fed's most direct connection to the community. I invite bankers to take advantage of our Community Affairs Department's valuable services.

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Fed Develops TIP, PATAX Systems to Replace TT&L

Beginning mid-year 2000, two new systems—the Treasury Investment Program (TIP) and PATAX—will replace the current Treasury Tax and Loan (TT&L) system.

Because newly automated business functions have placed additional data requirements on TT&L, centralized processing has become the focus in application development. Developed by the St. Louis Fed, the new TIP and PATAX systems allow for expanded functionality by addressing changes in payment mechanisms, incorporating changes in the data processing environment, and improving data reporting to the Treasury.

During the transition to an all-electronic environment in the mid-1990s, the Treasury implemented the Electronic Federal Tax Payment System (EFTPS), which allowed financial institutions to report their customers' tax payments electronically as an alternative to using federal tax deposit (FTD) coupons. PATAX was designed to process paper-based tax deposits after legislation was passed allowing small businesses to continue using FTDs.

The TIP system will receive summarized tax deposit information from ETA, EFTPS and PATAX. The information will be stored by TIP and used to provide real-time balances and capacity data to the Treasury. This will assist the Treasury in its daily projections of funds needed to maintain its working balance. From these projections, the Treasury will decide whether to invest or withdraw funds from the participating financial institution accounts.

Stay tuned for more detailed information on TIP and PATAX in the coming months.

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Fed Introduces Online Electronic Data Reporting

In April, the Federal Reserve began offering online data reporting for financial institutions. All institutions that complete the FR2900 "Report of Transaction Accounts, Other Deposits and Vault Cash" are able to file the report electronically through the Internet.

Reports can be filed through a specialized web site designed by the Fed. Reporting information this way offers several advantages. For example, the system performs mathematical edits to ensure accurate data and provides receipts showing the date and time of data submission. It also accommodates both users who report for more than one depository institution and those that cross district lines.

"This new reporting option is a convenient, secure and cost-effective alternative for electronic data reporting," said Frank Bufe, manager of Statistics at the St. Louis Fed. "Over time, we expect to introduce electronic filing for additional reports."

To sign up for Internet reporting or for additional information, contact Robin Miller of the St. Louis Fed's Statistics Department at (314) 444-8554, or via e-mail at robin.miller@stls.frb.org.

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Fed's Y2K Messages Designed to Reassure Public

To allay the public's fears and doubts about the banking system's Y2K readiness, the Federal Reserve has prepared four core messages that it intends to use in all of its communications. The messages are listed below and are each followed by supporting points. The Fed encourages financial institutions to pass along these same messages to their customers whenever possible.

1. **No one can say there won't be glitches, but we are confident that our nation's financial system will be prepared for the century rollover.**
   - Many experts in the United States rate the financial industry as superbly prepared for the Year 2000. The Fed expects the usual payment options, such as ATMs, credit cards, checks, debit cards, etc., to work through the Y2K rollover.
   - The strength of the U.S. banking system has been tested many times—from regional disruptions due to power outages to national crises that affected the entire financial system—and has weathered these disruptions successfully.
2. **The Federal Reserve is committed to doing all it can to safeguard the operations of the U.S. financial system.**
   - The Federal Reserve has acted to ensure that sufficient cash will be available at financial institutions throughout 1999 and 2000.
   - The Fed is developing detailed plans to handle any glitches that may occur in the early days of 2000. The Fed expects that any Y2K disruptions will be limited.
3. **As a country, we all share the responsibility for meeting the Y2K challenge. The Federal Reserve and the banking system are doing their parts, and we believe the public will do its part as well.**
   - Everyone in the country has an important role to play.
   - Government and businesses are working hard to fix and test computers and to find ways to continue providing service even if some problems occur.
   - Any Y2K financial disruption in the United States will likely be temporary and manageable.
4. **Public understanding of the banking industry's Year 2000 preparations will help maintain public confidence.**
   - Each financial institution should take it upon itself to communicate accurate information to its customers about the readiness of the banking industry.
   - The Fed strongly encourages self-assessment and public disclosure as the best way for individual financial institutions to keep bank supervisors and the public informed about Y2K readiness.

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Y2K Customer Checklist

The following is a list of actions that financial institutions can pass along to their customers to help them prepare for any possible detrimental effects of the Y2K computer bug.

1. **Stay Educated:** Customers should not hesitate to ask their financial institution what it is doing to address the Y2K bug.
2. **Keep Copies of Financial Records:** Keeping records of financial transactions, especially for the last few months of 1999 and the first few months of 2000, will be important for customers.
3. **Pay Attention to Finances:** Customers should always balance their checkbook and check their financial institution receipts for accuracy.
4. **Make Prudent Preparations:** If one payment option does not work, customers should remember that several others are available (checks, credit cards, debit cards, etc.).
5. **Guard against Y2K Scams:** Customers should be skeptical about those who ask for their account information or try to sell them a product, service or investment that's supposedly "Y2K safe."
6. **Review Deposit Insurance Coverage:** The federal government's protection of insured deposits will not be affected by Y2K. Customers with more than $100,000 in an insured bank, thrift or credit union will want to make sure they understand the insurance rules at their financial institution.

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Regional Roundup

St. Louis Fed Publishes Homebuyers Guide

The Federal Reserve Bank of St. Louis has published a brochure that lists St. Louis-area homebuyer counseling providers and a summary of their programs.

The brochure is in response to recommendations from the four groups of the St. Louis Mortgage Credit Partnership project (MCP). The MCP project, co-sponsored by the St. Louis Fed and the Institute for Policy Leadership at the University of Missouri-St. Louis, is an ongoing effort to identify and eliminate barriers to affordable housing in the city of St. Louis. Members of the MCP project studied all areas related to the homebuying process, including lending, appraisal, real estate, insurance and the secondary market.

The brochure is available free of charge. It is also available on the St. Louis Fed's web site at www.stlouisfed.org. For more information, contact Kristi O'Dell at (314) 444-8761.

One-Stop Shopping for Direct Payment Utility Bills

The St. Louis Fed has produced a brochure that financial institutions in the St. Louis area can use to increase their customers' use of direct payment for utility bills. The brochure contains an enrollment form in which customers can sign up for direct payment with multiple utility companies. Participating financial institutions will mail the brochure to their customers in June.

By simply filling out the form and mailing it in with a voided check, customers can begin using direct payment for the utility bills of their choice. The brochure also contains frequently asked questions about direct payment.

Participating utilities include: Illinois Power, AmerenUE, St. Louis County Water Co., St. Louis City Water, Laclede Gas, Metropolitan Sewer District, Illinois-American Water Company and Charter Communications.

For more information, or to order a supply of the brochures, call Laura Vermillion at (314) 444-8946.

Agencies Withdraw "Know Your Customer" Rule after Unprecedented Response

After receiving an unprecedented number of negative responses that climbed to more than 200,000, banking regulatory agencies withdrew the proposed "Know Your Customer" rule in late March. The agencies had invited comment on the rule beginning last December.

The onslaught of responses against the anti-money laundering proposal came from the public, banking organizations, industry trade associations and members of Congress. Most of the comments reflected public concern over the privacy of information that would be collected and held by financial institutions. Other responses addressed the burden the proposed rule would impose on financial institutions.

In a joint statement, the agencies reiterated that "the withdrawal of the proposed rule does not diminish in any manner our long-standing support for the anti-money laundering provisions of the Bank Secrecy Act."

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FedFacts

Fed Offers New ACH Service

The Federal Reserve has begun offering a new Automated Clearing House (ACH) service called the *ACH Information File Service*.

This auxiliary service is designed specifically for customers who have electronic connections to the Fed, yet contract with service providers to receive and process their ACH items. This product would benefit financial institutions using processors without EDI translation capabilities.

For more information about the service, call Pat McNamara-Smith at (314) 444-8713.

Fed Updates Regulation CC Brochure

The Federal Reserve Board has updated its brochure, *A Guide to Regulation CC Compliance*, to reflect minor revisions to the regulation. The new brochure was developed to provide financial institutions with a brief summary of the funds availability requirements of the regulation and highlight the elements of it that cause financial institutions the most difficulty. To request a copy, call Debbie Dawe at (314) 444-8809.

In Plain English on the Internet

In Plain English, the St. Louis Fed's recently published educational booklet about the Federal Reserve, is now available on the Internet. The booklet, which was written and illustrated to appeal to the general public and describes the history, functions and components of the Fed, can be found on the St. Louis Fed's web site (www.stlouisfed.org/in-plain-english).