

Research Update

Federal Reserve Bank of New York

Research and Market Analysis Group

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Study Foresees No Retrenchment in Consumer Spending as Mortgage Refinancing Boom Ends

According to many observers in the business press, the recent surge in home equity withdrawal has fueled a substantial increase in consumer spending and left household balance sheets in a much-weakened state. In this view, the return of interest rates to higher levels and the consequent end of the refinancing boom will compel consumers to cut back their spending sharply.

A new article in *Current Issues in Economics and Finance* (vol. 9, no. 12, “After the Refinancing Boom: Will Consumers Scale Back Their Spending?”) presents a markedly different view. Contending that consumers have used the equity withdrawn from their homes to restructure their balance sheets and reduce debt service burdens, authors Margaret

McConnell, Richard Peach, and Alex Al-Haschimi suggest that households will in fact be in a better position to spend going forward.

The authors base their conclusion on an analysis of household assets and liabilities from the late 1990s through mid-2003, the period when equity withdrawal was rising rapidly. The data indicate that during these years, households increased their acquisition of financial assets and reduced their reliance on nonmortgage liabilities—credit card debt and other forms of consumer credit. Households continued to purchase consumer goods, but they did so at about the same rate as in the past.

The authors infer from the data that households have not been using the withdrawn equity to step up their spending irresponsibly. Rather, households appear to be using low-cost, tax-advantaged mortgage debt to make many of the same purchases that they would otherwise have financed by drawing down their financial

New Research: October-December 2003

Call for papers on corporate governance	2
New <i>Staff Reports</i>	3
Papers recently published by RMAG staff	4
Presentations at conferences	5

assets or increasing their credit card debt. “The picture that emerges,” the authors note, “is one of financial prudence rather than profligacy.”

Additional support for this position, the authors contend, comes from tracking a comprehensive measure of the household debt service burden. Despite the rapid increase in mortgage debt in recent years,

debt service payments are claiming a smaller share of household after-tax income.

The authors conclude that, with debt service falling and household net worth rising at about the same rate as before the surge in home equity withdrawal, there is little reason to expect a slowdown in consumer spending. In fact, consumers may now be better able to spend than in the past.

Call for Papers on Corporate Governance

On September 30 and October 1, 2004, the Federal Reserve Bank of New York will host the conference Governance of Not-for-Profit Organizations. The conference is being cosponsored with Princeton University’s Bendheim Center for Finance and the *Journal of Accounting and Economics*.

Interested authors can submit papers relating to all aspects of the governance of not-for-profit firms by July 15, 2004, to hamid.mehran@ny.frb.org.

Detailed information can be found at www.newyorkfed.org/research/conference/2004/governance_call_papers.html.

Publications and Papers

The Research and Market Analysis Group produces a wide range of publications:

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

New Titles in the *Staff Reports Series*

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

Macroeconomics and Growth

No. 174, October 2003

What Explains the Stock Market's Reaction to Federal Reserve Policy?

Ben S. Bernanke and Kenneth N. Kuttner

This paper analyzes the impact of changes in the federal funds rate target on equity prices, with the aim of both estimating the size of the typical reaction and understanding the reasons for the reaction. On average, a typical unanticipated 25-basis-point rate cut is associated with a roughly 1 percent increase in broad stock market indexes. The response varies across industries in a pattern consistent with the capital asset pricing model. Policy's impact on expected future stock returns accounts for the largest share of the stock price response, while the direct effect of the real risk-free interest rate is small.

Microeconomics

No. 173, October 2003

Inflation Inequality in the United States

Bart Hobijn and David Lagakos

Inflation is often assumed to affect everyone the same way. However, differences in spending patterns across households and differences in price increases across goods and services lead to unequal levels of inflation. This paper measures the degree of inflation inequality across U.S. households from 1987 to 2001. Its results suggest that inflation experiences vary significantly, with most of the differences traceable to changes in the relative prices of education, health care, and gasoline. Cost-of-living increases are found to be generally higher for the elderly, largely because of their health care expenditures, and the cost of living for poor households is most sensitive to fluctuations in

gasoline prices. The study also finds that households experiencing high inflation in one year do not generally do so in the next year.

Banking and Finance

No. 175, October 2003

Cross-Country Differences in Monetary Policy Execution and Money Market Rates' Volatility

Leonardo Bartolini and Alessandro Prati

The volatility patterns of overnight interest rates differ across industrial countries in ways that existing models, designed to replicate the features of the U.S. federal funds market, cannot explain. The authors present an equilibrium model of the overnight interbank market that matches these different patterns by incorporating differences in policy execution by the world's main central banks, including differences in central banks' management of marginal lending and deposit facilities in response to shocks. Their model is consistent with central banks' observed practice of rationing access to marginal facilities when the objective of stabilizing short-term interest rates conflicts with another high-frequency objective, such as targeting exchange rates.

No. 176, December 2003

Are Banks Really Special? New Evidence from the FDIC-Induced Failure of Healthy Banks

Adam B. Ashcraft

The Federal Deposit Insurance Corporation (FDIC) used cross-guarantees to close thirty-eight subsidiaries of First RepublicBank Corporation in 1988 and eighteen subsidiaries of First City Bancorporation in 1992 when lead banks from each of these Texas-based bank holding companies were declared insolvent. The author uses this exogenous failure of otherwise healthy subsidiary banks as a natural experiment for studying the impact of bank failure on local-area real economic activity. He finds that the closings of the subsidiaries were associated with a significant decline in bank lending that led to a permanent reduction in real county income of about 3 percent.

Recently Published

Adam Ashcraft and Donald Morgan. 2003. “Using Loan Rates to Measure and Regulate Bank Risk: Findings and an Immodest Proposal.” *Journal of Financial Services Research* 24, no. 2-3 (October/December): 181-200.

Leonardo Bartolini. 2003. “The Execution of Monetary Policy: A Tale of Two Central Banks,” with Alessandro Prati. *Economic Policy* 18, no. 37 (October): 435-67.

Leonardo Bartolini. 2003. “The Overnight Interbank Market: Evidence from the G-7 and the Euro Zone,” with Alessandro Prati and Giuseppe Bertola. *Journal of Banking and Finance* 27, no. 10 (October): 2045-83.

Arturo Estrella. 2003. “Critical Values and P-Values of Bessel Process Distributions: Computation and Application to Structural Break Tests.” *Econometric Theory* 19, no. 6 (December): 1128-43.

James Harrigan. 2003. “Is Japan’s Trade (Still) Different?” with Rohit Vanjani. *Journal of the Japanese and International Economies* 17, no. 4 (December): 507-19.

James Kahn and Robert Rich. 2003. “Distinguishing Trends from Cycles in Productivity.” *Monetary Policy in a Changing Environment*, BIS Papers no. 19, October: 443-61.

Amartya Labiri. 2003. “Delaying the Inevitable: Interest Rate Defense and Balance of Payments Crises,” with Carlos Végh. *Journal of Political Economy* 111, no. 2: 404-24.

Jonathan McCarthy. 2003. “Capital Overhangs: Has Investment Spending Suffered from a Hangover?” *Business Economics* 38, no. 4 (October): 20-7.

Til Schuermann. 2003. “Risk Measurement, Risk Management, and Capital Adequacy of Financial Conglomerates,” with Andrew Kuritzkes and Scott Weiner. In Richard Herring and Robert Litan, eds., *Brookings-Wharton Papers on Financial Services 2003*, 141-93.

Kevin Stiroh. 2003. “Competitive Dynamics of Deregulation: Evidence from U.S. Banking,” with Philip E. Strahan. *Journal of Money, Credit, and Banking* 35, no. 5 (October): 801-28.

Kevin Stiroh. 2003. “Efficiency and Scale Economies in Universal Banks: Evidence from Switzerland,” with Bertrand Rime. *Journal of Banking and Finance* 27, no. 11 (November): 2121-50.

Kevin Stiroh. 2003. “Growth and Innovation in the New Economy.” In Derek C. Jones, ed., *New Economy Handbook*, 723-51. San Diego, Calif.: Academic Press.

Other New Publications

- *An Introduction to Economic Research at the Federal Reserve Bank of New York.* This online guide, updated for 2003–2004, is designed to give economists interested in joining the Research and Market Analysis Group a fuller understanding of our activities.

www.newyorkfed.org/research/intro/rmagtoc.html

- *The Research Group of the Federal Reserve Bank of New York.* This online guide, which complements *An Introduction to Economic Research*, offers economists an overview of our research and policy work and a description of our distinctive culture.

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

Presentations by Economists in the Research and Market Analysis Group

“New Evidence on the Lending Channel,” *Adam Ashcraft*. University of California at Berkeley, Haas School of Business, Berkeley, California, November 26.

“Metropolitan New York City Economy: Before and after September 11,” *Jason Bram*. Northeast Regional Science Council, State University of New York at Binghamton, Binghamton, New York, November 8.

“Neighborhood Revitalization in New York City in the 1990s,” *Jason Bram, Andrew Haughwout, Margaret McConnell, and James Orr*. Regional Science Association International conference, Philadelphia, Pennsylvania, November 20. With Jesse Edgerton and Yigal Gelb.

“Changing Commuting Patterns in the New York Metropolitan Region,” *Jason Bram and Alisdair McKay*. New York State Economics Association 2003 Annual Conference, New York City, October 10.

“Heat Waves, Meteor Showers, and Trading Volume: An Analysis of Volatility Spillovers in the U.S. Treasury Market,” *Michael Fleming*. Third Workshop of the European Central Bank and Center for Financial Studies Research Network on Capital Markets and Financial Integration in Europe, Bank of Greece, Athens, Greece, November 20. With Jose Lopez.

“The Specials Market for U.S. Treasury Securities and the Federal Reserve’s Securities Lending Program,” *Michael Fleming and Kenneth Garbade*. Rutgers Business School, Newark, New Jersey, October 31. Also presented at a University of Piraeus and Athens Derivatives Exchange seminar, Athens, Greece, November 21.

“Financial Crises and the Presence of Banks,” *Linda Goldberg*. World Bank Conference on Systemic Financial Distress: Containment and Resolution, Washington, D.C., October 8.

“Exchange Rates and Prices,” *Linda Goldberg*. Bank for International Settlements research seminar, Basel, Switzerland, October 16. With José Campa.

“Financial Foreign Direct Investment and Host Countries: New and Old Lessons,” *Linda Goldberg*. Bank for International Settlements, Committee on Global Financial Stability meeting, Basel, Switzerland, October 16.

“Does Dollarization of Debt Composition Lead to Strong Balance Sheet Effects of Exchange Rates?” *Linda Goldberg*. Inter-American Development Bank and Federal Reserve Bank of Atlanta, Atlanta, Georgia, November 23.

“Has Structural Change Contributed to a Jobless Recovery?” *Erica Groshen*. Information Policy Institute conference, Washington, D.C., December 11.

“Do Stock Price Bubbles Influence Corporate Investment?” *Charles Himmelberg*. University of Colorado at Boulder, Leeds School of Business Department of Finance, Boulder, Colorado, December 5.

“The Challenges of Consolidated Risk Management,” *Beverly Hirtle*. International Centre for Business Information Risk Management Conference, Geneva, Switzerland, December 3.

“Cross-Country Technology Adoption,” *Bart Hobijn*. Carnegie-Rochester Conference Series on Public Policy, University of Rochester, Rochester, New York, October 16.

“Regulation, Subordinated Debt, and Incentive Features of CEO Compensation in the Banking Industry,” *Hamid Mehran*. Federal Deposit Insurance Corporation and *Journal of Financial Services Research* conference, Washington D.C., December 6. With Kose John and Yiming Qian.

“Using Loan Rates to Measure and Regulate Loan Risk,” *Donald Morgan*. Federal Deposit Insurance Corporation and *Journal of Financial Services Research* conference, Washington, D.C., October 7.

“New York City Two Years after September 11: Economic Impact and Policy Response,” *James Orr and Jason Bram*. Regional Science Association International conference, Philadelphia, Pennsylvania, November 22.

“The Linkage between Economic Activity and Tax Bases: Evidence from New York,” *James Orr, Jason Bram, Andrew Haughwout, and Robert Rich*. Regional Science Association International conference, Philadelphia, Pennsylvania, November 26. With Rae Rosen.

“New Open Economy Macroeconomics and the Global Economy Model,” *Paolo Pesenti*. Cornell University Department of Economics seminar, Ithaca, New York, November 18. Also presented at a University of Houston Department of Economics seminar, December 10.

“When Leaner Isn’t Meaner: Measuring the Benefits and Spillovers of Greater Competition in Europe,” *Paolo Pesenti*. International Research Forum on Monetary Policy, sponsored by the European Central Bank, the Board of Governors of the Federal Reserve System, the Center for German and European Studies of Georgetown University, and the Center for Financial Studies of the University of Frankfurt, Washington, D.C., November 19. With Tamim Bayoumi and Doug Laxton.

“A Nonlinear Model of the Business Cycle,” *Simon Potter*. State University of New York at Albany seminar, Albany, New York, October 24.

“Why Firm Access to the Bond Market Varies over the Business Cycle: A Theory and Some Evidence,” *João Santos*. Third Workshop of the European Central Bank and Center for Financial Services Research Network on Capital Markets and Financial Integration in Europe, Bank of Greece, Athens, Greece, November 20. Also presented at the Norwegian School of Management, Oslo, Norway, December 3, and the New University of Lisbon School of Economics, Lisbon, Portugal, December 9.

“Macroeconomics and Credit Risk: A Global Perspective,” *Til Schuermann*. Penn Institute for Economic Research and Innocenzo Gasparini Institute for Economic Research Conference on Econometric Methods in Macroeconomics and Finance, Bocconi University, Milan, Italy, October 4.

“Manufacturing and the Business Cycle,” *Charles Steindel*. New York State Economics Association Meeting, New York City, October 10.

“The Dark Side of Diversification: The Case of U.S. Financial Holding Companies,” *Kevin Stiroh*. Bank of Canada conference, Ottawa, Ontario, December 4. With Adrienne Rumble.

“Optimal Monetary Policy and Productivity Growth,” *Andrea Tambalotti*. Second Workshop on Dynamic Macroeconomics, University of Milan, Milan, Italy, December 19.

“Monetary Policy Coordination under Complete Markets,” *Cédric Tille and Paolo Pesenti*. Swiss National Bank, Zurich, Switzerland, November 27. Also presented at the University of Lausanne, Lausanne, Switzerland, December 4.

“Using Home Maintenance and Repairs to Smooth Variable Earnings,” *Joseph Tracy*. City University of New York Graduate Center, New York City, November 12.

“A Simple Explanation of the Border Effect,” *Kei-Mu Yi*. Stanford University Department of Economics seminar, Palo Alto, California, November 5.

Publications and Papers: October-December 2003

Publications are available at www.newyorkfed.org/research/publication_annuals/.

Current Issues in Economics and Finance, Vol. 9

No. 10, October 2003

Taking the Pulse of the Tech Sector:
A Coincident Index of High-Tech Activity
*Bart Hobijn, Kevin J. Stiroh,
and Alexis Antoniadis*

No. 11, November 2003

Coping with Terms-of-Trade Shocks
in Developing Countries
Christian Broda and Cédric Tille

No. 12, December 2003

After the Refinancing Boom: Will Consumers
Scale Back Their Spending?
*Margaret M. McConnell, Richard W. Peach,
and Alex Al-Haschimi*

Staff Reports

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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.*