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Research Update

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Economic Policy Review Focuses on a Range of Finance Topics

Articles in the new issue of the ***Economic Policy Review*** (vol. 13, no. 1) offer fresh perspectives on foreign direct investment, the link between financial market concentration and stability, and the Treasury's debt management practices.

In "Financial Sector FDI and Host Countries: New and Old Lessons," Linda Goldberg discusses the effect of soaring foreign direct investment (FDI) in the financial sectors of developing countries. She concludes that in several respects, financial sector FDI—in which banks in industrialized countries establish branches and facilities in emerging ones—benefits the countries receiving the investments. Goldberg's analysis also suggests that the presence of bank branches from nations with highly developed financial systems brings with it exposure to best practices that can result in institutional strengthening of the host country in key areas such as bank supervision. Accordingly, the benefits of financial sector FDI can be substantial enough for a country to encourage and support entry from well-regulated and healthy banks.

Nicola Cetorelli, Beverly Hirtle, Donald Morgan, Stavros Peristiani, and João Santos, in "Trends in Financial Market Concentration and Their Implications for Market Stability," conclude that in the past decade there has been no pervasive pattern of high or increasing concentration in financial markets. The authors

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find that most wholesale credit and capital markets in the United States are only moderately concentrated, and that concentration trends are mixed—rising in some markets, falling in others. Consistent with past studies, Cetorelli et al. document an ambiguous relationship between market concentration and market instability. They argue that the risk of instability should a large player exit the market depends not just on concentration, but also on the speed at which other firms can substitute for the departing firm.

In addition, two separate studies provide insight into the U.S. Treasury securities market.

"An Examination of Treasury Term Investment Interest Rates," by Warren Hrung, studies the Term Investment Option (TIO) program, through which the Treasury lends excess cash balances to banks for a specified number of days at interest rates determined by single-rate auctions. Hrung finds that for small auction sizes, of $2 billion or less, interest rates received by the Treasury through TIO are comparable to market rates when term lengths are five days or more. When lengths are of shorter durations or the auction size is large, the Treasury tends to receive lower relative rates. He also concludes that the Treasury's announcement and auctioning of funds on the same day does not adversely affect rate spreads, suggesting that banks are indifferent to more advance notice of TIO auctions.

Kenneth Garbade's article, "The Emergence of 'Regular and Predictable' as a Treasury Debt Management Strategy," observes that the Treasury's practice of selling new notes and bonds on a "tactical," or offering-by-offering, basis proved problematic by 1975, when the Treasury had to finance an unusually rapid expansion of the federal deficit. Investors were sometimes unprepared, and market disruption ensued. These events, according to Garbade, led

Publications and Papers

The Research and Statistics 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 our research output.

Treasury officials to embrace a program of regular and predictable issuance of notes and bonds—a program they had been using for decades to auction bills—and by 1982, the Treasury had switched to predictably scheduled government debt auctions. The move, he says, was widely credited with reducing market uncertainty, facilitating investor planning, and lowering the Treasury's borrowing costs.

Articles are available at **www.newyorkfed.org/research/epr/index.html**.

New Titles in the *Current Issues* Series

Two ***Current Issues in Economics and Finance*** articles were published in the first quarter:

No. 1, January 2007
Who Buys Treasury Securities at Auction?
Michael J. Fleming

The U.S. Treasury Department now releases fuller information about its auctions than in the past, including new information on investor class and bidder category. The investor class data shed light on the distribution of demand for government securities, and the bidder category data, released first, offer an early read on demand. Purchases by indirect bidders, in particular, are a fairly good proxy for foreign purchases of Treasury notes, but not Treasury bills.

No. 2, February 2007
What Has Homeland Security Cost? An Assessment: 2001-2005
Bart Hobijn and Erick Sager

While homeland security is widely seen as an important national objective, the costs of this effort are not well understood. An analysis of public and private expenditures on homeland security shows that overall spending rose by $44 billion between 2001 and 2005—a clear increase but one that represents a gain of only ¼ of 1 percent as a share of U.S. GDP. Private sector expenditures increased very modestly in dollar terms and remained unchanged as a fraction of the sector's GDP.

Articles are available at **www.newyorkfed.org/research/current_issues/index.html**.

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. 277, February 2007
A Retrospective Look at the U.S. Productivity Growth Resurgence
Dale W. Jorgenson, Mun S. Ho, and Kevin J. Stiroh

It is now widely recognized that information technology (IT) was critical to the dramatic acceleration of U.S. labor productivity growth in the mid-1990s. This paper traces the evolution of productivity estimates to document how and when this perception emerged. Early studies concluded that IT was relatively unimportant. It was only after the massive IT investment boom of the late 1990s that this investment and underlying productivity increases in the IT-producing sectors were identified as important sources of growth. Although IT has diminished in significance since the dot-com crash of 2000, the authors project that private sector productivity growth will average around 2.5 percent per year for the next decade, a pace that is only moderately below the average for the 1995-2005 period.

INTERNATIONAL

No. 278, March 2007
Monetary Policy under Sudden Stops
Vasco Cúrdia

This study proposes a model to investigate the effects of monetary policy in an emerging market economy that experiences a sudden stop of capital inflows. Cúrdia shows that the higher the elasticity of foreign demand, the lower the contraction in output—leading, at the extreme, to the possibility of an expansion. A second result is that the recession is most severe in a fixed exchange rate regime. A comparison of alternative rules shows that low commitment to inflation stabilization allows for less contraction in output and even expansion but at the cost of stronger contraction in capital inflows and higher interest rates. Low credibility and the risk of loose policy imply increased trade-offs, stronger contraction of the economy, and higher interest rates.

No. 280, March 2007
International Capital Flows
Cédric Tille and Eric van Wincoop

Most theories of international capital flows are based on one-asset models, which have implications only for net capital flows, not for gross flows. Moreover, because there is no portfolio choice, these models allow no role for capital flows as a result of assets' changing expected returns and risk characteristics. This paper develops a method for solving dynamic stochastic general equilibrium open-economy models with portfolio choice. After showing why standard solution methods no longer work in the presence of portfolio choice, the authors extend these methods, giving special treatment to the optimality conditions for portfolio choice. They apply their method to a two-country, two-good, two-asset model. The approach identifies time-varying portfolio shares resulting from assets' time-varying expected returns and risk characteristics as a potential key source of international capital flows.

MICROECONOMICS

No. 275, February 2007

How Wages Change: Micro Evidence from the International Wage Flexibility Project

William T. Dickens, Lorenz Goette, Erica L. Groshen, Steinar Holden, Julian Messina, Mark E. Schweitzer, Jarkko Turunen, and Melanie E. Ward

Drawing on information compiled by the International Wage Flexibility Project, Dickens et al. analyze changes in individuals' earnings in thirty-one different data sets from sixteen countries. The 360 wage change distributions they derive from the data show a remarkable amount of variation in earnings changes across workers. These changes have a notably non-normal distribution; they are tightly clustered around the median and also have many extreme values. Furthermore, nearly all countries show asymmetry in their wage distributions below the median. Indeed, the authors find evidence of downward nominal and real wage rigidities and determine that the extent of both rigidities varies substantially across countries. Their results suggest that the degree of union presence in the labor market plays a role in explaining the differing degrees of rigidities among countries.

BANKING AND FINANCE

No. 272, January 2007

Personal Bankruptcy and Credit Market Competition

Astrid Dick and Andreas Lehnert

This study investigates empirically the relationship between credit market competition, lending to households, and personal bankruptcy rates in the United States. Dick and Lehnert exploit the exogenous variation in market contestability brought on by banking deregulation at the state level: after deregulation, banks faced the threat of entry into their state markets. The authors find that deregulation increased competition for borrowers, prompting banks to adopt more sophisticated credit rating technology. In turn, these developments led previously excluded households to enter the credit market. The authors document that, following deregulation, 1) overall lending increased, 2) loss rates on loans decreased, and 3) bankruptcy rates rose.

No. 273, January 2007

Defining and Detecting Predatory Lending

Donald P. Morgan

Morgan defines predatory lending as a welfare-reducing provision of credit. Using a textbook model, he shows that lenders profit if they can tempt households into "debt traps," that is, overborrowing and delinquency. The author then tests whether payday lending fits the definition of predatory. His study finds that in states with higher payday loan limits, less-educated households and households with uncertain income *are* less likely to be denied credit, but are *not* more likely to miss a debt payment. Absent higher delinquency, the extra credit from payday lenders does not fit our definition of predatory. Nevertheless, it is expensive. On that point, Morgan finds somewhat lower payday prices in cities with more payday stores per capita, consistent with the hypothesis that competition limits payday loan prices.

No. 274, January 2007

Commitment and Equilibrium Bank Runs

Huberto Ennis and Todd Keister

This paper studies the role of commitment in a version of the Diamond-Dybvig model with no aggregate uncertainty. As is well known, the banking authority can eliminate the possibility of a bank run by committing to suspend payments to depositors if a run were to start. The authors show, however, that in an environment without commitment, the banking authority will choose to only partially suspend payments during a run. In some cases, the reduction in early payouts under this partial suspension is insufficient to dissuade depositors from participating in the run. Bank runs can then occur with positive probability in equilibrium. The fraction of depositors participating in such a run is stochastic and can be arbitrarily close to one.

No. 276, February 2007

Credit Derivatives and Bank Credit Supply

Beverly Hirtle

The key question addressed in this paper is whether purchase of credit protection through credit derivatives is associated with an increase in bank credit supply. Hirtle examines a micro data set of individual loans made by a sample of banks between 1997 and 2005. She finds evidence suggesting that greater use of credit derivatives is associated with greater supply of bank credit for large term loans—that is, newly negotiated loan extensions to large corporate borrowers—though not for (previously negotiated) commitment lending. On-balance-sheet amounts of commercial and industrial loans also appear to increase as the protection afforded by credit derivatives increases.

No. 279, March 2007

The Bankruptcy Abuse Prevention and Consumer Protection Act: Means-Testing or Mean Spirited?

Adam B. Ashcraft, Astrid A. Dick, and Donald P. Morgan

Thousands of U.S. households filed for bankruptcy just before the bankruptcy law changed in 2005. That rush-to-file was more pronounced, this study finds, in states with more generous bankruptcy exemptions and lower credit scores. The authors take that finding as evidence that the new law effectively reduces exemptions, which in turn should reduce the "demand" for bankruptcy and the resulting losses to suppliers of consumer credit. Predictably, the savings to suppliers will be shared with borrowers by way of lower credit card rates, although credit card spreads have not yet fallen. If cheaper credit is the upside of the new law, the downside is reduced bankruptcy "insurance" against bad luck. The overall impact of the new law on the average household depends on how one weighs those two sides. ■

Recently Published

Mary Amiti. 2007. **"Economic Geography and Wages,"** with Lisa Cameron. *Review of Economics and Statistics* 89, no. 1 (February): 15-29.

Roc Armenter. 2007. **"Time-Consistent Fiscal Policy and Heterogeneous Agents."** *Review of Economic Dynamics* 10, no. 1 (January): 31-54.

Thomas Klitgaard and Cédric Tille. 2007. **"Borrowing without Debt? Understanding the U.S. International Investment Position,"** with Matthew Higgins. *Business Economics* 42, no. 1 (January): 17-27.

João Santos. 2007. **"Institutional Allocation of Bank Regulation: A Review,"** with Charles Kahn. In D. G. Mayes and G. E. Wood, eds., *The Structure of Financial Regulation*, 185-204. London: Routledge.

Asani Sarkar. 2007. **"Derivatives."** In Kaushik Basu, ed., *Oxford Companion to Economics in India*. London: Oxford University Press.

Kevin Stiroh. 2007. **"Playing for Keeps: Pay and Performance in the NBA."** *Economic Inquiry* 45, no. 1 (January): 145-61.

Wilbert van der Klaauw. 2007. **"The Socio-economic Consequences of 'In-Work' Benefit Reform for British Lone Mothers,"** with Marco Francesconi. *Journal of Human Resources* 42, no. 1 (winter): 1-31. ■

Call for Papers on Financial Intermediation

On November 16, New York University will host the third New York Fed/NYU Stern Conference on Financial Intermediation. The sessions, cosponsored by the Bank and the Salomon Center at NYU's Leonard N. Stern School of Business, are designed to enhance the interaction among researchers interested in this important topic.

Authors are welcome to submit for consideration papers on all areas of financial intermediation, **by July 31, 2007**.

Please send a PDF version of your paper along with a separate title page and abstract to rvanterp@stern.nyu.edu and nyfed_nyustern.conference@ny.frb.org, specifying "NY Fed/NYU Conference" in the subject line. Authors of accepted papers will be notified in early September.

For more information: **www.newyorkfed.org/research/conference/2007/fin_interm.html**.

Papers Presented by Economists in the Research and Statistics Group

"An Anatomy of China's Trade Growth," Mary Amiti. Keio University, conference on Empirical Investigations in Trade and Investment, Tokyo, Japan, February 8. With Caroline Freund.

"Intraday Liquidity Management: A Tale of Games that Banks Play," Morten Bech. Danmarks Nationalbank seminar, Copenhagen, Denmark, February 1.

"Systemic Risk in the Interbank Payment System," Morten Bech. Seminar sponsored by the Riksbank, Stockholm, Sweden, January 3. With Rod Garratt.

"Transmission of Liquidity Shocks by Globally Active U.S. Banks," Nicola Cetorelli. Allied Social Science Associations annual meeting, Chicago, Illinois, January 6. With Linda Goldberg.

"Are Charter Schools Perceived to Be Better than Regular Public Schools? Evidence from a New Approach Using Private School Enrollment Patterns," Rajashri Chakrabarti. American Education Finance Association conference, Baltimore, Maryland, March 23. With Joydeep Roy.

"The Intended and Unintended Consequences of No Child Left Behind: Evidence from Wisconsin," Rajashri Chakrabarti. American Economic Association annual meeting, Chicago, Illinois, January 6. Also presented at the American Education Finance Association conference, Baltimore, Maryland, March 24.

"Monetary Policy Tick-by-Tick," Michael Fleming. Allied Social Science Associations annual meeting, Chicago, Illinois, January 5. With Monika Piazzesi.

"A Framework for Identifying the Sources of Local-Currency Price Stability with an Empirical Application," Rebecca Hellerstein. Allied Social Science Associations annual meeting, Chicago, Illinois, January 7. With Pinelopi Goldberg.

"Commitment and Equilibrium Bank Runs," Todd Keister. University of Kentucky Department of Economics seminar, Lexington, Kentucky, March 3. With Huberto Ennis.

"Does Capital Hurt the Value of the Bank?" Hamid Mehran. American Economic Association annual meeting, Chicago, Illinois, January 6.

"ESOP Fables: The Impact of Employee Stock Ownership Plans on Labor Disputes," Hamid Mehran and Joseph Tracy. MIT Organization and Economics Seminar, Cambridge, Massachusetts, March 1. With Peter Cramton.

"Varieties and the Transfer Problem: The Extensive Margin of Current Account Adjustment," Paolo Pesenti. Second Annual Workshop on Global Interdependence, cosponsored by the Centre for Economic Policy Research and Trinity College, Dublin, Ireland, March 2. With Giancarlo Corsetti and Philippe Martin.

"Would Protectionism Defuse Global Imbalances and Spur Economic Activity? A Scenario Analysis," Paolo Pesenti. Conference on Advances in Open-Economy Macroeconomics, cosponsored by the Indira Gandhi Institute of Development Research and Northwestern University, Mumbai, India, March 18. With Hamid Faruqee, Douglas Laxton, and Dirk Muir.

"The Information Content of FOMC Minutes," Joshua Rosenberg. Allied Social Science Associations annual meeting, Chicago, Illinois, January 5. With Ellyn Boukus.

"Do Firms Benefit with Banks' Corporate Control?" João Santos. American Finance Association annual meeting, Chicago, Illinois, January 6. With Kristin Wilson.

"Dark Liquidity: An Empirical Analysis," Asani Sarkar. Financial Markets World Market Structure Conference: Sourcing and Managing Liquidity, New York City, January 16. With Robert Schwartz. Also presented at the World Research Group's Liquidity 2007 conference, New York City, February 1.

"Market Sidedness: Insights into Motives for Trade Initiation," Asani Sarkar. Baruch College Finance Department seminar, New York City, February 20. With Robert Schwartz.

"Recent Trends in the High-Yield Corporate Bond Markets," Asani Sarkar. World Research Group's Distressed Investing 2007 conference, New York City, February 28.

"What We Know, Don't Know, and Can't Know about Bank Risk," Til Schuermann. Fitch/Algo Credit and Capital Forum, New York City, February 16. With Andrew Kuritzkes.

"Money and Modern Banking without Bank Runs," David Skeie. American Economic Association annual meeting, Chicago, Illinois, January 6.

"A Retrospective Look at the U.S. Productivity Growth Resurgence," Kevin Stiroh. American Economic Association annual meeting, Chicago, Illinois, January 7. With Dale W. Jorgenson and Mun S. Ho. Also presented at an NBER Productivity Program Meeting, Cambridge, Massachusetts, March 9.

"Intertemporal Disturbances," Andrea Tambalotti. American Economic Association annual meeting, Chicago, Illinois, January 5. With Giorgio Primiceri and Ernst Schaumburg.

"International Capital Flows," Cédric Tille. University of Connecticut seminar, Storrs, Connecticut, February 8. With Eric van Wincoop. Also presented at a Georgetown University seminar, Washington, D.C., February 26.

"Macroeconomic Interdependence and the International Role of the Dollar," Cédric Tille. Graduate Institute of International Economics, Geneva, Switzerland, January 16. With Linda Goldberg. Also presented at a University of Connecticut seminar, Storrs, Connecticut, February 9.

"Two Puzzles in the U.S. External Transactions: The Role of Leverage," Cédric Tille. Graduate Institute of International Economics, Geneva, Switzerland, January 17.

"The Long-Term Effects of Economics Coursework on College Graduates' Behaviors and Outcomes in the Labor Market," Wilbert van der Klaauw. Allied Social Science Associations annual meeting, Chicago, Illinois, January 5. With Sam Allgood, William Bosshardt, and Michael Watts.

"Maternal Employment, Migration, and Child Development," Wilbert van der Klaauw. Allied Social Science Associations annual meeting, Chicago, Illinois, January 7. With Haiyong Liu and Thomas Mroz.

"Interest Rates and Consumer Choice in the Residential Mortgage Market," James Vickery. American Economic Association annual meeting, Chicago, Illinois, January 7. ■

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Research and Statistics Group Publications and Papers: January-March 2007

Publications are available at **www.newyorkfed.org/research/publication_annuals/index.html**.

ECONOMIC POLICY REVIEW, VOL. 13

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