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Research UPDATE

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RESEARCH AND MARKET ANALYSIS GROUP

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New York Fed Conference Offers Insight into Monetary Policy's Effects on the Economy

Financial innovation, the evolving behavior of firms, and changes in the conduct of monetary policy have altered the ways in which monetary policy affects the economy. This was the overall finding of the papers presented at the Federal Reserve Bank of New York conference "Financial Innovation and Monetary Transmission."

The conference proceedings are available in the new issue of the ***Economic Policy Review*** (vol. 8, no. 1), at **www.newyorkfed.org/rmaghome/econ_pol/**.

The economists from central banks, universities, and the private sector who participated in the sessions explored three reasons why monetary transmission may have changed recently. First, they looked at the impact of the financial innovations that motivated the conference—such as the growth of asset securitization, shifts between sources of financing for residential investment, or changes in the strength of wealth effects. Second, they considered whether a change in the way monetary policy is conducted explains what appears to be a change in policy's effectiveness, when in fact policy has become more effective in reducing economic fluctuations. Finally, the participants examined whether the fundamental structural changes affecting the economy's stability (and by implication, monetary transmission) may be due to nonfinancial factors, such as improved inventory management.

In addition to their overall finding, the presenters concluded that there is no evidence that the quantitative importance of either the wealth channel or the credit channel has changed much in recent years. Despite banks'

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declining role in credit formation, bank credit standards still have a significant effect on loan growth and economic activity. The contribution of the wealth channel to the impact of monetary policy has always been modest, and that contribution has actually decreased in recent decades.

The studies also found that the nation's housing sector is no longer a leading indicator of monetary policy's effects, owing largely to financial innovation and institutional changes in the housing finance industry. Furthermore, neither the consolidation and globalization of the financial services industry nor the shrinking volumes in the reserves market were considered to be a major factor affecting monetary transmission.

Firms Maintain Improved Inventory Control despite Massive 2001 Liquidation

During the recession that began in March 2001, U.S. firms liquidated inventories at an exceedingly rapid pace—$120 billion over the first three quarters of the year and a record $114 billion in the fourth quarter alone. This huge sell-off followed a two-decade period of moderation in inventory movements that had led a number of economists to theorize that firms, aided by advances in information technology, had achieved significantly tighter control over inventories.

In "Has Inventory Volatility Returned? A Look at the Current Cycle" (***Current Issues in***

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.
- ***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 on-line.
- ***Publications and Other Research***—an annual catalogue of the Group's research output.

Economics and Finance, vol. 8, no. 5), James Kahn and Margaret McConnell investigate whether the 2001 inventory rundown marks a reversion to the weaker inventory control that prevailed before the early 1980s. Such a development would cast doubt on the theory that firms had made significant progress in controlling inventory fluctuations and on the related notion that better inventory management would continue to keep the volatility of GDP growth in check.

By taking steps to avert a heavy buildup of stocks last year, firms were able to avoid the even deeper production cuts that would eventually have been required to work off the excess inventories.

To shed light on these issues, Kahn and McConnell undertake a detailed comparison of inventory behavior in the 2001 recession with inventory behavior in pre-1984 recessions. The comparison reveals significant differences in the timing of the inventory liquidations. While firms in the pre-1984 period typically continued to accumulate inventories until the middle of a recession, firms in 2001 anticipated the coming slowdown in sales and began to reduce inventories from the start of the downturn. By taking steps to avert a heavy buildup of stocks last year, firms were able to avoid the even deeper production cuts that would eventually have been required to work off the excess inventories.

The contrasting behavior of inventories in the two periods provides strong evidence that the 2001 recession did not signal a return to the less effective inventory control of the earlier postwar period. "Firms appear to have been very successful in managing their inventories to avoid the sharp changes in production that can contribute to output volatility," the authors observe.

In a separate consideration of the record-high fourth-quarter liquidation of inventories, Kahn and McConnell conclude that firms in this period were caught off guard by a strong surge in sales that drained inventories rapidly. Although the consequent shortfall in inventories did represent a lapse in firms' inventory management, the failure to predict sales growth correctly may have been unavoidable given the conditions of the time—the uncertain business outlook created by the September 11 attacks and the unusually short duration of the recession.

The authors conclude their analysis with a look at the implications of the fourth-quarter inventory shortfall for economic conditions in 2002. They argue that the shortfall may well contribute to the recovery by compelling businesses to boost production aggressively to replenish their stocks.

Policies to Promote Affordable Housing Are Subject of New York Fed Conference

Government policies can be useful tools for improving housing affordability through their effect on the housing supply. Yet to remain effective over time, these policies need to adapt to the ongoing changes in the housing market. These were the main conclusions derived from the Federal Reserve Bank of New York conference "Policies to Promote Affordable Housing."

Some of the papers presented discussed the housing affordability issue from a national perspective, while others addressed the conditions unique to New York City and its metropolitan areas.

The conference, held earlier this year, was cosponsored by the Furman Center for Real Estate and Urban Policy of New York University's School of Law. It was organized to advance a wider understanding of affordable housing: the cost burdens that housing places on low- and moderate-income households, the policies designed to lower housing costs for these households, and the policies that, ironically, may have exacerbated the lack of affordable housing. More than 125 representatives from the academic, government, and policy fields participated in the day's sessions.

Some of the papers presented discussed the housing affordability issue from a national perspective, while others addressed the conditions unique to New York City and its metropolitan areas. In the latter category, a central topic of discussion was the high percentage of houses in New York City that are valued significantly above their replacement cost. Although these house prices are high in part because of strong demand, government regulations such as zoning and building restrictions also exert upward pressure on prices by restricting the supply of new and renovated housing. Nevertheless, it was argued that the city has played an active role in providing affordable housing; since 1987, it has produced 28,000 new low- and moderate-income units and renovated another 155,000 units.

The conference proceedings will be published in an upcoming issue of the ***Economic Policy Review***. Forthcoming papers will be posted at **www.newyorkfed.org/rmaghome/econ_pol/**.

Recently Published

Erica Groshen. 2002. ***How New Is the "New Employment Contract?"*** with Dale Belman, Gary Charness, and David I. Levine. Kalamazoo, Mich.: W.E. Upjohn Institute Press.

Asani Sarkar. 2002. "A Model of Brokers' Trading, with Applications to Order Flow Internalization," with Sugato Chakravarty. ***Review of Financial Economics*** 11, no. 1: 19-36.

New Titles in the *Staff Reports* Series

The following new ***Staff Report*** is available at **www.newyorkfed.org/rmaghome/staff_rp/**.

International

No. 149
Exchange Rate Pass-Through into Import Prices: A Macro or Micro Phenomenon?
José Manuel Campa and Linda S. Goldberg

Exchange rate regime optimality, as well as monetary policy effectiveness, depends on the tightness of the link between exchange rate movements and import prices. Recent debates hinge on whether producer currency pricing (PCP) or local currency pricing (LCP) of imports is more prevalent, and on whether exchange rate pass-through rates are endogenous to a country's macroeconomic conditions. The authors provide cross-country and time series evidence on both issues for the imports of twenty-five OECD countries. Across the OECD and especially within manufacturing industries, there is compelling evidence of partial pass-through in the short run that rejects PCP and LCP. Over the long run, PCP is more prevalent for many types of imported goods. Higher inflation and exchange rate volatility are weakly associated with higher pass-through. However, for OECD countries, the most important determinants of changes in pass-through over time are microeconomic and relate to the industry composition of a country's import bundle.

Papers Presented by Economists in the Research and Market Analysis Group

"Votes without Dividends: An Examination of Managerial Control through Bank Trust Departments," *Renée Adams and João Santos.* Second Asian International Corporate Governance Conference, Korea University, Seoul, South Korea, May 17.

The authors find that while banks control a significant number of the voting rights of their own stock, bank value does not decrease as this control increases, as long as banks' voting rights do not exceed a certain level.

"Uncertainty, Exchange Rate Regimes, and National Price Levels," *Christian Broda.* New York University Department of Economics seminar, New York City, April 29. Also presented at Massachusetts Institute of Technology, Cambridge, Massachusetts, April 30.

Broda's empirical findings suggest that there is a strong relationship between national price levels and exchange rate regimes. As predicted by the study's model, countries with fixed exchange rate regimes have higher national price levels than countries with flexible regimes.

"Are Larger Treasury Issues More Liquid? Evidence from Bill Reopenings," *Michael Fleming.* Bank of Canada seminar, Ottawa, Canada, May 3.

Treasury bills first issued with fifty-two weeks to maturity and then "reopened" at twenty-six weeks are found to be more liquid than comparable-maturity bills first issued with twenty-six weeks to maturity. Nonetheless, Fleming finds that reopened bills have higher yields (lower prices) than comparable-maturity bills, showing that the indirect liquidity benefits of reopenings are more than offset by the direct supply costs.

"Exchange Rate Pass-Through into Import Prices: A Macro or Micro Phenomenon?" *Linda Goldberg.* University of North Carolina Economics Department seminar, Chapel Hill, North Carolina, April 29. With José Campa. Also presented at a New York University Department of Economics seminar, New York City, May 1, and a Dartmouth College-Tuck School of Business Administration seminar, Hanover, New Hampshire, May 9.

The authors find that across OECD countries, pass-through of exchange rates into import prices is best characterized as partial. Changes over time in exchange rate pass-through are driven primarily by a change in the composition of country imports, rather than by changes in macroeconomic variables.

"Global Banking," *Linda Goldberg.* World Bank and George Washington University conference "Financial Globalization: A Blessing or a Curse?" Washington, D.C., May 30.

Goldberg concludes that standard bank evaluation measures used in mature markets should be applied with care to transitioning financial markets. In addition, she argues that results from surveys in new markets may be affected by the timing of the studies because macroeconomic conditions in mature markets may influence the activities of their affiliate banks at any time.

"Board Committee Structures, Ownership, and Firm Performance," *Hamid Mehran.* Eastern Finance Association Conference on Employee Stock Options, Baltimore, Maryland, April 13. With Rachel Hayes and Scott Schaefer.

The authors examine committee structures of boards of directors for S&P 500 firms in 1997 and 1998 and find significant cross-firm variation in the number of committees and presence of various types of committees.

"Nonparametric Pricing of Multivariate Contingent Claims," *Joshua Rosenberg.* Twelfth Annual Derivative Securities Conference, New York City, April 27.

Price deviations are found to be significant in comparisons of fitted prices using nonparametric valuation versus standard multivariate diffusion-based valuation.

"An Empirical Analysis of Stock and Bond Market Liquidity," *Asani Sarkar.* Northwestern University Conference on Investments in Imperfect Capital Markets, Evanston, Illinois, April 26. With Tarun Chordia and Avanidhar Subrahmanyam.

The authors find that monetary loosening during times of crisis enhances stock and bond market liquidity. Thus, the paper links "micro" transaction liquidity with "macro" liquidity, or money flows.

"Information Technology, Education, and the Sources of Growth across U.S. Industries," *Kevin Stiroh.* National Bureau of Economic Research and Conference on Research in Income and Wealth Conference on Measuring Capital in the New Economy, Washington, D.C., April 29. With Dale Jorgenson and Mun Ho.

Stiroh, Jorgenson, and Ho examine the industry-level sources of the U.S. productivity revival and conclude that accumulation of information technology was pervasive, while multifactor productivity growth varied widely across industries.

"Projecting Productivity Growth: Lessons from the U.S. Growth Resurgence," *Kevin Stiroh.* United Nations University Conference on the New Economy in Development, Helsinki, Finland, May 14. With Dale Jorgenson and Mun Ho.

After explaining how information technology played a critical role in U.S. economic growth after 1995, the authors outline a methodology for projecting trend output and productivity growth for the intermediate future.

"Can Vertical Specialization Explain the Growth of World Trade?" *Kei-Mu Yi.* Center for Economic Policy Research European Research Workshop in International Trade, University of Munich, Munich, Germany, June 16.

The author shows that adding vertical specialization to standard trade models helps produce a more accurate explanation of world trade growth in the past forty years.

"Market Discipline and Government Guarantees in Life Insurance," *George Zanjani.* University of Illinois at Urbana-Champaign 2002 Risk Theory Society Seminar, Urbana-Champaign, Illinois, April 29.

Zanjani presents evidence of market discipline by ordinary life insurance policyholders. He finds only weak support for the argument that guaranty fund protections affected the intensity of market discipline.

RESEARCH AND MARKET ANALYSIS GROUP PUBLICATIONS AND PAPERS: April-June 2002

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Economic Policy Review, Vol. 8, No. 1

"Financial Innovation and Monetary Transmission"
Proceedings of a Conference Sponsored by the Federal Reserve Bank of New York

Papers include:
The Monetary Transmission Mechanism: Some Answers and Further Questions
Kenneth N. Kuttner and Patricia C. Mosser

Are U.S. Reserve Requirements Still Binding?
Paul Bennett and Stavros Peristiani

Assessing Changes in the Monetary Transmission Mechanism: A VAR Approach
Jean Boivin and Marc Giannoni

Monetary Policy Transmission through the Consumption-Wealth Channel
Sydney Ludvigson, Charles Steindel, and Martin Lettau

Monetary Policy Transmission to Residential Investment
Jonathan McCarthy and Richard W. Peach

On the Causes of the Increased Stability of the U.S. Economy
James A. Kahn, Margaret M. McConnell, and Gabriel Perez-Quiros

Credit Effects in the Monetary Mechanism
Cara S. Lown and Donald P. Morgan

Securitization and the Efficacy of Monetary Policy
Arturo Estrella

Current Issues in Economics and Finance, Vol. 8

No. 4
Securities Trading and Settlement in Europe: Issues and Outlook
Linda Goldberg, John Kambhu, James M. Mahoney, Lawrence Radecki, and Asani Sarkar

No. 5
Has Inventory Volatility Returned? A Look at the Current Cycle
James A. Kahn and Margaret M. McConnell

No. 6
The Consolidation of European Stock Exchanges
James McAndrews and Chris Stefanadis

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