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Research UPDATE

from the Federal Reserve Bank of New York

RESEARCH AND MARKET ANALYSIS GROUP

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Gains from Emerging Market Investments Outweighed the Effects of Trading Constraints in 1976-99

U.S. investors have long shunned foreign stocks, despite persuasive evidence that international diversification strengthens a portfolio. Many analysts attribute this reluctance to invest abroad to investors' fear that restrictions on stock trading in foreign markets will negate the gains from diversification.

To investigate whether such fears are well founded, a new study ("Should U.S. Investors Hold Foreign Stocks?" ***Current Issues in Economics and Finance***, vol. 8, no. 3) uses historical data to examine the effects of a key type of restriction, short-sale constraints, on the performance of diversified portfolios. The study finds that investing in emerging market stocks brings substantial benefits even in the face of a ban on short sales.

Authors Asani Sarkar and Kai Li construct four international portfolios offering various combinations of U.S. stocks and the stocks of G7 and emerging market countries. The authors then use data on stock returns over the 1976-99 period to estimate the benefit obtained by an investor who exchanges an exclusively domestic portfolio for each of these portfolios. The benefit—measured as an increase in risk-adjusted returns or a reduction in risk (that is, a decrease in the volatility of returns)—is calculated when no trading restrictions apply and, alternatively, when short selling is banned.

A portfolio whose foreign holdings are limited to G7 stocks shows only a small gain in returns under unrestricted trading, and *no* additional return when short sales are prohibited. By contrast, diversified portfolios that include emerging market stocks provide a substantial increase in risk-adjusted returns—as well as a large reduction in risk—when trading is unrestricted. These benefits fall somewhat when short sales are banned in emerging market countries only, but the gain in returns and reduction in risk remain sizable.

The authors also investigate whether the global integration of markets in the 1990s reduced the benefits of diversification or altered the impact of short-sale constraints. By measuring benefits separately for 1976-89 and 1990-99, the authors determine that emerging market investments continued to provide an appreciable gain in returns in the 1990-99 period, even after short-sale restrictions are taken into account.

Also in This Issue…

Forthcoming in the *Economic Policy Review*

Two upcoming issues of the ***Economic Policy Review*** will address the important topics of corporate governance and the effect of financial innovation on the transmission and implementation of monetary policy. Both volumes are planned for release in the coming months, but many papers are already available on our web site.

Papers on monetary policy include:

- "The Monetary Transmission Mechanism: Some Answers and Further Questions," by Kenneth Kuttner and Patricia Mosser
- "Are U.S. Reserve Requirements Still Binding?" by Paul Bennett and Stavros Peristiani
- "Assessing Changes in the Monetary Transmission Mechanism: A VAR Approach," by Jean Boivin and Marc Giannoni
- "Monetary Policy Transmission through the Consumption-Wealth Channel," by Sydney Ludvigson, Charles Steindel, and Martin Lettau
- "Monetary Policy Transmission to Residential Investment," by Jonathan McCarthy and Richard Peach
- "On the Causes of the Increased Stability of the U.S. Economy," by James Kahn, Margaret McConnell, and Gabriel Perez-Quiros
- "Credit Effects in the Monetary Mechanism," by Cara Lown and Donald Morgan
- "Securitization and the Efficacy of Monetary Policy," by Arturo Estrella

Corporate governance papers now available are:

- "Executive Equity Compensation and Incentives: A Survey," by John Core, Wayne Guay, and David Larcker
- "Transparency, Financial Accounting Information, and Corporate Governance," by Robert Bushman and Abbie Smith
- "The Corporate Governance of Banks," by Jonathan Macey and Maureen O'Hara
- "Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature," by Benjamin Hermalin and Michael Weisbach
- "A Survey of Blockholders and Corporate Control," by Clifford Holderness

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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.

Papers Presented by Economists in the Research and Market Analysis Group

"The Dual Role of Corporate Boards as Advisors and Monitors of Management: Theory and Evidence," *Renée Adams*. American Finance Association 2002 Annual Meeting, Atlanta, Georgia, January 4.

"Varying Economic Growth Patterns across New York State," *Jason Bram*. New York State Economics Association Annual Meeting, Canisius College, Buffalo, New York, October 13, 2001.

"Regional Diversity, Volatility, and Economic Growth," *Richard Deitz*. American Real Estate and Urban Economics Association Annual Meeting, Atlanta, Georgia, January 4.

"Are Larger Treasury Issues More Liquid? Evidence from Bill Reopenings," *Michael Fleming*. University of Kentucky Gatton College of Business and Economics seminar, Lexington, Kentucky, February 22.

"Has Monetary Policy Become Less Powerful?" *Marc Giannoni*. 2002 North American Winter Meeting of the Econometric Society, Atlanta, Georgia, January 7. With Jean Boivin.

"Optimal Interest Rate Rules," *Marc Giannoni*. Columbia University Graduate School of Business seminar, New York City, February 5. With Michael Woodford.

"Currency Arrangements and Goods Market Integration," *Linda Goldberg*. National Bureau of Economic Research International Finance and Macroeconomics Spring Meeting, Cambridge, Massachusetts, March 22.

"Exchange Rate Pass-Through into Import Prices," *Linda Goldberg*. American Economic Association Annual Meeting, Atlanta, Georgia, January 5. With José Campa. Also presented at a City University of New York Economics Department graduate seminar, New York City, March 19, and the National Bureau of Economic Research International Trade and Investment Spring Meeting, Cambridge, Massachusetts, March 22.

"Should Suburbs Help Their Central City?" *Andrew Haughwout*. American Economic Association Annual Meeting, Atlanta, Georgia, January 6. With Robert Inman.

"Investor Protection, Ownership, and the Cost of Capital," *Charles Himmelberg*. University of Navarra IESE Business School Conference on European Mergers and Acquisitions, Corporate Restructuring, and Consolidation Issues, Barcelona, Spain, March 13. With R. Glenn Hubbard and Inessa Love. Also presented at a University of Texas at Austin Economics Department seminar, March 20.

"The Ownership Dynamics of New Public Firms," *Charles Himmelberg*. Society for Economic Dynamics Annual Meeting, Atlanta, Georgia, January 5.

"The Credit Cycle and the Business Cycle: New Findings Using the Survey of Senior Loan Officers," *Cara Lown and Donald Morgan*. Econometrica Society 2002 Annual Meeting, Atlanta, Georgia, January 6.

"Financial Globalization and Emerging Markets: With or without Crash?" *Philippe Martin*. International Monetary Fund Research Department seminar, Washington, D.C., January 29. With Helene Rey. Also presented at a New York University Economics Department seminar, New York City, February 19; a University of California at Berkeley Economics Department seminar, Berkeley, California, February 25; a Stanford University Economics Department seminar, Palo Alto, California, February 27; a University of Toronto Economics Department seminar, Toronto, Canada, March 20; and the National Bureau of Economic Research International Finance Meeting, Boston, Massachusetts, March 22.

"Inventory Dynamics and Business Cycles: What Has Changed?" *Jonathan McCarthy*. Eastern Economic Association Conference, Boston, Massachusetts, March 17. With Egon Zakrajšek.

"Self-Validating Optimal Currency Areas," *Paolo Pesenti*. American Economic Association Annual Meeting, Atlanta, Georgia, January 4. With Giancarlo Corsetti.

"Bundling and the Dynamic Entry Process," *Chris Stefanadis*. American Economic Association Annual Meeting, Atlanta, Georgia, January 9. With Jay Pil Choi.

"The Embodiment Controversy: You Can't Have Two Prices in a One-Sector Model," *Kevin Stiroh*. American Economic Association Annual Meeting, Atlanta, Georgia, January 6. With Mun S. Ho.

"Information Technology and the U.S. Productivity Revival: What Do the Industry Data Say?" *Kevin Stiroh*. University of Maryland Department of Economics seminar, College Park, Maryland, February 26.

"How Valuable Is Exchange Rate Flexibility? Optimal Monetary Policy under Sectoral Shocks," *Cédric Tille*. Swiss National Bank seminar, Zurich, Switzerland, March 18. Also presented at a University of Lausanne Economics Department seminar, March 19, Lausanne, Switzerland; a Bank of Canada seminar, Ottawa, Canada, March 27; and a University of Quebec in Montreal seminar, Montreal, Canada, March 28.

"Can Vertical Specialization Explain the Growth of World Trade?" *Kei-Mu Yi*. National Bureau of Economic Research Economic Fluctuations and Growth Meeting, San Francisco, California, February 2.

Other New Publications

- ***Publications and Other Research*:** The 2001 edition of our catalogue lists all of the papers published in our research series as well as many papers published by RMAG economists in economic and finance journals, conference volumes, and scholarly books.
  www.newyorkfed.org/rmaghome/otherres/

- ***The Regional Economy of Upstate New York*:** This quarterly newsletter, produced by the New York Fed's Buffalo Branch, focuses on issues of importance to upstate New York. Now available are "Economic Diversity and New York State" (winter 2002) and "Regional Business Cycles in New York State" (spring 2002), both by Richard Deitz and Ramon Garcia.
  www.newyorkfed.org/rmaghome/regional/newsletter.html

New Titles in the *Staff Reports* Series

The following new ***Staff Reports*** are available at **www.newyorkfed.org/rmaghome/staff_rp/**.

Macroeconomics and Growth

No. 144
Has Monetary Policy Become Less Powerful?
Jean Boivin and Marc Giannoni

This study investigates why monetary policy shocks may have had a reduced effect on the economy since the early 1980s. The authors estimate a vector autoregression over the pre- and post-1980 periods and corroborate the existing results that suggest a stronger systematic policy response to the economy in the later period. They also estimate a fully specified model that replicates the dynamic response of output, inflation, and the federal funds rate to policy shocks in both periods. After quantifying the importance of changes in monetary policy and the private sector in explaining the reduced effect of shocks, the authors find that changes in the systematic elements of policy are consistent with a more stabilizing policy post-1980 and largely account for the reduced effect of unexpected exogenous interest rate shocks. Thus, little evidence points to monetary policy becoming less powerful.

International

No. 146
On the Distributional Effects of Exchange Rate Fluctuations
Cédric Tille

This paper examines the differential impact of exchange rate fluctuations on households in a country. The author extends earlier research by relaxing the assumption of complete international sectoral specialization. His setup allows for the presence of several different sectors in a given country, each producing a different type of good. In combination with incomplete asset markets, the sectoral dimension is found to lead to a heterogenous impact of exchange rate fluctuations within each country. In particular, although a depreciation of a country's currency has an adverse, "beggar-thyself" effect for the country as a whole, a minority of households do benefit.

No. 147
How Valuable Is Exchange Rate Flexibility? Optimal Monetary Policy under Sectoral Shocks
Cédric Tille

The author explores the optimal monetary policy reaction to productivity shocks in an open economy. Whereas earlier studies have assumed that countries specialize in producing particular goods, the author enriches the analysis by allowing for incomplete specialization. He confirms the finding of Obstfeld and Rogoff (2000)—who build on Friedman (1953)—that a flexible exchange rate is highly valuable in delivering the optimal response to country-specific shocks. Its value, however, is found to be much smaller when shocks are sector-specific, because exchange rate fluctuations then lead to misallocations between different firms within a sector. Moreover, the limitation on the value of flexibility is sizable even when specialization is high.

No. 148

Terms of Trade and Exchange Rate Regimes in Developing Countries

Christian Broda

Since Friedman (1953), an advantage often attributed to flexible exchange rate regimes over fixed regimes is the ability to insulate the economy more effectively against real shocks. Using a post–Bretton Woods sample (1973-96) of seventy-five developing countries, the author assesses whether the responses of real GDP, real exchange rates, and prices to terms-of-trade shocks differ systematically across regimes. He finds that responses are significantly different across regimes in a way that supports Friedman's hypothesis. In response to a negative terms-of-trade shock, countries with fixed regimes experience large and significant declines in real GDP, and the real exchange rate depreciates slowly and by means of a fall in prices. Countries with more flexible regimes, by contrast, tend to have small real GDP losses and immediate, large real depreciations.

Banking and Finance

No. 143

The Role of Bank Advisors in Mergers and Acquisitions

Linda Allen, Julapa Jagtiani, Stavros Peristiani, and Anthony Saunders

In their dual role as lenders and advisors to firms that are the target or the acquirer in a merger, banks can be viewed as serving a certification function. Such banks, however, face a potential conflict of interest that may mitigate or offset any certification effect. An analysis of this phenomenon finds evidence of this effect for banks as advisors to target firms. In contrast, conflicts of interest appear to dominate the effect when banks advise acquirers. Moreover, because the market prices conflicts of interest, the authors find significantly negative abnormal returns for bank advisors that advise their own loan customers in acquiring other firms.

No. 145

Are Larger Treasury Issues More Liquid? Evidence from Bill Reopenings

Michael J. Fleming

This paper makes use of a natural experiment of the U.S. Treasury Department to examine the relationship between Treasury security issue size and liquidity. T-bills first issued with fifty-two weeks to maturity and reopened at twenty-six weeks are shown to be more liquid than comparable-maturity bills first issued with twenty-six weeks to maturity. The relationship is less pronounced when bills are on-the-run (the most recently auctioned bills of a given maturity), as opposed to off-the-run, and persists when controlling for other factors that affect liquidity. The reopened bills are found to have higher yields (lower prices) than comparable-maturity bills, indicating that the indirect liquidity benefits of reopenings are more than offset by the direct supply costs.

Recently Published

Leonardo Bartolini. 2002. “Day-to-Day Monetary Policy and the Volatility of the Federal Funds Interest Rate,” with Giuseppe Bertola and Alessandro Prati. ***Journal of Money, Credit, and Banking*** 34, no. 1 (February): 137-59.

Christian Broda. 2001. “Coping with Terms-of-Trade Shocks: Peg versus Floats.” ***American Economic Review*** 91, no. 2 (May): 376-80.

Christian Broda. 2001. “Terms-of-Trade Shocks and Exchange Rate Regimes.” In Alberto Alesina and Robert J. Barro, eds., ***Currency Unions***. Stanford, Calif.: Hoover Institution Press.

Marc Giannoni. 2002. “Does Model Uncertainty Justify Caution? Robust Optimal Monetary Policy in a Forward-Looking Model.” ***Macroeconomic Dynamics*** 6, no. 1 (February): 111-44.

Bart Hobijn. 2001. “Did Trade Liberalization Induce a Structural Break in Imports of Manufactures in Turkey?” with Paul de Boer. In R. Kulikowski, Z. Nahorski, and J. W. Owsinski, eds., ***Modelling of Economic Transition Phenomena***, 198-219. Warsaw: University of Information Technology and Management Press.

Kenneth Kuttner. 2001. “The Great Recession: Lessons for Macroeconomic Policy from Japan,” with Adam S. Posen. ***Brookings Papers on Economic Activity***, no. 2: 93-160.

Philippe Martin. 2001. “Coordination, Cooperation, Contagion, and Currency Crises,” with Olivier Loisel. ***Journal of International Economics*** 53, no. 2 (April): 399-419.

Philippe Martin. 2001. “Global Income Divergence, Trade, and Industrialization: The Geography of Growth Take-Offs,” with Richard Baldwin and Gianmarco Ottaviano. ***Journal of Economic Growth*** 6, no. 1 (March): 5-37.

Philippe Martin. 2001. “Growth and Agglomeration,” with Gianmarco Ottaviano. ***International Economic Review*** 42, no. 4 (November): 947-68.

Carol Rapaport. 2002. “Medicare and Inequalities in Health Outcomes: The Case of Breast Cancer,” with Sandra Decker. ***Contemporary Economic Policy*** 20, no. 1 (January): 1-11.

João Santos. 2002. “Switching from Single to Multiple Bank-Lending Relationships: Determinants and Implications,” with Luisa Farinha. ***Journal of Financial Intermediation*** 11, no. 2: 1-28.

Kevin Stiroh. 2002. “Are ICT Spillovers Driving the New Economy?” ***Review of Income and Wealth*** 48, no. 1 (March): 33-57.

Kevin Stiroh. 2002. “Computers and Productivity: Are Aggregation Effects Important?” with Robert H. McGuckin. ***Economic Inquiry*** 40, no. 1 (January): 42-59.

Kevin Stiroh. 2002. “Information Technology and the U.S. Productivity Revival: A Review of the Evidence.” ***Business Economics*** 37, no. 1 (January): 30-7.

RESEARCH AND MARKET ANALYSIS GROUP PUBLICATIONS AND PAPERS: January-March 2002

Publications are available at **app.ny.frb.org/rps/publications.cfm**. You can also subscribe or obtain many back issues from our web site.

Current Issues in Economics and Finance, Vol. 8

No. 1
Has Foreign Bank Entry Led to Sounder Banks in Latin America?
Jennifer S. Crystal, B. Gerard Dages, and Linda S. Goldberg

No. 2
Live Long and Prosper: Challenges Ahead for an Aging Population
Erica L. Groshen and Thomas Klitgaard

No. 3
Should U.S. Investors Hold Foreign Stocks?
Asani Sarkar and Kai Li

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