

# Lending During the Volcker Disinflation

BY MATTHEW CONNER

**“The Effect of Monetary Tightening on Local Banks.” Rocco Huang. Federal Reserve Bank of Philadelphia Working Paper 08-20, September 2008.**

Beginning in 1979, the Federal Reserve under Paul Volcker instituted an anti-inflationary policy that focused on a drastic tightening of the money supply. At the time, the banking system in the United States was fragmented geographically due to restrictions on local banks that prohibited them from opening branches across county lines. Bank holding companies, however, were able to have subsidiaries in numerous counties. In theory, this should have made them more resilient in the face of monetary tightening because they could move capital between regions with differing demand for loans.

This paper presents new empirical evidence that suggests Fed policy did, in fact, affect isolated local banks more intensely than banks with operations spread across county lines. The study covers the period between 1977 and 1986, a time frame that includes tight as well as expansionary monetary policy stances by the Fed. The results of the analysis were consistent with theory: “Other things being equal, local banks’ loan supply exhibits stronger sensitivity to monetary policy, compared with that of nonlocal banks.” In a contractionary environment, the lending of local banks grew much more slowly relative to bank holding companies with branches than they did under an expansionary policy.

Huang reports that this historical experience suggests that the banking sector’s increasing consolidation and multicounty nature, accompanied by a decline in market share of local banks, might have contributed to the stability in the financial sector and could, therefore, help the Fed to better focus on price stability.

**“Can Smart Cards Reduce Payments Fraud and Identity Theft?” Richard J. Sullivan. Federal Reserve Bank of Kansas City *Economic Review*, Third Quarter, 2008, pp. 35-62.**

With the advent of electronic monetary transactions, the potential for identity theft and payment fraud has increased. Payments can sometimes be authorized by asking the purchaser to verify personal information such as an address or a phone number. But this presents an obvious flaw as this information can be obtained by a criminal who can then impersonate the cardholder.

Sullivan describes a safer alternative to these payment systems: “smart cards” that use less personal information for purchase verification and don’t require a magnetic strip. Smart cards require a user to provide a personal

identification number (PIN) but they also contain a computer chip that stores a digital signature. After the customer enters the PIN, the terminal in which the card has been scanned can verify it against the encrypted information on the card.

This sort of smart card has not been deployed in the United States and Sullivan offers a possible explanation as to why. In his view, offering differing security standards can be seen by vendors as a way to gain advantage over their competitors. This could reduce the willingness of these parties to participate in developing a consistent industry-wide security standard. “Even if the societal benefits justify their cost, payment smart cards with strong authorization security may be adopted slowly,” Sullivan concludes.

**“How Economic News Moves Markets.” Leonardo Bartolini, Linda Goldberg, and Adam Sacarny. Federal Reserve Bank of New York *Current Issues in Economics and Finance*, August 2008, vol. 14, no. 6.**

Economic data releases from the U.S. government and private agencies can have effects on the movements of the financial markets. The intensity of the response to these reports, however, seems to vary. The authors of this study compared the reactions of the markets to the release of 13 scheduled announcements of data from government and private sources between 1998 and 2007. Their focus is on the occasions that actually produce “news,” which is defined by the authors as “the surprise element, or the difference between the actual value announced for an indicator and market participants’ prior expectations of what that value would be.”

The results show that two government releases — the nonfarm payrolls and advance Gross Domestic Product reports — and the Institute for Supply Management’s “Manufacturing Report on Business” tend to affect prices of bond yields, equity prices, and exchange rates in significant and systematic ways. All other releases studied tended to generate erratic or insignificant effects.

The most significant effect tends to be on bond yields. According to the authors’ regression results, a 1 percent surprise increase in nonfarm payrolls, for instance, raises the yield on two-year Treasuries by 78 basis points on average. The yield on 10-year Treasuries sees an average basis point increase of closer to 60 basis points. The authors conclude that the observations in the data set confirm the intuition that markets react to surprise news of stronger economic growth in a way consistent with an expectation that stronger growth implies higher potential inflation in the future. **RF**