

The Costs and Benefits of Disclosure

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“Should Bank Supervisors Disclose Information About Their Banks?” Edward Simpson Prescott, Federal Reserve Bank of Richmond *Economic Quarterly*, Winter 2008, vol. 94, no. 1, pp. 1-16.

Bank supervisors monitor banks for “safety and soundness.” If investigations detect problems, supervisors can act to reduce a bank’s risk, which protects taxpayer liability. The supervisors collect, on- and off- site, a wide body of information, such as details on problem loans. They use this information to rate banks, and results remain private and confidential as required by regulatory policy.

Why not let banks voluntarily disclose or require supervisors to share useful information that, incidentally, costs about \$3 billion (in 2005) to collect? So if banks could disclose their risk ratings, would better information lead to more efficient market prices of bank securities and avoid costly, duplicate collection efforts?

Richmond Fed economist Ned Prescott built a model to investigate whether there was a good reason to require disclosure. He found that public disclosure of bank ratings by supervisors can create an incentive for banks to withhold information so they can get better ratings and gain market favor. So, mandatory disclosure may hurt the ability of the supervisor to collect that information in the first place. (In the model, allowing banks to make exam results public is the same as requiring a supervisor to share the information.) Prescott also shows that allowing a bank to voluntarily disclose its exam report is no better. If a bank did not disclose its report voluntarily, the markets would assume it withheld the information because it had a bad rating since, if it had a good rating, it would have disclosed the information. As a result, voluntary disclosure can impair supervisors’ ability to gather information in the same way that mandatory disclosure can — by creating incentives for banks to withhold it. His findings demonstrate that there are good reasons for supervisors not to share some of this information.

“What Is the Optimal Inflation Rate?” Roberto M. Billi and George A. Kahn. Federal Reserve Bank of Kansas City *Economic Review*, Second Quarter 2008, pp. 5-27.

The Federal Reserve Act calls on Fed policymakers to maintain price stability and maximum employment. The optimal long-run inflation rate is the rate that best fulfills this dual mandate. Kansas City Fed economists Roberto Billi and George Kahn argue in a new paper that for the Fed to carry out its mandate, its long-run

inflation target cannot be zero percent per year.

According to the authors, if the inflation rate is at zero percent, an adverse shock could easily push the inflation rate below zero. A negative inflation rate — known as deflation — can be particularly harmful to an economy. A positive — but low — inflation rate could serve as a buffer against any adverse shocks that could push the inflation rate into deflationary territory.

The authors cite studies that show an upward bias of as much as 1 percent in the Consumer Price Index annual inflation rate and as much as 0.6 percent in that of the Personal Consumption Expenditures (PCE) price index. As a result, an annual inflation rate of zero percent as measured by these indices would mean that the economy is undergoing a deflation. Billi and Kahn note that when the inflation rate is very close to zero, the federal funds rate is likely to be near zero as well. Thus, the ability of the Fed to lower the federal funds rate would be restricted. This could constrain the Fed’s ability to stimulate a slumping economy.

With these issues in mind, Billi and Kahn use a macroeconomic model of the U.S. economy to calculate the optimal annual inflation rate. They find that the optimal annual inflation rate is between 0.7 percent and 1.4 percent when measured using the PCE price index. This estimate is lower than previously published estimates that had specified the optimal annual inflation rate to be about 2 percent.

“How Do EITC Recipients Spend Their Refunds?” Andrew Goodman-Bacon and Leslie McGranahan. Federal Reserve Bank of Chicago *Economic Perspectives*, Second Quarter 2008, pp. 17-32.

First introduced in 1975, the Earned Income Tax Credit (EITC) is one of the largest federal government assistance programs targeted to lower-income households. Designed to encourage work force participation, the program distributed \$40 billion to 22 million families in 2004.

In a new study, Chicago Fed economist Leslie McGranahan and former associate economist, Andrew Goodman-Bacon, investigate the spending patterns of EITC-eligible households during February and March, the period in which EITC benefits are disbursed. The authors found that these households increase relative average monthly spending on vehicles in February by 35 percent relative to non-EITC families. The EITC families also spent more on other transportation costs. “Given the crucial role of access to transportation in promoting work, this leads to the conclusion that recipient spending patterns support the program’s prowork goals,” the authors conclude. **RF**