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1 Hedge Funds, Financial Intermediation, and Systemic Risk
John Kambhu, Til Schuermann, and Kevin J. Stiroh

Hedge funds, with assets under management approaching an estimated $1.5 trillion in 2006, have become important players in the U.S. and global capital markets. These largely unregulated funds differ from other market participants in their use of a variety of complex trading strategies and instruments, in their liberal use of leverage, in their opacity to outsiders, and in their convex compensation structure. These differences can exacerbate market failures associated with agency problems, externalities, and moral hazard. Counterparty credit risk management (CCRM) practices, used by financial institutions to assess credit risk and limit counterparty exposure, are the first line of defense against market disruptions with potential systemic consequences. This article examines how the unique nature of hedge funds may generate market failures that make CCRM for exposures to the funds intrinsically more difficult to manage, both for regulated institutions and for policymakers concerned with systemic risk. The authors acknowledge that various market failures, such as the one linked to the 1998 collapse of hedge fund Long-Term Capital Management, may make CCRM imperfect. However, CCRM has improved significantly since then, and it remains the appropriate starting point for limiting the potential for hedge funds to generate systemic disruptions.

19 A Comparison of Measures of Core Inflation

Robert Rich and Charles Steindel

The ability of central banks to differentiate between permanent and transitory price movements is critical for the conduct of monetary policy. The importance of gauging the persistence of price changes in a timely manner has led to the development of measures of underlying, or "core," inflation that are designed to remove transitory price changes from aggregate inflation data. Given the usefulness of this information to policymakers, there is a surprising lack of consensus on a preferred measure of U.S. core inflation. This article examines several proposed measures of core inflation—the popular ex food and energy series, an ex energy series, a weighted median series, and an exponentially smoothed series—to identify a "best" measure. The authors evaluate the measures' performance according to criteria such as ease of design and accuracy in tracking trend inflation, as well as explanatory content for within-sample and out-of-sample movements in aggregate CPI and PCE inflation. The study reveals that the candidate series perform very differently across aggregate inflation measures, criteria, and sample periods. The authors therefore find no compelling evidence to focus on one particular measure of core inflation, including the series that excludes food and energy prices. They attribute their results to the design of the individual measures and the measures' inability to account for variability in the nature and sources of transitory price movements.

39 The Role of Retail Banking in the U.S. Banking Industry: Risk, Return, and Industry Structure

Timothy Clark, Astrid Dick, Beverly Hirtle, Kevin J. Stiroh, and Robard Williams

The U.S. banking industry is experiencing a renewed interest in retail banking, broadly defined as the range of products and services provided to consumers and small businesses. This article documents the "return to retail" in the U.S. banking industry and offers some insight into why the shift has occurred. At the bank level, the principal attraction of retail banking seems to be the belief that its revenues are stable and thus can offset volatility in nonretail businesses. At the industry level, the authors show that interest in retail activities fluctuates in rather predictable ways with the performance of nonretail banking and financial market activities. They document the features that the recent "return to retail" has in common with past cycles, but also identify factors suggesting that this episode may be more persistent. The most important of these factors is the role of large banks: this retail banking cycle is being driven almost entirely by the very largest U.S. banking firms. The key role of very large banks gives extra weight to this retail banking episode.