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Economic Research

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Defense Spending Flies High in the Southeast

The recent U.S. defense spending bill has been a boon for much of the Southeast. New military contracts will benefit the region?s shipbuilders and aircraft manufacturers but will mostly serve to retain jobs rather than create new ones. Military projects are also rejuvenating technology and construction. But without improvement in the commercial sector, the economic boost from defense spending is unlikely to be sustained.

FEATURES

Glut of Office Space Plagues Atlanta As Tenants Disappear

In the 1990s, the Southeast experienced unprecedented commercial real estate growth. Atlanta, in particular, was the paradigm for development and investment. However, the boom ended in 2001, and now Atlanta is

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Photographs courtesy of Lockheed Martin, U. S. Department of Defense, Northrop Grumman and Elizabeth McQuerry

awash in vacant office space. When can Atlanta?s commercial real estate market expect to be back on track? Not until at least 2005, according to some analysts.

DEPARTMENTS

FEDERAL RESERVE BANK of ATLANTA
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CURRENT ISSUE

Risk and Uncertainty

At the conclusion of its March 18, 2003, meeting, the Federal Open Market Committee (FOMC) released an unusual statement.

Typically, after each periodic meeting, the FOMC issues a press release. This release announces the decision the committee has made on interest rates and gives a brief rationale for the policy stance — a paragraph or two regarding the balance of risks to the economy going forward. In its March statement, the committee wrote that it did not believe it could provide a useful risk characterization of the economy because of the amount of geopolitical uncertainty present at the time. In other words, the FOMC felt that the economic uncertainties overwhelmed any judgments about risks.

This announcement was made on the eve of the United States' invasion of Iraq, which began on March 19.

Risk . . . uncertainty—what's the difference?
Drawing a distinction between uncertainty and risk may seem odd. The terms may be used almost interchangeably in conversation — but not by economists. In his 1921 book, *Risk, Uncertainty, and Profit*, Frank Knight drew a significant economic distinction between the words.

Risk, according to Knight, stems from a random, but known, process. In other words, while any one particular outcome may be unknown, the chances of that outcome can be assigned. Uncertainty, on the other hand, exists when the probabilities of outcomes cannot be assigned. When uncertainty is sufficiently small, the probabilities of any one particular outcome — the risk — can be determined and compared quantitatively to the likelihood of other possible outcomes. Essentially, risk is measurable, but uncertainty is not.

It's like insurance
Being able to quantify risk is the basis of insurance: We do not know who will be involved in an automobile accident today, but we do know some accidents will occur. We share the risk of accidents' costs by joining a large pool of other drivers, paying premiums in accordance with relative risks. An adult pays a lower premium than a teenager because driving record data show a higher accident rate among the teenage population.

If a new form of transportation were developed, however, there would be no immediate way to price insurance premiums with the same degree of specificity as with autos. Insurance actuaries would have difficulty setting prices not because they don't understand risk estimation but because, with little experience with the new form of transport, there would be tremendous uncertainty about the risks entailed.

This example of Knight's distinction between insurable and uninsurable risk demonstrates the role information, or the lack of it, plays in uncertainty. We can insure autos because the probabilities of accidents are fairly certain. We can't insure the new form of transport until the uncertainties are resolved.

Understanding the FOMC's announcement
The FOMC knows that its decisions are closely scrutinized by millions, including financial analysts, business people and

the media. The committee's March 18 statement signaled that the FOMC members, without recent experience in considering monetary policy on the eve of military conflict, felt that they couldn't predict with a great amount of certainty all the possible outcomes that might arise from geopolitical uncertainty.

With the war's outcome decided, other uncertainties about a number of issues still lie ahead. Besides the incident in Saudi Arabia in May, will there be another large-scale terrorist attack on U.S. interests? What might be the economic implications of a possible spread of the SARS outbreak?

The answers to these questions are unknown, with some possible outcomes more easily quantifiable than others. What does this uncertainty hold for gauging the risks to the U.S. economy? That question is one that the FOMC members must continually grapple with.

By Thomas J. Cunningham, vice president and associate director of research
at the Federal Reserve Bank of Atlanta

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Federal Reserve Bank of Atlanta, 1000 Peachtree Street NE, Atlanta, GA 30309-4470 Tel. (404) 498-8500

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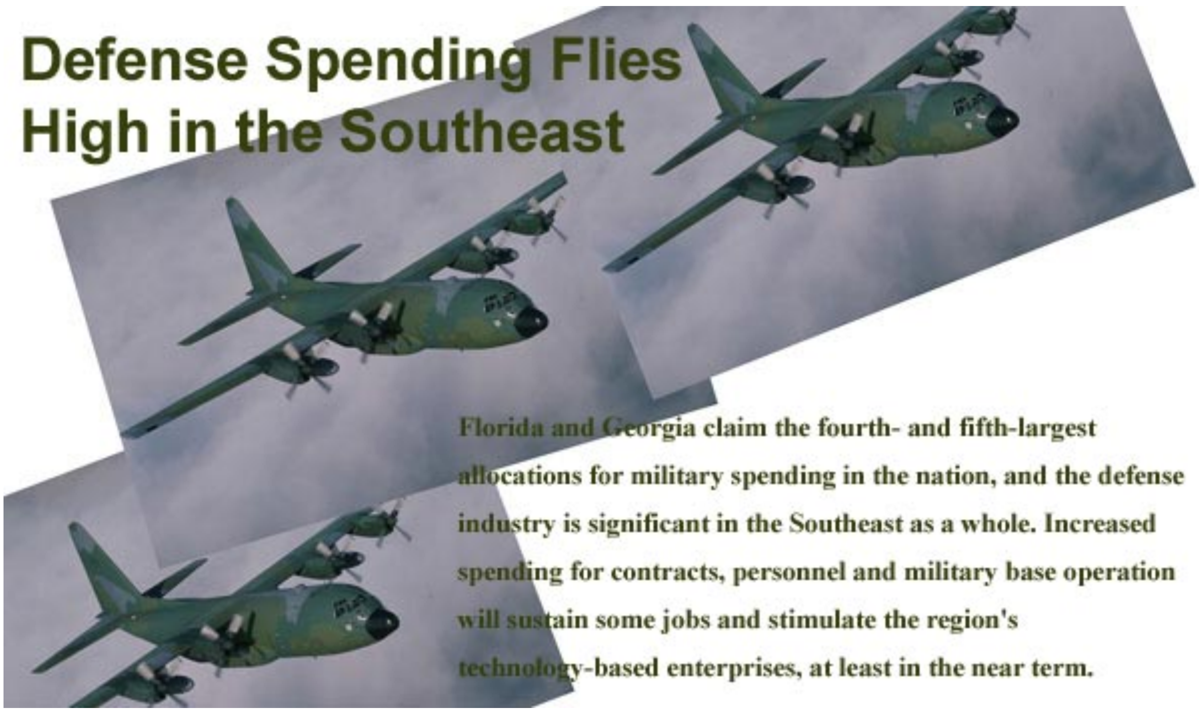
COVER STORY



Across the Southeast, military contractors are producing everything from virtual reality training modules to boots and breakfast cereal as part of the nation’s $243.7 billion 2002 defense spending bill.

Pockets of new jobs and higher salaries for the region’s military personnel are good news for the Southeast, especially in states that have experienced high employment losses during the past few years. However, this timely stimulus will not be sufficient by itself to spark an overall economic rebound in the region.

Businesses in Mississippi and Louisiana are on tap to add crucial new jobs as a result of $1.8 billion worth of ship contracts won by Northrop Grumman. The boost to employment will be significant compensation for shrinking work opportunities that have plagued both states.

Defense spending on aerospace production and research, concentrated in Georgia, Florida and Alabama, accounts for $8.7 billion of the $20 billion in military contracts awarded to the region as a whole. Rather than creating new jobs, however, these contracts will mostly serve to retain jobs.

Technology and communications expenditures could breathe new life into the struggling high-tech industry, which is especially important in Florida. Information technology, biomedical technology, modeling, simulation and training industries, and plastics industries have “attained critical mass” there, according to *Business Florida*, along with the aviation, aeronautics and defense industries. Aviation and aerospace industries alone generate more than $15 billion in annual sales in Florida. According to one research study cited in the *Real Estate Journal* (published by the *Wall Street Journal*), technology-related jobs account for $16.8 billion in wages annually, far outstripping the impact of tourism, which provides $9.6 billion each year.

In Tennessee, a state hard hit by the waning domestic apparel industry, an infusion of more than $1 billion in defense contracts to 2,000 companies will be a significant help. Apparel employment there has halved since 2000.

Contractors across the region will benefit from construction stimulus. In 2001 the Southeast received $1.7 billion of the $10.5 billion allocated for military construction in the nation as a whole. Analysts expect spending on military construction to increase slightly each year through 2005, helping to offset regional downturns in commercial construction that threaten to continue throughout 2003.

In addition, a 4.4 percent pay increase for armed services personnel will add to discretionary income and boost retail spending.

Defense spending remains important in the Southeast

The Southeast, which claimed about 16 percent of the nation's direct expenditures for defense in 2002, has historically relied on military spending as an economic spur. In 1996 the Southeast was the third-largest regional recipient of defense contracts, behind only the Western and Mid-Atlantic states.

Cuts in defense spending in the late '80s and early '90s compelled manufacturers to turn military capacity toward civilian production. For example, global positioning systems have been widely adapted for civilian use in navigation and agricultural equipment, some shipyards building naval vessels turned to producing pleasure boats, and some airplane manufacturers producing military planes switched to making corporate jets. While the orientation of traditionally defense-oriented industries shifted, the clusters of technological expertise and skilled labor remain intact and have drawn defense contractors back to the region. Georgia in particular has benefited, moving from eighth nationally in the amount of defense contract dollars received in 1996 to fifth in 2001. Florida moved from fifth to fourth in 2001.

Although Louisiana, Mississippi, Alabama and Tennessee receive considerably fewer defense dollars than Florida and Georgia, military spending is nonetheless an important factor in these states' economies.

Aviation struggles despite defense demand

The Lockheed Martin plant in Marietta, Ga., one of the region's largest benefactors of defense spending, landed a $4 billion contract to produce 40 C-130J aircraft for the Air Force and 20 KC-130J aircraft for the Marines. However, the six-year contract will not produce any new jobs at the plant; rather, it will ensure that the plant's 7,000 employees retain their jobs, according to a Lockheed spokesperson.

ALTHOUGH SOME BIG MILITARY CONTRACTORS SUCH AS LOCKHEED MARTIN AND RAYTHEON HAVE RETURNED TO PROFITABILITY IN RECENT MONTHS, THE INDUSTRY AS A WHOLE CONTINUES TO STRUGGLE.

The story is similar to what's going on elsewhere in the nation. Setbacks from the combined effects of terrorism and SARS as well as curtailed travel during the war with Iraq have cut commercial aviation production dramatically. Companies that would normally expand their facilities and workforce in response to the added demand of defense contracts currently have excess capacity. So instead of adding employees, the defense business is helping to forestall layoffs and shutdowns by contractors.

Boeing's contract to assemble a missile interceptor in Huntsville, Ala., will also help maintain the status quo, providing jobs mostly for its existing employees. The Arrow 2 interceptor, developed jointly by the United States and Israel, will be produced along with the earlier Avenger system. Although Avengers are still being manufactured for export, demand is flagging. Thus, Arrow 2 production will fill the gap. Boeing employs about 2,600 people in the Huntsville area on various NASA and military projects.

According to industry analysts, shifting civilian capacity to military projects will offset, but not fully compensate for, shrinking commercial demand in the aeronautics industry. Reduced production of commercial jetliners alone — down to 380 planes in 2002 from 526 in 2001 — cost aerospace manufacturing $6.8 billion in sales, about 20 percent of last year's total, says David Napier, director of the Aerospace Research Center.

Some of the region's aerospace operations will still yield new jobs, however. For example, a Lockheed Martin operation in Alabama's Pike County to assemble THADD missiles will add 150 new jobs there. And a Decatur, Ala., plant that produces Delta II and Delta III rockets will become the main headquarters for Boeing rocket production, adding another 160 jobs that are being moved from Pueblo, Colo. A Boeing contract for $150 million to upgrade E-6 Mercury plane cockpits will add 80 jobs at the former Cecil Field Naval Air Station near Jacksonville, Fla. Boeing recently created 95 new slots at Cecil, representing a doubling of the plant's workforce in less than a year.

Although some big military contractors such as Lockheed Martin and Raytheon have returned to profitability in recent months, the industry as a whole continues to struggle. Boeing registered a net loss of $478 million in the first quarter of 2003. In the aviation sector, military sales rose markedly in 2002, accounting for $50 billion of a total of $148 billion. Although increases in military sales helped offset losses in commercial sales, overall sales in 2002 were still down by about 3 percent. Total employment in the aerospace industry also dropped last year, sliding 72,000 from a total estimated at 712,000 workers.

Despite projected increases in military production in 2003, commercial production will continue to drop. Aviation industry analysts also project a decline for exports, which accounted for about $57 billion in 2002. Industry officials foresee a 6.8 percent downturn in total sales in 2003 — twice as steep as 2002's losses of 3.2 percent — despite welcome infusions of military demand.

Technology shows signs of life

Defense spending has sparked rejuvenation, if not recovery, in the ailing technology sector, which is showing signs of life for the first time since the technology bubble burst in late 2000. The demand for technological sophistication in weaponry and battle strategy has given rise to a new round of research and development, providing hefty grants for university-based research groups and independent firms.

Georgia Tech Research Institute was awarded $60 million in 2001 to continue work on research projects that could eventually translate into superior weaponry. Researchers there are working on sensor systems to monitor cargo containers, intelligence visualization systems to help determine the position of hostile troops, and standardized systems to evaluate military efficiency and structure timelines for equipment updates.

Miltope Group Inc., a laptop computer maker based in Hope Hull, Ala., recently landed a $19.5 million contract to produce 2,000 computers that can endure the rigors of deployment and combat. Slated for use by the U.S. Army, the TSC-750M is designed to withstand blowing sand and other atmospheric stresses and can be used on the field, in tanks or in helicopters.

Florida, which is well poised to make great strides in the technology arena through its decades of involvement in the defense and space industry, has become the defense technology hub of the Southeast. The state’s 21 military bases and various defense-related industries have a $32 million impact on Florida’s economy each year, according to economist Rick Harper, director of the Haas Center for Business Research and Economic Development at the University of West Florida. Economic developers hope to parlay this mutually beneficial relationship into an even more lucrative arrangement by becoming technology pioneers in “cyberwarfare.”

INDUSTRY ANALYSTS SEEM TO AGREE THAT WHILE MILITARY SPENDING IS HELPING SAGGING ECONOMIES THROUGHOUT THE NATION, IT WILL NOT CREATE A SUSTAINED REBOUND WITHOUT CONSIDERABLE IMPROVEMENT IN THE COMMERCIAL SECTOR.

Northrop Grumman’s Integrated Systems in Melbourne, Fla., has recently unveiled what it calls the Cyber Warfare Integration Network, or CWIN. Using approaches that seem to combine Disneyland, *Mortal Kombat*, and *Doom*, these facilities consist of multiple chambers that use sets, props and virtual reality to simulate battlefield conditions. The goal is to train soldiers to prepare for war under many conceivable circumstances. CWIN facilities can also be used to train police and firefighters for a whole range of critical scenarios. Another virtual reality training scheme is being hatched by a former Disney employee through his i.d.e.a.s. corp. He plans to create a sort of military training theme park called Battle Stations on the coast of Virginia. The military likes the idea: Simulation training centers are emerging throughout the region.

Government spending nationwide on computers, software and related services is projected to increase to $58.1 billion in

2003, up 17 percent from fiscal 2002. In an interview with Reuters news agency, senior defense analyst Jerry Weltsch with Frost & Sullivan predicted that the U.S. market for simulation and training alone will expand at the rate of 3.5 percent each year into 2008, with the Pentagon channeling $4.8 billion in defense dollars toward such high-tech projects.

Thus far, however, contracts have gone mostly to more conventional, proven applications such as a deal with Norcross, Ga.-based EMS Technologies Inc. to produce electronic systems that jam enemy radar and briefcase-sized communication systems that troops can carry into the field. According to a recent article in *Fortune*, entrepreneurs have been flooding the market with defense- and security-related technologies. However, venture capitalists remain leery of funding projects aimed at the Department of Defense.

Gulf Coast shipbuilding helps keep ailing economies afloat

Buffeted by diminished tourism, a steadily shrinking manufacturing sector and lackluster performance in services, Louisiana and Mississippi are in need of the boost promised by Northrop Grumman's multi-million-dollar shipbuilding expansions.

Northrop Grumman Ship Systems (formerly Ingalls) on the Mississippi Gulf Coast is the state's largest private-sector employer. It provides jobs for 11,000 workers in Pascagoula and Gulfport and hands out $8.6 million in payroll checks each week. In addition, the shipyard's impact extends to another 6,500 workers whose jobs depend on the huge operation, according to a study by the Gulf Coast Economic Research Center at the University of Southern Mississippi.

A $288 million expansion of the Northrop Grumman facility on the Gulf Coast will create as many as 2,000 new jobs. The expansion will convert the Gulfport yard to a facility that will build ships out of military-strength composites.

"When you talk about shipbuilding, you don't think about high-paying, high-tech jobs, but our employees in Mississippi average more than $40,000 a year," says Den Knecht, vice president of Northrop Grumman Ship Systems, as reported by the *Atlanta Journal-Constitution*. The construction phase could add another 6,000 jobs, according to an economic impact study by Bob Rohrlack, executive director of the Mississippi Development Authority.

"That will be major," says Rohrlack, in an interview with the Jackson Clarion-Ledger, "given the tough economic times we're seeing nationwide." Mississippi suffered one of the sharpest percentage drops in employment in the nation in 2001.

Northrop Grumman now has orders for $5.3 billion worth of ships to be made in its Pascagoula, Miss., yard, including a commission to head the team working on the high-tech DD(X) destroyer for the Navy.

Northrop Grumman now has orders for $5.3 billion worth of ships to be made in its Pascagoula yard, including a commission to head the team working on the high-tech DD(X) destroyer for the Navy. A number of other defense contract deals are pending. Although Pascagoula won't get all the work, the payback will help the state break even on its investment in refurbishing the yards — $144 million over three years — by 2013, according to the impact study. The state of Louisiana, like Mississippi, will contribute about $50 million to help refurbish its Avondale shipyard, now owned by Northrop Grumman, which will match that amount to upgrade the facility.

The Avondale shipyard, the largest manufacturing employer in the state, received a $150 million contract to make LPD-17 dock-landing ships. Shipbuilding contracts for the state totaled $806 million overall in 2002.

Economist Loren Scott of Louisiana State University predicts that transportation equipment manufacturing will generate about 3,000 new jobs in Louisiana. He believes the Avondale yard will provide a significant boost to the Thibodaux-Houma metropolitan areas.

Military building shores up construction industry

Soldiers at Fort Rucker, Ala., are looking forward to better facilities. As part of the $10.5 billion military construction bill signed into law in October 2002, the base will receive $32 million for additions and improvements, including six new TH-67 training aircraft, OH-58 Kiowa Warrior simulators for training, security barriers for the base's gates and a new fitness center.

Florida's Hulbert Field will be outfitted with new command and operation facilities and a 144-room dormitory. Fort Benning in Georgia has been awarded $45 million for a new barracks complex and an urban assault course, while Fort Polk in Louisiana will add a $31 million digital training range.

Military construction projects such as these will inject $1.7 billion into the region's building industry. This amount should help to offset slowing in the commercial construction industry that Atlanta Fed analysts expect to continue in most of the Southeast in 2003.

A look at the longer term

Defense industry analysts seem to agree that while military spending is helping sagging economies throughout the nation, it will not create a sustained rebound without considerable improvement in the commercial sector.

According to Wells Fargo economist Sung Won Sohn, as quoted in *USA Today*, "What tech really needs is for American companies to start spending again. War spending is helpful, but only for a short time."

ACCORDING TO U.S. DEPARTMENT OF DEFENSE PROJECTIONS, MILITARY SPENDING IN MOST CATEGORIES IS SLATED TO PEAK IN 2005 AND PLATEAU THROUGH 2007.

According to U.S. Department of Defense projections, military spending in most categories is slated to peak in 2005 and plateau through 2007, ensuring a few years of modest but reliable growth in defense contracts. However, Loren B. Thompson, chief operating officer of Lexington Institute, a defense think tank, notes in an interview with *Business Week* that defense money could be "leeched away" by Congress as it faces other spending needs approaching the 2004 election.

Plans for closing military bases in 2005 also loom. While decisions have not yet been reached regarding which bases to close, the Pentagon has committed itself to weeding excess capacity. Base closures can have catastrophic effects on local and state economies.

Critics of national priorities, such as Tennessee State Representative Kathryn Bowers, believe that the amount earmarked for defense spending jeopardizes crucial domestic programs that fund education, roads, health care, public assistance and the arts. States are also struggling to meet budgets. Bowers points out that Tennessee faces a $400 million budget gap and that states collectively lack $17.5 billion to meet their obligations in fiscal 2003.

Regardless of the long-term impacts of military spending on the Southeast, most defense workers in Marietta, Pascagoula, Gulfport, Huntsville and Jacksonville can count on their jobs for the next few years. Like many others across the nation, these workers hope military contracts will prime the pump to keep the dollars flowing.

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FEDERAL RESERVE BANK *of* ATLANTA

Economic Research

REGIONAL FOCUS

Corporate downsizing has taken a toll on office landlords across the Southeast. But the overabundance of office space, created by significant job losses and overbuilding, has been particularly severe in Atlanta, the region's largest commercial real estate market.

During the mid- and late 1990s, the Southeast set the pace for the nation regarding commercial real estate development and investment. The boom was most evident in Atlanta, where technology, telecommunications and the area's traditional base of blue chip companies expanded over an extended period of time — from before the 1996 Summer Olympics through 2000.

Even in early 2001, the outlook for Atlanta's commercial real estate market was generally favorable. The office vacancy rate was a healthy 11.6 percent during the first quarter. Certainly, the stock market was in decline and dot-com businesses were faltering. But some major companies such as WorldCom (now MCI) and Mirant were still in expansion mode, and investors remained eager to bankroll new office projects.

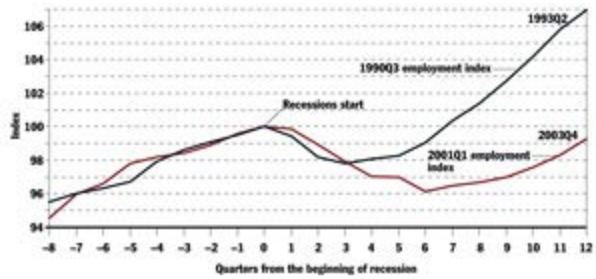
During 2001 and 2002, construction cranes were a frequent sight on Atlanta's ever-evolving skyline as speculative projects moved from concept to steel and glass reality. In early 2003, some three million square feet of new office properties were under construction in the Atlanta area. (See the sidebar) for a look at commercial real estate conditions elsewhere in the Southeast.)

"Phantom" vacancy haunts market

Many developers were counting on a continuation of Atlanta's strong job growth. In early 2001, however, the Atlanta job-creation machine suddenly cranked into reverse. According to the Bureau of Labor Statistics, after netting no fewer than 55,000 jobs each year between 1993 and 2000, Atlanta's payrolls grew by only 10,000 in 2001 and declined by 16,000 in 2002 (see the chart).

Atlanta: Total Employment, 1990Q1 vs. 2001Q2 Recession

The result: Atlanta today is awash in vacant office space. For example, in 2002 Houston-based developer Hines completed One Overton Park, a 380,000-square-foot office tower built speculatively to accommodate an anticipated expansion of corporate tenants in northwest Atlanta. As of early 2003, One Overton Park is more than 80 percent empty. Even signature buildings such as One Atlantic Center in midtown Atlanta have large vacancies, and major new projects in the area such as Atlantic Station (6.5 million square feet of office space) and the 41-story Symphony Center are in early phases of development with pre-leased tenants.



Note: This chart compares the impact in the Atlanta area of recessions that began in 1990 and 2001, measured in terms of employment. The blue line shows the downturn and recovery of 1990–93. The red line shows the 2001–2003 downturn and recovery; the data for 2003 are projections.
Sources: Economy.com; Torto Wheaton Research, Spring 2003 Outlook

As the office supply has increased, so has the vacancy rate in the Atlanta area, which has surged nearly 11 percentage points in two years to more than 22 percent as of the first quarter of 2003. Moreover, many real estate professionals believe that number is deceptively low given the undetermined amount of "phantom vacancy" — a large volume of subleased office space that has opened up as a result of corporate downsizing. If such phantom vacancies are factored in, the city's actual office vacancy rate is probably closer to 30 percent.

"I'm worried about Atlanta," said Raymond Torto, a principal with Torto Wheaton Research in Boston. "There has been a tremendous development spigot in recent years, and it's affected virtually all property types."

How out of balance is the supply of real estate in Atlanta? Even without considering the phantom subleased space, the market confronts some daunting arithmetic. Currently, some 25 million square feet of vacant space exists. The market needs to absorb 10 million square feet to get that number back to a healthy level of about 12 percent to 13 percent vacancy.

Assuming the most optimistic scenario — in which Atlanta's economy kicks into high gear later in 2003 and reports the same rate of job growth that it delivered during the late-1990 boom years — Torto projects the market will return to balance in about seven quarters, or sometime in 2005. If growth is slower — a prospect that Torto and others believe is more likely — the office vacancy rate could remain above 20 percent well beyond 2006.

Charlie Croker vs. Bernie Ebbers

Atlanta has an impressive track record of growth, and some signs are positive when looking ahead. Newell Rubbermaid recently announced it would relocate its headquarters from Freeport, Ill., to Atlanta's northern suburbs. The company is planning to lease or build about 300,000 square feet in north Fulton County as the new home for some 350 corporate staff.

With its premier airport, highway system, low corporate tax rate, wide variety of housing options and low cost of living in comparison to California and the Northeast Corridor, Atlanta is an attractive location for major corporations. But how the area will fare in the next 12 to 18 months is the subject of some concern.

Developers are accustomed to boom and bust, particularly in high-profile markets such as Atlanta. Some of the biggest players in today's real estate markets survived hard times in the '70s and '80s.

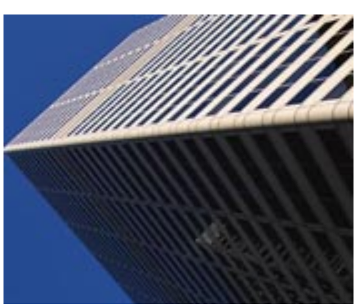
"Atlanta is home to a number of industries that are in downsizing mode," said John Robertson, assistant vice president and team leader for the Atlanta Fed's regional research group. Because of the city's heavy concentration of technology and travel-related industries, which were particularly hard hit in the latest recession, Robertson forecasts that Atlanta's recovery will probably lag that of the rest of the nation.

Developers are accustomed to boom and bust, particularly in high-profile markets such as Atlanta. Some of the biggest players in today's real estate market survived the painful shakeout of the mid-1970s, and most were around to experience the demanding years from 1989 through 1991.

How is the present market different from these difficult past episodes? It's too early to write a book about it, but it's likely the story will be different from Tom Wolfe's *A Man in Full*, a 1998 novel about the fall of high-living Atlanta developer Charlie Croker in the early 1990s. In Wolfe's story, the fictitious Croker battles lenders for control of his largely vacant real estate buildings in Atlanta. Eventually, he loses control of his real estate — along with his "trophy wife" and lavish lifestyle.

Perhaps a better symbol for today's battered real estate market is Bernard Ebbers. While he was chairman of WorldCom, the company was accused of inflating its financial performance and stock price. After the story broke about WorldCom's actual performance, the company declared bankruptcy and laid off thousands of workers. In the process, large chunks of empty office space became available, much of which was located at the company's Mississippi headquarters and major regional offices such as Atlanta.

The drop in demand for space has been painful for developers, who say they were responding only to what appeared to be a legitimate need for office supply. "We didn't overbuild the market — we overleased it," said Tad Leithead, senior vice president of Cousins Properties in Atlanta. "The problem was an unrealistic expectation among tenants for the amount of space that they would need."



"WE DIDN'T OVERBUILD THE MARKET – WE OVERLEASED IT. THE PROBLEM WAS AN UNREALISTIC EXPECTATION AMONG TENANTS FOR THE AMOUNT OF SPACE THAT THEY WOULD NEED."

TAD LEITHEAD
SENIOR VICE PRESIDENT
COUSINS PROPERTIES

Recovering from a "perfect storm"

Much of the development has been funded through publicly traded real estate investment trusts (REITs). For its part, the banking industry has probably mitigated the excess space problem somewhat by tightening underwriting standards. Savings and loans are not a major factor in the market as they were in the 1980s, and tax-driven deals are less of a problem now than they were before the IRS code was revised in 1986. Today, underwriters typically refuse to lend more than 70 percent of the value of the project, compared with 100 percent 15 years ago.

But even with stricter guidelines, the real estate market may be in a difficult position. How could this happen? Leithead describes an unforeseen "perfect storm" that struck the Atlanta economy with particular vengeance. A convergence of multiple forces took the area by surprise, pounding the area's office, industrial and multifamily real estate sectors while leaving the residential market (at least for now) relatively unscathed.

Elements of this storm include

- The collapse of demand from dot-com tenants. Firms such as eTour leased hundreds of thousands of square feet in Atlanta. Many of these companies are now out of business or significantly downsized.
- The telecom meltdown. Atlanta was a major center for telecom firms that attracted a great deal of investment during the 1990s. For example, WorldCom left behind a swath of office space in northwest Atlanta after the company declared bankruptcy in 2002.
- The terrorist attacks of Sept. 11, 2001. Atlanta is a major destination for business travel and conventions, two industries that have been hit hard following the attacks. Cutbacks in the airline industry, particularly Atlanta-based Delta Air Lines, also have hurt the area economy.
- Corporate layoffs. Major corporations such as Coca-Cola, Cingular Wireless and BellSouth have trimmed payrolls in an effort to sustain profits during a period of sluggish sales growth.

The impact of low interest rates

The Federal Reserve's low-interest-rate policy has also had a significant impact. Many property owners have coped with the financial strain of falling rentals by refinancing to low-interest, adjustable-rate debt. When short-term rates do begin to rise, however, some property owners may experience renewed pressure to make payments on their loans.

The Southeast's once-booming multifamily housing sector has had an especially difficult time adjusting (see the sidebar). The lowest mortgage rates in 40 years have bolstered the single-family residential market, enabling first-time home buyers to qualify for mortgages. This trend has prompted an exodus of apartment tenants across the Southeast because even low- and moderate-income residents are able to afford homes of their own.

A surplus of space also has developed in the Atlanta area's low-profile industrial sector, which is typically less susceptible to real estate cycles. Corporate cutbacks have taken a toll on Atlanta-area warehouses and factories; industrial vacancy rates jumped from 7 percent in early 2001 to more than 17 percent in the first quarter of 2003. Other Southeastern cities report similar patterns with continued consolidation, downsizing and the migration of operations to low-wage labor markets overseas.

Smoother sailing ahead?

The Atlanta real estate market will eventually recover. The question, though, is when and how. Egbert Perry, a member of the Atlanta Fed board of directors and chairman and CEO of Integral Group, an Atlanta firm that develops apartments, envisions an expansion of jobs in the area but nothing spectacular in the foreseeable future. His forecast: “Trickle-along growth, then a slow ramp-up.”

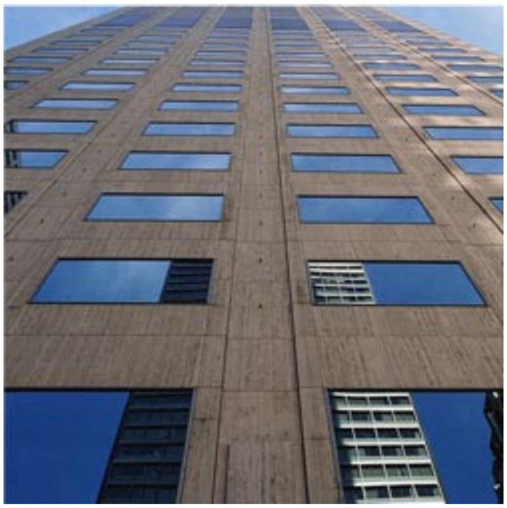
Real estate development is not for the faint of heart, and optimism runs deep in Atlanta. Leithead envisions short-term uncertainty and inertia, followed by a rapid, steady upturn as the area’s corporate executives realize that they need to hire more employees to grow and become more profitable. Once that happens, empty office space will start to fill up. “Irrational exuberance has been replaced by irrational pessimism,” he said. “But the market will even out in the long run.”

Mostly Sunny for Florida Office Market; Other Areas Cope with Overbuilding

Commercial real estate in Florida depends on a broad range of industries — tourism, support services, small businesses and investment from Latin America. Although some of these sectors have faltered, key real estate markets across the state are prospering, with the trend improving in recent quarters.

“Florida has been stronger than the nation because of its service industry focus,” said John Robertson, an officer in the Atlanta Fed’s research department. “There has been a lot of migration into Florida. Our best guess is that this trend will continue.” For a number of years Florida’s population has been growing at twice the rate of the rest of the country, driven significantly by migration from Latin America and by retirees.

Miami sidesteps overbuilding



Urban and cosmopolitan southeast Florida is an example of this trend. Miami’s reliance on small and medium-sized businesses has worked to the area’s advantage during a period characterized by corporate downsizing. Miami has avoided severe overbuilding because it has not traditionally attracted the big-money investors who have fueled rapid development in other markets such as Atlanta.

In a pattern mirrored elsewhere in Florida, Miami lost a moderate number of jobs in 2001 but began posting job growth in late 2002. Latin American banks and corporations continue to expand, along with law firms, trade consultants and other service organizations. The office vacancy rate for Miami is up from 10 percent in 2001 to more than 15 percent in the first quarter of 2003, but it appears to be leveling out. Demand for space is particularly strong in the downtown and beachfront areas.

Real estate analysts cite a trend toward 24-hour communities, with businesses moving back into historic urban areas and demand on the rise for environments where businesses and residents mingle. Miami, in particular, with its vibrant and colorful nightlife and ethnic diversity, has benefited. At the same time, many of the cookie-cutter office buildings in sprawling suburban locations across the Southeast have struggled.

Autos and health care drive other parts of the region

Other major commercial real estate markets in the Southeast have benefited from job growth in the automotive sector, which has partly offset reductions in relatively low-wage manufacturing fields such as textiles and apparel. Saturn and Nissan have expanded production facilities outside of Nashville. Computer manufacturers Dell and Hewlett-Packard also are absorbing more space in the area.

Nashville has avoided severe overbuilding, but excessive construction has created a modest glut of suburban office/industrial space. The office vacancy rate is close to 16 percent. Also working in Nashville's favor is a strong medical sector, which is less vulnerable to swings in the economy.

A similar situation applies in Birmingham. The University of Alabama has expanded its Biomedical Research Institute although the Birmingham office market may have suffered a setback with the recent SEC investigation involving Birmingham-based HealthSouth.

Alabama's automobile manufacturing sector has increased demand for industrial space and has caused a ripple effect, which has helped the market. Five major plants are located within 85 miles of Birmingham (Mercedes, Hyundai, Honda, Fiat and Toyota), and many other businesses have opened in the area to provide parts and services to the auto industry.

During the 1990s, Birmingham's office space was scarce. But the supply has now caught up with demand. Several downtown office projects, including Concord Center and One Federal Place, were launched in the downtown area in recent years. The result: Birmingham's office vacancy rate increased from under 6 percent in 1999 to about 10 percent as of early 2003, and it may go a bit higher still.

Commercial real estate will continue to be a major contributor to the Southeast's economy. It may be a while, however, before enough businesses can be found to fill some of the abundant vacancies. But eventually it's likely these assets will be utilized to support future growth.

"Bottom Fishers" Drive Southeastern Housing

As the economy in the Southeast has slowed, housing has emerged as a notable area of strength. Brisk residential construction has sustained growth in myriad related fields, from building materials to financial services.

"We continue to be amazed by the strength of the market," said John Wieland, an Atlanta-based homebuilder and former chairman of the Atlanta Fed's board of directors. "March (2003) was a record month for us, and April was strong as well. It's all being fueled by incredibly low (interest) rates."

Many consumers perceive the 40-year-low mortgage rates as a fleeting opportunity to buy. So-called bottom fishers (people who are motivated to buy or refinance homes because of low interest rates) are rushing into purchasing decisions while rates remain favorable, and the number of people who qualify for mortgages has never been higher.

For now, buyers have a strong hand, with "some areas reporting a softening in market conditions," according to the Atlanta District section in the April 2003 Beige Book, an anecdotal report on current economic conditions released eight times a year by the Federal Reserve. "High-end homes remained difficult to sell in most parts of the District." What's lacking, at least for now, is substantial job creation or relocation into parts of the region, according to the report.

Perhaps the softest price range for homes is $500,000 to $700,000. "A lot of people who buy in that range have taken it on the chin with investments," said Phillip Rassel, a vice president with Metrostudy, a residential real estate information service.

The decline in stock wealth has been broad but not catastrophic for a significant number of affluent families with the means to bid $1 million and up for their dream home, Rassel said. As a result, the value of some houses in exclusive neighborhoods continues to appreciate, and the second-home vacation market remains strong in certain locations.

Strength in the housing sector has applied to most parts of the Southeast. New Orleans has recovered from a slump in tourism late in 2001, and home-sale prices increased 7.5 percent during the first nine months of 2002. Sales activity also increased despite weak sales of multifamily dwellings.

Housing permits in 2002 were at or near peak levels in Birmingham, Nashville and Atlanta. And the residential market for Florida has been "exceptionally strong," said Brad Hunter, director of Metrostudy's south Florida office. "There's been a lot of capital flight from Venezuela and Argentina, and people are choosing to put it in the Miami market," he added.

Given the weak economy and the disparity between residential and commercial real estate, speculation exists about a "housing bubble" that could lead to a sudden decline in home prices and hence in equity.

Typically, this sort of bust would occur after a housing market boom. But that doesn't appear to be the pattern in the Southeast. Homes have been appreciating steadily at about 7 percent annually, compared with surges of 20 percent or more that prompted past collapses in California and elsewhere. "There hasn't been the hyperappreciation that lends itself to the bubble that people have been talking about," Rassel said.

Wieland agrees, adding that the price of building supplies (lumber, concrete and wallboard, for example) has fallen, helping to dampen the cost of housing. "There's nothing to collapse on sticks and bricks," he said.

Demand is expected to continue for well-situated homes built with quality construction techniques and materials, said Wieland. Residences that are hastily built on small or poorly located lots are more vulnerable to price correction.

When it comes to housing, the Southeast has inherent advantages. People continue to move south, and longstanding migration trends are unlikely to change because of interest rates. The region's track record for creating jobs, while it has lagged in the past two years, bodes well for this key driver of today's economy.

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Economic Research

INTERNATIONAL FOCUS

A Little Credit Goes a Long Way: The Global Microfinance Movement

A proverb says that “ready money works great cures.” Unfortunately, many of the world’s citizens have little or no “ready money” to cure the ills of living in poverty. But a decades-old movement that makes credit available to low-income families and businesses is gaining momentum worldwide, offering millions of people hope for greater financial security.

If it’s true that “a little credit goes a long way,” then Lucila Mendoza Moisin of Otava, Ecuador, is living proof of the adage. Through access to small loans, known as microcredit, Moisin was able to start her own crafts business, which provides a relatively steady income for her family and enabled her to buy a small house. Moisin and millions of people just like her have launched or are working in small businesses made possible by small loans and other financial services that were previously unavailable to them. They are benefiting from a global movement known as microfinance.

Microfinance institutions fuel microenterprises throughout the world.

Microfinance is commonly defined as the provision of a broad range of financial services — including loans, savings deposits, payment services, money transfers and insurance — to low-income households and their respective microenterprises. Microenterprises are more difficult to define because the term covers such a wide range of business types. However, in general, microenterprises have the following characteristics: They are run by their owners, they depend on family labor, they employ fewer than 10 workers, and they have limited access to formal financial services.

Recipients of microfinance services are typically struggling entrepreneurs who lack much-needed access to credit. Recipients may also include people who have lost their jobs as a result of a weak economy as well as underemployed workers earning extremely low pay. In the short term, access to microfinance services can help individuals increase their income, smooth consumption, build small enterprises and reduce their vulnerability to economic shocks. In the long term, microfinance aims to break the poverty cycle by contributing to food security, children’s education, investment opportunities, self-empowerment and gender equity.

One hallmark of the microfinance industry is its outreach to women, many of whom otherwise would not have an opportunity for fiscal independence. Especially in some developing countries, women are traditionally excluded from commerce and have limited access to most financial services. Approximately half of all microfinance clients worldwide are women, with many programs targeting them exclusively.

But microcredit is not a handout. It constitutes a loan, bound with the expectation of repayment of both principal and interest, which is often well above market rates because of high transaction costs. Several studies show that clients willingly, and successfully, pay the higher interest rates necessary to ensure long-term access to credit.

Currently, thousands of institutions commonly referred to as microfinance institutions (MFIs) exist to provide loans and other financial services to the world's poor and their microenterprises. Just as people such as Moisin benefit from greater access to financial services, MFIs benefit from being able to draw on a vast pool of underserved potential clients, who in the majority of cases have proved creditworthy, with average repayment rates higher than 90 percent.

As an industry, microfinance has grown remarkably. From its origins in the 1950s — when its roots were based in agricultural development — microfinance has broadened its range of services and in many cases has grown into a profitable, self-sustaining industry.

The evolution of microfinance

In the early development of microfinance, state-run Rural Development Institutions (RDIs) in the developing world provided small loans at highly subsidized terms to farmers to enable them to slowly increase their assets and build their small businesses. These programs had mixed success. Although farm production improved, loan repayment rates were extremely low.

From these experiences of early RDIs, microlending programs learned to focus on greater institutional sustainability and emphasized achieving high loan repayment rates. Nongovernmental organizations (NGOs) then dominated the landscape, and the concept of microlending began to broaden, encompassing other industry sectors, including simple manufacturing and trade.

Grameen Bank in Bangladesh emerged as a leader in this new environment. Grameen's microlending program was one of the first to provide very small loans of roughly $50 to $100 to the country's poor to build microenterprises. Nearly 95 percent of Grameen Bank's clients are women. On average, Grameen Bank has reported a recovery rate of 98 percent, which matches traditional banks' recovery rate. By the mid-1980s, other programs began to notice Grameen Bank's success. Microlending programs started emerging all over the world, including in developed countries such as the United States, Britain and Canada (see the sidebar).

The success of microlending programs eventually led to an institutional structure for microfinance. Microfinance also expanded financial services available to the poor. Most notable has been the growing presence of formal, regulated MFIs. Some of these formalized institutions have transformed from NGOs into regulated institutions. Others include already formal credit unions, consumer finance companies and private commercial banks, all of which have a small portion of their assets devoted to financial services for the poor.

At the most basic level, formalized MFIs emerged as a result of rapid growth and the need to finance that growth. A regulated, commercial environment has afforded these institutions greater credibility, freed them from the constraints of donor funding and allowed them to pursue a range of other viable financial services. In most cases, microcredit NGOs are not allowed to accept savings deposits from the general public and are restricted to offering only limited savings services to their own borrowers. Regulated MFIs enjoy greater flexibility in administering a wide range of financial services, including credit, savings and insurance. Despite the growing presence of formalized MFIs, informal NGOs still predominate. NGOs receive the majority of their funding from multilateral institutions, such as the World Bank and the United Nations Development Program, bilateral institutions such as aid agencies of donor countries, and individual governments.

The current microfinance landscape

The World Bank estimates that more than 7,000 MFIs exist worldwide, serving more than 16 million people in developing countries. MFIs are widely spread across the globe; a particularly high concentration of MFIs exist in Latin America. Statistics from the International Food Policy Research Institute support this picture. For example, in 1999 Latin America had the greatest concentration of microfinance clients as a percentage of population at 1.6 percent, followed by 1.5 percent for Asia and 1.0 percent for Africa.

The Inter-American Development Bank (IDB) estimates that Latin America has more than 65 million microentrepreneurs, who collectively employ more than 100 million people. This pool represents an enormous potential market for microfinance services. Although the level of market penetration is limited at this point, the growth in microfinance in Latin America has been astoundingly rapid. According to MicroRate, a leading microfinance tracker, from 1998 to 2001 leading Latin American MFIs expanded their loan portfolios by an average of 32 percent, even amid regional instability and banking crises (see the sidebar).

The move toward commercialization. The tremendous growth in microfinance has spurred and reflected a rapid movement toward formalization and commercialization unmatched in any other region of the world. In terms of loan volume, formalized MFIs now dominate in Latin America. In 2001, formalized financial institutions provided 76 percent of the microloans to borrowers in Latin America. In addition, regulated MFIs have achieved much greater leverage — as expressed in their debt-to-equity ratios — than their nonregulated peers.

Perhaps the most pronounced example of the transformation from a nonregulated to a regulated MFI is Bolivia's BancoSol. Bolivia has long been the most concentrated microfinance market in the Western Hemisphere. BancoSol emerged from a not-for-profit organization and received a full banking license in 1992. It now operates as a licensed commercial bank subject to the supervision of Bolivia's banking authorities. One of Latin America's leading MFIs, BancoSol possessed a gross loan portfolio in 2001 of U.S.$81 million serving 61,368 clients (see the table).

Still, the overwhelming majority of MFIs in Latin America remain unregulated NGOs. These NGOs remain dependent on donor funding and focus on small market niches that large formalized institutions are less interested in or are less able to penetrate.

Benefits. The shift toward commercialization has produced some favorable outcomes for Latin American MFIs and their clients. In particular, loan products and other financial services have become more diversified. Traditionally, microfinance NGOs in Latin America implemented group-lending techniques because a peer dynamic acted as a suitable proxy for collateral. These lending methods included solidarity group lending and village banking, in which group members provide a mutual guarantee of loan repayment. While many MFIs, including BancoSol, remain committed to group lending, individual lending is accounting for an ever-greater proportion of the market. Greater institutional scale has provided MFIs increased means and resources to handle individual transaction costs and creditworthiness issues, enabling MFIs to respond to clients' preferences for individual loans.

Meanwhile, the push toward formalization has also increased Latin American MFIs' capabilities in providing other financial services, such as savings. Savings are desirable for several reasons. Savings provide a relatively stable source of funds to MFIs, enabling them to become financially self-sufficient. In addition, savings services provide low-income clients with both a safe place for funds and increased liquidity, allowing them to better manage their day-to-day lives. Savings services can help smooth out income for low-income individuals who face special circumstances, including life-cycle events such as festivals and marriages, and emergencies such as floods and drought. Savings services also enable low-income individuals to take advantage of business investment opportunities and can provide funding for life-enhancing activities such as children's education and home improvement.

Drawbacks. Unfortunately, formalization of the microfinance industry in Latin America has not always led to positive outcomes. Increased competition has in some cases led to market saturation, predatory lending practices and a shift toward a higher-income clientele. The most salient example of such problems is the Bolivian Borrowers' Revolt of 1999. An influx of consumer lending agencies into the Bolivian microfinance market was soon followed by microentrepreneurs becoming overindebted, often juggling several loans at once. Borrowers organized into large groups demanding debt forgiveness.

Since that time, increasing evidence shows that Bolivian MFIs are shifting their focus toward a higher-income market. This example illustrates how market saturation, coupled with a shift to more profitable markets, can lead MFIs to drift away from serving the poor — the very clientele MFIs evolved to serve.

Leading Regulated and Nonregulated MFIs in Latin America

Institution	Country	Gross Portfolio ($US mil)	Debt/Equity Ratio	Number of Clients
Regulated MFIs				

BancoSol	Bolivia	$81.0	5.6	61,368
Caja los Andes	Bolivia	$52.6	7.3	43,530
Caja Municipal Arequipa	Peru	$50.0	6.5	50,209
Calpia	El Salvador	$31.9	3.2	36,318
Nonregulated MFIs				
WWB Cali	Colombia	$17.7	1.4	38,063
ADOPEM	Dominican Republic	$9.9	0.8	28,079
WWB Popayan	Colombia	$9.6	0.5	36,049
Fondesa	Dominican Republic	$5.3	1.9	3,367

Source: Table (The “MicroRate 29”: December 31, 2001) from *The Finance of Microfinance*, MicroRate, October 2002

Assessing impact and future direction

This development brings up an obvious question. What impact has microfinance had on the poor? Most efforts to evaluate microfinance have been geared toward monitoring the financial performance of MFIs in accordance with best practices lending techniques. Understanding the effect of microenterprise development on the world’s poor is largely limited to various case studies of individual programs. These studies’ findings are generally positive.

For instance, a study of Crédito con Educación Rural (CRECER), a Bolivian MFI, showed that the income of two-thirds of its clients had increased after joining the program, while 86 percent of clients reported increased savings.

Other studies have shown that children of microfinance clients are more likely to go to school and to stay in school longer. Households of microfinance clients appear to have better nutrition, health practices and health outcomes than comparable nonclient households do.

What does the future hold for microfinance and the world’s poor? Microfinance has made great strides in extending much-needed financial services to underserved populations throughout the world. Going forward, MFIs are geared for continued growth in loan portfolios and increased mobilization of savings deposits. MFIs also are moving toward incorporating business development services into their strategy.

Many microfinance practitioners are mindful of potential mission drift. They emphasize the need to balance the institutional approach, focused on industry expansion and financial self-sufficiency, with a community approach, committed to alleviating poverty among the very poor. But even a more balanced approach will face limitations in its outreach, especially in serving the extremely poor.

Microfinance practitioners recognize the risk of pushing these individuals further into debt and poverty with high-interest-rate loans they cannot repay. In spite of the limitations and downside risks, the success of many of these programs cannot be ignored. Microfinance provides a unique opportunity to help many low-income individuals improve their circumstances.

This article was written by analysts Elena Casal and Nicholas Haltom of the Atlanta Fed’s research department.

Microfinance in the United States and Other Developed Countries

In the United States more than 300 microfinance institutions — including the Good Faith Fund (GFF), promoted widely in Arkansas by former President Bill Clinton, and Working Capital in New England — have emerged to promote microenterprise development.

Microfinance programs in developed countries, such as the United States, operate in a different environment from those in developing countries. Microenterprises and MFIs in the United States face greater competition and barriers to entry from larger, well-established firms and financial institutions. Also, the abundance of wage jobs, a welfare safety net and a comprehensive regulatory environment increase the costs of self-employment and small business development relative to such costs in developing countries. In addition, American individualism limits the effectiveness of joint liability, a feature that makes community-based lending effective in developing countries. Working Capital has committed itself to group-lending methodologies, but this practice is an effort to build social capital rather than to take advantage of it.

Operating under a notably different economic and financial structure than in developing countries, microfinance programs in developed countries have been pushed to use different tools and approaches in achieving their goals. In particular, these MFIs have placed a greater focus on providing structured training programs that help clients build skills necessary to survive and thrive in a competitive economic atmosphere. Additionally, MFIs in developed countries tend to offer higher loan amounts and to focus on simple service-producing enterprises, such as childcare, hair salons, retail sales, transportation, and home and office maintenance.

Elliot Farmer’s story offers an example of the workings of microfinance in the United States. After losing his Atlanta-based job in the telecommunications industry during the recent recession, Farmer pursued his dream of running his own catering business. He applied and was accepted for a loan with ACCION USA.

Farmer currently owns The Farmer’s Kitchen, a successful catering company in metro Atlanta.

Latin American Microfinance Institutions and Recession

Economic recession in Latin America in the late 1990s dealt a significant blow to the region’s commercial banking sector. Loan portfolios stagnated, profitability fell and delinquencies rose. But MFIs in the region did not suffer the same fate, according to statistics provided by MicroRate, a leading microfinance tracker.

In Colombia, for example, where real GDP declined 4.2 percent in 1999, six leading MFIs tracked by MicroRate showed loan portfolio growth of near 10 percent while commercial banks’ loan portfolio growth declined 20 percent. In addition, the average return on equity in 1999 in Colombia was 7.1 percent for MFIs but –7.1 percent for commercial banks. Similar results were reported for Peru and Bolivia, but the greater maturity, market penetration and leverage of Bolivian MFIs did lead to a pronounced slowing in their portfolio growth and profitability.

Why have MFIs performed so well in comparison to commercial banks? Most of their success stems from their close ties with the communities they serve. MFIs typically know their borrowers and

markets well and possess a strong ownership structure, with investors and donors keenly interested in monitoring the MFIs' management and performance. Also key is the often-displayed strong repayment ethic of microentrepreneurs and other low-income borrowers.

In addition, MFIs and microentrepreneurs may actually benefit from hard economic times. Some borrowers may shift from traditional banks with rigid lending procedures to local MFIs specializing in flexible relationships with microentrepreneurs. At the same time, microentrepreneurs may benefit from consumers' preferences for less expensive goods during a recession.

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Research Notes & NEWS

Research Notes and News highlights recently published research as well as other news from the Federal Reserve Bank of Atlanta. For complete text of summarized articles and publications, see the "Publications" section of the Atlanta Fed's World Wide Web site.

Are online currencies "virtual banknotes"?

The history of money is marked by innovations that have expanded the role of "inside money" — money created by the private sector. For instance, the past few years have seen the development of several types of online payment arrangements, some of which have been dubbed "online currencies."

An article by Stephen F. Quinn and William Roberds examines the likely success or failure of online currencies by means of a historical analogy. The discussion compares the introduction of online currencies to the debut of the bearer banknote, the direct predecessor to modern currency, in London in the late 1600s.

The key innovation of the earliest banknotes, the authors argue, was to provide final payment under circumstances in which extant payment systems could not. The discussion considers how online currencies may be able to fill the same role in the context of e-commerce.

The authors note some conspicuous similarities between online currencies and physical banknotes. Both payment methods emerged to meet the need to conduct remote transactions (via the Internet or across physical distance), both face the risk of buyer-side fraud, and both have responded to the need for a new payment technology to allocate this risk. The authors stop short of calling online currencies "virtual banknotes" because it remains to be seen whether online currencies will gain sufficiently widespread acceptance to become a circulating medium of exchange.

Economic Review
Second Quarter 2003

Emotion and financial markets

Psychologists and economists hold vastly different views about human behavior. Psychologists contend that economists' models bear little relation to actual behavior. This view is supported by a large body of psychological research that shows that emotional state can significantly affect decision making.

Economists, on the other hand, argue that psychological studies have no theoretical basis and offer little empirical evidence about people's decision-making processes. The reigning financial economics paradigm — the efficient market hypothesis (EMH) — assumes that individuals make rational investment decisions using the rules of probability and statistics. A newer branch of financial economics called behavioral finance applies lessons from psychology to financial decision making, but most of these studies have focused on cognitive biases rather than emotion.

An article by Lucy F. Ackert, Bryan K. Church, and Richard Deaves argues that *emotion* has important, and possibly beneficial, influences on financial behavior. After defining the term emotion and describing how emotions can be categorized, the authors consider how emotions influence human behavior. The discussion focuses particularly on three aspects of emotion and financial decision making: emotional disposition and stock market pricing, the feeling of regret, and investors' emotional response to information.

No new financial economics paradigm that incorporates behavioral influences and better models actual behavior has yet emerged to replace the EMH. Yet the authors believe that emotional behavior's influence on financial decision making should be taken into account in future research.

Economic Review
Second Quarter 2003

Take an online tour

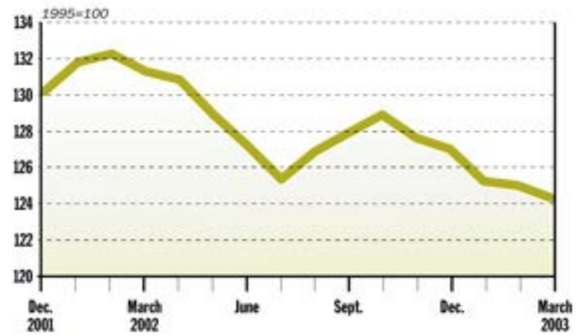
This spring the Atlanta Fed launched an online tour of its Visitors Center and Monetary Museum. The virtual tour "walks" Internet visitors through the central exhibits of the museum, which present the story of money's evolution from barter to modern currency, focusing particularly on money and banking in America. Ancient Greek coins, African throwing knives, Chinese shoe money, and wampum are just a few examples of the rare and unique artifacts, coins, and currency on display.

The virtual tour of the Visitors Center continues with photos and information about the bank's interactive and multimedia exhibits. These exhibits offer an in-depth look at the role of the Federal Reserve in the U.S. economy: how and why the Fed conducts monetary policy, the Fed's role in bank supervision and regulation, and the ways the Fed provides payment system services.

The online exhibits also introduce visitors to the bank's cash processing operations, where millions of dollars are counted and sorted each day. This portion of the tour offers a glimpse of the bank's automated vault, a look at the robotic transports that do the heavy lifting of cash and coins, and a close-up view of a currency transport, or cash bus.

For security reasons, the Atlanta Fed currently offers only pre-arranged, guided tours of its facility to school and business groups. But through the online tour, the bank is able to make its Visitors Center and Monetary Museum available to a much broader audience — anyone who has access to the Internet.

ATLANTA FED DOLLAR INDEX



The dollar continued its decline in the first quarter of 2003 against the 15 major currencies tracked by the Atlanta Fed. The drop in March was the dollar's fifth consecutive monthly decline. In January decreases were registered in all subindexes except the Americas subindex. The Americas and European subindexes fell in February. In March the dollar's decline was concentrated in the Americas subindex while the European and Pacific subindexes rose.

Note: For more detailed, monthly updates and historical data on the dollar index, see the Atlanta Fed's World Wide Web site at www.frbatlanta.org/econ_rd/dol_index/di_index.cfm.

Take the virtual tour of the Atlanta Fed's Visitors Center and Monetary Museum at www.frbatlanta.org/atlantafed/visitors_center/vc_index.cfm.

Managing money matters

Personal financial education is one of the Federal Reserve's ongoing commitments. As part of a broad initiative to improve financial literacy, the Fed rolled out a grassroots campaign to spread the word about the importance of sensible financial practices across all levels of the economy.

In a public service announcement aimed at raising awareness of the need for financial education, Federal Reserve Board Chairman Alan Greenspan stresses the benefits of sound economic and financial education. "No matter who you are, making informed decisions about what to do with your money will help build a more stable financial future for you and your family," notes Greenspan in the message, which is airing on major television networks and radio stations.

This initiative builds upon existing efforts to foster financial education. Using the public service message, a new brochure, enhancements to the Fed's financial education Web site as well as sponsorship of key programs and events, the Fed hopes to make people aware of the need to be knowledgeable about personal finance.

For more information on financial education, visit the Federal Reserve education Web site at www.FederalReserveEducation.org.

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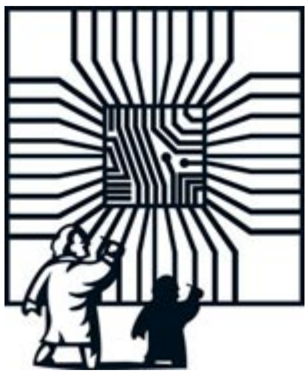
THE STATE OF THE STATES

Recent events and trends from the six states of the Sixth Federal Reserve District



Alabama

- Defense spending is boosting the state's economy. An Alabama-based laptop computer maker, for instance, won a $19.5 million contract to supply the U.S. Army with 2,000 battlefield laptop computers and accessories. In addition, some components of a missile interceptor will be assembled at a Boeing Co. plant in Huntsville.
- Although some of the states' steel producers and fabricators continue to operate well below capacity, firms producing pipe used in oil fields in the Middle East anticipate increased orders in the coming months.
- Venture Industries recently announced that it will construct a $100 million plant in Prattville to produce vehicle components for Hyundai Motor America. The facility, scheduled to open in June 2004, will eventually employ 600 workers.

Florida

- Reports from the tourism sector have been mixed. In south Florida, a successful spring break season helped offset weakness in international travel. Central Florida theme parks are offering summer discounts and new attractions in an attempt to bring back tourists.
- Favorable yields and stable prices should boost profitability for Florida's sugarcane and vegetable farmers. International competition continued to squeeze citrus prices.
- Miami's exports to Brazil, Venezuela and Mexico are still off sharply from 2002 levels. However, apparel and textile-apparel machinery exports to Central American countries posted healthy gains.

Georgia

- The Pentagon approved a $3 billion contract for Lockheed Martin to produce 20 more F/A-22 Raptor fighter jets. The planes are assembled in Marietta and account for about 1,700 jobs there. A sharp decline in business jet sales means that Savannah-based Gulfstream is likely to furlough some 1,000 workers in July.
- The Atlanta office market weakened further during the first quarter. The vacancy rate reached a new high of almost 22 percent, and net absorption remained negative. Commercial construction levels were down sharply from

last year.

- Higher export and import volume has resulted in a 33 percent increase, a new record, in the number of autos handled by the Port of Brunswick during the fiscal year that ended in February.
- Ford Motor Co. is considering building a new $1 billion factory in Georgia to assemble its next generation of midsized cars.

Louisiana

- Higher oil and gas prices have not translated into increased drilling activity in Louisiana. ChevronTexaco, however, will reportedly hire additional staff in New Orleans for the Tahiti oil prospect, the firm's largest deepwater find in the Gulf of Mexico.
- Louisiana's tourism and hospitality sector has reportedly softened. New Orleans' Jazzfest attendance numbers were below expectations. The state's riverboat casinos' revenues fell almost 5 percent from a year earlier.
- To cut costs, Hibernia National Bank recently laid off 120 workers, 70 of whom worked in the New Orleans area. The company reportedly expects to eventually lay off 5 percent of its 5,800-person workforce.

Mississippi

- Military contracts continue to stimulate the state's economy. Northrop Grumman plans to spend $288 million to expand its shipbuilding operations in Pascagoula and Gulfport. The shipyards already have contracts to develop prototypes for the next generation of destroyers.
- Local chemical companies report that high natural gas prices are adversely affecting their bottom lines and causing some production disruptions.
- Gaming operators along the Mississippi Gulf Coast continue to post good numbers. Gross gaming revenues from casinos were up by about 6 percent in March from a year earlier. A new casino was recently announced for Biloxi. This casino, the first new gaming house in Mississippi since 1999, will employ 500 workers.

Tennessee

- New auto parts manufacturing facilities were recently announced. Bridgestone will build an $11 million parts plant in Dickson to supply shock-absorbent pads and interior cushions for Honda, Toyota, and Nissan vehicles. Bodine Aluminum chose Jackson as the site for a new $124 million plant to build Toyota engine blocks.
- With the state's transportation budget reduced by some $65.8 million, the Tennessee Road Builders Association anticipates significant cuts in the state's road construction employment.
- Verizon announced plans for a new call center in Murfreesboro, scheduled to open this fall, that will initially employ 400 workers and could eventually employ more than 1,000.

Compiled by the regional section of the Atlanta Fed’s research department

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Southeastern Economic Indicators

		Alabama	Florida	Georgia	Louisiana	Mississippi	Tennessee	6th District	U.S.
Total Payroll Employment (thousands)[a]	**2003Q1**	**1,877.0**	**7,253.5**	**3,903.2**	**1,898.9**	**1,126.2**	**2,663.5**	**18,723.0**	**130,596.3**
% change from	2002Q4	–0.5	0.1	–0.1	0.1	–0.2	–0.1	0.0	–0.2
% change from	2002Q1	–0.5	1.4	–0.2	0.1	0.1	0.2	0.5	–0.1
Manufacturing Payroll Employment (thousands)[a]	**2003Q1**	**297.0**	**396.6**	**457.8**	**158.7**	**183.4**	**415.6**	**1,909.1**	**16,394.0**
% change from	2002Q4	–3.8	–1.7	–4.2	–0.6	–0.7	–2.0	–2.5	–0.8
% change from	2002Q1	–4.5	–3.9	–1.9	–2.2	–4.5	–3.1	–3.3	–2.9
Civilian Unemployment Rate	**2003Q1**	**5.6**	**5.3**	**4.6**	**5.8**	**6.2**	**4.8**	**5.2**	**5.8**
Rate as of	2002Q4	5.9	5.3	5.3	6.2	7.0	4.9	5.5	5.9
Rate as of	2002Q1	5.8	5.6	5.0	6.1	6.6	5.4	5.6	5.6
Single-Family Building Permits (units)[b]	**2003Q1**	**15,404.2**	**139,422.2**	**72,608.7**	**15,286.5**	**9,505.5**	**28,366.9**	**280,594.0**	**1,338,381.5**
% change from	2002Q4	–5.3	–0.8	–2.0	–2.3	4.2	–6.1	–1.9	–4.8
% change from	2002Q1	–0.1	6.2	–0.5	0.1	7.0	0.9	3.2	3.1
Multifamily Building Permits (units)[b]	**2003Q1**	**3,938.8**	**54,949.7**	**17,698.0**	**745.7**	**1,711.4**	**2,805.9**	**81,849.6**	**411,216.8**
% change from	2002Q4	158.1	7.3	–20.5	–80.7	–8.2	–39.8	–4.8	–1.6
% change from	2002Q1	56.9	–9.7	–22.1	–60.7	–57.6	–40.6	–15.4	1.4
Personal Income ($ billions)[b]	**2002Q4**	**114.2**	**502.0**	**249.3**	**115.6**	**65.2**	**162.5**	**1,208.9**	**9,035.0**
% change from	2002Q3	0.9	1.1	0.9	1.2	1.1	0.9	1.0	0.9
% change from	2001Q4	4.0	4.8	3.4	4.2	4.4	5.0	4.4	3.9

		Atlanta	Birmingham	Jacksonville	Miami	Nashville	New Orleans	Orlando	Tampa
Total Payroll Employment (thousands)[a]	**2003Q1**	**2,179.6**	**479.1**	**565.0**	**1,022.3**	**673.7**	**611.7**	**915.9**	**1,231.7**
% change from	2002Q4	0.5	0.2	0.4	–0.1	–0.1	0.3	0.1	0.7
% change from	2002Q1	0.0	–0.3	1.0	0.9	0.7	–0.3	1.6	1.1
Civilian Unemployment Rate	**2003Q1**	**4.9**	**4.3**	**5.0**	**7.3**	**3.6**	**5.2**	**5.1**	**4.5**
Rate as of	2002Q4	5.3	4.6	5.1	7.4	4.0	5.4	4.9	4.6
Rate as of	2002Q1	5.2	4.1	5.2	8.1	4.1	5.4	5.9	4.6

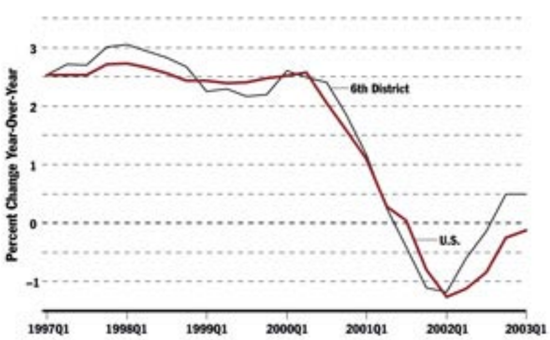
[a] Seasonally adjusted

[b] Seasonally adjusted annual rate

SOURCES: Payroll employment and civilian unemployment rate: U.S. Department of Labor, Bureau of Labor Statistics. Initial unemployment claims: U.S. Department of Labor, Employment and Training Administration. Single- and multifamily building permits: U.S. Bureau of the Census, Construction Statistics Division. Personal income: Bureau of Economic Analysis. Quarterly estimates of all construction data reflect annual benchmark revisions. All the data were obtained and seasonally adjusted by Regional Financial Associates. Small differences from previously published data reflect revisions of seasonal factors.

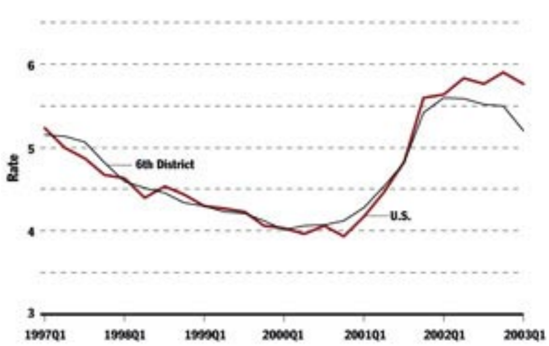
For more extensive information on the data series shown here, see the Atlanta Fed's World Wide Web site at www.frbatlanta.org/publica/econ_south/2003/q2/dist_data.htm.

Total Payroll Employment

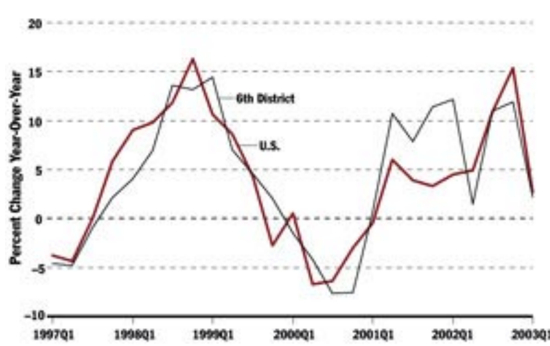


Manufacturing Payroll Employment

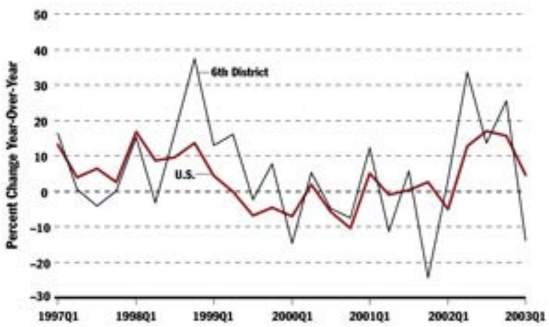
Civilian Unemployment Rate



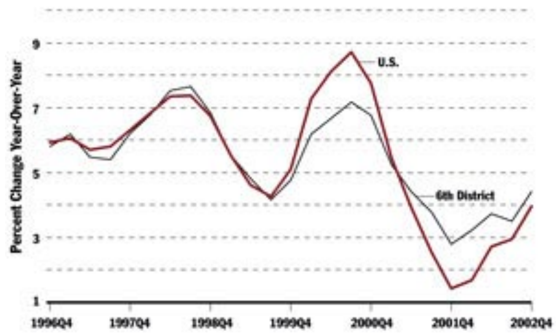
Single-Family Building Permits



Multifamily Building Permits



Personal Income



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