REGION FOCUS

FALL 2004

THE FEDERAL RESERVE BANK OF RICHMOND

THE CREATIVE CLASS

Are Technology, Talent, and Tolerance the Keys to Healthy Cities?

Appalachia's Changing Economy

Economics of Obesity

An Interview with Al Broaddus and Tom Humphrey

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Fed Lending and Moral Hazard

As many of you know — and as was announced in the last issue of this magazine — Al Broaddus has retired as president of the Federal Reserve Bank of Richmond, after more than 34 years of outstanding service to the Bank and the Federal Reserve System. I am honored and humbled to have been chosen to succeed him. His contributions have been enormous — and his leadership exemplary.

For the past seven years, Al's column has graced the opening pages of *Region Focus*. In this, as in so many other ways, I hope to live up to the high standards that Al has set. There are some very important challenges facing the Fed — including, of course, our ongoing efforts to maintain price stability — that I would like to address in this space. From time to time, I also would like to discuss some broader economic and public-policy issues that may seem to touch only peripherally on the Fed's core functions, but which nevertheless are vitally important. One such topic that comes to mind is the role that technological growth is having on wage inequality.

But for my initial "Noteworthy" column, I would like to stay fairly close to home and discuss a topic that occupies the time and minds of many people throughout this Bank and the Federal Reserve System: how to provide financial institutions with sufficient liquidity without encouraging them to engage in unsound business practices.

By lending through the discount window, the Fed can help stave off financial crises. For instance, in the days immediately following the terrorist attacks of Sept. 11, 2001, the Federal Reserve System loaned about $46 billion from the discount window. This was crucial in helping the nation's financial system cope with the disruptions caused by the attacks. In our financial system, the discount window has a useful role to play — and not just in situations as severe and tragic as 9/11.

But we also need to be wary of the risks that excessive lending can bring. Fed lending to a troubled bank can allow uninsured depositors and creditors to withdraw funds just before the bank fails. This weakens their incentive to monitor a bank's risk-taking and can increase the cost of the bank's failure to the deposit insurance fund. And by weakening this market discipline, we increase the chances that a bank will become insolvent.

Given the substantial financial safety net — and the risks it poses to taxpayers — the Fed must be vigilant in both its lending practices and its supervision of financial institutions. What does this mean in practice? In the past, the Fed typically has lent money to any bank with acceptable collateral, including many troubled banks that soon failed. The Federal Deposit Insurance Corporation Improvement Act of 1991 — better known as FDICIA — placed limits on the Fed's ability to lend to undercapitalized banks, but left the Fed with considerable discretion in extending credit to banks facing potentially critical financial problems.

This presents us with a dilemma: Should the Fed try to help those at-risk banks or instead withhold funds to limit moral-hazard problems? It's not an easy question to answer, but I'm inclined to say that the Fed should avoid lending to unsound banks, even those on the verge of collapse. It would be tempting for the Fed to intervene in such situations but, in my view, it would in many cases be unwise.

None of this is to say that sound, stable banks should be denied funds. In our banking system, discount window lending is important and useful. The Fed should continue to use this tool to help fundamentally healthy banks meet short-term liquidity needs — but it should do so judiciously and probably more sparingly.

As President of this institution, the risks associated with discount window lending is an issue that will occupy my attention much over the coming months and years. As my thoughts evolve — and as events dictate — I will have more to say on the topic. But for now I will close by reiterating what a pleasure it is to lead theRichmond Fed and its tremendous staff. It's a great challenge that I look forward to with great excitement.

JEFFREY M. LACKER
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND

The Road to Independence

The Federal Reserve was created by Congress, but must retain autonomy from the political branches to effectively execute monetary policy

BY ERIC NIELSEN

Since this nation's founding, central bank independence (CBI) has been a contentious and often-misunderstood issue. Our government and national character were formed in reaction to monarchy and centralized power, yet from the First and Second Banks of the United States to the current Federal Reserve System, central banks have played key economic and political roles at various points in history.

These banks have been attacked for being both too powerful and independent of the political structure, as well as for being too partisan in setting economic policy. Only through extensive trial-and-error experimentation, as well as significant economic scholarship, has the proper role of a central bank within a constitutional framework become understood and widely accepted.

Economists, policymakers, and journalists frequently make reference to "central bank independence," but what is meant by this term? There is no consensus as to what the definition of CBI ought to be (see sidebar), yet broadly speaking, independence is the ability of the bank to formulate and carry out monetary policy as best it can without political intervention. Independence is a complex blend of the bank's enumerated powers, its structure, and its leadership, as well as many other factors.

Central bank independence is important because it allows the government to commit credibly to a program of low inflation. On their own, governments have a strong inflationary bias; they often will try to boost output and employment in the short run for political gain, even though eventually such policies lead to inflation, not sustained growth.

Inflation can also act as a source of revenue for governments, further tempting them. Even if a government promises not to inflate, the public may remain skeptical, producing high inflationary expectations. By delegating responsibility for money creation to a central bank, the legislature can remove the temptation to abuse its power and pursue bad monetary policy for short-run gain. (It is important to note that this temptation to

AP/WIDE WORLD PHOTOS

Former Federal Reserve Chairman Paul Volcker talks with Sen. Paul Sarbanes of Maryland prior to a 1979 Senate hearing on monetary policy. The Federal Reserve is formally independent of the executive and legislative branches, but the President appoints the Fed's chairman, who must report regularly to Congress.

inflate is particularly acute in a system of fiat money. When a nation's currency is backed by a commodity, such as gold, the ability of the government to inflate at will is limited. Of course, such commodity-backed systems have their downsides as well.)

The Federal Reserve System clearly demonstrates this delegation of monetary authority by a legislature to a central bank. The Fed is ultimately a child of Congress, to which the chairman must report regularly, but it is free to pursue monetary policy as it sees fit. As economist Allan Meltzer of Carnegie Mellon University puts it, "The Fed is independent *within* government, not independent *from* government."

Modern ideas about the importance of central bank independence in maintaining good monetary policy took a long time to develop, with many missteps along the way. After two initial experiments in central banking, the United States went almost 80 years with no central bank. These early banks failed due to fears that they were too powerful, too corrupt, and too free from government oversight.

During the Revolutionary War, the fledgling U.S. government had difficulty financing wartime expenditures and resorted to excessive printing of continental dollars. (This is how the phrase "not worth a continental" originated.) This prompted the founding of the First Bank of the United States (FBUS) in 1791, a private bank with some special privileges to finance government debt. Though the FBUS worked reasonably well, its charter was not renewed in 1811 largely due to the belief that such an institution did not have an explicit constitutional mandate and fears that it wielded too much financial power.

After the United States once again experienced credit problems during the War of 1812, the Second Bank of the United States (SBUS) was chartered in 1816. The SBUS was not conceived as a central bank in the modern sense, though it soon evolved to fill that role during the 20 years of its initial charter. It was fairly successful in its attempts to regulate and stabilize the nascent U.S. banking industry.

When the time came, however, for the bank to be rechartered, President Andrew Jackson and Nicholas Biddle, head of the SBUS, argued fiercely about the Bank's place in U.S. governance. Jackson complained that the bank was run for the private interests of its shareholders and was not provided for by the Constitution. Biddle countered by arguing that a central bank was effective and justified, and should be separated in powers from the government, which might abuse its role in the financial system. Ultimately, Biddle lost the fight, and with it the Bank. The United States had no central banking authority until the Federal Reserve System was founded in 1913.

The Birth of the Modern Fed

The story of the modern Fed really begins in 1934, in the midst of the Great Depression. After its apparent failure to avert the economic disaster of the 1930s, the Fed subordinated its policy role to the U.S. Treasury. Once World War II broke out, the Fed further sacrificed independence, propping up government debt by holding interest rates constant. This policy was both inflationary and limiting since it prevented the Fed from taking other monetary actions. After the war was over, the Treasury as well as President Truman wanted the Fed to continue supporting their fiscal policies, but there were critics within the Fed of continuing this arrangement, and eventually the conflict escalated into open argument as each side publicly contradicted the other about the direction of U.S. monetary policy.

The dispute was finally resolved by the signing of the Treasury-Federal Reserve Accord of 1951. In the Accord, both parties agreed that the Fed should be the sole conductor of monetary policy. The disengagement of monetary from fiscal policy in effect allowed the Fed to gain back the independence it had lost during the war.

In the period immediately following the Accord, the modern character and role of the Fed were formed under the chairmanship of William McChesney Martin. According to Robert Hetzel, a senior economist at the Federal Reserve Bank of Richmond, "What happened after the Accord was that Martin gave effective substance to the federal character of the Reserve System by bringing in regional bank presidents as key members of the FOMC. So while there was no change in the law concerning Fed independence, there was an institutional change." Furthermore, the Accord saw the Fed commit to "lean against the wind" — that is, to adopt monetary policy with the intention of smoothing out business cycle fluctuations.

Since 1951, the results of Fed policy have been highly variable. During the 1950s and early '60s, inflation was low and steady. But in the late 1960s and much of the '70s, the United States suffered from high and variable inflation along with high rates of unemployment. Fortunately, since the early 1980s, inflation has been generally quite low, and it seems that price stability finally has been achieved. Some economists have suggested that at least some of this variation in performance should be attributed to occasional partisan political intervention by the Fed.

Others argue that the Fed simply did not have sufficient economic understanding during these bad spells to formulate effective policy. For instance, under the chairmanship of Arthur Burns (1970-1978), the Federal Reserve often pursued unwise monetary policies. Persistently high inflation coupled with economic stagnation, derogatorily dubbed "stagflation," characterized Burns' tenure.

Economists like Richard Timberlake of the University of Georgia think that Burns' Fed was clearly politically active. Timberlake argues that by keeping monetary policy loose throughout 1971, despite rising inflation, Burns boosted President Nixon's chances at re-election in 1972 by artificially stimulating the economy. "He [Burns] made the Fed, at least as far as he had control of it, an aide of the Nixon Administration," Timberlake says. He further cites Burns' unorthodox and ineffective use of wage-price controls in an effort to curb inflation.

Other economists such as Hetzel counter that, though misguided, Burns' policies were failures of economic understanding and leadership, not of political independence. He argues that most of Burns' policy blunders were foreseeable results of his previously stated economic beliefs — which, in large measure, were representative of the economics community generally during this period. As Marvin Goodfriend, an economist and senior vice president at the Richmond Fed, points out, "The central bank cannot be expected to do better than the economists."

In addition to hewing to questionable economic theories, Burns also changed his outlook and explanations frequently. This had the unintended policy effect of making it more difficult for businesses to understand and predict which policies the Fed was likely to pursue. This combination of loose policy, high inflationary expectations, and diminished Fed credibility set the stage for stagflation.

The quality of Fed monetary policy has improved markedly over the last two decades under the leadership of Paul Volcker and Alan Greenspan. For instance, during the presidential election in 1980, Volcker drastically tightened monetary policy. This put an end to inflation, although it caused a short but severe recession. Such actions seem to indicate that the Fed is more able, or at least more willing, to follow good policy regardless of political repercussions.

Measuring Independence

The chief problem facing economists seeking to understand the effect of central bank independence (CBI) on economic performance is the difficulty in ranking and comparing CBI across countries. Unlike many economic variables, independence is not simply a number, but instead a loosely defined concept dependent upon the specific institutional, legal, and cultural framework within which a particular central bank operates. No two countries, or their central banks, are alike. Essentially, researchers must find a way to compare apples to oranges.

Economists generally break independence down into two subcategories, political and economic, which they can then examine separately or in combination. Political independence is the degree to which a central bank is insulated from short-term political censure. Infrequent appointments of bank directors, legally mandated independence, and other institutional arrangements are taken to correspond with high political independence.

Compared to other countries' central banks, the Fed has a good deal of political independence. It can conduct policy that is contrary to the wishes of Congress (at least until Congress decides to change the law governing the Fed). Additionally, the chairman of the Fed serves a 14-year term, thus isolating him somewhat from political threats to his job. At the same time, informal bonds between members of the Fed and elected officials may jeopardize independence at times. For instance, some have argued that former Fed Chairman Arthur Burns' friendship with President Nixon may have informally decreased the Fed's independence from the executive branch.

Economic independence is the central bank's ability to effectively enact any monetary policy it may decide is best. The Fed now has economic independence since it has direct control over the implements of monetary policy, but did not through part of its history. Until the Treasury-Fed Accord of 1951, the Fed was required to support the nation's fiscal policy, which removed a huge array of options from its policy palette.

Attempts to rigorously analyze CBI are complicated further by cultural factors extending beyond mere institutional and legal arrangements. For instance, a country with a long tradition of deference to authority may have a less independent central bank in practice, regardless of how independent it looks on paper. Determining the cultural attitudes toward central banking within a given country requires intimate knowledge of its history and national identity.

Studies showing a correspondence between CBI and low inflation, then, need to be taken with a grain of salt. The indices used are generally quite crude. The most popular consist of a simple 1 to 4 ranking, and may be subject to researcher bias. Encouragingly, though, researchers have found similar results using a wide array of ranking schema, indicating that though the specifics may be difficult to measure, there is a real underlying relationship between CBI and some aspects of economic performance.

—Eric Nielsen

The Treasury-Federal Reserve Accord

The Treasury and the Federal Reserve System have reached full accord with respect to policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt.

What the Data Say

A great deal of theoretical and empirical investigation tentatively indicates that some form of CBI does indeed have beneficial long-run effects. For instance, economist Alberto Alesina of Harvard University has used various methods to quantify independence and has found that, across a wide sample of countries, greater CBI tends to correspond to lower and less variable inflation. At the same time, research also indicates that CBI has little effect on other important economic variables such as GDP growth.

Like all research, these results come with major caveats. As discussed in the sidebar, it is very hard to come up with a ranking of independence across countries. Though the correlation between high CBI and low inflation holds for a wide array of independence indices, the strength of the results does change.

Although economists and policymakers have made great strides in understanding the economic importance of CBI, there is still much work to be done. There are now major proposals being discussed to further institutionalize the Fed's independence and help protect it from potential crises.

The most prominent suggestion advocated by many monetary economists is that the Fed adopt an explicit inflation target as its primary operational goal. Under an inflation target, the Fed would simply pursue whatever monetary policies were necessary to maintain inflation at the desired level.

Over the last 20 years, the Fed has focused most of its energies on maintaining low inflation, yet there is nothing in the mandate of the Fed requiring that it make inflation its main priority. As Goodfriend puts it, "You want an inflation target to guard against the bad old days of high inflation. Independence becomes moot if the Fed follows an inflation target because it will be held accountable to something. Holding inflation constant would completely determine Fed policy — there would be no degrees of freedom to do anything else."

In addition to a publicly stated inflation target against which actual Fed performance could be compared, the Fed might also want to make its operating procedures more transparent. "The issue for the Fed is that it is not enough that we have oversight hearings in Congress. We also have a responsibility to conduct monetary policy in a way that allows easy monitoring by the public," says Hetzel. "It is incumbent upon us to make policy in a way that is in the spirit of a constitutional democracy."

An explicit inflation target mandate for the Fed would also help it surmount another potentially difficult issue: that of succession and leadership. Many economists now see the leadership of the chairman as vital to Fed success. "A lot of the credibility of the Federal Reserve System rests in the person of the Federal Reserve Chairman *because* we don't have any institutional requirements to target low and stable inflation," Hetzel says. "There is no obvious answer to how well we would work under a poor leader." As a result, some fear that when Greenspan retires, a lot of the faith in the effectiveness of the Federal Reserve System will retire with him.

Marvin Goodfriend and Robert Hetzel are not especially concerned, though. Goodfriend stresses that, over the last 20 years, a consensus has emerged within the economics community that the Fed should primarily strive to maintain low inflation. Such agreement effectively limits the opportunities for politicians to push for deviations from best practice behavior. "Intellectuals matter, when they are united," Goodfriend says.

New Pressures to Inflate?

Questions about the Fed's independence and ability to stave off political pressure may become particularly pressing in the near future. Laurence Kotlikoff of Boston University and Scott Burns of the *Dallas Morning News* argue in their new book, *The Coming Generational Storm*, that in the next 30 years, the Social Security and Medicare systems will come under tremendous pressure as the baby boom generation reaches retirement age. These programs' liabilities are close to 12 times the current national debt, Kotlikoff and Burns estimate.

Without a large increase in the size or productivity of the American work force, the government will have difficulty financing these expensive programs through the conventional means of taxation and borrowing. Kotlikoff and Timberlake fear that the Fed will be put under tremendous pressure by the political branches to use inflation to pay down this debt.

Another potential source for political pressure on the Fed comes from hard-to-predict geopolitical events such as terrorism. Several studies have shown that terrorism imposes enormous costs on the U.S. economy. In the wake of 9/11, the Fed drastically loosened monetary policy to help the economy rebound. That action has seemed to work, but a particularly severe attack in the future may prompt politicians to pressure the Fed into unsound monetary practices.

Such potential pressures on good monetary policy give the issue of central bank independence new relevance. The economic performance of the coming decades could hinge in part on how well the Fed can insulate itself from political machinations in the face of extreme circumstances. **RF**

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Opportunity Cost

BY ERIC NIELSEN

There is an old saying, "You can't have your cake and eat it too." Although this bit of folk wisdom may seem corny, it carries with it significant economic wisdom. It gets at the heart of one of the most important concepts in economics: opportunity cost. The opportunity cost of something is simply what you must give up in order to get it.

Resources are always limited, so not all wants can be satisfied. When you take a course of action, you use resources that cannot be applied to other projects. The opportunity cost is the value of those foregone opportunities. For example, if you decide to spend your money on a new bicycle, you cannot also spend it on a new computer. Or if you spend an hour watching television, you cannot also spend that time reading a book.

Opportunity cost is in many ways the most fundamental idea in economics. Economics at its core is the study of how decisions are made about the allocation of finite resources in the real world. If resources were not limited, there would be no reason to forego any desired activity and all projects could be undertaken. Every action has an opportunity cost, so it is important to try to understand the full extent of these costs.

Before the emergence of money, people traded goods directly, which made opportunity-cost relationships more obvious. One of the main functions of money, then, is to assign a unit of account to the relative costs of various items. Rather than having countless hard-to-fulfill barter relationships — such "as one car costs 1,500 pizzas" — you need only have their prices in dollars. The dollar price of various items reflects their opportunity costs.

To make an economic decision, you must fully consider the opportunity costs associated with various options. For example, say you are confronted with the choice of flying or driving to visit a friend in Chicago. A plane ticket costs $300, while gas for your car will only be $125. Given those figures, it's more economical to drive, right? Actually, the answer is not so clear. For instance, if it takes two days to drive to Chicago and back but only four hours to fly, a person earning a reasonably good salary would be better off working the extra day and a half, and then flying. For a student or someone else with little earning power, it still might be cheaper to spend the extra time and drive. So opportunity cost decisions involve many more factors than simply the dollar costs associated with various alternatives.

Opportunity cost also plays an important role in what economists call the labor-leisure decision. Possibly the most basic decision you can make is how to divide your time between work and play. All else being equal, most people prefer leisure to labor. At the same time, the greater wealth which comes from working allows us to consume things we like, and gives us greater freedom as to how we spend our leisure hours. You must take into account the competing desires to have some money to spend versus the pleasure of relaxation; the opportunity cost of taking a day off is the amount that you could have earned if you had worked. As another old saying goes, "Time is money."

Governments must also consider the opportunity costs of their actions. For instance, it would seem that a natural way to increase revenues would be to raise marginal tax rates — that is, raise the rate at which each additional dollar of personal income is taxed. Although it would appear that a higher tax rate on a given income stream would yield proportionally higher total tax revenue for the government, that is not necessarily the case. By raising marginal rates, the government has altered the labor-leisure calculation; it is now cheaper for a worker to forego an extra unit of labor in favor of leisure. The tax increase, then, likely will have the effect of reducing how much people work — which will tend to dampen or, in extreme cases, possibly even reverse the expected effect of the rate hike.

In short, many choices have consequences that are not immediately obvious. But to fully evaluate any decision — whether it is made by an individual or by the government — people must consider both "the seen and the unseen," as the 19th century French economist Frederic Bastiat put it. Opportunity costs are often unseen, yet they remain real and important. **RF**

ILLUSTRATION BY TIMOTHY COOK

The Economics of Happiness

BY ERIC NIELSEN

Most people have probably heard of the term *Homo sapiens*, but fewer are familiar with his more rational relative, *Homo economicus*, who is not emotional or impulsive. He learns quickly, plans ahead, and doesn't make repeated mistakes. He is useful for economists to study because his intelligent, predictable behavior is comparatively easy to model mathematically.

Not surprisingly, there are very few real-life examples of *Homo economicus*. People can be emotional and impulsive. The world is very complex, and our capacities are too limited for us never to be in error.

Behavioral economics is the rapidly growing branch of economics that seeks to incorporate such human imperfections into economic thinking. Instead of assuming perfect rationality, people are modeled as having "bounded" or imperfect rationality; their decisionmaking process can be subject to error or systematic bias. To characterize these less-than-perfect beings, behavioral economists rely on eclectic interdisciplinary tools such as surveys, experiments, and cognitive science. These methods have been applied to a wide range of economic questions, from the pricing of stocks to the hours cab drivers choose to work.

Perhaps the most fundamental behavioral challenge thus far has come from economists studying happiness. These researchers question one of the axioms of mainstream theory: that greater wealth and consumption bring greater happiness and well-being. For example, in a recent article titled "How Not to Buy Happiness," Cornell University economist Robert H. Frank advances the argument that most consumption goods — houses, cars, and clothes — do not permanently increase happiness.

Frank's conclusions come from some surprising survey results. Based on self-reporting surveys in which respondents are asked to rank their happiness, it appears that there is a paradox at the heart of economics. At any one time, rich people will report substantially higher levels of happiness than poor people. However, as all people become richer in tandem, the reported happiness for the two groups does not change. For example, between 1960 and 1980 Japan experienced a tremendous economic boom, yet people reported the same levels of happiness after the boom as before. Could it be that *relative* wealth is important, and not *absolute* wealth as economists assume?

"How Not To Buy Happiness"
by Robert H. Frank.
Daedalus, Spring 2004,
vol. 133, no. 2, pp. 69-79.

Frank thinks so — at least for some kinds of wealth. Goods that he dubs "conspicuous" do not permanently add to happiness, he argues. A new car might be nice and exciting for a time, but after awhile we start to take it for granted. On the other hand, "inconspicuous goods," such as vacation time, social interaction, and short commutes, might permanently change happiness. For example, people with shorter commutes have lower stress levels, lower blood pressure, and even lower risk of developing lung cancer.

If houses and cars do not really make us happier, then why are most of us willing to spend so much money on them? Frank argues that since happiness is essentially a question of relative consumption, one person's spending imposes negative externalities on others. These externalities will cause everyone to try to consume more than everyone else, instigating a consumption arms-race. If this is correct, the implications for policymakers could be enormous. By overturning one of the cornerstones of economic theory, a wide array of policy actions, such as a progressive consumption tax to discourage spending on consumer goods, may become desirable.

There is a strong case against these conclusions, however. Neoclassical economics uses the concept of *revealed preference* to determine what people want. People reveal their actual preferences by the actions they choose. They vote for their preferences with their consumption dollars.

Revealed preference could be a more reliable indicator of happiness than survey results. When responding to a survey, people might measure their happiness relative to some local norm, which may sound reasonable but would not capture absolute changes in happiness. For example, 150 years ago nobody had electric lighting in their homes. So a person from that era would probably not be unhappy about their lack of electricity. However, given a choice, people overwhelming want electricity, and it is difficult to argue electric power has not made us better off in real terms.

So what lies in store for economics as a discipline? Many of the results of behavioral economics are interesting, to be sure. Yet it is unclear how the work being done by Frank and his colleagues can provide a comprehensive, alternative way of looking at the world. This is the challenge now facing behavioral economics. **RF**

States Move to Prevent Post-Disaster Price Gouging

BY CHARLES GERENA

The remnants of Tropical Storm Gaston dumped more than a foot of rain on central Virginia in just one day in August, creating raging floodwaters that caused millions of dollars in damage and killed eight people. Within days, a few parking facilities in downtown Richmond allegedly raised their fees because many lots in the city's Shockoe Bottom district were covered in a mass of mud and wrecked vehicles.

The threat of rapid markups for goods and services after disasters like Gaston and Hurricane Isabel in 2003 is the reason why Virginia passed an anti-price-gouging law last April. North Carolina enacted a similar law in 2003 and the District of Columbia did it 11 years earlier. Lawmakers want to protect consumers from businesses deemed opportunistic.

In fact, not every post-disaster price hike is predatory. Some price increases are inevitable when a hurricane or some other calamity throws supply and demand out of whack.

After a disaster, the total supply of certain goods and services suddenly drops — there may be less gasoline due to power outages at service stations, for example. The disaster also creates a surge in demand for some items like generators. In either case, prices of those items tend to rise. Things become even more complicated when supply disruptions coincide with demand surges, for instance, when people need gas to fuel their generators.

In such situations, businesses want to increase their output, but they can't unless they take extraordinary measures. Goods producers and retailers may have to truck in fresh supplies from distant sources, while service providers may have to bring in extra help. Since these measures cost money, businesses must raise prices. Anti-price-gouging laws usually permit moderate price increases, which is why some industry groups aren't concerned about Virginia's law. It seems to them like a good compromise that both protects consumers and allows businesses to recover their added costs.

But economists like Donald Boudreaux counter that if businesses can't raise prices beyond a certain level, they may have to ration goods by limiting purchases. This prevents items from going to the people who need them most. "You have to make sure that existing supplies in the immediate vicinity of the distressed area ... are used as efficiently as possible," says Boudreaux, chairman of the economics department at George Mason University. Anti-price-gouging laws prevent this "economic triage" from taking place.

This means that even businesses with inventories on hand ought to be able to raise prices to market levels. Otherwise, "first come, first serve" becomes the standard for determining who gets what. The senior citizen who has a generator powering his respirator may end up at the back of the line for gasoline and get nothing, while the first person in line gets to refuel his generator so that he can keep his entertainment center running.

In addition, rising prices signal that an unmet demand exists. This entices new suppliers into disaster-struck communities with the promise of hefty profits. That's important because "you need to make sure that new supplies find their way into distressed areas as quickly as possible," says Boudreaux. Anti-price-gouging laws limit price increases, which "discourages suppliers from outside of the disaster area from putting forth the extra effort to get vitally needed supplies to that area."

Although higher prices boost the availability of goods and services in the medium and long run, one could argue that supply remains relatively constant in the short term. Variables that usually influence supply, such as the state of technology and the number of producers, can't change immediately. To make matters worse, flooded roads and power outages may make it impossible for new supplies to reach the market.

Therefore, higher prices won't immediately result in, say, many more bags of ice getting to many more people. Instead, only those who are willing and able to pay higher prices — no matter how outrageous they may seem — will get what they need. Some people may simply go without.

Government agencies and charitable organizations could meet unmet demand in the aftermath of a disaster. That way, the higher prices would be spread over a wider population beyond the individuals in need. However, buyers and suppliers may be less motivated to prepare for future disasters if they think a white knight will save them, and that doesn't always happen.

"No serious economist would ever claim that allocation [of goods] according to prices is perfect," says Boudreaux. Still, he argues, it is a better way to allocate resources in emergencies than the alternatives available with an anti-price-gouging law in place. **RF**

All's Fair in Love and War ... and Pricing?

There are good economic reasons for raising prices of essential goods following a natural disaster or major storm. But most people seem to think that this practice is unfair. Consider the responses to the following household survey question.

Question: A hardware store has been selling snow shovels for $15. The morning after a large snowstorm, the store raises the price to $20. Please rate this action.

Response: Unfair, 82%; Acceptable, 18%

SOURCE: Daniel Kahneman, Jack L. Knetsch, and Richard Thaler. "Fairness as a Constraint on Profit Seeking: Entitlements in the Market." *American Economic Review*, September 1986, vol. 76, no. 4, pp. 728-741.

SERVING THE UNBANKED

La Cooperativa Educates Members

"Mattress banking" has a competitor in North Carolina — the Latino Community Credit Union (LCCU), known informally as La Cooperativa.

In the central North Carolina Triangle area of Raleigh-Durham-Chapel Hill, criminals know that working-class Latinos may keep cash at home or in wallets instead of in a bank account. According to John Herrera, chairman of LCCU's board of directors, the credit union is a community response to increasing crime against the Latino population in Durham, N.C.

People without a deposit account at a bank, credit union, or thrift usually have below-average incomes. Alternate sources such as check-cashing outlets provide money orders, wire transfers, and other financial services that the "unbanked" require. But often fees are higher than those incurred by customers who have bank accounts.

LCCU's mission is to serve the unbanked, says Herrera. The credit union's target audience is "hard-working people with muddy boots." They are landscapers, hotel workers, dishwashers, and people with the repetitive manufacturing jobs — those who are most likely to be unbanked.

A conference in 2002 on the unbanked at the Chicago Fed noted that "… recent immigrants … make up a significant proportion of the unbanked population." Although LCCU is open to anyone, members are principally from Mexico, Puerto Rico, Honduras, and El Salvador. Because the members are shareholders, they own the credit union. That concept is familiar to many Latino people who have participated in Mexican "tandas," informal credit associations built on community trust.

LCCU gets technical assistance, access to lawyers, and admission to credit union groups from its founders — community leaders and organizations. Local churches play a significant role by providing information about LCCU to the community.

While realtors have coined the phrase, "location, location, location," LCCU's motto is "trust, trust, trust." That must be earned by partnering with area churches and community-based organizations. According to Herrera, the primary form of advertising is word of mouth. LCCU speaks to the community in English and Spanish. From the services of management and tellers to deposit tickets to mortgage documents to its web site *www.cooperativalatina.org*, the credit union's business is bilingual.

LCCU offers the usual array of credit union products and services, and places a big emphasis on financial education. "Everything we do is financial education. From the time an account is opened or a check cashed, it's an opportunity to teach," says Herrera. The approach to financial education is equivalent to a product cross-selling strategy. Employees always look for opportunities to present new or related financial education information.

Free financial literacy classes are available to members and nonmembers. According to Herrera, more than 85 percent of the credit union's members have never had a bank account, and new members may not understand what it means to earn interest on deposits.

"You can't start out selling them a CD," he says. "You have to explain these things first." Credit union members who want to open interest-bearing accounts need a social security number or taxpayer identification number for tax reporting. Classes are offered on obtaining a taxpayer identification number and filing a tax return, budgeting, and managing a checking account. More advanced topics include consolidating debt and home-buying. Classes may be required as part of the application for some services. Members are also given a phone number so they can call from the comfort and privacy of their home for answers to personal finance questions.

As members become better informed about money management, they develop opportunities to increase personal wealth by creating a clean credit history. Responsible members can apply for a small, collateralized loan.

The Latino Community Credit Union (LCCU) serves central North Carolina's growing Spanish-speaking population.

COURTESY OF LCCU

On-time payment of the loan leads to a good credit history and credit score, which are needed to qualify for bigger loans or mortgages.

In the four years since LCCU began serving the unbanked of central North Carolina, the Latino population has shown its trust. Herrera says membership has been growing at the rate of about 1,300 customers every month. There are now five branches in central North Carolina, with total assets of $17 million. LCCU has been so successful in its mission that banks and credit unions from across the country have been calling Herrera for information and advice on starting their own programs to serve the unbanked.

—Aileen Watson

SAVES TIME AND MONEY

Check Images Replace Paper

Come this fall, the nation's check collection system will fully enter the 21st century.

On October 28, the Check Clearing for the 21st Century Act, also known as Check 21, goes into effect. The legislation will make it easier for financial institutions to process checks electronically by removing some of the legal impediments to the process. While electronic presentment has been possible for many years, it previously required a standing agreement between two institutions.

The process, which involves the truncation and scanning of an original paper check and passage of its information via electronic image, is projected to save the industry more than $2 billion a year once it becomes commonplace. Financial institutions will save time and money by avoiding the physical transportation of paper checks and by either transmitting the electronic image when there is an agreement or by providing a substitute check printed from the electronic image if there is no agreement. Under the legislation, these "substitutes" will have the same legal standing as the original paper checks.

The Federal Reserve System clears nearly half of the current 39 billion checks written annually. As a result, the Fed has adapted its services to meet the change in processing trends expected to be brought on by the legislation.

Financial institutions processing through the Fed will continue to have the option of making either paper or electronic check deposits. Those institutions with imaging capabilities that submit electronically will benefit from later processing deadlines and national fees, rather than those based on geographic location.

For those items processed electronically, the Fed will print substitute checks and also offer the service of electronic return, giving financial institutions faster access to funds and greater protection against fraud.

If institutions do not have scanning and imaging capabilities, the Federal Reserve Bank will offer additional services to help them also realize savings from Check 21. Those companies can elect to have checks above a certain dollar amount sorted and processed electronically.

In the end, consumers may also see the benefits of the new legislation. Reduced costs and faster processing for financial institutions could mean greater customer service innovations and extended deposit times for their customers. Check 21 does come with a price, though — with faster processing consumers can expect to see a shorter float period from the time they write a check to the time the funds are withdrawn from their account.

—Alice Felmlee

GRUNDY MOVES ON

Town Relocates To Avoid Floods

Some communities have given up the fight to control the rivers on which they were built. They've sought refuge from severe and repeated flooding by making a permanent move to higher ground.

Grundy, a former coal mining boom town in Southwest Virginia, will soon be one of those communities. After enduring damaging floods almost every 20 years, from 1937 to 1993, Grundy is moving its business district across the Levisa River to a 13-acre site donated by Norfolk Southern Corp.

Relocating Grundy is tough because of the lack of flat land. "Most communities that have flooded have acres of level land to go back a couple of miles from the river," says Grundy's town manager Chuck Crabtree. "The way we were nestled between mountains, railroad tracks, the river, and U.S. Route 460, we had no level land. So floodproofing Grundy is very unique in itself."

The move is paving the way for a long-awaited highway project too. At one time, Grundy, the seat of Buchanan County, stood in the way of the Virginia Department of Transportation's (VDOT) plan to continue Route 460 to the Kentucky state line. But bypassing Grundy would have cost VDOT $150 million to $160 million, Crabtree says, and building the roadway through Grundy would have destroyed its downtown. And, there was little space for existing businesses to relocate in the mountainous terrain.

Thanks to a partnership with the U.S. Army Corps of Engineers (USACE) and VDOT, relocating Grundy and extending Route 460, once financial impossibilities, are becoming realities. VDOT's routing U.S. 460 through the old downtown will cost $77 million — $73 million to $83 million less than the original proposed cost. And USACE's cost in preparing the relocation site for development fell from somewhere between $200 million to $300 million to about $110 million as a result of the partnership, according to Crabtree.

Moving a town may seem like a radical measure. But for Grundy — with its dwindling population and an economy that never rebounded from the flood of 1977 — relocating may be its only chance. Many buildings were abandoned after the '77 flood, causing property values to fall. Federal laws have also changed, requiring that no more than half of a building's appraised value be spent on repairing it. In most cases, the amount allotted was insufficient to do the necessary work.

"People started going outside of Grundy for business," Crabtree said. "We had an outflow of people on the weekends, and when people started going out, they liked the community they were going to, and they started moving."

Although Grundy's citizens gave up on the town a long time ago, the proposed new Grundy is attracting new commerce already. A new Comfort Inn has almost quadrupled the taxes paid by previous downtown businesses, paying out about $50,000 annually, and has created jobs as well. Verizon has chosen Grundy as a pilot project for creating a wireless community. Groundbreaking on the relocation site is slated for fall 2006, and retail businesses have already spoken for the future buildings, according to Crabtree.

Grundy has now given the river back to itself and reopened the river channel, transforming the Levisa into an asset instead of a liability, Crabtree noted.

"It's not one big fix. It is a puzzle," Crabtree said. "No one would believe the benefits that have come out of this. I think we'll have the most unique small town in the country."

—Jennifer Sparger

The business district in Grundy, Va., will be relocated to a 13-acre site across the Levisa River.

TOWN OF GRUNDY CORPS OF ENGINEERS

GREYFIELD REDEVELOPMENT

Old Malls Seek New Life

Not far from the shoppers strolling through the bright corridors of Cloverleaf Mall, there are three eerily empty buildings filled with the echoes of times past. Every department store has abandoned this once-thriving regional mall in Chesterfield County, Va., along with a movie theater chain and most of the food court tenants.

County officials want this underused, 78-acre property to be replaced with a mix of offices, storefronts, and housing within walking distance of each other. Other declining malls across the Fifth District known as "greyfields" also need some form of redevelopment.

The rise and fall of regional malls parallels the suburbanization of America during the 1950s and 60s. Department stores followed shoppers out of downtown districts as development spread beyond cities. Eventually, retailers realized that putting a few anchor stores like Sears or J. C. Penney and an assortment of specialty stores under one roof created a safe, climate-controlled environment that suburbanites liked.

This clustering of retail gave regional malls an advantage. "From an economic point of view, [it] reduced search and information costs," notes Mark Eppli, who holds the Bell Chair in Real Estate at Marquette University. Because the mall offered a plethora of choices, shoppers could be confident of finding the quality or price they wanted. The result was that stores could generate more sales collectively than they could earn individually.

However, regional malls in aging, filled-out inner-ring suburbs have lost customers as development has continued its outward expansion. Outer-ring suburbs have space available for new residential and commercial development that meets the market's needs.

Some of this development has supported new retail formats that have taken market share from regional malls. For example, Cloverleaf Mall competes with Regency Square and Chesterfield Towne Center, two "superregional" malls that provide greater variety in 800,000 square feet or more of retail space. Then there is Stony Point Fashion Park, a "lifestyle center" that is somewhat smaller, but has an open-air design and the kind of upscale food and fashion offerings that used to be confined to cities. Finally, big-box retailers like Dick's Sporting Goods and Circuit City stores provide wider selections of specific product categories.

Some regional malls have renovated or replaced some of their tenants to keep pace with change. In 2002, Pennsylvania Real Estate Investment Trust (REIT) bought the Roses department store at Magnolia Mall in Florence, S.C., and reconfigured it for occupancy by

Best Buy, a new food court, and additional specialty retailers. Other malls have been radically remade — in 1998, Talisman Companies tore down the walls of a failing regional mall in Towson, Md., and created a strip center of big-box stores.

In some cases, however, the whole mall may have to be scrapped. "There may not be demand, the neighborhood may not have stepped up over time, or the other retail is too close and they can't compete," says Eppli.

While it could be obsolete for retail use, a regional mall has other qualities that make it attractive for redevelopment. According to Douglas Grayson, executive vice president of development at Pennsylvania REIT, a mall sits on a large parcel within a well-populated suburb where land is scarce and expensive, plus it has existing infrastructure like roads and utilities. "There is a high intrinsic value to that piece of property."

Realizing that value isn't easy, though. "The developer or owner of the mall almost never has the unilateral right to do anything," explains Grayson. "The number of stakeholders that have to be dealt with to reposition a property is huge [and each one] is looking for their opportunity to profit." Also, some of those stakeholders, or even the mall's primary owner, may resist any redevelopment that might eat into their existing returns, however meager they might be.

That's why local governments often intervene. They have the money to assemble the necessary property rights, tear down mall buildings, and tie the project into the surrounding neighborhood. They also have the power of eminent domain to take care of holdouts, although a Michigan Supreme Court decision in July may limit future seizures of private property for economic development purposes. While local governments want to stimulate more taxable economic activity, redevelopment experts say that efforts to revitalize greyfields and other obsolete properties must be economically justified.

—Charles Gerena

MALPRACTICE INSURANCE

Conflict Escalates

Doctors and lawyers, with insurers in the middle, continue their professional conflict over rising medical malpractice premiums.

At issue are medical malpractice insurance rates for certain physician specialties, such as obstetrics, that some doctors say are forcing them to quit. A Charleston, S.C., surgeon recently made a proposal that shocked the legal and medical community. Chris Hawk, who has practiced medicine for 26 years, suggested that the American Medical Association's House of Delegates pass a resolution that would encourage doctors to refuse treatment to trial lawyers. It did not pass.

"The physician has a right to refuse care to anybody," Hawk says. "The feeling was that it was so damaging from a political correctness viewpoint they didn't want to do anything with it. That may be legitimate, but on the other hand, it did get a lot of attention to what is a very broken system." Physicians in many Fifth District states have lobbied for caps on noneconomic damages. In West Virginia, the state legislature lowered in 2003 its cap to $250,000 on "pain and suffering" damages. In South Carolina, tort reform legislation was tabled earlier this year.

People investigating the rising rates of malpractice insurance would agree that the system is broken, but disagree about its causes and policy options that could help.

The United States General Accounting Office issued a report in October 2003 that outlined multiple reasons malpractice rates have soared. First, insurers' losses on medical malpractice claims have jumped in some states since 1998, more slowly in states that limit awards. Second, insurers lost money when interest rates dropped on bonds that comprised some 80 percent of their investment portfolios. The higher interest rates had allowed insurers to underprice rates in heated competition for malpractice business in the 1990s, rates that did not cover eventual losses. As a result, today fewer insurers offer medical malpractice and, accordingly, there is less competition.

But the current crisis is different from previous malpractice rate cycles, according to William Sage, a physician and professor of law at Columbia University. Sage suggests that medicine's success in treating disease has "outstripped the structural and financial framework of medical liability."

A proposal by the Institute of Medicine in 2002 suggests demonstration projects that would test replacing malpractice law with an administrative system for compensating patients who have experienced avoidable injury. The report cites the liability crisis as a key health-care policy problem because many cases of negligence don't end up in court and, conversely, many claims don't relate to negligence. Also, judgments are sometimes inconsistent with the medical evidence. Finally, legal and administrative expenses eat up half the cost of liability premiums.

The demonstration projects could create a system outside the courts that would "provide timely, fair compensation to injured patients and promote apologies and nonadversarial discussions between patients and clinicians." The projects would also encourage reporting and analysis of medical errors.

The idea is to put the incentives to reduce error in the right place as well as compensate patients quickly for avoidable injury.

—Betty Joyce Nash

DAVID ALLAN BRANDT/GETTYIMAGES

WHY CITIES GROW

Economist Richard Florida argues that cities must attract young, talented workers – what he dubs the "creative class" – if they want to prosper. Is he right? And is there anything new about his theory?

BY AARON STEELMAN

Economics can be used to better understand a whole host of social phenomena. But perhaps the most fundamental issue of all is why some places prosper while others stagnate. Often this question is posed of countries: Why has the United States outperformed Japan, for instance? But it also can be asked at the subnational level as well: Why have some individual states within the United States done better than others? And why have some cities within those states grown more quickly than their peers? Indeed, this last question is what vexes community development officials, many of whom are charged with revitalizing once-thriving urban centers.

Over the past 40 years — as the U.S. population has increasingly shifted from city to suburb — there has been no shortage of ideas about how to bring life back to America's downtowns. Pedestrian malls, convention centers, sports stadiums — these have all been touted as keys to urban redevelopment, but when tried they often have been unsuccessful. Today there is a new contender vying for the attention of city leaders: the "creative class" thesis, which says that a community's economic health is directly related to how attractive it is to young, talented, and open-minded people. These people generate ideas, work long hours, and generally make a city go.

In broad outline there doesn't seem much about this argument with which to quibble. As a descriptive matter, sociologists have talked about the "creative class" as a distinct group since at least the 1960s, although they haven't necessarily used that term. And as a prescriptive matter, economists have long argued that human capital, which the creative class is supposed to possess in abundance, is a key factor in economic growth — and may be more important now than ever. But when you scratch below the surface, some problems arise with the creative class theory. These problems don't invalidate the theory in its entirety — in fact, there is much that is important and true about the "creative class" concept — but they do suggest that it is not the magic bullet that many urban planners and developers have been hoping to find.

The Three Ts

If there is a leader of the creative class movement, it is without question economist Richard Florida, author of *The Rise of the Creative Class ... And How It's Transforming Work, Leisure, Community, and Everyday Life*. Florida, who developed most of his ideas regarding the creative class while teaching at Pittsburgh's Carnegie Mellon University, has recently taken a position at George Mason University's School of Public Policy. His move places him just miles from Washington, D.C., one of the cities that he touts as a leader in attracting the type of young, hip workers necessary for a dynamic, growing community.

According to Florida, economic development requires "The Three Ts": technology, talent, and tolerance. Many cities have one or even two of these traits, but all three are necessary for rapid growth because they work closely together. Florida's argument goes as follows:

> [R]egional economic growth is powered by creative people, who prefer places that are diverse, tolerant, and open to new ideas. Diversity increases the odds that a place will attract different types of creative people with different skills sets and ideas. Places with diverse mixes of creative people are more likely to generate new combinations. Furthermore, diversity and concentration work together to speed the flow of knowledge. Greater and more diverse concentrations of creative capital in turn lead to higher rates of innovation, high-technology business formation, job generation, and economic growth.

To measure how well cities fared on these three measures — technology, talent, and tolerance — Florida constructed separate indices for each. Combined, they are used to determine a city's overall "creativity index" score. The cities are then divided into the following four groups and ranked: (1) regions with populations over 1 million; (2) regions with populations between 500,000 and 1 million; (3) regions with populations between 250,000 and 500,000; and (4) regions with populations below 250,000. (For a list of the rankings of the best and worst cities in each group, see the accompanying charts.) Those cities with high creativity index scores should be expected to do well in coming decades, while those with lower scores should be expected to struggle. Not surprisingly, the index has ignited interest among city officials who wonder how they can move their region up the list.

The Memphis Manifesto

In the spring of 2003, representatives from 47 cities gathered in Memphis, Tenn., a city that fared particularly badly on Florida's creativity index, to draft the "definitive blueprint for communities competing for creative workers and seeking to retain their own." The result is what has been dubbed the "Memphis Manifesto." The document is long on vague notions and flowery language but short on concrete proposals. For instance, its number-one principle is, "Cultivate and reward creativity. Everyone is part of the value chain of productivity. Creativity can happen at any time, anywhere, and it's happening in your community right now. Pay attention." It also implores cities to "convert a 'no' climate into a 'yes' climate. Invest in opportunity-making, not just problem-solving."

The manifesto's most significant policy proposal is to "invest in the creative ecosystem," by which its authors mean "arts and culture, nightlife, the music scene, restaurants, artists and designers, innovators, entrepreneurs, affordable spaces, lively neighborhoods, spirituality, education, density, public spaces, and third places." If you build such institutions, they argue, creative, talented 20-somethings will be drawn to your city, fueling economic growth in the way Florida has described.

The problem, says Joel Kotkin, a senior research fellow at the Davenport Institute for Public Policy at Pepperdine University, is that the manifesto ignores the core functions of local government like public safety and effective schools. "The creative class concept is so popular with city officials because it acts as if there is an easy solution to the problems they face," he says. "There isn't. Cities need to work on fixing the basics and providing a reasonable tax and regulatory environment if they want to grow."

In fact, says Kotkin, some decidedly unhip places like Riverside, Calif.; Des Moines, Iowa; and Sioux Falls, S.D., are doing quite well while many of the places that scored well on Florida's index have been hurting in recent years. "Florida's theory looked pretty enticing during the tech boom. But a lot of those places that he says are models of urban growth, like San Francisco, are doing pretty badly now," he argues. "How can this theory be right when all the hip places aren't growing?"

In addition, even if a city can attract a talented young work force, it's risky to pin your hopes on them. People in their 20s are like a "revolving door," says William Frey, a demographer associated with the University of Michigan and the Brookings Institution. They tend to hop around a lot, taking advantage of new job and educational opportunities. The problem may be especially acute for the creative people described with so much enthusiasm in the Memphis Manifesto. "Once artists get their big break, they don't stick around. They go to New York or Los Angeles," says Kotkin. "The type of people who settle down, establish roots, and really contribute over the long run to a city's economy tend to be in their 30s or older. And they don't particularly want to live in lofts and go clubbing. They want some quiet and some space, and so they often go to the suburbs."

Human Capital or Creative Capital

The idea that talent is crucial to economic growth is not particularly controversial among economists. Adam Smith, Alfred Marshall, and Joseph Schumpeter all talked about the importance of new ideas to economic growth. In fact, Schumpeter described the "perennial gale of creative destruction" as the "essential fact about capitalism." More recently, Stanford University economist Paul Romer has made human capital a central part of his influential "new growth" theories.

But Florida wants to argue that his ideas are new — and the novel part is how he characterizes talented and creative people. He suggests that talented and creative people are drawn to "Bohemian" places that celebrate the new over the traditional, the unique over the conventional. Indeed, he has constructed a Bohemian Index, which measures the number of writers, designers, musicians, actors and directors, painters and sculptors, photographers, and dancers as a share of a region's total population. He then uses the Bohemian Index as one of the components of his larger Tolerance Index — the third of The Three Ts.

Many creative people, however, have little use for "socially free areas with cool downtowns and lots of density," writes Harvard University economist Edward Glaeser in a review of Florida's book. "I know a lot of creative people. I've studied a lot of creative people. Most of them like what most well-off people like — big suburban lots with easy commutes by automobile and safe streets and good schools and low taxes. After all, there is plenty of evidence linking low taxes, sprawl, and safety with growth."

In fact, the most successful skilled city in the 1990s, as measured by population growth, was Plano, Tex., not exactly a Bohemian paradise, says Glaeser. Indeed, the Research Triangle area of North Carolina, which has experienced rapid job growth in high-paying industries, is

America's Most — And Least — Creative Places

Regions With Population Over 1 Million

Top 10	Bottom 10
Austin, TX	*Norfolk, VA & Detroit, MI
San Francisco, CA	Cleveland, OH
Seattle, WA	Milwaukee, WI
Boston, MA	Grand Rapids, MI
Raleigh-Durham, NC	Memphis, TN
Portland, OR	Jacksonville, FL
Minneapolis, MN	Greensboro, NC
Washington, D.C.	New Orleans, LA
Sacramento, CA	Buffalo, NY
Denver, CO	Louisville, KY

Regions With Population Between 500,000 and 1 Million

Top 10	Bottom 10
Albuquerque, NM	Fresno, CA
Colorado Springs, CO	Greenville, SC
Tuscon, AZ	Scranton, PA
Richmond, VA	Mobile, AL
Columbia, SC	Tulsa, OK
Little Rock, AR	Toledo, OH
Wichita, KS	Fort Wayne, IN
Albany, NY	Baton Rouge, LA
Birmingham, AL	Stockton, CA
*Allentown, PA & El Paso, TX	Youngstown, OH

Regions With Population Between 250,000 and 500,000

Top 10	Bottom 10
Madison, WI	Erie, PA
Boise City, ID	Chattanooga, TN
Fort Collins, CO	Hickory, NC
Des Moines, IA	Johnson City, TN
Santa Barbara, CA	Ocala, FL
Lansing, MI	Saginaw, MI
Tallahassee, FL	Visalia, CA
Provo, UT	Evansville, IN
Lincoln, NE	Lakeland, FL
Melbourne, FL	Shreveport, LA

Regions With Population Below 250,000

Top 10	Bottom 10
Burlington, VT	Wausau, WI
Corvallis, OR	Mansfield, OH
Iowa City, IA	Victoria, TX
Champaign-Urbana, IL	Sheboygan, WI
San Luis Obispo, CA	Danville, VA
Portland, ME	Houma, LA
Charlottesville, VA	Lima, OH
Cedar Rapids, IA	Sumter, SC
Bryan-College Station, TX	Joplin, MO
Bloomington, IL	Gadsden, AL

Notes: Cities are listed in descending order. For instance, among cities with populations of 1 million or more, Austin is ranked as the most creative city, while Louisville is ranked as the least creative city. The rankings come from the overall "Creativity Index" scores compiled by Richard Florida and his colleagues.
*These cities tied.
SOURCE: Richard Florida, *The Rise of the Creative Class*, 2004 Paperback Edition

"a traditional Nerdistan," says Fred Siegel, professor of history at Cooper Union in New York and author of *The Future Once Happened Here: New York, D.C., L.A., and the Fate of America's Big Cities*. The majority of its residents are not at the cutting edge of popular culture, even though they may be tops in their highly creative professions.

Some might argue that this criticism is overly broad — that it overlooks too many obvious examples of tolerant, Bohemian places with strong, growing economies to be convincing. And the truth is there are quite a few such places. But ask yourself what else many of these cities have in common: Ann Arbor, Mich.; Austin, Tex.; Madison, Wisc. — these places are diverse and tolerant, and their economies are in fact growing quite rapidly. But they are also home to large research universities, which require support services from local businesses, have massive budgets of their own, and partner with private-sector firms on a wide array of projects. To some extent, such economic activity insulates these cities from broader downturns in the economy. And in the case of Austin and Madison, both state capitals, a large number of relatively stable, high-paying government jobs adds to the recession-proof nature of their economies.

When you subtract the number of university towns from the list of booming but also Bohemian cities, that list shrinks substantially. And of those that remain, it's not especially clear what policymakers can do to replicate their success. Consider Asheville, N.C. It's a relatively small city in the mountains of western North Carolina, just miles away from some of the poorer parts of Appalachia. Yet it has a thriving artistic community and a countercultural feel. How did this happen? Certainly not by any grand plan.

Instead, creative types have come to Asheville for differing reasons for more than a century, each adding to the area's unique culture. In the 1890s, artisans were drawn to Asheville to work on George Vanderbilt's famous Biltmore Estate, many of whom stayed in the area and continued to hone their skills. During the 1930s, a number of Bauhaus artists, including Josef Albers, fled Nazi Germany and settled in the Asheville region. And during the 1970s, New-Age bookshops and offbeat clubs began popping up.

In other words, much of Asheville's development was "spontaneous, organic, and untidy," to borrow the words of Jane Jacobs, author of the classic *The Death and Life of Great American Cities*. City officials may have played some part in fostering Asheville's growth, but the region's development was fundamentally bottom up, not top down. No manifesto could have accurately described or directed the path that Asheville has taken. "Local governments alone cannot make a place 'hip,'" says John Accordino, associate professor of urban studies and planning at Virginia Commonwealth University. "Usually there are other, more important factors, such as universities or a natural setting, that have already attracted artistic folks."

Sound and Fury Signifying What?

Like many other proposals that hold the promise of bettering society, Richard Florida's theories about the creative class have been seized by policymakers eager to help their cities. And in the process some of his ideas may have been distorted by well-intentioned public officials. At least that's how he sees it. "What's sometimes disheartening is that some community leaders seem to conclude the key lies in attracting creative class workers, and therefore the creative class simply needs to be lured like some sports franchise from another city with bike trails, music scenes, and other amenities," writes Florida in the preface to the 2004 paperback edition of his book. "There is no one-size-fits-all strategy. Each place has to use the ideas and theories developed in this book to create the best 'fit' for itself."

So where does this leave us? Florida's strongest ideas — about the importance of human capital to economic growth — aren't especially new. And his newest ideas — about the importance of creating Bohemian enclaves to attract talented people — don't appear to be particularly strong. As a matter of public policy, Harvard's Glaeser sums up things nicely: "Mayors are better served by focusing on the basic commodities desired by those with skills than by thinking that there is a quick fix involved in creating a funky, hip Bohemian downtown." The problem, of course, is that those basic commodities have proven awfully hard to provide in most cities. Perhaps it's time for economists to think creatively about how to deal with that issue. **RF**

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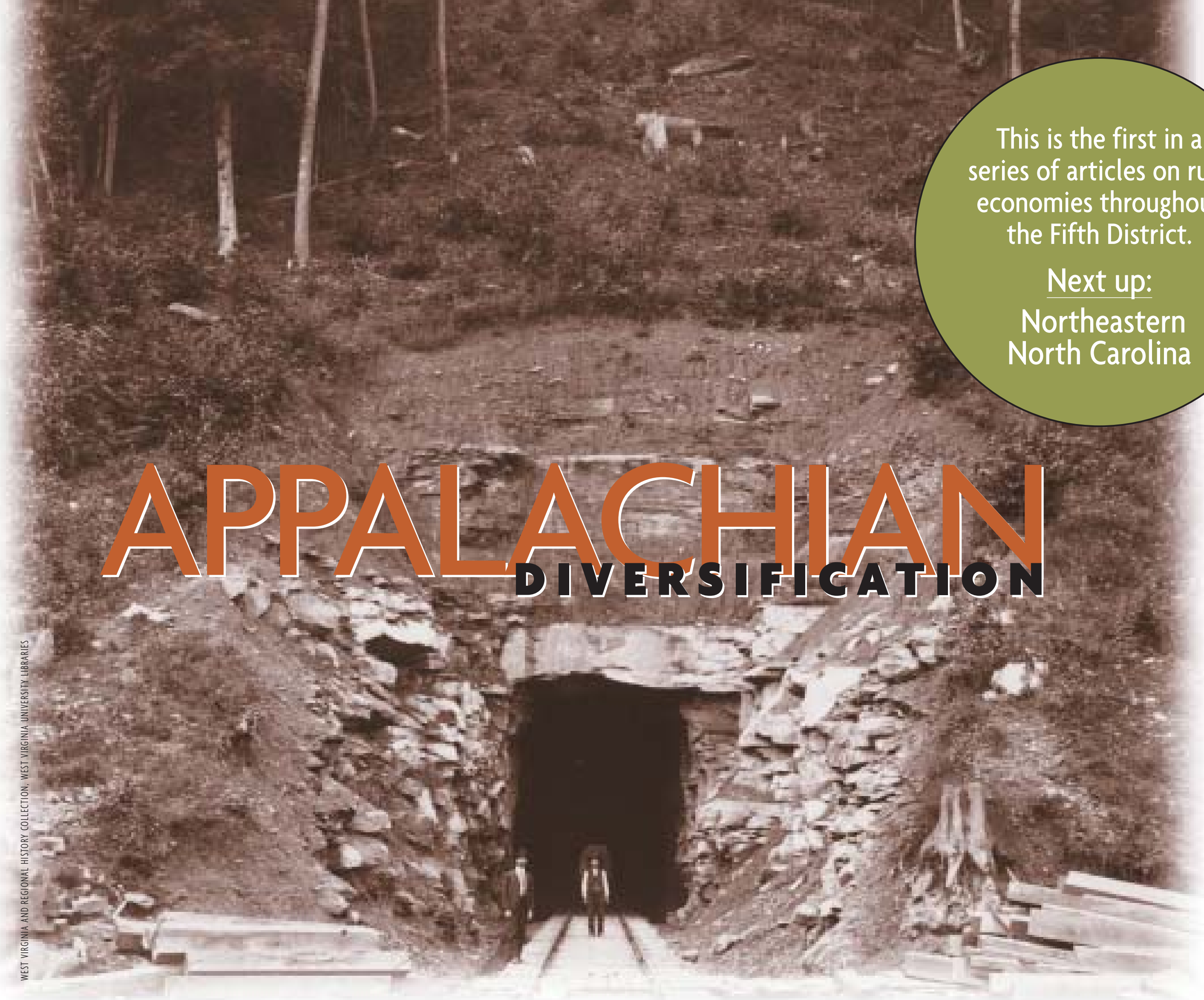

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This is the first in a series of articles on rural economies throughout the Fifth District.

Next up:
Northeastern North Carolina

APPALACHIAN DIVERSIFICATION

In the heart of Appalachia, the people of Southwest Virginia are creating economic opportunities to replace coal jobs

BY KARL RHODES

When the Woodtech plywood plant shut down in Tazewell County, Va., Steve Taylor and two other employees refused to quit. Even after their paychecks stopped coming in August 2002, they kept on working. They struggled to winterize $36.5 million worth of equipment. They contacted potential customers, and they worked on a business plan to reopen the plant.

Woodtech was in bankruptcy and so was its parent company, Fancy Tsuda of Japan. The company's primary lender had failed, and its plant was in sad shape. There was no electricity, no heat, and no running water — except the rain that seeped through dozens of leaks in the roof.

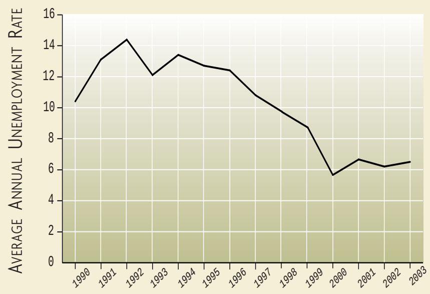
Looking for help, Taylor took his plan to reopen the plywood plant to Tazewell County's Industrial Development Authority (IDA). He didn't snare any financial assistance, but he did catch the attention of IDA board member Bill King, a former mayor of nearby Bluefield, Va., who had cashed out of the cable television business in 1999.

King was so inspired by Taylor and his cohorts that he resigned from the IDA board and started investing his own money in the project. A new company, Blue Ridge Wood Products, was born.

The story of Blue Ridge Wood Products showcases the hardworking, bootstrapping mentality that permeates Southwest Virginia, the geographic center of Appalachia. The people here are fiercely independent and self-reliant. They are as rugged as the mountains that separate them from the socioeconomic blessings and curses of big cities. For generations, their culture produced strong churches and cohesive families, good neighbors, and mountain music.

But their culture also valued manual labor at the expense of formal education. Many teenagers quit high school as soon as they could to work

Unemployment in Virginia's Coalfield Region



SOURCE: Virginia Employment Commission

in the coal mines, recalls Donald Baker, mayor of Clintwood and chairman of the Virginia Coalfield Economic Development Authority (VCEDA). "It was a family tradition. Your grandfather was a miner. Your father was a miner. You're a miner, and your children will end up being miners. But that's not the case anymore." (For more on the IDA, VCEDA, and other development authorities, see the sidebar.)

Coal's impact on the region's culture and economy has decreased substantially since the late 1970s. New mining techniques and equipment have eliminated thousands of jobs in the seven-county area covered by the VCEDA. "It took 900 to 1,000 people [in the 1950s] to produce the amount of coal that 10 people can produce now," says Baker, who spent 35 years in the business. "With longwall mining, it's nothing to produce 2,000 to 3,000 tons of coal in an eight-hour shift with six to eight people."

Baker says the region's county governments were slow to promote economic diversity in the 1970s and '80s. Looked at one way, this may have been a reasonable decision. The region's residents did what was most profitable — coal mining — for as long as they could. But when the coal-mining industry took a turn for the worse, the region was destined for hard times.

"When things were going OK ... no one seemed to be all that concerned," Baker recalls. "All of a sudden one morning, they woke up and said, 'We need to do other things!' ... I think they let a lot of time slip by."

Stepping Out of Denial

If anyone doubted that things in Southwest Virginia had taken a turn for the worse, a 1987 socioeconomic study of Virginia's coal counties entitled "Income Uncertainty and the Quality of Life" put those doubts to rest. The study, written by three Virginia Tech economists, found that per-capita income in the region was only 68 percent of the state average. And to make matters worse, the region's income was "more variable" and "less evenly distributed."

The study painted an empirical picture of Southwest Virginia that was hard to ignore. The disparities were dramatic in everything from test scores and dropout rates to "permits for mobile homes" and "housing units with no piped water."

Newspapers across the country picked up the story, recalls lead researcher Thomas Johnson, who is currently a professor of agricultural economics at the University of Missouri-Columbia. The study was prompted by "key activists in the area who felt that those sort of things needed to be aired," Johnson says. Southwest Virginia had "some devoted people who wanted to see change."

The Virginia General Assembly responded by forming the VCEDA in 1988. The authority promotes economic diversity in the counties of Buchanan, Dickenson, Lee, Russell, Scott, Tazewell and Wise plus the city of Norton — the same region that Johnson and his colleagues highlighted in their landmark study. The VCEDA is funded by 12.5 percent of the revenue from the region's 2 percent coal severance tax and 37.5 percent of the revenue from the region's 2 percent natural gas severance tax. (Severance taxes are levied by localities on the value of coal or natural gas extracted — or "severed" — from that locality.)

The authority has used that money to provide $66.5 million in total

Population in the Virginia Coalfield Region

	1900	1910	1920	1930	1940	1950	1960	1970	1980	1990	2000
Virginia	1,854,184	2,061,612	2,309,187	2,421,851	2,677,773	3,318,680	3,966,949	4,651,448	5,346,797	6,187,358	7,078,515
Buchanan County	9,692	12,334	15,441	16,740	31,477	35,748	36,724	32,071	37,989	31,333	26,978
Dickenson County	7,747	9,199	13,542	16,163	21,266	23,393	20,211	16,077	19,806	17,620	16,395
Lee County	19,856	23,840	25,293	30,419	39,296	36,106	25,824	20,321	25,956	24,496	23,589
Russell County	18,031	23,474	26,786	25,957	26,627	26,818	26,290	24,533	31,761	28,667	30,308
Scott County	22,694	23,814	24,776	24,181	26,989	27,640	25,813	24,376	25,068	23,204	23,403
Tazewell County	23,384	24,946	27,840	32,477	41,607	47,512	44,791	39,816	50,511	45,960	44,598
Wise County	19,653	34,162	46,500	51,167	52,458	56,336	43,579	35,947	43,863	39,573	40,123
Norton*	n/a	n/a	n/a	n/a	n/a	n/a	5,013	4,172	4,757	4,247	3,904
Virginia Coalfield Region	121,057	151,769	180,178	197,104	239,720	253,553	228,245	197,313	239,711	215,100	209,298

*Norton became a city in 1954. Before then, its population was part of Wise County.
SOURCE: U.S. Census Bureau

financing to more than 150 economic diversification projects since 1988, says Jonathan Belcher, the VCEDA's deputy executive director.

Most of that financing has come from the authority's revolving loan fund, which lends money at or below prime rate, Belcher says. About half of the loans go to new industry, while the other half is divided up among expanding businesses, infrastructure projects, land for industrial parks, etc.

"They have changed their dependence on coal mining," Johnson says. "It really is amazing when an area can pull itself back from that abyss."

Plying a New Trade

During the past 15 years, the VCEDA has assisted nearly every major non-coal employer in the region, most recently Blue Ridge Wood Products, the plywood plant that King is trying to reopen in Tazewell County.

King began working on Blue Ridge Wood Products in May 2003. He struck a deal with the bankruptcy court to lease the plant from Woodtech's creditors in exchange for providing security and electricity at the plant.

With his own money, King started hiring a mix of former Woodtech employees and new workers to patch the holes in the roof, repair water lines, and get the HVAC and fire-suppression systems working again. They also started reconditioning the plant's equipment and testing it on logs that King bought.

At the same time, King was lining up potential customers, hiring more workers, and presenting the plant's evolving business plan to any lender who would listen. He needed to borrow enough money to buy the business out of bankruptcy and get the plant "over the hump" to profitability.

"We basically had 22 rejections," King recalls. They were turned down by small local banks, large national banks, and statewide development agencies. In February 2004, King told his wife that he was "probably going to pull out. ... I just couldn't put her through it anymore," he says. King started packing up his office, and he called the Tazewell County administrator to let him know that he was calling it quits.

That's when one of the county supervisors came up with an interesting proposal: If King were able to buy the plant out of bankruptcy, he reasoned, the county would receive $608,000 in back taxes that Woodtech still owed. Why not agree to lend that money back to Blue Ridge Wood Products through the industrial development authority to keep the deal alive? Otherwise, the county and Woodtech's other creditors would have to find another buyer, and no one else seemed likely to purchase a plant that had failed before, was in poor condition and was deteriorating rapidly. Under the circumstances, the prospects of new jobs and future taxes outweighed the risk that King would not be able to repay the loan.

The county's pledge led to financial commitments from the Governor's Opportunity Fund and from the Virginia Tobacco Indemnification and Community Revitalization Commission. And those commitments helped King get a loan commitment from the Bank of Tazewell — one of the banks that had previously turned him down.

The other breakthrough that helped secure bank financing was finding an experienced plant manager who was willing to take a chance on the fledgling company. Enter R.D. Finley, the manager of a similar plant in Princeton, W.Va. The Princeton plant was shutting down its plywood production, and Finley did not want to move to Indiana or Pennsylvania to keep his job.

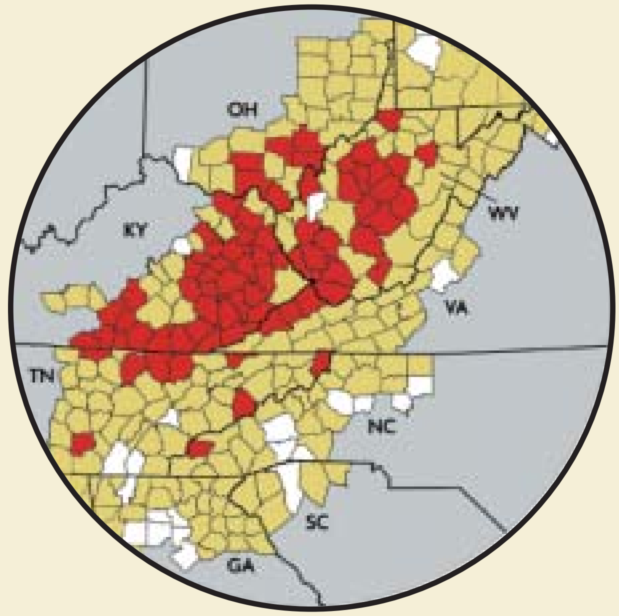
"I'm a hometown boy," Finley says. "I wanted to stay around here." Finley was born and raised in Gary, W.Va., about 35 miles from Bluefield. He returned to Appalachia after traveling extensively with the military. "I've been to Turkey, England, and Germany," says Finley, vetoing each country with a shake of his head. "I just love the mountains. I love the people. I love the natural beauty of West Virginia and western Virginia. ... All of my children and grandchildren are right here."

Down Home

When people try to define the alluring lifestyle of Southwest Virginia, they refer to "family values" more often than both presidential candidates combined. Their most common refrain is:

County Economic Status in Appalachia

(Fiscal Year 2004)

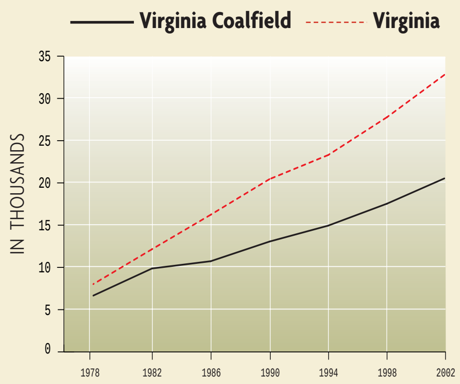


Distressed
Distressed counties are the most economically depressed. They have a three-year average unemployment rate that is at least 1.5 times the national average; a per-capita market income that is two-thirds or less of the national average; and a poverty rate that is at least 1.5 times the national average; or they have two times the national poverty rate and qualify on the unemployment or income indicator.

Transitional
Transitional counties are those below the national average for one or more of the three economic indicators (three-year average unemployment, per-capita market income, and poverty) but do not meet the criteria of the distressed category.

Source: Appalachian Regional Commission

Per-Capita Personal Income



SOURCE: U.S. Bureau of Economic Analysis

"It's a great place to raise a family."

That phrase captures many of the region's strengths, explains Jessica Horn, a marketing associate with the VCEDA. "It's the low crime rate. It's a feeling that you know who your neighbors are and you feel comfortable in your neighborhood," she says. "A lot of people are here because their families are here. They have that support system for raising their children."

Lots of rural areas in all parts of the country claim to be good places to raise families, notes Belcher at the VCEDA, "and by and large that's true. But here, we also have the beauty of the mountains and the [family-oriented] recreational opportunities," such as hiking, biking, hunting, and fishing.

Education is often cited as the weakest link in the region's family-friendly culture, but education is the main reason why King moved his family to Tazewell County in 1983. King grew up in McDowell County, W.Va., "in the heart of coal-mining country." In the 1950 census, the county's population peaked at nearly 100,000. Now it's barely above 25,000. The county had 10 high schools in the early 1950s, King recalls. Now it has just three, and that number soon will drop to two.

"I was very happy with the education I received in McDowell County," King says. But "as we lost population, ... a lot of the teachers had [migrated] to the school system in Tazewell County. ... The math instructor I had in junior high was down here teaching high school math."

Tazewell County's school system "does a very fine job of preparing kids to go on to college," King says. One of his children scored 800 on the math portion of the SAT, and all three of his children graduated from Virginia Tech.

King was willing to chase educational opportunities for his children, but he didn't want to leave Appalachia. "Walking down the street, people say, 'Hello!' and 'How are you doing?'" he notes. "That's the way I like it. I like to go out of my way to try to help somebody. I think it's one of the things that you are put on earth to do is to be friendly with people."

King wears his community pride on his sleeve. Today it happens to be the sleeve of a maroon shirt that's emblazoned with one bright orange word — "Risk." On closer examination, the word is not "Risk" but "Rish," the name of a heavy equipment dealer.

As King clarifies the ambiguous embroidery, two men hustle past him with fire extinguishers. Smoke rolls out into the plant as they throw open giant doors to the drying equipment and snuff out smoldering pieces of wood. King takes it all in stride. "It's like practicing on a football team," he says. "You run this play, and you run this play. You run it. You run it. You run it. So when you get in a game, you know what can go wrong. ... And when your butt's been between a rock and a hard spot enough, you know you are going to find a way out of it."

The biggest risk, King concedes, is investing substantial time, effort, and money into plant and equipment that he doesn't own yet. That's not exactly how they draw it up in business schools, but King saw no other way to get Blue Ridge Wood Products going.

"If the deal doesn't go through, I'm out seven figures," he says. And if the deal does go through, the company expects to employ 100 people within a month and 160 to 170 people by the end of the year. Finley, the plant manager, relishes that challenge, and he admires King's entrepreneurial zeal.

"Here is a guy who doesn't know the first thing in this world about the

By Whose Authority?

Local industrial development authorities — sometimes called economic development authorities — have played increasingly prominent roles in promoting economic activity in Virginia in the past few decades.

Beginning in the 1960s, the Virginia General Assembly has authorized localities to create industrial development authorities (IDAs) that are empowered to acquire, own, develop, and lease property to spark economic growth. The General Assembly has enabled these authorities to finance their activities by issuing tax-free bonds and by accepting loans and grants from government agencies.

Typically IDAs use these funds to develop industrial parks and to offer financial incentives to attract new companies and help existing businesses grow.

These authorities are governed by boards of residents who are appointed by their local governments. The governing boards and IDA boards are not allowed to overlap, except in towns with populations below 3,500. Even in these small towns, however, members of the towns' governing boards cannot comprise a majority on their IDA boards.

The Virginia Coalfield Economic Development Authority (VCEDA) is similar to an IDA, but it is unique in several ways. The General Assembly created this authority in 1988 specifically to help diversify the economies of Virginia's coal-producing counties and city.

The VCEDA takes a regional approach to economic development, and it receives nearly all of its funding from a portion of the coal-and gas-severance taxes that its member localities collect. The VCEDA board is a mix of local and regional officials, coal and gas industry representatives, and gubernatorial appointees.

—Karl Rhodes

wood industry. And he told me that right up front," Finley recalls. But King has surrounded himself with people who do know the business. Finley says he left a secure job to sign up with King's operation because "that's the kind of guy I want to work for. He has put his neck on the line."

As he waits for his loans to close in mid-August, King admits that the deal is risky. But it also has the potential to turn a nice profit and have a huge effect on the local economy.

"Some of the biggest mistakes I've ever made were not making decisions when I had good opportunities in front of me," King laments. "I was afraid to make a decision. I let it set too long. ... It goes back to this: Would I be satisfied on my death bed had I not tried this deal? No!"

On the Upswing ... Slowly

For the past 15 years, economic developers in Southwest Virginia have tried to diversify the region's economy and replace the thousands of coal-related jobs that are gone for good. In addition to wood products companies, they have attracted several automotive parts manufacturers and nearly a dozen customer-contact centers. They also have targeted companies manufacturing electronics, pharmaceuticals, and metal products.

Per-capita personal income is about two-thirds of the state average, but that figure has stabilized after years of decline. Meanwhile, unemployment in the region has fallen from 14.5 percent in 1985 to 6.5 percent in 2003. (See the accompanying graphs.)

Part of that improvement can be attributed to four prisons that opened in the region during those years. The VCEDA did not actively seek those prisons, but unlike many areas of Virginia, most local residents did not oppose them either. "We haven't seen the not-in-my-backyard syndrome with the location of the prisons," says Belcher at the VCEDA. They provide "steady jobs, sound jobs that are not likely to go away anytime soon. And our work force has adapted well to those positions."

Most residents also favor construction of a second coal-fired power plant in Southwest Virginia, according to Belcher. "We have a work force and a citizenry that has a background in coal mining," he explains. So they view a coal-fired power plant "as an opportunity that goes hand in hand with the mining industry that is already here."

Another new diversification effort that capitalizes on the region's existing assets is heritage tourism. Last year, the authority decided to commit $2.5 million to tourism projects during a three-year period.

One of those projects is the Ralph Stanley Museum & Traditional Mountain Music Center, which is scheduled to open in October on Clintwood's Main Street. The $2 million museum pays tribute to Ralph Stanley, a local musician who has become a bluegrass legend around the world. Housed in a turn-of-the-century mansion, it will anchor the western end of The Crooked Road: Virginia's Heritage Music Trail.

With several stops in Southwest Virginia, the trail is expected to attract thousands of country music fans to the region, says Baker, the mayor of Clintwood. Virginia has been losing tourism dollars to North Carolina, he says. "I think we missed the boat in the past. ... Now we're in the mode of promoting [tourism]. It's what should have happened several years ago."

Here to Stay

Some economists argue that spending tax dollars to promote economic diversification in Appalachia only postpones the inevitable outflow of population to regions that need more workers anyway. But Appalachian advocates counter that many people in the region are not as mobile as other U.S. residents.

Ron Eller, the former director of the Appalachian Center at the University of Kentucky, called residents of the region a "placed population" in a discussion published in *Appalachia Magazine* in 1998. "The larger society, especially in the late 20th century, assumes that jobs are available ... and that people are free to move wherever the jobs may be," Eller said. "That simply is not the case for many of the poor in Appalachia. They don't have the education to be mobile. In many cases they are tied because of a need to take care of a disabled or older relative or tied emotionally to their place."

The people interviewed for this story are not poor, and most of them have at least one college degree. None of them expressed any interest in leaving Southwest Virginia. In fact, as the region's unemployment rate has declined, the population has stabilized, and many people are gravitating back to their mountain homes.

At Blue Ridge Wood Products, King finally closed his loans and purchased his plywood plant. He rejects the suggestion that people live in Appalachia because they lack education. "Growing up in the coalfields, there were a lot of smart people — a hell of a lot of smart people," he insists. "And a lot of those people are coming back." **RF**

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TOMI/GETTYIMAGES

the Fattening of America

As we benefit from greater convenience and efficiency, our waistlines are widening in the process

BY CHARLES GERENA

Keeping employees safe at the DuPont plant in Chesterfield County, Va., is a top priority. Keeping them healthy and productive as they make Kevlar and other materials is equally important, but it hasn't been easy.

Linda Frye of the company's Health Services department began an effort four years ago to promote the merits of healthy living and to help workers make better choices. For example, the plant's fitness center offers a circuit-training program with a personal trainer for busy people who need an introduction to exercise. But preventive health services at the plant have been underutilized, she says. "We can't make people exercise," Frye notes with some frustration.

In general, there hasn't been a shortage of advice for getting healthy, from diet plans designed by Nathan Pritikin and Robert Atkins to workout videos led by buff celebrities. Still, 65 percent of Americans 20 to 74 years old are considered overweight compared to 47 percent in the late 1970s. During the same 30-year span, the percentage of the adult population considered obese doubled to 31 percent.

To determine these figures, the Centers for Disease Control and Prevention and other organizations used body mass index (BMI), a ratio of weight to height. The BMI for an athlete can be high because muscle weighs more than fat. Still, it's a good indicator of whether someone is carrying excess weight, which can increase the risk of death from diabetes, heart disease, hypertension, and other disorders.

So why do we knowingly endanger our health? Economists have addressed this puzzling question through empirical research that encompasses the work of nutritionists, physicians, sociologists, and other experts. Their conclusions don't excuse us from being responsible for our well-being. Rather, they offer insights into the choices we make and the challenges we face in making healthier ones.

Energy Equation Out of Whack

According to Eric Finkelstein, an economist with RTI International near Durham, it's cheap to be fat in modern-day America. Food is more plentiful, energy-dense, and affordable. Meanwhile, technological advances have enabled people to live and work almost anywhere, which means that most people drive more than they walk. In short, we are taking in more calories while burning fewer of them. Over time, small changes in calories consumed and expended may have accumulated into significant weight gains.

"The data on increasing obesity over the past two decades ... could be explained by a [net] increase of 100 to 150 calories per day," notes Alexander Tabarrok, an economist at George Mason University. The increase could result from consuming an additional can of soda or three extra cookies a day. Alternatively, "the same gain in weight could be explained by a more sedentary lifestyle resulting in ... fewer calories expended."

At an obesity summit held in Williamsburg, Va., last June, economist and nutrition expert Barry Popkin of the University of North Carolina at Chapel Hill described major shifts in body composition throughout the developing world. People generally are eating more animal-based foods and calorie-rich sweeteners like high fructose corn syrup while consuming fewer fruits and vegetables. At the same time, there has been a significant drop in the level of physical activity.

As a result, obesity is a worldwide problem. An estimated 15 percent to 20 percent of the population in England, Germany, New Zealand, and Australia are considered obese, as well as 10 to 15 percent of citizens in Canada, Spain, and Poland.

Yet obesity rates are less than 10 percent in Italy, Sweden, France, and Japan. And no developed country has seemed to grow as heavy so quickly as the United States. Why? A January 2003 working paper authored by David Cutler and two other health economists at Harvard University found that "obesity across countries is correlated with access to new food technologies and to processed food. ... Countries that are more regulatory and that support traditional agriculture and delivery systems have lower rates of obesity."

More Calories In

In America, caloric intake has been steadily climbing. Cutler and others attribute this trend to technological advances that have made the mass production of energy-dense processed foods possible, often at lower prices compared to fresh foods.

Barry Popkin also blames Uncle Sam for tilting the pricing of less healthful foods: "We spend all of our time subsidizing corn ... dairy products, and animal-based products. We have almost no subsidies for fruits and vegetables, and other high-fiber foods." Other critics say federal subsidies of corn have made it possible for food producers to fill grocery shelves with inexpensive sodas, snacks, and other processed foods that use corn syrup as a sweetener.

Aside from being cheaper, foods are available in more flavors and convenient forms than ever before. This brings more of our wants within reach. For example, Cutler gives the example of a family craving pizza. In the past, someone had to make the dough, grate the cheese, etc. Now a phone call to a pizza parlor can produce a hot pie in minutes.

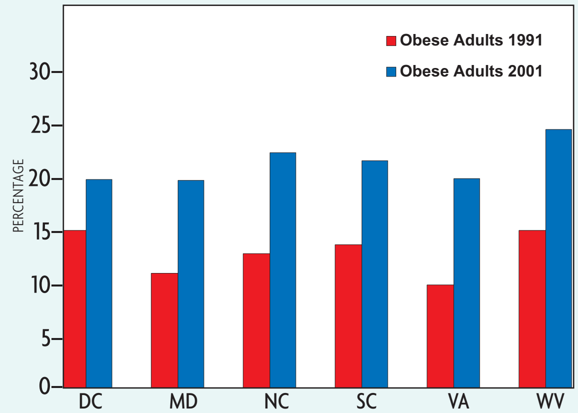
Food technology isn't the only thing that has changed, say researchers at the University of Munich. People may now have higher rates of time preference, which means they place a greater premium on current satisfaction over future satisfaction. This could have important implications for public health. "Individuals with high rates of time preference will consume more high-calorie foods ... at the expense of lower levels of health and utility in the future," the researchers noted.

In addition to changing time preferences, people may just feel more rushed than before. Therefore, the short-term demand for convenience and immediate relief from hunger may be more important than meeting one's long-term fitness objectives, say some economists.

"As we get more stressed out and there are longer intervals between meals, what you know about food and nutrition has less predictive value of what you intend to do," explains Lisa Mancino, an agricultural economist at

Obesity In The Fifth District

Mirroring national trends, waistlines in the Fifth District expanded significantly during the 1990s. West Virginia had the highest obesity rate in the region – 24.6 percent in 2001 – while Virginia experienced the largest rate increase between 1991 and 2001 – 98 percent.



NOTE: Percentage is an estimate of the mean number of state residents 18 years old and over who reported that they were obese. Obesity is defined as having a body mass index of 30 or greater.
SOURCE: Centers for Disease Control and Prevention, Behavioral Risk Factor Surveillance System, 1991-2001

Body Mass Index Formula

$$\textbf{BMI} = \left(\frac{\text{Weight in pounds}}{\text{Height in inches x Height in inches}} \right) \times 703$$

Body Mass Index **(BMI)** is a tool for indicating weight status in adults. Calculate your BMI using the equation above, and the weight status table will indicate where you fall on the BMI chart.

BMI Weight Status	
Below 18.5	Underweight
18.5 - 24.9	Normal
25.0 - 29.9	Overweight
30.0 and above	Obese

SOURCE: National Center for Chronic Disease Prevention and Health Promotion the U.S. Department of Agriculture. "You might have good intentions ... but when you wait five hours between meals [you] just go with what's available." In fact, many people are willing to pay more for a prepared meal if it saves time.

Also, many of the medical costs of overconsumption are borne by society rather than the obese because of the third-party payment system for health care (see the cover story in the Spring 2004 issue of *Region Focus*). People may continue to overeat because they are confident that private insurance or taxpayer-supported programs will cover the cost of saving them from disease or death.

There are other reasons why people could be eating too much. To begin with, many of the most convenient, inexpensive food products have processed wheat flour and other refined carbohydrates, which some nutritionists believe can be addictive to certain people.

Second, there could be a mismatch between current societal conditions and past eating preferences. "Through most of human existence, we lived in societies where there wasn't enough food, so we got used to eating a lot whenever food was plentiful," says Cutler. Now, food is plentiful for many people, yet we haven't adjusted our eating habits.

Finally, the marginal cost of increasing meal portions is very small. The result is that food producers can offer bigger portions that consumers view as a good value.

Fewer Calories Out

There is some debate about whether eating too much is harmful. Richard Forshee, director of research at Virginia Tech's Center for Food and Nutrition Policy, says research suggests that obese people can reduce some of their health risks by getting more exercise, while a slim person can be at risk from being a couch potato.

However, socioeconomic changes have reduced opportunities for physical activity in general, making it harder to burn calories. "For a variety of reasons, we are not using as much energy as we used to," notes Forshee.

Advances in workplace technology have occurred, as well as a shift in the economy from primarily agriculture and manufacturing to services. Both trends have been taking place for many years, though, so they probably account for only a portion of the population's weight gain in the last few decades.

Automation also has transformed households since World War II. This may have led people, especially women, to shift time away from housework to paid work, which tends to be less physical in nature. Whether this has had a major impact on the level of physical activity is hard to judge.

But wouldn't being more productive at non-leisure activities leave more time for biking through a park or hitting the treadmill at the gym? In fact, RTI's Eric Finkelstein says the level of leisure-time exercise has remained low and stable.

One reason is that while automation has reduced the number of people and the amount of physical labor required to perform a task, it has also increased the workload for the remaining workers. In addition, people have been willing to work longer hours to increase their income and, therefore, their consumption.

More money has been available to spend on entertainment as incomes have increased. Still, the more entertaining forms of exercise like hiking are expensive compared to just jogging around the block, notes George Mason's Tabarrok. Also, "exercise must compete against a host of other entertainments." Indeed, sedentary activities that weren't widely

What's The Big Deal?

Throughout the 1980s, fat was the enemy of people struggling to shed excess pounds and improve their health. In the new millennium, carbohydrates are supposedly the new culprits behind the nation's obesity epidemic. However, some academics argue the real problem is that this "epidemic" has been blown out of proportion.

Alexander Tabarrok, an economist at George Mason University, sides with researchers who have found that carrying excess weight increases the risk of heart disease and many other health conditions. "Eating is fun, however, and that has to be counted as a benefit," he says. Therefore, "even accepting the health evidence, I wouldn't argue that obesity is a big deal if I thought that rational consumers were making appropriate choices given their preferences."

Up until the 20th century, western society considered a large girth as a sign of prosperity and good health, partly because food distribution was more difficult and malnutrition was a concern. Moreover, large women were viewed favorably as child bearers, as well as symbols of beauty depicted by painters like Rubens and Renoir.

Today, Americans don't like being fat. In addition to facing ridicule and discrimination, overweight and obese people are more aware of the relationship between diet, exercise, and health. "The large and growing industry of diet books, drugs, clinics, etc., indicates that people do not want to be overweight," adds Tabarrok. "Obesity is a problem because obese people think that it is a problem."

Actually, skeptics like Paul Campos, author of the book *The Obesity Myth*, contend that not every study confirms a negative association between excess weight and poor health. Some, in fact, suggest that thin people don't live as long as those who have excess weight.

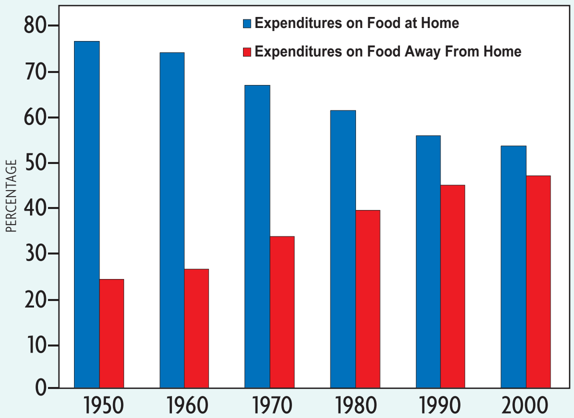
Such contradictions point out the challenges of studying complex social problems like obesity. Researchers usually can't observe the eating habits of individuals under controlled conditions. Instead, they have to rely on surveys and aggregate data about large groups acting in a world full of variables.

As researchers flesh out the consequences of obesity, economists argue that, ultimately, individuals will choose which lifestyles suit them best. "We make choices [in our own self interest] and I don't think our food decisions are any different," notes Eric Finkelstein, a health economist at RTI International near Durham. "As a society we weigh a lot more than we would like, and there are problems associated with that. But many individuals may not be making bad choices from their own perspective."

— Charles Gerena

Eating Out

Americans have preferred to eat fewer meals at home in the last 50 years. According to several studies, frequency of fast food restaurant use is associated with higher fat intake and greater body weight. Many full-service restaurants serve large portions of high-caloric, inexpensive food.



SOURCE: Economic Research Service, U.S. Department of Agriculture

available a generation ago — such as surfing the Internet, playing video games and watching television — occupy larger chunks of Americans' leisure time.

Exercise can be especially costly for people in sprawling communities dominated by automobile travel. It takes time and money for them to get exercise beyond their daily routine, notes Reid Ewing at the National Center for Smart Growth Research and Education based at the University of Maryland. "If [suburbanites] don't make a point of getting exercise, they don't get it," says Ewing, who recently co-authored one of the first studies on the relationship between sprawl and obesity.

Of course, suburban development has been demanded by homeowners and supported by public policy. Governments have facilitated it through investments in road infrastructure to connect distant communities and incentives to encourage development in rural areas.

Also, one could argue that sprawl has been fueled by the subsidization of automobile use. Ewing believes that only a fraction of the costs of automobile use are internalized — that is, borne by the user directly. The rest are externalities paid for by everyone else, such as the cost of pollution from tailpipe emission.

Restoring the Balance

Removing government subsidies on corn and sugar would seem to be part of the answer to America's obesity problem. Other possible solutions would also make it more expensive to be fat.

Canada and several U.S. states impose a "fat tax" on soda, snacks, and other so-called junk foods. Such a tax applied more broadly might discourage consumption of something that is unhealthy, similar to taxing cigarettes. At the very least, it would generate funds for public health campaigns, helping to counteract the billions of dollars spent on advertising high-calorie foods.

The drawback of these tactics is their broad impact. They not only impose costs on the overweight and obese, but also on those who can have occasional treats and still maintain a healthy weight.

Tying weight-related diseases to the price of health insurance might be a better way to make people bear the future cost of eating too much. On the flip side, Reid Ewing and others suggest that healthier people could pay lower premiums, similar to the "good driver" discounts offered by auto insurers. Of course, either premium arrangement would run contrary to the traditional pooling of insurance risks.

Eric Finkelstein advocates making it cheaper to be thin. For example, government can increase the number of opportunities for physical activity. This could be accomplished by favoring denser development in land-use policy, which would encourage people to walk from place to place rather than drive. Public funding of parks and bike paths, as well as increased support for physical education at schools, could also help.

Also, whole grains and produce could be made more accessible. This could include funding farmers' markets and requiring schools to offer healthier alternatives to students.

Whether they intend to make it pricier to be plump or cheaper to be thin, policy prescriptions for obesity could impose other costs on society that must be weighed against the health benefits they produce. For instance, policies that favor denser development may, in fact, lead people to walk more, but they also could produce sizable distortions in the housing market.

This underlines the challenges of understanding and dealing with the nation's growing girth. There are no easy answers, no matter what the makers of diet pills and exercise gadgets say.

"It is important to recognize the complexity of the problem we face," says Virginia Tech's Richard Forshee. "I don't think there is a single cause of overweight and obesity. There can be many different explanations for different people." **RF**

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ACORN

The campaign for living wages has spread from Baltimore to more than 100 cities around the country, including New Orleans, the location of this rally.

ABOVE the minimum

Living-wage statutes are designed to help low-income workers in Baltimore and other Fifth District communities, but do they get the job done?

BY JULIA R. TAYLOR AND CHARLES GERENA

The year is 1993 and a 30-something Baltimorean is working as a janitor for the city's ballpark. He leaves work at the end of the day, but instead of heading to his apartment or house, he walks to the homeless shelter that he temporarily calls home. The reason for his current living arrangement is not unemployment, but that his wage isn't enough to keep his family above the poverty line.

The above example described in a *Baltimore Sun* article — while not necessarily representative of the average low-wage worker's experience — illustrates the type of decisions that some have to make. "A lot of people who are working full-time jobs and [receive] other assistance still [can't] get by with minimum wage. If you work full time at a minimum-wage job, you [can still] fall below the poverty line," says Erica Schoenberger, an expert in regional economic development at Baltimore's Johns Hopkins University.

In the early 1990s, the city was in the middle of a fiscal crisis — with outlays chronically outpacing revenues — and was under enormous pressure to outsource activities to the private sector. This privatization push resulted in jobs going to private firms that often paid their employees lower wages than the government had paid its workers for performing the same tasks. Some citizens balked at having their tax dollars being used to employ people at what they saw as an unfair wage. At the same time, efforts to increase the minimum were at a standstill in Congress. The combination created an atmosphere ripe for change.

As Schoenberger explains, "It was plain the national policy wasn't going to change fast enough, so something had to happen at a local level." What happened was the living wage.

The term "living wage" is inherently subjective. Some define it as a salary that is just enough to keep a family out of poverty, while others view it as enough to be self-sufficient. In many cases, policymakers set the living wage 50 percent to 100 percent above the federal minimum wage in order to meet these fuzzy benchmarks. It can go even higher for employees that don't receive health benefits as part of their employment package.

In 1994, Baltimore became the first city in the United States to pass a living-wage ordinance. Employers that contracted with the city were ordered to pay their employees a wage of $6.10 per hour, enough to yield an income equal to the poverty threshold for a family of four. Now in 2004, those employers along with companies that receive tax breaks and other subsidies must pay their workers at least $8.85 an hour, substantially above the federal minimum wage of $5.15.

In the decade since the passage of Baltimore's living-wage law, about 100 cities and counties across the country have adopted similar legislation. On the surface, the living wage is fertile ground for controversy. Upon closer examination, however, the results are not as plain as either its proponents or critics would claim. The living wage has helped some low-wage workers, but the overall effects have been rather small. Those who have benefited the most, it appears, are unionized municipal workers, who because of living-wage laws face less competition from private firms eager to win government contracts.

Helping Some Workers ...

Despite the country's overall economic progress in the 1990s, the salaries of lower-wage workers have not grown as rapidly as those at the top of the earnings scale. "There has been a widening wage inequality. A good chunk of that has been between the bottom and the middle," says economist David Neumark of the Public Policy Institute of California. The economic reasons for this are complex. But the political effects have been pretty straightforward: Living-wage movements and other "progressive" causes have gained steam.

Indeed, many communities with traditionally large activist populations, including a number of college towns, have been at the forefront of the living-wage movement. Charlottesville, Va., and Durham, N.C., are just two such examples from the Fifth District. (Not all communities with living-wage laws resemble Charlottesville and Durham, though. See sidebar, "Where the Living Wage Is Law.") As David Neumark elaborates, "In a climate of relatively conservative politics and social policy, [these] localities have passed" ordinances of their own. "It's a victory for very progressive political ideas."

Communities also had another impetus to enact living-wage laws. It is here that the "fairness factor" comes into play, meaning that those companies receiving something from the government, whether it's tax benefits or contracts, should have to "give back" in the form of higher wages for their employees.

Jen Kern of the Association of Community Organizations for Reform Now (ACORN), which has pushed

Where The Living Wage Is Law

In 1994 Baltimore passed the country's first living-wage ordinance. Since then roughly 100 other communities around the nation have followed suit. Which places have been at the forefront of the living-wage movement and are there similarities among these communities?

Many college towns and other cities with large activist populations have passed living-wage laws. But they are not alone. According to a new study by Oren Levin-Waldman, a professor of public affairs and administration at Metropolitan College of New York, cities with high immigrant populations and relatively low levels of educational attainment are disproportionately likely to enact living-wage ordinances. Why? Because there is a substantial number of people who stand to benefit from such laws, Levin-Waldman argues. In general, these citizens lack the "requisite education and skills to command higher wages" on their own, he writes.

There is, however, an alternative explanation, one that is consistent with research by economist David Neumark. He has found that living-wage laws tend to benefit unionized municipal workers because they raise labor costs for private firms that do business with local governments, and thus make it more expensive to contract out government services. Many of those private firms, which are put at a disadvantage by living-wage laws, are likely to employ low-skilled immigrant labor.

What does this mean? Perhaps that living-wage laws are common in the communities Levin-Waldman describes because they protect municipal workers from low-skilled immigrant workers — not because they benefit those low-skilled immigrant workers.

At any rate, one thing seems clear. Living-wage laws are popular in these communities for very different reasons than most college towns, where residents tend to be wealthier and more educated than the overall population. It seems that in places like Charlottesville, Va., the living-wage movement may be driven more by ideology than basic economic factors.

hard for living-wage laws, says that although there are businesses that publicly oppose living-wage legislation, some employers support it privately. She claims that some employers want to increase worker wages but can't afford to do so because they are in competition with other businesses. Kern argues that if higher wages were mandated for all employers, it would take cost competition out of the equation. (Of course, such a move would almost certainly increase prices paid by consumers for various goods and services.)

Advocates of the living wage also say that entry-level workers who are offered higher wages will work harder and have better attendance, resulting in a more stable work force. "A higher wage will bring in a higher quality of workers. People will work harder when you pay them more. They take more pride in their work," says Burt Barnow, associate director for research at Johns Hopkins University's Institute for Policy Studies.

Committed workers, in turn, will rely less on social-welfare programs, reducing the overall cost to the government and taxpayers. If this reasoning is correct, though, it's not clear why higher wages would need to be mandated. Private companies would have a strong incentive to raise wages on their own, if doing so would result in a more stable, productive work force.

... But at What Cost?

The philosophy behind living-wage laws may be praiseworthy, but economists have been studying the possible unexpected effects. Their main concern is that living wages could squeeze some workers out of the job market altogether.

The Employment Policies Institute's director of research, Craig Garthwaite, puts it simply: "It's basic economics — when you increase the price of a good, people consume less of it." The "good" in this case is labor, meaning companies will not hire as many workers.

When a city forces a business to pay their workers higher wages than they normally would, the policy may unintentionally hurt the very people it was designed to help. Many opponents of living-wage laws argue that companies will look to find ways to cut labor costs, such as increased automation. Think of how gas stations have cut costs by making stations "self-service," rather than having a person pump your gas.

Or companies may try to make up for some of the higher costs by increasing the prices of their government contracts. But their leverage to do so is limited. Since living-wage laws effectively make it more expensive to contract work out, the law obstructs rather than aids privatization. This leaves governments in the position of increasing their own spending.

Some fear that the increased costs caused by these laws might make a city less attractive to outside businesses. No one likes to be told what to do, and private companies are no exception. They don't want to be forced to raise employee wages. Concerned about what it might do to his state's business climate,

How Much They Have To Pay

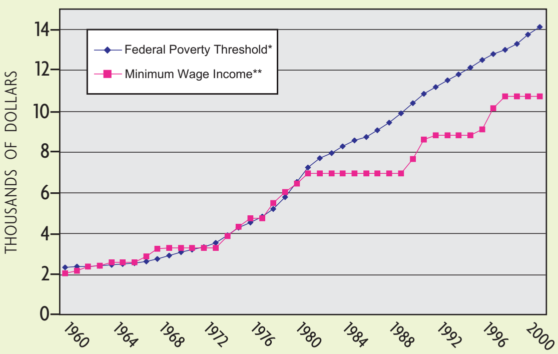
Municipalities in the Washington, D.C., metropolitan area like Alexandria, Va., and Montgomery County, Md., tend to have higher living-wage requirements than other parts of the Fifth District. This makes sense given the higher cost of living in the region.

	Living-Wage Requirement	Requirement Applies To	Law Enacted
Alexandria, VA	$11.36/hour	City contractors working on city-controlled property; excludes inmates	June 2000
Arlington County, VA	$10.98/hour	Companies with county contracts > $100,000 for services performed on county-controlled property	June 2003
Baltimore, MD	$8.85/hour	Companies with city construction and mail delivery firms	Dec. 1994
Charlottesville, VA	$9.00/hour	County contractors, except construction and mail delivery firms	Nov. 2001
Durham County, NC	$9.74/hour	County contractors, except construction and professional services firms; excludes inmates	June 2004
Montgomery County, MD	$10.75/hour	Companies with county contracts > $50,000 and 10 or more workers	June 2002
Prince George's County, MD	$10.50/hour	Companies with county contracts > $50,000 and 10 or more workers	June 2003

SOURCES: Employment Policy Foundation and ACORN

Keeping Your Head Above Water

Workers earning the federal minimum wage haven't been able to keep their families above the poverty line since the late 1970s. Due to the infrequency of minimum-wage increases, localities have stepped into the fray with living-wage standards of their own.



NOTES:
* The poverty threshold is presented for a three-person family because, according to the Census Bureau, this is the average family size in the United States.
** The minimum wage income was based on a person working full-time, 40 hours a day, 52 weeks per year at the federal minimum wage for that year. For periods when Congress raised the minimum wage midyear, the wage is the weighted average of the minimum wages in force during that year.
SOURCE: U.S. Census Bureau, U.S. Department of Labor

Gov. Robert Ehrlich Jr., of Maryland, last spring vetoed legislation that would have implemented a statewide living wage.

Have any of the dire predictions come true? In their book *The Living Wage: Building a Fair Economy*, Robert Pollin and Stephanie Luce concede that increased wages may drive up costs in some areas. But they argue that this effect is not large enough to make businesses go elsewhere — or to significantly affect government finances.

And according to a survey of Baltimore city administrators, contract costs did rise, but in the main the increases represented less than 1 percent of their total budgets. This is due in part to the fact that only select contract areas experience coverage by the living-wage ordinance. The law simply did not cover areas with the largest concentration of low-wage workers, such as social work or home health care. Since so few workers experienced an increase in wages, city budgets remained relatively unaffected.

In general, the benefits to low-income workers have been limited as well. A relatively small share of workers end up being covered by living-wage laws, namely those who work for companies that do business with the government. And even among that group, only some workers are affected. Those who are already making more than the living wage remain unaffected. Nevertheless, even if the measures help just a small percentage of workers, it would still be considered a victory for living-wage advocates.

Who Benefits the Most

According to Neumark's research, living-wage laws seem to favor unionized city workers the most. "Labor relations in the public sector are [handled differently] than in the private sector, where there are strikes when there is a conflict. If you're the mayor, you don't want a strike or the garbage piling up," so municipal unions have a lot of leverage.

In the past, local officials could counter that power by threatening to shift public jobs into the private sector unless they received concessions. But that is no longer a credible option. "The living-wage law removes the threat of privatization because the city would no longer have an incentive to privatize," explains Neumark. Both union workers and those who work for city contractors wind up with similar salaries.

Furthermore, the ordinances target low-wage workers but not necessarily low-income workers, lessening the effectiveness of the laws. For example, a high school student from a relatively affluent family who works an entry-level job in the summer to earn spending money is covered by living-wage legislation in the same way as workers who are trying to support families.

For this reason, as well as many others, economists argue that there are more efficient ways than living-wage laws to alleviate poverty on a widespread basis. A better solution, Barnow suggests, is the Earned Income Tax Credit (EITC), which "targets people with low earnings. ... If you're in a family with high income, you wouldn't be entitled to it no matter what your job is."

Still, national organizations such as ACORN are pushing to bring living-wage laws to cities that do not have them and to broaden coverage in those that already do. Many activists, for instance, would like to see living-wage laws expanded to cover all workers, regardless of employer. This effectively would raise a city's minimum wage — a development that many economists would look at unfavorably. As written, most living-wage laws have only limited effects on a region's economy. But if those laws were applied to everyone, the effects on economic growth and employment could become substantial. **RF**

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Al Broaddus & Tom Humphrey

Editor's Note: *This is an abbreviated version of RF's conversation with Al Broaddus and Tom Humphrey. For the full interview, go to our web site: www.rich.frb.org/pubs/regionfocus.*

Al Broaddus and Tom Humphrey joined the Federal Reserve Bank of Richmond in 1970 as economists. Both have had long and illustrious careers at the Bank. Broaddus was named Director of Research in 1985, a post he held until Jan. 1, 1993, when he was appointed President of the Bank. After more than 10 years of heading the Richmond Fed, Broaddus stepped down from his post in July 2004, when he turned 65, the age at which Fed presidents customarily retire.

Humphrey has been one of the Bank's most prolific economists, publishing numerous articles and books on monetary economics, macroeconomic theory, and the history of economic thought, and teaching at universities throughout the Fifth District as a visiting professor. He also has served as editor of the Bank's scholarly journal, *Economic Quarterly* (formerly called *Economic Review*), since 1975. Humphrey will retire from the Bank at the end of 2004.

During their more than 30 years of service to the Federal Reserve Bank of Richmond and the Federal Reserve System, Broaddus and Humphrey have witnessed significant changes in the way our nation's central bank operates. In the following interview they reflect on those changes, as well as what the future may hold for the Fed and for them personally. Aaron Steelman spoke with Broaddus and Humphrey on Aug. 26, 2004.

RF: How did each of you join the Fed?

Humphrey: There was a vice president here, who died a few years ago, named Pete Snellings. I think Pete was more responsible than anyone else in bringing me to the Bank. He was my teacher at the University of Tennessee and he also directed my master's thesis there. He and Bob Black, the former president of the Bank, were really good friends. They both went to the University of Virginia, where they got their Ph.D.s, and they both taught at Tennessee. Wherever Bob Black went to work, Pete seemed to follow him with a two- or three-year lag. So shortly after Bob Black came to the Richmond Fed from the University of Tennessee, Pete went as well.

Pete was an excellent teacher, and he really encouraged me. After I got out of school, I would see him periodically at conferences and he would keep tabs on me. He would say, "We have to bring you to the Richmond Fed." And eventually he and the research director at the time, Jim Parthemos, did bring me here.

RF: How about you, Al?

Broaddus: I actually grew up in Richmond. I left town when I went off to college, and I didn't really anticipate that I would come back. But while I was in the Ph.D. program at Indiana, my principal teacher was a fellow named Elmus Wicker, a great monetary historian. Elmus knew Jim Parthemos, who, as Tom mentioned, was research director at the Richmond Fed when I was entering the market. Jim interviewed me and offered me a job. I also had an opportunity to go to the Cleveland Fed and an opportunity to go to the Federal Deposit Insurance Corporation. So those were the three options. I had a lot of trouble getting comfortable with the idea of coming back home but, ultimately, this seemed to be the place where I would be happiest professionally. Jim Parthemos is a wonderful scholar, a great research leader, and a real gentleman too. I think that was the determining factor in my decision.

RF: How has the Research Department changed over time?

Humphrey: It has become more academic in orientation, with staff economists encouraged to publish not only in Bank publications but also in scholarly journals outside the Bank. The economists here are in an academic-type setting, and are expected to do the same things that academics do except teach. In place of teaching they give policy advice. So I think that is a fundamental change. The people we had here when I first came were fine economists, but they were business, not academic, economists. They were not into heavy theoretical and empirical work.

Broaddus: As Tom has said, I think I would put the emphasis on the word "academic." The department has definitely become more academically oriented. But I want to make it clear: There were very good economists here not only when we came, but before we came. It's just that their emphasis was different. Under the direction of Jim Parthemos, the department began to focus much more on basic research.

RF: The Richmond Fed has long had a reputation for supporting "hard-money" or "hawkish" views on inflation. Do you think that reputation is justified — and if so, what accounts for it?

Broaddus: Yes, I think it is deserved. This is an oversimplification, but when we came to the Fed, you had two camps. There was the monetarist camp, which was really more of an outsider group at the time. And there was the more mainstream, Keynesian camp. The key distinction, for me at least, was that many in the Keynesian camp seemed to think that it was possible to use monetary policy to fine-tune the economy, while the monetarist camp thought that we should have a more limited set of objectives.

For whatever reason, we had more people who were in the monetarist camp. Bob Black certainly felt very strongly about keeping a close check on the growth of the money supply. And Bob Hetzel, who had studied under Milton Friedman at the University of Chicago, came to the Bank in the mid-1970s with a strong monetarist orientation. When I first got here, I had a bit more of a Keynesian point of view but I was quickly converted.

Humphrey: I think that the hawkish tradition is warranted, and I think it goes to the old classical notion that the principal function of the central bank is to preserve the value of money. As long as inflation is a problem, much of the time you are going to be perceived as being hawkish if you're worrying about inflation. But on the other hand, I think the classical economists were very much worried about deflation too. As a matter of fact, they feared deflation more than inflation for the adverse effect it would have on real economic activity, but deflation just doesn't happen as frequently now as inflation. So I think that at this Bank we are hawkish on inflation because it occurs more often, but we're also concerned about deflation. Our real goal is price stability.

Broaddus: I want to add a quick note about terminology. When we came to the Bank, people didn't use the term "hawkish" very much. I think that whole terminology developed during the Volcker years when the Fed began to bring inflation down. The people who had this strong quantity theory orientation — and were determined to not allow inflation to rise again — were described as hawks, because they were seen as looking around at the economy for any sign of inflation so that they could stamp it out.

Al Broaddus (above left) and Tom Humphrey reflect on a lifetime of economics.

Humphrey: When we came to the Bank, the idea was widespread that inflation was so thoroughly entrenched in the economy that you really couldn't do much to get it down. More precisely, you could get it down, but the costs would be even greater than the benefits. So it was better to learn to live with some inflation than to try to get it down close to zero. But here in Richmond we thought that if a central bank could establish credibility as an inflation fighter — which is a really hard thing to do — it could actually get inflation down fairly readily, without great cost to the economy. That was certainly what Milton Friedman and the monetarists were teaching at the time, and it was in fairly sharp contrast with the views of some other people within the Fed and the profession generally. So, to get back to your question, I think that the Bank's reputation as being hawkish is well deserved and I'm very proud of it.

RF: Both of you have worked at the Fed during periods of high, erratic inflation as well as periods of low, stable inflation. What do you think the Fed has learned from those experiences?

Broaddus: I think the key thing we learned from the high-inflation period is how costly it can be to bring it down. Unless you have credibility, it is very costly to change expectations from a continuing inflation environment to something else. And once inflation gets up to a certain point you lose credibility. You can't get it back just by assertion — you have to earn it.

Humphrey: I also think we learned — although I'm not sure we subscribed to it in the Federal Reserve System as much as the rest of the profession did, especially the Keynesian wing of the profession in the 1950s and 1960s — that we can't really use monetary policy to fine-tune the real economy like we can use it to stabilize prices. The big lesson that we have relearned is the old classical doctrine that the main objective of monetary policy ought to be to stabilize and protect the value of money. Also, as Al mentioned, credibility is very important. If the Fed has credibility, it can focus in the short run on keeping disastrous things from happening to the real economy because people will know that, when push comes to shove, it's going to stabilize prices. Credibility is extremely fragile so you have to protect it. But if you have it, you have a lot more flexibility for dealing not only with the problem of maintaining price stability, but other short-run problems that creep up from time to time.

RF: The Fed's actions now garner a great deal of media attention, from both the financial and popular press. Indeed, Chairman Greenspan has gained almost celebrity status. How does this compare to 1970?

Broaddus: I think that the media have always paid attention to the Fed. But we now have more media outlets — for instance, cable television networks devoted entirely to financial news. That means that the Fed is naturally going to get more coverage. Also, I think that beginning in the late 1970s — when Chairman Volcker was working to bring down inflation — people started paying more attention to monetary policy. Volcker put a public face on the Fed, which may have increased media attention.

Humphrey: I generally agree with what Al said. But I think the difference may be more stark than he suggests. When I came to the Bank, the general public wasn't really aware of the Fed. To give you an example, in the 1970s I went to a conference in Boston. While I was there, I was looking for the Boston Fed and I was asking people on the street, "Could you tell me where the Federal Reserve Bank is?" I asked five or six people, and they had never heard of it. They knew where their own bank was, but they had no idea about the Fed. They thought it was just another commercial bank. So I think that the general public was not as aware of the Fed as it is now. I think that the same is true to a lesser

Al Broaddus

➤ Positions

Worked as an analyst at the Defense Intelligence Agency from 1964 to 1966, before joining the staff of the Federal Reserve Bank of Richmond in 1970. Served as the Bank's Director of Research from 1985 to 1992, and President from 1993 to 2004.

➤ Education

B.A., Washington and Lee University (1961); M.A., Indiana University (1970); Ph.D., Indiana University (1972) extent of the financial media. In the early 1970s, the financial press paid attention to the Fed. But their coverage was a bit superficial and not nearly as sophisticated as it is today. There are now several reporters who seem to know their economics and to really understand what monetary policy is all about.

RF: Recently, the Fed has taken a number of steps to enhance the transparency of its monetary policy decisions. Why has this been done — and what do you think have been the consequences?

Broaddus: I think it's very difficult for a central bank to have credibility unless it's transparent. I think they are two sides of the same coin. We're now at a point, I think, where the public needs to understand that we're going to give as clearly as we can our best estimate of where the economy is heading and where policy is going. At the same time, there needs to be a recognition that, in making such statements, we are not locking ourselves in to a particular policy path — and that if we do things that may be unexpected, we are doing them in good faith and in reaction to developments in the economy we ourselves did not anticipate. I think that we're pretty close to achieving that understanding.

Humphrey: There was this old idea that secrecy was a good thing for a central bank — that the policy analysis and actions were so complex that the public couldn't possibly understand them, and so the high priesthood of the central bank would just run things without telling why or how they were doing it. I think that has gone completely out the window now. Most people accept that transparency is important, and the real debate is not whether the central bank should become more transparent but how fast it should move in that direction.

RF: What do you think is the role of a regional bank within the Federal Reserve System?

Broaddus: In a democratic society like the United States, the central bank has to have public support, and I think that the regional structure of the Fed helps to build that support. Even though we have an economy that's highly integrated nationally, there's no question that there are regional economic differences, and it's important the central bank be aware of those differences when it is making its aggregate policy decisions. The regional Reserve Banks serve as a conduit. We gather information from our districts — in a variety of forms, both formal and anecdotal — and present it during discussions of the Federal Open Market Committee (FOMC). The regional system, then, gives the public a way to communicate what is happening on the ground more effectively to policymakers.

Also, I think that the decentralized structure promotes a diverse set of views within the System. Each of the 12 Reserve Banks has its own staff of economists, and arguably those economists pursue a wider variety of research agendas than they would if they were all located in Washington. The best of this research ultimately influences the way the FOMC thinks about and implements policy.

Humphrey: I think Al's last point is very important. If you believe, as economists do, that competition is healthy and promotes efficiency and ingenuity, you want 12 regional research departments rather than only one located in Washington, D.C.

RF: Tom, you are one of the few historians of economic thought working within the Federal Reserve System. How does your work fit in with the broader mission of the Fed?

Humphrey: I think it's good to have historical perspective. When we take a policy position, it's comforting to know that some of the greatest monetary economists of the past are supporting you. But going beyond that, history of thought can illuminate current policy discussions. For instance, the greatest of all monetary controversies was the debate between the bullionists and the anti-bullionists that took place in the first three decades of the 19th century in England.

All the things we worry about today — inflation, deflation, exchange-rate fluctuations, etc. — were discussed for the first time then, and were discussed very well by some of the greatest minds in the profession. Also, toward the end of the 19th century, Knut Wicksell established the model we use in central banking today of correcting price-level deviations from target by interest-rate adjustments. So I think that some of the insights and wisdom that these old fellows had to offer are still there to be rediscovered; they haven't all been teased out yet.

Some of the greatest economists of the 20th

Tom Humphrey

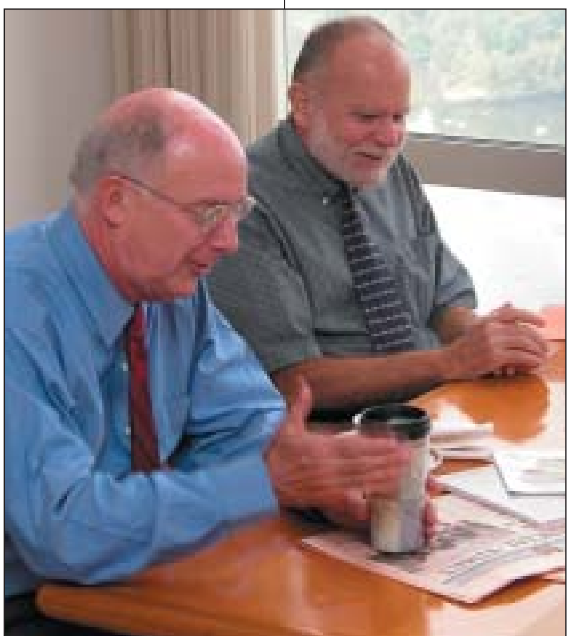
➤ Positions

Taught at Wofford College (1960-1963), Auburn University (1964-1965), Tulane University (1966-1968), and St. Andrew's Presbyterian College (1968-1969), before the joining the staff of the Federal Reserve Bank of Richmond in 1970.

➤ Education

B.S., University of Tennessee (1958);
M.S., University of Tennessee (1960);
Ph.D., Tulane University (1970)

century were historians of thought: Wesley Clair Mitchell, Jacob Viner, Joseph Schumpeter, Frank Knight, F. A. Hayek, Lionel Robbins, George Stigler, Don Patinkin. Even Paul Samuelson, arguably the greatest pure economic theorist of the 20th century, has contributed to history of thought. These economists used history of thought to inform their policy analysis and advice, especially Mitchell and Viner. Even though it's not practiced or respected very much today, I think history of thought has an awful lot going for it. It has ideas and analyses that have survived the toughest test of all — the test of time. These time-tested ideas can be used to shed light on current problems. That's why I think history of thought is important, in addition to being fascinating in its own right.



Having said all that, I think I have been especially fortunate to have worked for four Bank presidents who have been willing to tolerate me and who think that history of thought had something to offer. I'm reminded of a story that a fellow who jogs with Al and me tells. A friend of his came up to him and said, "Who is that crazy-looking guy I see you running with? And what does he do?" So he told him, "His name is Tom Humphrey and he works on the history of monetary thought." The guy responded, "You can make a living at that!" So I think that I have been really fortunate to have worked with such a sympathetic group here.

Broaddus: Tom is being too modest. His work has been crucial to the development of the Bank's research department. When people talk to me and mention Tom, they often say, "How did you manage to pull that off at Richmond — to have someone who could devote his time to history of thought?" The reason is because the leadership at this Bank — not just me, but the people before me — saw it as crucially important to having a good research program. I don't see how you can have a complete research department without having someone looking at things from this perspective.

RF: Tom, in addition to your own work, you have edited the Bank's *Economic Quarterly* and its predecessor, *Economic Review*, since the mid-1970s. What have been some of the more rewarding aspects of that job?

Tom: I think the most rewarding aspect of the job is seeing manuscripts take shape, all the way from a mere idea to a final, published article. The author gives us the initial draft, then the referee panel goes to work and tries to improve it, and I'm kind of an intermediary. I go back and forth between the authors and referees until both are satisfied with the end product. To see that process at work and to see fine, beautiful articles emerge is a great joy to me.

Also, there are two things that I think are unique about our publication. First, we are able to publish longer, more detailed, and more policy-oriented articles in the *Economic Quarterly* than most journals are willing to accept. So these ideas can be expressed more fully than if they were presented elsewhere. Second, the referees for papers in the *Economic Quarterly* are other economists at the Bank. These people are your colleagues, and you get to talk to them, instead of just seeing an anonymous referee report. Sometimes the discussions get kind of heated. But I think that everyone understands that the referees are trying to do the best they can to improve the papers. The economists here are genuinely open and receptive to suggestions for improvement. This give-and-take is really unique in scholarly publishing and I think it ultimately results in better papers being published here.

RF: What do you plan to do with your time after you leave the Bank?

Humphrey: I really don't know. I'll do a lot of reading, of course, and if I can stay healthy I hope to do a lot of running. I would also like to return to college teaching.

Broaddus: I am active in a number of nonprofit organizations, and I will be serving on the boards of a few public companies. But I have no plans to stop pursuing my interest in monetary economics and policy. The Federal Reserve is a great institution and I have been privileged to work here. No matter what I do in the future, I will always be a Fed person.

Humphrey: What Al said really is true. The Richmond Fed has been a huge part of my life, and I feel like I will always be part of the institution in some way. It has been a great run. **RF**

Labor Pains

The long and often violent struggle for unionization in West Virginia's coalfields

BY BETTY JOYCE NASH

During a United Mine Workers of America strike in the 1980s, a coal company hired replacements for striking workers. State troopers watched as the nonunion coal truck drivers passed picket lines. Old-timers around Matewan, W.Va., say those trucks would have remained idle "in my daddy's day."

The United Mine Workers of America today organizes other occupations as well as miners, including health care workers, truck drivers, and power plant workers. In 2003, about 23.6 percent of coal miners in the nation were union members, according to Barry Hirsch and David Macpherson, who compile union membership statistics based on the Census Bureau's Current Population Survey.

Early union organizing stories are the stuff of legend, with countless books and even a Hollywood movie depicting the "mine wars" of the 1920s. The labor strife that accompanied the industrialization of Appalachia mirrored those from around the globe as a new working class, only a generation or two removed from agricultural fields — even slavery — struggled against long hours, hazardous working conditions, and low wages.

Trails to Rails

Early settlers were few in West Virginia, which broke off from Virginia to become its own state in 1863. West Virginia's isolated mountains, layered by ice and continental drifts over millions of years, are slashed by streams and seams of coal in all but two of the state's 55 counties. But coal was virtually useless until the rails were laid to transport it. In 1883, when the major rail lines were completed, coal production reached 3 million tons. By the early 1890s, West Virginia had nearly 9,800 miners producing more than 10 million tons.

Railroads turned coalfields into powerful investments, and wealthy industrialists acquired mineral rights or outright ownership of fields. Land bought at $1.50 to $2 per acre in some areas was worth $100 per acre after the railroads came five years later, according to historian Ronald Lewis. Rails could send carloads of coal to the rivers, where barges shipped the fuel to the North and East.

By 1900, coal had become king of the mountain. In 1927 West Virginia produced about 146 million tons.

Some pioneer coal operators were keen small businessmen. As late as 1920, the state's four largest coal companies controlled less than 14 percent of the market. A few mine owners, though, hewed to social Darwinism, a sort of survival of the fittest for business, with a bit of paternalistic "welfare capitalism" thrown in for good measure. This meant that many thought of employment as a form of charity. The notion partly

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Early miners screen coal, separating slate and removing clay. By 1893, there were nearly 9,800 miners in West Virginia, producing more than 10 million tons of coal.

explains the coal operator's reaction when coal miners began to organize.

In his book, *In the Kingdom of Coal*, Dan Rottenberg wrote, "By this logic, it followed that unionization, by distracting and restraining management, threatened the effectiveness of a business and thus threatened workers themselves (who would lose their jobs if their employers and investors lost money). Consequently, in the minds of owners, almost any countermeasure against union organizers seemed justified."

And some operators were former coal miners themselves. For instance, Jack Dalton, the feisty owner of 27 mines in Logan County, W.Va., fought the union. Boyden Sparkes, who covered West Virginia's mine wars for a New York newspaper, described Dalton's opposition to unions as having a very personal flavor: "I think that the important thing is that he used to be a miner, a nonunion miner, and that he is determined that his miners shall continue to be nonunion. When the unions are willing to use force to effect organization, Jack Dalton is willing to use force to prevent it."

As the coalfields expanded, mine owners recruited labor. Immigration brought Poles, Slovaks, Italians, Welshmen, and Belgians. Word of work spread and black people seeking steady work and escaping Jim Crow laws farther south poured into West Virginia. The black population of West Virginia was about 3,769 in 1860, but grew to 21,584 by 1900 and to 60,400 by 1920.

Historian Lewis has studied this phenomenon and describes the towns: "Many early coal towns actually resembled semi-agricultural villages. More than half of the black migrants who came to these coalfields had been sharecroppers and most of the European immigrants and local white mountaineers had been farmers as well."

Many men saw the wage-earning work in the mines as an improvement compared to squeezing crops from worn-out soils. They worked for themselves. Mining was independent, supervision was light, with the miner in control of his hours and pace. He leased his tools from his employer or provided them himself, built his own explosives, and generally worked as an independent contractor. Time spent securing his own safety and that of others would not put food on the dinner table, though, since he was paid only for coal extracted. And few knew that lung disease could be caused from long-term inhalation of coal dust.

Miners couldn't control the price of coal and the fairness of those who weighed it. One practice that shortchanged miners was a system called cribbing: Mine cars held a certain weight, but sometimes cars were altered to hold more than the specified amount.

Ultimately, labor strife erupted over nearly every aspect of mining, from miners' shorted wages to life-threatening working conditions to prices in the company store, and, of course, to the right to assemble.

A Miner's Life

In recent years, economic historians have reviewed some features of early mining life. Price Fishback of the University of Arizona has studied mining's dangers, the sanitation in coal camps, and company stores.

Mining was risky business. Before the industry's stagnation in the 1920s when coal demand dropped after World War I, between 1,500 and 2,000 miners were killed in U.S. coal mines annually. That's three to four deaths for every thousand miners who worked a full year, according to Fishback. But miners who worked dangerous jobs in the industry got paid about 14 percent more than similarly skilled workers outside the mines.

In West Virginia, with its comparatively new and weak state government, mines were regulated poorly, if at all. Between 1890 and 1912, the state's mine death rate topped all other mining states. And in 1907, the nation's worst coal disaster killed 361 people in Monongah, W.Va.

Fishback has also studied mining towns — places where the company owned the town and everything in it. In 1924, 80 percent of West Virginia miners lived in such towns, compared with 9 percent in Indiana and Illinois.

Although the towns were controlled by the coal company, the communities offered recreation and social events, especially baseball. Companies recruited players, several of whom wound up playing in the major leagues.

Another point of contention among miners were prices at the company store — and the forms of payment accepted. Miners were typically advanced wages in scrip redeemable only at the company store, although Bill Boal, an economist at Drake University, says his research has found that some private stores also accepted scrip.

Isolated mining camps and company stores typically charged more for goods partly because of transportation costs, according to Fishback. He has compared prices of stores in coal areas with stores in manufacturing areas of nearby cities in 1922, following the mine wars in West Virginia. Price differences were lowest in four union districts. "Price differentials were also generally low in nonunion districts, less than 2 percent in three of the five comparisons," Fishback notes in a journal article.

But in the remote regions of southern West Virginia, the coal company controlled nearly all aspects of a miner's life, and social tensions simmered.

Matewan

Daisy Nowlin's parents came to Mingo County, W.Va., in 1898 hoping for work. Her uncle entered Stone Mountain Mine in the town of Matewan at 9 years of age. "They worked them like slave labor," Nowlin, now 75, says. "But they worked because they had to work. That's the only way they could put food on the table."

Ultimately labor tensions exploded. In May 1920, the mining company dispatched private detectives from the Baldwin-Felts agency to evict striking miners from company-owned houses. Matewan sheriff and former miner Sid Hatfield, a former sweetheart of Nowlin's mother, tried to stop them. Ten people were killed that day outside the town's railroad depot, including seven detectives, two miners, and the town's mayor. (Hatfield was killed by detectives from the same agency a year later.)

Today, Matewan has rebuilt and relocated the depot, turning it into a museum to remind people of its railroad and labor history. The "Matewan Massacre," as it came to be known, was only one bloodstain in a long line of labor struggles, including mining struggles, in U.S. labor history. Those include the 1914 Ludlow Massacre in Colorado when striking miners were attacked by hired mine guards, killing 20 people. Nineteen people had died in 1897 in northeastern Pennsylvania when striking miners were killed by police. And widespread rail strikes in 1877 led to riots in several cities, while 10 people were killed by Pinkerton detectives during a steelworkers' strike in 1892 in Pennsylvania.

The union exerted little influence in the Mountain State before 1910, according to Richard Brisbin, a political scientist at West Virginia University. The UMWA had organized miners in Pennsylvania, Ohio, Indiana, and Illinois between 1890 and 1900. But repeated attempts in the 1890s to organize West Virginia's miners failed until 1902, when the UMWA organized the coalfields around Charleston. Coal operators banded together and hired guards to prevent union activities. Southern West Virginia mine owners aimed to block the union in an effort to keep production costs down and gain coal market share.

By 1906, union membership was about 12 percent but began falling for several years, until 1918, when organizing began to bear fruit and membership grew to about 20 percent. By 1921, 32 percent of coal miners belonged to a union. In 1912, Paint Creek operators tried to de-unionize their mines, leading to violent strikes and the re-unionization in the fields around the Coal River, a tributary of the Kanawha River. Miners fought for the right to organize, an end to blacklisting organizers, an end to the practice of using mine guards, and a stop to cribbing. Striking miners also wanted scales installed at all mines, along with a union inspector to prevent cheating, and alternatives to company stores.

The coalfields calmed during World War I, when a boom in production and increased wages filled coffers. A national recession after the war sparked layoffs and wage cuts. This set the stage for the UMWA, with its legendary leader John Lewis, to begin serious efforts to organize southern West Virginia coalfields. Mine operators sealed off hollows and resisted the union any way they could.

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The National Guard was called out to quell violence between striking miners and company-employed police at Cabin Creek, W. Va., in 1912.

Their struggles culminated in the Battle of Blair Mountain after thousands of miners marched on Logan County at the southern tip of the state. In the end, federal troops were called in to quell violence. Though the violent strikes spotlighted the miners' cause nationwide, they failed to bring union recognition. Union membership plummeted from nearly 50,000 in 1920 to about 600 in 1929, partly a result of the national anticommunist mood that swept the nation after the Great War.

Enter the New Deal

UMWA membership stalled until federal legislation — specifically, the National Industrial Recovery Act of 1933 and the Wagner Act of 1935 — established what is now the basis of current labor laws. By 1935, according to Boal's research, 100 percent of West Virginia's coal was mined under union contract, compared to virtually zero in 1930.

"Eastern coal was the thing. And it wasn't mobile. As long as they were able to organize all the mines, they could shift income from mine owners to workers," notes Barry Hirsch, a professor of labor economics at Trinity University in San Antonio, Texas.

But coal's power of that era has eroded under competition not only from other fuel sources but also from other areas. Environmental concerns have pushed Wyoming's low sulfur coal to the top in the past 20 years or so. Also, productivity gains have reduced the demand for mine labor. By 2002, the number of people working in the coal industry in West Virginia had fallen to 44,274 from a 1948 high of 125,000. Recently, though, demand and prices have begun to rise for West Virginia coal, higher in BTUs and closer to East Coast markets than coal from other sources. Demand for miners is growing, says Dan Miller, vice president of the West Virginia Coal Association. State-sponsored programs are training a new generation of miners.

"There are a disproportionate number of coal miners in their 40s and 50s," Miller says. "We have to convince a new generation of young people that it's a good career." And whether it's a union career will be up to the miners. **RF**

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BOOK REVIEW

Market Discipline

TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS
BY GARY H. STERN AND RON J. FELDMAN
WASHINGTON, D.C.: BROOKINGS INSTITUTION PRESS, 2004, 230 PAGES

REVIEWED BY
H. S. MALEK

A few months ago, as I was researching the size distribution of U.S. commercial banks, I ran across *Too Big To Fail* in our Bank's library. The book, written by Gary Stern and Ron Feldman of the Federal Reserve Bank of Minneapolis, addresses one of the more important issues facing policymakers today: how to deal with large corporations that have been deemed so important to the U.S. economy that the government doesn't dare let one go bankrupt.

The term "too big to fail," hereafter referred to as TBTF, has been around since at least the mid-1970s. But it didn't enter common parlance until 1984, when Congress held hearings on the financial problems of Continental Illinois Bank. The banking sector, of course, is vital to the American economy — and fears that the collapse of one institution would lead to the fall of others has inspired much TBTF policy. Indeed, because of past bailouts, many investors now believe that large banks are subject to implicit government protection. Such protection may produce short-run stability, but the moral-hazard problems that arise from TBTF policies can produce major net costs. "While the fiscal flows of the savings and loan bailout in the United States equaled $150 billion, lost output from the savings and loan crisis — largely attributed to moral hazard and poor resource allocation — was on the order of $500 billion," Stern and Feldman write.

In essence, TBTF banks become 100 percent insured by the government, warping price mechanisms within financial markets. The higher premium that otherwise would be demanded by risk-averse depositors is depressed by implicit government insurance, and TBTF banks enjoy a government subsidy for their risk-taking. Market discipline evades the TBTF bank, leading to suboptimal performance. Independent of failure, there is an inefficient use of capital — and when you add a bank bailout to the mix, the costs can skyrocket.

In today's world of increasing bank consolidations there is some urgency for formulating good policy. Stern and Feldman are cognizant of the serious obstacle posed by systemic risk in correcting the present distorted incentive structure. Accordingly, they couple ways to preempt contagion and limit creditor losses with a credible commitment to let big banks fail.

Preempting Contagion

In Chapter 5, titled "Why Protect TBTF Creditors?", Stern and Feldman present potentially surprising arguments about bank runs. Historically, they claim, many bank failures have not produced the widespread ripple effects one might have expected. "Brief, rapid disruptions weed out poorly run or weak competitors and discipline banks as to future exposures. Banking panics are simply a form of the invisible hand," Stern and Feldman write. Still, they acknowledge that many people will not be convinced that intervention may be unnecessary. So in Chapter 10, titled "Reducing Policymakers' Uncertainty," they introduce targeted reforms aimed at lessening the chances — and costs — of contagion.

One of these potential reforms is scenario planning. By simulating bank failures, bank supervisors can examine the implications of cross-firm exposure for creditor solvency. Then they can test a wide range of resolution options, and pick the one that minimizes coverage provided to uninsured creditors without creating excessive financial instability.

"Almost as important as the planning itself is the disclosure of scenario planning to bank creditors," write Stern and Feldman. The mere fact that such planning is taking place would inform creditors that the wisdom of TBTF policies is being questioned and that alternatives are being considered. This would likely make those creditors more vigilant in monitoring banks' activities.

What's more, the suggestion for greater transparency in scenario planning "reflects lessons we take away from the experience of monetary policy," Stern and Feldman write. "During the period in which the U.S. central bank established and maintained greater credibility with regard to price stability, it also made its analysis and objectives more transparent. The greater transparency may have helped the Federal Reserve to establish its credibility. In a similar vein, going public with steps that make coverage of the uninsured less likely could establish credibility in reducing TBTF coverage."

Limiting Creditor Losses

The most direct way to limit the chance of a bailout is to reduce the expected loss to a creditor. This in turn limits the probability of systemic risk. To accomplish this, policymakers must be willing to close weak but solvent banks, Stern and Feldman argue. This is not a new concept. A provision of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) allows policymakers to take "prompt corrective action" (PCA). Stern and Feldman find this reform "attractive on a conceptual basis" but argue that there are flaws in the way PCA is triggered.

They suggest that PCA triggers must meet four conditions. They must be (1) largely outside the manipulation of the bank; (2) reflective of the current risk profile of the institution; (3) feasible to calculate routinely and to observe; and (4) set to close banks likely to fail while allowing those likely to survive to stay open. Also, "although it may appear obvious, to be effective, the early closure regime must take real steps to remove the discretion of supervisors," the authors write. The current PCA triggers do not meet those conditions and thus do too little to limit losses by shutting down insolvent banks, Stern and Feldman argue.

In addition to instituting more robust PCA triggers, Stern and Feldman would like to see a coinsurance system instituted for deposits at large banks that exceed the current FDIC insurance limit of $100,000. The idea is fairly simple. "Under a coinsurance scheme, the insured has to bear some of the loss rather than have the insurer pick up 100 percent of it," the authors argue. "For example, the government could give itself the right to provide coverage to the uninsured under extraordinary circumstances up to a capped amount (say, 75 percent of their funds)."

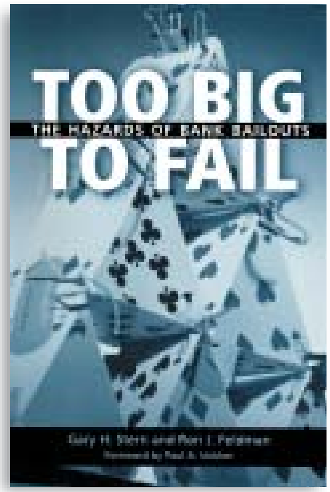
Stern and Feldman consider some possible objections to coinsurance, but one topic they don't address is the potential problem caused by discount window lending by the Federal Reserve, an issue raised by former Richmond Fed President Al Broaddus at the Chicago Fed's 2000 Annual Conference on Bank Structure and Competition. Coinsurance and other attempts at reintroducing market discipline can be undermined if the Fed makes last-minute loans to failing banks. In effect, the bank passes on the loss to the Fed as uninsured creditors flee.

Also, coinsurance is not costless to provide, since it involves more insurance for large banks than they currently receive. One could envision a number of ways of funding such a system — for instance, charging large banks an additional deposit insurance premium — but the authors have little to say on the issue. Certainly, should these ideas move toward becoming policy, the allocation of the costs of giving explicit special treatment to large banks would need to be considered.

Establishing Credibility

Throughout the book Stern and Feldman make it clear that they regard many of the FDICIA reforms as positive — though insufficient — steps toward limiting the problems associated with TBTF policies. Although FDICIA substantially increased the likelihood that uninsured depositors would suffer losses when their bank fails, it also provided for a "systemic risk" exception. This exception threatens the government's ability to credibly commit to closing troubled banks. Ending that exception and taking a harder line could help establish much-needed credibility. But taking a hard line requires putting your money where your mouth is — or in this case, not putting up any money when a bank goes down.

Getting creditors to believe that regulators will allow unsound banks to fail will not happen overnight. Still, policymakers must find a way to "establish credibility even when they face a history of actions that undermine the goal." (Again, Stern and Feldman point to the experience of Federal Reserve monetary policy during the 1980s and 1990s as an example of an institution earning credibility despite initial skepticism by market participants. During that time, the Fed established its commitment to achieving price stability following a relatively long period of high and variable inflation during the 1970s.) Putting the uninsured on notice by establishing an easily monitored com-



mitment and then sticking to it would help do the trick.

The optimal form of this commitment is not obvious to Stern and Feldman, though they offer some ideas. For instance, they suggest appointing "conservative" bank regulators — "that is, policymakers who have demonstrated a predilection for giving serious consideration to the costs of TBTF bailouts and an ability to reject bailouts where appropriate." This is similar to the appointment of "inflation hawks" within the Federal Reserve System — people who took the issue of price stability seriously and were willing to take necessary, if unpopular, actions to achieve that goal. In short, "personalities matter in establishing credibility," write Stern and Feldman.

The payoff from establishing credibility could be large. A "virtuous circle" might arise in which banks would take on fewer risks, presenting policymakers with fewer opportunities to bail them out. Outside of random shocks, the system converges to a situation where bailouts are no longer expected.

Stern and Feldman have written a book that is informed by the best basic research available but which should also be easily digestible by policymakers and non-economists more generally. Indeed, people particularly rushed for time could profit from reading Chapters 1 and 14, which summarize the book's major points. But hopefully many will take the time to read the entire book — and to take seriously the proposals contained within. The subject may seem dry, but it is important. The problems associated with too big to fail policies are simply too large to ignore. **RF**

District Economic

BY ROBERT LACY

Our monthly surveys of District businesses indicate that manufacturing shipments and services firms' revenues were moderately higher during the second quarter. Payroll employment generally expanded as well, with growth particularly strong in Virginia. Retail trade remained a soft spot, however, and higher prices for gasoline, steel, and some building materials continued to boost raw materials costs for manufacturers and builders.

Did You Know. . .

Georgia may be the Peach State but neighboring South Carolina often produces more peaches. Growers in South Carolina expect to harvest 140 million pounds of peaches this year, about 30 million pounds above the harvest expected in Georgia. The two states vie for second-place honors in the nation each year; most peaches consumed in the United States are grown in California.

Fifth District economic activity expanded at a solid pace in the second quarter of 2004, as services sector output picked up and employment gains mounted. Manufacturing shipments and new orders continued to rise, and housing activity remained strong despite an increase in mortgage interest rates. And while prices for some raw materials used in manufacturing and construction moved higher, overall price inflation in the District was contained.

Manufacturing Expansion on Track

Growth in manufacturing activity slipped a notch in the second quarter but remained generally strong. Industry contacts said that shipments and new orders rose at a solid pace and told us they expected growth to continue for the remainder of the year. In the words of a plastics manufacturer in North Carolina, "We are clearly seeing signs of an expanding economy: longer lead time on raw materials; raw material price increases; and decent, though not great, new order activity."

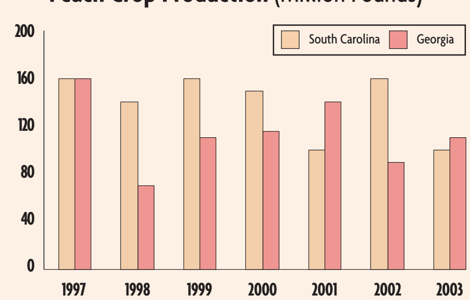
Higher steel, oil, and building materials prices caused a spike in raw materials prices in April. According to our monthly manufacturing survey, total raw materials prices increased at the strongest pace in several years. By June, however, price increases had eased back to about 2 percent.

Housing Buoyant

District housing markets remained upbeat despite somewhat higher mortgage interest rates in the second quarter. According to the Federal Home Loan Mortgage Corporation, average interest rates on 30-year fixed-rate conventional mortgages rose from 5.5 percent in March to 6.25 percent in June. With the exception of Maryland, the number of building permits issued in District states trended higher during the period.

Real estate agents in particularly hot markets such as in Northern Virginia told us that sales activity was so frenzied that some home buyers were waiving inspections and appraisals and offering to pay sellers' closing costs. On the construction side, home builders reported shortages of wallboard, plywood, and insulation in some areas.

Peach Crop Production (Million Pounds)



Better Job Growth

Growth in payroll employment in the District picked up in the second quarter of 2004. While the pace slowed in May, when only 18,000 jobs were added, it surged again in June with the addition of 40,000 District jobs.

The services sector continued to lead the way in job growth. Professional, business, health, education, and financial services jobs were substantially higher in most District states.

The District's unemployment rate was 4.8 percent in the second quarter of 2004, down from 5.5 percent a year earlier. Both Maryland and Virginia had unemployment rates below 4.0 percent in June.

Gray Skies

It was a rainy summer in much of the region. Washington, D.C., Richmond and Norfolk, Va., and Charlotte, N.C., received over 16 inches of rain between June 1 and mid-August, about three times the normal rainfall.

While South Carolina received less than most areas farther north, the state received enough rain to end the drought that prevailed through the spring. The agricultural sector in South Carolina received a boost from improved soil conditions and, as of August, crops were developing at or ahead of schedule. But excessive rain damaged crops in other areas of the District. On the Eastern Shore of Virginia soybean fields were waterlogged, and corn stalks were in danger of falling into the mud.

Developments

Nonfarm Employment
Second Quarter 2004

	Employment (Thousands)	% Change (Year Ago)
DC	670	0.8
MD	2,519	1.5
NC	3,841	1.2
SC	1,836	1.5
VA	3,582	2.6
WV	727	-0.1
5th District	13,175	1.6
US	131,119	1.0

Unemployment Rate
(Percent)

	2nd Qtr. 2004	2nd Qtr. 2003
DC	7.3	7.1
MD	3.9	4.5
NC	5.4	6.5
SC	6.5	6.8
VA	3.5	4.1
WV	5.3	6.3
5th District	4.8	5.5
US	5.6	6.1

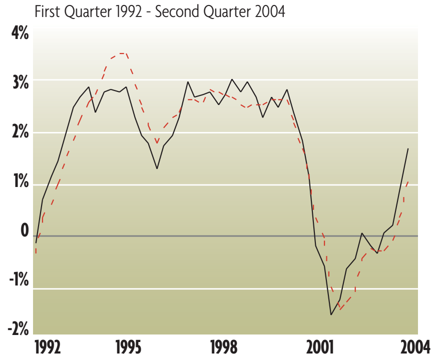
Personal Income
First Quarter 2004

	Income ($ billions)	% Change (Year Ago)
DC	28.2	5.1
MD	213.5	5.8
NC	247.5	5.8
SC	112.2	4.8
VA	260.7	6.7
WV	45.4	4.1
5th District	907.6	5.8
US	9,510.1	5.2

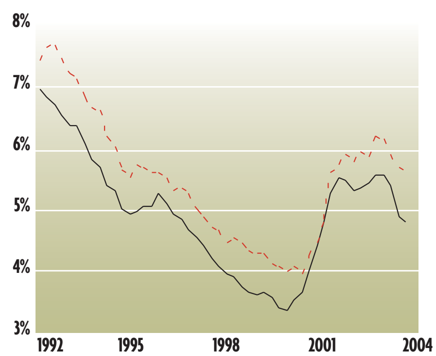
Fifth District — United States

Nonfarm Employment
Change From Prior Year

First Quarter 1992 - Second Quarter 2004

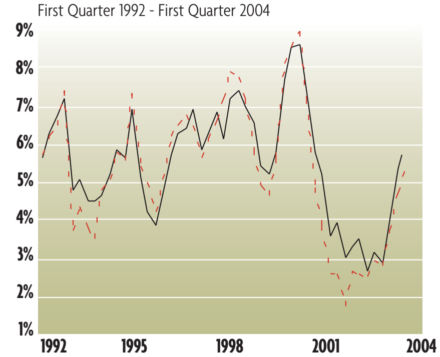


Unemployment Rate
First Quarter 1992 - Second Quarter 2004

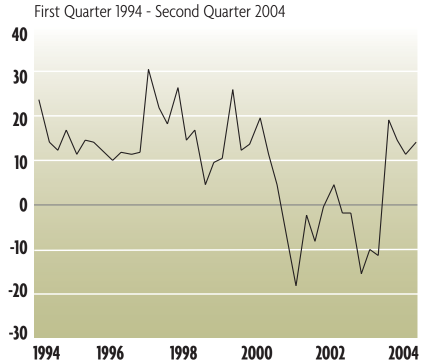


Personal Income
Change From Prior Year

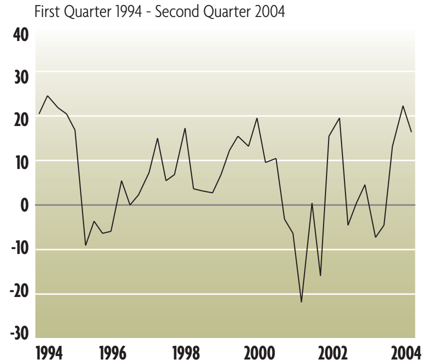
First Quarter 1992 - First Quarter 2004



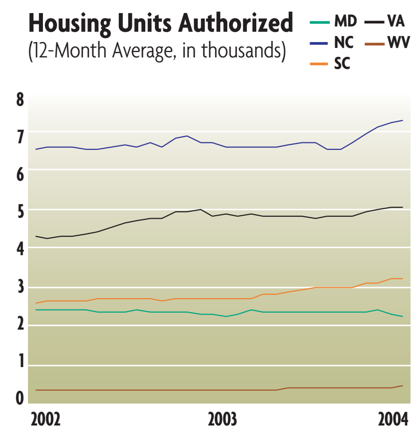
FRB—Richmond Services Revenues Index
First Quarter 1994 - Second Quarter 2004



FRB—Richmond Manufacturing Shipments Index
First Quarter 1994 - Second Quarter 2004



Housing Units Authorized
(12-Month Average, in thousands)



NOTES:
1) All data series are seasonally adjusted.
2) FRB-Richmond survey indexes are diffusion indexes. Positive numbers represent expansion, negative numbers contraction.
3) State nonfarm employment estimates are based on surveys of establishments. These employment figures differ from those used to calculate state unemployment rates.

SOURCES:
Income: Bureau of Economic Analysis, U.S. Department of Commerce, http://www.bea.doc.gov
Unemployment rate: LAUS Program, Bureau of Labor Statistics, U.S. Department of Labor, http://stats.bls.gov
Employment: CES Survey, Bureau of Labor Statistics, U.S. Department of Labor, http://stats.bls.gov

For more information, contact Robert Lacy at 804-697-8703 or e-mail Robert.Lacy@rich.frb.org.

DISTRICT OF COLUMBIA

BY ANDREA HOLLAND

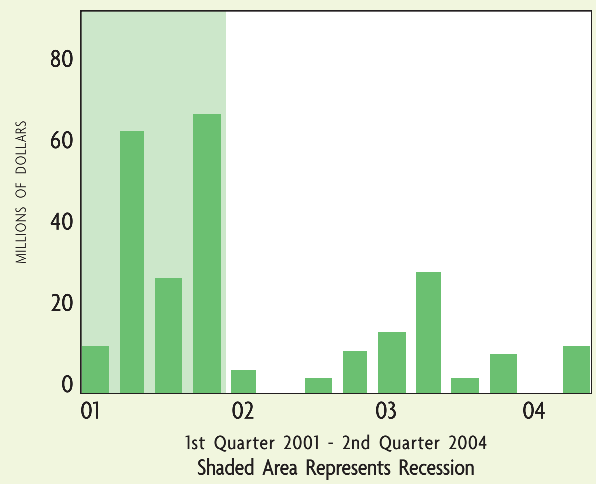
Venture capital is an alternative source of funding for fledgling companies that are oftentimes perceived as more risky and lack the capital to develop their own product. Investment of this type is important because, if successful, it could boost the number of cutting-edge companies, which in turn, stimulates employment and wage growth in the higher-paying knowledge sector. Furthermore, a recent joint study by DRI-WEFA and Venture Economics suggested that venture-backed companies may be more immune to economic downturns than are traditionally funded businesses.

Supporting this theory, 2000 revenues from venture-backed businesses in the District of Columbia contributed 2.4 percent toward gross state product, and the number of workers equaled 10,850, or 1.7 percent of the total work force. Three years later, revenues at these firms were up 33 percent (the fastest growth rate districtwide), and job numbers had expanded 16.5 percent in spite of the 2001 recession. In contrast, aggregate employment in the District of Columbia rose only 2.2 percent during the same time period.

In light of the above findings, recent investment activity has been discouraging. District of Columbia businesses have struggled to attract capital this year, and had raised only $12 million at the end of the second quarter. By comparison, inflows had reached $44.5 million by midyear 2003.

With only two investment deals recorded in the second quarter, the District of Columbia ranked 26th nationally by deal volume. The lion's share of the funding, $11.5 million, was awarded to a telecommunications firm, and the remaining $0.5 million was granted to a software firm. By stage of financing, 96 percent of the capital was expansion funding for an already up-and-running business, and the remaining 4 percent was listed as seed funding, which provides new firms with the backing necessary for their initial development. Geographically, the second-quarter funding originated in California, the District of Columbia, Illinois, and Maryland.

Venture Capital Investment



NOTE: No bar represents a zero or close to zero value.
SOURCE: PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association MoneyTree™ Survey

		Percent Change at Annual Rate From	
	2nd Qtr 2004	1st Qtr 2004	2nd Qtr 2003
Nonfarm Employment	670.4	0.3	0.8
Manufacturing	2.5	5.5	-3.8
Professional/Business Services	144.5	1.9	3.0
Government	230.8	0.8	-0.5
Civilian Labor Force	300.7	-4.9	-0.8

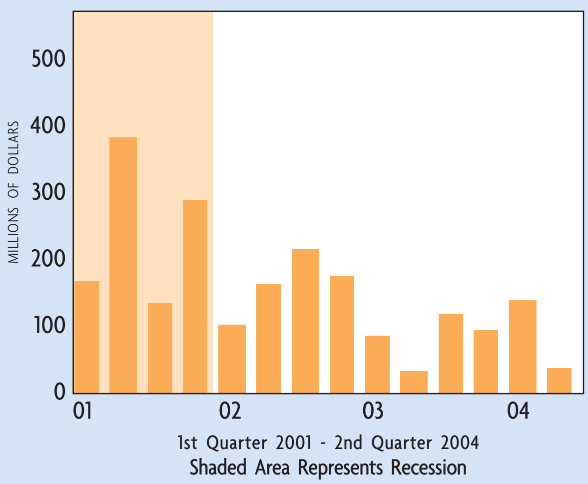
	2nd Qtr 2004	1st Qtr 2004	2nd Qtr 2003
Unemployment Rate	7.3	6.5	7.1
Building Permits, NSA	760	153	539
Home Sales	17.9	16.5	14.9

NOTES:
Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
Manufacturing, thousands of jobs, not seasonally adjusted (NSA); BLS/Haver Analytics
Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics
Government, thousands of jobs, SA; BLS/Haver Analytics
Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics
Unemployment Rate, percent, SA; BLS/Haver Analytics
Building Permits, number of permits, NSA; U.S. Census Bureau/Haver Analytics
Home Sales, thousands of units, SA; National Association of Realtors®

MARYLAND

BY ANDREA HOLLAND

Venture Capital Investment



SOURCE: PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association MoneyTree™ Survey

		Percent Change at Annual Rate From	
	2nd Qtr 2004	**1st Qtr 2004**	**2nd Qtr 2003**
Nonfarm Employment	2,518.8	4.4	1.5
Manufacturing	145.4	1.8	-2.2
Professional/Business Services	372.1	12.3	2.8
Government	461.5	1.0	-0.4
Civilian Labor Force	2,948.2	1.0	1.5

	2nd Qtr 2004	**1st Qtr 2004**	**2nd Qtr 2003**
Unemployment Rate	3.9	4.1	4.5
Building Permits, NSA	7,636	5,875	8,849
Home Sales	146.0	141.5	124.0

NOTES:
Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
Manufacturing, thousands of jobs, SA; BLS/Haver Analytics
Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics
Government, thousands of jobs, SA; BLS/Haver Analytics
Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics
Unemployment Rate, percent, SA; BLS/Haver Analytics
Building Permits, number of permits, not seasonally adjusted (NSA); U.S. Census Bureau/Haver Analytics
Home Sales, thousands of units, SA; National Association of Realtors®

Investment by venture capitalists is a means of turning a concept into a product for entrepreneurs without the needed startup capital. Venture funding accounts for a modest share of Maryland's financial market; its major importance lies in the nurturing of future businesses, which if viable, could translate into better employment opportunities. In addition, a recent study by DRI-WEFA and Venture Economics suggested that the presence of venture-backed firms could have a stabilizing effect on a state's economy because employment at venture-backed businesses appeared to be less susceptible to recessionary periods.

To illustrate this point, employment at venture-backed firms grew from 95,000 to 104,300 from 2000 to 2003 — an increase of nearly 10 percent. By comparison, total payroll growth in Maryland measured only 1.3 percent. Revenues also forged ahead; venture-backed firms recorded a 21.8 percent rise during the same time frame.

Realizing more fully the long-term benefits of venture capital investment, the most recent readings have been particularly heartening. According to data from the MoneyTree survey of venture capital spending, midyear capital inflows to Maryland firms in 2004 outpaced activity recorded in the first two quarters of last year.

Second-quarter disbursements into Maryland businesses totaled $39.8 million, and with 20 deals on the books, the state ranked 8th nationally by deal volume. Within the state, Montgomery, Anne Arundel, and Baltimore City attracted the most capital. Montgomery County alone recorded eight deals, ranking 20th nationwide. By business type, software firms garnered the majority of the funding, with nine deals totaling $25.8 million. Close behind was the biotechnology industry, which captured five deals in the amount of $10.5 million.

By stage of investment, 60 percent of the businesses that received capital were classified as seed, startup, or early stage — firms which have not yet fully established operations. This is encouraging, as an increase in new deals could suggest increased investor confidence. The remaining 40 percent of the businesses were in the expansion and later stages — additional funding which is usually used to solidify a firm's current standing.

NORTH CAROLINA

BY ANDREA HOLLAND

A private donation made to a promising business with many prospects but no capital is known as a venture capital investment. The aggregate level of investment injected into a state is critical, but just as important are the possible downstream effects on the economy such as the creation of higher-paying jobs. According to a recent study by DRI-WEFA and Venture Economics, a solid knowledge-skilled employment base in historically goods-producing states such as North Carolina could help soften payroll losses during periods such as the 2001 recession.

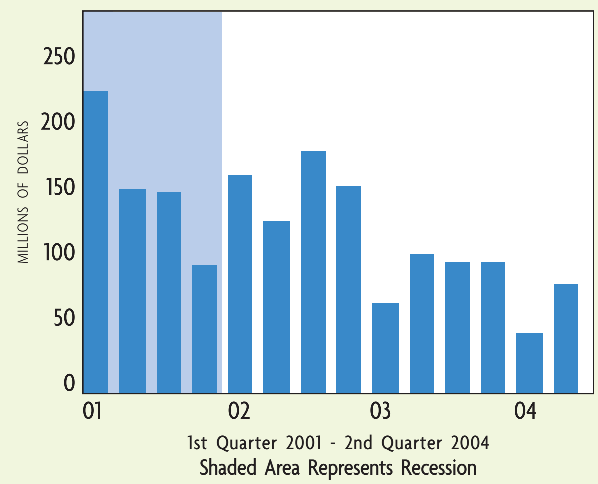
To highlight this point, venture-backed businesses in North Carolina employed 165,500 persons in 2000, or 4.2 percent of the total work force. Over the next three years, job numbers at these firms expanded 2.7 percent despite the 2001 recession. In contrast, aggregate employment in North Carolina contracted 3.3 percent during the same time period, marking the greatest loss districtwide.

Armed with this knowledge, the most recent reports from North Carolina's venture market have been somewhat uninspiring. Firms have had to look hard and long to secure available capital this year despite a recovering economy. Compared to total capital captured by midyear 2003, investors have injected substantially less into North Carolina businesses during the first two quarters of 2004.

Second-quarter capital inflows into North Carolina totaled $81.8 million. By volume, deals totaled 11 in the second quarter, placing North Carolina 18th nationwide. The counties pulling in the largest number of deals were Durham (ranked 24th nationally), Wake, and Guilford. The health-care services industry courted the most cash, with one deal totaling $55 million. Telecommunications firms came in second, with three deals garnering $9.5 million.

By stage of funding, second-quarter investment into seed companies — businesses that have no viable product and are still working on concept development — was zero in North Carolina, suggesting that potential investors remain hesitant. The majority of the funding, 84 percent, instead went to firms in the expansion and later stages.

Venture Capital Investment



SOURCE: PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association MoneyTree™ Survey

		Percent Change at Annual Rate From	
	2nd Qtr 2004	1st Qtr 2004	2nd Qtr 2003
Nonfarm Employment	3,841.0	3.6	1.2
Manufacturing	583.4	-2.5	-4.5
Professional/Business Services	441.2	17.4	5.2
Government	654.8	3.4	2.4
Civilian Labor Force	4,199.9	0.2	-0.6

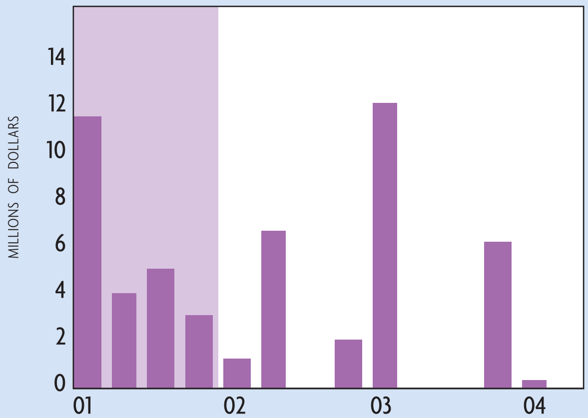
	2nd Qtr 2004	1st Qtr 2004	2nd Qtr 2003
Unemployment Rate	5.4	5.7	6.5
Building Permits, NSA	24,664	22,329	20,776
Home Sales	337.4	281.7	270.3

NOTES:
Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
Manufacturing, thousands of jobs, SA; BLS/Haver Analytics
Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics
Government, thousands of jobs, SA; BLS/Haver Analytics
Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics
Unemployment Rate, percent, SA; BLS/Haver Analytics
Building Permits, number of permits, not seasonally adjusted (NSA); U.S. Census Bureau/Haver Analytics
Home Sales, thousands of units, SA; National Association of Realtors®

SOUTH CAROLINA

BY ANDREA HOLLAND

Venture Capital Investment



1st Quarter 2001 - 2nd Quarter 2004
Shaded Area Represents Recession

NOTE: No bar represents a zero or close to zero value.
SOURCE: PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association MoneyTree™ Survey

		Percent Change at Annual Rate From	
	2nd Qtr 2004	1st Qtr 2004	2nd Qtr 2003
Nonfarm Employment	1,836.0	2.7	1.5
Manufacturing, NSA	271.2	1.6	-2.6
Professional/Business Services, NSA	191.9	18.0	2.2
Government	330.4	-0.7	1.0
Civilian Labor Force	2,055.3	2.5	2.8

	2nd Qtr 2004	1st Qtr 2004	2nd Qtr 2003
Unemployment Rate	6.5	6.4	6.8
Building Permits, NSA	11,249	9,474	9,471
Home Sales	165.5	152.1	134.0

NOTES:
Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
Manufacturing, thousands of jobs, not seasonally adjusted (NSA); BLS/Haver Analytics
Professional/Business Services, thousands of jobs, NSA; BLS/Haver Analytics
Government, thousands of jobs, SA; BLS/Haver Analytics
Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics
Unemployment Rate, percent, SA; BLS/Haver Analytics
Building Permits, number of permits, NSA; U.S. Census Bureau/Haver Analytics
Home Sales, thousands of units, SA; National Association of Realtors®

In return for investing in higher-risk, private companies that lack the capital to develop and market their own product, venture capitalists typically expect greater-than-average returns in the future. Investors, however, aren't the only ones who could potentially win. The existence of a strong venture capital industry could result in significant benefits for the economy, particularly in light of South Carolina's historically strong ties to the goods-producing sector.

According to a recent, joint study released by DRI-WEFA and Venture Economics, successful venture-backed companies generally expand faster and create more jobs than businesses in other sectors. If this holds true, the maturation of venture-backed companies in South Carolina could help promote a higher-paid and higher-skilled work force.

In addition to accelerating job growth, the DRI-WEFA and Venture Economics report also suggested that the existence of venture-backed firms could result in fewer payroll losses during future recessionary periods as knowledge-based jobs were more recession proof than labor-intensive jobs. Employment data from South Carolina seem to back up these findings — venture-backed companies do appear hardier. Notwithstanding the 2001 recession, venture-backed employment in South Carolina contracted only 0.7 percent (the only decline districtwide) from 2000 to 2003. In contrast, aggregate employment in South Carolina fell 2.6 percent during the same time period.

In light of the above findings, the most recent reports rolling in from South Carolina's venture capital market were disappointing: The state continues to trail behind all other Fifth District jurisdictions when it comes to attracting capital. Further, inflows into South Carolina businesses have grown increasingly sporadic since the end of the 2001 recession. For example, investment deals were recorded in only three quarters out of the year in 2002. By 2003, that number had dropped to two quarters. The most recent data from 2004 have been no more encouraging: State businesses received zero funding in the second quarter, down from a modest $0.3 million deal recorded in the first quarter of this year.

VIRGINIA

BY ANDREA HOLLAND

Venture capital investment is the private funding of early stage, high-risk businesses that are lacking their own capital. In addition to playing a vital role in the nurturing of new companies, the venture capital industry also promotes innovation, economic growth, and better employment opportunities. Also, a recent study DRI-WEFA and Venture Economics suggests that employment at venture-backed companies appears to be less susceptible to fluctuations in the business cycle, and as such, the existence of venture-backed firms in a state economy could have a stabilizing effect during recessionary periods.

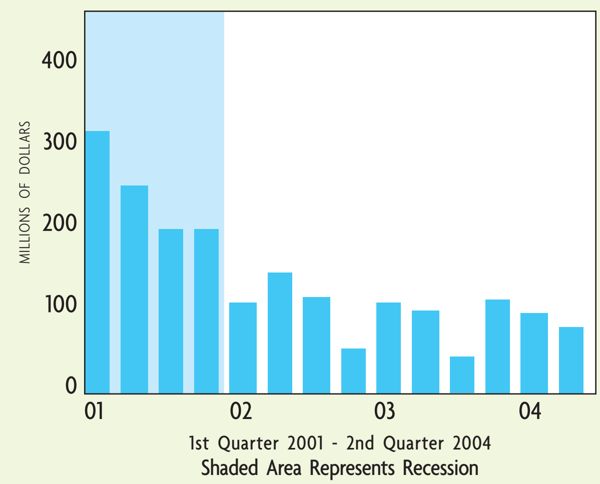
To illustrate this point, employment at venture-backed firms in Virginia grew from 310,200 to 333,200 from 2000 to 2003 — an increase of nearly 7.4 percent, even with the backdrop of a recession. By comparison, total payrolls in Virginia contracted 0.5 percent over the same time period.

Realizing more fully the long-term benefits of venture capital investment, recent reports on activity have been auspicious. Virginia has maintained a vibrant venture capital report in recent years, despite the fact that disbursements in the first and second quarters of 2004 came in a bit under those recorded during the same time frame last year.

Second-quarter capital inflows into Virginia businesses totaled $80.1 million, and deal volume numbered 19, consigning the state to 9th place nationwide. Within Virginia, localities receiving the most money were Fairfax (ranked 19th nationally), Alexandria, and Arlington. By business sector, the software industry attracted the most deals and venture funds totaled $26.4 million. Telecommunications businesses were the second most appealing to investors, capturing three deals and $2.6 million in the second quarter.

By stage of investment, 58 percent of the businesses receiving capital were classified as seed, startup, or early stage — firms that have not yet fully established operations. The preference to support fledging firms is encouraging, as an increase in deals on riskier projects could suggest a rise in investor confidence. The remaining 43 percent of the businesses were either expansion or later stage; in these cases funding is typically used to further develop the operations of an up-and-running enterprise.

Venture Capital Investment



SOURCE: PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association MoneyTree™ Survey

		Percent Change at Annual Rate From	
	2nd Qtr 2004	1st Qtr 2004	2nd Qtr 2003
Nonfarm Employment	3,582.1	2.9	2.6
Manufacturing	297.3	2.2	-3.3
Professional/Business Services	574.5	4.6	5.4
Government	647.7	2.3	1.7
Civilian Labor Force	3,844.3	1.1	2.0

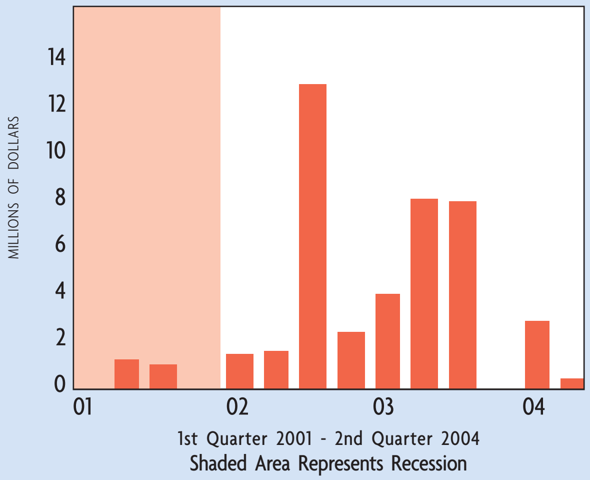
	2nd Qtr 2004	1st Qtr 2004	2nd Qtr 2003
Unemployment Rate	3.5	3.5	4.1
Building Permits, NSA	17,237	14,931	15,801
Home Sales	200.4	174.8	171.0

NOTES:
Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
Manufacturing, thousands of jobs, SA; BLS/Haver Analytics
Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics
Government, thousands of jobs, SA; BLS/Haver Analytics
Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics
Unemployment Rate, percent, SA; BLS/Haver Analytics
Building Permits, number of permits, NSA; U.S. Census Bureau/Haver Analytics
Home Sales, thousands of units, SA; National Association of Realtors®

WEST VIRGINIA

BY ANDREA HOLLAND

Venture Capital Investment



NOTE: No bar represents a zero or close to zero value.
SOURCE: PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association MoneyTree™ Survey

	2nd Qtr 2004	Percent Change at Annual Rate From 1st Qtr 2004	2nd Qtr 2003
Nonfarm Employment	727.1	2.4	-0.1
Manufacturing	69.4	-2.9	-1.4
Professional/Business Services	56.9	0.7	1.4
Government	141.0	-3.2	-1.6
Civilian Labor Force	796.9	0.1	0.9

	2nd Qtr 2004	1st Qtr 2004	2nd Qtr 2003
Unemployment Rate	5.3	5.4	6.3
Building Permits, NSA	1,544	1,255	1,315
Home Sales	31.6	31.8	25.8

NOTES:
Nonfarm Employment, thousands of jobs, seasonally adjusted (SA); Bureau of Labor Statistics (BLS)/Haver Analytics
Manufacturing, thousands of jobs, SA; BLS/Haver Analytics
Professional/Business Services, thousands of jobs, SA; BLS/Haver Analytics
Government, thousands of jobs, SA; BLS/Haver Analytics
Civilian Labor Force, thousands of persons, SA; BLS/Haver Analytics
Unemployment Rate, percent, SA; BLS/Haver Analytics
Building Permits, number of permits, not seasonally adjusted (NSA); U.S. Census Bureau/Haver Analytics
Home Sales, thousands of units, SA; National Association of Realtors®

Venture capital is funding supplied by private investors to high-risk businesses that are unable to obtain financing through more conventional methods. The existence of a strong venture capital industry could result in significant benefits for a state economy, particularly those with historically strong ties to the goods-producing sector, such as West Virginia. According to a report released by DRI-WEFA and Venture Economics, successful venture-backed companies generally expand faster and create more jobs than traditionally funded businesses. If this holds true, the maturation of venture-backed companies could help foster a higher-paid, higher-skilled work force in West Virginia.

The DRI-WEFA and Venture Economics study also suggested that the presence of venture-backed firms could result in shallower employment losses in future business cycle downturns. Data show that knowledge-based jobs at venture-backed firms are more recession proof than West Virginia's more traditional labor-intensive jobs. Illustrating this, venture-backed employment in West Virginia grew 18.4 percent (the fastest growth rate districtwide) from 2000 to 2003, despite the 2001 recession. In contrast, aggregate employment in West Virginia contracted 1.4 percent during the same time period.

In light of these findings, recent reports on capital inflows have been generally upbeat. Though not traditionally thought of as a repository for venture capital, investments into West Virginia's capital market have, with the exception of the last three quarters, steadily risen since the end of the 2001 recession. In line with higher inflows, revenues from venture-backed companies grew 27.9 percent from 2000 to 2003, marking the third fastest growth rate districtwide.

West Virginia businesses raised $0.5 million from April through June 2004. The second-quarter deal apportioned expansion funding into a software business in Berkeley County — expansion and later stage funding is usually used to solidify the current standing of an already operating business. With only one deal in the second quarter, West Virginia ranked 33rd in terms of deal volume nationwide.

For more information regarding state summaries, call 804-697-8273 or
e-mail Andrea.Holland@rich.frb.org.

The Paradox of Voting

BY AARON STEELMAN

This fall, more than 100 million Americans will vote in the presidential election. To many observers, this number is appallingly low. The fact that only 50 percent or so of eligible voters will show up at the polls is surely bad for democracy, they argue. But to many economists, the number is surprisingly high. In fact, given the rational-choice models that most economists employ, it's hard to understand why any individual voter would cast a ballot.

According to the rational-choice perspective, a potential voter should make the following calculation. Multiply the benefits (B) he would receive if his preferred candidate were to win the election by the probability (P) that he would cast the deciding vote. If that figure exceeds the costs (C) he incurs — the time it takes to register to vote and go to the polling place, as well as the effort required to become well enough acquainted with the candidates' positions to cast an informed vote — then voting is rational. The voter gets more out of the act than he puts in.

The problem is, C is almost always larger than B x P. "The standard conclusion that is reached from the application of such a model is that in an election with a large number of voters the rational citizen decides not to vote," writes André Blais of the University of Montreal in his book *To Vote or Not to Vote? The Merits and Limits of Rational Choice Theory*. "The cost of voting is small, but the expected benefit is bound to be smaller for just about everyone because of the tiny probability of casting a decisive vote."

> ***"Given the rational-choice models that most economists employ, it's hard to understand why anyone would cast a ballot."***

Does this mean that rational-choice models of electoral participation should be abandoned entirely? And, if so, what should we use instead?

It seems clear that rational-choice theory doesn't fully explain why people vote. But that doesn't mean that it is without merit. Rational-choice models predict that people will vote in higher numbers when the stakes are high and/or the election is close. Both, in fact, are true. Turnout increases when voters' B and P values increase.

Still, even when the election is both important and close, the chance of any single voter actually influencing the outcome remains tiny. Consider the 2000 presidential election. This was probably the tightest election that most people will ever witness — yet no single vote came close to proving pivotal.

So to fully understand why people vote requires us to move beyond economics and into the realm of social psychology. Most people have a natural desire to be part of a group. They want to know that others share their basic views and sentiments. Voting allows them to do this.

At the very minimum, by casting your vote for a major-party candidate, you will know that millions of others made the same choice as you. And for many people the experience of voting will involve much more. Prior to going to the polls, they may attend rallies for their preferred candidate or enter into discussions with other likely voters. They will get some benefit from this interaction, and may even gain some friends. Voting, then, can be seen as a social act.

This process may be even more important for people who vote for minor-party candidates. Such candidates often hold views well outside the mainstream of American politics. The people who support those candidates, then, probably have fewer chances each day to interact with like-minded people. A presidential election allows them to meet people with similar views — and to know that they are not alone.

Voting might also be seen as a cheap insurance policy. Although the chances that your vote might actually tip the balance of an election are virtually zero, the regret you would feel if the race ended in a tie might be very great. You could insure yourself against this unlikely — though quite expensive — possibility simply by going to the polls.

What does this all mean? Well, one could come away with a number of lessons. My take is: Go ahead and vote if doing so will bring you satisfaction. But don't let some busybody tell you that voting is your moral duty.

Most of us agree that people have an obligation to help others. But it's hard to understand how any action that neither benefits nor harms other people could be construed as immoral. And make no mistake about it, your vote almost certainly will not affect the well-being of others. It will add only one more number to an already enormous tally. If you want to do something constructive, consider spending the hour you would take voting to do volunteer work or visit friends and family. The payoff almost certainly will be higher. **RF**

Next Issue

The Evolving Banking Industry

In the late 1990s, during the middle of the tech boom, many predicted that conventional banking practices were on the decline. People would conduct more and more transactions online, and rarely if ever set foot in actual brick-and-mortar banks. That prediction was partially correct. Online banking has grown over the last five years — but it has not revolutionized the industry. In fact, banks are opening branches at a brisk pace and enhancing their physical presence throughout their market areas. What's happening in the retail banking industry — and why?

Equine Economics

Kentucky may be the "horse capital of the world," but the horse industry has left hoof prints throughout the Fifth District as well. Maryland and Virginia are home to important races, breeding farms, and equestrian centers. And the Carolinas and West Virginia boast significant horse populations of their own. We'll take a look inside this unique industry.

Port Development

Competition is intense among ports along the Eastern seaboard, with each vying for additional cargo volume. Some ports, such as Charleston, S.C., argue that physical expansion is necessary to accommodate ever-larger ships. But many of these waterfront areas are also popular spots for residential and commercial development. How can cities most effectively reconcile the interests of these important, yet quite different, sectors?

ACC Expansion

The Atlantic Coast Conference used to have seven member schools and was based entirely within the Fifth District. But over time the conference has expanded and is welcoming two new members, Miami and Virginia Tech, this year and yet another, Boston College, in 2005. The current round of expansion will bring the total number of members to 12. The ACC is not alone. Other conferences have expanded recently as well, picking off the most attractive schools from rival conferences. What are the economic forces behind the consolidation of college athletic conferences?

Interview

A conversation with economist Frank Sloan, director of Duke University's Center for Health Policy, Law, and Management.

Research Spotlight

Is good journalism also good business? An analysis of America's newspaper industry.

Federal Reserve

Many within the Federal Reserve System and the economics profession more generally have argued that the Fed should adopt an "inflation targeting" system. How would such a system work — and what are the possible benefits as well as downsides?

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The Winter 2005 Issue will be published in January.

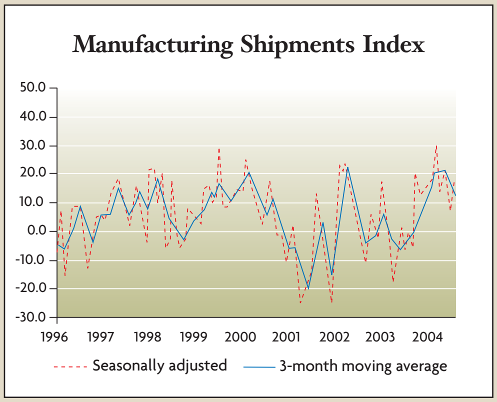
Trends & Outlooks

Highlighting Business Activity in the Fifth District

For over a decade, the Richmond Fed has conducted monthly surveys of manufacturing, retail and services firms in the Fifth District on their current levels of business and outlook for near-term future activity. Over that period, respondents' assessments have proven to be an accurate gauge of economic conditions in the Mid-Atlantic region.

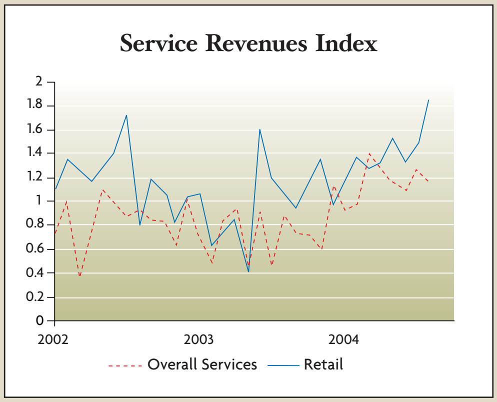
Manufacturing Surveys

The Manufacturing Survey receives responses from approximately 100 businesses whose type, size and location match the profile of overall manufacturing in the District. Respondents provide information on current activity, including shipments, new orders, order backlogs, and inventories. Manufacturers also supply information on employment conditions, prices, and their expectations of business activity for the next six months.



Service-Sector Surveys

Representative retailers and services firms are also polled each month with about 100 responses. Retailers provide information on sales revenues, big-ticket sales, inventories, and shopper traffic. Contacts at services firms report on their revenues. Both sets of respondents also provide information on employment and wages at their firms as well as information on prices and their anticipated demand for the coming six months.



In both surveys, respondents indicate whether measures of activity rose, remained unchanged or decreased. Their responses are converted into diffusion indexes by subtracting the percentage of reported decreases from the percentage of increases.

Interested in an update on District Manufacturing and Service-Sector conditions?

Check out the Regional Economic Surveys by the Richmond Fed today!

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